13 December 2019

Z Energy earnings update

Lower margins negatively affect FY20 earnings outlook

Z Energy (NZX: ZEL ASX: ZEL) is forecasting a reduction in operational performance for December and the final quarter of FY20 due to the negative impact of low refining margins and continued price discounting in the retail fuel market.

Because of weaker than expected refining margins, our response to the changes arising from MARPOL and lower forecast retail margins, Z Energy (Z) has revised its EBITDAF earnings guidance for FY20 to be between $350 million and $385 million from the previous range of $390 million to $430 million[1].

Consistent with our dividend policy, Z is reflecting the lower earnings outlook in our dividend guidance for FY20 of $0.40 per share, compared to previous guidance of $0.48 to $0.50 cents per share.

Previously Z was able to maintain the bottom of its original dividend guidance by increasing the pay-out ratio to the top of the range and making minor adjustments to capital strategy. The additional reduction in earnings is now at a level where Z believes that it should let the reduced earnings capacity flow to the dividend rather than compromise its pay-out ratio or debt reduction program.

When comparing the latest earnings guidance to the original FY20 forecast, Z has reduced its earnings guidance from $450 million to $490 million[1] to currently $350 million to $385 million. The reduction of $120 million (from mid-point to mid-point offset by strategy and opex savings) can be split into $20 million in lower refining margins and our response to the changes arising from MARPOL and $90 million in lost retail margins. The reduction in retail margin being a balance of lower volumes ($25 million) and reduced retail margins ($65 million) for the whole of FY20.

Retail price competition

As stated at our 1HFY20 earnings announcement in October, retail trading conditions remain challenging with continued, elevated price competition. Despite the current trading environment Z's volume performance has shown improvement during 3QFY20.

Z prices its fuel on an integrated basis, i.e. when setting pump prices, we take a view on combined refining and marketing margins. This integration is typical of how the industry has operated for many years so that shortfalls in refining margin have been moderated by increases in marketing margins, and vice versa. The current market conditions reflect a decline in both refining and retail margins and this has been further exaggerated by the December drop in refining margins.

Retail margins have not materially improved since our earnings announcement and the competitiveness of the retail environment does not suggest any improvement over the forecast period.

Z estimates that the impact of reduced retail margins for the balance of 3QFY20 and 4QFY20 will negatively impact EBITDAF earnings by $15 million.

Refining margins

During the first half of FY20 refining margins were weak across the region, relative to Z's target of US$8/bbl contained within the original FY20 guidance. We saw some recovery in refining margins during 2QFY20 which we had expected to hold steady or increase slightly with the introduction of IMO2020 regulation changes.

1. Previous guidance ranges include the adoption of IFRS16 accounting standard changes as highlighted at the FY19 results announcement.

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However, we have seen a return to weaker than expected refining margins in the third quarter of FY20 and we expect margins to deteriorate further in 4QFY20 based on our market observations in December.

The contractual arrangements that Z has with the New Zealand Refining Company (NZX: NZR) means we have a 'floor' in the processing fee that we pay to the refining company. Third party forecasts regularly provided to Z estimate that during 4QFY20 refining margins will drop below the 'floor' level and may require Z to 'top up' the refining company. We do not expect these conditions to persist beyond 4QFY20. Z estimates that the impact from low refining margins, forgone dividend and any potential 'top up' payments on processing fees will negatively impact Z's FY20 EBITDAF earnings by $10million; some of which has already been recorded in December.

MARPOL

There is ongoing uncertainty in how we manage our response to the changes arising from MARPOL including arrangements with third parties. At the EBITDAF level the additional risk to earnings is $10 million and we have reduced the FY20 outlook to reflect this

Conference call

Z Energy (Z) will hold a conference call at 11.00am NZT today to discuss the revised earnings outlook.

To participate please call:

New Zealand: 0800 122 360
Australia: 1800 760 146
Hong Kong: 800 960 484
Singapore: 800 101 3287
Japan: 0053 112 2880
UK: 0808 145 3702
USA / Canada: 1844 393 3437

Confirmation code: 10003293 (Z Energy)

A recording of the conference call will be posted for replay on www.z.co.nz/investor later today.

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