

Update Centrica: A mixed bag of energy

Company:	Centrica	Market Cap:	£5.1bn
Industry:	Utility	Net Cash:	£316mio (+ ~£1.9bn liabilities)
Country:	UK	Revenue:	£20.6bn
Date:	5 th August 2022	Net Income:	£722mio (3.5%)
Dividend:	4.6%	Free Cash Flow:	£1.3bn (6.3%)
Entry:	£4.83bn	Target Market Cap:	£7.5bn

Phase 1 of turnaround completed

Having completed the sale of their Norway upstream assets, Centrica is now entering phase 2 of its turnaround, which focuses on improving operational performance of their restructured business and investing into the future. The half-year results were somewhat of a mixed bag, below updated numbers and a few points on each division.

Centrica fundamentals 2021 vs. 2022

Segment	Adj. operating profit 2021	Adj. operating profit 2022 (estimated in April 22)	Adj. operating profit 2022 (based on H1, estimated annual)
British Gas Services & Solutions	121	150	20
British Gas	118	300	300
Business Solutions	-52	-40	40
Bord Gais	28	45	66
Energy Marketing & Trading	70	70	350
Upstream (commodity tax deducted for April estimated 2022)	663	1,162	842
EBIT	948	1,687	1,618
Interest expense	187	165	165
Taxation	218	436	731
Net income	543	1,086	722
Net income (after capex, pension deficit)	-32	836	297

Source: Centrica, own estimates

1. British Gas Services & Solutions: Higher absences due to Covid and the impact of fire and rehire (more junior people) has actually left the division in worse shape. Given increasing costs for labour, profitability might continue to be impacted for the foreseeable future
2. British Gas: operating profit declined by over 40% y-o-y. However, they are claiming back 2/3 of over £500mio of losses incurred by taking on new customers of failed suppliers from Ofgem, which will get compensated over the course of a year
3. Business Solutions: Business energy supply achieved profitability amid higher energy prices. Their renewable energy services remain loss-making
4. Energy Marketing & Trading: The jump in profits is partly a one-off due to the high volatility in gas prices over the Ukraine invasion. However, their Cheniere long-term LNG contract is becoming profitable as they buy at Henry Hub +115% +\$3 liquefaction +\$1 shipping to Europe (\$13-15/mmbtu) vs. current prices of 300p/th in the UK, which equates to \$36/mmbtu. Although they hedge this forward and have sold a few cargos to 2025-27 already
5. Upstream: The hedges of the retained Spirit Energy upstream business for H2 22 were executed at much lower levels than I estimated (GBp 55 vs. GBp 150 estimated – although climbing to GBp 86 next year). Most profits have come from the Nuclear division, which is set to continue with hedged prices at similar levels as in H1 out to 2023. However, one nuclear plant has closed this month and two more are set to be closed in 2024 (remaining two to be closed in 2028 and the last one in 2055)

Cash outflows remain high, but liquidity, too

Although their pension deficit declined due to lower real interest rates, they have decided against paying it down in one go and therefore the annual £175mio pension deficit payments will continue over the next few years. This, in combination with £165mio interest expense and around £250mio capex, will leave cash outflows high over the next few years. With expected net income of around £722mio in 2022, the net income after capex and pension deficit payments would only be £297mio. While this will decline next year, the cash outflows remain relatively high at around £0.5bn in 2023.

Centrica cash outflows

Cash Outflows	2021	2022	2023
Spirit Energy capex	£400mio	£150mio	£10-50mio
Pension Deficit	£175mio	£175mio	£175mio
Interest Expense	£185mio	£165mio	£155mio
Renewable capex	-	£100mio	£100mio
Sum	£760mio	£590mio	£480mio

Source: Centrica

With regards to cash on balance sheet, while the cash position of £4.093bn is very healthy, the current net assets actually declined to £571mio due to a near doubling of provisions for other liabilities and charges of £4.578bn. These charges are reflecting mark-to-market on energy contracts due to the low price achieved on Spirit Energy forward sales. However, most of these charges won't result in margin calls as their main counterparty is Equinor and they have a "no margin payment" agreement in place. Therefore, releasing these liabilities would make Centrica's net current assets go to over £5bn. On the £1.9bn net liabilities, it is important to emphasize that the pension deficit roll forward to 30th June is only £600mio and the decommissioning costs will be largely financed by Spirit Energy profits over the coming decade.

Centrica key balance sheet items

Category	£ mio
Net current assets	571
Cash and cash equivalents	4093
Provisions for other liabilities and charges	-4578
Net cash	316
Pension deficit	-944
Decommissioning	-1200
Sole Pit contract	-72
Net liabilities	-1900

Source: Centrica

Analysts diverge

Given the complexity of understanding the business of Centrica and its different divisions, the market is having outsized reactions to analyst reports. After the results GS raised their price target above mine, and HSBC (the analysts who put 50% of their valuation on dividend and expected a smaller dividend) raised their target to 90p and changed from “reduce” to “hold”. While I found the analysis from HSBC in the past without merits, the Citi analyst has been even more confusing. Despite raising their EPS for 2022 and 2023 by 63% and 23% respectively, they have cut their target price to 97p from 105p amidst the decline in Centrica’s service division profits and unsustainable commodity prices. Although this is a fair argument, cutting the target price does not make sense to me when at the same time raising EPS by a substantial amount. The diversion amongst analysts should be treated with caution, as it shows that Centrica is a volatile business and earnings come with a few “if” and “but”.

Target valuation change?

My earnings expectations of April 2022 have been lowered mostly due to a lower hedged gas price from their upstream business. The biggest concern I have is that the new investments target >5% returns, while some of their debt is paying 6-7% coupons. I continue to see an enterprise value of £7.5bn as fair – however, including pension deficit and decommissioning costs, Centrica’s enterprise value is roughly £7bn. British Gas will likely have a volatile winter as well, because if temperatures are warmer than expected, British Gas would need to sell excess energy back into the market, which will probably be at lower prices. This is quite a big risk, which is why I was planning on selling Centrica by October to avoid taking this risk. However, given the mixed analyst reports and missing catalysts that could boost the valuation of Centrica ahead of the winter, I am now seeking to reallocate the capital.



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