NZ Equity Strategy

NZ Equities: Playing a Tight Game

Key Points

- **The global investment environment remains volatile, with rising concerns over European sovereign debt issues and a very slow recovery in the USA, as well as a potential slowdown in China's strong growth rate. The US, Japanese and UK markets have fallen around 12%-14% in the September quarter, and several of the major European markets have fallen by about -25%. Australia is down around -13%, but New Zealand has held up much better, with the NZX50 down -5% and the NZX50 Gross down only -3%. This is a pattern of local outperformance which we expect to continue.**

- **Growth is beginning to improve in New Zealand and is likely to positively surprise next year, driven by exporters, particularly in agriculture, but also a modest improvement in consumer demand. Australia and New Zealand are much better placed than most developed economies, with relatively low public sector debt and a significant production base of commodities which are in demand from the rapidly growing Asian developing economies.**

- **The New Zealand equity market is about 5%-10% cheap on the key valuation metrics of PE ratio and price to valuation, and we estimate New Zealand market earnings are still about 14% below trend. Although further FY12 downgrades are possible, we expect revisions for subsequent years to turn positive. We are maintaining our central scenario gross return at 15%-20%, assuming little change in the market PE ratio, but 5%-15% annual average earnings growth across FY12 and FY13.**

- **In an attempt to identify the best value stocks in this volatile market, we have revisited our earlier "Hunting for Alpha" screen which was based on our DCF valuations. We have re-run that methodology, but added two PE–based factors. Six stocks make the cut on all three measures: FBU, HLG, MHI, SKC, STU and TWR.**

Chart i. NZ 12-Month Forward Earnings Forecasts and Long-Term Trend

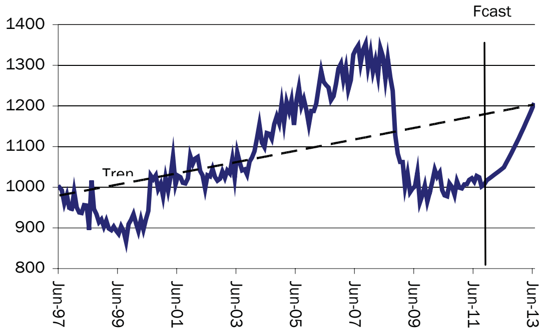


Chart ii. NZ Market P/E vs P/E on Trend Earnings (median)

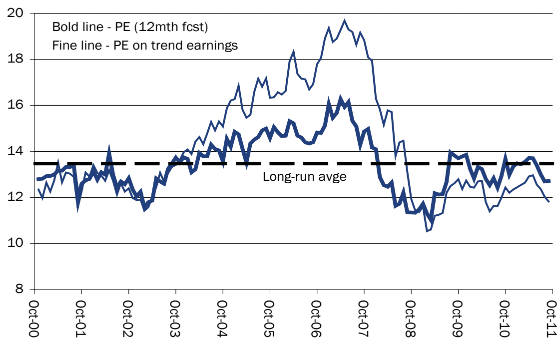


Chart iii. NZX50G Five-Year History

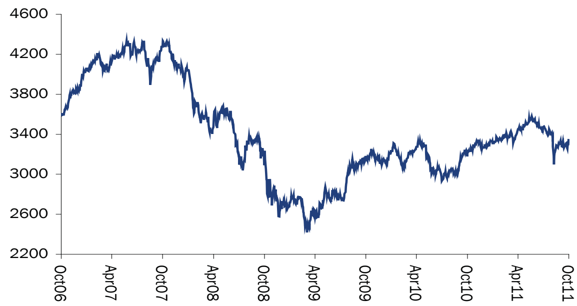


Table i. Target Gross Returns

Scenarios	FY11-13 eps growth p.a.:		
PE in 1 yr:	5%	10%	15%
12.0x	1%	12%	23%
12.5x	4%	**15%**	26%
13.0x	8%	**19%**	30%
13.5x	11%	**22%**	33%
14.0x	15%	26%	37%

Analysts

Guy Hallwright (+64 9 369 0006)
guy.hallwright@forbar.co.nz

Rob Mercer (+64 4 495 1325)
rob.mercer@forbar.co.nz

Matthew Leach (+64 4 495 1324)
matthew.leach@forbar.co.nz

1 Market Review

Global economic risks remain elevated

The global investment environment remains volatile, with concerns over European sovereign debt issues and a very slow recovery in the USA rising over the last quarter. The US, Japanese and UK markets have fallen around 12%-14% in the September quarter, and several of the major European markets have fallen by about -25%. Australia is down around -13%, but New Zealand has held up much better, with the NZX50 down -5% and the NZX50 Gross only -3%. This is a pattern of local outperformance which we expect to continue. Growth is beginning to improve in New Zealand and is likely to positively surprise next year, driven by exporters, particularly in agriculture, but also a modest improvement in consumer demand.

Global economic risks have increased, with recent data out of the USA and Europe more negative than had been expected, suggesting we may be on the verge of another global slowdown. Concerns are focused on sovereign risk, and particularly the political will and ability to deal with debt problems across many of the developed economies. It is likely that growth will be slower in these economies for an extended period of time.

However the developing countries, especially China, continue to show strong growth, although that could ease amid fears of overheating. The challenge for these countries is to rebalance towards domestic consumption and away from over-investment and from export reliance on the struggling western economies, which in turn need to rebalance their own economies away from excess (debt-fuelled) domestic consumption. Lower currencies (USD and euro) will assist in this.

Australia and New Zealand are much better placed than most developed economies, with relatively low public sector debt and a significant production base of commodities which are in demand from the rapidly growing Asian developing economies – hard commodities in the case of Australia, soft commodities in New Zealand's case.

In Australia the mining boom looks set to continue for some time, but the rest of the economy is weakening, due to the high AUD which is making life difficult for exporters, and declining house prices which are having a negative impact on consumer demand. However, with interest rates 2% higher than in New Zealand, the RBA has considerable room to move to stimulate demand.

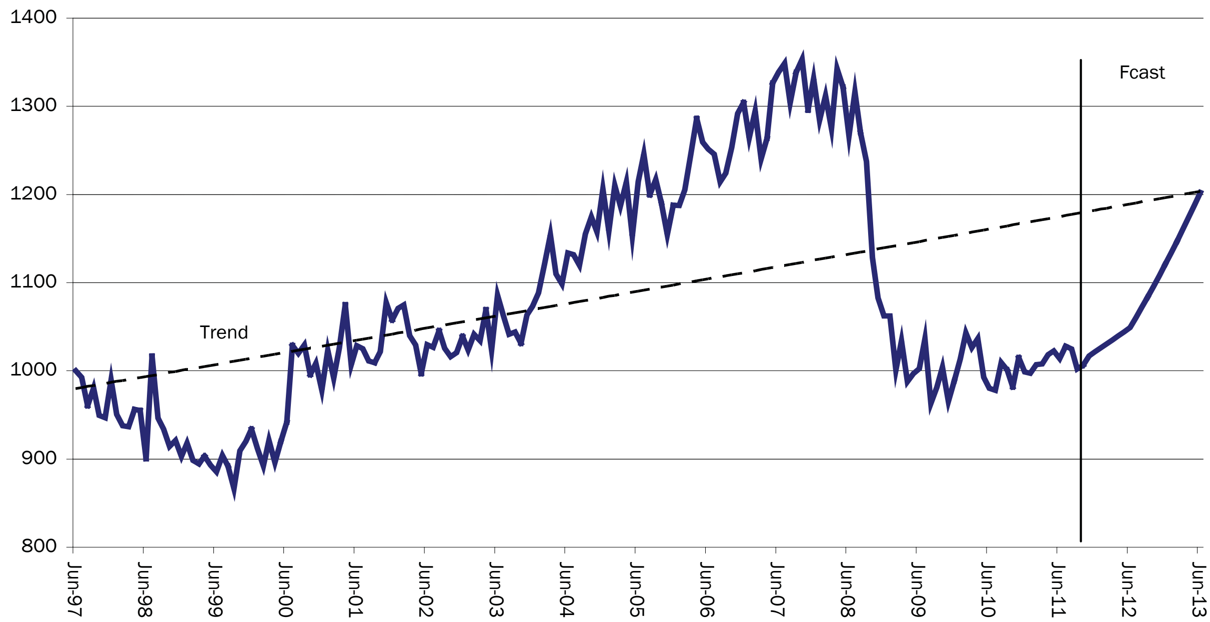
In New Zealand consumer demand is finally showing (modest) signs of improvement after a long flat period. Export growth is solid and agriculture is strong, despite a high NZD which is unlikely to soften much unless we get negative external shocks. Economic growth could easily surprise on the upside over the next 1-2 years, particularly as the Christchurch rebuild gets under way. However, in both New Zealand and Australia capacity constraints could see inflation pressures emerging, and ultimately we expect interest rates to rise back towards more normal levels.

Earnings poised to improve towards trend

Over the past two years we have emphasised "mid-cycle" earnings in assessing market value, but earnings growth has been elusive and our 12-month-forward NZ market earnings forecasts remain around -14% below their long-run trend and around -24% below their peak level before the GFC.

Chart 1 below tracks our 12-month-forward earnings forecasts, based on median market PEs rather than cap-weighted, to avoid large companies skewing the data. Over the last three years we have seen a continuing downward drift to forecast revisions, with the slight growth visible in the chart due to years rolling forward rather than forecast upgrades. To the right of the vertical line is our estimate of market earnings growth through the next two years. This is based on rolling our current forecasts forward through time, ie it assumes no forecast revisions, and has forecast earnings rising approximately back to trend by mid-2013. However, we believe we should get a revenue-driven lift in earnings in FY13 as the economy recovers.

Chart 1. NZ market 12-month rolling earnings forecasts and trend



Target gross return 15%-20%

The New Zealand market is currently trading on a median FY12 PE of 12.8x, below its long-run average of around 13.5x. Our bottom-up forecast for FY12 market earnings growth is around +13% and for FY13 it is +5%, an annual average of +9% over the two years.

Historically, bottom-up forecasts have tended to fade at around 5%-10% p.a. on average, and some fade to our FY12 forecasts is possible, with the Christchurch rebuild slower than anticipated. However we expect an export-led recovery to boost GDP growth over the next 18 months, and we believe the earnings risk for FY13 is to the upside.

Table 1 updates our gross return scenarios for the New Zealand market, using a forecast PE range of 12x – 14x, and an earnings growth range of 5% - 15% p.a. for the FY12 and FY13 years. If FY12 earnings are revised down, the required FY13 growth to achieve these returns would rise by the amount of the FY12 downgrade. The range of likely gross returns over the next year, assuming the current gross dividend yield of 7.9%, is as follows:

Table i. Target Gross Returns

Scenarios	FY11-13 eps growth p.a.:		
PE in 1 yr:	5%	10%	15%
12.0x	1%	12%	23%
12.5x	4%	**15%**	26%
13.0x	8%	**19%**	30%
13.5x	11%	**22%**	33%
14.0x	15%	26%	37%

We are maintaining our central scenario gross return at 15%-20%, assuming little change in the market PE ratio, but 5%-15% earnings growth in FY12 and FY13. The gross return range across our scenarios is from around 5% to around 30% (with the higher end requiring PE expansion, quite likely if earnings growth comes through as expected).

Forecasts downgrades dragging on but trends improving

Earnings growth during the last reporting season (June 2011 6-mth results) showed a continuation of the improving trend we have seen over recent quarters, with revenues up +3% on pcp (median) and +6% (weighted), and EBIT up +5% on a median basis and +7% weighted (Chart 2). Results were broadly in line with our forecasts although the weighted results were slightly ahead, with some of the larger companies (FBU, TEL) coming in better than expected.

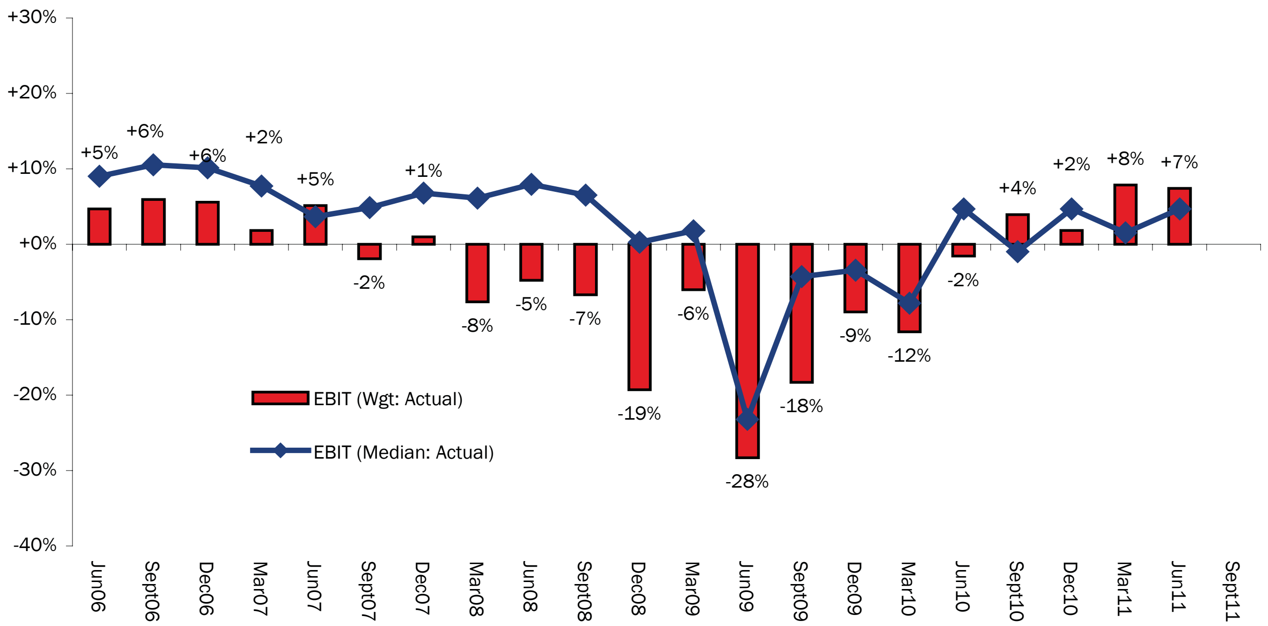
While the earnings trend has improved, we find we are still making net downgrades to our forecasts. Table 2 shows our earnings upgrades/downgrades over the past three months. In the last quarter we downgraded FY12 forecasts for 19 companies (by more than 1.5%) and upgraded 13, for net downgrades of -6. Valuations were upgraded for 27 companies and downgraded for 17, a net balance of +10 upgrades to valuations. With the fall in the share prices over the quarter, we upgraded our recommendations on 10 companies and only downgraded 2, a net upgrade of +8.

Our current forecasts factor in EPS growth of about 15%-20% over FY12 and FY13; as we expected our FY12 forecasts have drifted lower over the quarter, so that growth is now skewed more towards FY13. The biggest influence on the timing of an earnings recovery is still likely to be the timing of Christchurch rebuilding activity.

Table 2. Number of Upgrades/Downgrades Jun11-Sep11

	Earnings	Valuations	Recommendations
Upgrades	+13	+27	+10
Downgrades	-19	-17	-2
Net Upgrades	**-6**	**+10**	**+8**

Chart 2. Earnings Momentum

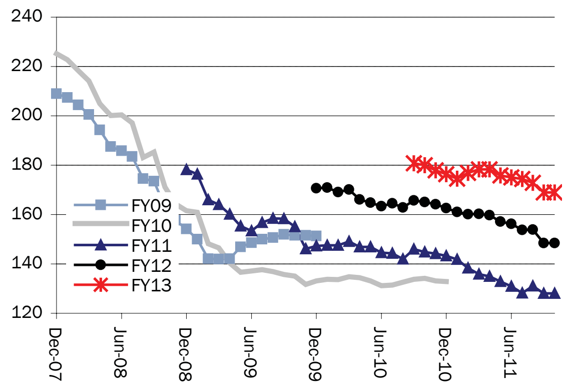


Earnings forecasts

Chart 3 shows the historic trends in our earnings forecasts for the years from FY09 to our current FY12 and FY13 forecasts. Our FY12 and FY13 forecasts continue to drift down, and while we are forecasting solid earnings growth in FY12 and FY13, the level of FY12 earnings growth has been trimmed.

We believe the New Zealand economy is poised to move into an export-led recovery over the next 12 months, and as GDP growth recovers to above +2% we should begin to see earnings upgrades emerge.

Chart 3. NZ Market Earnings (in NZX50 index points) – weighted average



2 NZ Equities Valuation

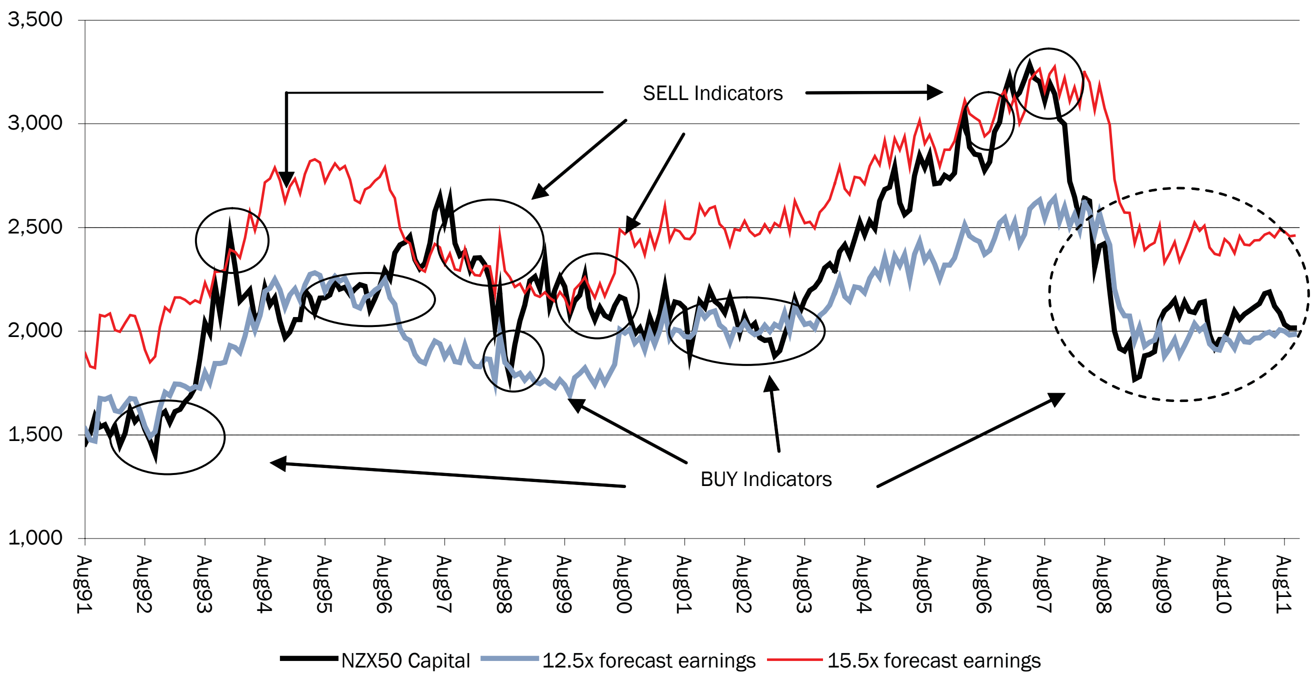
P/E band market indicator positive

Our P/E band BUY/SELL indicator (Chart 4) is again sending a BUY signal. Even in the absence of earnings upgrades, the relatively low 12-month median forward P/E ratio of 12.7x is undemanding and supports our gross return target of 15%-25% over the next year, with the risks being asymmetric to the upside in our view.

Implied growth indicator now 1.5%

Chart 5 shows our implied growth and 12-month forecast P/E series since 1990. The market 12-month forward P/E fell from 16.3x at the market peak in April 2007 to 11.0x at the market low and is 12.7x today, below the long-term average of around 13.5x, and based on forecast earnings which are around -14% below trend. The implied growth rate is 1.5%, well below the historic average over the past 20 years of 4%.

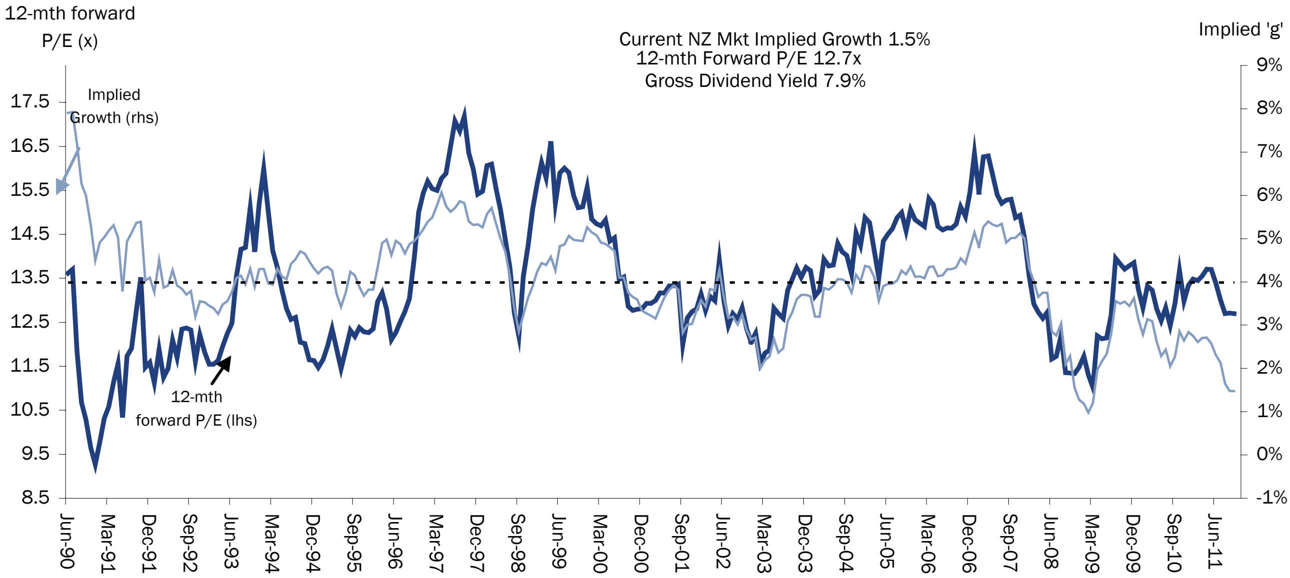
Chart 4. NZ Market P/E Band Indicator



As earnings begin to be upgraded the market will regain confidence in medium-term earnings projections. This should lead to the market multiple expanding on the higher projected earnings. We may still be some months away from this positive re-rating, but the likely double impact of the eventual upgrades makes equities attractive today in our view.

With a current gross dividend yield of 7.9%, investors are being paid to be patient ahead of the upgrade cycle, and fundamentals support an asymmetric risk to the upside as noted earlier, potentially as high as +30%, although this level of return may take a couple of years to achieve.

Chart 5. Forbar 12-month Forward P/E and Implied Growth

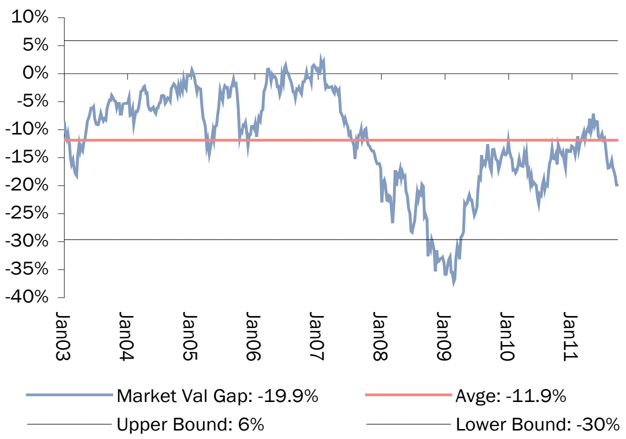


Discount to bottom-up valuations has widened

Chart 6 shows the trend in the market median discount to valuation, which is based on our individual stock valuations. Over the past seven years the market has on average traded at a median discount to our valuations of -12%; excluding the unusually wide discounts seen in the wake of the GFC through 2008-09, the historic average is around -8%.

Following the GFC the median discount to our valuation widened to -35% at the market's low. It subsequently recovered but has now widened again to around -20%, larger than its historic average.

Chart 6. Discount to Valuation



Hunting for Alpha 2

In an attempt to identify the best value stocks in this volatile market, we have revisited our earlier "Hunting for Alpha" piece which was based on our DCF valuations, and assumed mean-reversion to the average historic discount to valuation at which each stock had traded (ie the analysis corrected for systematic bias in analyst views).

This update re-runs that methodology, but also adds two additional PE–based factors, so that the screens are now:

- Our original valuation-based method, which assumes that a stock should trade back to its long-run average discount to our DCF valuation;
- A PE mean-reversion model, which uses our forecasts, and assumes that within a year the stock will have traded 50% of the way back from where it is now to its long-run average PE multiple; and
- The same PE mean-reversion model, but using consensus forecasts instead of our own.

The cheapest stocks in the NZX50, based on these methods, are set out in the Table 3. Criteria for selection are that a stock is in the top twenty on at least two of these methods, and/or has share price upside of 30%+ on a single method.

Seven stocks make the cut on all three measures: FBU, HLG, MHI, PPL, SKC, STU and TWR. Of these, PPL is higher-risk, with significant earnings uncertainty given a history of forecast downgrades.

Another five stocks make it on two of the three measures: FPA, FRE, KMD, RAK and RYM. Three stocks, GPG, NPX and PGW join the list based on much higher discounts to our valuations than their historic averages. As with PPL above, we would characterise FPA, PGW and RAK as having higher earnings risk than the others; GPG is also in a higher risk category due to valuation uncertainty around Coats. KMD may deserve a higher ranking as there is little history on which to base our average discount to valuation.

Of the stocks highlighted by this analysis, the six higher-quality stocks in the first group appear the most likely to produce superior returns over the next year. These are FBU, HLG, MHI, SKC, STU and TWR.

Table 3. Alpha Screen

Code	Price	Forbar Valuation	Price target on hist avg disc to Forbar valn	Upside to target price	Price target on hist avg PE (FB fcsts)	Upside to target price	Price target on hist avg PE (cons fcsts)	Upside to target price
FBU	$7.75	$10.42	$9.35	+21%	$8.88	+15%	$8.77	+13%
HLG	$3.40	$4.02	$3.89	+14%	$3.92	+15%	$3.74	+10%
MHI	$0.81	$1.04	$1.00	+23%	$1.00	+23%	$1.08	+33%
PPL	$0.82	$1.56	$1.29	+57%	$1.07	+31%	$0.96	+17%
SKC	$3.35	$4.25	$3.92	+17%	$3.72	+11%	$3.64	+9%
STU	$2.35	$3.03	$2.85	+21%	$2.70	+15%	$2.82	+20%
TWR	$1.39	$2.24	$1.99	+43%	$1.56	+12%	$1.54	+10%
FPA	$0.45	$0.87	$0.76	+68%	$0.49	+8%	$0.48	+7%
FRE	$3.20	$4.21	$3.85	+20%	$3.46	+8%	$3.37	+5%
GPG	$0.59	$1.01	$0.86	+46%				
KMD	$2.20	$2.79	$2.36	+7%	$2.51	+14%	$2.86	+30%
NPX	$2.84	$4.10	$3.76	+32%	$2.94	+4%	$2.89	+2%
PGW	$0.40	$0.67	$0.59	+47%	$0.42	+5%	$0.40	0%
RAK	$0.65	$1.07	$1.06	+63%	$0.60	-8%	$0.73	+13%
RYM	$2.55	$3.09	$3.01	+18%	$2.70	+6%	$2.86	+12%

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