

Wealth Weekly

Recovering From a Shock

WEALTH MANAGEMENT RESEARCH

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Most major equity markets rose by a percent or two last week on the whiff of further fiscal stimulus from governments in the US and Europe and ongoing hopes that a successful vaccine will soon emerge.

Electricity sector: It's bad, but not that bad for patient investors

We continue to like the long-term thesis for the electricity sector, as demand growth from the electrification of vehicles and dairy factories towards the end of the decade should ultimately help earnings recover and will underpin valuations. But in the short term, the impending closure of the Tiwai Point aluminium smelter in August 2021 and the resulting overcapacity of the country's electricity generation plants has set off a bout of **uncertainty about the extent of the short-term earnings impact**. The earnings outcomes for different electricity generator-retailers will depend on management decisions that have yet to be made, about: i) when the smelter will actually close (negotiations for a more gradual closure are ongoing), ii) the timing of Transpower's transmission line upgrades, iii) whether and when Genesis Energy and Contact Energy will mothball thermal plants, iv) the success of wholesale contract negotiations between the gentailers, and v) how retail price competition evolves.

Following an in-depth review of the dynamics of this situation, **we have cut our short-term earnings forecasts for the gentailers by an average of -22% in FY23**. We expect Contact Energy and Meridian Energy to be the most impacted companies, as they will have stranded generation in the lower South Island from when the smelter winds down until Transpower finishes upgrading the transmission grid (which could be as soon as mid-2022 or as late as mid-2023, depending on when Transpower can source the cables).

Contact's and Meridian's share prices have fallen -14% and -15% since the Tiwai closure announcement 12 days ago. **We believe these share price reactions have been greater than the long-term effects on the companies**. In contrast the other gentailers have fallen by less than -5%.

Our preferred electricity company is now Contact Energy, which offers an attractive gross dividend yield. **We also retain an OUTPERFORM rating on Meridian Energy**, which has the lowest cost generation. We have NEUTRAL ratings on Mercury NZ, Trustpower and Genesis Energy. Genesis will have significantly more retail demand than cost-effective generation capacity to supply it, which will squeeze its margins.

Themes of the week

The local housing market has so far appeared resilient to the pandemic, and this has also been seen in the **solid recent sales results from aged care village operators, Summerset Healthcare, and last week, Arvida**.

Equity markets have recovered strongly from the pandemic selloff in March – largely thanks to extraordinary intervention by central banks and governments – yet the risk remains that the economic recovery from it will be more muted and drawn out than investors have been expecting. Nonetheless, **a case can still be made for owning equities at these levels**. Central banks are unperturbed by the prospect of asset market bubbles and look prepared to leave yield curves at very low levels for years to come, which makes the declining yields on equities still look relatively attractive.

If bond markets are any guide to economic conditions, tough times are ahead. **Recent bond issuance has been met by extraordinary demand**. Meanwhile, we continue to await corporate issuance to satisfy demand in the domestic market.

The week ahead

On Tuesday New Zealand credit card spending data is due out, and the Reserve Bank of Australia will release its interest rate decision. Microsoft will release its quarterly earnings on Thursday, and Intel on Friday.

New Zealand Electricity Sector

Smelter's Electric Shock Far From Fatal

Rio Tinto's (RIO) shock announcement that it is closing New Zealand Aluminium Smelters (NZAS) in 13 months has resulted in a high degree of short-term uncertainty, with all of the generator/retailers re-evaluating their strategies, but we remain confident about the sector in the long-term. Electricity demand growth from de-carbonisation of transport and process heat will eventually help wholesale electricity prices and sector earnings to recover.

We have retained **OUTPERFORM** ratings on **Contact Energy (CEN)** and **Meridian Energy (MEL)** but have downgraded Genesis Energy (GNE), Mercury (MCY) and Trustpower (TPW) to **NEUTRAL**.

Forecast and dividend changes reflect an initial view on the likely future path

The forecast changes we have made to FY22 and FY23 are significant, with **FY23 sector earnings forecast to be -22% lower than our old forecast**. Our new forecasts are shown in Figure 1. CEN and MEL have stranded generation volumes in Southland/Otago until Transpower completes grid upgrades, and they are the most affected. In addition, we expect a fall in retail prices as MEL seeks to increase its retail position. The NZ weighted average future wholesale electricity prices has fallen by c.-NZ\$18/MWh and we assume most of that will be passed through to end users.

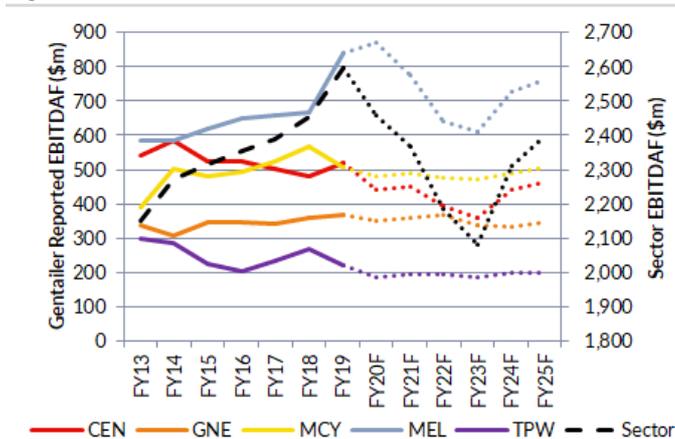
Our analysis suggests **sector earnings will return to current levels in FY25 and then continue their steady growth trajectory**.

We expect all of the generator/retailers, except **MCY**, will trim their dividends (Figure 2) as the sector navigates the next few years. MEL has already announced that it is ceasing its 4.88cps "special" dividend. Whilst some of our forecast dividend cuts are ~-20%, we are confident that they will be sustainable, with a particularly severe retail price war the main downside risk.

More upside than downside risk from here

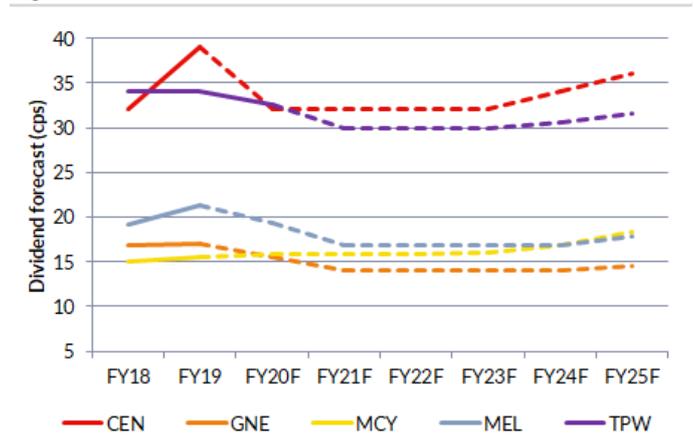
Our revised sector forecasts assume NZAS goes through with its hard close in August 2021 and that Transpower takes until June 2023 to upgrade the lower South Island transmission (which will alleviate the constraints on MEL's and CEN's ability to export power from the lower South Island to where the demand is further north). There is a reasonable chance that a longer ramp-down period is negotiated with NZAS and that Transpower can complete transmission work a year earlier. That would provide more time for the market to adjust and minimise some of the effects described in this report.

Figure 1. Headline EBITDAF



Source: Company reports, Forsyth Barr analysis

Figure 2. Revised dividend forecast



Source: Forsyth Barr analysis

Winners and losers

There will be winners and losers from the new post-NZAS reality.

- **In time, we expect MEL to be the main winner.** MEL is the largest supplier of electricity to NZAS. It should ultimately receive a higher price for its generation than it received from NZAS. It is also the lowest cost generator in the market, which places it in a strong position to grow retail market share if it wants to, which we believe is a strategy it will pursue.

- **CEN receives a similar, but smaller benefit.** However, CEN also faces downsizing its business slightly as we expect it will close one of its generation plants.
- **GNE is most at risk** as it is the largest residential retailer yet it faces the biggest drop in generation market share as its coal and gas-fired generation cannot compete with MEL's lower cost of generation. Whilst GNE may have ambitions to maintain its retail market share, ultimately we expect MEL will win that battle, meaning GNE faces being a materially smaller business today and will be curtailing more generation than the other generators. In addition, GNE's Kupe value has taken a hit.
- **The impacts on MCY and TPW are limited to lower retail electricity prices,** which are still material. However, unlike the other generator/retailers, MCY and TPW do not have any offsetting material positive benefit (such as a significant exposure to the NZAS contract or thermal generation cost reduction).

Long-term sector thesis intact

We maintain our long-term positive stance on the electricity sector.

Wholesale electricity prices (and their influence on retail prices) are the key value drivers for the sector. When the electricity market is in balance, (i.e. supply roughly meets demand), wholesale electricity prices track close to the cost of building new generation (otherwise there would be no incentive to build new generation, and a lack of new generation in a world of rising demand would cause prices to rise...). Consequently, we expect the electricity market will adjust relatively quickly to its new reality, and we do not foresee a material change to the cost of new generation, hence, **wholesale electricity prices and sector earnings will revert to current levels,** albeit we are forecasting a lag in retail prices recovering.

Long-term, electricity demand growth will be robust as electricity is at the heart of New Zealand's decarbonisation strategy. **Confidence in the long-term electricity demand outlook underpins our positive long-term outlook for the sector.**

Rating changes see us take a more cautious approach in the near-term

The rating changes we have made (Figure 3) reflect a more cautious approach to the near-term outlook, but also reflect the share price reactions since RIO's announcements. CEN and MEL's share prices have fallen -14% and -11% respectively compared to less than -5% for the other generator/retailers. CEN and MEL are negatively impacted the most in the short-term due to stranded generation in Southland/ Otago, but they both had the largest exposure to the discounted NZAS price and therefore have the most to gain from selling electricity into the market. In contrast, TPW's share price has barely moved, yet it (broadly) faces the same retail price pressure as the other electricity stocks.

In our view CEN is particularly attractive and is trading on an FY21 gross dividend yield of 6.9%. Whilst GNE still has an attractive yield, dividend growth will be challenging.

Figure 3. Summary company valuation metrics

Company	Price	Target	Target	Rating	FY21			EBITDAF NZ\$m	Changes	
		Price	Return		EV/EBITDA	PE	Gr Yld		Target Price	Rating
CEN	\$5.77	\$7.50	35.5%	OUTPERFORM	11.3	17.7	6.9%	446	-\$0.65 (-8%)	-
GNE	\$3.01	\$2.75	-3.7%	NEUTRAL	11.5	17.3	6.5%	378	-\$0.55 (-17%)	▼
MCY	\$4.64	\$4.41	-1.6%	NEUTRAL	14.9	25.1	4.7%	499	-\$0.54 (-11%)	▼
MEL	\$4.69	\$4.80	6.0%	OUTPERFORM	17.2	27.3	4.7%	792	+\$0.00 (0%)	-
TPW	\$6.90	\$6.55	-0.4%	NEUTRAL	14.6	24.6	6.0%	190	-\$0.95 (-13%)	▼

Source: Refinitiv, Forsyth Barr analysis

Details in the full report

For our complete analysis of the impacts of the Tiwai closure, the assumptions behind our forecasts, and investment views on each of the stocks, see the full report [Electricity Sector – Smelter's Electric Shock Far From Fatal](#), published on 20 July 2020.

Themes of the Week

NZ Equities

Arvida (ARV.NZ) – Q1 Sales Tracking Well Post Lockdown

ARV's sales of retirement village units in the June quarter paint a promising picture for the sector. ARV sold 32 existing units and 12 new ones.

We walk away with three main conclusions:

- Much like for Summerset's June quarter sales, Arvida's June quarter sales point to normal activity levels in June but also to some degree show May being back to "high" normal
- Margins on re-sales of existing units are holding up well (25%, up from 22% in the June 2019 period), which is backed up by early signs of strong domestic housing market activity
- While margins on new unit sales were down (to 15% from 21%) this was offset by higher priced units being sold and a higher level of new sale activity vs pcp.

Going forward we believe cost control and ability to execute on its build program will be in focus. We continue to reverse our COVID-19 related downgrades and have increased our FY21 estimates by +8%.

ARV is priced at 14x FY22 earnings. OUTPERFORM.

Macro Strategy

While equity valuations have on average pushed higher this year, there is justification to hold equities even as real economic activity risks increase. Valuations deserve to be higher in a world of persistently low interest rates. But companies still have to produce earnings and the more you pay for those earnings now, the lower the future returns are likely to be.

Fundamentals versus valuations

- The strength of the rebound in equities since the 23 March low has caught many investors by surprise. It has been underpinned and justified by the **extraordinary policy response from central banks and governments**. The US Federal Reserve and other central banks have overridden free markets and flooded the global system with liquidity. By directly purchasing government and corporate bonds (including junk bonds), the Fed has significantly reduced the risk of credit defaults.
- The Fed's statements make it clear it remains **committed to controlling the shape of the yield curve as necessary to keep interest rates at or around 0% for as long as it deems necessary** – possibly years. The direct purchases of bonds and other fixed income securities is allowing bond holders to switch out of bonds and back into equities, something they couldn't do when liquidity froze during the March market melt-down.
- Fed chair Jay Powell has commented that he is **not at all concerned about the inflationary impact of the central bank's policies on asset prices**; he is only concerned that financial markets are working correctly and, in his opinion, they currently are.
- **China two weeks ago exhorted its domestic investors to embrace the wealth effect of equities** and capital markets, and to look forward to the prospect of a healthy bull market. Retail investors immediately flocked into Chinese shares after these equity-supporting statements.
- **Merger and acquisition activity continues to increase**. Large companies with strong balance sheets and surplus cash balances are buying assets off weak holders. Warren Buffet's Berkshire Hathaway group has started spending some of its cash, with the acquisition of gas pipeline and storage assets from Dominion Energy. This weak-to-strong transfer of company ownership makes sense and will continue to provide support to equity markets overall.
- **Equity dividend yields remain well above the inflation-adjusted cash rates and bond yields** around much of the world. Despite many companies cutting or deferring dividends, the yield story still favours equities over bonds, particularly as dividends tend to grow faster than inflation over time.
- **Technology and investments continue to be poured into the development of vaccines and treatments for COVID-19**. The investment of billions of dollars around the world makes the biotech sector one of the winners in the current environment.

Risks continue to increase

- Small businesses tend to contribute 40–50% of GDP in most developed economies and employ 60–70% of the labour force. In the US, **reportedly over 100,000 small businesses have already closed permanently** due to the impact of the pandemic, despite the massive levels of monetary and fiscal support available.
- As the US earnings season progresses, we will get a better picture of the outlook for the underlying economy. But already, **the major banks have increased their provisions for loan losses** to a total in excess of US\$83b. They also warn that a V-shape recovery is unlikely and that the recession in the real economy is only just starting.
- The current recovery in consumption and activity is put down to the reopening of parts of the economy, with pent-up demand spurring retail consumption and house buying. But much of this is backed by **large fiscal support packages which are due to expire shortly**.
- **The virus continues to rampage** through the US and other parts of the world and disrupt economies.
- Market technical analysts point to a "golden cross" with the S&P 500's 50-day moving average crossing above the 200 day moving average, which they normally regard as a bullish signal. But offsetting that is the narrow breadth of the market advance, with **the FAANG stocks (Facebook, Amazon, Apple, Netflix, and Google/Alphabet) now making up around 25% of the US market cap**.

In summary, a case can be made to remain invested in equities after such a strong recovery. But the longer the market melts up, the more likely we will see a correction.

The best case would be to see a period of consolidation, allowing earnings to catch up to valuations. In this environment, it pays to be extra careful what you buy and when you buy it.

Fixed Income

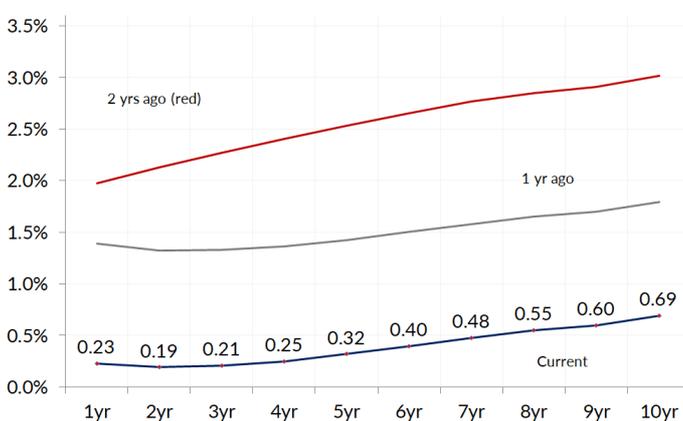
The bond market is generally regarded as a pretty good guide to future economic conditions and **despite record low interest rates around the globe, the demand for bonds, both corporate and government, is extraordinary**. The last two government bond auctions undertaken by the Australian Government have seen record bids. The issue of a 2025 bond saw A\$50.6bn worth of bids for the A\$17bn of bonds issued. This was on the back of the previous record set just a couple of months earlier in May.

At the other end of the quality scale, National Australian Bank (NAB) managed to raise A\$600m via its first hybrid issue post the COVID-19 drama which saw an earlier deal pulled. Whilst the headline amount was smaller than the deal NAB had to cancel due to COVID-19, this particular deal was an institutional deal only and one would have thought that if retail investors had the opportunity to invest in a deal paying 400bp over swap, the issue size would have been significantly larger.

The story in New Zealand has been similar with the Debt Management Office undertaking a 2041 maturity (its longest) which also saw significant demand for its NZ\$4.5bn issue. **Unfortunately, there remains little action on the corporate front with no new issuance announced** and with corporate reporting season just around the corner, **fixed income investors may need to wait for company results to see if any new debt will be issued**.

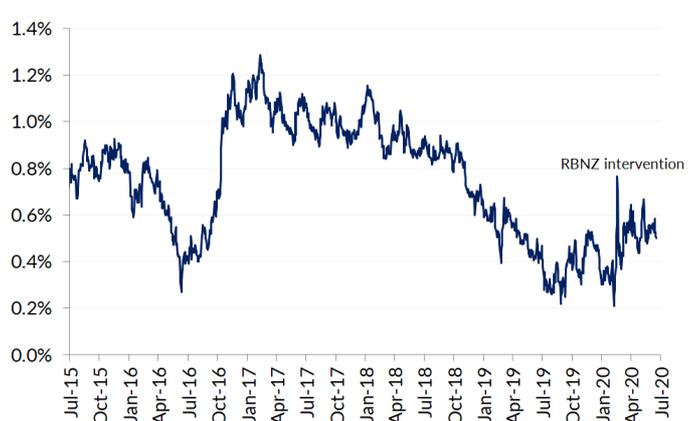
Corporate debt issuance is, however, not an issue in the US, with the US investment grade bond market ballooning by US\$1.5 trillion in the past four months to US\$6.7 trillion! Further down the quality scale, the junk bond market (below BBB-) has grown by US\$400bn to US\$1.4 trillion.

Figure 4. NZ Swap curve



Source: Forsyth Barr analysis, Thomson Reuters

Figure 5. Steepness of the curve



Source: Forsyth Barr analysis, Thomson Reuters

Research Worth Reading

New Zealand

Chorus (CNU) – ComCom Message Lost in Translation?

We believe the market has likely overreacted to the Commerce Commission's (CC) latest release on the fibre regulatory process. We acknowledge the CC's communication is not completely clear, however, when considered in a broader context we do not believe the announced review represents material risk to our CNU valuation or investment view. We remain comfortable with our OUTPERFORM rating. (Published by Forsyth Barr)

Equity Strategy – Recovery Heat Map; School Holiday Boost

This week's update of our COVID-19 recovery heat map shows the significant impact of school holidays on domestic tourism, and a sense of stability in key economic activity measures, though unemployment continues to drift higher. Domestic passenger flights have increased sharply in the past week and hotel occupancy has enjoyed another strong week of improvement, helped by both domestic tourism and higher numbers of quarantined arrivals. Vehicle traffic, retail spending and general economic sentiment appear stable. However, both wage subsidy payments and Jobseeker/COVID-19 Income Relief Payment recipients continue to rise steadily week-on-week. The underlying impact of COVID-19 on the economic base rate of activity is, and will remain, clouded by a number of factors given (1) school holidays, (2) the wage subsidy ending, (3) the typically more conservative consumption trends pre-election, and (4) increasing optimism over a vaccine solution. (Published by Forsyth Barr)

Australia

Aristocrat Leisure (ALL.AX) – UBS Evidence Lab Inside: Digital app revenue trends – July 2020

UBS Evidence Lab tracks revenue share data for social gaming and social casino apps in the iOS and Google Play store. The data suggests a significant increase to 2H20 social casino revenue, driven by continued social distancing restrictions. UBS estimates that ALL experienced +40-50% year-on-year (y/y) growth over the June quarter, driven by strong market growth (market share was broadly flat y/y). In their view, these results represent peak disruption as a result of COVID-19 and this should moderate as economies open up. UBS upgraded its social casino growth forecasts to +35% for 2H20 to reflect current trends, acknowledging there could be some lasting benefits with some returning customers re-activating their interest in the apps. BUY. (Published by UBS)

Origin Energy (ORG.AX) – Lower oil prices attract lower book values

ORG announced FY20 impairment charges and higher bad debt provisions arising from lower oil prices and rising customer hardship from COVID-19. UBS remains positive on ORG, recognising it is well placed to capture upside from higher oil prices, successfully integrating the Kraken customer relationship management system and exploration success in the Beetaloo. BUY. (Published by UBS)

Qube Holdings (QUB.AX) – Capital recycling refuels growth projects

QUB has exchanged contracts for the sale of the Minto (NSW) properties to entities associated with Charter Hall for \$207m. Recycling capital from a fully mature property is a positive signal for a company that has deployed substantial capex into new projects. The transaction is subject to Foreign Investment Review Board approval. ACCUMULATE (from HOLD). (Published by Ord Minnett)

Senex Energy (SXY.AX) – Fourth-quarter FY20 production report

SXY delivered June-quarter production of 0.7 million barrels of oil equivalent (mmboe), taking full-year output to 2.1mmboe, at the top end of guidance. In Ord Minnett's view, there were a number of reasons to be positive about the report: 1) production continues to improve, with FY20 output achieving the top end of the guidance range; 2) realised prices remained elevated despite lower benchmark oil prices; 3) upgraded reserves imply a life of more than 30 years for the Atlas project and more than 50 years for Roma North. ACCUMULATE. (Published by Ord Minnett)

International

Abbott Laboratories (ABT) – 2Q20 Results: Improving Base, Increasing Diagnostics

ABT is in an enviable position. A global, diversified business model that includes recovering trends in elective procedures for its Medical Device segment and a leading COVID-19 diagnostic business. These dynamics were evident in the 2Q20 results, with 2Q20 revenue of \$7.33B surpassing the consensus estimate of \$6.81B, with three of the four segments exceeding consensus: 1) Diagnostics up +7.1%; 2) Established Pharmaceuticals Division down -0.7%; 3) Nutrition up +3.1%; and 4) Medical Devices down -19.9%. BUY. (Published by Citi)

Johnson & Johnson (JNJ) – 2Q20 Takeaways: The Recovery, Vaccine and Diversification

The first out of the box, JNJ delivered 2Q20 results that surpassed expectations. Revenue of \$18.3b exceeded consensus's \$17.6b. Yet it was management's commentary regarding the recovery in elective procedures and its efforts on a COVID-19 vaccine that reigned during the day as progress on both bodes well for the company in the 2H20 and into 2021. Management, one of the few to provide financial guidance on the 1Q20 call, actually increased 2020 guidance. Full-year revenue guidance was increased to \$79.9-\$81.4B. BUY. (Published by Citi)

Funds

Biotech Growth Trust (BIOGW.L) – Notes from a presentation at the AGM on 15 July by Geoff Hsu, manager of the fund and partner at OrbiMed

BIOGW's manager thinks the biotech sector can perform well whether or not the pandemic is brought under control, as long-term growth drivers (acquisitions, a supportive regulatory environment and strong innovation) are favourable. The fund is prone to volatility in risk-off environments, and election campaigning could bring some political noise this year but the risks appear manageable. The sector does not face the same level of concern over valuations or concentration as the technology sector. (Published by Winterflood)

BlackRock World Mining (BRWM.L) – Notes from a presentation by Evy Hambro and Olivia Markham on 15 July

BRWM's managers this year increased the portfolios weighting to gold miners to 33% at the end of May, with holdings such as Newmont Mining, Barrick Gold, Wheaton Precious Metals and Franco Nevada. They expect increased infrastructure and green spending to drive demand for commodities. Mining companies generally have strong balance sheets and good capital spending discipline. Valuations are low by historical standards. BRWM remains an enticing long-term prospect. One clear risk is whether the dividend can be maintained. (Published by Winterflood)

Polar Capital Technology (PCT.L) – Notes from a presentation on 14 July by Ben Rogoff

PCT's global technology portfolio is positioned in both companies that benefit from working and living at home (e.g. Amazon, Ocado) and those that will see trends accelerate as the economy opens and evolves (e.g. TripAdvisor, Uber, Fanuc, Teradyne and 5G-related stocks). Volatility and profit-taking in the tech sector is possible following its strong run. But longer-term prospects look bright. PCT's peer, Allianz Technology Trust (ATT.L), has a more flexible mandate and a more concentrated portfolio. (Published by Winterflood)

Calendar

Figure 6. Description

Date	New Zealand	Australia	International
20-Jul		South32 4Q20 Sales & Revenue	CH: PBoC Loan Prime Rate
21-Jul	Credit Card Spending	RBA Governor Lowe Speaks RBA Meeting Minutes BHP Group 4Q20 Sales & Revenue Oil Search 2Q20 Sales & Revenue	
22-Jul	GlobalDairyTrade Price Index	MI Leading Index Retail Sales OZ Minerals 2Q20 Sales & Revenue	
23-Jul		NAB Quarterly Business Confidence	US: Existing Home Sales (Jun) US: Crude Oil Inventories Microsoft 4Q20 Earnings
24-Jul	Exports (Jun) Imports (Jun) Trade Balance (Jun)	Manufacturing PMI Services PMI	UK: Retail Sales (Jun) UK: Manufacturing PMI (Jul) UK: Services PMI EU: German Manufacturing PMI (Jul) Intel 2Q20 Earnings Dow Chemical 2Q20 Earnings
25-Jul			US: New Home Sales

Source: Forsyth Barr analysis, Bloomberg

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