

# Wealth Weekly

## Ageing Well

WEALTH MANAGEMENT RESEARCH

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New Zealand's aged care landscape is changing. The provision of aged care beds has not kept pace with rising demand, at least in part, due to government funding lagging the upward pressures on cost. Some operators are pivoting to a different model for their rest home businesses, hoping to improve the economics of providing care.

### Changing the economics of aged care

The earnings and portfolio composition of the aged care sector has undergone significant change over the past decade, with retirement village-related earnings starting to dominate over traditional rest home care-related earnings.

The industry is now at an interesting juncture, with **innovation in the form of care suites becoming a widely used solution to turn around the profitability of the care businesses**. Three of the four listed aged care companies are focussing their new care development activity on care suites (or similar), which, rather than renting on a weekly basis, they sell under Occupational Rights Agreements (ORA) — a similar model to that used for their independent living village units. The reason for this pivot is likely a combination of poor profitability of standard care, increased resident expectations for room standards, and a wish to differentiate offerings. The shift to selling care suite ORAs has three main implications; 1) it increases the cash recovery of new builds, 2) it improves the profitability of care, but 3) it reduces the cash conversion and predictability of earnings.

**Oceania Healthcare has led the way in care suite ORAs, but Arvida is a fast follower.** Summerset is still in its infancy and will deliver premium care through a combination of care suites and memory care (dementia). **We upgraded Arvida to OUTPERFORM, reiterated our OUTPERFORM on Oceania,** and kept NEUTRAL ratings on Summerset and Ryman Healthcare.

### Themes of the week

After underperforming both the sector and the broader market, **Arvida is currently priced at close to an all-time low P/E multiple relative to the sector and market.** We believe this underperformance has been driven by concerns around increasing leverage and slow organic growth. We expect robust FY21 earnings, and believe a re-rating will be driven by earnings growth from an increased rate of independent living units resales as villages mature, and from the sale of care suite ORAs.

In the property sector **we downgraded Investore from OUTPERFORM to NEUTRAL.** Asset values lifted substantially in FY21 — delivering sizable share price gains but also making it harder for Investore to profitably deploy the capital it raised in April 2020. Without acquisitions, we expect no growth in earnings, and rising interest rates are tempering our valuation.

**It has been a tough six months for Chinese ecommerce giant Alibaba.** In November 2020 Chinese regulators toughened the rules on payment companies like Ant Financial (in which Alibaba owns a 33% stake) and halted its IPO, and in April Alibaba was fined c.US\$2.8b for anti-competitive practices. **Alibaba remains one of the e-commerce market leaders in the world's second largest economy.** The medium-term outlook for Alibaba remains favourable in our view, and the stock's valuation is attractive relative to other global technology leaders.

As expected, **the Reserve Bank of New Zealand (RBNZ) left the Official Cash Rate (OCR) unchanged at 0.25%.** After recovering over recent months, wholesale interest rates have stabilised in the last couple of weeks. Rising wholesale interest rates have been accompanied by contractions in credit spreads on corporate bonds, limiting the rise in bond yields.

### Looking ahead

The US earnings season got off to a mixed start last week, with strong results being met by disappointing share price reactions. Companies reporting this week include Johnson & Johnson, Netflix and Intel. NZ inflation data is due out on Wednesday.

## NZ Equities

### Aged Care Sector – Changing the Economics of Care

Care ORAs improve the economics of care and development; but it is not a "free lunch"

The proportion of capital expenditure on new developments that the aged care operators recover has deteriorated substantially across the sector over the last 5–10 years; from over 90% to around 60–70%. This low cash recovery of capex has driven up net debt across the sector over the last few years. We discussed this dynamic in detail in our report [Different Times Call for Different Measures](#), published 15 October 2020.

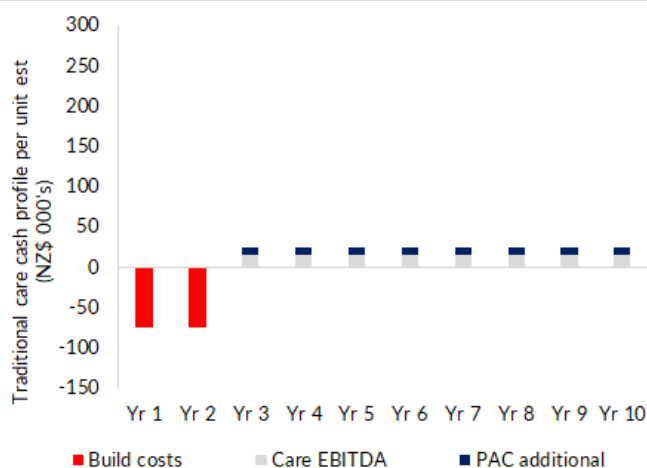
The traditional (and still dominant) model of charging for care is through a base fee with an additional premium accommodation charge (PAC) for premium offerings. Over 90% of facilities today have beds with a PAC, up from 20% 15 years ago, as resident demand has increased (particularly from those in retirement villages) and as aged care operators sought other sources of income to top up relatively static government funding. We believe there is not much room for further growth in applying PACs.

Recently, **Oceania (OCA)**, **Summerset (SUM)** and **Arvida (ARV)** have introduced the option for care residents to buy **Occupational Rights Agreements (ORAs)** on resthome care suites, rather than paying recurring fees. **Ryman Healthcare (RYM)** has introduced **Refundable Accommodation Deposits (RADs)**, similar to an ORA but without a Deferred Management Fee (DMF) applied to its existing traditional beds.

The ORA business model for care suites has the potential to restore the aged care operators' ability to recycle cash faster (Figures 1 & 2). However, with it comes higher volatility in business cash flow.

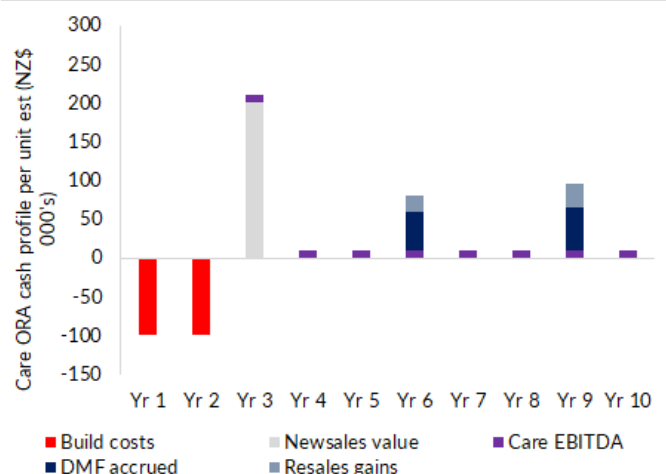
Demographics suggest c.2,500 care beds are needed annually, compared to c.500 pa that have been added in recent years. We believe the high acuity nature of care allows it to derive similar earnings growth from the ageing population thematic, but with lower volatility than retirement village earnings.

Figure 1. Traditional care cash profile



Source: Forsyth Barr analysis

Figure 2. Care ORA cash profile



Source: Forsyth Barr analysis

**Our preference is for the smaller two operators, OCA and ARV.** We believe both will deliver the fastest organic growth in the sector yet are valued at an almost -50% discount to RYM and SUM. We acknowledge they should be valued at a discount due to their unproven track record of consistent greenfield delivery. However, over the medium term, we see the potential for both to close the valuation gap as investors grow comfortable with their ability to grow earnings organically.

#### Aged care tour confirms that recent strong demand is continuing

We recently visited 11 villages on our Kaimai aged care tour. We walked away with three main impressions that support our overall positive view of the sector and our upgraded OUTPERFORM rating on Arvida:

- Demand for retirement village units remains very strong across the board, but in particular for high-end villages
- OCA and ARV are targeting near 100% uptake of care suite ORAs, above our prior estimates of ~80%, and demand appears strong
- There have been some construction cost increases, but no severe materials or labour shortages were noted.

## Themes of the Week

### NZ Equities

#### Arvida Group — Ageing Well; Upgrade to OUTPERFORM

The NZ aged care operators' business model demands a lot of patience from investors; cash is spent upfront to build villages, which can take a decade or more to reach maturity. When residents of independent living units (ILUs) move into care, their ILUs can be resold for a capital gain, and they start to provide steady annuity earnings streams.

The large proportion of young villages with comparatively low annuity earnings in Arvida's (ARV) portfolio has resulted in the company delivering only mid-single digit organic growth. Looking ahead, **we see an acceleration of ARV's organic growth up to over +15% per annum**, driven by:

- High end villages approaching maturity
- A focus on care suites with faster maturity

Since listing ARV acquired six major villages. Around a quarter of ARV's portfolio of ILUs were built between 2012 and 2017. These **newer ILUs are now approaching maturity and will contribute incremental re-sale gains over the next five years.**

ARV has committed to building out its care offering using the care ORA model, whereby care bedrooms are sold using an Occupational Rights Agreement (ORA) rather than a recurring Premium Accommodation Charge. **Over 90% of ARV's planned care units will be built with the intention of selling them under an ORA, which will materially improve cash recovery of capex.**

In our view, ARV's accelerating organic growth is not reflected in its valuation. Following a period of underperformance, **we believe a sustained re-rating of the stock will be driven by the market pricing in the earnings potential from maturing villages and care ORA.** We upgraded the stock from NEUTRAL to OUTPERFORM.

### NZ Property

#### Investore (IPL.NZ) — Too Much of a Good Thing

Supermarket and large-format retail landlord **Investore (IPL) has benefitted from high demand for yield assets and properties as a result of low interest rates.**

'Essential' tenants like supermarkets are viewed as lower risk following the pandemic lockdown. Supermarket and standalone large-format retail assets have found particular favour with syndicates and high net worth individuals, given their affordable size, strong tenant covenants and long weighted-average lease terms.

**This competition for assets from private buyers, and the resulting high asset prices, make it difficult for IPL to deploy the c.NZ\$168m of surplus capital it has available to invest**, following a capital raising in April 2020 that reduced gearing from 42% to 31%. IPL has been disciplined with regards to its acquisition metrics, but with no transactions announced to date, **its superior earnings growth track record is coming into question.**

We have adjusted our forecasts marginally downwards to reflect the lack of acquisitions so far, higher management fees (due to higher asset values), and updated interest rate assumptions. **With valuation upside tempered** by the impact of higher interest rates on our DCF, and with earnings growth being contingent on acquisitions in a competitive market, **we downgraded our IPL rating to NEUTRAL.**

## International Equities

### Alibaba (BABA.K) — Poised to be positively re-rated

Alibaba fell foul of Chinese regulators late in 2020, and the stock has materially underperformed the market since. The moves by the Chinese regulators may have dented the underlying short-term value of Alibaba and its subsidiaries (including 33%-owned Ant Financial). But **we maintain a favourable medium-term outlook for Alibaba and believe the stock offers good value for risk at its current share price of US\$239.**

Here is a snapshot of key events affecting Alibaba and its stock over the past 6 months:

- 24 October 2020: **Alibaba founder Jack Ma openly criticised China's risk-averse financial regulations** and the lending practices of banks.
- 27 October: Alibaba's share price peaked at US\$317.
- 2 November: **Ma was summoned to a meeting with China's financial regulators.** The regulators revised the rules for payment services companies like Ant Financial Group (in which Alibaba owns a 33% stake).
- 3 November: **Chinese Regulators halted the pending IPO of Ant Financial.** This contributed to a -19% drop in Alibaba's share price towards US\$256 by 18 November. The prospect of tougher regulation, and concerns that it might have been payback for Ma's criticisms, caused a substantial de-rating in the valuation of Alibaba stock in absolute terms and relative to the market. Investors were spooked by the potential for Alibaba to face further regulatory risks.
- 18 November: The US Securities and Exchange Commission (SEC) proposed requiring foreign firms to follow US audit rules or else face having their stocks delisted from US exchanges (Alibaba's primary listing is in the US; it also has a secondary listing in Hong Kong). China has long refused to let US audit overseers examine the audits of US-listed Chinese companies. Congress subsequently passed the SEC's rule into law in December.
- 31 December: Alibaba stock closed the year at US\$233, down -26% from its late October peak, while the MSCI All Country World Index was up +11% over the same period. In our opinion this magnitude of underperformance (-37%) was excessive.
- 24 March 2021: The US SEC started enforcing its audit requirements on foreign firms.
- 10 April 2021: **Chinese regulators announced they were fining Alibaba CNY18b (US\$2.8b) for violating anti-monopoly rules** and abusing its dominant market position. This fine represents less than 1% of Alibaba's current market capitalisation of US\$650b.

Whilst Alibaba's underperformance (+2.6%) versus the global benchmark (+9.7%) has continued into 2021, this has generally been in line with other big tech names like Amazon, as the market has favoured recovery/value sectors over the prior market winners from the technology/growth segments of the market.

**Alibaba provides investors with exposure to one of the largest ecommerce companies in the world;** its mobile monthly active users reached 900m in 2020, the most of any E-commerce company.

Alibaba's has four key segments: 1) ecommerce, 2) retail, 3) internet and 4) technology.

Alibaba's ecommerce platform focusses mostly on two key groups: 1) business-to-business trade through Alibaba.com, and 2) business-to-consumer online retail through AliExpress, Tmall.com and Tmall Global. In our view, **Tmall Global provides a key source of growth as Alibaba helps businesses connect their products to Chinese consumers.** Alibaba's "Singles Day" has been a key initiative connecting global companies to Chinese consumers. For example, Alibaba allows NZ agriculture/horticulture producers to export their products direct to Chinese customers, including fresh produce like salmon.

In addition to Alibaba's core e-commerce business, many other areas of expansion are becoming material contributors to group earnings or valuation, including: Fintech (Ant Financial being a key subsidiary), cloud computing (Alibaba), digital entertainment, artificial intelligence and venture capital.

In early May Alibaba is due to report its result for the fiscal year to the end of March 2021. The substantial pullback in its share price since early November 2020 has seen its **12-month forecast price/earnings multiple decline from around 30x to close to 20x. Earnings forecasts, however, have remained resilient,** with analysts on average forecasting around +20% pa EPS growth out to FY24, which we believe is achievable. This underpins our judgment that Alibaba offers good value for risk at its current share price.

## Fixed Interest

### RBNZ holds the line...for now

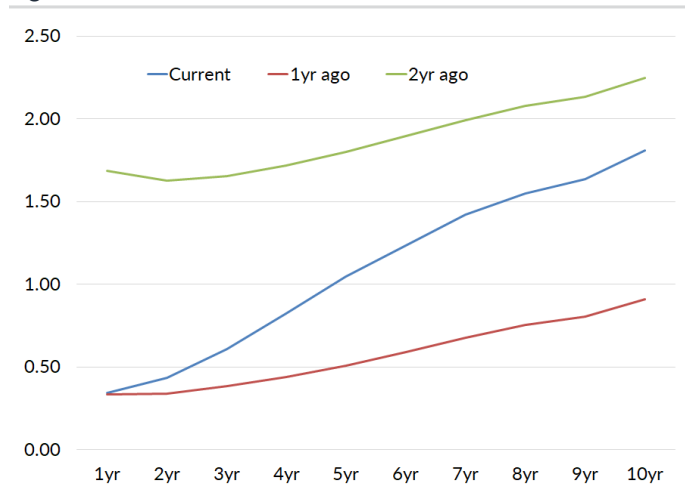
The Reserve Bank of New Zealand (RBNZ) left the Official Cash Rate (OCR) on hold last week at 0.25%. The 'hold' and accompanying commentary were largely expected given the level of uncertainty that currently exists. This week's inflation report for Q1 may have also weighed on the RBNZ's decision. **The debate around whether inflation will rise in a sustained way or just as a temporary blip is ongoing, both in New Zealand and globally.**

Given this uncertainty around inflation and the impact of the government's housing policies, a prudent 'wait and see' approach from the RBNZ was always on the cards. The Monetary Policy Committee did, however, agree that it was still prepared to take the OCR negative if required.

After a rather aggressive move higher, **wholesale interest rates (Figure 2) have been somewhat more stable in recent weeks**, with the 5-year swap rate now -22bp lower than at the start of March. Global fixed income markets seem to have paused after a busy few months, taking solace from Central Bank commentary globally, all seeming relatively relaxed about rising inflation and interest rates.

The current pause provides fixed income investors time to reassess whether their portfolios are able to perform should interest rates continue their climb higher in the coming years. **The rise in headline yields has been constrained by the contraction in credit spreads.** For example, Ryman (RYM) and Summerset (SUM) in 2020 issued six and seven year bonds respectively at coupons of 2.55% and 2.30% (or an issue credit spread of 2.00%). The current yields for both are ~2.30%, despite the rise in underlying interest rates, with the credit spreads tightening from 2.00% to just 1.28% and 1.13% (Figure 3).

**Figure 3. New Zealand wholesale interest rates**



Source: Forsyth Barr analysis, Refinitiv

**Figure 4. Change in credit spreads**



Source: Forsyth Barr analysis, Refinitiv

## Research Worth Reading

### New Zealand

#### Contact Energy (CEN) – Earnings Humming Nicely

For the third month in a row, CEN has produced a monthly EBITDAF result better than the pc, with March 2021 EBITDAF of NZ\$40m +NZ\$3m better than March 2020. The outlook for the remainder of FY21 and into FY22 has improved and we have upgraded our FY21 and FY22 EBITDAF forecasts +NZ\$14m (+3.0%) and +NZ\$24m (+4.9%) respectively. In addition, we believe earnings risks are still to the upside. CEN continues to be our preferred electricity stock and we retain our OUTPERFORM rating. (Published by Forsyth Barr)

#### Michael Hill Intl (MHJ) – 3Q21 Sales Checkout

MHJ has delivered another strong quarterly (3Q21) trading update, highlighted by its seventh consecutive quarter of gross margin expansion, attributable to continued execution on its strategic initiatives. Alongside +200bps of gross margin expansion on the prior year period, MHJ recorded group same store sales (SSS) growth of +16%. We are encouraged by continuing signs of execution, providing further confidence in management's ability to grow earnings. Trading on a one year forward PE ratio of 10x and offering a 12 month forward cash yield of 5.9%, we continue to see value at current levels. OUTPERFORM. (Published by Forsyth Barr)

#### Napier Port (NPH) – Cargo Offsets Cruise

NPH reported robust 1H21 cargo volume growth and upgraded FY21 earnings guidance. The better-than-expected first half trading is due to strong log export growth, largely offsetting the absence of cruise ship calls. Container volumes were flat relative to the prior year. FY21 EBITDA guidance was increased to NZ\$39m–NZ\$42m from NZ\$34m–NZ\$38m, a +13% upgrade at the midpoint. Despite NPH navigating short-term industry congestion issues well, valuation headwinds remain in the form of 1) the return on capital dilution arising from 6 Wharf investment, and 2) the recent rise in bond rates. Trading at an ~18x one year forward EV/EBITDA and a ~34x one year forward PE, we view NPH as expensive and retain our UNDERPERFORM rating. (Published by Forsyth Barr)

### Australia

#### Cleanaway Waste Management (CWY.AX) – Veolia and Suez merger implications

France-based Veolia Environnement and Suez announced their respective boards of directors have reached an agreement in principle to the key terms and conditions of a merger between the two groups. The move would effectively terminate CWY's agreement to purchase Suez's Australian waste management assets for A\$2.52b, announced on 6 April, and change CWY's position to now potentially acquire seven strategic assets from Suez Australia for A\$501m, as announced previously. The timing and funding of any transaction is still uncertain, but Ord Minnett believes CWY (through either transaction) remains in a very strong position to acquire strategic assets at a relatively attractive valuation. ACCUMULATE. (Published by Ord Minnett)

#### Ramsay Health Care (RHC.AX) – Potential M&P opportunity

According to an article in the *Australian Financial Review*, RHC and Pacific Equity Partners (PEP) are working together to bid for rival Healthe Care's hospitals. The plan is reportedly to split the assets such that RHC "would take what it could from an antitrust perspective". There is little information on the likelihood of this arrangement progressing, let alone pricing, but Ord Minnett would view this as a positive development. It would open the door to RHC deploying capital on attractive domestic assets that had appeared to be beyond its reach. ACCUMULATE. (Published by Ord Minnett)

#### Transurban Group (TCL.AX) – Traffic update

TCL delivered a broadly positive March-quarter traffic update that showed a continued improvement in traffic volumes. Average daily traffic (ADT) at the group level increased +1% on the same period in 2020 (and -3.8% compared to 2019), or reduced -5.3% excluding new road openings (or -9.9% compared to 2019). This was a strong improvement on the -12% decline in the December quarter. Overall, Ord Minnett has increased its traffic forecasts slightly for the second half of FY21, driving a +3% upgrade to its FY21 and FY22 free cash flow per share estimates. Ord Minnett believes the medium-term outlook is sound, with traffic growth strong as it recovers from COVID-19-affected levels and development completions boost growth. Ord Minnett believes demand for long-duration assets is very strong globally, as evidenced by TCL's sale of its stake in US assets. BUY. (Published by Ord Minnett)

## International

### **L'Oréal (OREPA) – Q1 further illustrating L'Oreal's virtuous model**

L'Oréal's Q1 like-for-like (LFL) revenue growth of +10.2% beat expectations of +9.1%. The result provided evidence of two sources of additional upgrades for the next 24 months:

- A structural improvement in the group's LFL sales growth prospects in both its Professional and Active Cosmetics divisions
- A strong but gradual recovery of the beauty market, in particular for make-up, hair salons and Western Europe, which should have a spill over effect in 2022.

UBS has increased its 2021 & 2022 like-for-like (LFL) sales growth estimates to +13.2% and +8.1% respectively, up from +12.0% and +7.3%. BUY. (Published by UBS)

### **McDonald's (MCD.N) – McMomentum Positioned to Continue**

UBS continues to like MCD's prospects for 2021 comparable-store sales growth, but also believes the brand is positioned for a multi-year period of sales outperformance. Structural improvements to marketing, digital, an updated store base, drive-thru efficiencies, and menu upgrades should provide ongoing share gain opportunities. UBS used a recent survey of 2,000 consumers to help assess the sustainability of MCD's US same-store-sales strength over the next 12 months. UBS found consumers continue to appreciate key brand advantages and indicate their intent to increase visits going forward. MCD should remain a core long-term holding as a quality compounder set to further increase global market share and accelerate free cashflow growth. BUY. (Published by UBS)

### **NVIDIA Corp (NVDA.O) – Updated Apr-Q Guide + Surprising CPU Announcement: Positive**

NVDA announced its first central processing unit (CPU), called Grace, which will be based on Arm-based processors and designed for data center computing to solve complex artificial intelligence and high-performance workloads. Grace system will deliver 10x faster performance than today's state-of-the-art NVDA DGX-based systems, which run on x86 CPUs. Samples of the CPUs are expected to be available next year and to be broadly available in early 2023. They will have a two-year refresh cycle that is offset from the existing two-year GPU refresh cycle. Management noted that it is hard to estimate what the revenue opportunity will be once the product launches. Citi views the announcement as a positive, as it shows what NVDA can deliver with or without Arm, which it is looking to acquire. That said, it could make regulatory antitrust approval for the ARM merger more difficult to obtain. BUY. (Published by Citi)

### **Taiwan Semiconductor Manufacturing (2330.TW, TSM.N) – Increasing 5/3nm customer engagement to drive higher capex**

Despite the ongoing investor debate on Intel's outsourcing of CPU fabrication, TSM reiterated its confidence in capex investment on the back of the structural opportunities from high performance computing, 5G, and automotive. It confirmed US\$100b of capex for 2021- 23, and increased 2021 capex guidance from US\$25-28b to US\$30b. UBS believes TSM's technology leadership will enable upside in new growth areas, and CPU should be a key driver based on Intel's two-year process lag behind TSM. Management revised up 2021 sales growth from mid-teens-% YoY to +20% in US\$ terms, supported by stronger demand across all main application markets. BUY. (Published by UBS)

## Calendar

Figure 5. Calendar

Date	New Zealand	Australia	International
19-Apr		HIA New Home Sales Orocobre 1Q Operating Results	
20-Apr	RBNZ Offshore Holdings (Mar)	RBA Meeting Minutes	UK: Average Earnings Index + Bonus (Feb) UK: Claimant Count Change (Mar) CN: PBoC Loan Prime Rate Coca Cola 1Q21
21-Apr	GlobalDairyTrade Price Index Consumer Price Index (1Q)	Melbourne Institute Leading Index Retail Sales Galaxy Resources 1Q Operating Results	UK: Consumer Price Index (Mar) UK: BoE Gov Bailey Speaks Abbott Laboratories 1Q21 ASML Holdings 1Q21 Intuitive Surgical 1Q21 Jonhson & Johnson 1Q21 Netflix (1Q21)
22-Apr		NAB Quarterly Business Confidence	US: Crude Oil Inventories EU: ECB Interest Rate Decision EU: ECB Monetary Policy Statement Verizon Communications 1Q21
23-Apr	Credit Card Spending	Manufacturing PMI Services PMI	EU: ECB Press Conference US: Initial Jobless Claims US: Existing Home Sales (Mar) UK: Retail Sales (Mar) UK: Composite/Manufacturing/Services PMI EU: German Manufacturing PMI (Apr) Intel 1Q21 IQVIA Holdings 1Q21 AT&T 1Q21 Union Pacific 1Q21
24-Apr	CFTC NZD Speculative Net Positions	CFTC AUD Speculative Net Positions	US: New Home Sales (Mar) American Express 1Q21

Source: Forsyth Barr analysis



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