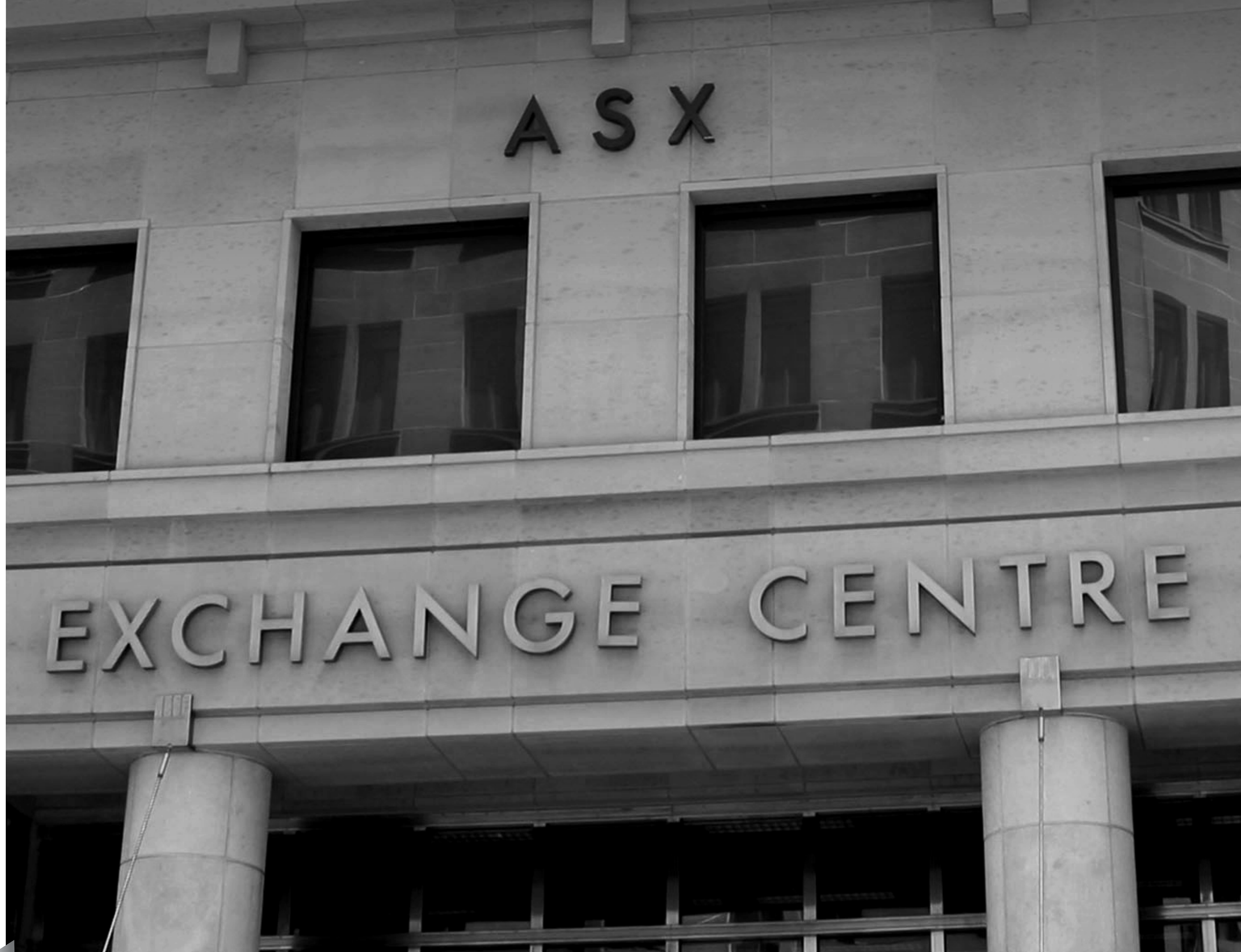
STOCKS DOWN UNDER

24 OCT 2022

ASX Top 200 Stocks Down Under

> *The most dangerous people are very smart traders who've never gotten their teeth kicked in.*

- F. Helmut Weymar (b. 1936), Former President of Commodities Corporation



AGL ENERGY

We're not energised by this one

AGL ENERGY

We're not energised by this one

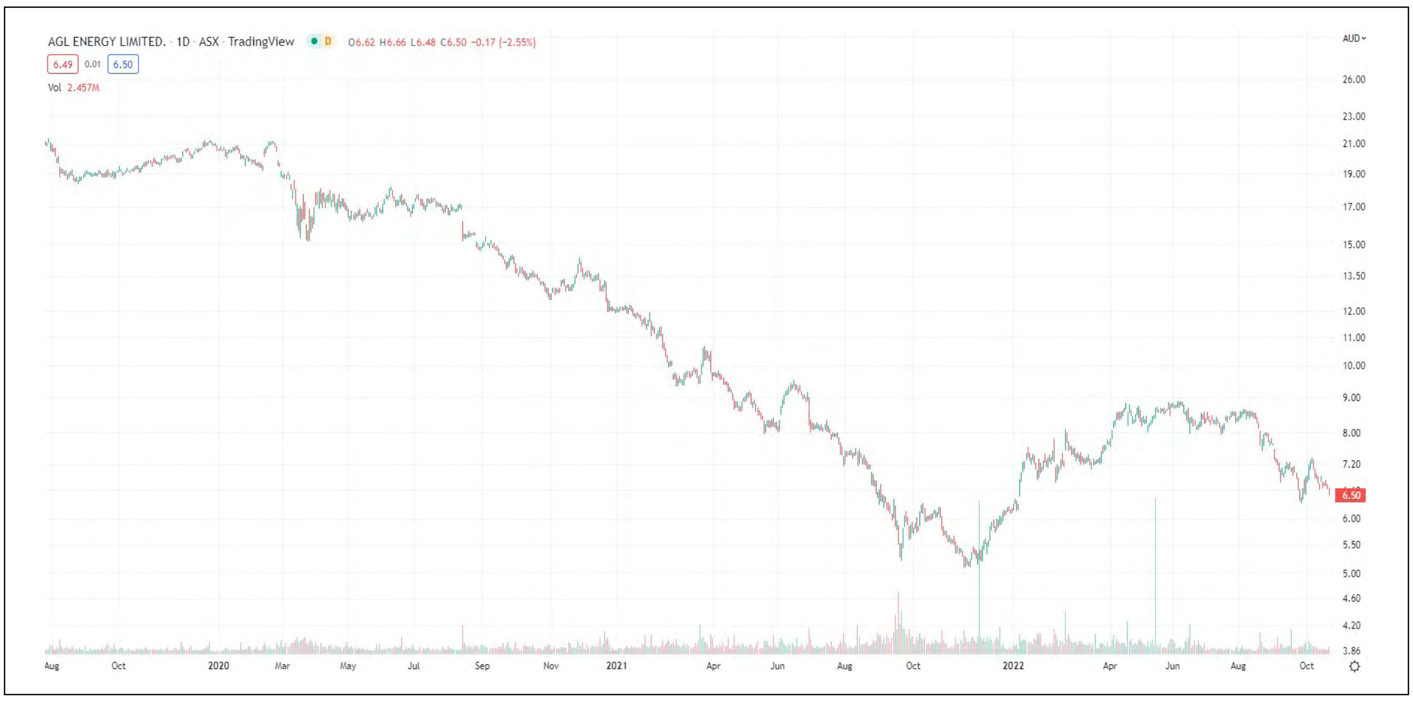
Stocks Down Under rating: ★★

ASX: AGL
Market cap: A$4.4BN

52-week range: A$5.10 / A$8.88
Share price: A$6.47

Few ASX companies have had more internal drama than AGL Energy (ASX: AGL). With consensus estimates signaling EBITDA growth this year, an 8% share price gain in a calendar year where the ASX 200 has lost over 12% and a good track record of high dividend yields, investors might think AGL looks attractive at these prices. But we are not so convinced.

Share price chart



Source: Tradingview

The second publicly listed company in Australia

AGL Energy has a long history, dating back to 1837 and it was actually only the second company to list on the Sydney Stock Exchange – as the Australian Gas Light Company. Today, it generates and sells electricity and gas to Australian households and businesses, boasting over 4.2m customers. It is Australia's largest electricity generator.

AGL Energy is also the largest carbon emitter, accounting for 8% of Australia's national carbon footprint. For some years it was trying to shake off this identity with plans to split its coal business into a separate entity named Accel Energy. But this was not good enough for tech billionaire Mike Cannon-Brookes.

Defeated by Mike Cannon-Brookes

The Atlassian co-founder made two takeover bids in early 2022 together with Canada's Brookfield Asset Management, but the board rejected both bids on the basis that they were below the fair value of the company. Not taking no for an answer, Cannon-Brookes put enough pressure on shareholders to force AGL to withdraw plans to put the demerger to a shareholder vote. The company would have needed 75% of shareholders to vote in favour and it was clear this would not happen.

Obviously, Cannon-Brookes didn't want coal-fired power to be maintained. But he also persuaded shareholders that Accel Energy would become a stranded asset because of the coal exposure and that shareholder value would be negatively affected by the higher costs of running two smaller, inefficient entities.

The scuttling of the plans led to four board members resigning and the company to undertake a strategic review of its operations. The review was completed last month and AGL is now targeting an exit from coal by the end of FY35, a decade earlier than planned. Its greenhouse gas emissions would fall from 40mt to Net Zero. But decarbonisation would require up to $20bn before 2036, funded from assets on its balance sheet, offtakes and via partnerships.

The company aims to have up to 5GW of new renewables and firming capacity in place by 2030, which will be aided by new projects, some on site of existing power sites. One example is at Liddell where AGL will build a 500-megawatt, two gigawatt-hour (GwH) grid-scale battery on the existing site.

AGL looks like a cheap growth stock, but is it too good to be true?

In FY22, AGL made a statutory profit of $13.2bn (up 21%), EBITDA of $1.2bn (down 27%) and an underlying profit of $225m (down 58%). This was due to lower earnings from trading, increased capacity costs to cover periods of peak demand and the absence of Loy Yang Unit 2 insurance proceeds that inflated FY21 results.

For FY23 the company has issued guidance of $1.25bn-$1.45bn in EBITDA and $200m-$320m in NPAT. Despite challenging market conditions, the company anticipates earnings will be resilient in FY23 and then take off from FY24 as historical hedge positions roll off and assuming wholesale electricity pricing remains elevated. The company paid a dividend of 26c per share that represents a yield of 3.8%, far lower than last year when it paid a dividend of 65c a share.

Consensus estimates suggest EBITDA will grow solidly over the next few years although it will only seriously take off in FY24. For FY23, $1.33bn is forecast (up 9%) followed by $1.75bn in FY24 (up 32%), then $1.87bn in FY25 (up 7%) and $1.99bn in FY26 (up 6%). Revenues, however, are forecast to fall to $12.49bn in FY23 (down 5.5%) and then not surpass FY22 levels until FY26.

Valuation multiples for FY23 look very cheap at 5.5x EV/EBITDA (and therefore 0.61x EV/EBITDA), 16.3x P/E and 0.47x PEG. But the PEG ratio assumes long term growth of 34.5%. And you have to wonder to what extent these analysts' models are influenced by two things: energy prices and the desire for their employers to be chosen by AGL when it kicks off its financing initiatives.

Too much uncertainty

We think AGL Energy is two stars for the same reason we rated Fortescue (ASX: FMG) two stars, which we wrote about last month. Namely because of the extent of its green energy ambitions on its results as well as the capital that will likely be required. Granted, consensus estimates for AGL suggest growth while Fortescue's suggest declines (as does the company's guidance), but AGL's ambitions will need substantially more funding ($20bn over the next 13 years). 13 years is long time, but we anticipate the funding will have to start flowing through soon. We also anticipate this will have an impact on dividends.

Some investors might be tempted to buy in just because of the low multiples. But when we last wrote about AGL (in an Insights Article published in November last year), we observed the company had been a value trap. Once a stock declines and starts to look cheap, investors flood in thinking it will rise just because it is perceived as undervalued. But they get trapped as the stock keeps going down further and further. In our view, there are many other companies without long term funding requirements and set to undergo such a radical shift in operations, that trade at similar multiples to AGL. Hence, they're a lot less risky and, therefore, more attractive.

Pitt Street Research Pty Ltd

3 Spring Street, Sydney, NSW 2000, Australia

Stocks Down Under gives you an information advantage to better invest and trade in ASX-listed stocks!

Stocks Down Under (Pitt Street Research AFSL 1265112) provides actionable investment ideas on ASX-listed stocks. The Content is financial advice but is not (and cannot be construed or relied upon as) personal financial advice. No investment objectives, financial circumstances or needs of any individual have been taken into consideration in the preparation of the Content. Please make sure that investing in such products is suitable for your circumstances, and ensure you obtain, read and understand any applicable offer document.

Financial products are complex, entail risk of loss, may rise and fall, and are impacted by a range of unpredictable market and economic factors.

Stocks Down Under/Pitt Street Research directors and staff may own shares in the companies mentioned in our articles, videos, reports and analyses.