30 January 2024

Briefing Call Transcript:
Profit Warning
Impairment of Goodwill of EnergyAustralia's Customer business

Marissa Wong, Director – Investor Relations

Good evening, everybody, and thanks for dialling into this briefing regarding the impairment of goodwill of EnergyAustralia's customer business. My name is Marisa Wong, I'm director of Investor Relations. I am accompanied by CEO, Mr. TK Chiang, and CFO Mr. Nicolas Tissot. We've got 45 minutes today, and we'll start with a briefing delivered by Nicolas, and that will be followed by a Q&A Session. We will be taking questions, live or through the text box function. But please focus your questions today off to the topic of the impairment. It is not our intention to provide a full update of the business on this call, we will be sharing full set of financial results and a comprehensive update as part of the annual results announcement at the end of February. And also we are in blackout period. So, unfortunately, my team and I are unable to address follow up questions so I do encourage you to make the most of this opportunity, and engage us on the topic of the impairment. With thatm I will now pass over to Nicolas.

Nicolas Tissot, Chief Financial Officer

Good evening everybody and thank you for joining this call with quite short notice.

We lodged an announcement earlier today after closing of the Hong Kong Stock Exchange to foreshadow the impairment of part of EnergyAustralia's Customer Cash Generating Unit or 'CGU' goodwill.

As usual in the closing of year-end accounts process, an impairment test was undertaken, and while there is still the need to finalise calculations, the exercise has indicated a decline in the valuation of the EnergyAustralia Customer CGU. The expected impairment is approximately HK$5.9 billion for the year ended 31 December 2023, from a carrying amount of goodwill of HK$8.4 billion.

This one-off non-cash item has no impact on operating earnings of the Group. It reflects the recognition, to the best of our knowledge, of the recent evolution of economic reality of the retail environment that EnergyAustralia currently operates in.

The amount will be taken through the P&L as an item affecting comparability. It is thus expected that we will record it as a charge against Total Earnings of the CLP Group for the full year 2023.

To put this expected impairment in perspective, we want to share that the overall Group financial results for 2023 have been strong. Operating Earnings before fair value movements are expected to be approximately HK$10.1 billion; up more than 30% compared to 2022. This was in large part due to the dependable contribution from Hong Kong, a strong financial performance from CLP China, and Apraava Energy continuing to grow profitably, while EnergyAustralia recovered from the heavy losses incurred in 2022, to be expected close to breakeven in 2023.

Group Total Earnings before EnergyAustralia impairment are expected to be HK$12.5 billion, including a favourable fair value movement on forward energy contracts of approximately HK$2.1 billion. Taking into account the goodwill impairment, Total Earnings are expected to be HK$6.6 billion, a strong rebound from the low HK$0.9 billion of 2022.

I'd now like to touch on what has led to this impairment charge.

The goodwill in our Australian Customer CGU arose from the acquisitions of large customer bases back in 2005 and 2011, when there were less price regulations and less pressure on margins.

More demanding economic and operating conditions in the Australian retail market have come to bear recently. This has come in the form of higher inflation and interest rates leading to cost pressures, combined with energy markets volatility and intense competition constraining retail margins. This has led to a revision of our assumptions on retail margins, customer growth and our weighted average cost of capital, with retail margins revision being the key driver for the impairment.

The recent 2023 ACCC report into the National Electricity Market points to continuing pressure on margins and increase in costs for retailers. Retail margins as a percentage of residential cost stack settled at a low 2.3% for Australian financial year 2022–23, and the average total cost stack for retailers supplying residential customers increased by 7.2% in nominal terms from 2022 to 2023. On that basis, we recalibrated our retail margins assumptions accordingly. We also reviewed customer accounts growth targets and increased our weighted average cost of capital to reflect the evolution in interest rates.

With these updated assumptions, the valuation for the Customer CGU is reduced. We continue to see value in the retail business, both as an key component of the EnergyAustralia gentailer integrated model, and an important driver of future growth and value streams, albeit at a level more reflective of the recent evolutions we've seen in the market.

Overall, EnergyAustralia's financial performance has markedly recovered in 2023 after a very challenging 2022, off the back of improved generation fleet performance and roll-off of low-price forward contracts. Operating earnings before fair value movements are expected to recover from heavy losses of HK$2.3 billion in 2022 to close to breakeven in 2023.

With this impairment, we've recognised the impact of the recent evolution of economic reality of the energy retail sector in Australia on the value of EnergyAustralia Customer CGU in our books. As we navigate the energy transition in Australia, the scale and quality of EnergyAustralia's customer base continues to be strategic in underpinning the investment required for the transition of our generation portfolio, and to capture future opportunities and value, including behind-the-meter, as electrification accelerates.

Operationally, Group results were strong, and we are confident in EnergyAustralia profitably participating in the clean energy transformation that's happening in Australia.

Finally, on a more personal note, I wanted to share that after very careful consideration, I will leave the company for personal reasons. Nothing to do with the impairment announcement, but as it is happening today, we wanted to be transparent that a CFO succession was happening. I'm proud about my contributions during these almost four very intense years. And I'm happy that an orderly transition was organised, with Alex Keisser succeeding me. I will be working with him and the executive team to ensure a smooth and effective finance leadership transition through the Annual Results, which will be my last one, and leading up to Interim Results.

With that, we can now take questions together with TK.

Marissa Wong, Director – Investor Relations

Thank you, Nicolas, for that. So open up the lines now and please go ahead and ask your questions if you have any. Think there's Rob, you have your hands up so we'll just unmute the line for you. Go ahead.

Question 1 – Rob Koh (Morgan Stanley)

Yes. Good evening, Rob Koh from Morgan Stanley. Thanks for taking my question, I guess, as a starting point I'm sorry to hear that you will be moving on, Mr. Tissot, and thank you for all your help over the years. I guess I just wanted to ask a few clarification questions, and the impairment to the EnergyAustralia customer business. Just make sure I'm interpreting the statements correctly. That is not any impairment to the generation, part of EnergyAustralia, just to the customer side. Is that correct?

Nicolas Tissot, Chief Financial Officer

Absolutely correct.

Rob Koh (Morgan Stanley)

Okay. Great and then in terms of competition, which is the one of the drivers for I guess the numerators of this equation. Obviously, there's a cost of capital change to the NPV as well. Is there a comment about current conditions in the name with, say, discounting in churn rate and things like that, I might be asking an inappropriate question. If so, then that's fine.

Nicolas Tissot, Chief Financial Officer

Good evening, Rob. Thanks for the kind personal comment. And yeah, I do confirm that the impairment is an impairment of goodwill of the retail customer cash generating unit, which is one of the two cash generating units in our EnergyAustralia operation. Just for clarity, in terms of competition in the market. I think it's been quite a few years of intense competition in that market. But we've seen in the last few months, especially second part of the year, we've seen confirmation of the intensity of the level of competition, with also new players coming back to the market after the tough challenging year 2022 so it's kind of adding up to the competitive environment in Australia. And this is putting pressure on margins, and we felt that was the right time to recalibrate the level of margin we take into account in our valuation model. We have gone through repricing this year in the market. So it's also an element of our assessment that it's very difficult to transfer the increasing costs in pricing. So the market continued to be very demanding, including in terms of discounts and special offers proposed by every player in order to maintain its market check. Sorry for a bit of a long answer but your question is complex.

Rob Koh (Morgan Stanley)

Yeah, it's Australian utilities. It's always been so. Thank you very much for your answers. I'll leave it there and let other people get a turn. Thank you so much.

Marissa Wong, Director – Investor Relations

Thanks Rob. While we wait for others to put their hands up to ask for their question, I will ask a question that's come through on the text box.

Question 2 – Text Question from Jordan Corser (Vivcourt)

Can you elaborate on what you mean when you say "the competition in energy retail markets has intensified and the outlook is that this competition will remain for a period of time" in the report? Does this mean that EnergyAustralia has failed to secure retail contracts? And further, what implications does this have for EnergyAustralia's generation business?

Nicolas Tissot, Chief Financial Officer

Yeah, I think on the first part of your question, yes, we've seen now level of margin, sort of stay at a rather low level, so confirming in the second part of 2023, trends which were existing before. And that's what make us believe that this level of competition is here to last for a period of time and therefore we needed to adjust our retail margin assumptions in our models. And this is based on the observations mentioned in the most recent ACCC report released in December 2023. So yes, a global environment with significant pressure and we wanted to adjust our assumptions. Regarding the second part of your question. No, it doesn't mean we failed to secure retail contracts. It's more the level of margin at which we're able to operate. I don't think there is any major revolution in the way we were able to retain customers and gain customers compared to the recent trend. So it's more on the level of margin. And the outlook in margins that the adjustments have happened, although we also revised our ambition in terms of gaining additional customers in the future. Implications on generation business as I briefly mentioned in my introduction, we still see the EA retail business as part of a portfolio, and as part of an integrated gen-tailer model and in particular, we still see that both businesses are sort of hedging each other. Because it's an element of reduction of volatility in earnings to have generation business backed by a retail business and vice versa. So there's no change in terms of our strategy to manage EnergyAustralia business as an integrated business.

Marissa Wong, Director – Investor Relations

Nicolas, and following on another question on the textbox.

Question 3 – Text Question from Jordan Corser (Vivcourt)

Can you elaborate on what you have done to recalibrate the retail margins?

Nicolas Tissot, Chief Financial Officer

So are we not be able to disclose the details of our assumptions but we have mentioned in the announcement the reference of the latest ACCC report is 2.3% level of retail margin mentioned in the report as the average level in the market in 2023. You can see it as a reference. So as one of the key references we used in our valuation. But obviously this is to be combined with a number of elements which are specific to EnergyAustralia, and which are not necessarily the same for every player in the market.

Marissa Wong, Director – Investor Relations

I don't see any other hands up for live questions. I just pause for a couple of moments just in case we do get a few in, otherwise, if there are no other questions, I will conclude the session. A reminder that our results announcement and presentation is scheduled for the end of February.

Okay, got one coming in.

Question 4 – Text Question from Yonghua Park (HSBC)

Does this impairment affect the sale of EnergyAustralia?

Nicolas Tissot, Chief Financial Officer

I mean, short answer is no, if I understand well the question. But you may want to give us more details about what you mean. No, I think there's no impact on sales. It's an adjustment of the value of the customer business of EnergyAustralia in our books. So it's a purely non-cash write down of goodwill allocated to that activity that cash generation unit. So nothing to do with sales if that's clarifying this question. But you can further elaborate if this is not exactly your question.

Marissa Wong, Director – Investor Relations

And a question from Andreina Low from Pictet.

Question 5 – Text Question from Andreina Low (Pictet & Cie)

Will it have any implications on dividend decisions?

Nicolas Tissot, Chief Financial Officer

Basically, in principle, it's a non-cash writedown so it doesn't have any impact on the cash position or the debt position at the end of 2023. As usual, based on the final results of the group, our board will appreciate what level of dividend distribution is to be considered. But I would say this announcement is not expected to have any direct impact on this decision.

Marissa Wong, Director – Investor Relations

Thanks. Evan Li from HSBC.

Question 6 – Text Question from Evan Li (HSBC)

For the book value that remains at EA, what businesses or subsets of operations does that represent?

Nicolas Tissot, Chief Financial Officer

Good evening, Evan. Thank you for your question. We have mentioned that the remaining level of goodwill allocate it to the customer CGU is now down, after impairment, to 2.5 billion HK dollars, in our books. Obviously, that's just the goodwill. But we are not excluding the rest of the book value of the customer business. But you can expect that it's the bulk of it. Most of that business was built by acquisitions, and then the other piece is the generation CGU and there are no other subsets of operations in the book value of EnergyAustralia in CLP books.

Marissa Wong, Director – Investor Relations

Add I think to add onto that, for the generation business there is no goodwill in that business.

Nicolas Tissot, Chief Financial Officer

There is no goodwill and obviously this business also went through impairment test as usual.

Marissa Wong, Director – Investor Relations

Thanks, Evan, for your question.

Question 7 – Text Question from Stephen Tsui (JPM)

How shall we think about the operating outlook for the retail business in Australia. Also, Australia has been facing high inflation and we have faced pressure on operating margins over the past 2 years. Why have we made the impairment in financial year 2023?

Nicolas Tissot, Chief Financial Officer

Regarding operating outlook, I think the elements we have released today about EnergyAustralia, financial performance are in line with the progressive turnaround we talked about over the results. Basically, moving along 3 axes, first one being improving, making the coal supply of Mt Piper more reliable and at the higher level. This is based on signing new long-term supply contract early on last year, mid-year. Second is making our Yallourn operation more reliable, more steady, and we have said that continued during the second half. And certainly we have adjusted our hedging policy. Hedging smaller proportion of our generation forward and all these elements combined and delivered progressive recovery we've seen with EnergyAustralia and let EnergyAustralia to deliver an operating earnings level before fair value, which is close to breakeven this year. So it's a progressive recovery. It's well under way. But it will continue next year so our outlook is to continue along the same lines and return to profitability. On Australia facing higher inflation and pressure on operating margins, yes, it's been the case. I mean these trends, as I mentioned earlier, appeared already earlier in the last few years. But the difference in the second part of this year is that they really combine with other constraining factors, such as increased inflation, difficulty to pass this inflation through to the customer, higher interest rates. So it was combined with a number of other factors which led us to trigger an impairment and the modifications in the assumptions in the model in terms of retail operating margins were adjusted, based on combination of these trends, not only the intensity of competition in the market. It's a combination of factors.

Chiang Tung Keung, Chief Executive Officer

This is TK. I just want to make a supplementary point about our outlook. Because, you know, we adopt this gen-retail integrated model in the Australian market. So basically, we see the retail customer business as a strategic asset for us, in particular, you know in New South Wales and in Victoria where we have quite a significant generation portfolio so we see this as a very important asset. And also going forward, because of decarbonization, climate change, we do see growth opportunities when there are more electrification accelerate in future. So we do see opportunities in retail, in customer business in Australia.

Marissa Wong, Director – Investor Relations

Thank you, TK. There's a question comes through from Jordan Corser (Vivcourt), about the coal supply situation of Mt Piper. We will address that in full when we present a full set of results at the end of February so stay tuned for that. If there is no other question, hopefully we have addressed most of your concerns or questions, but there will be again a full opportunity to engage at the end of February when we do announce our full set of results for financial year 2023. An archive of this briefing call will also be available on the IR website. With that, thank you, Nicolas. Thank you. TK, for your time and answering questions. Thank you everybody on the call for attending. I will now close the briefing.

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