

# ERM Power

## US update and focus on energy solutions

Update and FY results  
preview

Utilities

ERM Power's strategy is focused on sustaining growth in its cash-generative core Australian activities while developing two new growth areas: energy solutions and US supply. While we have reduced our short-term forecasts for the US activities to reflect lower margins and volumes, as guided by the company, we have increased our forecasts for energy solutions on the back of our new assessment following a recent investor briefing. Our analysis suggests this business could drive up to 40% growth in group EBITDA in the medium term (16% mid-case). Overall, our FY18-21e EBITDA forecasts change by -6%, -14%, -9% and +7% respectively. Our base case valuation, which includes core Australian business only, is unchanged at A\$2.6/share.

Year end	EBITDA (A\$m)	PBT* (A\$m)	EPS* (A\$)	DPS (A\$)	P/E (x)	Yield (%)
06/17	78	15	(0.11)	0.07	N/A	4.8
06/18e	84	11	0.03	0.07	45.0	4.8
06/19e	93	16	0.05	0.07	30.8	4.8
06/20e	117	36	0.11	0.07	13.9	4.8

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

## Focus on energy solutions; lower US forecasts

ERM Power's energy solutions business provides value-added services to its commercial and industrial (C&I) supply customers, including solutions to improve energy efficiency, reduce costs and improve customers' environmental footprint. Based on our analysis following an investor briefing, we estimate 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. We have increased our medium-term forecast for energy solutions, but reduced the short-term estimates for the US activities following the latest trading update, which guided for lower margins and volumes. Overall our FY18-21 EBITDA forecasts change by -6%, -14%, -9% and +7% respectively.

## Next catalyst is FY18 results

We believe the next catalyst for ERM Power is the FY18 results presentation on 23 August. We now forecast FY18 underlying EBITDA of A\$84m, underlying NPAT of A\$8m and DPS of A\$0.07. We expect ERM Power to provide more details on the challenges/outlook for the US activities, as well as updated expectations for core Australian supply activities. Furthermore, as ERM Power is in a net cash position, we see room for additional balance sheet redeployment, including acquisitions and/or a continuation beyond 2018 of the recently announced A\$20m share buyback programme.

## Valuation: Base case unchanged at A\$2.6/share

Our base case SOTP valuation is unchanged at A\$2.6/share (excluding any value for US activities and energy solutions), implying significant upside following recent share price weakness (post the trading update downgrading the outlook for the US). Including a valuation for energy solutions and the US, and taking into account updated forecasts for these divisions, our SOTP would increase to A\$3.2/share.

01 July 2018

**Price** **A\$1.46**  
**Market cap** **A\$364m**

Net cash (A\$m) end FY18e	40.0
Shares in issue	249.6m
Free float	75%
Code	EPWX
Primary exchange	ASX
Secondary exchange	N/A

## Share price performance



%	1m	3m	12m
Abs	(4.9)	(17.6)	20.5
Rel (local)	(7.8)	(23.0)	10.8
52-week high/low	A\$1.9	A\$1.2	

## 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. Key areas of growth are the US electricity retail market (entered in 2015) and energy solutions.

## Next events

FY18 results	23 August 2018
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## Analysts

Dario Carradori	+44 (0)20 3077 5700
Graeme Moyse	+44 (0)20 3077 5700

[industrials@edisongroup.com](mailto:industrials@edisongroup.com)

[Edison profile page](#)

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## Forecasts update and focus on energy solutions

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ERM's strategy is focused on delivering continued medium-term growth in its core Australian electricity supply and production activities, while at the same time expanding in new growth markets and areas: energy solutions and US supply. While Australian supply and power production currently generate all the group's cash flow, ERM Power expects the growth to come from US retail (a business which ERM Power entered in 2015) and energy solutions, the most innovative product offering of the group. In its latest trading update, ERM Power has stated that activities in Australia are performing in line or better than management expectations in FY18 (in line for FY19), while the short-term outlook for the US activities has been reduced. We have updated our forecasts to reflect lower contribution from the US but higher estimates for energy solutions (forecasts for other Australian activities are broadly unchanged), on the back of our analysis following an investor briefing, which has provided new elements on the growth potential of the division. We estimate that the medium-term development of the business could drive up to 40% of group EBITDA and 16% in a mid-case scenario (12.5% market share and 40% gross profit margin). The next catalyst for ERM Power is the FY18 results presentation on 23 August. We expect the company to provide more details on the challenges and outlook for the US activities, as well as updated guidance for the core Australian electricity supply activities.

## FY18 results to provide update on US/Australian supply

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ERM Power will present FY18 results on 23 August. We believe key investor focus will be on:

**FY18 results:** we now forecast FY18 underlying EBITDA of A\$84m, +8% y-o-y, underlying NPAT of A\$8m (vs -A\$26m in FY17) and DPS of 7 Australian cents (stable y-o-y; H2 DPS 3.5c). For our previous forecasts and forecasts changes, see Exhibit 5.

**Australian supply outlook:** current guidance for FY18 gross supply margin is A\$4.7/MWh "with upside potential" and A\$4.0-5.5/MWh in the medium term. In its latest trading update, released at the end of May 2018, ERM Power said Australian activities were performing in line or better than expectations in FY18 and in line for FY19.

**US supply outlook:** we expect ERM Power to provide more details on current challenges, which led the company to materially reduce the outlook for unitary gross margins to A\$3.7/3.3/MWh respectively for FY18/19 in its latest trading update.

**Balance sheet capacity:** we forecast that ERM Power will be A\$40m net cash positive at end FY18 (non-recourse debt in power generation assets is more than offset by the cash in the holding), and see room for additional balance sheet redeployment, including acquisitions and/or a continuation beyond 2018 of the recently announced A\$20m share buyback programme.

## Focus on energy solutions

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We have assessed the earnings growth potential of ERM Power's recently launched division, Energy Solution, on the back of the company's Investor Day on 29 May. Based on the information provided, we have built a sensitivity analysis to illustrate the potential positive impact on earnings of the growth in this new business.

## Market context: New technology and client demand create business opportunity

The energy market in Australia (and globally) is undergoing significant transformation as a result of the energy transition, the emergence of new technology, and customers' demand for higher energy efficiency and sustainable solutions. Sophisticated C&I customers, who represent the company's core business, increasingly require a comprehensive energy service in addition to delivery of the physical commodity, with the objective of reducing costs and consumption and improving their environmental footprint. All of these trends are supported by more stringent government regulations (eg energy efficiency, renewables growth and carbon reduction), an increase in electricity costs for commercial and industrial customers, and corporates' desire to target a reduction in carbon emissions to reduce costs and achieve sustainability targets.

## Product offering: Track, Advise and Deliver

ERM's product offering includes the following services:

- **Track (20% of business mix):** tools and digital platforms to monitor, measure and verify energy consumption, visualize data, receive data management alerts, and data insights and optimisation solutions.
- **Advise (20%):** advisory services with the support of data analytics aimed at providing integrated energy solutions and action planning to implement energy efficiency investments.
- **Deliver (60%):** product sourcing, equipment installations and partnerships with customers.

ERM power highlighted that a key achievement over the last few years was to increase the proportion of revenues from multi-product deals (to >50% in FY18e from 0% in FY16), as opposed to single-product deals and to increase the proportion of revenue from projects over A\$100k (to c 90% in FY18e from less than 50% in FY16).

## Competitive landscape: ERM Power's key strengths amid high competition

Currently, the energy services industry is fragmented and dynamic, with new players that have recently entered the markets. We believe ERM Power faces significant competition from the following:

- global technology players such as Schneider Electric, Siemens, Signify (previously Philips Lighting) and global utility/energy services companies such as Veolia, GDF SUEZ and Vinci;
- local utility players such as AGL, Origin Energy and Energy Australia;
- energy savings consultancy and technology installation companies such as AECOM, Airmaster, City Holdings, Conservia, Ecosave, Energetics, Energy Action, Norman Disney & Young, Total Energy Solutions, Verdia, and Vivid Illuminate/Vivid Industrial; and
- local renewable plant providers to commercial/industrial users, such as solar installation companies Todae Solar, Cherry Energy Solutions, Solgen Energy Group.

In this highly competitive environment, we see the following competitive advantages for ERM Power:

1. **It already has a large client base** to which it can cross-sell its energy solutions (although its offer is not limited to these clients), as ERM Power is the second largest retailer to commercial and industrial customers in Australia, with 22% market share in FY17. ERM Power has very good visibility on its customers' energy consumption data.
2. **It provides a fully comprehensive service** (auditing of energy costs/consumption through data science and analytics, development of tailored integrated solutions, sourcing and installation of multiple products such as solar PV plants, LEDs, etc, performance monitoring,

and finance and funding solutions), rather than just focusing on one category of products like several specialized competitors.

3. **It has an established brand with strong reputation:** number one in both customer satisfaction – Utility Market Intelligence (UMI) Survey, February 2018 and broker satisfaction – Markets & Communication Research (MCR), February 2018.

### **Financial impact: We estimate energy solutions could drive 0%-40% EBITDA growth in the medium term**

- **Starting point:** Although the energy solutions activities have experienced significant revenue growth since the launch in 2016, from a financial point of view this business has so far been a drag on profit and cash flow. The negative EBITDA contribution currently has a significant effect on the bottom line: company guidance for FY18e EBITDA of -A\$4.0-4.5m implies a negative effect on net income (on a post-tax basis) of -A\$3m vs our FY18 group net income forecast of A\$8m. In addition, we estimate a negative cash flow for the division of -A\$11m, equivalent to 32% of FY18e free cash flow and 3% of ERM's market cap. The reversal of this loss into a medium-term profit is a key driver of the earnings growth we forecast for ERM Power, although clearly this is subject to risks. The company targets a positive contribution to group net income from 2020.
- **Energy solutions market size:** ERM Power estimates that the addressable market for its energy solutions business is A\$1bn+. This was calculated on the basis of an estimate of 25% potential energy savings applied to a A\$16bn energy market and a payback period of four years. The size of the market was calculated exclusively based on the energy efficiency savings that corporates could theoretically achieve, but we highlight that this excludes the additional business potentially deriving from other corporate priorities such as the improvement in environmental sustainability, etc.
- **Market share and revenue potential:** ERM Power expects that it can realistically achieve a 5-20% share of the Australian energy solutions market (as guidance, ERM Power had 22% market share in the Australian C&I supply market in FY17). Applying 5-20% market share to the A\$1bn market potential provides a A\$50-200m range for potential revenues for the energy solutions business in the medium term.
- **Gross profit margin:** ERM Power has provided no indication about gross margin prospects for the energy solutions business, and has only shown that it expects "high" gross margins in the Track and Advise activities and the lowest margins in the Deliver activities. As a starting point, however, we have calculated that company guidance for FY18 energy solutions activities (revenues doubling vs FY17, capex of A\$15m and EBITDA loss of A\$4.0-4.5m) implies a gross profit margin of c 40%. In our sensitivity analysis we have considered a range of 30-50%.
- **Opex:** the company guides for A\$15m opex in FY18 and indicates that the growth in headcount is expected to moderate significantly thereafter, following a material initial investment. In our sensitivity analysis, we have assumed opex to grow to \$20-30mn in the medium term depending on the size of the business (\$50-200m revenues).
- **Medium-term potential impact:** overall, based on the above assumptions, we estimate that the medium-term development of the business could drive up to 40% growth in group EBITDA (2022e) and 16% in a mid-case scenario (12.5% market share and 40% gross profit margin).
- **Our forecast:** in our model we have included gradual growth in revenues to A\$125m in 2022e, a gross profit margin of 38% and EBITDA of A\$21m (we previously forecast A\$79m revenues and A\$4m EBITDA in 2022).

**Exhibit 1: Energy solutions could drive up to 40% EBITDA growth medium-term**

Addressable market size	A\$m	1,000								
Market share	%	5%			12.5%			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	%	-3%	0%	3%	8%	16%	23%	19%	31%	43%

Source: Company data, Edison Investment Research.

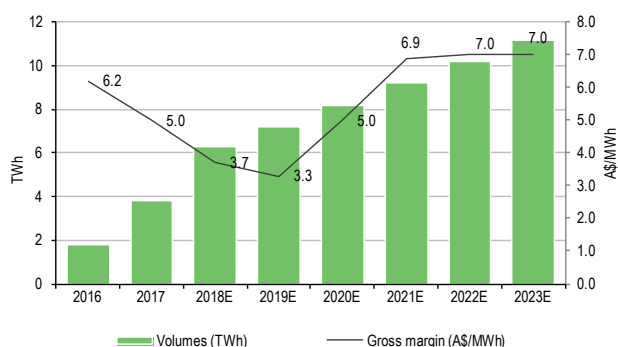
We believe delivery on the growth potential of energy solutions activities represents a significant value creation opportunity for ERM Power. For example, the global utility player ENGIE completed 33 acquisitions of energy services companies at an average multiple of 9x (pre-synergies) over the last five years. Applying this multiple to our FY22e EBITDA for energy solutions (A\$21m) and discounting back to the end of FY18 would generate a valuation for this business of A\$126m, equivalent to c 35% of ERM Power's current market cap.

## Forecasts updated: Lower US, higher energy solutions

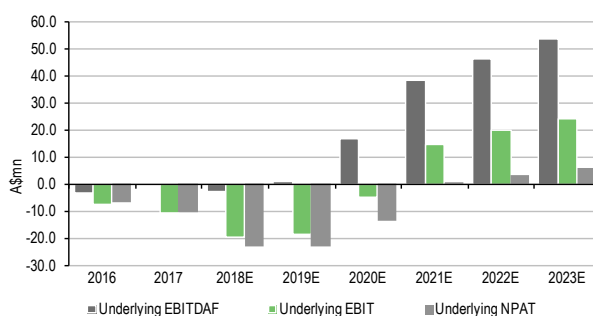
As described in our note [US outlook downgraded; Australia in line or better](#) (published on 29 May 2018), ERM Power issued a trading update on 25 May 2018. Although the company said it expects the Australian activities (retail, generation and energy solutions) to perform in line or above expectations for 2018 (in line for 2019), it expects slightly lower volumes in the US and significantly lower gross margins. For the US business (17% of 2018e group revenues), ERM Power expects volumes of c 6.3TWh in FY18 (vs 6.5TWh previously), increasing to c 7.2TWh in FY19. The US gross margin in FY18 is expected to be c A\$3.70/MWh (vs A\$4.50/MWh previously), reducing to A\$3.30/MWh in FY19. ERM Power also said that although it sees a significant improvement in US gross margins in FY20 vs FY19, it will provide an update in FY19 regarding its current guidance that the US business will be NPAT break-even in FY20.

The new guidance has a negative impact on our FY18 and FY19 net income forecasts of A\$4m and A\$13m respectively (vs our previous forecasts). Although we see the downgrade in the US outlook as disappointing, we believe downside risks for the ERM Power group are limited. In our view, the current negative impact on group earnings of the loss-making US business will eventually be eliminated, either because ERM Power manages to improve the profitability of this business to at least break-even, or because the business, which is independently financed, is sold/closed down. Hence the risk to the company is of a limited duration, in our view.

We have updated our US forecasts to reflect a larger NPAT loss in the short term and a delayed NPAT break-even point (we now assume 2021 vs current company guidance of FY20).

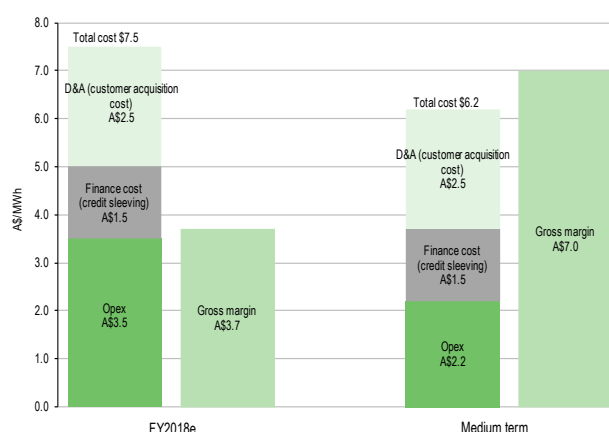
**Exhibit 2: US breaks even with rising volumes/margins**


Source: ERM Power, Edison Investment Research.

**Exhibit 3: We have moved US NPAT break-even to 2021**


Source: ERM Power, Edison Investment Research.

Our forecasts for core Australian supply and generation activities, which produce all the cash flow of the group, are unchanged. Overall, our FY18-21 EBITDA forecasts change by -6%, -14%, -9% and +7% and these impacts are amplified at the bottom line. We show the full changes to our forecasts in Exhibit 5.

**Exhibit 4: Gross margins need to rise to cover opex, D&A and financing costs**


Source: Company data, Edison Investment Research.

**Exhibit 5: Forecasts lowered short-term, energy solutions increase drives medium-term upgrade**

	New forecasts				Old forecasts				% change			
A\$m	2018e	2019e	2020e	2021e	2018e	2019e	2020e	2021e	2018e	2019e	2020e	2021e
Revenues	3,391	3,524	3,676	3,794	3,406	3,544	3,689	3,791	0%	-1%	0%	0%
EBITDA	84	93	117	146	89	109	130	137	-6%	-14%	-9%	7%
Electricity retail AUS	66	68	70	70	66	68	70	70	0%	0%	0%	0%
Electricity retail US	(3)	1	17	38	3	18	36	42	-194%	-96%	-52%	-7%
Power generation	39	39	40	40	39	39	40	40	0%	0%	0%	0%
Energy solutions	(4)	0	6	14	(4)	(2)	0	2	-6%	-97%	N/A	734%
Corporate	(15)	(15)	(16)	(16)	(15)	(15)	(16)	(16)	0%	0%	0%	0%
EBIT	41	48	69	94	46	64	82	88	-10%	-25%	-16%	8%
PBT	11	16	36	61	15	31	49	54	-28%	-49%	-27%	13%
Net Income from continuing operations	8	21	55	42	11	32	64	38	-28%	-34%	-14%	13%

Source: Edison Investment Research

## Valuation unchanged at A\$2.6/share

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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 unchanged at A\$2.6/share, implying significant upside vs the current share price of A\$1.46. As this valuation excludes any value for US activities and energy solutions, and forecasts for core Australian supply and generation activities are unchanged, there is no change to our valuation. Including a valuation for energy solutions and the US business (with updated forecasts, as described earlier in the note) would increase the SOTP valuation to A\$3.2 (vs \$2.8/share before; the increase in valuation is driven by a higher valuation for the energy solutions business on the back of higher forecasts). Our recent outlook note [Offering solutions to corporate energy challenges](#), published on 29 March 2018, includes more details 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 6: Financial summary**

Accounts: IFRS, Year-end: June, A\$m	2016	2017	2018e	2019e	2020e	2021e
<b>INCOME STATEMENT</b>						
Total revenues	2,691	3,127	3,391	3,524	3,676	3,794
Cost of sales	(2,620)	(3,049)	(3,306)	(3,431)	(3,559)	(3,649)
Gross profit	71	78	84	93	117	146
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)	(43)	(45)	(49)	(51)
Reported EBIT	40	41	41	48	69	94
Finance income/(expense)	(23)	(26)	(30)	(32)	(33)	(34)
Other income/(expense)	0	(0)	0	0	0	0
Exceptionals and adjustments	39	37	0	0	0	0
Reported PBT	57	52	11	16	36	61
Income tax expense (includes exceptionals)	(22)	(52)	(3)	5	19	(18)
Reported net income	36	(1)	8	21	55	42
Basic average number of shares, m	242	244	238	230	230	230
Basic EPS	0.15	(0.00)	0.03	0.09	0.24	0.18
Adjusted EBITDA	71	78	84	93	117	146
Adjusted EBIT	46	41	41	48	69	94
Adjusted PBT	23	15	11	16	36	61
Adjusted EPS (A\$)	0.08	(0.11)	0.03	0.05	0.11	0.18
Adjusted diluted EPS (A\$)	0.08	(0.10)	0.03	0.05	0.11	0.18
DPS (A\$)	0.12	0.07	0.07	0.07	0.07	0.07
<b>BALANCE SHEET</b>						
Property, plant and equipment	391	391	383	370	358	345
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	589	576	563	551
Cash and equivalents	192	245	229	249	300	335
Inventories	22	42	46	48	50	51
Trade and other receivables	331	361	391	407	424	438
Other current assets	164	331	331	331	331	331
Total current assets	709	979	998	1,035	1,106	1,156
Non-current loans and borrowings	184	181	181	181	181	181
Other non-current liabilities	161	287	287	287	287	287
Total non-current liabilities	345	467	467	467	467	467
Trade and other payables	367	464	504	523	542	556
Current loans and borrowings	37	8	8	8	8	8
Other current liabilities	18	70	70	70	70	70
Total current liabilities	422	543	582	601	621	634
Equity attributable to company	471	566	537	542	581	605
Non-controlling interest	0	0	0	0	0	0
<b>CASH FLOW STATEMENT</b>						
EBIT	40	41	41	48	69	94
Depreciation and amortisation	16	53	43	45	49	51
Share based payments	0	0	0	0	0	0
Other adjustments	60	69	0	0	0	0
Movements in working capital	0	0	5	2	(0)	(2)
Interest paid / received	3	3	4	3	4	4
Income taxes paid	(0)	(14)	(3)	(5)	(11)	(18)
Cash from operations (CFO)	120	152	90	94	110	130
Capex	(26)	(40)	(35)	(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)	(35)	(32)	(37)	(39)
Net proceeds from issue of shares	0	0	(20)	0	0	0
Movements in debt	(22)	(24)	0	0	0	0
Dividends paid	(28)	(23)	(17)	(16)	(16)	(18)
Other financing activities	(27)	(33)	(34)	(25)	(7)	(38)
Cash from financing activities (CFF)	(76)	(79)	(71)	(41)	(23)	(57)
Currency translation differences and other	0	0	0	0	0	0
Increase/(decrease) in cash and equivalents	20	53	(15)	20	51	35
Currency translation differences and other	0	(1)	0	0	0	0
Cash and equivalents at end of period	192	245	229	249	300	335
Net (debt)/cash	(29)	56	40	60	111	146
Movement in net (debt)/cash over period	(29)	85	(15)	20	51	35

Source: Company data, Edison Investment Research.



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