Breaking News

Reuters	VCT.NZ
Bloomberg	VCT NZ
Exchange	NZE
Ticker	VCT

9 November 2015

Issued by:

Craigs Investment Partners Ltd

Hold

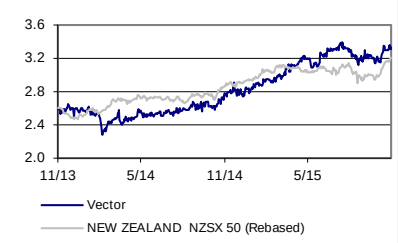
Price at 9 Nov 2015	3.33
Price target - 12mth	3.41
52 week range (NZD)	3.39 - 2.74
NEW ZEALAND NZSX 50	6,079

Key changes

Price target	3.36 to 3.41	↑	1.5%
Sales (FYE)	1,319 to 1,325	↑	0.5%
EBIT margin (FYE)	31.8 to 32.1	↑	1.0%
Net profit (FYE)	158.9 to 163.3	↑	2.8%

Source: Craigs Investment Partners

Price/price relative



Performance (%)	1m	3m	12m
Absolute	3.4	0.6	19.8
NEW ZEALAND NZSX 50	7.1	2.7	12.0

Source: Craigs Investment Partners

Vector

Recycling assets at a premium

Vector to sell non-Auckland gas assets at a premium

Vector announced that as a result of its strategic review, it has agreed to sell all of the shares in Vector Gas Limited for NZ$952.5 million – this resulting in a gain on sale of c. NZ$167m. We estimate that the sale price equates to a c. 11.2X EV/EBITDA, a premium to the 10.2X FY15 multiple that it is currently trading at (NZ$3.33). Based on the difference between our DCF valuation and the sale price, the deal is c. NZ$80m accretive and adds 8c to our target price. While we have raised our TP to NZ$3.41, due to limited upside we retain our HOLD rating.

What Vector is selling

The company's gas assets are comprised of gas transmission pipelines and gas distribution networks outside of Auckland. Vector Gas is also a provider of unregulated pipeline management services and is the technical and system operator for the Maui Pipeline. We estimate that the RAB of the assets being sold is c. NZ$652m with EBITDA of c. NZ$85m.

We view the transaction as value accretive

We value the gas distribution business at 1.22 times RAB, the sale price implying a c. 1.33 times RAB and the deal therefore accretive. This transaction adds c. NZ$80m to our valuation (8cps). As the company has a capex profile that requires NZ$1.8bn to be spent in Auckland over the next ten years, selling a slower growing asset at a 30% premium to RAB, while investing at RAB, is a positive asset recycling initiative.

We raise our target price from NZ$3.33 to NZ$3.41 and retain our HOLD rating

We value Vector using a DCF methodology. We use a 6.86% WACC, with an equity risk premium of 6.5%, a RFR of 4.4%, an asset beta of 0.52 and a LTG rate of 1.2%. Key up/down risks include regulatory uncertainty and gas contract risk.

Forecasts And Ratios

Year End Jun 30	2014A	2015A	2016E	2017E	2018E
EBITDA (NZDm)	582	598	626	628	647
Net Profit (NZDm)	164	157	163	162	174
EPS (NZD)	0.16	0.16	0.16	0.16	0.17
PER (x)	15.6	18.1	20.3	20.5	19.0
EV/EBITDA (x)	8.6	9.2	9.9	9.9	9.6
DPS (net) (NZD)	0.15	0.16	0.16	0.16	0.17
Yield (net) (%)	5.9	5.4	4.8	5.0	5.1

Source: Craigs Investment Partners estimates, company data

1 Pre-exceptionals/extraordinaries

2 Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses the year end close

Model updated:08 November 2015

Running the numbers

Australasia

New Zealand

Utilities

Vector

Reuters: VCT.NZ Bloomberg: VCT NZ

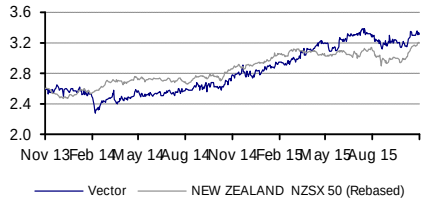
Hold

Price (9 Nov 15)	NZD 3.33
Target Price	NZD 3.41
52 Week range	NZD 2.74 - 3.39
Market Cap (m)	NZDm 3,317
	USDm 2,160

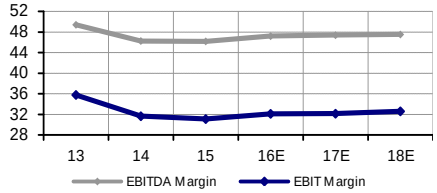
Company Profile

Vector was established as owner-operator of Auckland's electricity distribution network resulting from the 1998 industry reforms and breakup of Mercury Energy. In 2002 Vector acquired United Networks, including the electricity distribution networks in Wellington and north and west Auckland, the Auckland gas distribution network, fibre-optic networks in Auckland and Wellington, and services businesses Utilitech and Treescape. In 2005 Vector acquired vertically integrated gas company NGC Holdings. NGC's operations include gas wholesaling, processing, transmission and distribution, electricity metering, and LPG distribution and sales.

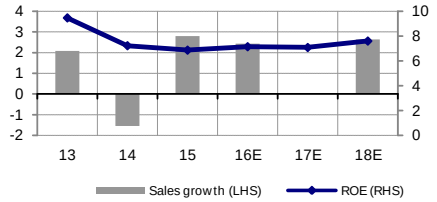
Price Performance



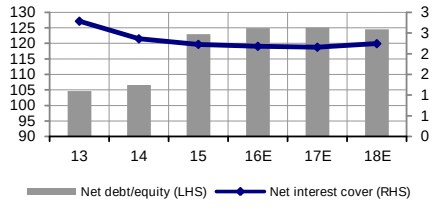
Margin Trends



Growth & Profitability



Solvency



Fiscal year end 30-Jun	2013	2014	2015	2016E	2017E	2018E
Financial Summary						
CIP EPS (NZD)	0.21	0.16	0.16	0.16	0.16	0.17
Reported EPS (NZD)	0.20	0.17	0.15	0.16	0.16	0.17
DPS (NZD)	0.15	0.15	0.16	0.16	0.17	0.17
BVPS (NZD)	2.25	2.30	2.29	2.30	2.30	2.31
Valuation Metrics						
Price/Sales (x)	2.2	2.0	2.2	2.5	2.5	2.4
P/E (CIP) (x)	13.4	15.6	18.1	20.3	20.5	19.0
P/E (Reported) (x)	13.6	15.2	19.5	20.3	20.5	19.0
P/BV (x)	1.2	1.1	1.4	1.4	1.4	1.4
FCF yield (%)	5.1	1.5	2.0	3.0	4.6	5.1
Dividend yield (%)	5.4	5.9	5.4	4.8	5.0	5.1
EV/Sales	4.0	4.0	4.3	4.7	4.7	4.6
EV/EBITDA	8.2	8.6	9.2	9.9	9.9	9.6
EV/EBIT	11.3	12.5	13.7	14.5	14.6	14.0
Income Statement (NZDm)						
Sales	1,279	1,259	1,294	1,325	1,326	1,361
EBITDA	632	582	598	626	628	647
EBIT	458	399	403	426	426	444
Pre-tax profit	290	234	211	231	229	246
Net income	203	169	146	163	162	174
Cash Flow (NZDm)						
Cash flow from operations	426	367	369	370	375	391
Net Capex	-283	-327	-312	-270	-222	-223
Free cash flow	143	39	57	100	153	168
Equity raised/(bought back)	0	0	0	0	0	0
Dividends paid	-148	-157	-155	-157	-162	-167
Net inc/(dec) in borrowings	-24	129	118	97	59	47
Other investing/financing cash flows	4	-59	-20	0	0	0
Net cash flow	-25	-48	0	40	51	48
Change in working capital	75	-57	23	-5	-1	1
Balance Sheet (NZDm)						
Cash and cash equivalents	56	8	8	49	99	147
Property, plant & equipment	3,849	4,000	4,130	4,200	4,220	4,240
Goodwill	0	0	0	0	0	0
Other assets	1,842	1,831	1,985	1,967	1,967	1,973
Total assets	5,747	5,839	6,123	6,215	6,287	6,360
Debt	2,420	2,469	2,836	2,933	2,992	3,039
Other liabilities	1,068	1,062	989	974	983	998
Total liabilities	3,489	3,531	3,824	3,907	3,975	4,037
Total shareholders' equity	2,258	2,308	2,299	2,308	2,312	2,323
Net debt	2,364	2,461	2,827	2,884	2,893	2,892
Key Company Metrics						
Sales growth (%)	2.1	-1.5	2.8	2.4	0.0	2.6
CIP EPS growth (%)	1.8	-20.9	-4.0	4.0	-0.7	7.5
Payout ratio (%)	73.5	90.2	105.7	97.6	101.4	97.1
EBITDA Margin (%)	49.4	46.3	46.2	47.2	47.4	47.5
EBIT Margin (%)	35.8	31.7	31.1	32.1	32.2	32.6
ROE (%)	9.5	7.2	6.9	7.1	7.1	7.6
Net debt/equity (%)	104.7	106.6	123.0	124.9	125.1	124.5
Net interest cover (x)	2.8	2.4	2.2	2.2	2.2	2.2
DuPont Analysis						
EBIT margin (%)	35.8	31.7	31.1	32.1	32.2	32.6
x Asset turnover (x)	0.2	0.2	0.2	0.2	0.2	0.2
x Financial cost ratio (x)	0.6	0.6	0.6	0.5	0.5	0.6
x Tax and other effects (x)	0.7	0.7	0.7	0.7	0.7	0.7
= ROA (post tax) (%)	3.6	2.9	2.4	2.6	2.6	2.8
x Financial leverage (x)	2.6	2.6	2.6	2.7	2.7	2.8
= ROE (%)	9.3	7.4	6.4	7.1	7.1	7.6
annual growth (%)	-1.1	-20.1	-14.1	11.9	-0.9	7.3
x NTA/share (avg) (x)	2.2	2.3	2.3	2.3	2.3	2.3
= Reported EPS	0.20	0.17	0.15	0.16	0.16	0.17
annual growth (%)	2.3	-17.1	-13.3	11.8	-0.7	7.5

Source: Company data, Craigs Investment Partners estimates

Recycling assets

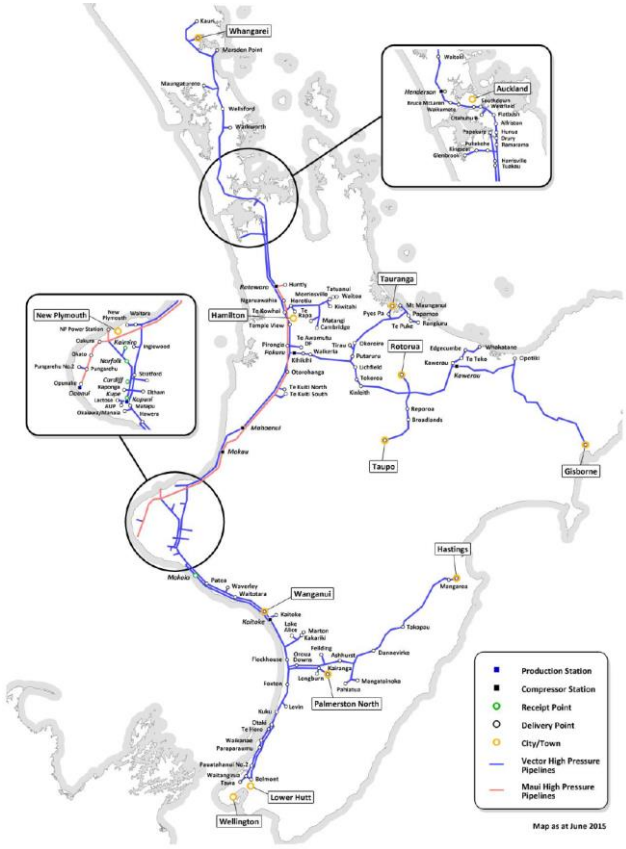
We see the sale of the company's gas-related assets as a positive move

Vector announced that as a result of its strategic review, it has agreed to sell all of the shares in Vector Gas Limited for $952.5 million, this resulting in a gain on sale of approximately NZ$167m. The company's Gas assets include the gas transmission pipelines and gas distribution networks outside of Auckland. Vector Gas is also a provider of unregulated pipeline management services and is the technical and system operator for the Maui Pipeline.

We estimate that the RAB of the assets being sold is c. NZ$652m, these assets generating EBITDA of c. NZ$85m – hence an EV/EBITDA multiple of 11.2X. This is ahead of the company's FY15 multiple of 10.2X.

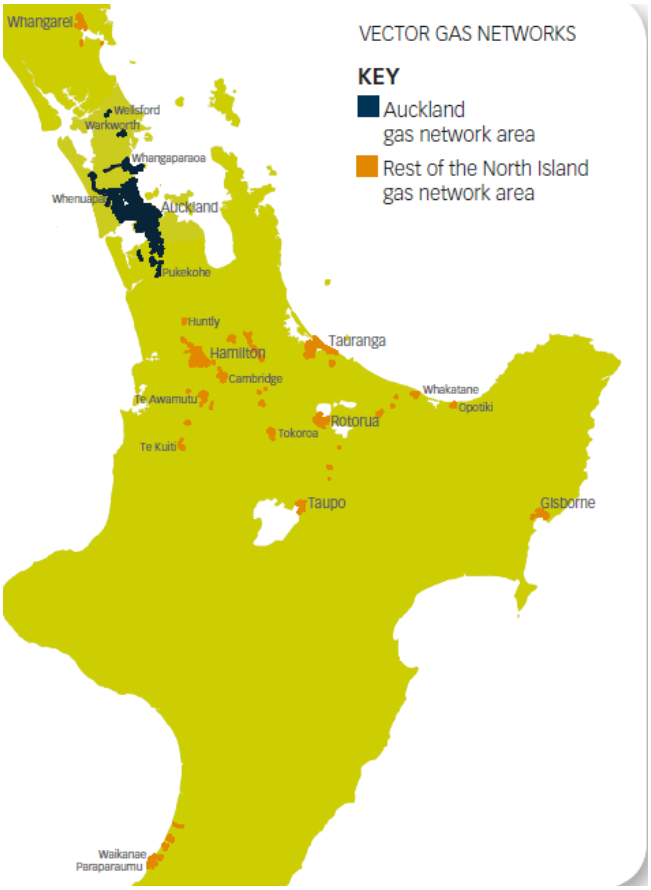
While the sale RAB multiple looks extreme, there is c. 10% of the sale price that is likely be due to unregulated income and hence we estimate a multiple of 1.31X the RAB was achieved, ahead of the 1.22X valuation that we ascribe in our by-parts DCF valuation.

Figure 1: Vector gas transmission network map



Source: Vector

Figure 2: Vector gas distribution network map



Source: Vector

An overview of the assets

The FY14 regulated asset base (RAB) for the gas transmission network was NZ$502.1m, while the gas distribution RAB was NZ$483m – however only the non-Auckland portion of the distribution is being spun off. Based on a mix of customers, system length and peak load requirements, we estimate that the non-Auckland share is c. 30-40% of the RAB (NZ$150m). As a result, the total combined RAB of the two businesses is c. NZ$652m.

Figure 3: Vector gas distribution network: operational summary

Description	Auckland Region			North Island Region			Total		
	2014	2013	Change	2014	2013	Change	2014	2013	Change
Consumers connected[1] (no.)	94,821	92,843	2.1%	64,917	64,109	1.3%	159,738	156,952	1.8%
System length[2] (km)	5,795	5,713	1.4%	4,827	4,766	1.3%	10,623	10,479	1.4%
Consumer density (consumer/km)	16	16	0.7%	13	13	0.0%	15	15	0%
Gate stations[3]	11	11	0.0%	53	54	-1.9%	64	65	-2%
District regulating stations[4] (DRS)	311	353	-11.9%	135	137	-1.5%	446	490	-9%
DRS density (system km/DRS)	19	16	15.1%	36	35	2.8%	24	21	11%
DRS utilisation (consumers/DRS)	305	263	15.9%	481	468	2.8%	358	320	12%
Peak load[5] (scmh)	80,490	75,407	6.7%	69,995	67,354	3.9%	150,486	142,761	5.4%
Gas conveyed[6] (PJ pa)	12.2	12.1	0.5%	9.7	9.4	3.0%	21.9	21.6	1.6%

Source: Vector

While gas transportation's FY15 EBITDA was NZ$143m, there was NZ$10.8m of capital contributions, a total of NZ$132m normalised EBITDA. We estimate that c. 10% of this is non-regulated income and we assume that the sold assets get their share of this. In total we estimate that the sold assets achieved an EBITDA in line with the RAB split of gas transportation (NZ$652m/NZ$985m), equating to c.NZ$85m.

We value the gas distribution – see sum of parts in the valuation section below – at 1.22 times RAB, so this sale price implies a c. 1.33 times RAB is accretive. This adds c. NZ$80m to our valuation, 8cps.

As the company has a capex profile that requires NZ$1.8bn to be spent in Auckland over the next ten years, selling a slower growing asset at a 30% premium to RAB, while investing at RAB, is a positive asset recycling initiative.

Valuation and risks

We use a rolled forward DCF valuation in setting our target price. We have added NZ$80m to our "cash" due to the value accretion of the gas asset sale. The following table shows the value we ascribe to each division.

Figure 4: Vector – DCF and sum of the parts valuation (NZ$m, unless stated)

	Total	Electricity lines	Gas transmission	Gas trading	Technology / Other	Debt
Explicit Cashflows	2,268	1,109	616	235	307	
Terminal Item	3,741	2,497	806	147	291	
Total Firm Value	6,009	3,606	1,422	382	598	
Less: Net Debt	2,745	0	0	0	0	-2,745
Less: Distributions Already Paid	80	0	0	0	0	-80
Total Equity Claims	3,264	3,606	1,422	382	598	80
No Shares	996	996	996	996	996	996
Per Share Value	3.28	3.62	1.43	0.38	0.60	-2.76
ODV	4,791	2,656	1,155	382	598	
EV/ODV		1.26	1.22	1.00	1.00	
FY15A EV/EBITDA (x)	10.07	10.34	9.97	7.40	11.12	
FY16F EV/EBITDA (x)	9.62	9.82	9.54	8.40	9.51	

Source: Vector, Craigs Investment Partners

In our DCF valuation we use a 6.86% WACC which incorporates a corporate tax rate of 28%. This is calculated by using an equity premium of 6.5%, a RFR of 4.4%, a debt premium of 2.13% and an asset beta of 0.52. We apply a long-term growth rate of 1.35% which is a blend of regulated electricity at 2.0%, a 1.2% growth rate for the regulated gas business, a 2% decline in the technology and other business and a 2.5% decline for the wholesale gas business.

We calculate a total firm EV of NZ$6.009 bn, which after debt equates to spot value of NZ$3.28 per share. Rolling this forward 12 months by the cost of equity and subtracting anticipated dividends over the period, this comes to a target price of NZ$3.41. Due to limited upside potential to the current share price, we retain our HOLD recommendation.

Risks

Key risks include regulatory uncertainty (positive or negative) and the impact of the depletion of domestic gas reserves (negative). The regulated gas and electricity distribution and gas transmission profits are subject more to government decisions than demand dynamics. The wholesale gas business also requires Vector to secure gas supply contracts into the future, a further risk.

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