ERM Power

FY18 results update

Upcoming US business disposal is positive news

Utilities

In the context of the FY18 results (23 August), ERM Power announced its intention to sell US supply activities, which we view as very positive, as we expect this business to continue to generate significant negative profit and cash flow. On an underlying basis, FY18 EBITDA was 12% better than expected, while net income was in line with our forecast. On the negative side, the company moved from a net cash position to a net debt position as a result of cash outflows related to derivatives variation margins. Overall, we see the announcement of the US business sale as a major positive catalyst and expect the stock to reverse the negative share price performance since the US outlook downgrade at the end of May.

Year end	EBITDA (A$m)	PBT* (A$m)	EPS* (A$)	DPS (A$)	P/E (x)	Yield (%)
06/17	78.4	51.7	(0.11)	0.070	N/A	4.5
06/18	97.5	43.1	0.12	0.075	12.9	4.8
06/19e	93.4	36.9	0.11	0.080	14.4	5.2
06/20e	103.5	46.4	0.14	0.080	11.4	5.2

Note: *PBT and EPS are normalised and from continuing operations (ex-US), excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Intention to sell US business a positive

ERM Power announced its intention to sell its entire US business by 31 December 2018 and that the process is "well advanced". We view the news very positively as: 1) ERM Power has struggled to improve the financial performance of this business over the past few years and unitary margins have reduced significantly; 2) we expect the business to generate A$20m+ negative cash flow and a similar negative impact on group net income in FY19, with a large impact on the group; and 3) the recent US outlook downgrade drove large share price underperformance (-27% since May to 22 August).

FY18 underlying EBITDA strong; cash flow weaker

On an underlying and continuing basis (ex-US), FY18 EBITDA was 12% higher than we expected, driven by stronger Australian supply and power generation, although the beat was offset at net income by higher D&A, financial expenses and taxes. DPS of A$7.5 cents was 7% higher than we forecast, although net debt of A$109m was worse than our expectations due to a large cash outflow related to derivatives variation margins. The outlook for FY19 was broadly in line with our expectations. On an underlying continuing basis, we increased FY19–21 EBITDA by 1–5%, although net income reduces 7–24% due to higher non-cash charges (higher D&A).

Share price rebound likely to continue

Even after the share price rebound post-FY18 results, we believe the stock trades on undemanding multiples, with FY19e P/E of 14.4x reducing to 9.5x in FY21e. Our base case SOTP value is A$2.3/share (ex-US and loss-making Australian energy solutions business), down from A$2.6/share due to higher net debt. We expect the stock to recover the negative performance since the US outlook downgrade in May.

30 August 2018

Price	**A$1.55**
Market cap	**A$377m**

Net debt (A$m) at 30 June 2018	108.7
Shares outstanding at end FY18	243.3m
Free float	75%
Code	EPWX
Primary exchange	ASX

Share price performance

%	1m	3m	12m
Abs	1.0	(0.3)	9.5
Rel (local)	0.0	(5.5)	(2.7)
52-week high/low		A$1.9	A$1.3

Business description

ERM Power is an energy retailer and trader founded in 1980 and listed in 2010. In Australia 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, while the company has announced its intention to sell its US business.

Next events

Disposal of US business	Before 31 December 2018
H1 results	February 2019

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Intention to sell US business is positive news

US business to be sold before 31 December 2018

In our view, the key news was the announcement of the intention to sell its entire US activities. We view the disposal as very positive as we expect the business to continue to be loss-making (we forecast a A$23m net loss in FY19) and generating negative cash flow (we expect A$22m negative cash flow generation in FY19). ERM Power has struggled to improve the financial performance of this business since the acquisition in 2015, with unitary margins declining sharply from A$6.2/MWh in FY16, to A$3.3/MWh in FY18 and despite large volume growth. The outlook for the US business was significantly downgraded at the end of May 2018, precipitating a significant share price underperformance. The stock is down 27% over the period from the day before the US downgrade announcement (24 May) to the day before the US sale announcement (22 August); hence, we expect the disposal news to drive a reversal in share price performance. In terms of timing, ERM Power said that the disposal process is "well advanced" and it is expected to be concluded by the end of calendar year 2018. The business was acquired for US$16m (including financing of working capital) in FY16; we currently include no value in our base case group SOTP valuation. We view this announcement and the eventual sale of the business as major catalysts for share price recovery and expect a reversal of the recent share price underperformance.

FY18 results: Underlying EBITDA ahead, net income in line, worse net debt

Overall, excluding exceptional items and contribution from the US business (now classified as held for sale), ERM Power reported underlying FY18 profits in line with or above our expectations, although cash flow was weaker. More in detail:

- **EBITDA of A$97.5m, +25% y-o-y** was 12% higher than our previous forecast (adjusted to exclude the US contribution, now accounted as held for sale) of A$86.9m, driven by better margins in the Australian supply business (A$71.9m EBITDA vs our forecast of A$66.3m; A$4.9/MWh gross margin was higher than our forecast of A$4.7/MWh) and stronger contribution from the power-generation business (A$43.8m EBITDA vs our forecast of A$39.1m, thanks to good merchant activity). EBITDA contribution from energy solutions was broadly in line with our expectations, although this was based on significantly higher margins than we expected (60% gross profit margin vs our expectation of 41%) applied to lower revenues than our forecasts – this can be explained by a higher weight in the business mix of the high-margin advisory services.
- **Underlying net profit from continuing operations (ex-US) of A$30.2m** was broadly in line with our forecast ex-US (A$30.5m) as the beat at EBITDA was offset by higher D&A, financial expenses and taxes than we expected.
- **Net debt of A$108.7m** vs a net cash position of A$55.7m one year earlier and compared to our expectation of a net cash position of A$40m. The financial position was negatively affected by a large cash outflow as a result of the negative variation margin from derivatives. As ERM Power is a net buyer of derivatives, the recent decrease in energy prices drove a reversal of the positive cash inflow of the periods FY16 and FY17 (when prices increased). Excluding non-recourse debt associated with the Neerabup power plant, ERM Power still had a net cash position of A$64m.
- **DPS of A$7.5 cents, up 7% y-o-y** and 7% higher than our forecast of an unchanged DPS.

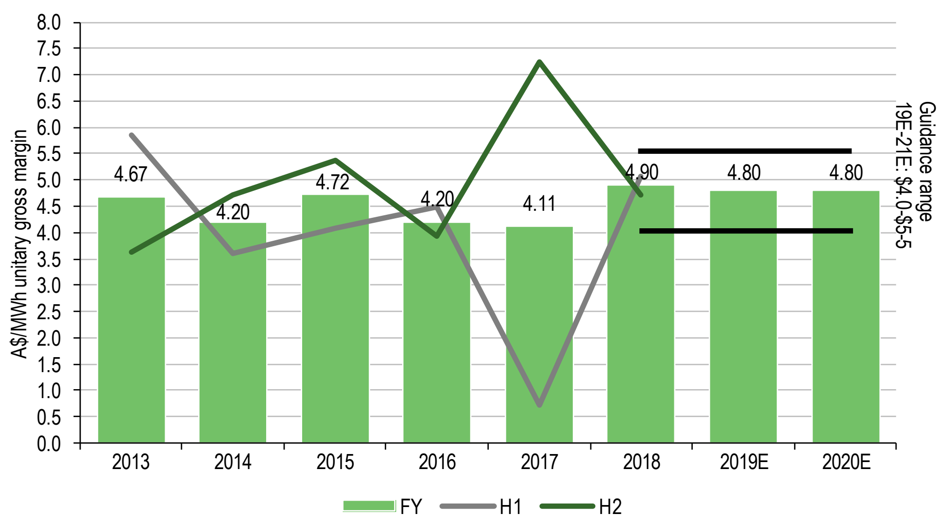
On a reported basis, ERM Power achieved a statutory net loss (including the US) of A$80.7m (vs our forecast for a net profit of A$7.7m), driven by exceptional items (unrealised net fair value losses of $76.4m on financial instruments designated at fair value through profit and loss, and the loss from US discontinued operations of $34.0m).

FY19 outlook broadly consistent with our expectations

Apart from the unexpected announcement of the intention to sell the US business by the end of 2018, the FY19 outlook for the rest of the group was broadly consistent with our expectations. More in detail:

- **Australian supply:** ERM Power guides for a 2019 margin of A$4.75/MWh (broadly consistent with our previous forecast of A$4.7/MWh) and maintains the medium-term target range of A$4.0–5.5/MWh (FY19–FY21).

Exhibit 1: Evolution of Australian unitary gross margins and volumes



Source: ERM Power data, Edison Investment Research

- **Generation:** ERM Power guides for A$26m EBITDA for the Neerabup power plant and A$14–16m EBITDA for the Oakey power plant, which are both in line with our forecasts.
- **Energy solutions:** ERM Power guides for c 50% revenue growth (vs A$18.9m revenues in FY18), which was slightly lower than our forecast of +60%. ERM Power also guides for an FY19 EBITDA loss of A$2.5m, which is worse than the A$0m we expected (although a small impact in the context of the group). ERM Power reiterated that the business is expected to generate positive EBITDA and NPAT by FY20. We have assessed the earnings growth potential of this division in detail in the note US update and focus on energy solutions, published on 2 July 2018. Based on our sensitivity analysis, we previously estimated that the medium-term development of the energy solutions activities could drive up to 40% growth in group EBITDA and 16% in a mid-case scenario.
- **D&A and financial expenses:** below EBITDA, ERM Power guided for a similar increase in D&A in FY19 to the one occurred in FY18 (ie c A$3m) and for financial expenses broadly in line with FY18 (A$24m).
- **Capital allocation:** ERM Power confirmed the framework previously announced (surplus capital, in excess of the $40m spending budgeted for financing organic and inorganic growth opportunities, to be distributed to shareholders). A A$20m share buyback programme is underway and was confirmed (only A$2.8m has been completed; the rest of the shares will be

purchased after the sale of the US business). ERM Power said it will consider "further distributions/change to dividends" after H119 and following the sale of the US business. Because of the cash outflow related to the variation margin of the derivatives, overall we see less balance sheet headroom now than we previously expected. We continue to include only the announced A$20m share buyback programme and no additional shareholder remuneration.

Forecasts update: Higher EBITDA, lower net income, higher net debt

We have updated our forecasts, which now reflect the US business accounted as held for sale. We provide an overview of our forecast changes in Exhibit 2. Although FY19–21 EBITDA forecasts increase by 1–5%, underlying net income reduces by 7–24%, almost entirely driven by non-cash costs (higher D&A). We have also reflected in our forecasts the negative cash flow generation of FY18 and now expect the reported net debt of A$109m in FY18 to reduce to A$21m in FY21, thanks to cash flow generation.

Exhibit 2: Key forecast changes

	New forecasts				Old forecasts (ex-US)				Forecast changes (%)			
(A$m)	**2018**	**2019e**	**2020e**	**2021e**	**2018**	**2019e**	**2020e**	**2021e**	**2018**	**2019e**	**2020e**	**2021e**
Revenues	2,047	2,068	2,124	2,151	2,832	2,886	2,950	2,979	(28)	(28)	(28)	(28)
EBITDA	**98**	**93**	**103**	**112**	**87**	**92**	**100**	**107**	**12**	**1**	**3**	**5**
Electricity retail AUS	72	72	74	73	66	68	70	70	8	5	5	5
Power generation	44	40	41	42	39	39	40	40	12	2	4	6
Energy solutions	(4)	(3)	5	13	(4)	0	6	14	(10)	NA	(27)	(4)
Corporate	(15)	(16)	(16)	(17)	(15)	(15)	(16)	(16)	1	7	3	3
EBIT	**67**	**61**	**70**	**78**	**61**	**66**	**73**	**80**	**11**	**(9)**	**(5)**	**(2)**
PBT	**43**	**37**	**46**	**56**	**40**	**45**	**52**	**60**	**8**	**(18)**	**(12)**	**(7)**
Underlying net income from continuing operations*	**30**	**26**	**33**	**39**	**30**	**34**	**38**	**42**	**(1)**	**(24)**	**(15)**	**(7)**
Statutory net income, incl. discontinued operations*	(81)	13	49	40	8	21	55	42	NA	(39%)	(10%)	(7%)

Source: ERM Power data, Edison Investment Research. Note: *Excludes expected profits on the large scale generation certificates market, which we estimate at a total of A$40m after-tax in FY19-20.

We now forecast EBITDA to decline slightly in FY19 (-4%, due to non-repeat of strong performance of the power generation merchant activity) with growth thereafter (+11% in FY20 and +8% in FY21), driven mainly by the energy solutions business. At the net income level, following an expected decline in FY19 to A$26m, we expect strong growth thereafter of c 50% to A$39m in FY21.

Valuation of A$2.3/share implies significant further upside

We value ERM Power using a sum-of-the-parts approach, which we believe allows us to capture the different risk profile and asset life of the various activities. We value the various divisions mostly with DCF valuations (with an average WACC of c 11%) and we back-test this approach by comparing the implied valuation multiples with comparable companies for each activity. Our base case SOTP valuation is A$2.3/share (reducing from A$2.6/share, reflecting higher net debt). Even significant share price appreciation following the FY18 results implies significant upside vs the current share price. This valuation excludes any value for US activities and energy solutions, which are currently loss-making and generating negative cash flow. Including a valuation for the energy solutions business, which, although has not reached break-even yet, has strong growth prospects in our view, would increase the SOTP valuation to A$2.9/share (vs $3.2/share before; the decrease is driven by higher net debt). Our initiation note, Offering solutions to corporate energy challenges, published on 29 March 2018, includes more detail on our valuation methodology.

Key risks to our valuation and investment case are higher/lower supply and power-generation margins in Australia, higher/lower supply margins in the US, and higher/lower growth in energy solutions.

Exhibit 3: Financial summary

Accounts: IFRS, year-end June, A$m	2016	2017	2018	2019e	2020e	2021e
Income statement						
Total revenues	2,691	3,127	2,047	2,068	2,124	2,151
Cost of sales	(2,620)	(3,049)	(1,950)	(1,974)	(2,021)	(2,039)
Gross profit	71	78	98	93	103	112
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)	(33)	(34)	(34)
Reported EBIT	40	41	67	61	70	78
Finance income/(expense)	(23)	(26)	(24)	(24)	(23)	(23)
Other income/(expense)	0	(0)	0	0	0	0
Exceptionals and adjustments	39	37	0	0	0	0
Reported PBT	57	52	43	37	46	56
Income tax expense (includes exceptionals)	(22)	(52)	(90)	(1)	16	(17)
Reported net income	36	(1)	(81)	13	49	40
Basic average number of shares, m	242	244	244	238	233	233
Basic EPS	0.15	(0.00)	(0.33)	0.05	0.21	0.17
Adjusted EBITDA	71	78	98	93	103	112
Adjusted EBIT	46	41	67	61	70	78
Adjusted PBT	23	15	43	37	46	56
Adjusted EPS	0.08	(0.11)	0.12	0.11	0.14	0.17
Adjusted diluted EPS	0.08	(0.10)	0.12	0.11	0.14	0.16
DPS	0.120	0.070	0.075	0.080	0.080	0.090
Balance sheet						
Property, plant and equipment	391	391	393	392	395	400
Goodwill	0	0	0	0	0	0
Intangible assets	79	89	89	89	89	89
Other non-current assets	59	116	116	116	116	116
Total non-current assets	529	597	599	598	600	606
Cash and equivalents	192	245	80	113	154	168
Inventories	22	42	28	28	29	29
Trade and other receivables	331	361	236	239	245	248
Other current assets	164	331	331	331	331	331
Total current assets	709	979	676	710	760	777
Non-current loans and borrowings	184	181	181	181	181	181
Other non-current liabilities	161	287	253	276	290	289
Total non-current liabilities	345	467	434	457	470	470
Trade and other payables	367	464	297	331	339	342
Current loans and borrowings	37	8	8	8	8	8
Other current liabilities	18	70	70	70	70	70
Total current liabilities	422	543	376	409	417	420
Equity attributable to company	471	566	465	442	473	493
Non-controlling interest	0	0	0	0	0	0
Cash flow statement						
EBIT	40	41	67	61	70	78
Depreciation and amortisation	16	53	30	33	34	34
Share based payments	0	0	0	0	0	0
Other adjustments	60	69	(119)	0	0	0
Movements in working capital	0	0	(18)	31	1	(0)
Interest paid / received	3	3	4	1	2	2
Income taxes paid	(0)	(14)	(24)	(11)	(14)	(17)
Cash from operations (CFO)	120	152	(59)	115	92	97
Capex	(26)	(40)	(32)	(32)	(37)	(39)
Acquisitions & disposals net	12	26	0	0	0	0
Other investing activities	(9)	(6)	0	0	0	0
Cash used in investing activities (CFIA)	(24)	(20)	(32)	(32)	(37)	(39)
Net proceeds from issue of shares	0	0	(3)	(17)	0	0
Movements in debt	(22)	(24)	0	0	0	0
Dividends paid	(28)	(23)	(17)	(18)	(19)	(20)
Other financing activities	(27)	(33)	(30)	(15)	5	(25)
Cash from financing activities (CFF)	(76)	(79)	(51)	(50)	(13)	(45)
Currency translation differences and other	0	0	0	0	0	0
Increase/(decrease) in cash and equivalents	20	53	(142)	32	42	14
Currency translation differences and other	0	(1)	(23)	0	0	0
Cash and equivalents at end of period	192	245	80	113	154	168
Net (debt) cash	(29)	56	(109)	(76)	(35)	(21)
Movement in net (debt) cash over period	(29)	85	(164)	32	42	14

Source: ERM Power data, Edison Investment Research

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