Meridian Energy Limited Pre-IPO Report

An opportunity to invest in the shares of a high-income low-cost energy provider with regulatory uncertainty being the main concern

Recommendation:
Subscribe to the share offer

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Executive Summary

Meridian Energy, or Meridian, is a vertically-integrated renewable electricity generator accounting for 30% of New Zealand's total electricity output. It enjoys a strong competitive position and we rate the firm as having a narrow economic moat due to cost advantages and the fact that New Zealand's small population creates barriers for would-be entrants. Accordingly, we expect Meridian and the other incumbent energy providers to generate solid returns, above the cost of capital, over the long term. That said, from time to time, Meridian will be impacted by adverse hydrological conditions due to deficient rainfall and/or inadequate snowmelt. Therefore, the firm's margins and earnings will continue to be more volatile than its peers. Apart from operational risks, there is the potential for regulatory change with the New Zealand opposition Labour Party's plans to regulate electricity prices through a single-buyer model. We believe regulation would most likely reduce returns for all power companies and possibly reduce Meridian's operating income by NZD 170 million, all else being equal. We believe the opposition proposal is fairly extreme but it would significantly reduce our fair value estimate if implemented. Given this regulatory uncertainty, we ascribe a high fair value uncertainty rating to the stock. Barring major regulatory changes, returns are forecast to exceed the cost of capital, supporting our narrow moat rating.

Our fair value estimate of NZD 1.75 per share for Meridian is towards the top end of the share offer's indicative price range of NZD 1.50 to 1.80. This represents a fiscal 2014 enterprise value/EBITDA multiple of 9.6 times, which is consistent with our fair value estimate for Mighty River Power (NZX:MRP) and at a slight premium compared with our fair value estimate for Contact Energy (NZX:CEN). The New Zealand government has removed the pricing uncertainty for retail investors by capping the issue price at NZD 1.60 per share provided they keep their shares until May 2015. Also, investors will only have to pay an initial instalment of NZD 1.00, with the balance payable in May 2015. The retail offer price of NZD 1.60 per share translates to an attractive dividend yield of 6.5%. Moreover, investors will be paid full dividends on the instalment receipts they hold, which equates to a yield of 10.5%. However, unlike Mighty River Power, Meridian's dividends will not be fully imputed, with the firm forecasting imputation credits of 72% and 73% for fiscal 2014 and fiscal 2015 respectively. We believe this is due to the fact that tax paid during 2014 and 2015 will not create sufficient imputation credits, as the forecast dividends are greater than the underlying earnings. However, dividends are covered by operating cash flows .

The retail offer capped price of NZD 1.60 is a modest discount to our fair value estimate. We generally prefer to buy stocks at a larger discount to fair value and in Meridian's case, this would be around NZD 1.50. However, in the context of what we regard as a stretched New Zealand market, the capped price appears reasonable value, hence our recommendation to subscribe to the offer. It will particularly appeal to long-term investors seeking an investment with a stable and steadily rising income stream as Meridian's dividend and yield are set to increase going forward.

Key Investment Considerations

We expect Meridian to generate a return on invested capital of 11.5% on average during the next five years, above its cost of capital of 7.5%, with the potential for regulation being the main impediment.

We expect Meridian to generate strong free cash flow from 2015 onwards due to a dramatic decline in capital expenditure. This, in our view, will prompt the board to lift the dividend payout from 80% to 100% of free cash

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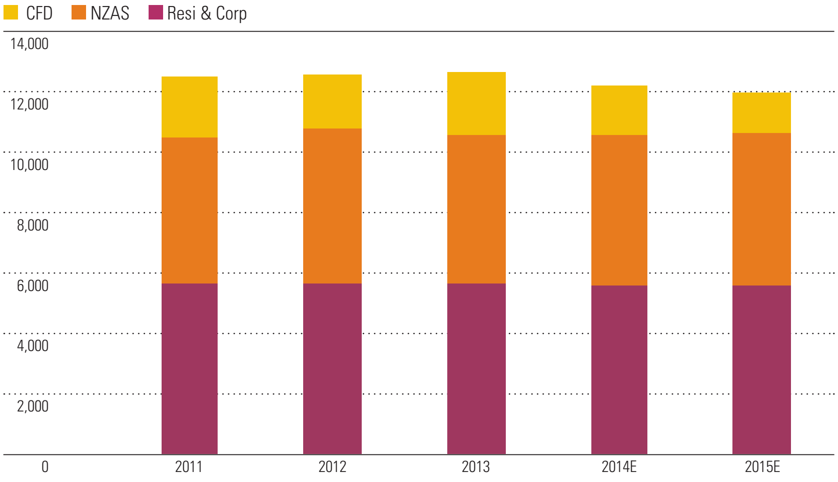
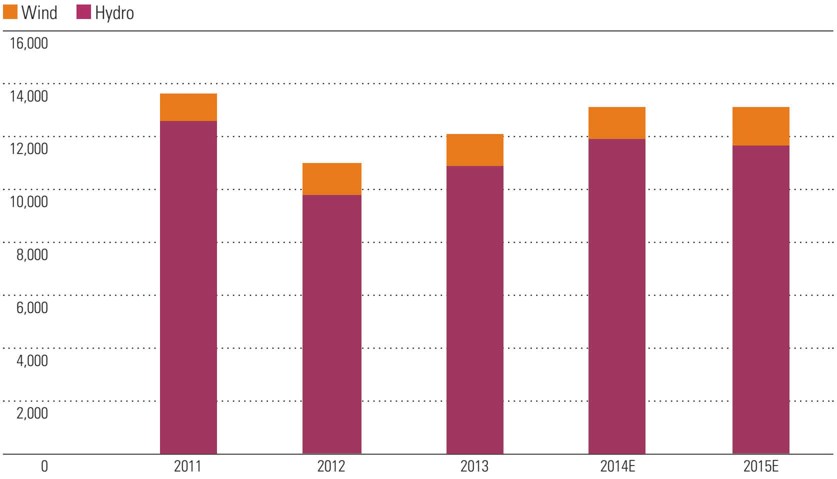
Figure 1: Annual Sales to Customers (GWh)



Source: Meridian

Figure 2: Annual Production (GWh)



Source: Meridian

flow. Consequently, we project dividends to increase by 11% per annum on average during the next five years.

The closure of the Tiwai Point aluminium smelter plant could greatly affect electricity demand in New Zealand, potentially depressing electricity prices for a protracted period. However, the risk of the smelter closing immediately has been greatly averted following Meridian's new agreement with the owners of the smelter. We have not factored in the closure of the smelter in our forecasts.

Hydrological conditions can impinge on earnings and cash flow, especially during a very dry year, as the company is forced to buy power at a time when wholesale electricity prices are high.

Investment Thesis

Meridian is a vertically-integrated renewable energy company involved in the generation and retailing of electricity. Nearly 90% of its electricity is generated from low-cost hydro power plants, with wind making up the rest. While the significant hydro capacity is a source of competitive advantage and high returns for Meridian, it also increases the firm's risk during dry conditions when rainfall or snowmelt is below average, resulting in substantially lower hydro production.

Therefore, to meet its customer commitments, Meridian is forced to buy power at a time when wholesale electricity prices are high. Lower hydro production, coupled with the high cost of purchased electricity, could squeeze Meridian's margins. This is aptly exemplified by the adverse hydrological conditions witnessed in 2008 and 2009 when Meridian's operating margins were half that of a normal year. Consequently, Meridian's earnings volatility is greater than some of its peers.

However, Meridian is getting better at managing the vagaries of weather and this is substantiated by the fact that underlying earnings before interest, tax, depreciation and amortisation, or EBITDA, in fiscal 2012 was NZD 103 million higher than in fiscal 2008, despite being a dryer year than 2008. We attribute this to a more liquid and far more developed derivatives market than a few years ago. The Australian Securities Exchange, or ASX, futures market is now widely used by electricity generators for buying and selling contracts for difference, or CFDs. Meridian is therefore able to take large quantities of cover quicker than it could previously. Secondly, Meridian has an arrangement with Genesis Energy (a competitor) through a CFD contract, whereby Meridian has the option to receive 1,000 gigawatt hours, or GWh, of electricity at a fixed price between April and October every year, which is a useful option to have during a dry year. Lastly, Meridian's wind capacity has increased over the years and is likely to increase further with the commissioning of the Mill Creek wind farm near Wellington next year. Wind offers Meridian much needed diversity in times of adverse hydrological conditions. Therefore, while we still believe earnings will be negatively affected during a very dry year, the impact will be less than in prior years.

New Zealand Aluminium Smelters, or NZAS, which owns and operates the Tiwai Point aluminium smelter in the South Island is Meridian's largest customer, accounting for nearly 40% of total output. Given the large exposure, the smelter's existence remains critically important to Meridian and the entire electricity sector. During the past few years, the smelter has been buffeted by weak aluminium prices and the high New Zealand dollar. At NZAS's behest, Meridian entered into a new long-term contract, which took effect from 1 July 2013 and runs until 2030. The new contract is a financial rather than physical one, but contains certain incentives for NZAS to consume electricity in accordance with quantities specified in the agreement. Principally, NZAS receives a discounted price from 1 July 2013, which we believe is in the order of 15%, if it consumes the requisite amount of electricity. The price discount is also applicable after January 2017, provided NZAS decreases its electricity consumption from 572 MW to 400 MW. This gives Meridian the opportunity to sell 172 megawatts, or MW, of power at a higher price in the spot market. Furthermore, Meridian will receive a higher price if the New Zealand dollar value of aluminium rises. NZAS can terminate the contract by giving notice to Meridian of between 12 and 18 months, with the earliest termination date being 31 December 2016.

We think the new deal provides Meridian, and the electricity industry in general, more certainty and allows firms to adjust to the changing circumstances. Should NZAS cut back production equivalent to 400 MW of electricity due to financial difficulties, causing demand to reduce by 172 MW, that could potentially see capacity closures and/or reduction in thermal generation. Genesis, for example, has signalled its intention to close its 220 MW thermal power plant in Huntly in December 2014 if wholesale prices are unfavourable. Contact Energy, with a total installed capacity of 780 MW, is also keeping its options open. On the flipside, if aluminium prices increase, this would improve the profitability of the smelter and would also allow Meridian to receive higher prices for its electricity. Our forecasts assume that NZAS consumes 572 MW of electricity until 1 January 2017, with volumes declining to 400 MW thereafter.

Meridian could see a reasonable uplift in margins, when a fairer transmission pricing regime, resulting in redistribution of transmission costs, is in place. Under the current transmission pricing structure, South Island generators bear the brunt of the transmission costs. Given Meridian is mainly a South Island generator, the cost of transmission, levied by government-owned Transpower, is largely borne by Meridian. We believe it is only a matter of time before a policy making transmission costs more equitable comes into effect. Our five-year explicit forecasts do not include any reduction in transmission costs given the uncertainty with respect to the quantum of any reductions and the fact that any benefits will accrue only after 2017.

Meridian is nearly at the end of its capital expenditure cycle and we envisage growth capital expenditure to dramatically abate going forward, as major expansion is unlikely given excess industry capacity. Capital expenditure averaged NZD 353 million per annum between 2009 and 2013, mainly reflecting the construction of wind farm projects in New Zealand and Australia. We forecast capital expenditure of NZD 153 million on average from 2014 to 2018, consisting of the Mill Creek wind farm project in New Zealand and the Mt. Mercer wind farm development in Australia. These growth projects will result in higher cash outflows, mainly in 2014, and to some extent in 2015. However, from fiscal 2016 onwards, Meridian is likely to mainly incur maintenance capital expenditure of NZD 65 to NZD 75 million. Given the strong balance sheet, with low gearing and escalating free cash flow, we expect the board to lift its dividend payout from 80% to 100% of free cash flow. Consequently, we forecast dividends to rise by approximately 11% per annum on average during the next five years.

We think the near- to medium-term outlook for the electricity industry is not promising. The sector is characterised by excess supply as a spate of new capacity came on stream in the last few years, and more supply is expected during the next 6 to 12 months from Mighty River's geothermal plant (commissioned recently), Contact Energy's Ti Mihi geothermal capacity and Meridian's Mill Creek wind farm. At the same time, demand has barely changed since 2008, due to a combination of economic weakness instigated by the global financial crisis and more efficient energy consumption by households and businesses. The shutting down of energy-intensive businesses involved in the production of paper and pulp has particularly hurt the industry. Given this backdrop, we anticipate demand growth on average to increase by around 1.5% per annum during the next several years, a deceleration from the 2% per annum growth witnessed historically. At this rate, we believe it will take at least 2 to 3 years for supply and demand to balance, which could prompt thermal generators to modulate supply in accordance with demand and wholesale electricity prices. We think retail competition, which escalated a few years ago perpetuated by the governments "Whatsmynumber" advertising campaign, is unlikely to abate anytime soon.

Despite excess supply, New Zealand will continue to face dry-year risk during times of deficient rainfall given 55% of the total industry output is derived from hydro generation. Based on historical evidence, we estimate that nearly 4000 GWh of annual supply (representing 10% of annual demand) could potentially disappear, should lake levels in both islands fall well below normal levels, sparking a surge in spot wholesale electricity prices. Arguably, companies such as Contact Energy, which has significant peaking thermal capacity, would be best positioned to take advantage of this situation.

While electricity prices are not currently regulated, this could change if the opposition Labour party comes to power in November 2014. Labour, with support from the Green party, announced a comprehensive plan in April 2013 to regulate the electricity sector in a bid to bring down retail electricity prices. We believe Labour's policy would particularly affect low-cost producers such as Meridian and Mighty River Power, as they would get a return based on their cost of operation. In essence, Labour would level the playing field for all generators such that thermal operators would achieve returns similar to their renewable counterparts. We continue to believe that wholesale electricity prices need to be higher than NZD 75 to NZD 80/MWh for new geothermal and wind units to be viable and above NZD 100/MWh to warrant investments in hydro generation, well above what Labour is prepared to pay. In other words, Labour's policy would render investments in new generation uneconomical. We think it might take Labour (if it comes to power) at least four to five years to regulate the sector given the complexities involved in working out the regulatory asset base for each generation unit due to their differing ages and fuel types. Considering that elections are held every three years in New Zealand, we think the chance of regulation occurring during the next five years is remote.

Valuation Profitability and Growth

Our fair value estimate for Meridian is NZD 1.75 per share, which is based on a discounted cash flow analysis, incorporating a 9% cost of equity and 7.5% weighted average cost of capital. Our fair value estimate implies a fiscal 2014 enterprise value/EBITDA of 9.6 times and price/earnings of 27.5 times. Any changes to the regulatory environment could adversely impact our valuation.

Our 2014 and 2015 forecasts incorporate Meridian's assumptions, which we think are reasonable. The forecasts assume normal hydrological conditions with total hydro production of 11,890 GWh in fiscal 2014 (up 8% from 2013), reducing slightly to 11,700 GWh in 2015. Fiscal 2013 was a dry year but not as dry as fiscal 2012, when production declined to 9,790 GWh. Wholesale electricity prices are expected to decline to NZD 56/MWh in 2014 from NZD 60/MWh in 2013, reflecting increased hydro generation. Wholesale electricity prices generally tend to fall when conditions are wetter, and 2014 is expected to be wetter than 2013. Retail electricity prices are forecast to remain stable in fiscal 2014 and 2015. We believe generators will be cautious at raising retail prices, lest they incur the wrath of the government and/or the commerce commission. In addition, excess supply will keep a lid on both wholesale and retail electricity prices for the next few years.

Meridian's revenue is projected to decline by 10% in 2014, mainly reflecting the newly renegotiated contract with NZAS, which is at a lower price. However, this is fully offset by the reduction in the cost of goods sold due to higher hydro production and lower cost of acquired generation, because of lower hedges and softer electricity prices. Consequently, the energy margin, which basically reflects the performance of the core energy division is expected to remain flat at NZD 915 million in fiscal 2014. The energy margin is expected to increase to NZD 959 million in 2015, mainly reflecting an increase in Australian earnings due to the commissioning of the Mt. Mercer wind farm, and slightly higher New Zealand earnings due to the commissioning of the Mill Creek wind farm near Wellington.

Overall, underlying EBITDA in fiscal 2014 is expected to decline by 6.5% because of higher transmission and costs related to the initial public offering, or IPO. EBITDA is expected to increase by 7.6% in fiscal 2015, mainly reflecting higher electricity earnings and the absence of IPO costs. Underlying EBITDA margins in fiscal 2014 and fiscal 2015 are projected to be 22.5% and 23% respectively, which is consistent with historical margins of 24% on average. EBITDA and margins are highly susceptible to hydrological conditions, with fiscal 2012 and 2008 bearing the brunt of dry conditions, resulting in significantly lower hydro generation. Table 1 highlights this correlation between hydro output and energy margins.

During a five-year period (2014 to 2018) we forecast revenues to grow by 1.2% per annum, reflecting flat demand and modestly higher electricity prices, mainly as a result of the pass-through of distribution charges. Operating earnings are projected to increase by 5.6% per annum during the same period, primarily due to the reduction in depreciation costs as capital expenditure is expected to decline substantially. Consequently, operating margins are projected to progressively rise, from 13.5% in 2013 to 16.6% in 2015. Our forecasts assume stable NZAS volumes of 5,011 GWh during 2014 to 2016, dropping to 4,258 GWh in 2017 and 3,504 GWh in 2018. The reduction in volumes is unlikely to impact revenues as we project Meridian to achieve similar prices in the wholesale spot market. However, higher wholesale spot prices in 2017 and

Table 1: Energy Margin and Electricity Generation

	2011	2012	2013	2014E	2015E
Energy Margin (NZD million)	950.3	763.2	915.8	915.1	958.6
% chg		*-19.7*	*20.0*	*-0.1*	*4.8*
Total Generation (GWh)	13652	10996	12071	13136	13148
% chg		*-19.5*	*9.8*	*8.8*	*0.1*
Hydro generation (GWh)	12629	9760	10918	11890	11699
% chg		*-22.7*	*11.9*	*8.9*	*-1.6*

Source: Meridian, Morningstar estimates

Table 2: Peer Group Comparison (using forward earnings estimates)

Name*	Country	Fair Value	EV/EBITDA 2014E	PER 2014E	Div Yield 2014%	FCF Yield 2014%
Meridian Energy	NZ	1.75	9.6	27.7	6.0	-1.4
Mighty River (MRP)	NZ	2.70	9.7	27.4	4.8	4.3
Contact Energy (CEN)	NZ	5.50	9.1	18.0	4.9	6.6
TrustPower (TPW)	NZ	8.50	9.6	18.5	5.0	3.2
Origin Energy (ORG)	Australia	16.00	9.4	18.0	3.6	-5.6
AGL Energy (AGK)	Australia	16.00	8.5	15.0	3.9	8.7

* Data is based on fair value estimate

Source: Morningstar estimates

2018, versus the prices received from NZAS, provides upside to our estimates.

On an enterprise value/EBITDA basis, our fair value for Meridian is consistent with the fair value multiples for Mighty River Power and TrustPower (NZX:TPW), both renewable energy operators, and equates to a 5% premium to Contact Energy's fair value. Meridian's operating margins have been lower than those of Mighty River Power and similar to those of Contact Energy historically. However, Meridian's operating margins tend to fluctuate more than its peers due to the firm's dependence on hydro generation, and the fact that Meridian is forced to buy electricity from the wholesale market during a dry year when the prices are higher. We believe Meridian is likely to benefit significantly from the transmission pricing review which, if enacted, will materially increase its operating margins. On the other hand, we expect margins of Meridian's competitors to reduce, should they be unable to fully pass on the higher transmission costs to its customers.

Economic Moat

We believe Meridian Energy has a narrow Morningstar Economic Moat Rating by virtue of its position as a low-cost electricity producer and efficient scale in the New Zealand electricity market. Meridian Energy is the largest vertically-integrated electricity firm in New Zealand. It owns significant hydro power plants, with total output of around 12,000 GWh and nationwide market share of approximately 30%. The company's electricity retailing business supplies electricity to mass-market residential as well as industrial customers. We estimate its retail and industrial (including NZAS) market share to be approximately 24%. The New Zealand retail market is dominated by four major players that include Meridian and three other vertically-integrated power companies. The retail electricity market is not regulated and firms can set their own prices. Consequently, there is some level of competition between the big four companies from time to time, resulting in market share movements. However, over time, the retail market share of the big four players has more or less remained steady. We believe Meridian, like its listed peers Contact Energy and Mighty River Power, deserves a narrow economic moat because of its reasonably strong competitive position and consolidated market structure. We think Meridian (along with Mighty River Power) currently has the lowest cost structure in the industry, as approximately 90% of its power is derived from hydro generation. We believe Meridian's transmission costs are higher than those of Mighty River because it bears a disproportionate share of transmission charges as, for some inexplicable reason, South Island producers bear the brunt of the transmission costs under the current regime. However in our view the transmission charges will be spread evenly across all the major generators. As a result, Meridian's transmission cost is expected to fall dramatically, making the firm the lowest-cost producer of electricity in New Zealand. We also believe the efficient scale phenomenon will work in the firm's favour, due to the fact that potential new entrants might find New Zealand to be an unattractive market as a result of its small population base and unappealing growth prospects. We believe it would be more sensible for would-be entrants to acquire one of the four major players, rather than build capacity from scratch, as the returns would be unattractive. We also believe that the four major companies have locked up most of the low-cost geothermal and hydro sites and, as such, new entrants would be relegated to higher-cost thermal or wind generation.

Moat Trend

Meridian's moat trend is stable in our view. The big four companies will continue to dominate the New Zealand electricity market for the foreseeable future and generate returns in excess of their cost of capital. We believe Meridian will continue to grow its share of generation capacity in line with demand growth and its market share will likely remain stable. Being vertically integrated, the four major electricity companies can weather the downturn in electricity prices far better than pure retailers, as their output is fully hedged, with lower margins in the retail business offset by higher

Table 3: Key dates

General offer opens	30-Sep-13
General offer closes	18-Oct-13
Institutional offer and book build	21-23 October 2013
Pricing and allocation announcements	23-Oct-13
Allotments expected to be available	25-Oct-13
Expected commencement of trading on NZX and ASX	29-Oct-13

Source: Company Prospectus

Table 4: Key financial information

	2011	2012	2013	2014E	2015E
Adjusted NPAT	219	106	163	162	179
EPS (cps)	8.5	4.1	6.4	6.3	7.0
Growth %		-51.6	53.8	-0.6	10.5
DPS (cps)	26.7	2.8	10.0	10.5	11.5
Yield*				6.0%	6.6%
PE*				27.7	25.1
EV/EBITDA*				9.6	9.3

* Based on fair value of NZD 1.75 per share

Source: Morningstar estimates

generation margins and vice versa. Wholesale prices in New Zealand tend to be volatile and are generally linked to hydrology conditions, given hydro generation accounts for a significant chunk of the country's generation capacity. Needless to say, pure retailers will find the going tough during periods of high wholesale prices. It is not surprising, therefore, that many pure retailers have gone bankrupt over the years, while some of those that exist continue to struggle. Their retail market share in aggregate is currently less than 5% and is likely to remain at these levels for some time.

Key Risks

We ascribe a high fair value uncertainty to Meridian. The high uncertainty reflects the possibility of regulation going forward, which is a risk for all generator/retailers. Meridian faces the risk of lower hydro production due to adverse hydrological conditions in the South Island of New Zealand. The potential closure of NZAS is a concern for Meridian since it accounts for 40% of the firm's electricity output. It also accounts for 13% of New Zealand's overall electricity consumption and, consequently, the closure of the plant could result in excess supply, putting downward pressure on electricity prices. However, we think the renegotiated contract with Meridian will prevent the plant from closing immediately, giving the industry some time to adjust to the changing circumstances. Meridian's returns could also be affected if it is unable to achieve adequate returns in its overseas ventures, mainly in Australia.

The company is currently setting up the 131 MW Mt. Mercer wind farm in Victoria and plans to sell the output in the wholesale electricity market. It also currently owns the Mt. Millar wind farm in South Australia. The returns of both Mt. Mercer and Mt. Millar are dependent on wholesale electricity prices and the amount of wind, which is out of Meridian's control.

Offer Price and Allotment to Investors

The New Zealand government is reducing its stake in Meridian to 51% and offering shares to New Zealand retail and institutional investors. The offer is only open to institutional investors in Australia. The government is adopting a unique model to sell shares in a bid to incentivise investors to participate in the offer. Prospective investors will be able to purchase the shares of Meridian in two instalments, with the first instalment of NZD 1.00 per share payable on application and the final instalment payable by 15 May 2015. Successful applicants will be issued with instalment receipts pending payment of the final instalment. Meridian will pay dividends in full for holders of instalment receipts.

The final instalment will be between NZD 0.50 to NZD 0.80 per share for institutional investors, based on the offer price of NZD 1.50 to NZD 1.80 per share. The final price will be determined by the book build process, which will be conducted betwee 21 and 23 October 2013. For retail investors, the final instalment will be NZD 0.60 per share, based on the retail price cap of NZD 1.60 per share. However, the retail price cap will apply only if investors hold onto their instalment receipts continuously in the same registered name until 4 May 2015.

The instalment receipts will list on the New Zealand Stock Exchange, or NZX, and the Australian Stock Exchange, or ASX, on or about 29 October 2013 under the ticker symbols MELCA and MEZCA respectively. It is expected that trading in instalment receipts on the NZX and ASX will cease on 29 April 2015, being three trading days prior to the final instalment record date. The underlying shares of Meridian will list on the NZX and ASX on 30 April 2015. Initially, the trading of shares on both exchanges will occur on a deferred settlement basis, until the shares are available on the register following the payment of the final instalment by holders of instalment receipts. Trading of shares on a normal settlement basis on both exchanges is expected to commence from 22 May 2015. The shares will be listed under ticker symbols MEL and MEZ on the NZX and ASX respectively.

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Currency

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