

Wealth Weekly

Down But Not Out

WEALTH MANAGEMENT RESEARCH

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Despite several trading outages on the New Zealand stock exchange due to cyber attacks, the NZX 50 index still managed to jump another +2.2% last week as company results rolled in. Global markets did even better, rising about +2.7% in US dollar terms, but for NZ investors that was more than offset by the +2c appreciation in the NZ dollar.

Results season rolled on

The significant disruptions to the NZX website resulted in NZX-listed securities being unable to be traded on the local market for some hours on four days last week. Off-market transactions and trading of some NZ stocks on the ASX continued. Importantly, these delays to trading did not affect the share registries, custodians or ownership of stocks.

The stock exchange may have taken a few unscheduled breaks, but results season continued unabated. **Meridian Energy delivered another bumper result**, as strength in electricity generation and retail volumes and pricing made up for lower wholesale prices and outages. There was no news on whether and when the NZ Aluminium Smelter (NZAS) will close. The sector's fortunes and dividends for the next few years will depend on the closure decision, and (if/when it does close) on how the gentailers will compete.

Metlifecare's result confirmed what we heard from Summerset Group earlier in the reporting season: Demand for retirement village units returned to normal following the first lockdown. The listed operators' villages came through the lockdowns looking like a safe place to be, which probably reinforced the value proposition for their customers. Solid house price expectations are also positive for investor sentiment towards the sector. Meanwhile, construction costs for new villages could decline over the next 6–12 months compared to last year as building industry capacity constraints ease up, which would help the aged care companies' development margins beyond FY21.

Spark NZ's result included a good performance from the mobile business as customers traded up to more expensive plans, while the IT and broadband businesses struggled to grow profits. The company indicated it might need to trim its dividend slightly in order to maintain its credit rating while funding its capital expenditure plans. After a strong share price performance over the past year, we pull back our rating to NEUTRAL.

Themes of the week

The Australian reporting season is largely through, and company results have on average been better than expected. It will be interesting to see whether rising hopes for a successful COVID-19 vaccine or an acclimatisation to living with the virus will prompt investors to transition from backing the stocks that benefited from COVID to those that have lagged in the post-March rally.

The big news overseas last week was the **confirmation from Federal Reserve Chairman Jerome Powell that the US central bank will let inflation run over its 2% p.a. target for a while** to make up for all the time it has spent under that level over the past decade. The purpose of doing so is to drive greater employment. The Reserve Bank of New Zealand also chimed in, saying its view is much the same as the Fed's. Together, with recent talk of a negative Official Cash Rate and direct funding of banks, that reinforced the expectation that New Zealand interest rates will stay so low that they won't compensate investors for higher inflation ("negative real rates"), eroding the value of investors' cash in term deposits.

This low-rate/higher-inflation policy certainly remains **an incentive to buy assets which provide cash flow growth or inflation protection – despite valuations that are high against historical benchmarks.**

Looking ahead

Results season is winding down, with SKYCITY reporting on Thursday and Property For Industry on Friday.

NZ Company Results

Of the 28 New Zealand company results reported in the August earnings season to-date (among companies we cover), twelve have beaten expectations and nine were below. Outlook statements have been similarly spread with ten positive and nine negative. Median earnings per share is tracking just -1.4% below the prior year.

Meridian Energy (MEL.NZ) – FY20 Result Review – In a State of Flux

A year ago, after MEL's stellar FY19 result, we were reasonably confident that result wouldn't be repeated, but it has been. FY20 operating profit was up +2% from FY19. Record electricity generation volumes and continued retail improvement (volumes up +18% and average selling price up +3%) more than offset lower wholesale electricity prices, the HVDC outage and increased operating expenses.

The uncertainty about when/if the NZ Aluminium Smelter (NZAS) will close and how the industry players will behave in response to the resulting surplus of generation capacity in the lower South Island are keeping MEL and the industry in a state of flux:

- There was little new information on the NZAS closure decision, with the negotiation ball currently in the government's court. If NZAS delays closure, that should bring MEL's dividend growth forward.
- Encouragingly, MEL indicated there is strong interest for new South Island electricity demand from industrial users, but it's unclear how much is "tyre-kicking" – and none will be ready in time to absorb the excess supply in the lower South Island.
- MEL said its next best alternative is to grow its retail customer base, which raises the spectre of intense retail price competition.

Our forecasts for MEL were little changed following the result. Looking ahead, investors should expect flat dividends of 16.9cps for several years. Large reductions in our team's cost of capital assumptions boosted our target price by +70cps (+15%) to NZ\$5.50/share. We retain an OUTPERFORM rating.

Metlifecare (MET.NZ) – FY20 Result – End of a Long Journey?

The ongoing takeover offer for MET, which appears likely to succeed, means its result will be of more interest to investors in other aged care stocks than to MET shareholders. MET's recent operating performance reinforced our view that the aged care sector has emerged from the COVID-19 crisis strong. Demand appeared to be back to normal in June and above last year's level in July and August. MET expects the high construction costs experienced in FY19/20, combined with likely flattish price realisation, will weigh on development margins in FY21. However, MET expects construction costs to reduce, a sentiment mirrored by management at Summerset and Precinct Properties. Separately, a survey released on Friday showed consumer expectations for house prices remain solid, which is supportive for sentiment towards the aged care sector.

MET has been trading around -1-2% below the takeover price of \$6.00/share, implying that investors are attributing a high probability of the deal proceeding (or – less likely – a high probability of a better offer emerging). Our rating on MET is NEUTRAL.

Spark NZ (SPK.NZ) – FY20 Breaking the Quarter Buck; NEUTRAL

Despite the loss of roaming revenues, SPK's mobile business remained the principal good news story in the company's result, with gross margins rising +7% as customers traded up (from prepaid to postpaid, to higher tier plans and to higher data use). Elsewhere in the business growth remained challenging:

- Cloud, security, and service management delivered +11% revenue growth, but margin pressures and investment in staff meant profit growth was minimal.
- Broadband suffered as there was pressure on average revenue per user, and the selling of wireless broadband stalled (SPK has ambitions to reignite it, supported by 5G's greater capacity and speed).
- The decline of legacy voice calling revenues unsurprisingly remained the largest headwind – but the good news is there's ever less of this business left to shrink.

The main news in SPK's result was it has eased back on its ambition to sustain its 25cps dividend, guiding to 23-25cps in FY21 in order to protect its A- credit rating while funding medium-term capital requirements (for mobile spectrum, 5G infrastructure, Southern Cross Next cable, Spark Sports). A dividend cut is no *fait accompli* – SPK has consistently outperformed market expectations, and COVID-19 impacted revenue streams such as mobile roaming will bounce back once lockdowns end. Even with a dividend cut, SPK should still offer an attractive yield in an income-scarce world. But after a strong share price performance through this volatile year, we downgraded our rating to NEUTRAL principally on valuation grounds. SPK remains in our model portfolio.

Themes of the Week

Australian Equities

Australian Reporting Season Wrap-up

With the Australian reporting season coming towards an end, we outline some of the key themes from the reporting period.

Profits recession is ending, earnings expansion is ahead

Australia Inc mitigated the downturn in revenues with cost cuts focussed in wages, cost of debt and energy costs, which will increase their leverage to a recovery in economic activity and in revenues.

The reporting period provided fledgling signs that the profits recession is ending, with broad EPS upward revisions and positive trading updates. Many companies are starting FY21 with considerable momentum. Expectations are for profits to bottom out in the current half-year and consensus forecasts are for flat earnings by June 2021 and +14% yoy EPS growth by December 2021; a V-shaped recovery.

History suggests as profits begin to recover we will enter a new phase of the market cycle. This is the earnings expansion phase where the gains in stock indices are more moderate and bottom-up drivers dominate stock returns.

Dividends were supported, the 'buyback carrot' appears once again

The stability in dividends has been impressive. While ASX 200 EPS was downgraded by -1.4% or -A\$1.3bn, DPS was downgraded by just -0.2% or by -\$100m. The saviour for dividends was the commodity producers, particularly the three iron ore producers. Some companies suspended buybacks, while others dangled the buyback carrot to investors and we think some (like **BHP Billiton**) should be taken more seriously than others (**Dexus**).

An embarrassment of riches for the commodity producers

Supporting further capital returns from the commodity producers are strong balance sheets and strong cashflows. Commodity companies are beginning to spend more on capex, but this still seems moderate compared to previous periods of excess investment.

What to do with the COVID-19 darlings and the dogs

It was the COVID reporting season and the obvious question is what to do with the "COVID darlings" (companies that benefited) and the "COVID dogs" (which suffered from lockdowns etc). Investors may transition towards a more normal view of the world as hopes for a successful vaccine grow and/or society learns how to better live with the virus.

The COVID darlings that may struggle most in that scenario are those already enduring weaker earnings momentum, such as **ASX** and **Evolution Mining**.

COVID dogs that may benefit most from the recovery in both the economy and investor sentiment include those that are still trading below peak stock prices yet are already seeing improving profit trends, such as **Santos**, **Star Entertainment** and **QBE**.

Fixed Interest

Is the market already pricing in negative interest rates?

Over the last month or so, as commentary around the possibility of a negative Official Cash Rate (OCR) became more common following the August Monetary Policy Statement and the second lockdown (in Auckland), **swap rates (wholesale interest rates) have declined to levels close to 0%**. The impact on individuals has only been felt to date on the investor side of the equation, with **retail bond issuers reaping the benefits of lower coupon rates**. Mortgage holders are yet to benefit, with **mortgage rates holding up quite well** (from a bank's perspective!).

With the Reserve Bank of New Zealand (RBNZ) indicating it may look to directly provide banks with cheap funding alongside a negative OCR, one must wonder where term deposit rates will go. At two-year term deposit rates of around 1.4% currently, the real return (nominal interest rate less the inflation rate) is already negative, and that is before income tax is deducted.

There remain a few questions that need to be addressed before a negative OCR and direct RBNZ funding are considered:

- **First, how does this method of funding impact the banks' Core Funding Ratios** (which have been reduced already due to COVID-19)? Will banks have to abide by these rules? It seems unlikely and pointless if banks are receiving cheap funding directly from the central bank. This is likely to negatively impact term deposit rates further. It may not be an issue at present but a large refinancing risk may be just around the corner for many term deposit holders.
- **Secondly, is there demand for the huge quantitative easing programme that is being suggested?** Many corporates are likely to go into conservative balance sheet mode, reducing dividend payout ratios and deferring capital expenditure. Retail punters are also likely to be somewhat subdued in their borrowing if their job prospects are on shaky ground; some first time house buyers will be loving it, but with house prices continuing to rise, even with lower service costs, many are still priced out of the market.

With central banks overseas having had very little success in generating inflation despite many years of using negative interest rates, the pessimistic sentiment that the move could unleash risks accentuating already depressed economic activity.

Research Worth Reading

New Zealand

Equity Strategy – Recovery Heat Map; Auckland's Second Full Week of Alert Level 3

Our COVID-19 recovery heat map has experienced further decline in a number of indicators last week, as Auckland remained at Alert Level 3 and the rest of the country at Alert Level 2. The most significant declines were in credit card spending and light vehicle traffic, followed by domestic passenger flights and heavy vehicle traffic. The number of recipients of Jobseeker Support/COVID-19 Income Relief Payment (CIRP) continues to drift upward, as does the amount paid under the wage subsidy scheme. The lagged nature of much of our data means last week's lockdown will be reflected in another challenged data set next week. (Published by Forsyth Barr)

Air New Zealand (AIR) – FY20 – Viral Load Factor

AIR posted its first annual loss in 18 years. Border closures and social distancing will remain key headwinds. Cash burn is through the worst, given major cost cutting and scope for recovery, particularly domestically, but will likely continue until borders reopen. The government has confirmed it will remain a majority shareholder, and therefore would support a recapitalisation, which we believe is necessary given elevated gearing. NAV remains our anchor for valuation purposes, and in light of the share price trading at a material premium to it, we retain an UNDERPERFORM rating. (Published by Forsyth Barr)

Freightways (FRE) – FY20 – Pricing for Effort Lifts Target

FRE's FY20 result showed cashflow was robust. FRE has started FY21 on an above-trend growth trajectory, which is supportive to earnings upgrades and a valuation re-rating. FRE is considered a GDP proxy stock, yet we believe has the potential to outgrow economic activity via strategic growth. Improved management disclosure offers insight into the forward looking opportunity. Upgrade to OUTPERFORM. (Published by Forsyth Barr)

Mainfreight (MFT) – Q2 Peer Read-through – A Blue Blooded Anomaly

Second quarter 2020 results from MFT's global peers highlight material declines in freight demand as a result of COVID-19, but resilient margins across most industry segments. MFT's superior performance in the context of broader industry profitability decline highlights its best-in-class characteristics and continued strong growth potential. OUTPERFORM. (Published by Forsyth Barr)

Port of Tauranga (POT) – FY20 – More Ebbing than Flowing

POT reported a softer FY20 result than has been customary in recent years, given an -8% decline in cargo during the year. Underlying NPAT fell -5% against the prior year, on a revenue decline of -4%. As a result of lower profitability the company cut its final dividend and has suspended (we believe temporarily) its 2.5c special dividend programme. Management has acknowledged that it would be interested in participating in any ownership/business structure change at Ports of Auckland, if its owner, Auckland Council, was to consider alternative options to the status quo. UNDERPERFORM. (Published by Forsyth Barr)

Australia

Afterpay (APT.AX) – Singapore sling, BUY

First Europe, now Asia – it was quite a week for APT shareholders! Last week's result coincided with the announcement of an acquisition of EmpatKali, to help establish an in-region team to explore opportunities in select Asian markets. This follows the acquisition of Pagantis as part of another retailer-led expansion, this time into southern Europe. These expansion efforts are unlikely to generate significant revenues until FY22, in Ord Minnett's view. In the meantime, APT will continue to benefit from the rapid acceleration in ecommerce as well as the growing appetite for micro instalments as a way for consumers to fund more of their discretionary purchases. BUY. (Published by Ord Minnett)

APA Group (APA.AX) – Still a standout in listed Real Assets despite a lost year of growth

While the FY21 outlook has disappointed, Citi argues that headwinds related to lower gas demand will begin to turn around in FY22. While lower on an absolute cents per share basis than Citi's prior forecasts, the growth trajectory is still better than most listed real assets, in Citi's view. Citi sees limited downside risk from here (outside of any continuing pain at Orbost) and hence in a low rate environment Citi thinks APA's income should remain desirable to investors. BUY. (Published by Citi)

Cleanaway Waste Management (CWY.AX) – FY20 Result – Good Start to FY21 in a Difficult Environment

CWY reported underlying +12% EBITDA growth to A\$516 million, +4% ahead of consensus. Trading performance appears to have recovered in July. Despite limited near-term visibility (provision of guidance was deferred until the AGM in October), investors should be comforted by rebounding activity in June/July, coupled with strong cost management. The Municipal and Health businesses continue to perform well and the balance sheet remains in good shape. BUY. (Published by Citi)

Qube Holdings (QUB.AX) – Result reflects COVID-19 volume decline

QUB reported underlying EBITA of A\$160m, in line with UBS's forecast. The impact of COVID-19 was -A\$20m as container, bulk cargo and automotive volumes fell sharply in 2H20. While the outlook statement from QUB suggests ongoing pressure on business activity across the group, there has been a recent increase to port container volumes, which management said is likely to continue for the next couple of months. Additional comments suggest that the peak disruption has passed, which is reflected in UBS's estimates through an improvement in performance from 2H21. NEUTRAL. (Published by UBS)

Ramsay Health Care (RHC.AX) – FY20 result review

RHC reported an FY20 core net profit of A\$387.7m, -10% below Ord Minnett's forecast. There was no final dividend, as expected, leaving the full-year payout at 65.5cps. The result confirmed activity is recovering, with volumes above pre-COVID-19 levels in most regions. Management highlighted the headwinds from higher costs and a slower recovery at mental health and rehab facilities, although Ord Minnett believes a strong rebound across most specialties is just a matter of time. ACCUMULATE. (Published by Ord Minnett)

International

Abbott Laboratories (ABT.N) – The Strong Getting Stronger: New Antigen POC Test

As the world evolves to manage the COVID-19 pandemic, ABT has come up with another tool for the armamentarium. ABT received FDA emergency use authorisation for its BinaxNOW antigen test, the first COVID-19 diagnostic test where results can be read directly from the testing card. This is a game changer as Citi believes that COVID-19 testing will be part of our lives for some time and ABT is leading the way. Citi increased its estimates, forecasting COVID-19 related testing revenues of US\$2.7b in 2020, US\$5.1b in 2021, and US\$3.3B in 2022. BUY. (Published by Citi)

Medtronic (MDT.N) – Better-than-Expected FY1Q; the Tempo Is Even More Important

MDT's 1Q21 result was better than expected, yet Citi thinks most investors will focus on the subtle change of tempo in management's delivery. The potential of the pipeline is well known (130 regulatory approvals worldwide in the year to-date), but the shift in discussion not only about the expanding market opportunity but also about increasing market share is a notable pivot. These efforts are allowing MDT to gain share in some of its largest businesses, including spine, implantable cardioverter defibrillators (ICDs), and transcatheter aortic valve replacements (TAVRs). There are still areas of focus, namely in diabetes, but the organisation is working to better partner with customers. BUY. (Published by Citi)

Ping An Insurance (2318.HK) – 1H20 Broadly In-line; Earnings and CoR Modestly Miss

Ping An reported a broadly in-line set of 1H20 results. Group Operating Profit After-Tax (OPAT) managed to inch up +1% yoy, while interim DPS hiked at a faster pace of +7% yoy to CNY0.8. BUY. (Published by Citi)

Salesforce.com (CRM.N) – Solid Q2 Results As Digital Transformation Tops

After a mixed Q1, CRM saw a sharp recovery in Q2. UBS thinks this strong result highlights the ongoing customer prioritisation of digital transformation initiatives, with the COVID-19 pandemic driving even greater urgency to engage customers in new ways. Not only did key top line measures beat expectations, but margin outperformance and reaffirmation that no M&A is likely in the near-term should also counter key tenets of the bear case on the stock. UBS thinks the solid Q2 print can reverse some of the concerns that caused CRM shares to lag large cap growth peers over the past 12-18 months and foresees a catchup trade ahead. BUY. (Published by UBS)

Calendar

Figure 1. Calendar

Date	New Zealand	Australia	International
31-Aug	ANZ Business Confidence (Aug)	Company Gross Operating Profits (Q2) Private Sector Credit (Jul) Melbourne Institute Inflation Gauge Housing Credits	CN: Manufacturing PMI (Aug)
1-Sep	Building Consents (Jul) Terms of Trade Index (Q2)	AIG Manufacturing Index (Aug) Building Approvals (Jul) Current Account (Q2) RBA Interest Rate Decision (Sep) RBA Rate Statement Manufacturing PMI	UK: Manufacturing PMI (Aug) EU: CPI (Aug) EU: German Manufacturing PMI (Aug) EU: German Unemployment Change (Aug) CN: Caixin Manufacturing PMI (Aug) Siemens Energy Capital Markets Day
2-Sep	GlobalDairyTrade Price Index	GDP (Q2) RBA Chart Pack Release	US: ISM Manufacturing PMI (Aug) Pernod Ricard FY20 Barratt Developments FY20
3-Sep	SkyCity Entertainment FY20	Trade Balance (Jul) AIG Construction Index (Aug) Services PMI	US: ADP Non-Farm Employment Change (Aug) US: Crude Oil Inventories UK: Composite PMI (Aug) UK: Services PMI (Aug) CostCo August Sales
4-Sep	Property For Industry 1H20	Retail Sales (Jul)	US: Initial Jobless Claims US: ISM Non-Manufacturing PMI (Aug) UK: BoE Governor Bailey Speaks UK: Construction PMI (Aug)
5-Sep	CFTC NZD Speculative net positions	CFTC AUD Speculative net positions AIG Services Index (Aug)	US: Non-Farm Payrolls (Aug) US: Unemployment Rate (Aug)

Source: Forsyth Barr analysis

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