

# Equity Strategy

## The Year Ahead; Five/Five for 2020

A new year and a new decade follows the longest bull market in modern history, with the NZX50 delivering a CAGR of +13.4% during the 2010s and a tidy +29.2% in 2019-to-date. Markets are in uncharted territory — record high valuations (at least domestically) and record low interest rates. Key drivers (growth, rates, and regulation) will remain supportive to elevated valuations through 2020, in our opinion. Our key picks for the year ahead are A2 Milk, Arvida, Contact Energy, Chorus and Sanford.

### Five themes for 2020

- **Late cycle recovery:** Global economic growth is expected to accelerate modestly through 2020 as central bank stimulus takes hold and the US–China trade war eases or resolves. Domestically, a robust housing market and improving consumer confidence point to a modestly positive outlook, supportive to corporate EPS growth holding firm in the mid-single digits.
- **Elections:** The upcoming New Zealand election will inevitably have a temporary dampener on consumer demand, but to be announced policies are unlikely to have any meaningful impact on NZX companies, in our view. The US election promises to be more divisive, albeit few NZX companies will be directly impacted.
- **Rates:** We expect the RBNZ to hold the cash rate through 2020. Recent yield curve steepening reflects more optimism around growth. However, rates will be capped to the upside by monetary policy, the reach for yield, and the inability of the global economy to sustain materially higher rates.
- **Sustainability drive:** At Government, investor, corporate and consumer levels, the drive for sustainable behaviours and outcomes will increase in importance. From measuring and disclosing greenhouse gas emissions, to actively reducing waste, NZX companies will be at pains to stress their greater focus on green initiatives.
- **M&A:** The NZX lost TradeMe, Methven, Orion Healthcare and SLI Systems to M&A in 2019. Others (e.g. Abano) will likely follow in 2020. While market valuations are relatively high, cheap debt and cashed up private equity means more companies could be subject to bids through the year ahead, particularly those that have been beaten up. Our M&A screen suggests potential targets include Refining NZ, Z Energy and Gentrack.

### Five picks for 2020

- **A2 Milk (ATM):** Notwithstanding a CEO change, we are attracted to the opportunity for ATM in existing markets and optionality of new markets and products.
- **Arvida (ARV):** ARV has an attractive blend of a solid dividend yield of ~5% on a 40% pay-out of underlying earnings and a building growth profile given its expanded development expertise, track record and pipeline.
- **Chorus (CNU):** We remain attracted to CNU's fundamental value underpinned by the considerable long-term free cash flow we expect the company to generate once its fibre network is complete in 2022.
- **Contact Energy (CEN):** We view CEN as offering the best value amongst the generator/retailers. It offers an attractive dividend yield and has one of the best potential development projects (Tauhara) in the country.
- **Sanford (SAN):** SAN has a unique asset in its significant holdings of commercial fishing quota and extensive marine farming operations. Its strategy to move up the value chain appears both sensible and achievable. Execution on EBIT/kg target is likely to be a key driver of performance.

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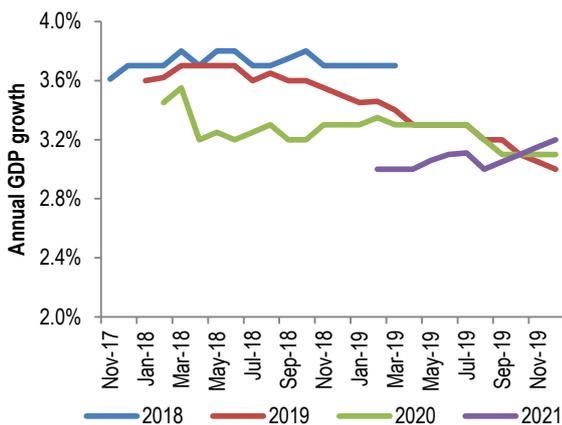
# Our five themes for 2020

## Theme #1: Growth

Policy easing from central banks is contributing to a more optimistic outlook for the global economy. Consensus expectations for GDP growth in 2021 have risen in recent months (see Figure 1). A possible resolution to the US–China trade war will assist sentiment and could have an immediate impact on trade.

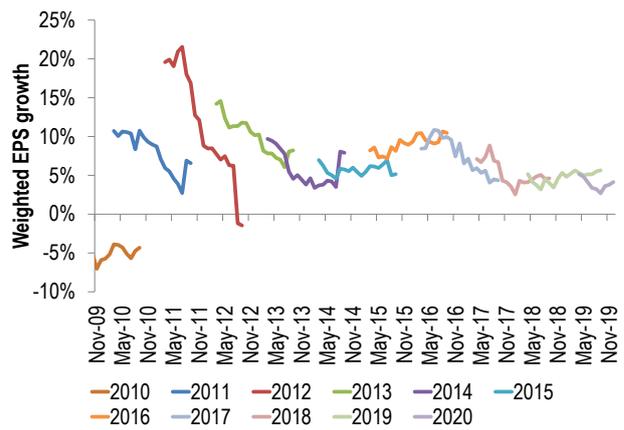
Domestically, a robust housing market and improving consumer confidence point to a modestly positive outlook supportive to corporate EPS growth in mid-single digits.

Figure 1. Global growth has slowed but should recover from 2H20



Source: Bloomberg, Forsyth Barr analysis

Figure 2. EPS growth expectations are fair for FY20



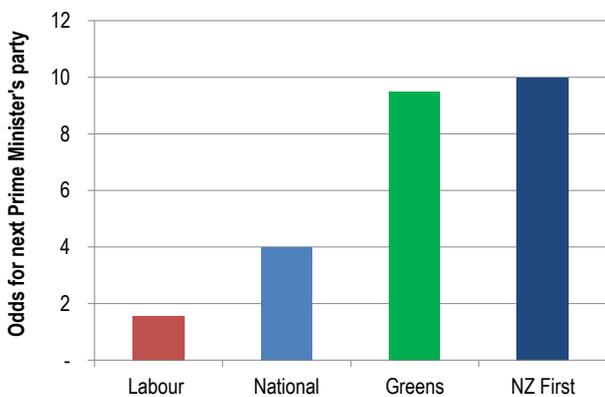
Source: Forsyth Barr analysis

## Theme #2: Elections

The New Zealand general election will be held on or before 21 November 2020. While current polling suggests it will again be a close run event, betting websites suggest The Labour Party will remain in power, despite National currently enjoying a polling lead. Election turnout will likely be enhanced by referendums on personal cannabis consumption and on euthanasia.

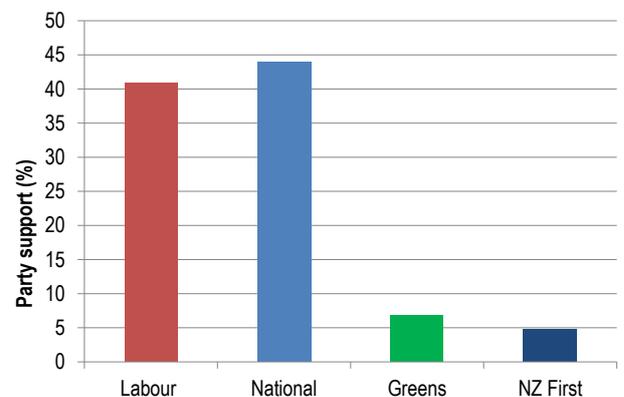
The election will inevitably have a temporary dampener on consumer demand and corporate investment decisions. However, policies are unlikely to have any meaningful impact on NZX companies, in our view, with several exceptions — in particular Port of Tauranga (POT) and Marsden Maritime Holdings (MMH) will be impacted by the ultimate outcome of the Upper North Island Supply Chain Strategy, which is likely to drag on beyond the current term.

Figure 3. Labour odds-on favourite to lead next Government



Source: Sportsbet.co.m.au, Forsyth Barr analysis

Figure 4. Average of last five major polls



Source: Colmar Brunton, YouGov, Reid, Forsyth Barr analysis

In contrast, the US election promises to be more divisive with wider political outcomes possible compared to the relative middle ground in New Zealand. There are currently 15

Democratic nominees vying to be President, with a clearer picture of the front runners emerging when Democratic primaries kick-off in February 2020.

While few NZX companies — those with direct US exposure include Fisher & Paykel Healthcare (FPH), Mainfreight (MFT), Pushpay (PPY), Tourism Holdings (THL), and Delegats (DGL) — will be directly impacted by the US election, the implications for the global economy, global markets and the climate change movement could be far reaching.

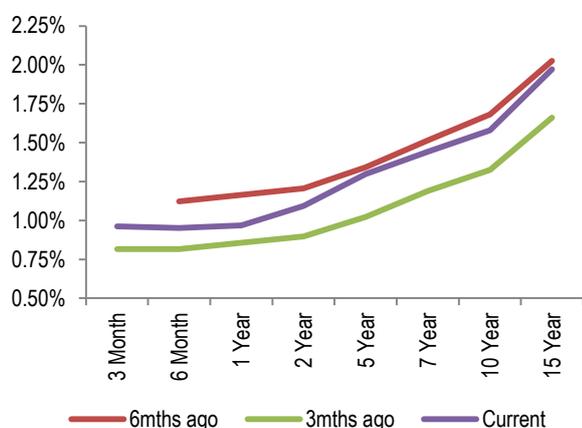
### Theme #3: Rates

If growth and earnings pick up, interest rates should also (both the New Zealand five year and 10 year Government bonds are now ~50bps off their respective lows), albeit inflation remains below most Central Bank targets.

Yield curves are and will continue to reflect an improving economic outlook; they should steepen further from current levels. But the upside will be capped by (1) monetary policy, (2) the global reach for yield, and (3) the inability of the global economy to sustain materially higher yields.

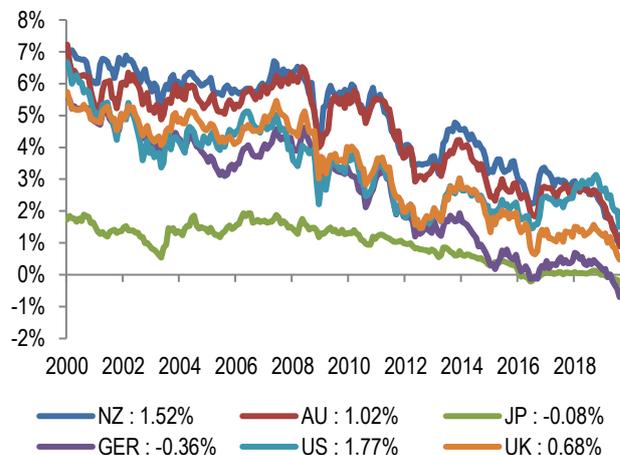
In New Zealand, we expect the RBNZ to remain on pause through 2020.

**Figure 5. New Zealand yield curve**



Source: Bloomberg, Forsyth Barr analysis

**Figure 6. Have global rates hit a floor? (10 yr Government bond rates)**



Source: Bloomberg, Forsyth Barr analysis

### Theme #4: Sustainability

The environment and social components of ESG (environment, social and governance) are becoming as big as, if not bigger, than the governance one in investment circles. We expect the sustainability push to be increasingly noticeable at Government, investor, corporate and consumer levels through 2020.

Our recent report 'The Carbon Report, Counting Carbon Costs: Climate Change and NZX Companies', dated 5 December 2019, highlighted that only 27 companies of the NZX50 (excluding the Australian banks) have disclosed any form of emissions data. We expect the level of disclosure and the number of companies reporting their emissions to increase. Resulting in greater corporate focus on lowering emissions.

Over the past 12 months flight shaming has become a common term. The consumer response to climate change and sustainability will grow and rapidly expand, in our opinion. Single use plastics are in the spotlight and could have implications for food and beverage producers including Fonterra (FSF), A2 Milk (ATM), and Restaurant Brands (RBD).

### Theme #5: M&A

M&A has been a feature in 2019 with a number of NZX companies being acquired and delisted (including TradeMe, Methven, Orion Healthcare and SLI Systems) , while others have been acquisitive (for example Infratil's acquisition of Vodafone NZ, Kathmandu buying Ripcurl, and Freightway's proposed acquisition of Big Chill).

While valuations are high relative to historic levels, very cheap debt and cashed up private equity will likely be a feature through the year ahead. Our M&A screen as outlined in Figure 7 suggests potential targets include Refining NZ, Z Energy, Gentrack, Sky TV, Metro Performance Glass and Vista Group.

**Figure 7. Forsyth Barr M&A screen (higher ranked stocks = greater chance of takeover target)**

Source: Forsyth Barr analysis

Rank	Code	Share price vs. 6m VWAP	12m fwd PE vs. 5yr ave	EBIT margin vs. 5yr ave	ND/EBITDA vs. 5yr ave
1	NZR	-9.1%	-15.0%	-19%	0.3x
2	ZEL	-30.6%	-7.3%	-3%	0.7x
3	GTK	-34.1%	6.5%	-10%	n/a
4	SKT	-37.8%	-2.8%	-15%	-0.1x
5	MPG	-18.8%	-58.8%	-4%	-0.3x
6	VGL	-26.7%	0.4%	-1%	n/a
7	NZM	-13.6%	-13.3%	-1%	-0.2x
8	VCT	-4.1%	17.9%	-4%	0.2x
10	SPG	-1.6%	13.9%	-8%	0.1x
10	SKC	-0.9%	5.1%	-1%	0.6x
11	ARG	-6.6%	15.1%	-1%	0.2x
13	CVT	-9.0%	-22.6%	2%	0.0x
13	GNE	-12.9%	24.3%	-2%	0.1x
16	AIR	3.0%	21.5%	-4%	0.2x
15	AIA	-6.5%	21.0%	-2%	0.1x
14	KPG	-6.9%	4.5%	-1%	0.0x
17	VHP	0.5%	32.3%	-3%	0.3x
18	PGW	-35.3%	-6.7%	0%	-0.8x
20	MHJ	19.3%	-17.2%	-1%	0.1x
20	SUM	29.8%	-10.5%	-3%	0.0x
21	THL	-20.9%	8.2%	-1%	-0.3x
23	NZK	1.0%	-1.4%	-2%	-0.3x
23	AUG	1.6%	29.1%	-12%	n/a
24	TPW	-7.7%	31.1%	-2%	0.0x
25	MCY	-0.7%	34.9%	-3%	0.1x
26	ABA	25.6%	-24.6%	0%	0.1x
29	IPL	-4.1%	17.4%	-1%	-0.1x
29	KMD	28.0%	2.8%	0%	1.4x
29	CNU	7.4%	138.4%	-5%	0.3x
31	ARV	17.3%	-7.4%	6%	1.0x
36	SML	-4.4%	-6.0%	2%	-0.2x
31	APL	-0.3%	1.2%	2%	0.1x
34	STU	-13.2%	12.2%	-1%	-0.8x
34	SPK	1.9%	8.8%	2%	0.3x
34	CEN	-11.6%	22.8%	-1%	-0.3x
36	EBO	-4.5%	12.2%	0%	-0.1x
39	MET	34.3%	-3.7%	2%	0.7x
38	OCA	5.8%	-7.2%	3%	0.1x
40	SCL	2.5%	34.5%	-4%	n/a
38	FRE	1.9%	14.4%	-1%	-0.2x
41	RYM	24.1%	12.6%	0%	0.2x
42	DGL	-0.8%	24.5%	0%	-0.1x
45	ATM	3.3%	-11.6%	9%	n/a
45	FSF	10.1%	23.3%	-2%	-0.1x
45	PCT	0.6%	26.9%	2%	0.2x
48	GMT	3.0%	67.1%	-2%	-0.2x
46	NPH	11.7%	2.5%	-1%	-0.7x
47	BGP	8.2%	-1.5%	1%	n/a
49	SAN	16.5%	0.3%	1%	-0.2x
50	WHS	24.1%	-3.0%	0%	-0.5x
51	SKL	2.2%	19.9%	1%	-0.3x
52	MEL	0.7%	36.7%	2%	-0.1x
54	POT	12.5%	37.3%	1%	0.2x
54	RBD	12.6%	51.2%	0%	0.0x
55	FBU	6.8%	15.1%	1%	-0.5x
56	PFI	2.5%	29.3%	4%	0.0x
57	MFT	4.9%	31.9%	1%	-0.4x
58	NZX	5.9%	20.2%	3%	n/a
59	FPH	30.6%	36.1%	2%	n/a
60	TLT	21.1%	260.9%	253%	n/a

## Our five stocks for 2020

Our five stock picks for 2020 — A2 Milk, Arvida, Chorus, Contact Energy, and Sanford — provide a balanced mix of yield, structural growth and exposure to key multi-year trends; premiumisation, demographics, the emerging middle class in Asia, sustainability and the generally favourable regulatory environment in New Zealand.

Figure 8. Forsyth Barr picks for 2020

Company	Code	Rating	Share price (NZ\$)	Target price (NZ\$)	TSR 2019-ytd	EPS CAGR (FY19–FY21)	One yr fwd PE	One yr fwd EV/EBITDA	Cash yld
A2 Milk	ATM	OUTPERFORM	15.30	17.50	37.5%	21.4%	29.7x	19.8x	0.0%
Arvida	ARV	OUTPERFORM	1.63	1.78	36.5%	14.8%	14.5x	14.7x	3.3%
Chorus	CNU	OUTPERFORM	5.89	6.40	30.9%	-33.9%	95.2x	8.2x	3.9%
Contact	CEN	OUTPERFORM	7.20	8.15	31.5%	-2.3%	19.6x	12.5x	5.4%
Sanford	SAN	OUTPERFORM	7.81	8.35	19.9%	21.4%	13.1x	7.3x	2.9%

Source: Eikon, Forsyth Barr analysis

### A2 Milk (ATM)

ATM offers investors a unique growth story with product penetration still low of a large (and growing) addressable market. Sales momentum is strong, it generates strong free cash flow, has a high return on capital, and a large net cash position. There is attractive optionality from scope to expand with new products and in new markets. While it is going through a CEO transition, company strategy is firmly in place, with its key priority being execution.

### Arvida (ARV)

ARV has a robust pipeline of greenfield and brownfield sites providing a structural growth opportunity, supported by its track record around execution. Its earnings have a defensive profile, reflecting its care focus and strong geographical diversification. Valuation is favourable with an attractive dividend yield on just a ~40% pay-out of underlying earnings.

### Chorus (CNU)

CNU offers an attractive long-term free cash flow once its fibre network is completed in 2022. The Commerce Commission's draft input methodologies suggests a favourable regulatory outlook. We expect meaningful dividend per share upside from FY23.

### Contact Energy (CEN)

CEN is our preferred gentailer exposure. It provides defensive characteristics, a long-term steady growth outlook and favourable yield. We believe the risk of the Tiwai Point aluminium smelter closing is low, despite owner Rio Tinto's current strategic review. CEN has one of the best development projects in the country with its Tauhara geothermal option.

### Sanford (SAN)

SAN's value orientated strategy offers upside should it execute on its stated target of NZ\$1 EBIT/kg. We recognise its results can be volatile given the vagaries of its business mix. However, valuation is undemanding, it benefits from the on-going protein trend and it has long-term optionality around additional aquaculture water space, backed by Government support.

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