FORSYTH BARR

NEW ZEALAND EQUITY STRATEGY

5 JUNE 2020

Equity Strategy
Institutional Model Portfolio

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Having a strong view on market direction in these remarkable times remains a major challenge, even for the most seasoned investors. Significant uncertainty prevails at a micro and macro level and will continue to do so, despite our domestic success in eliminating COVID-19, as the virus continues to spread globally. We know more than we did two months ago, but we still have a large margin for error on the short, medium and long term outlooks for many companies. Our conversations with management teams suggest they are firmly in the same camp. Nonetheless, the recovery trade has been a key feature in recent weeks. Investor optimism has increased materially, but seemingly more from economy re-opening sentiment than economic reality. We're wary and edge towards the side of caution; we retain a bias towards dividend paying defensives.

Tina Fomo

In a world of ultra-low interest rates (and low returns from bonds and term deposits), "there is no alternative" (TINA) for some investors to equities, to generate an acceptable investment return. Some investors look at the returns on offer from hibernating in cash or bonds and say no thanks. Markets start to rally. "Fear of missing out" (or FOMO) kicks in and other investors follow, not wanting to be left behind. Risk appetites increase. Latterly there has been a rapid recovery in beaten-up/value stocks. While we accept TINA and FOMO are unlikely to leave the stage anytime soon, risk tolerance will be tested over the coming months as companies provide more earnings and cashflow insight into the enduring impact of COVID-19.

Portfolio changes; adding KMD and fully closing underweights on MEL and MCY

We add Kathmandu (KMD) to the portfolio in a staged manner given liquidity limitations. We are attracted to its strong management team with a track record of execution, re-strengthened balance sheet, well recognised adventure brands and a loyal customer base. Having added consistently to our utility positions in recent months, we now fully close our underweights on Meridian (MEL) and Mercury (MCY). We remain overweight on Genesis (GNE) and Contact (CEN).

Reducing IFT to neutral, trimming large overweight in ATM, and increasing underweight positions in AIA and FBU

We take profits on Infratil (IFT) given the narrowing of its NTA discount but retain a market weight position. We also partially trim our large overweight in The A2 Milk Company (ATM), which had lifted in recent months given strong outperformance. The recovery trade has played out well for Auckland Airport (AIA), and therefore we're extending our underweight position. Fletcher Building (FBU) has again bounced from recent lows, but cyclical pressures on building activity levels will restrict its medium term earnings recovery.

Figure 1. Forsyth Barr Institutional model portfolio summary

Market breakdown	Benchmark	Active weight	Portfolio
Defensive yield	**48.6%**	**-1.4%**	**47.2%**
Utilities	14.3%	+3.6%	17.9%
Property	8.7%	-4.8%	3.9%
Other defensive yield	25.6%	-0.2%	25.4%
Structural growth	**44.4%**	**+0.7%**	**45.0%**
Aged care	7.9%	+1.2%	9.1%
Other structural growth	36.4%	-0.5%	35.9%
Cyclicals	**7.0%**	**-2.8%**	**4.3%**
Total	**100.0%**	**0.0%**	**100.0%**

Source: Forsyth Barr analysis NOTE: The portfolio includes a cash weighting of 3.5%

Institutional model portfolio

The Forsyth Barr institutional model portfolio is outlined in Figure 2. We incorporate 25 stocks together with a ~3.5% nominal cash holding. All portfolio holdings are ~1.0% or more, unless (1) we are adding new positions, or exiting positions, in less liquid stocks, or (2) existing positions are diluted by relative underperformance.

Figure 2. The Forsyth Barr institutional model portfolio

Code	Portfolio weight	Active weight	12m fwd PE	12m fwd cash dividend yield	Rating
ATM	15.3%	+3.1%	31.1x	0.0%	OUTPERFORM
FPH	12.4%	-2.5%	51.4x	1.2%	UNDERPERFORM
SPK	9.0%	+1.8%	19.6x	5.6%	OUTPERFORM
CEN	6.4%	+2.4%	18.5x	6.2%	OUTPERFORM
RYM	5.8%	+0.9%	39.2x	1.3%	OUTPERFORM
MEL	5.3%	+0.0%	27.2x	4.5%	OUTPERFORM
AIA	5.2%	-1.8%	n/a	0.0%	NEUTRAL
CNU	3.8%	+0.8%	67.3x	3.2%	OUTPERFORM
GNE	3.6%	+2.3%	15.5x	6.1%	OUTPERFORM
MFT	3.6%	+0.6%	30.6x	1.5%	OUTPERFORM
Cash	3.5%	+3.5%	n/a	n/a	n/a
IFT	3.1%	+0.0%	n/a	3.3%	NEUTRAL
SKC	2.9%	+1.2%	33.8x	1.9%	OUTPERFORM
MCY	2.6%	+0.0%	24.4x	3.4%	OUTPERFORM
EBO	2.6%	+0.3%	19.5x	3.7%	NEUTRAL
SAN	2.2%	+1.8%	13.7x	3.1%	OUTPERFORM
ARV	2.1%	+1.4%	17.6x	3.1%	OUTPERFORM
VHP	2.0%	+1.2%	25.2x	3.4%	OUTPERFORM
ZEL	1.3%	+0.0%	n/a	n/a	RESTRICTED
FBU	1.3%	-1.5%	19.3x	3.6%	NEUTRAL
SUM	1.2%	-0.0%	29.1x	1.0%	OUTPERFORM
TLT	1.1%	+1.1%	28.6x	0.0%	OUTPERFORM
PFI	1.0%	-0.0%	28.4x	2.9%	OUTPERFORM
ARG	0.9%	+0.1%	17.0x	5.3%	NEUTRAL
FRE	0.9%	-0.0%	19.3x	3.9%	NEUTRAL
KMD	0.8%	+0.3%	21.5x	2.4%	OUTPERFORM

Source: Forsyth Barr analysis

Our portfolio is less expensive on a one year forward PE basis than the market and provides a higher level of EPS growth, whilst also providing a similar level of income (on a cash basis).

Figure 3. Portfolio characteristics vs. the S&P/NZX 50 (based on Forsyth Barr estimates)

	12m fwd PE	12m fwd cash div yield	12m fwd EV/EBITDA	12m-24m EPS growth
FB Institutional Model Portfolio	30.3x	2.5%	16.1x	17.1%
S&P/NZX 50	31.4x	2.4%	16.0x	11.5%

Source: Forsyth Barr analysis

Key active weights

We outline our key active weights in Figure 4 where weightings are 1.5% or greater relative to the benchmark.

Figure 4. Key active weights

Code	Active weight	Rationale
Key over-weights		
ATM	+3.1%	Unique growth story with penetration still low of a large (and growing) addressable market. Strong free cash flow, high return and a large net cash position. Optionality from new products/markets.
CEN	+2.4%	Defensive characteristics, long-term steady growth outlook and strong yield. Risk of NZAS closure is low. Has one of the best development projects in the country with its Tauhara geothermal option.
GNE	+2.3%	Defensive characteristics, long-term steady growth outlook and strong yield. Provides best near-term earnings growth as long-term expensive take or pay gas contracts roll off.
SAN	+1.8%	Value strategy with upside should it execute on stated target of NZ$1 EBIT/kg. Attractive PEG. Long-term optionality around additional aquaculture water space backed by Government support. Protein theme.
SPK	+1.8%	Attractive dividend yield. Relative earnings resilience to COVID-19 crisis and recessionary conditions. Strong execution track record consistently, with solid A- rated balance sheet.
Key under-weights		
FPH	-2.5%	High quality, long-term growth story. However, we struggle to justify valuation levels (~49x PE) which are elevated against any benchmark (even when growth adjusted).
GMT	-2.1%	Well place Auckland centric portfolio but trading at a substantial premium to its NTA and wider sector metrics.
POT	-2.0%	COVID-19 risks made clear in removal of FY20 guidance. Risk to FY21 earnings also given supply chain disruption. Upper North Island study unlikely to lead to meaningful benefits for POT.
AIA	-1.8%	Beneficiary of travel/tourism sentiment improvement. Recovery will be long dated and return on capital outcomes lower than historically given travel retail concession demand risks.
PCT	-1.5%	Office exposure increases its susceptibility to cyclical swings. Cashflow outlook muted despite subdued supply outlook for office assets in Wellington and Auckland.
FBU	-1.5%	Cancellation and deferral of corporate work, reasonable lead time for new infarstructure projects and slowing residential activity will weigh on demand profile over the medium term.
KPG	-1.5%	Despite trading at a discount to its NTA value, we believe risks are skewed to the downside given KPG's leverage to the uncertain economic backdrop.

Source: Forsyth Barr analysis

Portfolio Changes

We have made a number of changes to our portfolio as summarised in Figure 5.

Figure 5. Portfolio changes

Code	Portfolio move	Weighting change	New portfolio weight	Rationale
AIA	Sell	-0.50%	+5.2%	Taking profits from recovery trade beneficiary
ATM	Sell	-0.50%	+15.3%	Re-weighting after outperformance in recent months
FBU	Sell	-0.50%	+1.3%	Activity to slow markedly given ensuing cyclical challenges
IFT	Sell	-0.60%	+3.1%	Profit taking after narrowing of NTA discount
KMD	Buy/Add	+0.75%	+0.8%	Higher quality recovery play
MCY	Buy	+0.30%	+2.6%	Closing underweight
MEL	Buy	+0.50%	+5.3%	Closing underweight
CASH		+0.55%	+3.5%	

Source: Forsyth Barr analysis

Figure 6. Forsyth Barr Institutional model active weights relative to benchmark (priced as at 3 June 2020)

Thematic/company	Active weight	Price (NZ$)	12m fwd PE	12m fwd divi yld*	12-24m EPS growth	Rating
Defensive Yield	-1.4%					
Utilities	**+3.6%**					
CEN	+2.4%	$6.26	18.5x	6.2%	2.7%	OUTPERFORM
GNE	+2.3%	$2.88	15.5x	6.1%	18.5%	OUTPERFORM
MCY	+0.0%	$4.70	24.4x	3.4%	5.9%	OUTPERFORM
MEL	+0.0%	$4.76	27.2x	4.5%	1.1%	OUTPERFORM
TPW	-0.4%	$7.14	23.5x	4.6%	8.4%	OUTPERFORM
VCT	-0.8%	$3.71	30.1x	4.4%	0.2%	NEUTRAL
Property	**-4.8%**					
ARG	+0.1%	$1.19	17.0x	5.3%	0.7%	NEUTRAL
GMT	-2.1%	$2.19	33.3x	2.4%	2.5%	UNDERPERFORM
IPL	-0.4%	$1.70	22.8x	4.5%	1.5%	OUTPERFORM
KPG	-1.5%	$1.07	17.9x	4.7%	15.9%	UNDERPERFORM
PCT	-1.5%	$1.61	24.7x	3.2%	0.8%	NEUTRAL
PFI	-0.0%	$2.42	28.4x	2.9%	2.5%	OUTPERFORM
SPG	-0.5%	$1.62	16.4x	4.4%	7.6%	NEUTRAL
VHP	+1.2%	$2.51	25.2x	3.4%	3.6%	OUTPERFORM
Other defensive yield	**-0.2%**					
AIA	-1.8%	$6.85	n/a	0.0%	n/a	NEUTRAL
CNU	+0.8%	$7.76	67.3x	3.2%	-0.2%	OUTPERFORM
IFT	+0.0%	$5.24	n/a	3.3%	n/a	NEUTRAL
POT	-2.0%	$7.23	47.4x	1.9%	8.5%	UNDERPERFORM
RBD	-0.3%	$12.65	77.4x	0.0%	109.8%	NEUTRAL
SKC	+1.2%	$2.85	33.8x	1.9%	115.9%	OUTPERFORM
SPK	+1.8%	$4.45	19.6x	5.6%	3.2%	OUTPERFORM
ZEL	+0.0%	$3.00	n/a	n/a	n/a	RESTRICTED
Structural Growth	+0.7%					
Aged care	**+1.2%**					
ARV	+1.4%	$1.37	17.6x	3.1%	40.8%	OUTPERFORM
MET	-0.6%	$4.28	13.0x	1.5%	20.8%	NEUTRAL
OCA	-0.5%	$0.94	14.7x	3.7%	36.4%	NEUTRAL
RYM	+0.9%	$13.35	39.2x	1.3%	52.8%	OUTPERFORM
SUM	-0.0%	$6.34	29.1x	1.0%	87.3%	OUTPERFORM
Other structural growth	**-0.5%**					
ATM	+3.1%	$18.94	31.1x	0.0%	20.2%	OUTPERFORM
EBO	+0.3%	$22.46	19.5x	3.7%	7.5%	NEUTRAL
FPH	-2.5%	$29.35	51.4x	1.2%	9.8%	UNDERPERFORM
FRE	-0.0%	$6.95	19.3x	3.9%	18.4%	NEUTRAL
GTK	-0.1%	$1.73	92.8x	0.9%	199.0%	OUTPERFORM
MFT	+0.6%	$39.96	30.6x	1.5%	31.8%	OUTPERFORM
NZK	+0.0%	$1.95	14.6x	3.4%	24.4%	OUTPERFORM
SCL	-0.5%	$5.00	21.1x	4.3%	8.8%	NEUTRAL
SKL	-0.3%	$1.98	12.9x	6.8%	2.4%	n/a
SML	-0.5%	$7.05	13.8x	0.0%	17.5%	NEUTRAL
TLT	+1.1%	$3.38	28.6x	0.0%	13.1%	OUTPERFORM
Cyclicals	-2.8%					
AIR	-0.7%	$1.45	-17.5x	0.0%	n/a	UNDERPERFORM
FBU	-1.5%	$3.90	19.3x	3.6%	-4.2%	NEUTRAL
FSF	-0.3%	$3.68	12.3x	4.3%	16.5%	n/a
HGH	-0.6%	$1.26	n/a	n/a	n/a	n/a
KMD	+0.3%	$1.07	21.5x	2.4%	104.9%	OUTPERFORM
NZR	-0.1%	$0.80	-6.0x	0.0%	n/a	UNDERPERFORM
NZX	-0.3%	$1.41	25.3x	4.3%	15.3%	OUTPERFORM
SAN	+1.8%	$6.70	13.7x	3.1%	26.9%	OUTPERFORM
SKT	-0.2%	$0.15	n/a	n/a	n/a	RESTRICTED
THL	-0.2%	$2.17	-25.2x	0.3%	n/a	UNDERPERFORM
Cash	**+3.5%**					

Source: Bloomberg, Forsyth Barr analysis *cash dividend yield NOTE: PPH (active weight -1.3%), VGL (-0.4%), ANZ (-0.4%) and WBC (-0.4%) not included in the above table.

Valuation

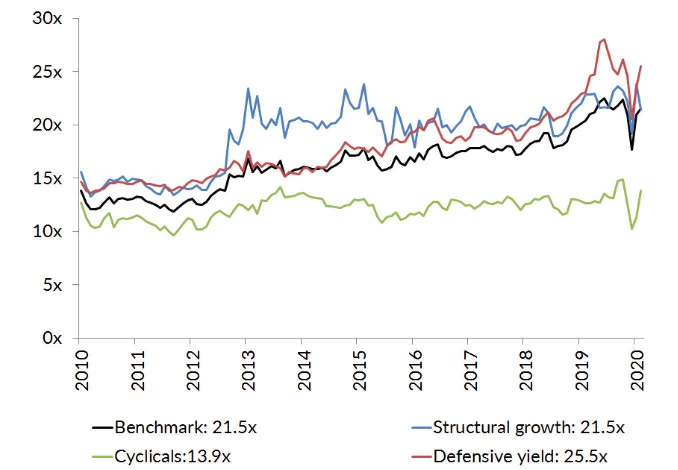
- After a strong recovery from the March low, market valuations are almost back to pre COVID-19 levels.
- Lower rate outlook is supportive to defensive yield type stocks.
- Dividend yields have moved lower as companies cut and cancel upcoming dividends.

Figure 7. Market valuation metrics (based on consensus earnings estimates)

Thematic	12mth fwd PE		12mth fwd EV/EBITDA		12mth fwd cash divi yield	
	Ave.	Wghtd ave.	Ave.	Wghtd ave.	Ave.	Wghtd ave.
Cyclicals	13.9x	15.5x	6.3x	6.3x	4.6%	4.1%
Defensive yield	25.5x	25.4x	14.8x	13.3x	4.1%	4.0%
Structural growth	21.5x	26.1x	14.5x	18.3x	2.4%	1.3%
Market	**21.5x**	**24.8x**	**12.9x**	**14.8x**	**3.7%**	**2.8%**

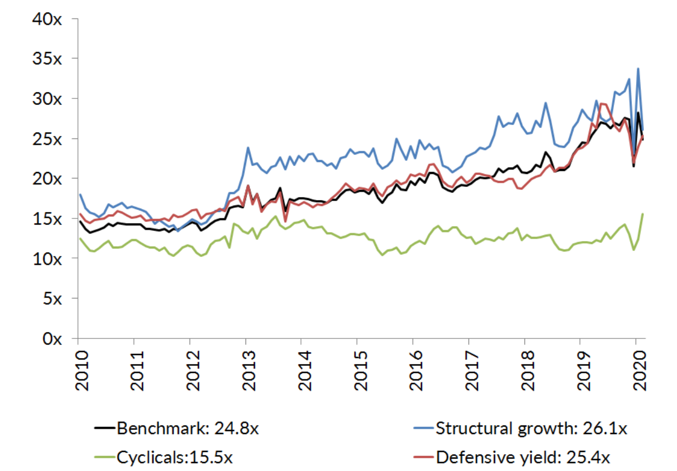
Source: Forsyth Barr analysis, Bloomberg

Figure 8. Consensus 12m fwd PE — average



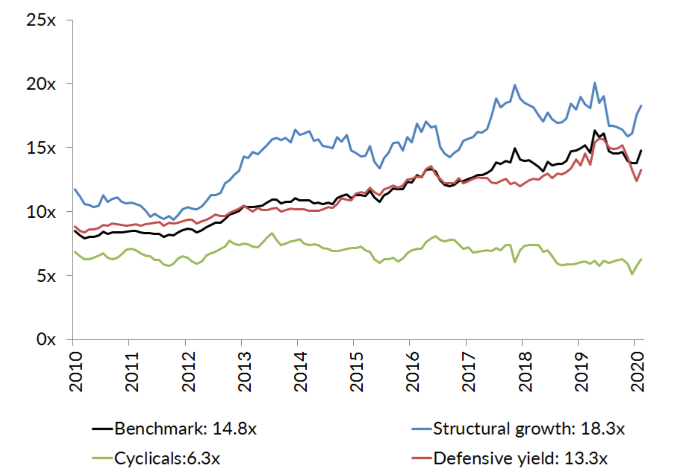
Source: Forsyth Barr analysis, Bloomberg

Figure 9. Consensus 12m fwd PE — weighted average



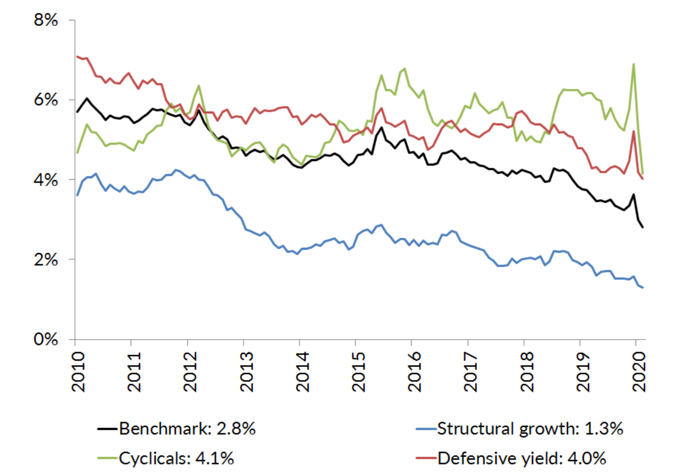
Source: Forsyth Barr analysis, Bloomberg

Figure 10. Consensus 12m fwd EV/EBITDA — weighted average



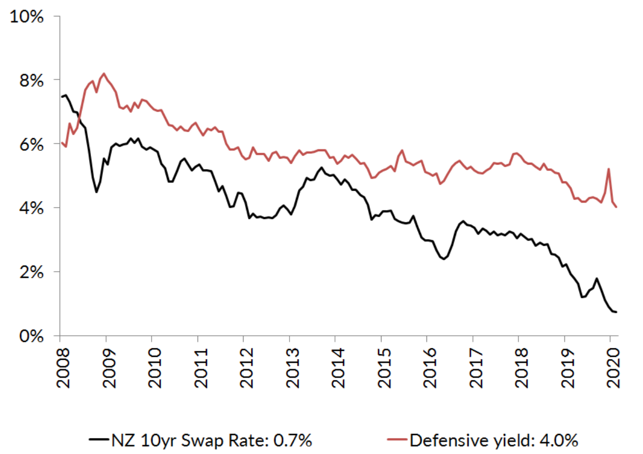
Source: Forsyth Barr analysis, Bloomberg

Figure 11. Consensus cash dividend yield — weighted average



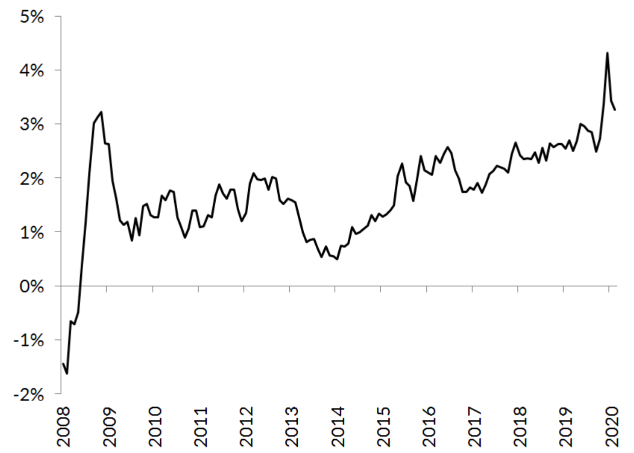
Source: Forsyth Barr analysis, Bloomberg

Figure 12. Defensive yield cash dividend yield vs. 10yr bond



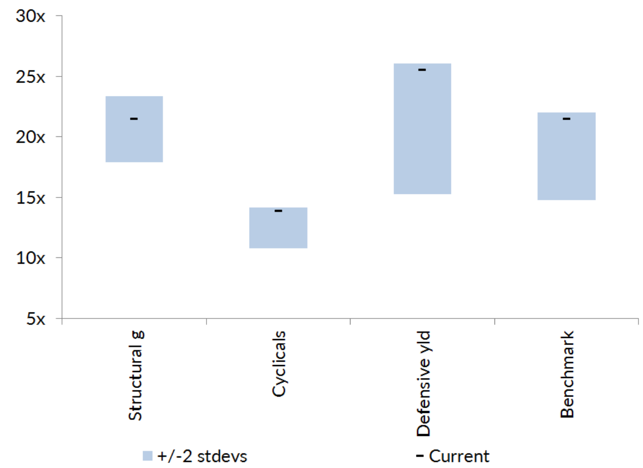
Source: Forsyth Barr analysis, Bloomberg

Figure 13. Defensive yield cash div yield and 10yr bond diff.



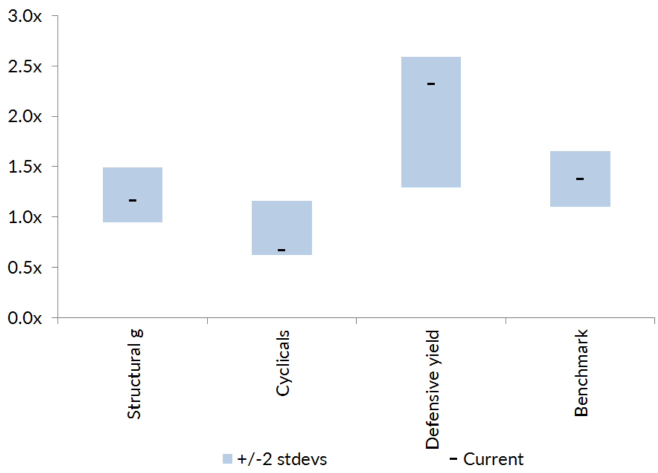
Source: Forsyth Barr analysis, Bloomberg

Figure 14. Consensus 12m fwd PE vs. historic (five year) average



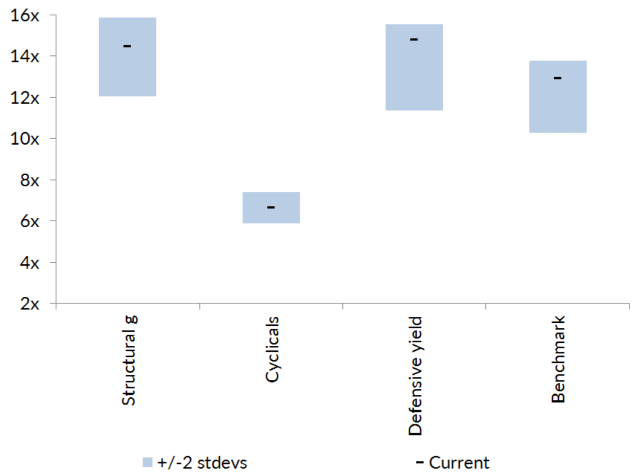
Source: Forsyth Barr analysis, Bloomberg

Figure 15. 12m fwd PEG vs. historic (five year) average



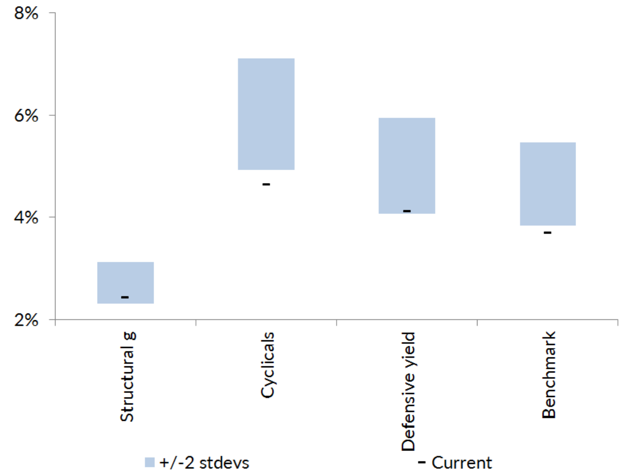
Source: Forsyth Barr analysis, Bloomberg

Figure 16. 12m fwd EV/EBITDA vs. historic (five year) average



Source: Forsyth Barr analysis, Bloomberg

Figure 17. 12m fwd cash div. yield vs. historic (five year) average



Source: Forsyth Barr analysis, Bloomberg

Earnings

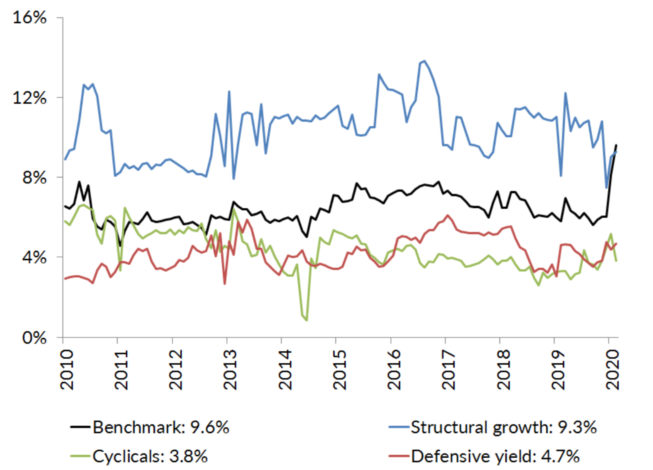
- Consensus earnings expectations distorted by COVID-19 recovery and cycling of weaker year one comparatives.
- Defensive yield earnings growth outlook remains solid.
- Bottom-up margins reflect operating leverage available in recovery.

Figure 18. Market earnings estimates (based on consensus earnings estimates)

Thematic	12-24mth Revenue growth		12-24mth EBITDA growth		12-24mth EPS growth		12-24mth OCF growth	
	Ave.	Wghtd ave.	Ave.	Wghtd ave.	Ave.	Wghtd ave.	Ave.	Wghtd ave.
Cyclicals	3.8%	3.5%	6.6%	8.3%	16.0%	20.4%	18.6%	15.0%
Defensive yield	4.7%	2.4%	7.9%	6.2%	6.9%	6.9%	6.2%	4.0%
Structural growth	9.3%	11.8%	15.2%	14.4%	16.0%	15.4%	18.1%	13.0%
Market	**9.6%**	**11.4%**	**10.3%**	**10.4%**	**11.9%**	**12.2%**	**13.3%**	**9.4%**

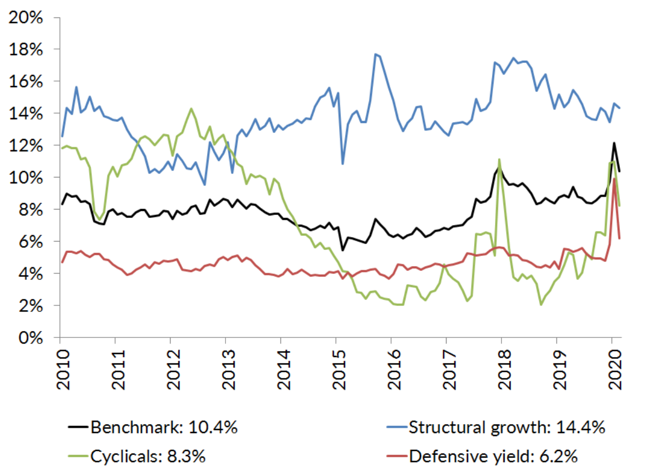
Source: Forsyth Barr analysis, Bloomberg

Figure 19. 12–24m revenue growth — average.



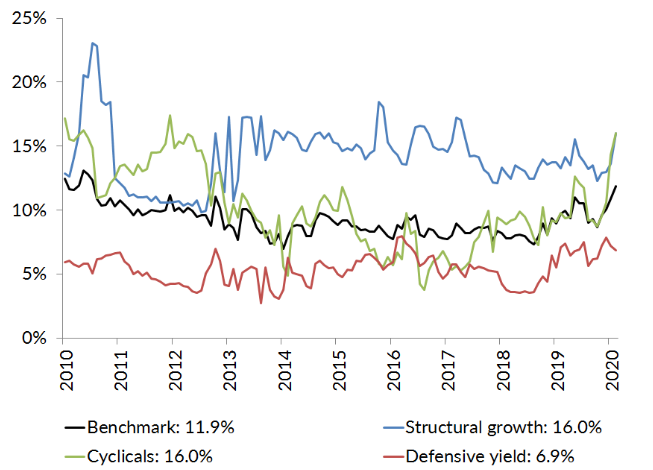
Source: Forsyth Barr analysis, Bloomberg

Figure 20. 12–24m EBITDA growth — weighted average.



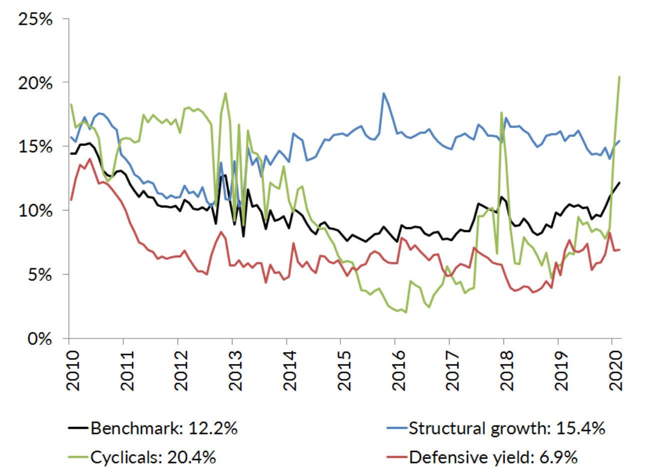
Source: Forsyth Barr analysis, Bloomberg

Figure 21. 12–24m EPS growth — average



Source: Forsyth Barr analysis, Bloomberg

Figure 22. 12–24m EPS growth — weighted average

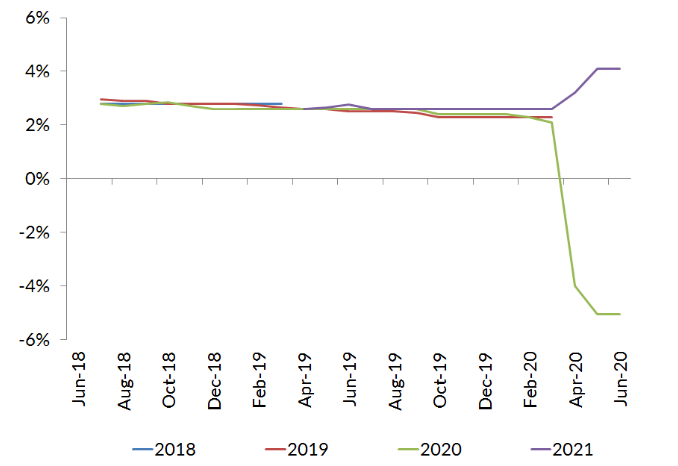


Source: Forsyth Barr analysis, Bloomberg

GDP and interest rates

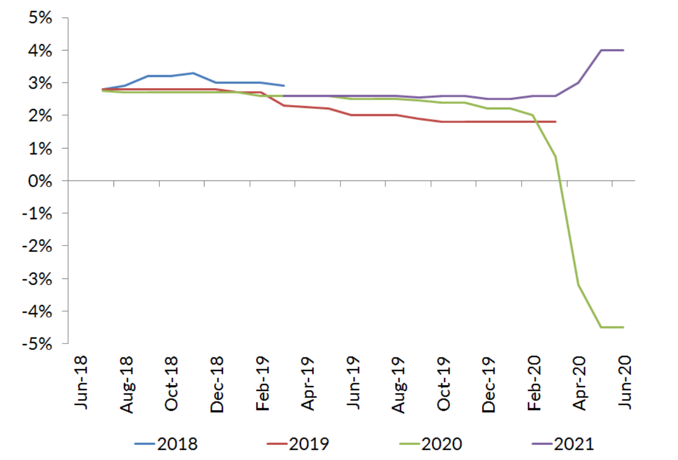
- GDP expectations have plummeted in light of COVID-19 lock-downs globally, this has been accompanied by an up-tick in 2021 growth forecasts.
- The yield curve has steepened in light of a reduction in near term rates. Longer term rates remain significantly lower than where they were historically. The curve has moved progressively lower over the last 6 months.
- Domestic and global inflation remains muted, affording interest rates to remain lower for longer.

Figure 23. New Zealand consensus GDP growth forecast



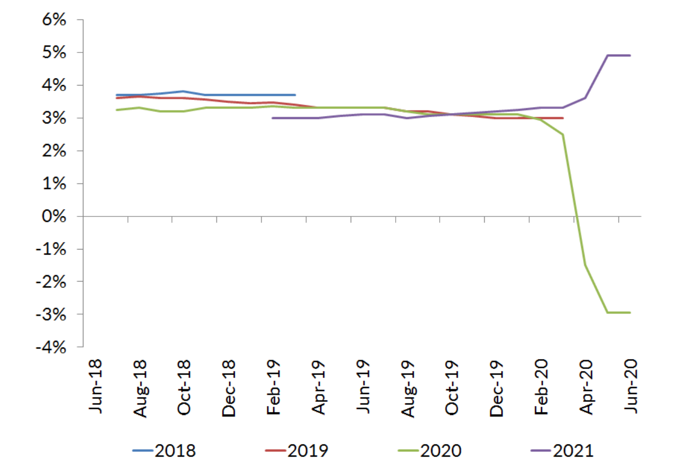
Source: Forsyth Barr analysis, Bloomberg

Figure 24. Australia consensus GDP growth forecast



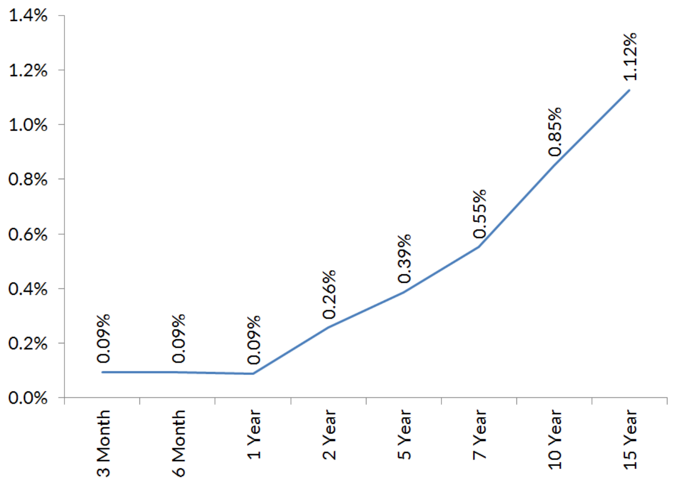
Source: Forsyth Barr analysis, Bloomberg

Figure 25. World consensus GDP growth forecast



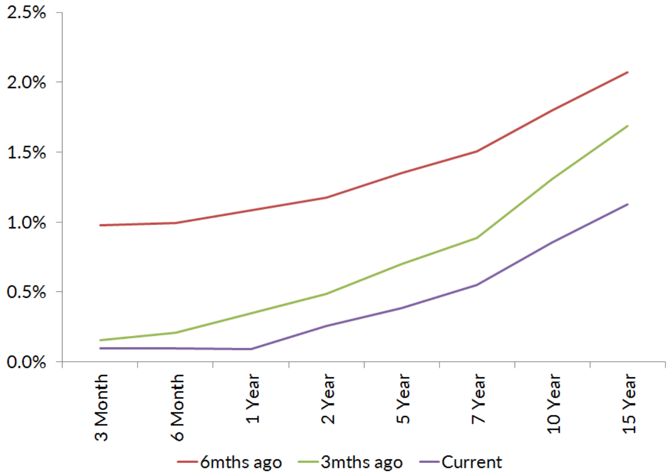
Source: Forsyth Barr analysis, Bloomberg

Figure 26. NZ yield curve — current



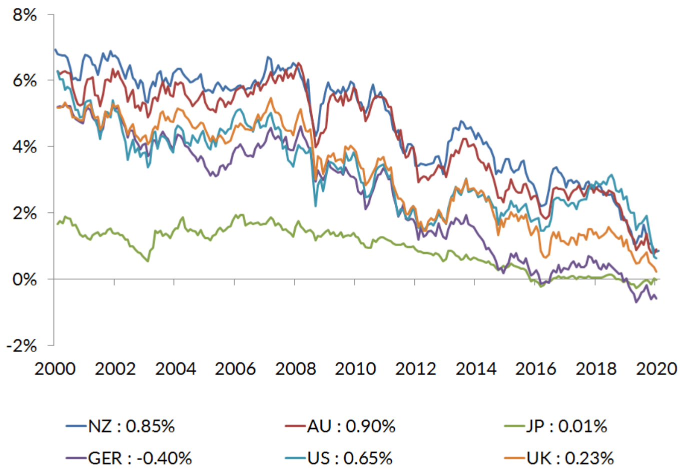
Source: Forsyth Barr analysis, Bloomberg

Figure 27. NZ yield curve — 6 month trend



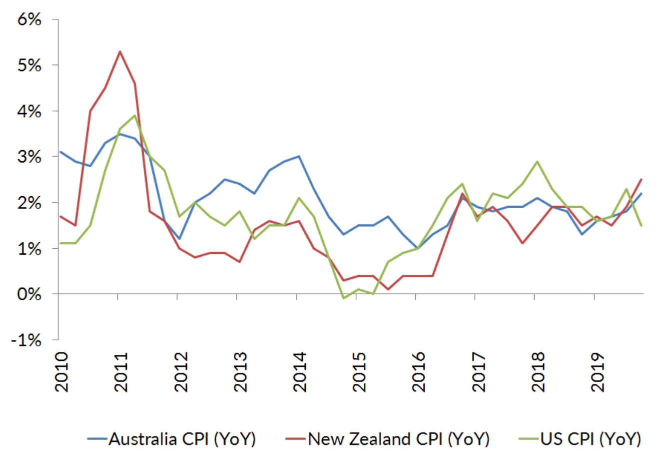
Source: Forsyth Barr analysis, Bloomberg

Figure 28. Global 10yr bond yields



Source: Forsyth Barr analysis, Bloomberg

Figure 29. Consumer price index (CPI)



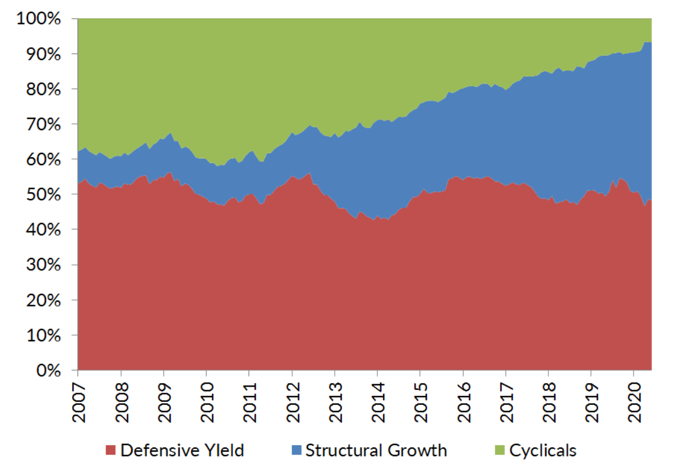
Source: Forsyth Barr analysis, Bloomberg

Other NZ market charts

- Larger cap stocks have been leading the market for the past two years.
- International ownership of the S&P/NZX 50 appears to have stabilised after a period of sustained growth, while Australian ownership has shown strong growth during 2020.
- Gearing levels across the market have been rising in recent years. COVID-19 is likely to create major gearing challenges for some corporates and new equity will need to be issued.

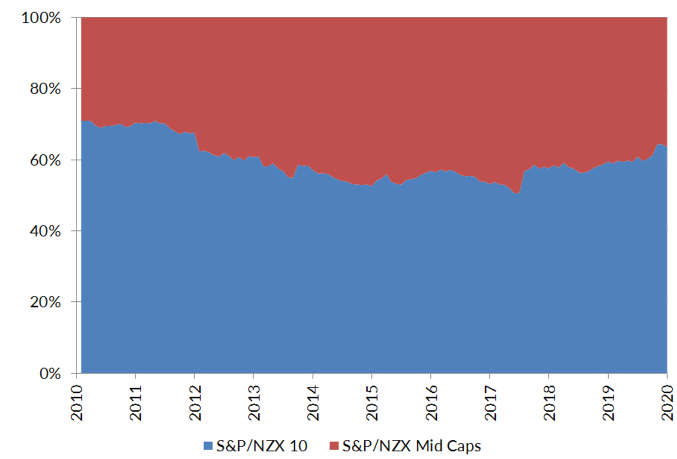
Market Structure

Figure 30. S&P/NZX 50 structure by thematic



Source: Forsyth Barr analysis, Bloomberg,S&P DJI

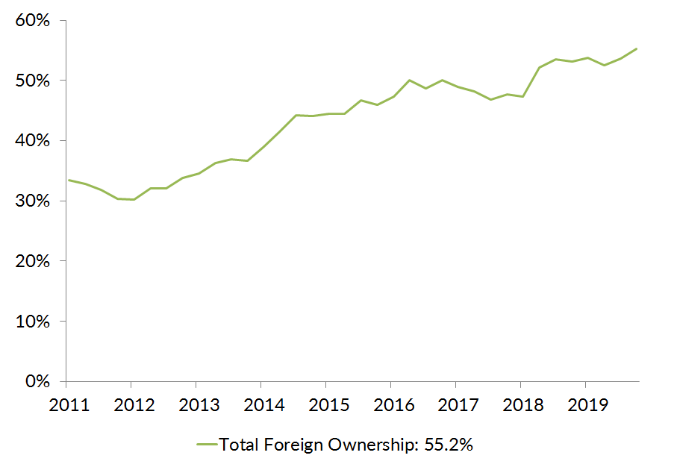
Figure 31. S&P/NZX 50 structure by size



Source: Forsyth Barr analysis, Bloomberg,S&P DJI

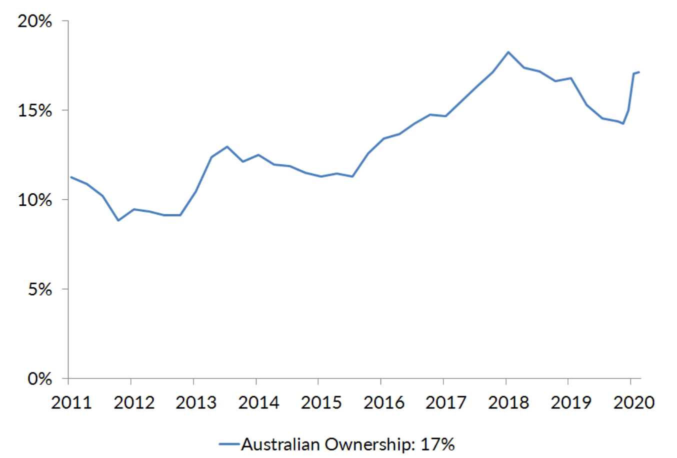
Market Ownership

Figure 32. Total foreign ownership of the S&P/NZX 50



Source: Forsyth Barr analysis, Stats NZ

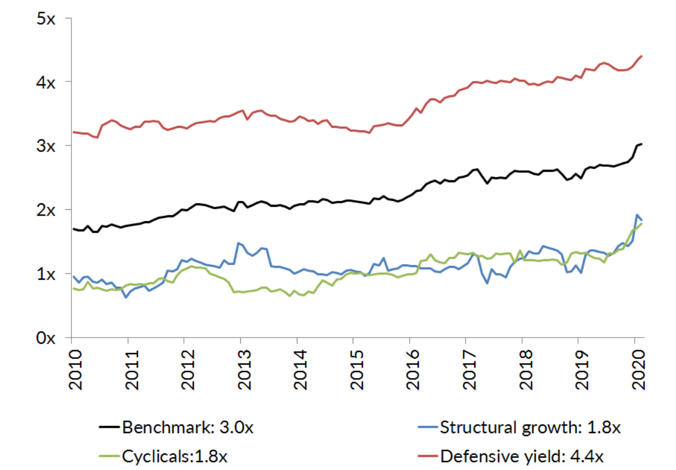
Figure 33. Australian Ownership of the S&P/NZX 50



Source: Forsyth Barr analysis, ASX

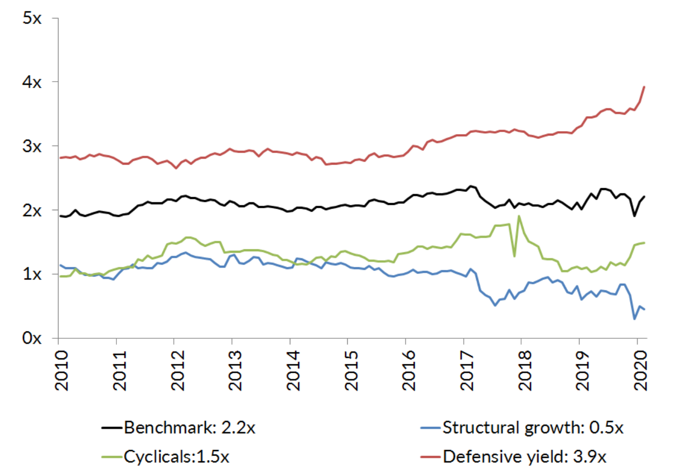
Capital Structure

Figure 34. 12mth fwd ND/EBITDA — average



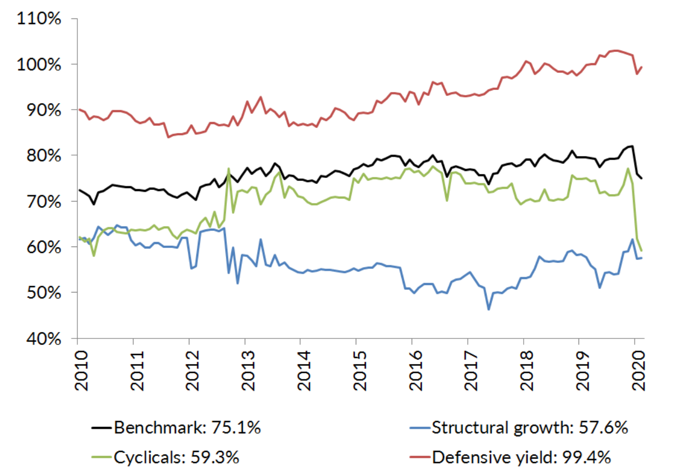
Source: Forsyth Barr analysis, Bloomberg

Figure 35. 12mth fwd ND/EBITDA — weighted average



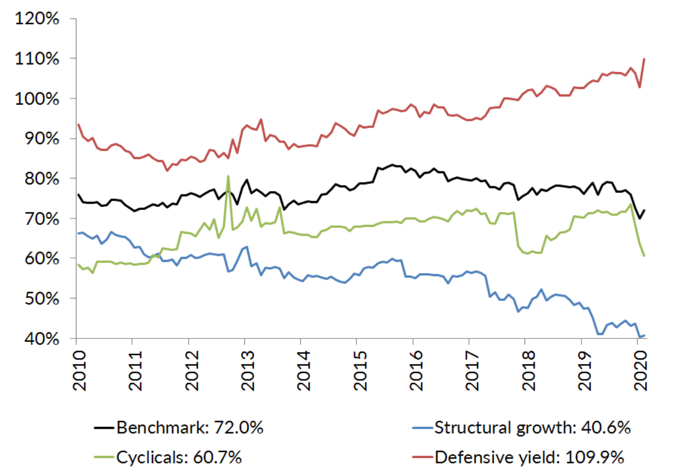
Source: Forsyth Barr analysis, Bloomberg

Figure 36. 12mth fwd EPS pay-out ratio — average



Source: Forsyth Barr analysis, Bloomberg

Figure 37. 12mth fwd EPS pay-out ratio — weighted average



Source: Forsyth Barr analysis, Bloomberg

Forsyth Barr institutional model portfolio rules

- The Forsyth Barr Institutional model portfolio is monitored on a continuous basis.
- Company ratings are factored into portfolio decisions but weightings can reflect other portfolio considerations.
- Companies with UNDERPERFORM ratings can still be held in the portfolio but will normally have portfolio weightings that would be lower than the benchmark weighting.
- Companies not researched by Forsyth Barr or associated research partners with weightings above 2%, and where no view is held, would be held at a benchmark weighting.
- The portfolio can participate in IPO and 2POs but weightings would initially be limited to the lower of the desired weighting or such holding that could realistically be obtained by bidding into the process.
- The portfolio will reflect strategic biases.
- The portfolio targets portfolio holdings of approximately 25 companies.

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