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Research

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Price (p) 631.00

Shares in issue (m)	401
Mkt Cap (£m)	2,531
Net debt (£m)	1
EV (£m)	2,532
BVPS (p)	328.0

Share price performance

1m	-2.8%
3m	2.4%
12m	-2.6%
12 m high/low	845/467.6
Ave daily vol (30D)	1,276,852

Shareholders

Invesco Ltd	7.0%
Jupiter	6.2%
Blackrock Inc	5.2%
Vanguard Group Inc	4.2%
Orbis Allan Gray Ltd	3.9%
Dimensional Fund	3.6%
Schroders Plc	3.5%
Abrdn Plc	3.3%
M&G Plc	2.6%
Aviva Plc	2.5%
Total for top 10	41.9%
Free float	99.8%
Source: Bloomberg	23 Feb 23

Next news CMD May

Business description

Integrated biomass, hydro and storage IPP



FLEXIBILITY REVEALED

We think the strong performance from the Drax pumped storage gives grounds for upside as it demonstrates the flexibility the company has across its GB portfolio. We have upgraded our numbers on a better, long term storage spread compared with FY 21 and our central case valuation rises to 1,111p from 1,030p as a result. Our central case now also includes the assumption of CCS on two units at Drax.

Pumped storage and hydro key feature of results

The highlight of the Drax full year results in our view was the strong performance from the pumped storage and hydro assets with EBITDA from these assets coming in at £171m against £68m the year before. In some ways this is not surprising. We can examine the average spreads between the highest half hour prices and the lowest and see that for a typical long duration storage asset like Cruachan the spread will have gone from £171/MWh in 2021 to £264/MWh in 2022. While FY 23 baseload futures are now below £200/MWh having hit over £270/MWh in FY 22, they remain above the c.£100/MWh figure for FY 21. And with volatility around the baseload price likely to remain on the high side we think spreads can certainly beat FY 21 going forward.

Hedging beats forward curve

Drax also updated on its hedging position with net capacity on ROC biomass, hydro and gas assets of 12.4TWh hedged at £158.1/MWh in FY 23, 9.0TWh at £149.2/MWh in FY 24 and 1.9TWh at £135.7/MWh in FY 25. The average baseload forward price for those years is now at £192/MWh, £143/MWh and £131/MWh respectively. FY 23 hedging includes earlier lock-ins of lower prices and taken with the FY 24 and FY 25 hedging we see these levels as modestly positive.

Upgrading on storage outlook

We see the FY 22 results as showing that Drax has flexibility across its GB portfolio with the company able to weight biomass generation to the winter, optimising between generation and biomass pellet sales, and capture market volatility in the hydro and pumped storage assets. As a result, we see the likelihood of strong storage spreads further out as a net upside and we are upgrading our numbers for this and for the recent capacity market win announced last week.

£,000 Dec	2021a	2022a	2023e	2024e	2025e	2026e
Sales	5,174	8,159	5,744	6,022	6,075	5,502
EBITDA	370	709	1,100	1,157	1,246	699
PBT	101	405	752	806	921	390
EPS	22.3	85.1	100.2	107.0	174.5	75.1
CFPS	34.7	25.2	53.3	240.8	218.1	118.9
DPS	18.8	21.0	23.1	25.4	27.9	30.7
Net Debt (Cash)	1,170	1,356	1,316	535	-175	-497
Debt/EBITDA	3.2	1.9	1.2	0.5	-0.1	-0.7
P/E	28.3	7.4	6.3	5.9	3.6	8.4
EV/EBITDA	10.0	5.5	3.5	2.6	1.9	2.9
EV/sales	0.7	0.5	0.6	0.6	0.6	0.7
FCF yield	5.5%	4.0%	8.4%	38.2%	34.6%	18.8%
Div yield	3.0%	3.3%	3.7%	4.0%	4.4%	4.9%

WHY CRUACHAN CAN REMAIN STRONG

The economics of power trading, or arbitrage to use the energy industry term, are based on the ability to buy power and charge storage assets when prices are low and to sell power by discharging when prices are high. Our analysis of the past three years suggests that the average spread between high and low prices can be significant and make power trading a key part of the revenue stack. We think we can read forward from this recent past to show that projects can deliver even stronger returns as renewable penetration grows with planned developments of offshore wind projects in the North Sea.

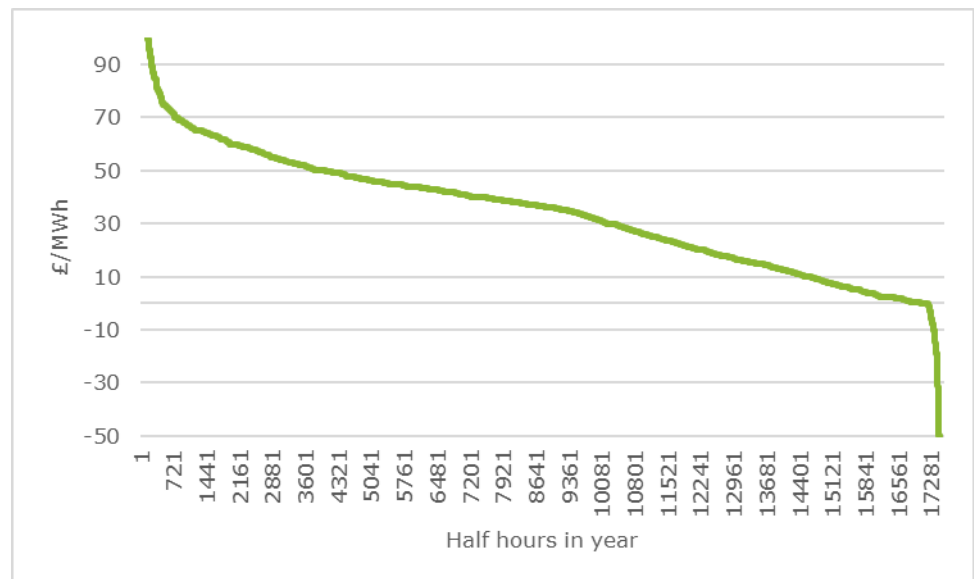
Power prices in 2022 were clearly exceptional. We also see them as an extreme example of the way in which power markets are likely to develop going forward with relatively high gas prices determining peak and peak load prices and higher renewables penetration keeping off peak prices low. These low off peak prices will occur more often as renewable penetration increases.

Power markets are seeing growing penetration of intermitted renewable energy in the form of wind and solar PV. At the same time gas prices have been rising and were already doing so before the Russian invasion of Ukraine. While they have already fallen back and may fall further, we think it likely that, in the UK and Europe at least, they remain higher than before 2021.

Broadly speaking, generators in electricity markets compete on the basis of their short run marginal costs. When renewables are running, they have a very low short run marginal cost. In fact, this can be negative in that they will bid down to the negative value of any subsidy they receive in order to generate the electricity on which the subsidy is paid. This results in negative pricing periods. As renewables take up more of the system, low price periods become more frequent. However, when there are not enough renewables to meet demand, more expensive fossil fuelled generation becomes price setting. With high fossil fuel prices this makes these periods very expensive.

We can look at the distribution of prices in what the power industry has historically termed a price duration curve with highest prices shown first at the left hand end and low prices at the right hand end.

Price duration curve 2020



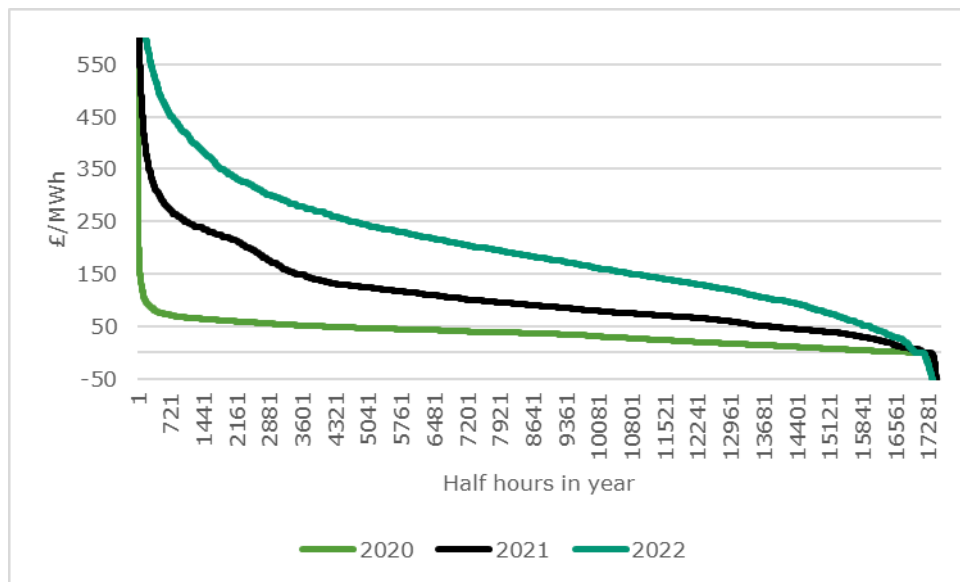
Source: Longspur Research, ELEXON

The experience in 2020 was unusual with exceptionally low demand due to COVID lockdowns. While this meant that there were relatively more periods when renewables

were price setting, penetration rates remained low so these periods were still not particularly frequent. With lower overall demand pricing was weak across all periods.

2021 was a more normal year with renewable penetration as a percent of demand growing but gas prices also starting to rise leading to higher peak prices. 2022 saw high gas prices but demand had grown so renewables set prices less of the time.

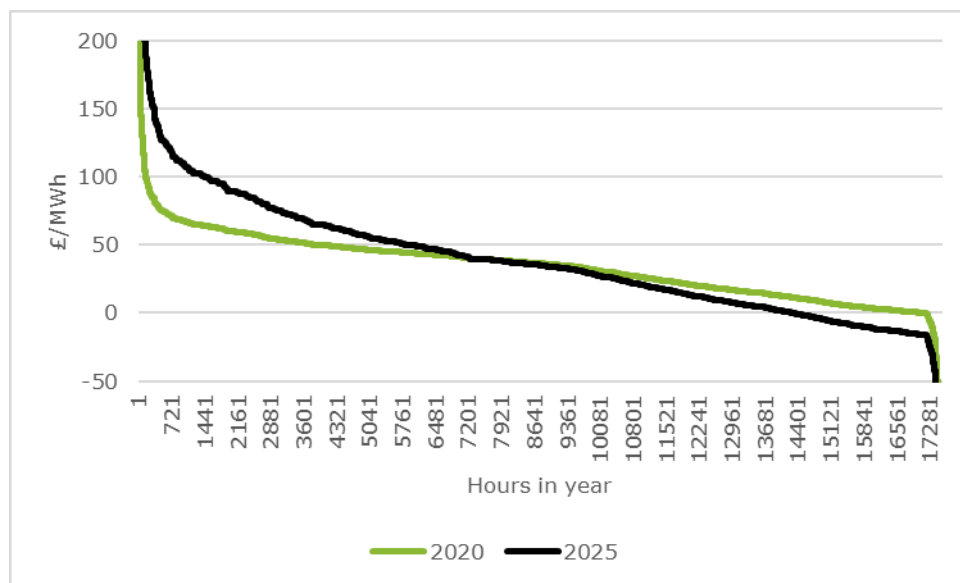
Price duration curves for 2020, 2021 and 2022



Source: Longspur Research, ELEXON

We expect gas prices to fall back towards 2021 levels but to still remain well above 2020 levels as more reliance is placed on higher cost LNG trains as the UKCS sees further decline. We also expect renewable penetration to increase. The likely outcome is that high prices will drop compared with the exceptional 2022 outcome but remain above 2021 and a gradually more extended low price regime will apply at the right hand end of the curve.

Expected price evolution



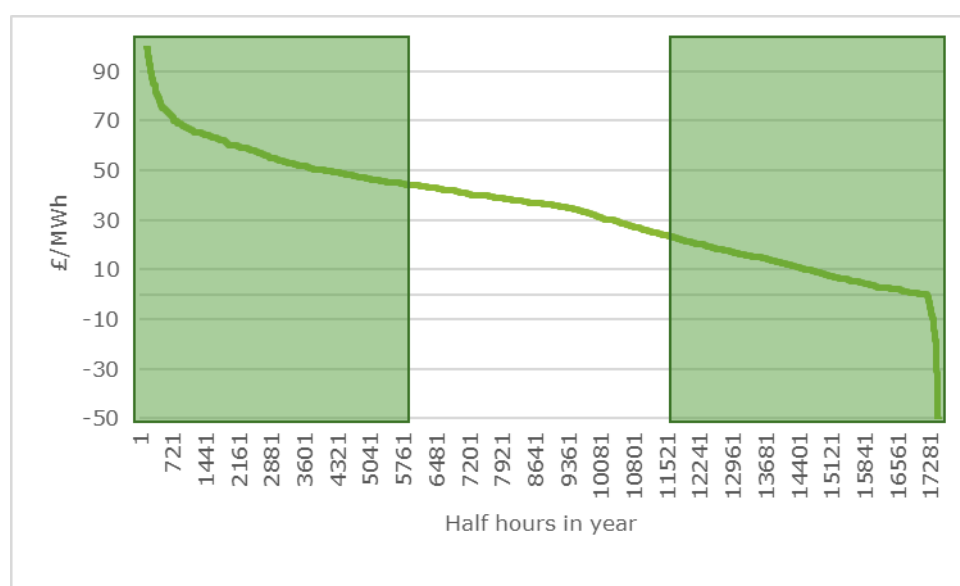
Source: Longspur Research, ELEXON

IMPACT FOR CRUACHAN

Looking at the price duration curves we can estimate the average charging cost and discharging price assuming utilisation of 33.3% based this on 16 hours of storage duration with one cycle every two days ($16/48=0.333$). This is consistent with the 16 hours of operation quoted by Drax. In reality there will be more cycles of shorter duration in order to take advantage of market opportunities allowing a better potential outcome but this analysis should capture the main value of the arbitrage opportunity for Cruachan.

The resulting average spread will then be the difference between the average prices in the two green boxes below.

Calculating the storage spread



Source: Longspur Research, ELEXON

We have shown the top and bottom 33.3% of prices in the table below. 2020 shows low spreads based on low gas prices. 2021 starts to reflect higher gas prices to deliver a spread of £171/MWh, with a charging cost of £40/MWh and a discharging price of over £210/MWh. 2022 sees the spread rise to £264/MWh as high gas prices drive peak power prices.

Storage spreads

£/MWh	High 33.3%	Low 33.3%	Spread
2020	62	8	53
2021	210	40	171
2022	341	77	264

Source: Longspur Research, ELEXON

Both 2020 with its low demand and 2022 with high gas prices were exceptional but 2021 could represent a sensible base case going forward. But given our expectations of how the market will evolve, 2021 could look conservative given it assumes that charging costs stay on the high side when they are likely to fall as renewable penetration grows more significant. In our view 2021 now represents a low case and 2022 is a potential high case.

FINANCIAL MODEL

FORECAST CHANGES

We have increased our long term spread assumption at Cruachan in FY 24 and beyond. We had already assumed a high spread in FY 23 so have left our forecasts broadly unchanged for that year. FY 24 and beyond will not equal the exceptional FY 22 but we think should be stronger than FY 21. We have also increased our capex forecast to reflect the guidance in the results presentation. This includes £220m of spend on the OCGT projects. We have assumed that the company sells these with a 10% return on this and previous capex so that this spend is reversed in FY 24. We have also adjusted FY 26 and FY 27 revenue for an increased capacity market pricing assumption based on the recent T-4 auction success.

Key forecast changes

	2023 Old	2023 Revised	2024 Old	2024 Revised	2025 Old	2025 Revised
EBITDA	1,100	1,100	1,124	1,157	1,233	1,246
EPS	99.9	100.2	101.1	107.0	173.4	174.5
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 better longer term storage spreads. 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 960p per share on better pricing and if we add new pellet capacity and full economic for UK CCS, this rises to 1,111p which we see as a sensible central case. Full economics for overseas BECCS and the Cruachan expansion all contain elements of regulatory uncertainty but factoring in sensible scenarios could see a valuation of 1,319p.

Valuation scenarios

p per share	Incremental	Cumulative
Existing assets	887	960
Pellet expansion – central case	89	1049
CCS on two UK units	62	1111
Cruachan expansion	77	1188
Global BECCS – high case	131	1319

Source: Longspur Research

RISK

The key risks to our valuation are driven by potential policy changes, competition and commodity price risk. Policy risk includes 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

£,000, Dec	2021a	2022a	2023e	2024e	2025e	2026e
Turnover						
Power Generation	4,682	7,358	4,599	4,658	4,586	3,862
B2B Energy Supply	2,360	4,143	2,791	2,989	3,201	3,428
Pellet production	450	803	789	871	846	834
Central, int gp and depn	-2,318	-4,145	-2,435	-2,496	-2,558	-2,622
Total	5,174	8,159	5,744	6,022	6,075	5,502
Operating profit						
Power Generation	352	679	817	807	920	384
B2B Energy Supply	6	26	13	15	17	19
Pellet production	86	134	391	460	437	428
Central, int gp and depn	-273	-369	-376	-382	-388	-394
Operating profit	170	469	845	900	986	437
P&L Account						
Turnover	5,174	8,159	5,744	6,022	6,075	5,502
Operating Profit	170	469	845	900	986	437
Investment income	0	0	0	0	0	0
Net Interest	-70	-64	-94	-94	-65	-47
Pre Tax Profit (UKSIP)	101	405	752	806	921	390
Goodwill amortisation	0	0	0	0	0	0
Exceptional Items	21	-327	0	0	0	0
Pre Tax Profit (IFRS)	122	78	752	806	921	390
Tax	-12	-67	-351	-378	-222	-90
Post tax exceptionals	-30	72	0	0	0	0
Minorities	1	3	0	0	0	0
Net Profit	80	85	401	428	699	301
Dividend	-71	-80	-89	-98	-108	-118
Retained	9	5	312	330	591	183
EBITDA	370	709	1,100	1,157	1,246	699
EPS (p) (UKSIP)	22.31	85.06	100.23	106.96	174.49	75.10
EPS (p) (IFRS)	20.01	21.25	100.23	106.96	174.49	75.10
FCFPS (p)	34.66	25.20	53.30	240.82	218.06	118.92
Dividend (p)	18.80	21.00	23.10	25.40	27.90	30.70

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 in FY 25 as pricing starts to normalise
- Dividend remains covered throughout

Balance Sheet

£,000, Dec	2021a	2022a	2023e	2024e	2025e	2026e
Fixed Asset Cost	4,166	4,482	5,079	4,878	5,017	5,156
Fixed Asset Depreciation	-1,855	-2,094	-2,349	-2,606	-2,865	-3,128
Net Fixed Assets	2,311	2,388	2,730	2,272	2,151	2,028
Goodwill	416	424	424	424	424	424
Other intangibles	189	142	142	142	142	142
Investments	125	145	145	145	145	145
Stock	501	536	377	396	399	361
Trade Debtors	642	1,227	864	906	914	827
Other Debtors	1,324	1,294	1,294	1,294	1,294	1,294
Trade Creditors	-1,211	-1,528	-1,076	-1,128	-1,138	-1,030
Other Creditors <1yr	-966	-1,013	-1,013	-1,013	-1,013	-1,013
Creditors >1yr	-767	-877	-877	-877	-877	-877
Provisions	-86	-59	-59	-59	-59	-59
Pension	0	0	0	0	0	0
Capital Employed	2,476	2,680	2,953	2,502	2,384	2,244
Cash etc	317	238	326	1,126	1,257	1,595
Borrowing <1yr	56	67	67	67	67	67
Borrowing >1yr	1,431	1,527	1,575	1,594	1,016	1,032
Net Borrowing	1,170	1,356	1,316	535	-175	-497
Share Capital	48	48	48	48	48	48
Share Premium	432	433	433	433	433	433
Retained Earnings	198	194	506	837	1,428	1,610
Other	607	636	636	636	636	636
Minority interest	22	13	13	13	13	13
Capital Employed	2,476	2,680	2,953	2,502	2,384	2,244
Net Assets	1,307	1,324	1,637	1,967	2,558	2,741
Total Equity	1,307	1,324	1,637	1,967	2,558	2,741

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

£,000, Dec	2021a	2022a	2023e	2024e	2025e	2026e
Operating profit	170	469	845	900	986	437
Depreciation	199	239	254	257	260	262
Provisions	-4	-29	0	0	0	0
Other	-42	14	0	0	0	0
Working capital	32	-374	-222	-44	144	139
Operating cash flow	355	320	878	1,113	1,390	838
Tax paid	12	-39	-67	-351	-378	-222
Capex (less disposals)	-209	-173	-597	202	-139	-139
Investments	-20	-8	0	0	0	0
Net interest	-60	-74	-94	-94	-65	-47
Net dividends	-71	-79	-80	-89	-98	-108
Residual cash flow	7	-52	40	781	710	322
Equity issued	2	1	0	0	0	0
Change in net borrowing	363	187	-40	-781	-710	-322
Adjustments	-359	-136	0	0	0	0
Total financing	7	52	-40	-781	-710	-322

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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