Mighty River Power Pre-IPO Report

An opportunity to invest in a low-cost electricity company with renewable generation and a strong retail franchise but regulatory risk a key issue

Recommendation:
Subscribe to the share offer

Note: This offer is only open to New Zealand residents and Australian institutional investors

Executive Summary

Mighty River Power (Mighty River) is predominantly a renewable electricity generator accounting for 17% 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 vertical integration (power generation and retailing) in the oligopolistic New Zealand electricity market. The regulatory environment has been favourable and the market is dominated by four major electricity companies, providing an attractive landscape supportive of solid cash flows and returns. However, there is the potential for regulatory change, with the New Zealand opposition Labour Party announcing plans for a new regulatory environment that would most likely reduce returns for all the power companies and possibly reduce Mighty River's operating income by NZD 100 million. We believe the opposition proposal is fairly extreme, but it would significantly reduce our fair value estimate if implemented. Barring major regulatory changes, returns are likely to exceed the cost of capital over the longer term, supporting our narrow moat rating. Nonetheless, the medium-term outlook for the electricity sector is not very promising because of excess supply and sluggish demand, which will temper operating income growth for the next few years. However, cash flows and dividends should rise strongly as capital investment wanes.

Our fair value of NZD 2.70 per share is towards the top end of the indicative offer price range of NZD 2.35 to NZD 2.80 per share and suggests a fiscal 2014 net dividend yield of 4.8%, fully-imputed for New Zealand shareholders. The government could set a price above or below the indicative price range. We believe this creates some pricing uncertainty for individuals participating in the offer. Our recommendation to subscribe to the share offer is contingent on the issue price being within the price band of NZD 2.35 to NZD 2.80 per share, which we believe will be the most likely outcome.

An issue price within the offer range would allow fair, or better, returns. In the context of a fully-priced New Zealand market this appears reasonable value. We generally prefer to buy at a larger discount to fair value, but long-term investors, particularly those seeking an investment with a stable and steadily rising income stream, may find the issue attractive within the offer range. Recent regulatory proposals, if implemented, would significantly reduce returns and investors need to take this into consideration when deciding whether to subscribe, because Mighty River's profitability and valuation could be substantially impacted under a Labour Party regime.

Key Investment Considerations

We expect Mighty River to generate return on invested capital of 12.5% on average over the next five years, with the potential for regulation being the main impediment.

Strong free cash flows due to a declining capital expenditure program should result in higher distributions to shareholders going forward. We project dividends to rise by 11.5% per annum on average between 2013 and 2017.

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, pricing pressure can be mitigated if higher-cost thermal capacity is mothballed and generators resort to pricing discipline.

Business and Industry Overview

Mighty River is one of New Zealand's leading producers of electricity, accounting for 17% of the country's total generation. The firm enjoys a good retail presence with Mercury Energy, Mighty River's retail brand, being the largest supplier of electricity in

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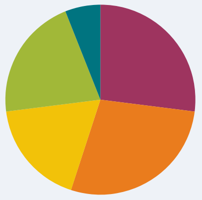
the fastest growing Auckland region, with an estimated market share of 48%. Mighty River currently operates in a favourable environment dominated by four electricity producers, leading to disciplined competition and reasonably good pricing power. Barring regulatory change, we expect stable industry dynamics and, as a result, believe the four major players will continue to generate favourable returns on invested capital in the long run. Given this backdrop, we think Mighty River possess strong competitive advantages and deserves a narrow economic moat rating. However, unwelcome regulatory rhetoric of late leads to our high uncertainty rating for Mighty River despite otherwise stable cash flows.

Mighty River's installed capacity of 1700 megawatts (equivalent to around 7000 gigawatt hours of annual production), including the impending new geothermal capacity, consists of hydro, geothermal and thermal generation. The generation business is significantly hedged by the supply of electricity to residential and industrial customers, with the added ability to alter the fuel mix should weather conditions change. For instance, when wholesale prices are low (which occurs during periods of excess rainfall) Mighty River can opt to reduce output from its thermal power stations if it is more cost effective to purchase electricity for its retail business than to produce it. On the other hand, the firm's thermal generation provides 'dry-year' cover when wholesale electricity prices surge and hydro generation is impacted because of low lake levels. Even so, the firm is impacted during a dry year because of lower hydro output which comprises 61% of total generation. We think the new geothermal power plant will to some extent alleviate dry-year risk and provide additional stability for the firm's revenues and earnings.

Mighty River has the lowest cost structure in the industry, a key source of its economic moat. The cost of hydro generation is less than NZD 5.00 per MWh (megawatt hour) while the cost of geothermal generation is less than NZD 10.00 per MWh.
In comparison, gas-fired generation can cost anywhere between NZD 80 and NZD 120 per MWh depending on whether it is base-load generation or peakers, and can start and stop instantaneously. The company's hydro and geothermal units comprise 90% to 95% of total generation with geothermal providing a stable source of volumes at all times. Mighty River, unlike other hydro generators, has the unique ability to vary its hydro output depending on prevailing spot electricity prices. For example, the company can save water and purchase electricity from the spot market if prices are depressed. The water saved can then be used during

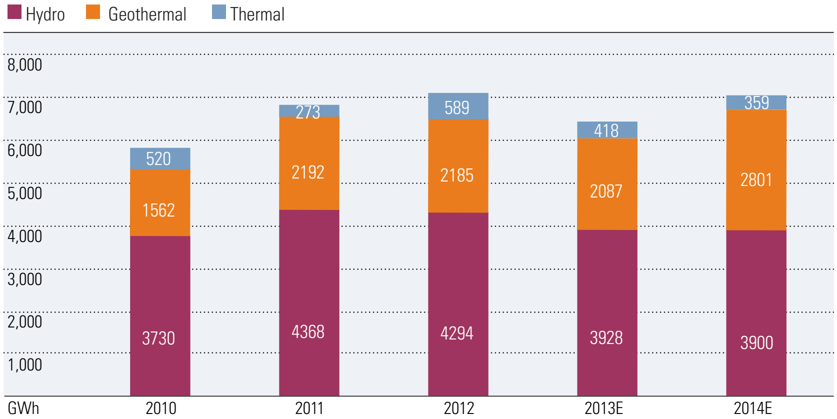
Figure 1: 2012 Industry Production (GWh) and Market Share



Contact Energy	10,653	27%
Meridian Energy	10,996	28%
Mighty River Power	7,068	18%
Genesis Energy	8,467	21%
Trustpower	2,582	6%

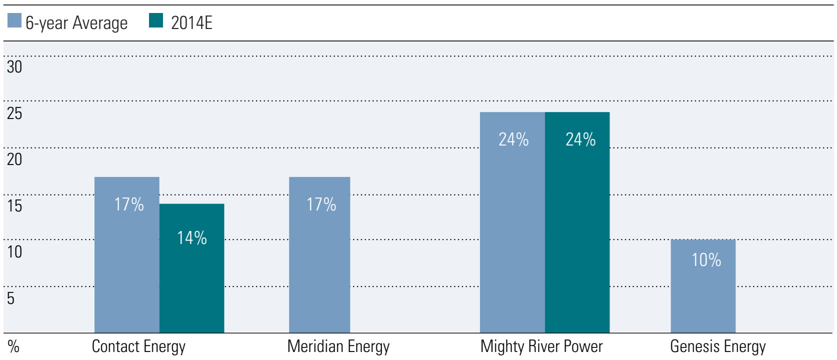
Source: Morningstar, Company estimates

Figure 2: Mighty River Annual Production Trend (GWh)



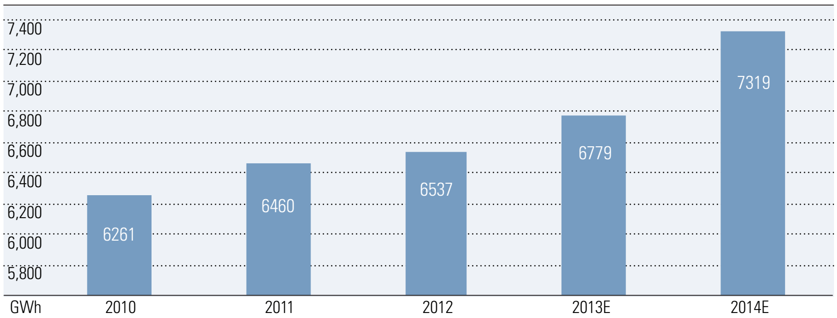
Source: Mighty River

Figure 3: Operating Margins of Generators (%)



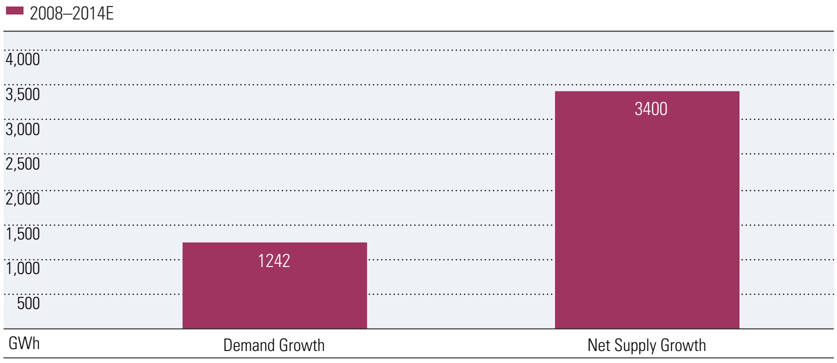
Source: Company data

Figure 4: Mighty River Annual Sales to Customers (GWh)



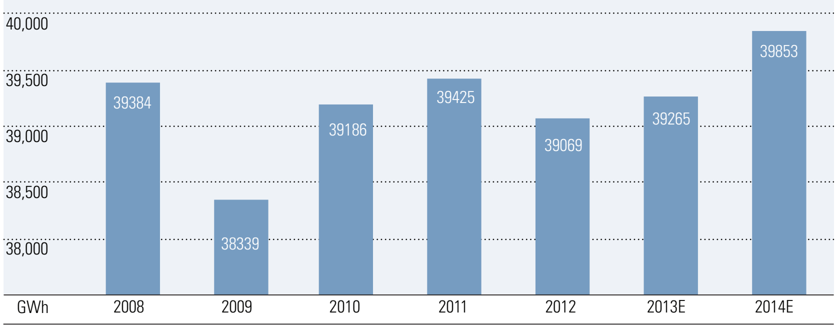
Source: Mighty River

Figure 5: Demand Growth vs, Net Supply Growth (GWh)



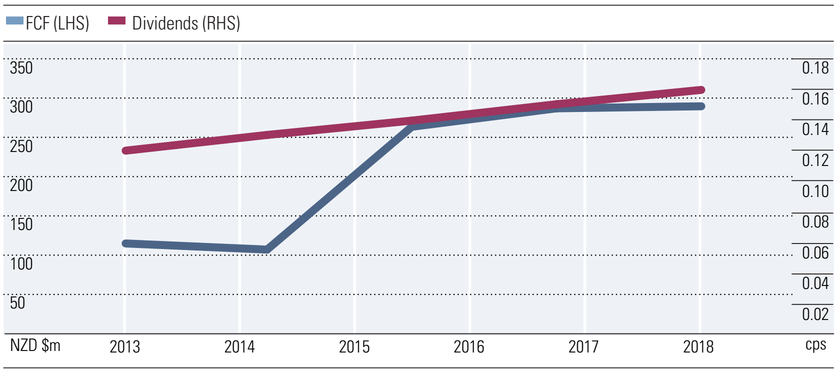
Source: Morningstar estimates

Figure 6: Annual Consumption Trend (GWh)



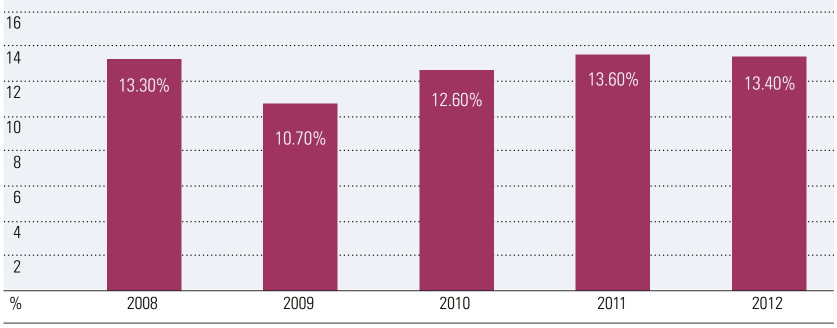
Source: Industry data

Figure 7: Mighty River Free Cash Flow and Dividends



Source: Morningstar estimates

Figure 8: Tiwai Point % of Total New Zealand Power Consumption



Source: Meridian Energy

times of peak demand. Mighty River's hydro capacity is generally better utilised than competitors because its hydro generation typically increases during the winter months (due to more rainfall) coinciding with seasonally high electricity consumption. Due to all these factors the company's operating margins have historically been higher than peers, and we expect the same going forward.

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 over the next 6 to 12 months. At the same time, demand has barely budged 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 manufacturing industry in particular is witnessing sluggish demand in New Zealand, as companies relocate offshore to improve their cost structure and to be in close proximity to their customers. As a result, demand growth will likely decelerate from 2% to around 1.5% over the next several years. At this rate we believe it will take at least three 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 government's "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 deduce that nearly 4,000 GWh (gigawatt hours) 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.

In addition to structural issues impinging on electricity demand, there is a great deal of uncertainty stemming from the possible closure of the Tiwai Point smelter in the South Island. The plant, which belongs to Rio Tinto, consumes around 13% of New Zealand's electricity output. However, the smelter is struggling to generate adequate returns due to soft aluminium prices and the high New Zealand dollar. Meridian Energy supplies electricity on a long-term contract basis, part of which is linked to aluminium prices. There is a possibility that Rio Tinto might close the plant if it cannot find a buyer or is unable to turn the business around. Given this uncertainty we don't envisage any further additions to generation capacity, except existing commitments, and possible closures of a few thermal plants.

We believe Mighty River is nearly at the end of its capital expenditure cycle and envisage growth capital expenditure to dramatically abate going forward as major expansion is unlikely given excess industry capacity. Capital expenditure averaged NZD 219 million per annum from 2008 to 2013, reflecting the construction of two geothermal power plants. We forecast capital expenditure of NZD 117 million on average from 2015 to 2018, consisting mainly of maintenance expenditure of NZD 70 to NZD 75 million. The primary caveat to our thesis is the possibility of Mighty River stepping up investments internationally, principally targeting geothermal opportunities in the United States and Chile. A lower capital expenditure program would translate to solid free cash flows and higher dividends going forward. Consequently, we forecast dividends to rise by approximately 11.5% per annum on average from 2013 to 2017.

Valuation Profitability and Growth
Our fair value estimate for Mighty River of NZD 2.70 per share is based on a discounted cash flow valuation and assumes a weighted average cost of capital of 7%. This equates to forward price/earnings of 27 times, dividend yield of 4.8%, enterprise value/EBITDA of 9.9 times and free cash flow yield of 2.8%. Any changes to the regulatory environment could adversely impact our valuation.

Our 2013 and 2014 forecasts incorporate Mighty River's assumptions which we think are reasonable. Revenue is projected to decline by 11.8% in 2013, reflecting lower hydro output because of deficient rainfall and weaker wholesale prices, but to rise by 3.3% in 2014, driven by additional volumes from the new geothermal capacity. In the long term, we forecast revenues to rise by 4% per annum on average, driven by price increases and modest volume growth. Operating margins in 2013 are expected to be around 22% stripping out one-off restructuring and other costs. We expect operating margins to average between 24% and 25% in the long term, which is consistent with historical levels. In particular we expect depreciation cost as a percentage of sales to gradually decline over our forecast period, reflecting a significant reduction in growth capital expenditure.

Table 1 on energy margins highlights the performance of the core electricity division and the correlation between energy margin and hydro output. The drought in 2013 will impact margins because of lower hydro generation.

We have undertaken a peer group comparison versus other Australasian listed electricity companies (illustrated in Table 2). Mighty River will be the third integrated electricity company listed on the New Zealand Stock Exchange after Contact Energy and TrustPower. Contact Energy has historically traded at 9.5 times EV/EBITDA while TrustPower's multiples have been slightly higher at 11 times, possibly due to stronger EBITDA growth. We think a comparison with Contact Energy is apt as both are similar in size and are domestically orientated. TrustPower, on the other hand, is increasingly pursuing opportunities in Australia through the Snowtown 2 project and we expect it to make further investments in that market overtime. Mighty River's returns and operating margins have historically been higher than those of Contact Energy and therefore it deserves to trade at a slight premium in our view. Over the next few years we expect Contact Energy's growth to be higher than that of Mighty River, mainly due to the commissioning of the Ti Mihi geothermal capacity which should result in significant cost savings and margin expansion. However, over the longer term, we think both companies have similar growth prospects. Valuation with Australian peers is not strictly comparable due to market differences, particularly the regulatory environment. Also, listed firms have significantly larger

Table 1: Energy Margin and Electricity Generation

	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
Energy Margin (NZD million)	465	458	590	534	655	685	675	724	753
% chg		-2	29	-9	23	5	-1	7	4%
Total Generation (GWh)	5564	5042	6095	5572	6597	6829	6189	6819	6921
% chg		-9	21	-9	18	4	-9	10	1%
Hydro generation	4019	3650	4350	3730	4368	4294	3928	3900	3928
% chg		-9	19	-14	17	-2	-9	-1	1%

Source: Mighty River, Morningstar estimates

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

Name	Country	EV/EBITDA 2014E	PER 2014E	Div Yield %	Payout	FCF Yield	Adjusted RoIC (6 year average)	EBIT margins (6 year average)
Mighty River (MRP)*	NZ	9.9	27.4	4.8	110	2.8	11.6	24.0
Contact Energy (CEN)	NZ	9.2	18.5	4.9	80	5.7	11.0	17.0
TrustPower (TPW)	NZ	9.9	18.1	5.2	95	-0.16	11.5	28.0
Origin Energy (ORG)	Australia	8.4	16.5	3.9	65	-4.6	9.5	11.5
AGL Energy (AGK)	Australia	6.8	11.9	3.9	48	8.2	7.0	6.8

* Based on fair value of NZD 2.70 per share. Source: Mighty River, Morningstar estimates

exposure to retail than generation and, consequently, are not as vertically-integrated as their New Zealand counterparts. Mighty River looks expensive based on the fiscal 2014 price/earnings ratio because of higher taxes and increased depreciation and interest costs. These costs should progressively decline going forward, resulting in strong underlying earnings growth. Overall we think our fair value of NZD 2.70 per share seems reasonable, based on an EV/EBITDA comparison with peers.

Economic Moat

We rate Mighty River Power as having a narrow economic moat due to cost advantages and a strong position in the oligopolistic New Zealand electricity market. Mighty River is one of the largest vertically-integrated electricity firms in New Zealand, owning significant hydro and geothermal power plants with a total generation capacity of 1700 MW and a nationwide market share of approximately 17%. The company's electricity retailing business supplies electricity to mass-market residential as well as industrial customers. We estimate its national retail market share to be approximately 20%. The New Zealand electricity market is dominated by four major players that include Mighty River (currently a state-owned enterprise) and three other vertically-integrated power companies of which two are state-owned. Mighty River and Meridian Energy have some offshore interests, while Contact Energy and Genesis have no overseas investments. In our view, Mighty River's overseas ventures in the U.S. and Chile (which account for 4.3% of total assets) are unlikely to become large enough to meaningfully impact its moat.

Retail electricity prices in New Zealand are currently not regulated and firms can set their own prices, causing some competition among the big four companies from time to time as switching costs are relatively low. However, over time, the retail market share of the big four players has more or less remained steady. Mighty River has the lowest cost structure in the industry as approximately 95% of its power is derived from lower-cost renewable sources such as hydro and geothermal. We also believe that the efficient-scale phenomenon will work in the firm's favour because potential new entrants might find the New Zealand power market insufficiently appealing due to a small population base and limited growth prospects relative to other markets globally. We therefore believe that Mighty River will continue to generate returns in excess of its cost of capital over the long run and, as such, deserves a narrow economic moat rating.

Moat Trend

Mighty River's moat trend is stable. We think the company's return on invested capital will see a modest uplift from 2014 following the completion of its capital expenditure program, which has depressed returns during the last few years. However, we don't believe this warrants a positive trend as Mighty River's cost structure versus peers is unlikely to change materially. Mighty River has significant development options at its disposal which will allow the firm to grow share of generation capacity if it so chooses, but excess industry capacity will discourage Mighty River and other electricity companies from investing in new generation for at least another five to six years. Consequently, we expect Mighty River's share of generation to remain stable for the foreseeable future. We would consider downgrading our moat and/or moat trend should the regulatory environment change, resulting in price restrictions and returns on invested capital for generators to fall to, or below, their cost of capital. Also, Mighty River's international investments could influence its moat trend depending on whether it is able to succeed abroad.

Key Risks

Tiwai Point smelter: Our forecasts do not assume the immediate closure of the Tiwai Point aluminium smelter plant, which could throw the electricity market into disarray in the near to medium term. We think there is a good chance the plant will continue operating until 2018 at least, (due to Rio Tinto's

Table 3: Key Dates

General offer opens	15 April 2013
General offer closes	3 May 2013
Institutional offer and book build	7–8 May 2013
Pricing and allocation announcements	8 May 2013
Allotments expected to be available	10 May 2013
Expected commencement of trading on NZX and ASX	15 May2013

Source: Company prospectus

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Table 4: Key Financial Information

	2010	2011	2012	2013E	2014E
Adjusted NPAT	140	162	163	159	138
EPS	0.10	0.12	0.12	0.11	0.10
Growth %	–	15.6%	0.4%	-2.2%	-13.2%
DPS	0.20	0.07	0.09	0.12	0.13
Yield*	–	–	–	4.4%	4.8%
PE*	–	–	–	23.8	27.4
EV/EBITDA*	–	–	–	13.2	9.9

*Based on fair value of NZD 2.70 per share. Source: Morningstar estimates

long-term take-or-pay contract with Meridian Energy), giving the industry time to adjust to the anticipated fall in consumption.

Transmission pricing: The government-owned Electricity Authority (EA) is currently reviewing the transmission pricing methodology. If implemented in 2015 the proposed changes may materially increase Mighty River's costs. The EA estimates the annual cost impact on Mighty River's generation assets to be NZD 65 million, with potentially further charges to the company's retail activities. These charges might not be fully passed on to residential/industrial customers, which could dampen margins.

Substantial increase in international investments: Our forecasts assume there is no significant increase in overseas ventures, the prospects for which remain unclear at this point in time. Clearly cash flows and returns would be impacted if the company steps up investments abroad and fails to derive commensurate returns from those investments. So far Mighty River has deployed NZD 250 million (or 4.3% of its total assets) overseas.

Regulatory: Wholesale and retail electricity prices in New Zealand are currently unregulated with generators and retailers free to set prices. We believe the retail market is quite competitive, as evidenced by the level of customer churn during the last few years. However, there is a risk that present or future governments could impose price regulation should they feel residential customers are being gouged by power companies. In this regard the opposition Labour Party recently announced it would regulate electricity prices if it comes to power. It intends to establish a new regulatory body call NZ Power, which will act as the single buyer of wholesale electricity with the power to set prices. NZ Power would then on-sell electricity to retailers on the basis of long-term contracts. Generators like Contact Energy and Mighty River would be paid the actual cost of generation and a fair return on their capital. Overall we believe that returns for integrated power producers could come under pressure under Labour's regime, potentially reducing the operating earnings of Mighty River by NZD 100 million. Retail competition might increase with new players entering the market, while integrated power companies could end up being less integrated as they might seek to pare their retail exposure and focus instead on achieving returns on their generation businesses.

Offer Price and Allotment to Investors

Mighty River will use an institutional bookbuild process to determine the final price on 8 May 2013. Shares will be allotted to individual and institutional investors on 10 May 2013 based on the final price of the offer. Depending on the demand for shares in the general and institutional offer, the government (which is selling down its stake from 100% to 51%) could set a price above or below the indicative price range. We believe this creates some pricing uncertainty for individuals participating in the offer. Our recommendation to subscribe to the share offer is contingent on the issue price being within the price band of NZD 2.35 to NZD 2.80 per share, which we believe will be the most likely outcome. The government has sweetened the offer by giving away bonus shares to retail investors who hold onto their shares for 24 months, equating to an additional return of approximately 2% per annum at our fair value. M