

# Contact Energy

OUTPERFORM

## When it Rains it Pours

Following ASM commentary that it has been a difficult start to FY20 for Contact Energy (CEN), the heavens opened, to the point where CEN has more water than it can handle. In addition, its deal to accelerate the removal of lower South Island transmission constraints and finalised 2020–2024 transmission prices lower than expected means it has been a good month for CEN. We have upgraded our FY20 EBTDFA forecast +\$12m to \$478m, lifted our target price +12cps to \$8.15 and reiterate our OUTPERFORM rating.

### What's changed?

- **Earnings:** FY20/FY21 EBITDAF lifted +\$12m/+12m to \$478m/\$495m
- **Target Price:** Increased +12cps to \$8.15
- **Rating:** OUTPERFORM rating retained

### Clutha spilling water after deluge

In the space of four weeks, CEN's hydro storage levels have gone from ~-100GWh (-39%) below average to +180GWh (+56%) above average. The only time CEN has had more water in its lakes was 20 years ago (almost exactly), and it is no surprise CEN is spilling water at present.

### Deal to relieve lower South Island transmission constraints a positive

CEN and Meridian Energy have paid \$5m each to Transpower in order for it to start work earlier than it otherwise would have on relieving lower South Island transmission constraints. Whilst the transmission lines will only constrain in the event the aluminium smelter (NZAS) closes, it is a significant positive as it materially reduces the amount of lost hydro generation if NZAS were to close. In addition, it improves CEN's negotiating position with NZAS (and the North Island generators). We have lowered our NZAS risk adjustment 3cps to -9cps.

### FY20 earnings uplift on more water, offset by Transpower payment

We have lifted our FY20 EBITDAF forecast +\$12m (+2.7%) to \$478m. The increase is largely due to the increase in hydro storage, offset by the -\$5m payment to Transpower and the fact EBITDAF to the end of October was tracking worse than expected. Our FY21 EBITDAF forecast has also increased +\$12m (+2.5%) to \$495m, mainly due to lower transmission and distribution prices following the Commerce Commission's recent regulatory decisions.

The earnings uplifts and lower NZAS risk adjustment increases our target price +12cps (+1.5%) to \$8.15.

| NZX Code               | CEN                 |
|------------------------|---------------------|
| Share price            | NZ\$7.23            |
| Target price           | NZ\$8.15            |
| Risk rating            | Low                 |
| Issued shares          | 715.5m              |
| Market cap             | NZ\$5,173m          |
| Average daily turnover | 1,290k (NZ\$9,155k) |

### Share Price Performance



| Financials: June | 19A   | 20E   | 21E   | 22E   |
|------------------|-------|-------|-------|-------|
| NPAT* (NZ\$m)    | 280.4 | 257.6 | 267.6 | 265.8 |
| EPS* (NZc)       | 39.2  | 36.0  | 37.4  | 37.1  |
| EPS growth* (%)  | 23.4  | -8.1  | 3.9   | -0.7  |
| DPS (NZc)        | 39.0  | 39.0  | 39.5  | 40.0  |
| Imputation (%)   | 64    | 65    | 70    | 75    |

| Valuation (x)            | 19A  | 20E  | 21E  | 22E  |
|--------------------------|------|------|------|------|
| EV/EBITDA                | 12.3 | 12.8 | 12.4 | 12.4 |
| EV/EBIT                  | 20.3 | 22.1 | 20.9 | 20.9 |
| PE                       | 18.5 | 20.1 | 19.3 | 19.5 |
| Price / NTA              | 2.2  | 2.3  | 2.4  | n/a  |
| Cash dividend yield (%)  | 5.4  | 5.4  | 5.5  | 5.5  |
| Gross dividend yield (%) | 6.7  | 6.8  | 7.0  | 7.1  |

\*Historic and forecast numbers based on underlying profits

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### Investment View

Our rating is OUTPERFORM. We view CEN as offering the best value amongst the generator/retailers. We believe the NZAS closure risk is more than priced into the share price. CEN is offering an attractive dividend yield and has one of the best potential development projects (Tauhara) in the country.

**Contact Energy Limited (CEN)**

Priced as at 06 Dec 2019: NZ\$7.23

June year end

| Forsyth Barr valuation                          |              |                     |              |              | Valuation Ratios              |                                  |              |              |              |              |              |
|---|--------------|---------------------|--------------|--------------|-------------------------------|----------------------------------|--------------|--------------|--------------|--------------|--------------|
| Valuation methodology                           |              |                     |              |              | 2018A 2019A 2020E 2021E 2022E |                                  |              |              |              |              |              |
| Blend of spot valuations, weighted to multiples |              |                     |              |              | EV/EBITDA (x)                 | 13.9                             | 12.3         | 12.8         | 12.4         | 12.4         |              |
|   |              |                     |              |              | EV/EBIT (x)                   | 25.8                             | 20.3         | 22.1         | 20.9         | 20.9         |              |
| <b>12-month target price (NZ\$)*</b>            |              |                     |              |              | PE (x)                        | 22.8                             | 18.5         | 20.1         | 19.3         | 19.5         |              |
| <b>8.15 Spot valuations (NZ\$)</b>              |              |                     |              |              | Price/NTA (x)                 | 2.3                              | 2.2          | 2.3          | 2.4          | 2.6          |              |
| Expected share price return                     | 12.7%        | 1. DCF              | 7.40         |              | Free cash flow yield (%)      | 5.7                              | 6.5          | 5.0          | 5.7          | 5.7          |              |
| Net dividend yield                              | 5.4%         | 2. Market multiples | 8.26         |              | Net dividend yield (%)        | 4.4                              | 5.4          | 5.4          | 5.5          | 5.5          |              |
| Estimated 12-month return                       | 18.2%        | 3. Dividend yield   | 8.54         |              | Gross dividend yield (%)      | 5.3                              | 6.7          | 6.8          | 7.0          | 7.1          |              |
| <b>Key WACC assumptions</b>                     |              |                     |              |              | Imputation (%)                | 48                               | 64           | 65           | 70           | 75           |              |
| <b>DCF valuation summary (NZ\$m)</b>            |              |                     |              |              | Pay-out ratio (%)             | 101                              | 100          | 108          | 106          | 108          |              |
| Risk free rate                                  | 2.00%        | Total firm value    | 6,470        |              | <b>Capital Structure</b>      |                                  |              |              |              |              |              |
| Equity beta                                     | 0.88         | (Net debt)/cash     | (1,108)      |              | 2018A                         | 2019A                            | 2020E        | 2021E        | 2022E        |              |              |
| WACC  | 6.7%         | Value of equity     | 5,363        |              | Interest cover EBIT (x)       | 3.3                              | 4.8          | 5.2          | 5.5          | 5.6          |              |
| Terminal growth                                 | 1.5%         | Shares (m)          | 716          |              | Interest cover EBITDA (x)     | 5.7                              | 7.4          | 8.3          | 8.5          | 8.6          |              |
| <b>Profit and Loss Account (NZ\$m)</b>          |              |                     |              |              | Net debt/ND+E (%)             | 34.7                             | 25.3         | 26.6         | 27.1         | 27.7         |              |
| 2018A   | 2019A        | 2020E               | 2021E        | 2022E        | Net debt/EBITDA (x)           | 3.0                              | 1.8          | 2.0          | 1.9          | 1.9          |              |
| Sales revenue                                   | 2,275        | 2,519               | 2,278        | 2,291        | 2,210                         | <b>Key Ratios</b>                |              |              |              |              |              |
| <b>Normalised EBITDA</b>                        | <b>479</b>   | <b>518</b>          | <b>478</b>   | <b>495</b>   | <b>493</b>                    | 2018A                            | 2019A        | 2020E        | 2021E        | 2022E        |              |
| Depreciation and amortisation                   | (220)        | (205)               | (202)        | (201)        | (199)                         | Return on assets (%)             | 4.9          | 9.8          | 5.7          | 6.2          | 6.4          |
| <b>Normalised EBIT</b>                          | <b>259</b>   | <b>313</b>          | <b>276</b>   | <b>294</b>   | <b>294</b>                    | Return on equity (%)             | 4.7          | 6.3          | 5.9          | 6.6          | 6.9          |
| Net interest                                    | (84)         | (70)                | (58)         | (58)         | (57)                          | Return on funds employed (%)     | 4.5          | 9.4          | 5.5          | 6.0          | 6.2          |
| Depreciation capex adjustment                   | 99           | 104                 | 100          | 98           | 96                            | EBITDA margin (%)                | 21.1         | 20.6         | 21.0         | 21.6         | 22.3         |
| Tax   | (48)         | (72)                | (61)         | (66)         | (66)                          | EBIT margin (%)                  | 11.4         | 12.4         | 12.1         | 12.8         | 13.3         |
| Minority interests                              | -            | -                   | -            | -            | -                             | Capex to sales (%)               | 3.6          | 2.5          | 4.1          | 2.8          | 3.0          |
| <b>Adjusted normalised NPAT</b>                 | <b>227</b>   | <b>280</b>          | <b>258</b>   | <b>268</b>   | <b>266</b>                    | Capex to depreciation (%)        | 37           | 31           | 46           | 32           | 33           |
| Abnormals/other                                 | (97)         | 65                  | (100)        | (98)         | (96)                          | <b>Operating Performance</b>     |              |              |              |              |              |
| <b>Reported NPAT</b>                            | <b>130</b>   | <b>345</b>          | <b>157</b>   | <b>170</b>   | <b>170</b>                    | 2018A                            | 2019A        | 2020E        | 2021E        | 2022E        |              |
| Normalised EPS (cps)                            | 31.7         | 39.2                | 36.0         | 37.4         | 37.1                          | Revenue (%)                      | 9.4          | 10.7         | -9.6         | 0.6          | -3.5         |
| DPS (cps)                                       | 32.0         | 39.0                | 39.0         | 39.5         | 40.0                          | EBITDA (%)                       | -4.4         | 8.1          | -7.6         | 3.4          | -0.4         |
| <b>Growth Rates</b>                             |              |                     |              |              | EBIT (%)                      | -11.6                            | 20.8         | -11.7        | 6.3          | 0.0          |              |
| 2018A   | 2019A        | 2020E               | 2021E        | 2022E        | Normalised NPAT (%)           | 9.1                              | 23.4         | -8.1         | 3.9          | -0.7         |              |
| Revenue (%)                                     | 9.4          | 10.7                | -9.6         | 0.6          | -3.5                          | Normalised EPS (%)               | 9.1          | 23.4         | -8.1         | 3.9          | -0.7         |
| EBITDA (%)                                      | -4.4         | 8.1                 | -7.6         | 3.4          | -0.4                          | DPS (%)                          | 23.1         | 21.9         | 0.0          | 1.3          | 1.3          |
| EBIT (%)  | -11.6        | 20.8                | -11.7        | 6.3          | 0.0                           | <b>Divisional Revenue (\$m)</b>  |              |              |              |              |              |
| Normalised NPAT (%)                             | 9.1          | 23.4                | -8.1         | 3.9          | -0.7                          | Wholesale electricity            | 1,157        | 1,463        | 1,254        | 1,235        | 1,127        |
| Normalised EPS (%)                              | 9.1          | 23.4                | -8.1         | 3.9          | -0.7                          | Retail electricity               | 883          | 863          | 871          | 888          | 903          |
| DPS (%)   | 23.1         | 21.9                | 0.0          | 1.3          | 1.3                           | Retail gas sales                 | 71           | 73           | 81           | 83           | 86           |
| <b>Cash Flow (NZ\$m)</b>                        |              |                     |              |              | LPG sales                     | 121                              | 58           | -            | -            | -            |              |
| 2018A   | 2019A        | 2020E               | 2021E        | 2022E        | Other                         | 31                               | 32           | 33           | 33           | 33           |              |
| EBITDA  | 479          | 518                 | 478          | 495          | 493                           | <b>Total Revenue</b>             | <b>2,263</b> | <b>2,489</b> | <b>2,238</b> | <b>2,239</b> | <b>2,149</b> |
| Working capital change                          | 38           | (19)                | (9)          | (5)          | (1)                           | <b>Operating Statistics</b>      |              |              |              |              |              |
| Interest & tax paid                             | (111)        | (112)               | (121)        | (129)        | (131)                         | Hydro generation (GWh)           | 3,479        | 4,232        | 4,117        | 3,887        | 3,887        |
| Other   | (27)         | 14                  | -            | -            | -                             | Geothermal generation (GWh)      | 3,323        | 3,257        | 3,346        | 3,346        | 3,346        |
| <b>Operating cash flow</b>                      | <b>379</b>   | <b>401</b>          | <b>349</b>   | <b>361</b>   | <b>362</b>                    | Thermal generation (GWh)         | 1,812        | 1,422        | 1,508        | 1,704        | 1,784        |
| Capital expenditure                             | (82)         | (63)                | (93)         | (65)         | (66)                          | <b>Total Generation (GWh)</b>    | <b>8,614</b> | <b>8,911</b> | <b>8,971</b> | <b>8,937</b> | <b>9,018</b> |
| (Acquisitions)/divestments                      | 6            | 382                 | -            | -            | -                             | GWAP (\$/MWh)                    | 85           | 129          | 112          | 101          | 87           |
| Other   | (7)          | -                   | -            | -            | -                             | Gas consumed (PJ)                | 17.5         | 13.9         | 14.4         | 16.1         | 16.9         |
| <b>Funding available/(required)</b>             | <b>296</b>   | <b>720</b>          | <b>256</b>   | <b>296</b>   | <b>295</b>                    | Gas price (\$/GJ)                | 6.1          | 7.1          | 7.2          | 7.3          | 7.4          |
| Dividends paid                                  | (201)        | (251)               | (279)        | (279)        | (283)                         | Retail electricity volumes (GWh) | 6,997        | 6,554        | 5,948        | 6,188        | 6,183        |
| Equity raised/(returned)                        | 1            | -                   | -            | -            | -                             | Electricity customers (000)      | 413          | 411          | 411          | 408          | 406          |
| <b>Increase/(decrease) in net debt</b>          | <b>(96)</b>  | <b>(469)</b>        | <b>23</b>    | <b>(17)</b>  | <b>(13)</b>                   | Average usage/customer (MWh)     | 8.7          | 8.6          | 8.6          | 8.6          | 8.6          |
| <b>Balance Sheet (NZ\$m)</b>                    |              |                     |              |              | Average retail price (\$/MWh) | 242                              | 244          | 247          | 252          | 257          |              |
| 2018A   | 2019A        | 2020E               | 2021E        | 2022E        | LWAP (\$/MWh)                 | 91                               | 138          | 122          | 110          | 94           |              |
| Working capital                                 | (22)         | (3)                 | 6            | 10           | 11                            | LWAP/GWAP                        | 1.07         | 1.07         | 1.09         | 1.09         | 1.08         |
| Fixed assets                                    | 4,253        | 4,126               | 4,017        | 3,881        | 3,748                         | Retail gas volumes (PJ)          | 2.9          | 3.1          | 3.2          | 3.2          | 3.2          |
| Intangibles                                     | 441          | 425                 | 425          | 425          | 425                           | Gas customers (000)              | 65           | 67           | 67           | 68           | 68           |
| Other assets                                    | 404          | 132                 | 132          | 132          | 132                           | Average gas sales price (\$/GJ)  | 24.6         | 23.6         | 25.5         | 26.0         | 26.5         |
| <b>Total funds employed</b>                     | <b>5,076</b> | <b>4,680</b>        | <b>4,580</b> | <b>4,448</b> | <b>4,316</b>                  | <b>Operating Performance</b>     |              |              |              |              |              |
| Net debt/(cash)                                 | 1,448        | 943                 | 966          | 949          | 936                           | 2018A                            | 2019A        | 2020E        | 2021E        | 2022E        |              |
| Other non current liabilities                   | 901          | 955                 | 950          | 941          | 931                           | Revenue (%)                      | 9.4          | 10.7         | -9.6         | 0.6          | -3.5         |
| Shareholder's funds                             | 2,727        | 2,782               | 2,664        | 2,558        | 2,449                         | EBITDA (%)                       | -4.4         | 8.1          | -7.6         | 3.4          | -0.4         |
| Minority interests                              | -            | -                   | -            | -            | -                             | EBIT (%)                         | -11.6        | 20.8         | -11.7        | 6.3          | 0.0          |
| <b>Total funding sources</b>                    | <b>5,076</b> | <b>4,680</b>        | <b>4,580</b> | <b>4,448</b> | <b>4,316</b>                  | Normalised NPAT (%)              | 9.1          | 23.4         | -8.1         | 3.9          | -0.7         |
|   |              |                     |              |              | Normalised EPS (%)            | 9.1                              | 23.4         | -8.1         | 3.9          | -0.7         |              |
|   |              |                     |              |              | DPS (%)                       | 23.1                             | 21.9         | 0.0          | 1.3          | 1.3          |              |

\* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

## Summary forecast changes

Figure 1. Summary forecast changes

|                                      | FY20       |            |             | FY21       |            |             | FY22       |            |             |
|--------------------------------------|------------|------------|-------------|------------|------------|-------------|------------|------------|-------------|
|                                      | Old        | New        | % chg       | Old        | New        | % chg       | Old        | New        | % chg       |
| Revenue                              | 2,363      | 2,278      | -3.6%       | 2,273      | 2,291      | 0.8%        | 2,231      | 2,210      | -0.9%       |
| <b>EBITDAF</b>                       | <b>466</b> | <b>478</b> | <b>2.8%</b> | <b>483</b> | <b>495</b> | <b>2.3%</b> | <b>490</b> | <b>493</b> | <b>0.5%</b> |
| EBIT                                 | 264        | 276        | 4.9%        | 282        | 294        | 4.0%        | 291        | 294        | 0.9%        |
| Reported NPAT                        | 148        | 157        | 6.5%        | 161        | 170        | 5.4%        | 167        | 170        | 1.6%        |
| <b>Normalised NPAT</b>               | <b>148</b> | <b>157</b> | <b>6.5%</b> | <b>161</b> | <b>170</b> | <b>5.4%</b> | <b>167</b> | <b>170</b> | <b>1.6%</b> |
| Adjusted NPAT                        | 248        | 258        | 3.9%        | 259        | 268        | 3.3%        | 263        | 266        | 1.0%        |
| EPS                                  | 34.7       | 36.0       | 3.8%        | 36.2       | 37.4       | 3.3%        | 36.8       | 37.1       | 1.0%        |
| DPS                                  | 39.0       | 39.0       | 0.0%        | 39.5       | 39.5       | 0.0%        | 40.0       | 40.0       | 0.0%        |
| Generation (GWh)                     | 8,763      | 8,971      | 2.4%        | 8,937      | 8,937      | 0.0%        | 9,018      | 9,018      | 0.0%        |
| Electricity Wholesale Price (\$/MWh) | \$121.2    | \$111.6    | -7.9%       | \$98.0     | \$100.9    | 3.0%        | \$88.4     | \$86.8     | -1.7%       |
| Retail Demand (GWh)                  | 6,108      | 5,948      | -2.6%       | 6,234      | 6,188      | -0.7%       | 6,229      | 6,183      | -0.7%       |

Source: Forsyth Barr analysis

## Investment summary

Our rating is **OUTPERFORM**. We view Contact Energy (CEN) as offering the best value amongst the generator/retailers. We believe the NZAS closure risk is more than priced into the share price. CEN is offering an attractive dividend yield and has one of the best potential development projects (Tauhara) in the country.

### Key drivers

- **Wholesale electricity prices and the electricity demand/supply balance:** The wholesale electricity price is the key driver of retail and commercial prices and therefore the key value driver. The electricity demand/supply balance and the cost of new generation underpin the wholesale price. Currently the NZ market is balanced.
- **Retail margins:** In recent years intense retail competition and new entrant retailers have eroded retail margins. Strong margins support profitability.
- **Hydrology:** Short-term earnings are impacted by hydrology. CEN prefers wet conditions as it lowers its average cost of generation. However, CEN's thermal fleet provides it with some downside protection from dry conditions.

### Other key company and industry issues

- **Increased carbon costs:** Following changes to the Emissions Trading Scheme, CEN has to relinquish more carbon credits and carbon prices have increased materially. This is a modest headwind for FY20.

### Upcoming catalysts/events

- **Geothermal development:** CEN has one of the best generation development opportunities in its Tauhara geothermal field. With modest electricity demand growth expected and CEN likely to close its base-load gas plant within three years, there is a strong chance it develops this field.
- **Success of cost-out:** CEN has successfully removed operating and capital costs over the past four years. It believes additional cost-out opportunities exist; delivering on these will be important for earnings.

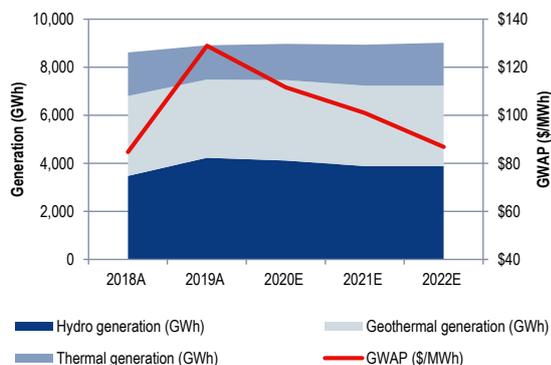
### Key risks

- **Political/regulatory:** The 2014 election and recent Electricity Price Review (EPR) highlighted the political/regulatory risks inherent in the sector. Whilst the EPR gave the sector a thumbs up in most areas, the political risk is unlikely to ever disappear.
- **NZAS risk:** NZAS has indicated it is undertaking a strategic review, raising the possibility it may close. In our view, the smelter is unlikely to close (less than 10% chance) and the downside risks are fully factored into the share price.

### Company description

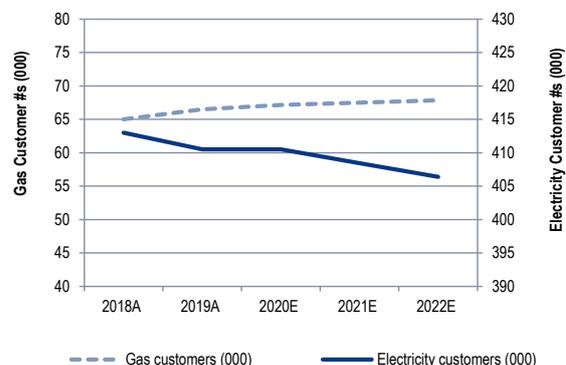
CEN generates around 25% of New Zealand's electricity and supplies electricity, gas and LPG to ~560,000 customers nationwide. Its generation portfolio consists of gas (a combined-cycle gas turbine and a gas-peaking plant), hydro (on the Clutha River in the South Island) and geothermal (in the central North Island). CEN typically produces ~8,800 GWh of electricity per annum and sells ~7,800 GWh of electricity, around half of which is sold to mass market customers. CEN produces strong cash flows which it intends to return to shareholders.

Figure 2. Generation volumes and average generation price



Source: CEN, Forsyth Barr analysis

Figure 3. Customer numbers



Source: CEN, Forsyth Barr analysis

Figure 4. Substantial Shareholders

| Shareholder                         | Latest Holding |
|-------------------------------------|----------------|
| No current substantial shareholders |                |

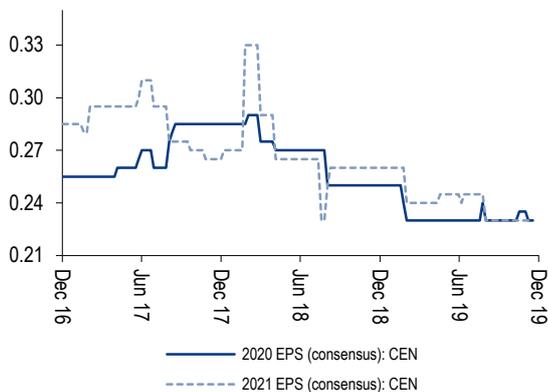
Figure 5. International Compcos

| Company                 | Code   | Price    | Mkt Cap (m) | PE           |              | EV/EBITDA    |              | EV/EBIT      |              | Cash D/Yld  |
|-------------------------|--------|----------|-------------|--------------|--------------|--------------|--------------|--------------|--------------|-------------|
|                         |        |          |             | 2020E        | 2021E        | 2020E        | 2021E        | 2020E        | 2021E        | 2021E       |
| Contact Energy          | CEN NZ | NZ\$7.23 | NZ\$5,173   | 20.1x        | 19.3x        | 12.8x        | 12.4x        | 22.1x        | 20.8x        | 5.5%        |
| Genesis Energy*         | GNE NZ | NZ\$3.09 | NZ\$3,181   | 20.3x        | 16.0x        | 12.0x        | 10.7x        | 28.3x        | 22.3x        | 5.7%        |
| Meridian Energy*        | MEL NZ | NZ\$4.96 | NZ\$6,512   | 26.6x        | 29.8x        | 17.3x        | 18.8x        | 27.9x        | 31.4x        | 4.4%        |
| Mercury*                | MCY NZ | NZ\$4.78 | NZ\$6,512   | 26.1x        | 23.5x        | 14.7x        | 14.4x        | 24.2x        | 23.5x        | 3.4%        |
| Trustpower*             | TPW NZ | NZ\$7.21 | NZ\$2,257   | 23.2x        | 21.7x        | 13.8x        | 13.3x        | 17.1x        | 16.4x        | 4.8%        |
| AGL Energy              | AGL AT | A\$20.24 | A\$13,055   | 15.6x        | 15.6x        | 7.5x         | 7.5x         | 11.5x        | 11.6x        | 4.9%        |
| ERM Power               | EPW AT | A\$2.41  | A\$603      | 12.5x        | 15.4x        | 7.0x         | 6.6x         | 10.0x        | 9.3x         | 4.4%        |
| Origin Energy           | ORG AT | A\$8.53  | A\$15,023   | 14.3x        | 13.8x        | 6.4x         | 6.4x         | 15.7x        | 15.5x        | 4.5%        |
| <b>Compcos Average:</b> |        |          |             | <b>19.8x</b> | <b>19.4x</b> | <b>11.2x</b> | <b>11.1x</b> | <b>19.2x</b> | <b>18.6x</b> | <b>4.6%</b> |
| <b>CEN Relative:</b>    |        |          |             | <b>+1%</b>   | <b>-0%</b>   | <b>+14%</b>  | <b>+11%</b>  | <b>+15%</b>  | <b>+12%</b>  | <b>+20%</b> |

EV = Current Market Cap + Actual Net Debt

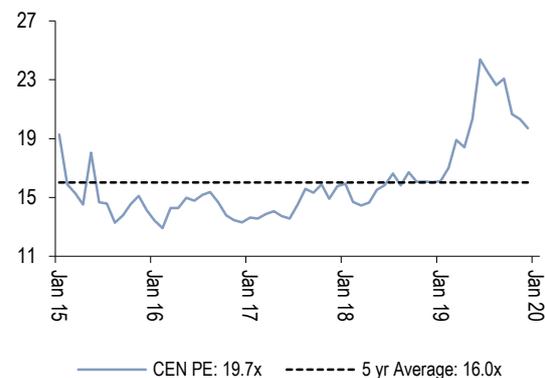
Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (CEN) companies fiscal year end

Figure 6. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 7. 12 Month Forward PE



Source: Forsyth Barr analysis

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