

Turnaround: Centrica, a hidden cash cow

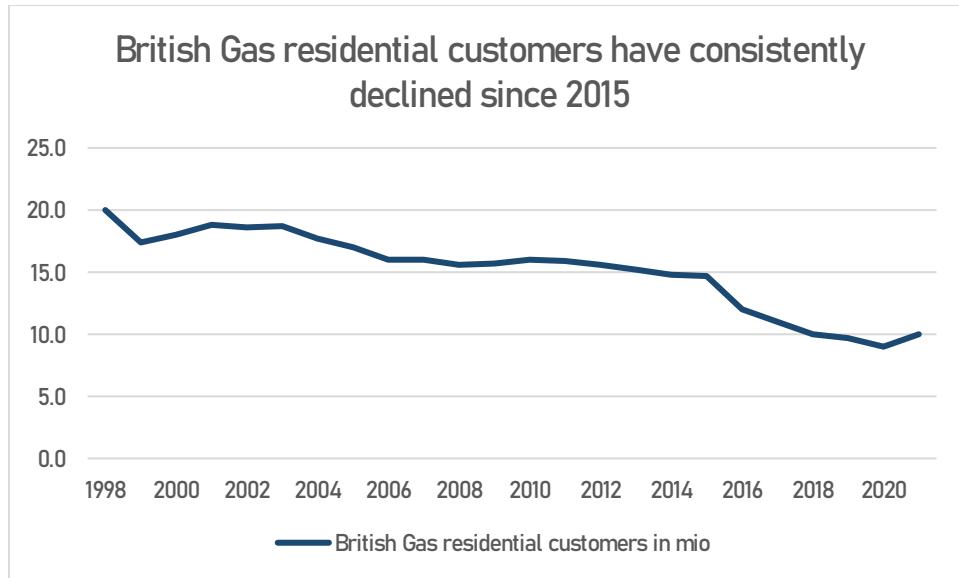
Company:	Centrica (CNA LN)	Market Cap:	£3.9bn
Industry:	Utility	Net Debt:	£0 (+ ~£1.5bn pension deficit)
Country:	UK	Revenue:	£16bn
Date:	15 th November 2021	Net Income:	£200mio (1.25%)
Dividend:	None	Free Cash Flow:	£1bn (6.25%)
Entry:	£3.1bn	Target market cap:	£4.5bn to £6bn

Introduction

Centrica is the largest UK downstream energy supplier & owner of British Gas and Ireland's Bord Gáis Energy, together with currently 10mio customers. The company is also active in upstream with its 69% ownership in natural gas E&P business Spirit Energy and is owning 20% of the UK's operating nuclear fleet. Furthermore, Centrica is helping businesses to achieve net zero, advising and building energy plants and owning a battery energy storage system as well as being the largest renewable energy supplier of the country. In light of UK's goal to achieve net zero, Centrica is targeting to build a low carbon portfolio of 800MW of solar and battery storage, install 20,000 heat pumps and 100,000 EV charge points a year, as well as helping at least 2.5mio customers to use less energy by adopting its Hive heating solutions by 2025.

Why so cheap?

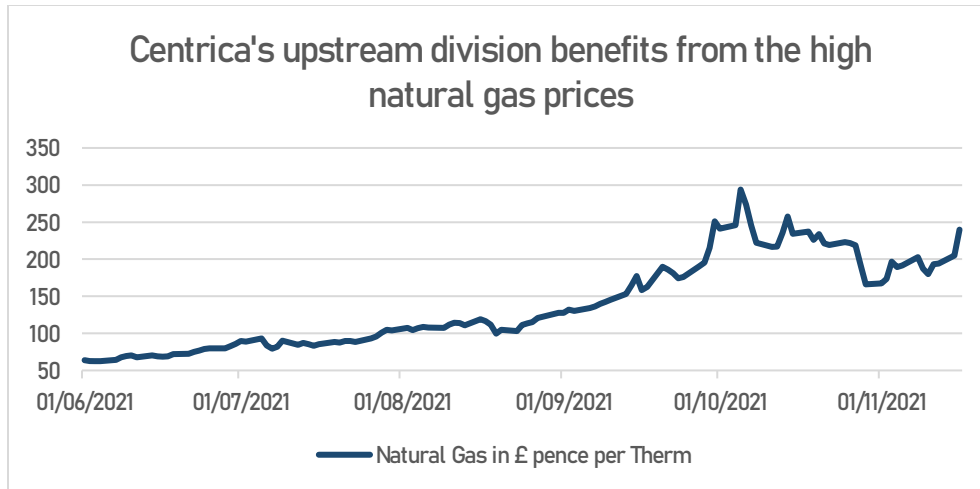
With a market cap of just £3.9bn, but achieving £1bn in free cash flows, Centrica appears cheap and the reason for this has largely been the UK's downstream energy market, which was plagued by large competitors taking market share and in recent years also by small, private equity funded companies that targeted market share at any costs, making the entire industry loss-making – except Centrica's British Gas. In result, margins have declined and British Gas's 20mio customers from 1998 slumped to just below 9mio customers last year, declining rapidly since 2015. At the same time, results have consistently had a number of exceptional items, which ultimately reduced profits year after year. From 2018, matters were complicated further, as the UK energy regulator Ofgem introduced a price cap for the default tariff that dictates how much a customer can get charged, which put further pressure on margins.



Source: Centrica annual reports

What's the turnaround?

In 2020, Centrica focused on its core UK market and sold their US business, Direct Energy, for £2.85bn, enabling Centrica to pay down €750mio of expensive hybrid bonds, reaching a small net cash position, while ensuring enough cash is available to prop up their pension deficit, an estimated £1.5bn. By eliminating their pension deficit, Centrica will save approximately £175mio annual pension deficit contributions, and will have further cash to pay down debt, decreasing their £185mio annual interest expense further. This action alone could free up additional £200mio in annual cash flow for the shareholders. At the same time, Centrica is managing the recent energy crisis well, as their upstream business, Spirit Energy, benefits from the rise in natural gas prices, which Spirit Energy sells forward to achieve an average price over 24 months. While the plan is to sell Spirit Energy for an estimated £1.5bn and transform their Rough gas field (Centrica Storage Limited) to a hydrogen storage facility at a cost of £1.5bn, Centrica might even transform their Rough asset to a natural gas storage facility first amid the current energy crisis, as there is almost no natural gas storage in the UK, making the country reliant on Netherlands and France. The key for the turnaround, however, will likely be the transformation of the UK downstream energy market, which will depend on how Ofgem adjusts the Ofgem price cap for the default tariff, on which 2/3 of British Gas's customers are on.



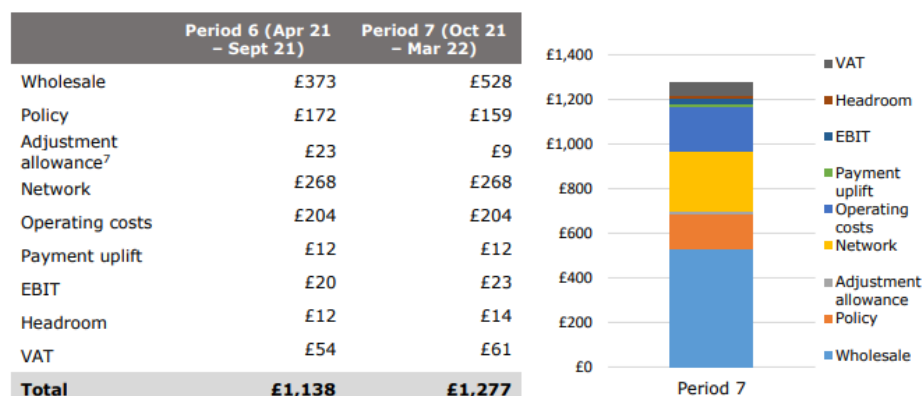
Source: Bloomberg

The Ofgem price cap

The UK energy regulator, Ofgem, introduced price caps for the default tariff, which get reviewed on a semi-annual basis and allow for around ~3% profit margin. The tariff runs from October-March and from April-September and needs to be hedged for six months, starting eight months in advance, i.e. for the October-March period, the energy supplier needs to hedge from February-August. However, the problem with the price cap is that when you, as an energy supplier, supply energy at a fix price to a customer, you only hedge the period the customer is with you on a fix tariff. Once the customer finishes their fixed tariff, they will automatically roll onto the Ofgem price capped default tariff. This year we have seen natural gas prices rise as much as seven times, which means, if you are an energy supplier that has customers on a fixed tariff rolling into the Ofgem price capped default tariff during a time of highly volatile energy prices, you are having to buy energy at very expensive prices in the spot market, while only being able to charge the customer for the average forward price between February-August. If the energy supplier does not have any upstream assets and not enough cash in the bank to bear the sudden loss, the energy supplier goes bust. The cap has led to 40 energy supplier failures since 2016 and more than 20 this year alone¹. What was once a market of around 70 energy suppliers, might lead to a market of as few as 10 suppliers next year. The Ofgem price cap has been dreadful for the entire industry, but it has now cleaned up the industry completely, leading to a consolidation of large suppliers, which have all gained new customers. The higher consolidation and a likely adjustment to the price cap next year will enable larger profit margins from next year.

¹ <https://www.energyscanner.com/which-energy-suppliers-have-gone-bust/>

Latest Ofgem Price Caps example for a dual fuel Typical Domestic Consumption Value



Source: Ofgem

Conclusion

While Centrica has cleaned up its balance sheet and, everything else stable, will be able to increase profitability by its cost reduction programme alone, the recent volatility in energy prices and resulting failures of suppliers has enabled Centrica to turn around their falling customer numbers and return to growth. The combination of idiosyncratic changes and macroeconomic development are all in Centrica's favour and I estimated the company's fair value at £4.5bn, before the energy crisis hit. While it's hard to put a price tag on the company amid uncertainty over Ofgem's price cap and how many customers British Gas is ultimately able to gain, the company's valuation should be well in excess of the £4.5bn. There are estimates that the next Ofgem price cap is as much as £400 higher than the current one, which would be on average £1,677. If British Gas has, say 10mio customers with 6.6mio on the default tariff and margins stay the same ~3%, the operating profit on those 6.6mio customers will be £332mio for British Gas, £113mio higher than in 2021². Given that British Gas Energy profits make up ~65% of the group's total operating profits and the growth in upstream profits is more or less the same, one can roughly estimate operating profits to be £680mio ($(£332\text{mio} + (332\text{mio} \times 1/3)) / 0.65$), which compares to £447mio operating profit in 2020. Potential net profits of £400mio and benefits of no payment of £175mio in pension deficits as well as a potential interest expense reduction from the current £185mio should value the business at £6bn market cap with the £175mio being paid out as dividends to shareholders at a 3% yield.



² Estimated based on HY21 results

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