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Research

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| | |
|---------------------|---------------|
| Price (p) | 601.00 |
| Shares in issue (m) | 401 |
| Mkt Cap (£m) | 2,410 |
| Net debt (£m) | 1 |
| EV (£m) | 2,411 |
| BVPS (p) | 337.6 |

Share price performance

| | |
|---------------------|-----------|
| 1m | 13.6% |
| 3m | -18.1% |
| 12m | 9.3% |
| 12 m high/low | 845/467.6 |
| Ave daily vol (30D) | 1,313,324 |

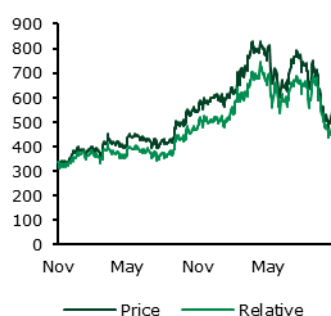
Shareholders

| | |
|----------------------|-----------|
| Invesco Ltd | 6.9% |
| Blackrock | 5.2% |
| Orbis Allan Gray Ltd | 3.9% |
| Vanguard Group | 3.9% |
| Adrdn | 3.9% |
| Dimensional Fund | 3.7% |
| Schroders Plc | 3.7% |
| Aviva Group | 2.7% |
| Deutsche Bank Ag | 2.7% |
| Jupiter | 2.4% |
| Total for top 10 | 38.9% |
| Free float | 99.8% |
| Source: Bloomberg | 17 Nov 22 |

Next news Finals Q1

Business description

Integrated biomass, hydro and storage IPP



KNOWN UNKNOWN NOW A KNOWN

The Electricity Generator Levy has been set at 45% of profit above a power price of £75/MWh. While slightly higher than some expectations, when we update for higher current prices, the overall impact on our valuation is negligible. The long-term impact is also minimal in our view and the removal of uncertainty over the extent of the taxation is beneficial. Drax remains essential to the decarbonisation of the UK power industry as the main viable route to negative emissions at scale.

Windfall tax at 45% of profit over £75/MWh

The autumn statement includes a windfall tax of 45% on the profits of electricity generation companies, based on revenue above a power price of £75/MWh. Costs are set at a fixed allowance of £10m per corporate group. The Levy will not apply to electricity generated under Contracts for Difference (CfDs) or from gas generators, pumped hydro or battery storage. The tax will become effective from 1 January 2023 and is described as temporary with a backstop date of 31 March 2028. For renewables this is mainly targeting those on the Renewables Obligation (RO) where c.£50/MWh of revenue is generated from the sale of Renewable Obligation Certificates (ROCs) and the rest is from power market sales. Revenue from the sale of the ROCs themselves will not be taxed but profits on the latter where the price is above £75/MWh will now be taxed at 45%. There is some further potential cost allowance where there are exceptional costs, but no further details have been given. There is also no mention of allowances for investment although this has been suggested.

Valuation impact but uncertainty removed

For Drax the key assets affected are the three 645MW RO funded biomass units and the smaller Scottish hydro units amounting to 126MW. Drax last updated on its hedging at its interim results in July. Of its ROC output, hedging levels were £98.3/MWh on 8.8TWh of generation in FY 23 and £109.5/MWh on 4.5TWh in FY 24. Assuming the hedging levels are mirrored in the spot market then we see the maximum additional tax in FY 23 as £108m and in FY 24 as £162m. Of course, Drax will continue to benefit from higher power prices even though it is now taxed on these. The forward curve continues to show historically high pricing, and this is remaining high further out. In addition to the tax changes, we are also revising our forecasts to fully reflected the hedging prices across all output, raising EBITDA in FY 23 and FY 24. We have also factored in an increase in FY 25 which increases our central DCF based valuation to 960p from 951p.

| £,000 Dec | 2020a | 2021a | 2022e | 2023e | 2024e | 2025e |
|-----------------|--------|--------|--------|--------|--------|--------|
| Sales | 4,235 | 5,174 | 4,519 | 4,893 | 5,206 | 5,334 |
| EBITDA | 379 | 370 | 666 | 881 | 981 | 912 |
| PBT | 119 | 101 | 348 | 582 | 684 | 630 |
| EPS | 24.3 | 22.3 | 81.1 | 93.2 | 90.0 | 120.4 |
| CFPS | 48.8 | 34.7 | 83.9 | 115.3 | 128.4 | 154.0 |
| DPS | 17.1 | 18.8 | 21.0 | 23.1 | 25.4 | 27.9 |
| Net Debt (Cash) | 806 | 1,170 | 982 | 676 | 323 | -143 |
| Debt/EBITDA | 2.1 | 3.2 | 1.5 | 0.8 | 0.3 | -0.2 |
| P/E | 24.7 | 26.9 | 7.4 | 6.4 | 6.7 | 5.0 |
| EV/EBITDA | 6359.1 | 6525.3 | 3621.9 | 2736.1 | 2456.4 | 2643.0 |
| EV/sales | 569.2 | 465.9 | 533.4 | 492.7 | 463.1 | 452.0 |
| FCF yield | 8.1% | 5.8% | 14.0% | 19.2% | 21.4% | 25.6% |
| Div yield | 2.8% | 3.1% | 3.5% | 3.8% | 4.2% | 4.6% |

FINANCIAL MODEL

FORECAST CHANGES

We have revised our forecasts to add the new tax but also to update to reflect the current electricity price forward curve. This remains high but also shows high prices persisting into FY 25 and even beyond. We have assumed that the hedge price levels reported at the interims will now be met in all output and we have assumed a rise in FY 25 pricing. These increases are all now taxed.

Key forecast changes

| | 2023 Old | 2023 Revised | 2024 Old | 2024 Revised | 2024 Old | 2024 Revised |
|--------|-------------|-----------------|-------------|-----------------|-------------|-----------------|
| EBITDA | 796 | 881 | 796 | 981 | 763 | 912 |
| EPS | 102.8 | 93.2 | 95.9 | 90.0 | 92.5 | 120.4 |
| DPS | 23.1 | 23.1 | 25.4 | 25.4 | 27.9 | 27.9 |

Source: Longspur Research

VALUATION IMPACT

We have updated our base case forecast to adjust for the impact of the tax and to capture better near-term pricing. We have also modelled scenarios to include a return on the CCS element of the UK BECCS units, overseas BECCS plants and the Cruachan expansion. Our base case valuation rises to 806p per share on better pricing and if we add new pellet capacity this rises to 960p which we see as a sensible central case. Full economics for UK CCS, overseas BECCS and the Cruachan expansion all contain elements of regulatory uncertainty but factoring in sensible scenarios could see a valuation of 1,179p.

Valuation scenarios

| p per share | Incremental | Cumulative |
|---------------------------------|-------------|--------------|
| Revised base case | 806 | 806 |
| Pellet expansion – central case | 154 | 960 |
| CCS on two UK units | 62 | 1022 |
| Cruachan expansion | 26 | 1048 |
| Global BECCS – high case | 131 | 1,179 |

Source: Longspur Research

RISK

The key risks to our valuation are driven by potential policy changes, competition and commodity price risk. Today's tax is a crystallisation of policy risk but there are others notably around the carbon capture and long duration storage consultations currently underway. We see the signs on both of these as potentially positive for Drax by creating certainty of income for these activities. Competition always exists but Drax has a strong position both in the UK power market and as a global first mover in BECCS. Commodity price volatility is a big driver of the upgrading of our price forecasts today but there is two way risk and we have remained cautious further out.

Profit and Loss Account

| £m, DEC | 2020a | 2021a | 2022e | 2023e | 2024e | 2025e |
|--------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Turnover | | | | | | |
| Power Generation | 3,646 | 4,682 | 3,761 | 3,916 | 4,019 | 3,951 |
| B2B Energy Supply | 2,119 | 2,360 | 2,607 | 2,791 | 2,989 | 3,201 |
| Pellet production | 231 | 450 | 528 | 620 | 694 | 741 |
| Central, int gp and depn | -1,761 | -2,318 | -2,376 | -2,435 | -2,496 | -2,558 |
| Total | 4,235 | 5,174 | 4,519 | 4,893 | 5,206 | 5,334 |
| Operating profit | | | | | | |
| Power Generation | 400 | 352 | 563 | 727 | 768 | 650 |
| B2B Energy Supply | -39 | 6 | 24 | 13 | 15 | 17 |
| Pellet production | 52 | 86 | 159 | 223 | 282 | 331 |
| Central, int gp and depn | -224 | -273 | -321 | -307 | -312 | -316 |
| Operating profit | 189 | 170 | 425 | 657 | 754 | 682 |
| P&L Account | 2020a | 2021a | 2022e | 2023e | 2024e | 2025e |
| Turnover | 4,235 | 5,174 | 4,519 | 4,893 | 5,206 | 5,334 |
| Operating Profit | 189 | 170 | 425 | 657 | 754 | 682 |
| Investment income | 0 | 0 | 0 | 0 | 0 | 0 |
| Net Interest | -69 | -70 | -77 | -74 | -70 | -52 |
| Pre Tax Profit (UKSIP) | 119 | 101 | 348 | 582 | 684 | 630 |
| Goodwill amortisation | 0 | 0 | 0 | 0 | 0 | 0 |
| Exceptional Items | -354 | 21 | -25 | 0 | 0 | 0 |
| Pre Tax Profit (IFRS) | -235 | 122 | 323 | 582 | 684 | 630 |
| Tax | 40 | -12 | -24 | -210 | -325 | -150 |
| Post tax exceptionals | 37 | -30 | 0 | 0 | 0 | 0 |
| Minorities | 0 | 1 | 0 | 0 | 0 | 0 |
| Net Profit | -158 | 80 | 299 | 372 | 359 | 481 |
| Dividend | -65 | -71 | -80 | -89 | -98 | -107 |
| Retained | -223 | 9 | 219 | 283 | 262 | 373 |
| EBITDA | 379 | 370 | 666 | 881 | 981 | 912 |
| EPS (p) (UKSIP) | 24.29 | 22.31 | 81.11 | 93.19 | 90.04 | 120.43 |
| EPS (p) (IFRS) | -39.79 | 20.01 | 74.85 | 93.19 | 90.04 | 120.43 |
| FCFPS (p) | 48.84 | 34.66 | 83.90 | 115.30 | 128.37 | 154.01 |
| Dividend (p) | 17.10 | 18.80 | 21.00 | 23.10 | 25.40 | 27.90 |

Source: Company data, Longspur Research estimates

KEY POINTS

- Flattish EBITDA in FY 21 reflects loss of income from gas assets now sold
- Strong recovery in FY 22 as new pellet income contributes for a full year
- FY22 also benefits from stronger generation market
- COVID 19 impact on customers' business in FY 20 but recovery in FY 21 and FY 22
- Overall recovery sustained in FY 23 with stronger pricing
- Net interest balanced between cashflow and capex
- Higher tax due to windfall tax in FY 23 and Fy 24, lower inFY 25 as pricing starts to normalise
- Dividend remains covered throughout

Balance Sheet

| £m, DEC | 2020a | 2021a | 2022e | 2023e | 2024e | 2025e |
|--------------------------|--------|--------|--------|--------|--------|--------|
| Fixed Asset Cost | 3,484 | 4,166 | 4,409 | 4,616 | 4,755 | 4,895 |
| Fixed Asset Depreciation | -1,543 | -1,855 | -2,096 | -2,320 | -2,547 | -2,777 |
| Net Fixed Assets | 1,941 | 2,311 | 2,313 | 2,296 | 2,208 | 2,118 |
| Goodwill | 248 | 416 | 416 | 416 | 416 | 416 |
| Other intangibles | 182 | 189 | 189 | 189 | 189 | 189 |
| Investments | 292 | 125 | 145 | 145 | 145 | 145 |
| Stock | 348 | 501 | 437 | 473 | 504 | 516 |
| Trade Debtors | 525 | 642 | 561 | 607 | 646 | 662 |
| Other Debtors | 367 | 1,324 | 1,324 | 1,324 | 1,324 | 1,324 |
| Trade Creditors | -907 | -1,211 | -1,058 | -1,145 | -1,219 | -1,249 |
| Other Creditors <1yr | -394 | -966 | -966 | -966 | -966 | -966 |
| Creditors >1yr | -364 | -767 | -767 | -767 | -767 | -767 |
| Provisions | -91 | -86 | -86 | -86 | -86 | -86 |
| Pension | -1 | 0 | 0 | 0 | 0 | 0 |
| Capital Employed | 2,146 | 2,476 | 2,508 | 2,485 | 2,393 | 2,301 |
| Cash etc | 290 | 317 | 530 | 829 | 1,182 | 1,147 |
| Borrowing <1yr | 7 | 56 | 56 | 56 | 56 | 56 |
| Borrowing >1yr | 1,089 | 1,431 | 1,456 | 1,450 | 1,449 | 948 |
| Net Borrowing | 806 | 1,170 | 982 | 676 | 323 | -143 |
| Share Capital | 48 | 48 | 48 | 48 | 48 | 48 |
| Share Premium | 430 | 432 | 432 | 432 | 432 | 432 |
| Retained Earnings | 153 | 198 | 417 | 700 | 962 | 1,335 |
| Other | 709 | 607 | 607 | 607 | 607 | 607 |
| Minority interest | 0 | 22 | 22 | 22 | 22 | 22 |
| Capital Employed | 2,146 | 2,476 | 2,508 | 2,485 | 2,393 | 2,301 |
| Net Assets | 1,339 | 1,307 | 1,525 | 1,809 | 2,071 | 2,444 |
| Total Equity | 1,339 | 1,307 | 1,525 | 1,809 | 2,071 | 2,444 |

Source: Company data, Longspur Research estimates

KEY POINTS

- Working capital remains comfortable across period
- Goodwill increases in FY 21 with pellet acquisition
- Net debt rises with acquisition and then drops with cashflow

Cashflow

| £m, DEC | 2020a | 2021a | 2022e | 2023e | 2024e | 2025e |
|-------------------------|-------|-------|-------|-------|-------|-------|
| Operating profit | 189 | 170 | 425 | 657 | 754 | 682 |
| Depreciation | 190 | 199 | 241 | 224 | 227 | 230 |
| Provisions | 20 | 0 | 0 | 0 | 0 | 0 |
| Other | -23 | -42 | -25 | 0 | 0 | 0 |
| Working capital | 37 | 27 | -30 | -190 | -119 | 167 |
| Operating cash flow | 413 | 355 | 611 | 691 | 862 | 1,079 |
| Tax paid | -48 | 12 | -12 | -24 | -210 | -325 |
| Capex (less disposals) | -171 | -209 | -244 | -207 | -139 | -139 |
| Investments | 0 | -20 | -20 | 0 | 0 | 0 |
| Net interest | -59 | -60 | -77 | -74 | -70 | -52 |
| Net dividends | -65 | -71 | -71 | -80 | -89 | -98 |
| Residual cash flow | 70 | 7 | 187 | 306 | 354 | 465 |
| Equity issued | 1 | 2 | 0 | 0 | 0 | 0 |
| Change in net borrowing | -67 | 363 | -187 | -306 | -354 | -465 |
| Adjustments | -3 | -359 | 0 | 0 | 0 | 0 |
| Total financing | -70 | 7 | -187 | -306 | -354 | -465 |

Source: Company data, Longspur Research estimates

KEY POINTS

- Working capital modestly negative assuming no change in payment timings
- Capex slightly down in FY 20 as signalled by company
- Windfall tax outflows in FY 24 and FY 25
- Net investment outflow in FY21 as gas asset sales offset by pellet acquisition
- Cash positive from FY 22
- Further capex on pellet business expansion

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