FORSYTH BARR

Z Energy

OUTPERFORM
Conviction List stock

Deciphering the Message

Z Energy's (ZEL) investor day may have underwhelmed the market on the day, but in reality little has changed and the investment thesis remains intact. Material presented at the investor day suggests a lower the anticipated dividend trajectory, but closer analysis reveals that shareholders can still expect dividends of ~55cps in FY19 rising above 60cps in later years. We are retaining our OUTPERFORM rating.

What's changed?

- **Earnings:** FY18 EBITDAF reduced -$5m to $461m, dividend down -3.8cps to 32.2cps. FY19 EBITDAF lowered -$7m to $488m, dividend -2.5cps lower to 55.0cps
- **Target Price:** Lowered -25cps to $8.45
- **Rating:** OUTPERFORM rating retained

Capital management policy as expected, kind-of

ZEL's new capital management policy is to return between 80% and 100% of free cash flow (after deducting debt principal repayments). Its intention is to reduce debt levels to 1.5x net debt/EBITDAF by the end of FY21. Indicative FY19 dividends provided by ZEL appear to have spooked that market as they suggest the FY19 dividend could be as low as 35cps, but only as high as 58cps (+0.5cps higher than our old FY19 forecast). However, closer analysis reveals that ZEL's indicative dividends would have to assume either a significant drop in earnings (and there is no indication of that occurring), or net debt levels will fall very quickly. Whilst we have trimmed our FY19 dividend forecast -2.5cps to 55.0cps, we still assume that ZEL's debt targets will be achieved a year early. The fall in the FY18 dividend forecast reflects ZEL retaining its current dividend policy (growth of +10% per annum) slightly longer than expected.

Strategy 3.0 solid, but a little lower than expected

ZEL has indicated it will add between +$30m and +$35m to EBITDAF by the end of FY20. The additional growth is a combination of further Caltex/Z merger benefits and other factors (the uplift in jet margins as jet prices move to import parity pricing being the primary driver). Whilst the expected earnings uplift is -$5m to -$10m lower than anticipated, it is still a solid increase.

Moderate negative forecast changes, but investment thesis remains intact

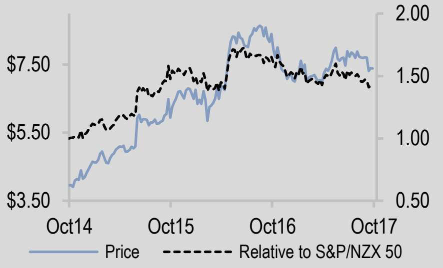
We have trimmed our EBITDAF forecasts -$5m, -$7m and -$11m in FY18, FY19 and FY20 respectively. The lower forecasts reflect the impact of the pipeline outage and the lower than expected Strategy 3.0 uplift. However, offsetting the lower earnings outlook is a lower capex outlook, with ZEL guiding to maintenance capex ~-$10m lower than our old forecast. The net effect of the earnings and dividend forecast changes is to lower our target price -25cps to $8.45. Nevertheless, we believe the investment thesis remains intact and that ZEL's forecast dividend yield is one of the best in the market.

Investment View

Our rating is OUTPERFORM. After FY18 we expect ZEL's dividends to increase materially, providing investors with an attractive yield relative to other opportunities. In addition, we expect short-term earnings growth to continue.

NZX Code	ZEL
Share price	NZ$7.39
Target price	NZ$8.45
Risk rating	Medium
Issued shares	400.0m
Market cap	NZ$2,956m
Average daily turnover	645.6k (NZ$4,819k)

Share Price Performance



Financials: March	17A	18E	19E	20E
NPAT* (NZ$m)	195.4	235.7	254.3	269.4
EPS* (NZc)	48.9	58.9	63.6	67.4
EPS growth* (%)	1.8	20.6	7.9	6.0
DPS (NZc)	29.3	32.2	55.0	60.0
Imputation (%)	100	100	100	100

Valuation (x)	17A	18E	19E	20E
EV/EBITDA	8.4	8.3	7.7	7.4
EV/EBIT	10.5	10.2	9.4	8.9
PE	15.1	12.5	11.6	11.0
Price / NTA	n/a	22.3	12.0	9.4
Cash dividend yield (%)	4.0	4.4	7.4	8.1
Gross dividend yield (%)	5.5	6.1	10.3	11.3

*Historic and forecast numbers based on underlying profits

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Z Energy (ZEL) Priced as at 28 Sep 2017: NZ$7.39 March year end

Forsyth Barr valuation			
Valuation methodology		Blend of spot valuations	
12-month target price (NZ$)*	**8.45**	**Spot valuations (NZ$)**	
Expected share price return	14.3%	1. DCF	8.12
Net dividend yield	5.9%	2. Dividend Yield	8.04
Estimated 12-month return	20.2%	3. Market Multiple	8.10
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	3.50%	Total firm value	4,390
Equity beta	0.85	(Net debt)/cash	986
WACC	7.7%	Value of equity	3,343
Terminal growth	-2.0%	Shares (m)	400

Profit and Loss Account (NZ$m)	2016A	2017A	2018E	2019E	2020E
Sales revenue	2,521	3,871	4,348	4,727	4,790
Normalised EBITDA	**302**	**419**	**461**	**488**	**506**
Depreciation and amortisation	(41)	(89)	(95)	(96)	(94)
Normalised EBIT	**284**	**336**	**375**	**401**	**422**
Net interest	(32)	(56)	(51)	(51)	(51)
Associate income	23	6	9	8	10
Tax	(46)	(76)	(88)	(96)	(101)
Minority interests	-	-	-	-	-
Normalised NPAT	**192**	**195**	**236**	**254**	**269**
Abnormals/other	(43)	(19)	-	-	-
Reported NPAT	**149**	**176**	**236**	**254**	**269**
Normalised EPS (cps)	48.0	48.9	58.9	63.6	67.4
DPS (cps)	26.6	29.3	32.2	55.0	60.0

Growth Rates	2016A	2017A	2018E	2019E	2020E
Revenue (%)	-17.7	53.6	12.3	8.7	1.3
EBITDA (%)	22.8	38.7	10.0	5.9	3.7
EBIT (%)	33.3	18.3	11.5	6.9	5.3
Normalised NPAT (%)	58.7	1.8	20.6	7.9	6.0
Normalised EPS (%)	58.7	1.8	20.6	7.9	6.0
DPS (%)	9.9	10.2	10.0	70.6	9.1

Cash Flow (NZ$m)	2016A	2017A	2018E	2019E	2020E
EBITDA	**302**	**419**	**461**	**488**	**506**
Working capital change	(49)	(75)	(3)	(31)	(1)
Interest & tax paid	(55)	(98)	(136)	(145)	(154)
Other	2	(71)	-	-	-
Operating cash flow	**200**	**175**	**323**	**311**	**351**
Capital expenditure	(77)	(75)	(90)	(46)	(43)
(Acquisitions)/divestments	(73)	(737)	-	-	-
Other	13	4	7	10	11
Funding available/(required)	**63**	**(633)**	**239**	**275**	**319**
Dividends paid	(105)	(121)	(121)	(168)	(226)
Equity raised/(returned)	(2)	(3)	-	-	-
Increase/(decrease) in net debt	**44**	**757**	**(118)**	**(107)**	**(93)**

Balance Sheet (NZ$m)	2016A	2017A	2018E	2019E	2020E
Working capital	153	269	272	303	304
Fixed assets	674	900	904	881	856
Intangibles	44	693	684	657	631
Other assets	163	129	131	130	129
Total funds employed	**1,034**	**1,991**	**1,991**	**1,972**	**1,920**
Net debt/(cash)	354	1,033	915	808	714
Other non current liabilities	114	256	259	261	259
Shareholder's funds	566	702	817	903	947
Minority interests	-	-	-	-	-
Total funding sources	**1,034**	**1,991**	**1,991**	**1,972**	**1,920**

Valuation Ratios	2016A	2017A	2018E	2019E	2020E
EV/EBITDA (x)	10.4	8.4	8.3	7.7	7.4
EV/EBIT (x)	11.0	10.5	10.2	9.4	8.9
PE (x)	15.4	15.1	12.5	11.6	11.0
Price/NTA (x)	5.7	>100x	22.3	12.0	9.4
Free cash flow yield (%)	4.2	3.4	7.9	9.0	10.4
Net dividend yield (%)	3.6	4.0	4.4	7.4	8.1
Gross dividend yield (%)	5.0	5.5	6.1	10.3	11.3
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	55	60	55	87	89

Capital Structure	2016A	2017A	2018E	2019E	2020E
Interest cover EBIT (x)	8.9	6.0	7.3	7.9	8.2
Interest cover EBITDA (x)	9.4	7.5	9.0	9.6	9.9
Net debt/ND+E (%)	51.2	68.7	61.0	54.6	50.0
Net debt/EBITDA (x)	1.2	2.5	2.0	1.7	1.4

Key Ratios	2016A	2017A	2018E	2019E	2020E
Return on assets (%)	20.4	13.6	14.2	14.6	15.1
Return on equity (%)	33.9	27.8	28.9	28.1	28.5
Return on funds employed (%)	33.1	16.3	18.2	19.7	21.4
EBITDA margin (%)	12.0	10.8	10.6	10.3	10.6
EBIT margin (%)	11.3	8.7	8.6	8.5	8.8
Capex to sales (%)	3.1	1.9	2.1	1.0	0.9
Capex to depreciation (%)	208	129	151	76	71

Operating Performance	2016A	2017A	2018E	2019E	2020E
Product volumes (m litres)					
Petrol	824	802	1,184	1,216	1,226
Diesel - retail	288	283	430	474	467
Diesel - commercial	573	537	747	819	847
Diesel - biofuels	-	-	-	3	16
Other fuels	625	626	1,034	1,139	1,171
Supply - domestic	-	-	400	508	525
Sub-total	**2,310**	**2,248**	**3,795**	**4,158**	**4,253**
Supply - industry & export	-	-	400	508	525
Total Fuels	**2,310**	**2,248**	**4,195**	**4,666**	**4,778**
Retail service stations	210	213	204	204	204
Petrol/service station (m litres)	3.90	3.79	5.78	5.96	6.01
Diesel/service station (m litres)	1.36	1.34	2.10	2.32	2.29
Gross profit (NZDm)					
Fuels	448	491	669	704	732
Refining	31	48	58	65	60
Non-fuels	61	64	69	71	73
Gross profit	**540**	**603**	**796**	**841**	**865**
Fuels gross margin (cpl)	19.4	21.8	17.6	16.9	17.2
Fuels margin incl refining (cpl)	19.3	22.8	18.6	18.3	18.4
Fuels margin excl supply (cpl)	20.7	23.9	19.1	18.5	18.6
Non-fuels revenue/station (NZD 000)	286	303	326	341	356
Refining volume (m barrels)	11.7	12.4	18.3	19.7	19.3
Sales sourced from refinery (%)	80	88	77	75	72
ZEL refining margin (USD/barrel)	6.9	8.7	7.5	7.6	7.0

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Dividend Policy as Expected, But Indicative Figures Puzzling

As expected, ZEL's new dividend policy (commencing in FY19) is similar to that of the generator/retailers, but there is a twist. The new dividend policy is to pay between 80% and 100% of free cash flow (FCF). The twist comes in the FCF definition which includes the repayment of debt.

Figure 1. ZEL dividend policy

	Dividend policy	Free cash flow definition
Current (old) policy	Grow dividends +10% per annum	n/a
New policy (FY19 and beyond)	80% to 100% of underlying free cash flow	Net operating cash flow, less maintenance capex, less principal debt repayments, adjusted for short-term working capital fluctuations
Forsyth Barr expected policy	75% to 90% of underlying free cash flow	EBITDA, less interest, tax and maintenance capex — based on generator/retailer dividend policies

Source: ZEL, Forsyth Barr analysis

A key factor in determining likely dividend levels is ZEL's aim to reduce its net debt/EBITDAF ratio to ~1.5x by the end of FY21, from ~2.0x at the end of this financial year. Stripping out the debt repayment, we estimate that ZEL's policy is the equivalent of a 55% to 80% standard FCF payout ratio, so materially lower than the generator/retailers. In our view, even at the highest payout ratio, ZEL's debt will fall well below the target 1.5x net debt/EBITDAF ratio by the end of FY21.

Indicative dividends appear light, or earnings will be softer, or ZEL will repay more debt

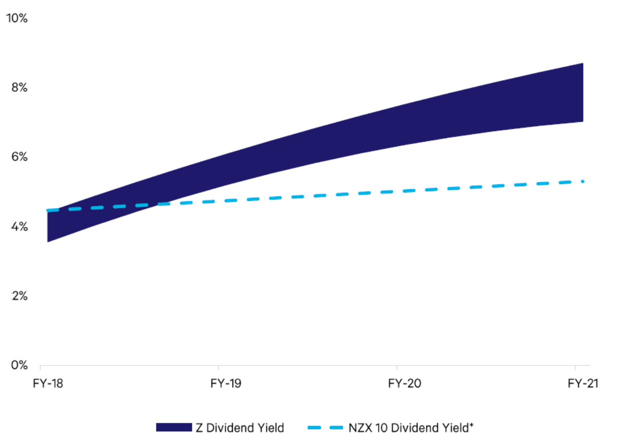
We have tried to unpick ZEL's underlying view on dividends and earnings going forward by looking at the potential FY19 dividend (and EBITDAF) using three separate pieces of analysis based on information presented by ZEL. Fundamentally, earnings, target debt levels and dividends are all interrelated. Our analysis suggests three alternative interpretations vs. the information ZEL has provided at face value. Either:

- Actual FY19 dividends will be higher than the indicative range presented on slide 48 of its investor presentation
- EBITDAF will be lower than guidance plus Strategy 3.0 growth (slide 18)
- Net debt levels will fall below that target net debt/EBITDAF ratio of 1.5x

Suggested dividend yields imply very low FY19 dividend

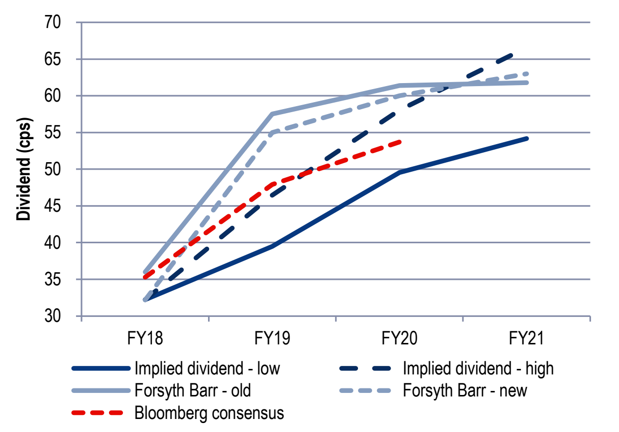
ZEL's chart showing estimated dividend yields implies an FY19 dividend of between 39cps and 46cps. However, other information ZEL has provided suggests the dividend should be higher.

Figure 2. ZEL estimated cash dividend yields



Source: ZEL, Forsyth Barr analysis
Note: Assumes constant share price of ~$7.75

Figure 3. Implied dividends



Source: Bloomberg, Forsyth Barr analysis

Dividend depends on target debt levels and EBITDAF earnings

One of the paradoxes of using a net debt/EBITDAF ratio for setting target debt levels and using that to guide the dividend, is that ***the dividend is leveraged to EBITDAF***. ***i.e. the lower EBITDAF is, the more debt needs to be repaid to hit the target ratio, therefore the lower the dividend***.

With ZEL including debt repayments as part of the free cash flow calculation, it is necessary to estimate the target debt level, and therefore the likely debt repayments. Assuming no growth in underlying EBITDAF we estimate that ZEL FY21 EBITDAF will be between $475m and $510m based on ZEL's guidance and expected Strategy 3.0 earnings uplift (we discuss the Strategy 3.0 uplift in more detail later).

Figure 4. ZEL EBITDAF guidance assuming no underlying profit growth

	Low $m	High $m	Comment
FY18 guidance	**445**	**475**	FY18 guidance remains unchanged
Strategy 3.0 (net of one-off opex)	14	18	Equates to FY18 & FY19 Strategy 3.0 growth ($19m to $23m less $5m FY19 one-off costs)
FY19 EBITDAF	**459**	**493**	
Strategy 3.0 (net of one-off opex)	14	15	Additional FY20 growth ($11m to $12m, add back FY19 one-off costs, less FY20 one-off costs)
FY20 EBITDAF	**473**	**508**	
Strategy 3.0 (net of one-off opex)	2	2	FY20 one-off costs that do not recur
Underlying FY21 EBITDAF	**475**	**510**	

Source: ZEL, Forsyth Barr analysis

Underlying FY21 EBITDAF sets the target FY21 net debt level. Based on the $475m to $510m range, we estimate target net debt will be between $713m and $765m. From a starting position of between $905m to $930m, that suggests annual repayments of between $47m and $73m.

Figure 5. Implied debt repayment levels

	Low debt	High debt	Comment
Target gearing	1.5	1.5	ZEL's target net debt/EBITDAF ratio by the end of FY21
FY21 EBITDAF ($m)	475	510	Underlying FY21 EBITDAF assuming no growth in underlying earnings
Implicit debt ($m)	713	765	
FY18 debt ($m)	930	905	Debt estimated at end of FY18 per ZEL indicative net debt/EBITDAF ratio
Annual debt repayment (3 years) ($m)	73	47	Annual debt to be repaid in FY19, FY20 & FY21

Source: Forsyth Barr analysis

Based on annual debt repayments of between $47m and $73m, we estimate an FY19 dividend of between 51cps and 64cps under a 100% payout scenario. We note that any payout ratio below 100% increases the debt levels being repaid.

Figure 6. Implied FY19 dividend

	Low	High	Comment
FY19 EBITDAF ($m)	459	493	FY19 EBITDAF range per Fig. 4 analysis
Less interest, tax & capex ($m)	(182)	(192)	Assumes interest costs of ~$50m, maintenance capex of $40m and tax of between $92m & $102m
Less debt repayment ($m)	(73)	(47)	Annual debt repayment per analysis is Fig. 5
Free cash flow ($m)	**204**	**254**	
Dividend (100% FCF) (cps)	51	64	
Dividend (90% FCF) (cps)	46	57	
Dividend (80% FCF) (cps)	41	51	

Source: Forsyth Barr analysis

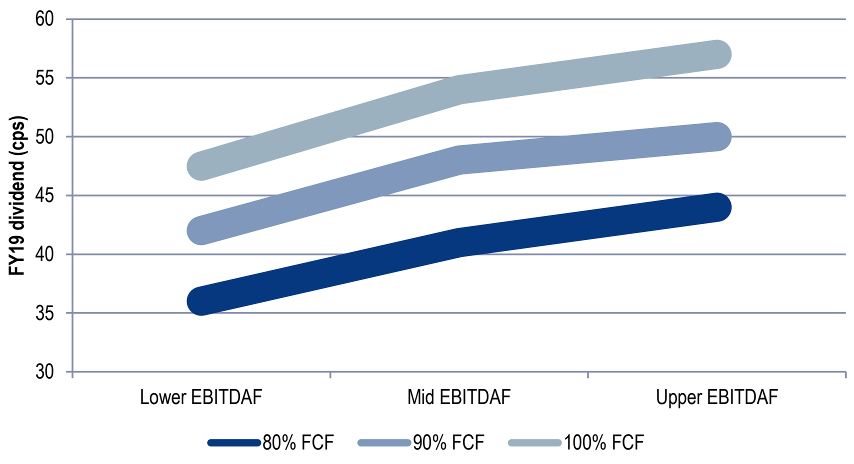
The analysis highlights the leverage that EBITDAF has on the final dividend payment. The high case scenario is only +7% greater than the low case scenario, and yet under each payout ratio assumption, the dividend is +25% higher.

We suspect ZEL has an absolute debt level in mind, such that debt repayments are likely to be between $65m and $75m per annum regardless of actual EBITDAF. The end result is higher EBITDAF equates to lower absolute debt levels and a lower net debt/EBITDAF ratio. Under the high EBITDAF scenario (per Fig. 6), repaying $70m of debt per annum, implies a dividend of ~58cps.

Indicative dividends appear low and imply underlying EBITDAF is going backwards

ZEL has presented a range of possible FY19 dividend outcomes (slide 48), which could be as low as 35cps (assuming low EBITDAF and an 80% payout ratio) and as high as 58cps (assuming high EBITDAF and a 100% payout ratio). However, ZEL has not provided its EBITDAF or debt repayment assumptions underpinning the analysis.

Figure 7. ZEL indicative FY19 dividends



Source: ZEL (slide 48), Forsyth Barr analysis

Back-solving for EBITDAF, we estimate that ZEL is indicating FY19 EBITDAF of between $420m and $501m, a range which is well below FY18 levels, except at the upper end.

Figure 8. Back-solving EBITDAF based on indicative dividend payments

	Lower EBITDAF		Mid EBITDAF		Higher EBITDAF	
	Low	High	Low	High	Low	High
Dividend per ZEL (cps)	46	49	53	55	56	58
Dividend ($m)	184	196	212	220	224	232
Debt repayment ($m)	65	75	65	75	65	75
Interest, tax and capex ($m)	171	180	182	189	187	194
Implied EBITDAF ($m)	**420**	**451**	**459**	**484**	**476**	**501**

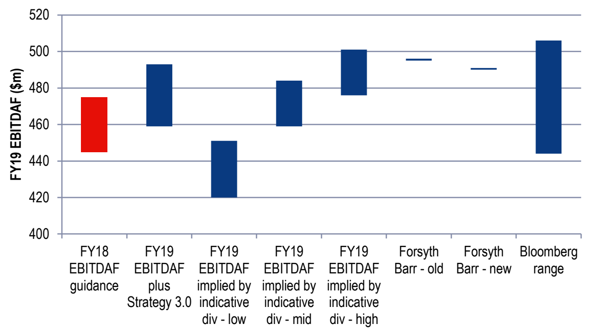
Source: ZEL, Forsyth Barr analysis

Note: under this analysis we assume a constant level of debt repayments, irrespective of EBITDAF. We also only assume a 100% payout ratio as a lower payout ratio simply assumes higher debt repayments.

Summary and conclusion

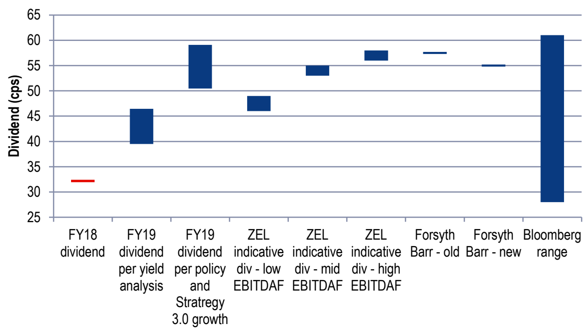
Whilst ZEL's dividend policy appears clear, the conclusions drawn from the additional information presented can vary significantly. Our analysis indicates that our FY19 dividend and earnings forecasts are not materially different to those implied by ZEL's material. Using the bottom end of the ranges ZEL provides results in either hard-to-believe earnings destruction or debt repayment far in excess of its target.

Figure 9. FY19 EBITDAF estimates



Source: ZEL, Forsyth Barr analysis

Figure 10. FY19 dividend estimates



Source: ZEL, Forsyth Barr analysis

From an earnings perspective, we are inclined to follow the view that FY19 EBITDAF will be towards $490m, as per FY18 guidance, plus earnings growth from Strategy 3.0. In turn that implies a dividend in the mid-50s cps. ZEL's underlying performance remains strong and we note that if anything, ZEL has a tendency to be conservative with its guidance. For example, it is achieving its initial target net debt/EBITDAF ratio of 2.0x a year earlier than planned (although the timing was consistent with our forecasts of two years ago).

Strategy 3.0 Solid, But Lower Than Expected

Outside of the capital management plans, the main focus of the investor day was the additional gains expected from merging the Caltex NZ and ZEL businesses. Initial synergies of $40m to $42m (note the top of the range is -$3m lower than previous guidance) were the low hanging fruit and largely consisted of cost out initiatives by removing duplicate costs and the benefits of economies of scale. The additional benefits outlined under Strategy 3.0 are harder to achieve, will take longer to achieve, and in some cases require additional investment. Included within Strategy 3.0 are also further areas of growth ZEL has identified, unrelated to the merger of Caltex NZ and ZEL.

Heading into the investor day, we expected additional synergy benefits of ~+$20m and jet repricing benefits to increase to ~+$20m. These assumptions had been included in our forecasts. ZEL's Strategy 3.0 guidance of $30m to $35m, therefore, is -$5m to -$10m lower than expected.

Figure 11. Strategy 3.0 EBITDAF increases

	FY18		FY19		FY20		
	Low $m	High $m	Low $m	High $m	Low $m	High $m	Comment
Supply chain	0	0	4	5	5	6	Synergy benefits associated with scale. Consolidation of existing contracts and exiting industry joint ventures in favour of in-house solutions (possible due to scale)
Commercial	8	9	13	15	21	24	Large proportion is lift in jet margins as contracts transition to import parity pricing. Also includes enhanced commercial offering as ZEL leverages NZ's largest network
Retail & marketing	1	2	2	3	4	5	Optimising retailer offering (two tiers instead of three, plus franchise model) and ongoing retail innovations lifting store sales
Underlying EBITDAF increase	**9**	**11**	**19**	**23**	**30**	**35**	$30m to $35m expected to be delivered
Less one-off opex	(6)	(6)	(5)	(5)	(2)	(2)	One-off opex required to deliver expected benefits
EBITDAF uplift net of opex	**3**	**5**	**14**	**18**	**28**	**33**	
Incremental annual uplift (net of opex)	3	5	11	13	14	15	Incremental earnings increases weighted to FY19 and FY20

Source: ZEL, Forsyth Barr analysis

The largest single contributor is the increase in jet margins due to import parity pricing, which is included in the commercial segment. Contracts are still transitioning to the new market dynamic and will not be complete until FY20.

Plans Beyond 2020 Sensible

ZEL provided some insight into its thinking beyond 2020 — "what is next?" ZEL has not committed to any particular path, although it appears unlikely it will be sinking significant capital into new ventures. Its analysis thus far has highlighted:

- Managing for cash is an option and ZEL has the scope to transition to a low cost option (similar to how Caltex NZ was operated prior to it being bought)
- There are opportunities in adjacencies that are being explored further
  - Potential future fuels (bio-fuels being the obvious example)
  - Extend influence in mobility sector (e.g. autonomous vehicles. To that end ZEL has made a small [$250k] stake in the start-up car sharing business Mevo, with

the aim to learn more about that space)

- Participating in the last mile (e.g. 3D printing at Z sites, leveraging fact 80% of NZ population is within 5km of a Z site)

Overall, the work ZEL is doing appears sensible and more importantly, no significant capital is being committed.

Forecast Changes and Investment View

Forecast earnings changes

ZEL reiterated its FY18 guidance range of $445m to $475m. The guidance range reflects the modest uplift expected from Strategy 3.0 (+$3m to +$5m net of one-off opex) as well the cost impacts associated with the refinery to Auckland pipeline (RAP). ZEL indicated that the outage related costs are unlikely to reach its insurance excess of ~$10m. Overall, ZEL remains comfortable with its guidance.

The forecast changes we have made are relatively minor and reflect:

- Minor costs associated the outage (+$4m) impacting on FY18
- Lower jet margins impacting on FY18 through to FY20 (-$7m)
- Lower “additional” synergy benefits reflected in lower commercial margins (-$4m)

The cumulative effects are to reduce FY18, FY19 and FY20 EBITDAF forecasts -$5m, -$7m and -$11m respectively.

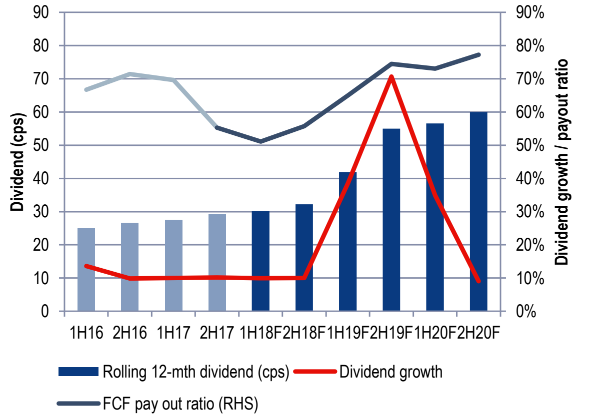
Offsetting the lower earnings forecasts, is a reduction in our long-term maintenance capex forecast -$8m to $42m following ZEL’s $40m maintenance capex guidance.

Forecast dividend changes

We have lowered our FY18 dividend -3.8cps to 32.2cps. ZEL has indicated that it does not plan to move to its new dividend policy until FY19. We had assumed a step towards a revised policy in the 2H18 dividend.

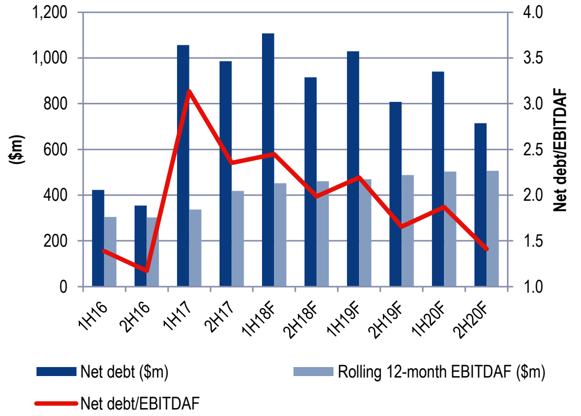
Our longer-term forecasts are not changed materially. Notwithstanding the slightly lower earnings outlook, our FY19 and FY20 dividend forecasts of 55cps and 60cps respectively still result in a net debt/EBITDAF ratio of 1.4x at the end of FY20, below ZEL’s target ratio of 1.5x a year ahead of plan.

Figure 12. Dividend forecast



Source: Forsyth Barr analysis

Figure 13. Net debt forecast



Source: Forsyth Barr analysis

The modest declines in our earnings forecasts and dividend outlook has lowered our target price -25cps (-2.9%) to $8.45.

Figure 14. Forecast changes

	FY18 Old	FY18 New	% Chg	FY19 Old	FY19 New	% Chg	FY20 Old	FY20 New	% Chg
Revenue	4,445	4,348	-2%	4,787	4,727	-1%	4,853	4,790	-1%
Gross profit	844	841	0%	873	865	-1%	896	884	-1%
Gross Margin	**19.0%**	**19.3%**	**2%**	**18.2%**	**18.3%**	**0%**	**18.5%**	**18.4%**	**0%**
Operating costs	(379)	(380)	0%	(378)	(377)	0%	(379)	(378)	0%
Underlying EBITDA	**466**	**461**	**-1%**	**495**	**488**	**-1%**	**517**	**506**	**-2%**
Depreciation & amortisation	(95)	(95)	0%	(96)	(96)	0%	(95)	(94)	-1%
Associate income	9	9	6%	9	8	-4%	10	10	-1%
EBIT	**379**	**375**	**-1%**	**408**	**401**	**-2%**	**432**	**422**	**-2%**
Net Interest	(51)	(51)	-1%	(51)	(51)	-1%	(52)	(51)	-1%
Pre-tax profit	**328**	**324**	**-1%**	**357**	**350**	**-2%**	**380**	**370**	**-3%**
Tax expense	(89)	(88)	-1%	(97)	(96)	-2%	(104)	(101)	-3%
NPAT	**238**	**236**	**-1%**	**259**	**254**	**-2%**	**277**	**269**	**-3%**
Earnings per share (eps)	59.6	58.9	-1%	64.8	63.6	-2%	69.2	67.4	-3%
Dividend (cps)	36.0	32.2	-11%	57.5	55.0	-4%	61.4	60.0	-2%
Key operating assumptions									
Petrol	1,216	1,216	0%	1,226	1,226	0%	1,226	1,226	0%
Diesel - Retail	474	474	0%	467	467	0%	457	457	0%
Diesel - Commercial	819	819	0%	847	847	0%	870	870	0%
Diesel - Biofuels	5	3	-40%	16	16	0%	24	24	0%
Jet	876	823	-6%	909	854	-6%	934	878	-6%
Marine	172	172	0%	173	173	0%	174	174	0%
Bitumen & Other	143	143	0%	144	144	0%	145	145	0%
Domestic supply	508	508	0%	525	525	0%	538	538	0%
ZEL volumes (m litres)	***4,213***	***4,158***	***-1%***	***4,307***	***4,253***	***-1%***	***4,368***	***4,311***	***-1%***
Industry and export supply	51	51	0%	50	50	0%	49	49	0%
Total fuel volumes (m litres)	***4,263***	***4,209***	***-1%***	***4,357***	***4,303***	***-1%***	***4,417***	***4,361***	***-1%***
GM excl supply (cpl)	16.8	16.9	1%	17.2	17.2	0%	17.3	17.3	0%
GM incl refining (cpl)	18.3	18.5	1%	18.6	18.6	0%	18.8	18.8	0%
Gross profit make-up									
Fuels gross profit	709	704	-1%	741	732	-1%	755	744	-1%
Refining gross profit	64	65	2%	59	60	3%	67	66	-2%
Non-fuel gross profit	71	71	0%	73	73	0%	74	74	0%
	844	**841**		**873**	**865**		**896**	**884**	

Source: Forsyth Barr analysis

Investment View

We are retaining our OUTPERFORM rating. The share market reacted negatively (down -3.0%) to the investor day announcements and the suggestion that the FY19 dividend may be well below 60cps. However, on closer analysis we believe that the dividend story remains intact. In addition, we note that ZEL has a track record of delivering on or exceeding expectations, and this appears to be another instance where ZEL has set itself relatively benign targets. Based on our forecasts, the FY18 PE is 12.5x (and falling) and the revised FY19 gross dividend yield is +10.3% (and rising thereafter). Compared to other defensive yield stories in the market, ZEL appears cheap.

Investment summary

Our rating is OUTPERFORM. After FY18 we expect Z Energy's (ZEL) dividends to increase materially, providing investors with an attractive yield relative to other opportunities. In addition, we expect short-term earnings growth to continue. In our view, the risks associated with the fuel price inquiry are long-dated and not material.

Key drivers

- **Fuel margins:** Fuel margins are the key value driver and have trended upwards from unsustainably low levels over the past five years. We do not expect margins to increase materially from current levels.
- **Sales volumes:** Fuel demand is generally inelastic, so whilst it is an important value driver, its variability is less than margins. However, volumes are important for maintaining supply chain economics.
- **Refining performance:** ZEL refines ~75% of its product at NZR. NZR is generally a positive and provides a competitive advantage over imported product when refining margins are high.

Other key company and industry issues

- **Industry structure:** The industry is an oligopoly dominated by ZEL, BP, and Mobil (Exxon). Gull features in the upper NI market. ZEL's NZ-centric business model provides it with flexibility and a market leading position.

Upcoming catalysts/events

- **Strategy 3.0:** ZEL has guided to earnings growth of +$30m to +$35m above underlying earnings. Growth is predominantly coming from additional Caltex/Z merger benefits and jet fuel being repriced to import parity.
- **Dividend growth:** ZEL is producing significant free cash flow. Once debt levels are reduced to target levels (by the end of FY18), we expect a material increase in returns to shareholders.

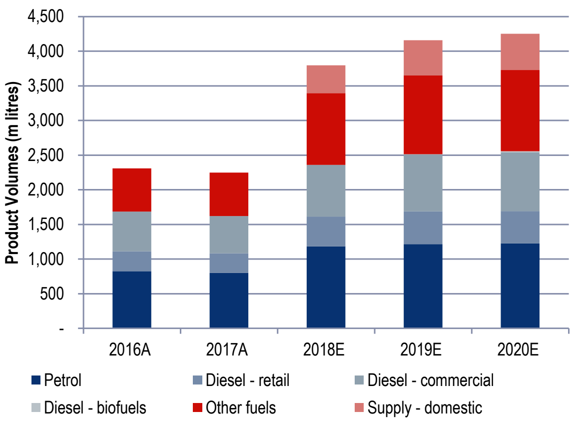
Key risks

- **Long-term threat to industry volumes:** Increased vehicle efficiency and the threat from electric vehicles will pressure industry volumes. However, the near-term risks are low, with industry volumes growing at a fast rate.
- **Fuel Price Inquiry:** Continued fuel margin increases have created political noise about fuel prices, resulting in the fuel price inquiry. Whilst the inquiry is an asymmetric downside risk, we believe the ultimate outcomes from the inquiry will have an immaterial effect on ZEL.

Company description

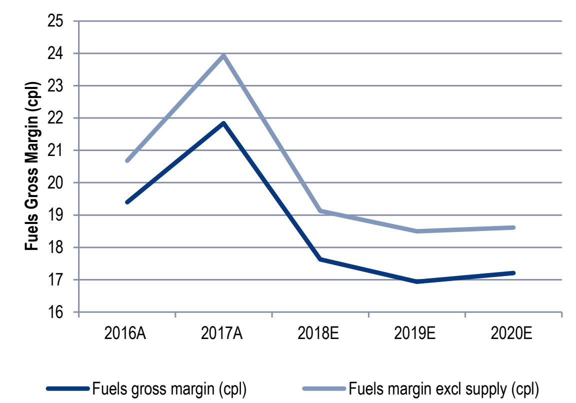
Z Energy is a downstream oil company. Its products include petrol, diesel, marine fuel oil and aviation fuel. Z retails petrol and diesel through a network of ~200 Z branded service stations and ~140 Caltex branded service stations. It sells fuel to the commercial market, which includes a network of 161 truck stops. ZEL also owns terminal storage facilities in 12 centres, share of local distribution ships and distribution infrastructure, 15% of Refining NZ (NZR) and 25% of Loyalty NZ (Fly Buys). It has also recently opened a bio-diesel plant in Wiri, South Auckland.

Figure 15. Product volumes (excl export and industry supply)



Source: Company reports, Forsyth Barr analysis

Figure 16. Fuels gross margin



Source: Company reports, Forsyth Barr analysis

Figure 17. Substantial Shareholders

Shareholder	Latest Holding
Lazard	9.2%
Perpetual	7.4%
Airlie Funds Mgmt	6.6%
Cooper Investors Ptd Limited	6.2%
Investor Mutual	5.2%
CBA	5.0%

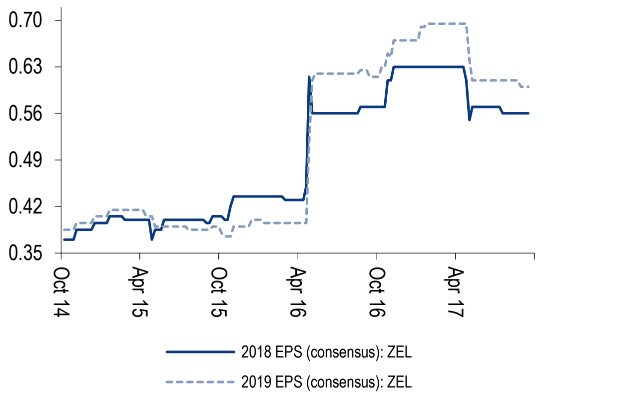
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 18. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect ZEL's balance date - March)			(m)	2018E	2019E	2018E	2019E	2018E	2019E	2019E
Z Energy	**ZEL NZ**	**NZ$7.39**	**NZ$2,956**	**12.5x**	**11.6x**	**8.7x**	**8.2x**	**10.6x**	**10.0x**	**7.4%**
Suburban Propane Partners LP	SPH US	US$25.70	US$1,570	29.6x	16.3x	10.6x	9.4x	21.4x	17.2x	10.6%
World Fuel Services Corp	INT US	US$33.10	US$2,267	13.9x	11.6x	8.1x	7.6x	10.8x	9.6x	0.7%
Contact Energy *	CEN NZ	NZ$5.58	NZ$3,995	27.2x	24.8x	10.9x	10.5x	18.8x	17.9x	6.7%
Mercury *	MCY NZ	NZ$3.35	NZ$4,608	27.0x	26.5x	10.9x	11.2x	17.1x	18.1x	4.5%
Trustpower *	TPW NZ	NZ$5.42	NZ$1,696	16.2x	18.0x	10.3x	11.1x	13.1x	14.3x	6.3%
Meridian Energy *	MEL NZ	NZ$2.84	NZ$7,279	34.7x	32.7x	12.9x	12.4x	22.2x	20.8x	6.9%
Genesis Energy *	GNE NZ	NZ$2.35	NZ$2,350	41.6x	39.9x	10.2x	9.9x	22.2x	22.7x	7.3%
Caltex Australia	CTX AT	A$32.63	A$8,510	13.7x	13.9x	7.9x	8.1x	9.6x	9.8x	3.7%
			Compco Average:	**25.5x**	**23.0x**	**10.2x**	**10.0x**	**16.9x**	**16.3x**	**5.8%**
EV = Current Market Cap + Actual Net Debt			**ZEL Relative:**	**-51%**	**-49%**	**-15%**	**-18%**	**-37%**	**-39%**	**+28%**

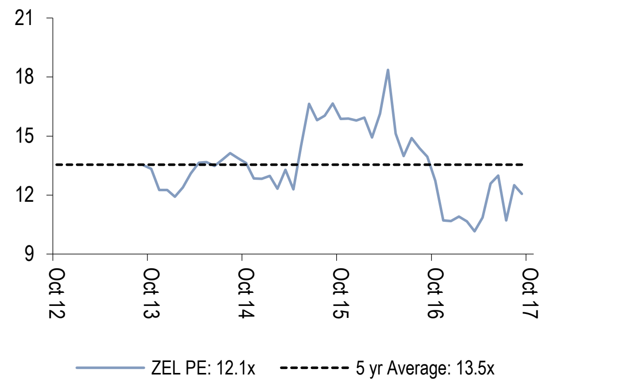
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ZEL) companies fiscal year end

Figure 19. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 20. 12 Month Forward PE



Source: Forsyth Barr analysis