Conference call transcript

22 February 2018

FY2018 HALF YEAR RESULTS ANALYST AND INVESTOR CONFERENCE CALL

Jon Stretch: ERM Power

Thanks and good morning and welcome everyone. Thanks for joining our half year results call.

I will be providing an overview of our financial performance and outline our position on national energy policy, then I'll hand over to James to talk through the numbers and then I'll conclude with an overview of the operations and the outlook. We should have plenty of time for questions after that.

If we turn to slide 3, ERM Power has reported an underlying EBITDAF of $51.1 million.

This result is a significant uplift on the comparative period and is due to sales volume growth in both Australia and the US, gross margin being at the higher end of range for our Australian retail business and also a modest result in the comparative period.

The performance of our Australian electricity retailing business is underpinned by our award-winning customer service, as evidenced by our number one ranking in the UMI electricity customer satisfaction survey for the seventh year running. This year ERM Power achieved 92% customer satisfaction, with a record 56% of customers stating they are very satisfied, which is particularly encouraging given the pain our customers are enduring due to increased wholesale prices.

For the half year we reported sales load of 9.6 terawatt hours, which means we're well on track to reach our FY18 outlook of 19 terawatt hours. Gross margin for the period was $5.08 per megawatt hour.

Our US retail business, Source Power & Gas, doubled sales load to 3 terawatt hours with a gross margin of $3.78 per megawatt hour. Gross margin for the half is behind our full year expectations.

The increase in volume reflects our success in developing and capitalising on broker relationships, as the recent results of the 2017 ERCG surveys show, with Source maintaining its top three broker satisfaction ranking.

Generation's performance is in line with expectations, reporting an EBITDAF of $20.6 million.

Energy Solutions, our integrated energy management offering, posted revenues of $9.7 million, 143% growth on the comparative period and an EBITDAF loss of $1.8 million. During this investment phase, we maintain our expectation that the business will be NPAT positive by FY20.

Finally, in view of the positive earnings outlook and strong financial position of the Company, the Board has declared an interim dividend of 3.5 cents per share fully franked, and announced an on-market buyback of up to $20 million which will be launched in March.

Now slide 4 for some brief commentary on National Energy Guarantee.

This is topical, and as advocates will see in our customers, we're taking a key role.

The NEG presents an opportunity to deliver enduring national energy policy. This is important to providing an acceptable level of investment certainty to deliver sustainable, reliable and affordable energy.

ERM Power is deeply involved in the energy consultation process, we're on all of the key policy committees for the relevant industry bodies and we've joined with energy users and other retailers to drive the NEG in the right direction.

We need to keep the problem top of mind. The exit of base load generation and growth in the intermittent generation has posed reliability issues and driven up costs, which is compounded by gas availability and price. Concentration of ownership of dispatchable generation and a lack of energy policy and planning has stifled infrastructure investment that supports the renewables transition. The NEG must be a policy that delivers investment without undermining market price transparency and competition and it cannot add complexity, all of which will translate to higher costs for energy consumers. The NEG must enhance competition.

This is entirely achievable and we are confident our views will support a NEG which delivers the desired outcomes. The consultation process is just getting underway and we'll be deeply involved.

Now I'll pass over to James for a dive into the half year numbers.

James Spence: ERM Power

Thank you Jon. Now looking at slide 6, to go through the headline financial results for the first six months of FY2018.

Firstly we can see contestable revenue increased by 59% to $1.1 billion. This was driven primarily by an increase in the Australian underlying commodity price, sales volume and continue growth in our US business. Underlying EBITDAF has increased from $11.1 million to $51.1 million. This increase in earnings was due primarily to Australian retail performance, which I will detail further on coming slides.

Underlying NPAT has increased from a loss of $51 million to a profit of $9.3 million, reflecting the impact of Australian retail performance and the comparative period containing a one-off tax adjustment of $37 million, relating to the LGC short surrender in February 2017.

Statutory NPAT is $49.6 million, with the difference to underlying NPAT being mainly the fair value gain on financial instruments excluded from the underlying results.

While we're on this slide, I'll take the opportunity to discuss the items below the EBITDAF line.

Depreciation has increased to $22.7 million from $18.1 million, mainly reflecting increased amortisation of US broker costs on higher US sales volumes.

Net finance costs have increased primarily due to US sleeving costs, again driven by higher US sales volumes.

Net cash increased to $111.6 million, this movement reflects operating cash flow and favourable working capital, timing benefits, including renewable energy schemes that settle after 31 December 2017. I'll go into further detail on the balance sheet on slide 11.

As Jon mentioned earlier, ERM Power will be paying an interim, fully franked dividend for FY18 of 3.5 cents per share. I'll go into further detail on our capital management framework when we get to slide 12.

Now turning to slide 7 for a breakdown of EBITDAF by division, you can see the main movement versus the comparative period relates to the Australian retail business.

Australian retail businesses reported an underlying EBITDAF of $37.7 million, a $42 million increase reflecting strong performance across the business, which we'll discuss in further detail on a later slide.

The US retail business reported an EBITDAF of AU$1.4 million, which is a decrease of $0.5 million on the first six months of last year, driven by lower margins which I'll outline on slide 11.

Generation EBITDAF has been stable against the comparative period. Oakey has produced a stable return and Neerabup continued to perform well with additional merchant opportunities.

Energy Solutions, which has been reported separately, posted an EBITDAF loss of $1.8 million and is tracking favourably towards the previously communicated FY18 EBITDAF outlook of $4.5 million loss.

Net corporate costs of $6.8 million are up on the comparative period due to first half of FY17 containing additional revenue from software licence fees. However, costs are tracking lower against our previous FY18 outlook of $15.5 million, reflecting our focus on controlling overhead costs with potential for further savings for the full year. So, we've revised our corporate costs outlook down to $14.5 million for FY18.

On slide 8, you can see a segmental breakdown of our NPAT.

The purpose of including this is to illustrate the relative contributions of our established and growth businesses and particularly to highlight the P&L investment we're making in our two growth businesses, Energy Solutions and the US.

As can be seen from the table, NPAT related to the established operations, including all Australian finance costs, is $19 million. The investment in Energy Solutions and US retail in the first half has resulted in negative $9.7 million of NPAT. Our expectation is that both Energy Solutions and US retail will be NPAT positive by FY2020.

Turning to slide 9, where Australian retail headline results are outlined.

We're pleased to report a gross margin for the first six month period of $5.08 per megawatt hour. This reflects strong performance across all areas of the retail business. Renewal and run rates remain in line with previous trends and ERM's award-winning customer satisfaction has been confirmed again. Margin optimisation activities have performed well in the half and the Vales Point off-take agreement has again provided value.

At $11 million opex remains stable, reflecting the business continuing to scale without additional costs.

We've previously communicated a medium-term gross margin range of between $3.50 and $5.00 per megawatt hour for the FY18 to FY20 timeframe. Given the performance of the Australian retail business, driven by improved underlying retail gross margin, portfolio optimisation and growth in the forward book, we have upgraded the medium-term gross margin range to between $4.00 and $5.50 per megawatt hour.

This margin range does not include any potential benefit arising from the LGC strategy announced in January 2017. Today we're providing an update on the expected NPAT profit range associated with the strategy which we anticipate will be in the range of $35 million to $45 million to be realised over FY19 and FY20, weighted to FY20.

Specifically, for FY18, we're updating our outlook for retail margin to $4.70 per megawatt hour, on a volume of around 19 terawatt hours, with further upside potential. This compares to the $4.40 per megawatt hour communicated in August and October.

Operating costs are expected to remain around $23 million in FY18.

Moving on to slide 10 for the US business, Source Power & Gas.

US retailing reported an EBITDAF of AU$1.4 million, a $0.5 million decrease on the comparative period. The underlying NPAT loss of AU$7.9 million reflects the investment we're making in the business as it grows and achieves scale.

We see a continuing decrease in opex costs to AU$3.30 per megawatt hour, from $5.29 per megawatt hour for the period, a 38% decrease. This reflects the increase in load providing scale benefits. This outcome is above the outlook provided of AU$3.20 per megawatt hour due to load coming in below expectation.

Sales load doubled to 3 terawatt hours. While this is strong growth, it is lower than previously planned as we have carefully controlled our pricing and risk management processes, leading to a moderation in the rate of sales growth. Accordingly, we're revising down our FY18 outlook from 7.5 terawatt hours, to around 6.5 terawatt hours, representing an anticipated 70% year-on-year increase in load sold.

The underlying gross margin performance of our US retail book in both ERCOT and PJM markets met expectations, however the margin optimisation activities have delivered lower than anticipated results, with reported gross margin of AU$3.78 per megawatt hour, which is down on the comparative period.

In January 2018, hedging costs have exceeded our internal forecasts, due mainly to weather events in the north east of the country.

In consideration of the first half results and January 2018 performance, our FY18 US gross margin outlook is AU$4.50, with further risk to downside.

Over 50% of our load is in PJM. Due to the reducing capacity cost curve in PJM, margin is skewed to the back end of the written contract. This is impacting FY18 margins by approximately AU$1 per megawatt hour and will have a similar impact on FY19. Our medium term gross margin view remains in the range AU$6.50 to $7.50 per megawatt hour.

Below EBITDAF, the main cost drivers are amortisation of broker costs, which run at approximately AU$2.50 per megawatt hour and sleeving arrangements which results in finance costs of around AU$1.50 per megawatt hour, which runs through to July 2021.

Now turning to slide 11 for balance sheet and cash.

As at 31 December 2017, the Group reported a net cash position of $111.6 million. This improvement is due to strong operating cash flows and net positive working capital movements. Working capital movements were primarily driven by timing differences associated with the large scale generation certificate costs, which settle in February.

Now to slide 12, a brief overview of the capital management framework which we're sharing with the market today. The purpose of this disclosure is to outline how we will manage capital given the improved funding position of the Group and management's increased confidence in the medium-term growth outlook for earnings. This framework encompasses our approach to dividends, how we reserve capital for growth and the deployment of any surplus capital. The intention of the framework is to optimise long-term shareholder returns, making the best use of surplus capital, while maintaining a prudent approach to funding of capital management.

Our approach, as outlined on this slide, will be to determine capital available for distribution and reinvestment. Our key measure for this is the liquidity position of the Group after allowing appropriate buffers for business performance and potential volatility in wholesale energy market prices.

Our expectation will be to maintain the ordinary dividend of approximately 3.5 cents per share fully franked per half year. We will revisit this depending on business performance, but will avoid reduction except due to a high level of variability in earnings. Increases will be considered in the context of sustained improved earnings levels and when surplus capital permits.

We will continue to invest in growth opportunities particularly, but not exclusively in Energy Solutions in Australia and in our US retail business. We're currently maintaining around $40 million for growth investment opportunities, either organic or inorganic. We will be disciplined in the use of this growth capital.

After allowing for dividends and growth capital, we expect to return surplus capital to shareholders by the most efficient mechanism having regard to quantum of surplus capital, franking credits and market conditions.

Moving to slide 13 and with the context just provided on the capital management framework, we currently have $20 million of surplus capital. This has arisen due to the strong business performance and to our program of managing capital as efficiently as possible. As mentioned, this surplus is after allowing prudent buffers for business performance, payment of ordinary dividends and around $40 million of capital reserved for growth opportunities.

Given our view for the potential medium term earnings improvement of the business, we consider that the best way to return the surplus capital to shareholders is by way of a share buyback. So, today we're announcing our intention to spend up to $20 million to buy back ERM power stock on the open market. This reflects the strong liquidity position, our confidence in the earnings outlook and our view that ERM power stock is undervalued.

The buyback will start during March. The required disclosures will follow as appropriate.

I will now hand back to John to discuss the operational performance of the business.

Jon Stretch: ERM Power

Thanks James. Now turning to slide 15, the Australian retail business.

The retail business reported growth in sales load and gross margin. We've also seen growth in our forward contracted load on the comparative period, the forward contract book increased by 21% to a record, 33.5 TWh.

A contributing factor to this growth is our innovative STEP online product. When customers use this ERM Power developed tool we've seen the average contract period increase as it allows them to better manage their exposure to volatile energy markets. We've seen contract lengths increased to 2.3 years on contracts signed in the first half. This is evident in the significant increase in load contracted beyond two years, which is at 10.9 TWh.

During the six months we've seen operational performance keep pace with load growth as reflected by re-contracting and win rates remaining within the historical range.

Our SME focus remains on multi-site customers. With SME sales volume of 0.4 TWh for the half. We're taking a disciplined approach to SME growth to ensure profitable sales volume.

Moving now to slide 16, ERM Power is supporting the evolution of the Australian energy market mix. We participate in the National Renewable Energy Target scheme through the procurement and surrendering of large scale generation certificates. For calendar year 2017, ERM Power surrendered over 2.6 million large scale certificates and 1.3 million small scale certificates.

Our LGC strategy ensures we're well positioned to invest in renewable energy through participating in offtake agreements with renewable energy developers. To this end, this half we announced contracts with Lincoln Gap Wind Farm and Hamilton Solar Farm.

Now, to US operations on slide 17.

As mentioned earlier sales load increased from 1.5TWh to 3TWh. We anticipate full year sales load of around 6.5 TWh. Forward contracted load is 15.5TWh as at 31 December, a 1TWh increase over the comparative period. This financial year we've raised prices in order to realise greater gross margin at contract booking. This has impacted load growth but in a way which we're quite comfortable with.

The ERCG broker survey has confirmed for the third year running brokers have strong preference for Source Power & Gas, our US business, which has been placed third overall for broker satisfaction. We believe this is a key leading indicator for the growth potential of the business.

In the first half we've seen underlying retail margins meet our expectations. Margin optimisation activities have been below expectation. In our FY2017 full year results we flagged the need for changes in trading, risk management and pricing, which we have implemented and we're confident that this will lead to improved profitability in the medium term. This gives us confidence in the medium term gross margin outlook of AUD$6.50-AUD$7.50. On that basis we maintain our expectation that the US business will report a positive NPAT by FY2020.

Now to slide 18, Energy Solutions.

Customers are increasingly aware that energy, like any volatile commodity, needs to be a managed business cost. This means employing long term procurement and energy management strategies.

ERM takes an integrative view of customers' energy supply and demand requirements. We combine digital technology and commercial solutions to provide customers with the best value options.

We partner with big energy users to both monitor and optimise their energy productivity. You can take a look at Megan Houghton's video on our YouTube channel where she outlines the value of the Energy Solutions proposition to our customers.

On the left hand side of the slide you can see revenue continues to grow at a significant rate, up 143% on the same period last year. Currently we see the majority of our revenue is generated from the sale of individual products or services. One of the key factors driving the overall revenue growth is our transition to a multi-product and service revenue model as business' approach to energy management becomes more sophisticated.

Now generation on slide 19.

During the half our Oakey and Neerabup plants continued to deliver outstanding availability and overall performance, while maintaining excellent safety records.

Generation earnings are in line with the comparative period as expected.

The Western Australian energy market provided Neerabup with merchant opportunities in the shoulder months when other generators were offline for maintenance.

In the Queensland market we've seen decrease in price volatility due to the State Government's directive on generator pricing. This is counter balanced with the increase in intermittent generation coming on within the network, which requires peaking generation to ensure reliable energy supply to the market.

In April 2017, the first of the two turbines at Oakey power station underwent a scheduled overhaul. The second turbine scheduled maintenance will be undertaken this coming April. Estimated capex for this overhaul and upgrade is $10-$12 million. If you want to see what's involved in an overhaul of a gas fired turbine check out the two minute time lapsed video on the first turbine being dismantled and reinstalled on our YouTube channel.

Finally, to the outlook for FY2018, which is on slide 21.

We've upgraded our view of the Australian retail gross margin from $4.40 per MWh to $4.70 per MWh with upside potential. As noted in James' commentary we've increased our medium term range to between $4.00-$5.50 per MWh based on the improved value of the forward book.

For the US business we've revised down sales to 6.5 TWh. The revision in sales volume has resulted in a unit cost opex outlook of $3.50 per MWh with no change in the absolute costs. Also, given the half year gross margin and hedging costs in January 2018, we revised gross margin outlook to $4.50 per MWh with further downside risk.

You will note on the slide small favourable revisions to Energy Solutions and Corporate FY2018 outlook.

Thank you for your time this morning. Kayleigh, why don't you open it up for Q&A.

Operator:

Thank you. If you wish to ask a question please press star one on our telephone and wait for your name to be announced. If you wish to cancel your request please press star two. If you are on a speaker phone, please pick up the handset to ask your question.

Your first question comes from Ian Myles with Macquarie Group.

Ian Myles: Macquarie Group

Hey guys, nice result. Can we just talk to the top level first? Gross margin, you made a comment in your results that you realised a futures position and I think you described it as portfolio optimisation. I was wondering how significant was that optimisation in the first half for the business? I'm trying to work out if that is the cause for the uplift of the guidance?

James Spence: ERM Power

Ian, James here, thanks for the question. As you know, we don't break down our gross margin into the individual component parts. We think we give a fair bit of disclosure on our gross margin. There are a number of items that contribute to the positive performance of our gross margin in the period. We've seen that our customer margins and the underlying retail margin has been strong. The management of the hedging and the optimisation of our margin which we do through the wholesale market has also delivered a positive contribution and as we mentioned the Vales Point offtake agreement, which we entered into in November 2015, which runs through seven years has again contributed positively to our gross margin.

So, there are a number of factors, all of which have contributed and in view of those and the medium term nature of those that's what's given us confidence to upgrade our outlook for the medium term to $4.00-$5.50. This shouldn't be seen as an impact on one particular half, but more a sustained improvement that we're seeing in our gross margin into the medium term, driven by a number of different factors.

Ian Myles: Macquarie Group

Is point two and point three which you make there about the hedged delivery and Vales Point are they arguably temporary benefits? If I look past that three year horizon, we're going to see a reset again back to a normalised level because you've just got favourable hedges and favourable Vales Point contracts in there.

James Spence: ERM Power

Well, look I think the first point Ian to that is the Vales Point agreement goes through to 2022. In terms of the portfolio optimisation, we clearly see this as one of our strengths as an organisation is our capability in managing the hedging for our customers and the risk management associated with that. That's part of our business model and it's been an area of continued success for us. We don't see that as a one-off temporary phenomenon. We see it absolutely as part of our business.

Ian Myles: Macquarie Group

Forward curves are in backwardation which is probably about the first time I think since you guys have been listed that the forward curves have been consistently in backwardation. I was wondering how is the environment for the operation in that environment? Do you increase the amount of hedging you take in that and I guess is that really the driver of the C&I load increasing their length of book that they want to lock in those year two and year three prices?

David Guiver: ERM Power

David Guiver here. Yes, as far as pricing the customers, whether that's occurred in contango or backwardated, doesn't really affect our business model, because we reprice off the market of the day continuously. That's not really a big influencing factor.

Contract lengths, we have seen a bit of a step up in average contract lengths, but that's driven by product offerings, not by actual shape of the forward curves.

Ian Myles: Macquarie Group

What's drastically changed to see I think nearly half a year increase in the space of six months?

James Spence: ERM Power

Yeah. I mean, in terms of our gross margin Ian, what we're seeing is the evolution from twelve months ago. We're seeing a continued improvement across all areas. We've seen, quite clearly, Vales Point is part of that, but also our underlying operations are working well. I'll ask Steve who runs our retail business to talk a little bit more to the customer operations side.

Steve Rogers: ERM Power

Yeah. Morning, Ian. What we've seen quite strongly in the last 12 months is that customers are very happy with our service and product offerings, particularly our STEP online product offering. This means that we no longer need to be the cheapest on price or low on price to attract and retain customers.

Ian Myles: Macquarie Group

As on retail, I've noticed you've been losing some share in New South Wales. It's not a large amount but your volume growth has actually been going backwards a little, but I've - given you've got the wonderful Vales Point contract I'm wondering why is that actually occurring?

Steve Rogers: ERM Power

Again, I just don't think you can read anything too significant into that. People have particular approaches to particular markets at a point in time and they always wash out.

Ian Myles: Macquarie Group

Okay. Also, the loss of SME loads, what's the cause of that and why are you confident it's going to reverse?

Steve Rogers: ERM Power

The cause of that, Ian, is our competitors' practice within the market of updating their retail offers once per year. Obviously in a situation then when you've had dramatic increases in wholesale prices we adjust our pricing live to reflect that. We only wish to write profitable deals that make money. Our competitors will leave those same market offers sitting out there for very long periods of time and they are well underwater. As a consequence, obviously, that makes it very hard for us to acquire market share, but we are very comfortable with the approach that we take in that space.

Ian Myles: Macquarie Group

Okay. The other final question, just on the US, the interest expense which you report it's quite high, and I was just trying to understand, is that because of the termination of the sleeving agreement or is there something else I've missed there?

James Spence: ERM Power

Yes. Ian, there is a termination cost of the sleeving agreement which we've disclosed as a significant item. The way to think about our US finance costs looking forward is AUD$1.50 per megawatt hour which encompasses all of our needs, including working capital and collateral. That agreement runs through 2021.

Ian Myles: Macquarie Group

Yeah. Okay. That's great. Thank you.

Operator

That does conclude our conference for today. Thank you for your participation. You may now disconnect your lines.

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