ERM Power

Update post investor day

Investor day confirms structural growth trends

Utilities

The recent investor day confirmed the opportunities we see for ERM Power from an evolving energy market, which we expect will create medium-term growth potential especially for the Energy Solutions business. In the meantime, investors will benefit from strong forecasted cash flow generation, with total free cash flow over the period FY19–21 equivalent to c 40% of the current market cap. We expect this to be allocated in a balanced way between shareholders' remuneration and growth capex.

Year end	EBITDA (A$m)	PBT* (A$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
06/17	78.4	14.7	(10.5)	7.0	N/A	3.8
06/18	97.5	43.1	12.0	7.5	15.3	4.1
06/19e	90.6	35.4	10.1	12.0	18.0	6.5
06/20e	105.6	50.3	14.5	12.0	12.7	6.5

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Structural growth trends confirmed

The investor day presentation focused on the impact of the structural growth trends on ERM Power's activities, including the development of Energy Solutions and the opportunities for power generation activities as a result of the energy transition. We maintain our view that the Energy Solutions business has the potential to develop to a sizeable business, with the mid-case of our sensitivity analysis suggesting the business can generate c 20% of group EBITDA in the medium term. In addition, we believe the high flexibility of ERM Power's generation assets is likely to benefit from increasing price volatility and increasing volumes.

Strong cash flow generation provides opportunities

In our view, a key attractiveness is the strong cash flow generation. Over the three years FY19–21 we estimate ERM will generate total free cash flow (FCF) equivalent to c 40% of the current market cap. We expect this cash flow will be used in a balanced way for shareholder remuneration and growth initiatives. We estimate total dividends and share buyback over FY19–21 equivalent to 21% of the current market cap (assuming a special dividend in FY20 and growth in ordinary dividends thereafter). ERM Power will report FY result at the end of August; we will mainly focus on the guidance for Energy Solutions and Retail as well as an update on capital allocation. Our forecasts are broadly aligned with Refinitiv consensus for FY19 (our EBITDA is 1% higher), while we see c 10% upside to consensus EBITDA for FY20–21 as we factor in growth in Energy Solutions and Electricity Retail.

Valuation: Undemanding despite recent recovery

Despite the recent share price recovery (+17% ytd), the valuation is attractive with the stock trading at undemanding earnings multiples (c 13–11x P/E in FY20–21, excluding a one-off contribution from the LGC sale) and robust cash flow generation with FCF yield of 14% a year on average in FY19–21. The dividend yield is 6.5% in FY19–20 (including the special dividend, 4.9% based on ordinary dividend only). Our SOTP valuation of A$2.4/share (A$2.8/share including a valuation for Energy Solutions) and our forecasts are unchanged.

23 May 2019

Price	**A$1.84**
Market cap	**A$463m**
Net cash (A$m) at 31 December 2018	78.6
Shares in issue	251.5m
Free float	75%
Code	EPWX
Primary exchange	ASX
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	4.3	12.0	1.1
Rel (local)	0.4	6.0	(5.8)
52-week high/low		A$1.99	A$1.30

Business description

ERM Power is an Australian commercial and industrial energy retailer and trader founded in 1980 and listed in 2010. It operates an electricity supply business (second-largest retailer to C&I customers) and two gas-fired generation plants. A key area of growth is energy solutions.

Next events

FY results	August (tbc)

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Edison profile page

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Evolving market creates opportunities

The recent investor day confirmed the opportunities we see for ERM Power from an evolving Australian energy market. In particular, we believe that delivery of growth for the Energy Solutions business would provide evidence of the growth potential of the company and would result in a strong catalyst for a re-rating on higher multiples.

Investor day focuses on opportunities from energy transition

ERM Power held an investor day on 14 May, which provided an update on its activities, strategy and growth opportunities. The presentation focused on the impact of energy transition on ERM Power's activities and the implications for its power generation, energy retail and energy solutions businesses. Overall, we believe the growth trends identified by the company are consistent with our forecasts and growth outlook for the company. We provide more details below.

- **Energy Retail and Energy Solutions:** With the emergence of new technologies, and the need to increase energy efficiency and adopt more sustainable solutions, sophisticated commercial and industrial (C&I) customers, which represent the core business of ERM Power, increasingly require a comprehensive energy service in addition to the delivery of the physical commodity. In its investor day presentation, ERM Power has highlighted that for a typical C&I customer paying A$150/MWh for its electricity, Energy Solutions can secure net benefits ranging from A$8/MWh to A$20/MWh (A$30/MWh, or 20% of their costs, before capital costs associated with the required investment). While, according to ERM Power, the company may lose part of its Electricity Retail margin (20% or A$1/MWh out of c A$5/MWh) as a result of the lower customer consumption, the company is likely to achieve a significant net increase in profits thanks to the sharing with the customer of the A$8–20/MWh saving. Energy Solutions is at an early stage of development and we have previously estimated the potential for this business. We set out the up-to-date analysis in Exhibit 1, which shows that in a mid-case this business development could drive significant growth, with 21% growth in group EBITDA in the medium term (vs FY22e). Our published forecasts currently assume the mid-case EBITDA is achieved in FY24.

Exhibit 1: Energy Solutions – medium-term EBITDA potential

Addressable mkt size	A$m					1,000				
Mkt share	%			5%			13%			20%
Revenue	A$m			50			125			200
Gross profit margin	%	30%	40%	50%	30%	40%	50%	30%	40%	50%
Gross profit	A$m	15	20	25	37.5	50	62.5	60	80	100
Opex	A$m	20	20	20	25	25	25	30	30	30
EBITDA	A$m	-5	0	5	12.5	25	37.5	30	50	70
% of 2022e group EBITDA	**%**	**-4%**	**0%**	**4%**	**10%**	**21%**	**31%**	**25%**	**41%**	**58%**

Source: Edison Investment Research

- **Power generation:** ERM Power sees long-term opportunities for its power generation portfolio, which is expected to benefit from the evolving market conditions thanks to its flexibility. The Neerabup and Oakey Power plants are open-cycle gas turbine (OCGT) plants, with total installed capacity of 662MW (of which ERM Power has 497MW equity ownership) generating c 40% of FY19 group EBIT, on our estimates. ERM Power's generation assets are highly flexible, with high availability and fast start times, which should allow the company to capture the opportunities from increasing volatility in wholesale electricity prices as a result of growing renewable installed capacity (wind and solar are intermittent sources of generation) and from reducing production from coal-fired plants (regulation and ageing plants are likely to result in significant closures). In particular, Oakey is very exposed to this trend as it is 100% merchant, while Neerabup has more limited exposure to merchant activities.

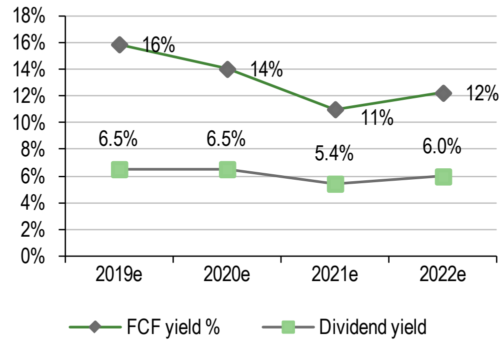
Although the regulatory environment remains uncertain, on our estimates, by FY35 c 70% of Australia's current coal-fired power plant capacity will have reached 50 years of age. In our view, the levels of investment needed to continue to generate, combined with likely stricter environmental regulations in the longer term, are unlikely to allow the operation of the plants beyond this limit.

We currently assume a moderate increase in profits for this business, with a 2% EBITDA CAGR FY19–22 but see risks to our forecasts as skewed to the upside.

Three-year cash flow equivalent to c 40% of market cap

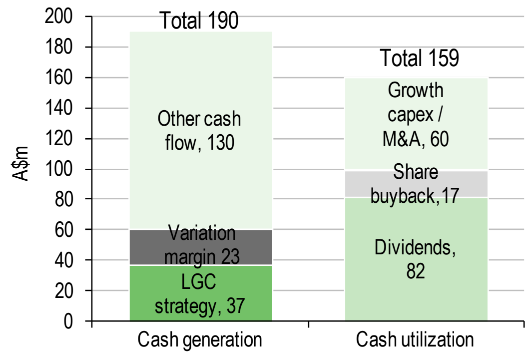
We forecast strong cash flow generation with an average FCF yield of 14% in FY19–21. The strong cash flow generation is driven by healthy margins in the supply and power-generation activities and one-off cash inflow from the sale of its portfolio of large-scale generation certificates (LGC). We estimate total A$190m free cash flow in FY19–21, before M&A and growth capex, equivalent to 41% of the current market cap. On top of this, A$37m was raised at the end of 2018 with the disposal of the US business. We expect this cash flow will be used in a balanced way for shareholder remuneration and growth initiatives. We estimate total dividends and share buyback over the period of A$99m, equivalent to 21% of the current market cap (assuming a special dividend in FY20 and growth in ordinary dividends thereafter). On our estimates, the free cash flow yield will easily cover the high dividend yield (Exhibit 2). In addition, the company has announced that A$60m has been reserved for growth initiatives (not included in our forecasts); we expect this will be used mainly for acquisitions by the Energy Solutions business. As shown in Exhibit 3, the cash flow generation we forecast is higher than expected cash flow utilisation, which leaves more room for dividends and/or growth capex, also considering the strong financial structure of the company (net cash at H119).

Exhibit 2: FCF yield vs. dividend yield for ERM Power



Source: Edison Investment Research

Exhibit 3: FY19-FY21e cash flow generation/ utilisation



Source: Edison Investment Research

As sensitivity, a A$1/MWh increase or decrease in Electricity Retail gross margin per unit sold (equivalent to c 20% of current margin) would increase or decrease group FCF yield by c 2.5 percentage points. As a result, FCF yield would comfortably cover the dividend yield even with a rather large reduction in retail margins.

What to focus on at the FY19 results

ERM Power will report full year results at the end of August. At H1 results in February the company sent a strong signal of confidence with the announcement of a c 30% dividend hike (from 7c to 9c), the introduction of an additional special dividend of A$0.03/share for FY19 (another special dividend will be considered for FY20, with an update by the H120 results), A$60m reserved for growth investments, a c 10% higher medium-term outlook for margins per MWh for its core Electricity Retail business (from a range of A$4.00–5.50/MWh to A$4.50–6.00/MWh). The only slightly negative trend was that the FY19 outlook for the Energy Solutions business was confirmed despite the contribution from the recent acquisition of Out Performers.

Following the positive update at H1 results, at the FY results we will focus on the outlook for:

- **Electricity Retailing:** ERM Power guided for A$5.1/MWh unitary gross margin for FY19 and A$4.50–6.00/MWh (FY20–21). We expect narrower guidance for FY20 and we currently assume a A$5.25/MWh gross margin and a small pick-up in volumes (18.8TWh, +4% y-o-y), based on growing forward sales disclosed at H1.
- **Energy Solutions:** at H1 ERM Power confirmed the FY20 target of a positive net income contribution. We currently assume a €1m positive net income contribution in FY20 (vs negative €3m in FY19).
- **Power generation:** we forecast a A$16m EBITDA for Oakey and A$27m for Neerabup in FY20.
- **Capital allocation:** we expect more details on the A$60m reserved for organic and inorganic growth investments and an update on the A$15m share buyback programme. In addition, we will also look for signals on whether the A$0.03/share special dividend will be repeated in FY20, although the company is more likely to wait to confirm this until it has more visibility at H120 results.

Valuation: Attractive FCF and dividend yields

In our view, the valuation for ERM Power remains compelling, despite the recent share price recovery (+17% ytd). The stock trades at undemanding earnings multiples (c 13–11x P/E in FY20–21, excluding a one-off contribution from the LGC sale). The cash flow generation is robust with a FCF yield of 14% a year on average in FY19–21, which is attractive also considering that a good portion of the cash flow is paid in dividends: the dividend yield is 6.5% if FY19–20 (including the special dividend, 4.9% based on ordinary dividend only).

Excluding Energy Solutions (which is loss making and generating negative cash flow), our base case valuation is unchanged at A$2.4/share (based on a DCF-based SOTP valuation with an 11% WACC). Including a valuation for the Energy Solutions business, which has not yet reached break-even but has strong growth prospects in our view, would increase the SOTP valuation to A$2.8/share based on a multiples valuation.

Key risks to our valuation and investment case are higher or lower supply and power-generation margins in Australia and higher or lower growth in Energy Solutions.

Exhibit 4: Financial summary

Accounts: IFRS; year end 30 June; A$m	2016	2017	2018	2019e	2020e	2021e
INCOME STATEMENT						
Total revenues	2,691	3,127	2,047	1,966	2,047	2,078
Cost of sales	(2,620)	(3,049)	(1,950)	(1,876)	(1,941)	(1,963)
Gross profit	71	78	98	91	106	115
SG&A (expenses)	0	0	0	0	0	0
R&D costs	0	0	0	0	0	0
Other income/(expense)	0	0	0	0	0	0
Exceptionals and adjustments	(5)	0	0	0	0	0
Depreciation and amortisation	(25)	(38)	(30)	(29)	(30)	(31)
Reported EBIT	40	41	67	62	76	84
Finance income/(expense)	(23)	(26)	(24)	(26)	(26)	(25)
Other income/(expense)	0	(0)	0	0	0	0
Exceptionals and adjustments	39	36	(34)	8	21	0
Reported PBT	57	51	9	44	71	59
Income tax expense (includes exceptionals)	(22)	(52)	(90)	(11)	(15)	(17)
Reported net income	36	(1)	(81)	33	56	41
Basic average number of shares, m	242	244	244	240	237	237
Basic EPS (A$)	0.15	(0.00)	(0.33)	0.14	0.24	0.17
DPS (A$)	0.120	0.070	0.075	0.120	0.120	0.100
Adjusted EBITDA	71	78	98	91	106	115
Adjusted EBIT	46	41	67	62	76	84
Adjusted PBT	23	15	43	35	50	59
Adjusted EPS (A$)	0.08	(0.11)	0.12	0.10	0.15	0.17
Adjusted diluted EPS (A$)	0.08	(0.10)	0.12	0.10	0.14	0.17
BALANCE SHEET						
Property, plant and equipment	391	391	391	358	350	341
Goodwill	0	0	0	0	0	0
Intangible assets	79	89	38	38	38	38
Other non-current assets	59	116	43	43	43	43
Total non-current assets	529	597	473	440	432	423
Cash and equivalents	192	245	228	282	317	340
Inventories	22	42	82	79	82	83
Trade and other receivables	331	361	320	323	336	341
Other current assets	164	331	258	106	106	106
Total current assets	709	979	888	789	841	870
Non-current loans and borrowings	184	181	177	177	177	177
Other non-current liabilities	161	287	160	168	168	168
Total non-current liabilities	345	467	337	344	344	344
Trade and other payables	367	464	424	448	464	469
Current loans and borrowings	37	8	160	160	160	160
Other current liabilities	18	70	191	39	39	39
Total current liabilities	422	543	774	647	662	667
Equity attributable to company	471	566	250	238	266	281
Non-controlling interest	0	0	0	0	0	0
CASH FLOW STATEMENT						
EBIT	40	41	67	62	76	84
Depreciation and amortisation	16	53	32	29	30	31
Share based payments	0	0	0	0	0	0
Other adjustments	60	69	(119)	0	0	0
Movements in working capital	0	0	0	25	(1)	(1)
Interest paid / received	3	3	3	3	4	5
Income taxes paid	(0)	(14)	(27)	(11)	(15)	(17)
Cash from operations (CFO)	120	152	(43)	109	94	101
Capex	(26)	(40)	(49)	(21)	(20)	(20)
Acquisitions & disposals net	12	26	6	25	(2)	(2)
Other investing activities	(9)	(6)	(0)	0	0	0
Cash used in investing activities (CFIA)	(24)	(20)	(44)	4	(22)	(22)
Net proceeds from issue of shares	0	0	(3)	(17)	0	0
Movements in debt	(22)	(24)	140	0	0	0
Dividends paid	(28)	(23)	(17)	(28)	(28)	(26)
Other financing activities	(27)	(33)	(38)	(14)	(9)	(30)
Cash from financing activities (CFF)	(76)	(79)	82	(58)	(37)	(56)
Currency translation differences and other	0	0	0	0	0	0
Increase/(decrease) in cash and equivalents	20	53	(5)	54	35	23
Currency translation differences and other	0	(1)	(12)	0	0	0
Cash and equivalents at end of period	192	245	228	282	317	340
Net (debt) cash	(29)	56	(109)	(54)	(20)	4
Movement in net (debt) cash over period	(29)	85	(164)	54	35	23

Source: Company data, Edison Investment Research

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