Contact may have been the country's number one stock-pick (of the large caps) well before recent corporate activity. But the long-awaited decision by majority shareholder Edison Mission Energy to sell-down its 51.2% stake to victorious bidder Origin has sweetened brokers' already rosy outlook on the stock.

Unshackled

Contact's turning point

By Mark Story

Due to some natural synergies in the exploration space – especially since Contact Energy (NZX ticker: CEN) acquired its exploration licence offshore - the market was hoping that Origin Energy (ASX ticker: ORG) – which has a track-record in exploration - would out-duel rival Aussie bidder AGL for the lion's share of the energy giant.

ORG may indeed help CEN dip its (retail) toes into its own back yard Victoria, especially now that CEN's Australian subsidiary has a licence to commence retail electricity sales. But the benefits of the deal should cut both ways. With a third of its assets now tied up in NZ, Origin is now a major energy player locally. So it's a fair bet that CEN – which has traditionally operated in the electricity space - will also be able to assist ORG as the Aussie company moves into the power generation game.

Ascribing valuations

But despite these potential synergies, it's still too early for brokers to have ascribed valuations to either the exploration upside or the strategy changes that may arise from ORG's influence in CEN. It's not a forgone conclusion that a trade buyer like ORG will necessarily deliver tangible value to target companies like CEN.

Left: Contact Energy Taranaki Combined Cycle Power Station.
Right: Contact Energy Otahuhu B Power Station

Growth & GDP story

Nevertheless, knowing what they do with CEN going forward, brokers are beginning to sniff the makings of a five year growth (and then GDP) story. CEN's earnings are primarily driven by GDP growth and price increases, and while brokers aren't "gung ho" on further price hikes for CEN, they could easily see another 15% increase on top of recent rises.

Origin upside

Initial observations by broker ABN Amro suggest that ORG has the potential to deliver significant value to CEN shareholders on three key fronts.

Firstly, ORG will probably do what Edison was reluctant to do – go upstream. As well as being a retailer and generator, the broker expects ORG to give CEN the intellectual capital and moral authority to do - what it's done in Australia - and proceed with E&P (exploration and production) activity. Not surprisingly, CEN is keenly searching for new gas supplies to fuel its gas-fired power stations.

Secondly, in addition to owning the fuel source, ORG's knowledge of the terms and conditions of the Kupe gas deal (in which it owns a 50% stake) with CEN's major competitor, Genesis Energy - which has pre-emptive rights to the majority of Kupe gas - could be very valuable indeed.

Thirdly, ORG's other NZ investment, Rockgas could be useful in terms of offering cross-marketing opportunities with CEN's electricity offer, particularly in the South Island where there's no reticulated gas supplies.

Flat short-term outlook

CEN is benefiting from higher electricity prices on the back of concerns about a shortfall in gas production. But despite ORG's takeover putting a floor under the share price and removing the massive stock overhang within CEN, the fourth quarter result might be relatively flat (versus last year) due to the hydro lakes being full. So it remains to be seen if wet weather and lower electricity prices (this winter) do soften CEN's earnings in the financial year to 30 September.

This means the "spot market" price will not be higher than average - and in the electricity game - that's when the companies like CEN make the "real money". So without any other immediate

Recent corporate activity – what happened?

- Origin paid $1.67bn for a controlling block (51.2%) of Contact Energy.
- At $5.67 a share Origin is acquiring control of Contact at a 4.5% discount to the target company's share price prior to the deal being disclosed (around $5.98).
- NZ law requires Origin to extend the offer to all shareholders, but given the discount acceptances are likely to be few.
- The way the deal (to be completed by 30 November at the latest) will be structured – with Origin acquiring the NZ holding company and assuming $535m of debt that Edison had used to finance its shareholding - the deal is subject to an exemption from the NZ Takeovers Panel.
- Given the ORG bid structure, it's safe to assume that CEN will continue to deliver a healthy dividend.
- It's also reasonable to assume that CEN will clear its imputation credit account (before Edison exits) with a special final dividend of 13c per share

Left: Contact Energy Clyde Dam

catalysts and an assumption that some of the upside is already factored into the share price, rival broker Direct Broking expects CEN to range-trade between $5.80 and $6.20. Taking a slightly more robust outlook, ABN Amro maintains its ADD recommendation with a DCF valuation of $6.38.

Earnings upgrades

But share price aside, ORG's conclusion that the full year consensus forecasts on CEN ($128m) are materially light has forced some brokers to upgrade their earnings forecasts. Greg Main, analyst with broker Forsyth Barr is forecasting net profit for the year to September 30 2005 at $209m, and $230m the following year. Meantime, based on ORG's implied expectation that it can increase tariffs more aggressively than previously assumed – especially in FY05 and FY06 – Sydney-based broker UBS has also increased its tariff assumptions and earnings forecasts.

The broker has lifted its FY05 forecast from $174.9m to $182.5m, and its FY06 NPAT forecast from $193.8m to $201.5m. As a result, this broker has increased its DCF-based price target from $6.30 to $6.50 to reflect forecast increases.

For FY04E the Sydney-based broker's target implies an EV/EBITDA of 10.9x and a PE of 24.6x.

Currency play?

Profit taking was inevitable in the short term and has forced the price below $6.00. Offshore buyers are locking in a currency gain and giving a return too good to miss.

Downside risk

Like other brokers, UBS believes the net affect of CEN's link to an active E&P company such as ORG will likely be positive for CEN's market position and gas supply risk. But on the downside, the broker believes there's

What brokers' think

Broker	Recommendation	Valuation	FY04 Forecast
Direct Broking	Accumulate	$6.52	$144.5m
Forsyth Barr	Buy	$6.43	$145m
UBS	Neutral	$6.30 to $6.50	$141m
ABN Amro	Add	$6.38	$148.4m

Contact Energy at a glance

Established by the NZ government in 1995 to introduce competition in the electricity market, CEN acquired a portfolio of well diversified hydro, gas and geothermal electricity generating assets from the state owned electricity generator ECNZ (Electricity Corporation of New Zealand). In October 1998 the government decided to proceed with a 60% public share float combined with a share sale to a cornerstone shareholder. With a 28% market share, CEN supplies energy to over 620,000 businesses and homes across NZ.

The company is the largest wholesaler and retailer of natural gas in the country and generates approximately 30% of New Zealand's electricity usage. CEN is also the country's second biggest power generator and retailer after state-owned Meridian Energy and New Zealand's third largest listed company.

a chance this relationship is taken too far. If this is the case CEN could become the vehicle for ORG's E&P investments locally. Such a scenario could alter the risk of the business and be to the detriment of cash flow and dividend payouts. ORG presently has a 40% dividend payout and uses the remainder to fund its E&P activities. Meantime, CEN maintains a payout of close to 100% and to date has very little E&P focus.

ORG management has no plans of using CEN as the vehicle for its NZ E&P activities (given the skills and acreage residing within ORG). But over time, UBS believes the situation could change as management of the two companies becomes closer.

Management changes?

While ORG's presence will be well represented at CEN's board level, there's no guarantee,

Contact – Top-line results

(Source: ABN Amro)

	FY03 (Actual)	FY04 (Forecast)
Earnings per share c (EPS)	25.5c	27.5c
Dividend yield (%)	3.91%	6.51%
Price to earnings (P:E)	23.0	21.4
Dividend per share c (DPS)	23.0c	38.3c
EBITDA (NZ$m)	$376.6	$449.1

Above: Contact Energy Wairakei Geothermal Power Station

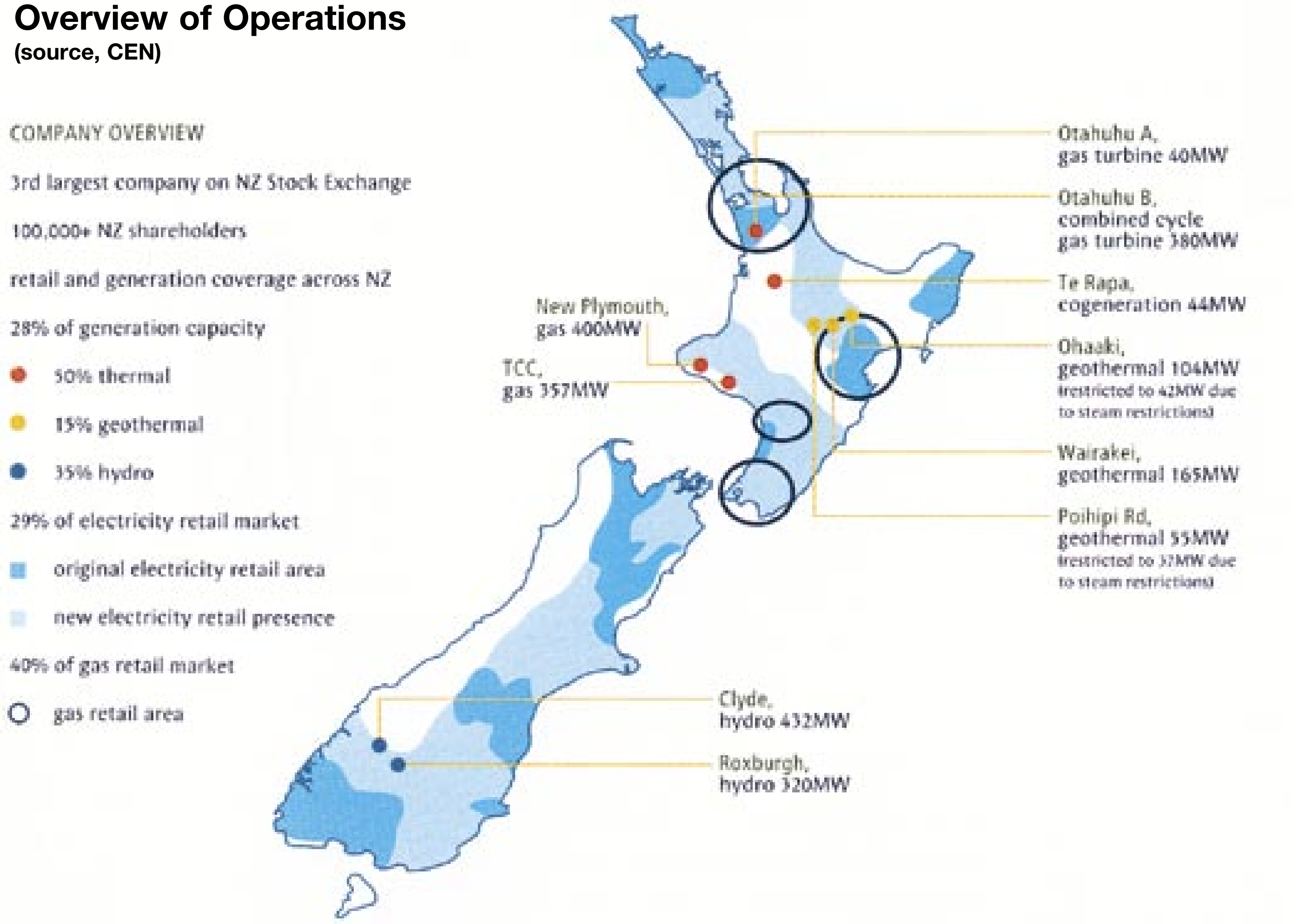
Right: Contact Energy Clyde Dam

says ABN Amro analyst James Miller that CEN's incumbent CEO Steve Barrett will automatically be replaced by someone from ORG's management team.

In fact with local management so highly regarded, UBS would be surprised (and concerned) to see substantial changes at the senior level.

In an effort to retain key talent, senior management are being offered an additional payment of 15% (of base salary) to buy CEN shares in three years' time (should performance targets be met).

Overview of Operations
(source, CEN)



So with wet weather (possibly) putting a dampener on this year's earnings the next price-moving event could be the management and director changes and the resulting strategy changes that come from ORG's influence.

Few will argue that the fundamentals look particularly good for CEN. For the nine months to 30 June 2003 the company delivered a net profit of $100m - up 36% on the same period last year. Based on these numbers brokers expect CEN to deliver a full year net profit of between $130m to $140m.

Gas supply
But as rosy as these numbers may look, it's worth remembering that at least 25% of NZ's electricity is generated from gas, which now comes from the declining Maui gas-field (CEN has rights to 40%). Future electricity will be generated with gas from the new Pohokura field at an increased price, and this means all electricity prices will rise.

So what's the end result of all this? Well it means that gas prices will likely form the basis for wholesale electricity prices and determine the profitability of the company's hydro and geothermal power plants. So without putting too fine a point on it, the investment risks for CEN stem from the price and availability of new gas supplies upon Maui's closure. Until it finds a longer-term supply of gas its ability to capitalise on spikes in the spot market will be significantly diminished.

Gas price
In a worst case scenario, CEN could lose around 50% of generation capacity unless replacement sources are found.

Similarly, the competitiveness of the company's thermal generation, and gas wholesale and retail operations will be impacted by the price at which the company negotiates its new gas supplies from 2006 and beyond.