

Equity Strategy

The Year Ahead

ANDY BOWLEY

andy.bowley@forsythbarr.co.nz
+64 4 495 8246

CHELSEA LEADBETTER CFA

chelsea.leadbetter@forsythbarr.co.nz
+64 4 495 5262

ROHAN KOREMAN-SMIT CFA

rohan.koreman-smit@forsythbarr.co.nz
+64 9 368 0085

AARON IBBOTSON CFA

aaron.ibbotson@forsythbarr.co.nz
+64 9 368 0024

ANDREW HARVEY-GREEN

andrew.harvey-green@forsythbarr.co.nz
+64 4 495 8185

JAMIE FOULKES

jamie.foulkes@forsythbarr.co.nz
+64 4 914 2217

LIAM DONNELLY

liam.donnelly@forsythbarr.co.nz
+64 4 495 8194

GUY HOOPER

guy.hooper@forsythbarr.co.nz
+64 4 495 5255

FORSYTH BARR RESEARCH TEAM

fb.research@forsythbarr.co.nz
+64 4 499 7464

The year of the virus makes way for the year of the vaccine, or at least we hope. Despite apparent armageddon for markets in March and continued challenging health situations in many countries, the global economy is learning to live with COVID-19. This paves the way for a robust economic recovery and relative market stability, albeit we caution the recovery may not be linear given (1) vaccine hype is currently elevated, (2) the global geo-political landscape is at risk from a more assertive China, and (3) sovereign debt issues are resurfacing. Market valuations are elevated but supported by low rates and a lack of investment options. Our key picks for the year ahead are A2 Milk, EBOS, Genesis, Kathmandu and Skellerup.

Five investment themes for 2021

- *Supportive macro environment:* A combination of low rates, rising employment, asset inflation, strong capex intentions, and healthy consumer confidence bodes well for a robust macro backdrop, supporting (1) a further recovery in corporate earnings through 2021 and (2) a bias to growth focussed companies and risk assets.
- *From virus to vaccine:* With vaccine roll-out at its infancy, we believe markets have peaked in terms of vaccine hype. The two early pace-makers, Pfizer and Moderna, both have high efficacy rates and limited side effects. We do not yet know the durability, acceptance or longer term side effects. Any negative vaccine news will dent confidence in key vaccine leveraged sectors.
- *M&A opportunities:* The recent bid for Infratil (IFT) by Australia Super highlights the relative attractiveness of certain assets listed on the NZX. Our quantitative and qualitative screen highlights a number of potential M&A candidates.
- *Climate change investing:* The "E" of ESG is becoming more important as investor mandates and investment philosophies change. This is a multi-year theme that investors can no longer ignore, not least given the upcoming emissions disclosure requirements for both NZX listed companies and fund managers.
- *China's assertiveness:* The global order is slowly changing. China's increasing assertiveness on the US and Australia (trade war) has not been missed, its neighbours (militarisation), and in Hong Kong (legislative). New Zealand has never been more reliant on trade with China. This poses an increasing economic risk (we consider low at this stage), that our politicians need to navigate carefully.

Five stock ideas for 2021

- **A2 Milk (ATM):** Recent proprietary channel checks in China reinforced our view that the challenges are in one channel, daigou, with other areas still growing strongly. Attractive value more than compensates for risk.
- **EBOS (EBO):** Solid growth outlook, improving free cashflow profile, healthy balance sheet headroom to invest and structural tailwinds.
- **Genesis (GNE):** A potential ESG winner given Kupe investment review and new carbon neutral targets. Key beneficiary of Tiwai smelter staying open for longer.
- **Kathmandu (KMD):** Reopening play internationally through RipCurl business. Scope to grow Kathmandu brand through wholesale channels.
- **Skellerup (SKL):** Further re-rating supported by international comps that trade at a premium and recovery momentum in industrial operations.

Five stock ideas for 2021

Our top five picks for 2021 – A2 Milk, EBOS, Genesis, Kathmandu and Skellerup – provide a mix of structural growth, recovery, quality, yield and exposure to both our key market themes for 2021 as outlined in this report, but also important secular multi-year trends; premiumisation, ageing demographics, the emerging middle class in Asia, and sustainability.

Figure 1. Forsyth Barr top picks for 2021 (NZ\$)

Code	Rating	Share price	Target price	TSR 2020-ytd (%)	EPS CAGR (FY20-FY22)	One yr forward PE (x)	One yr forward EV/EBITDA (x)	Cash yld
ATM	OUTPERFORM	14.20	23.00	-8.3	12.4%	23.5	14.3	0.0%
EBO	OUTPERFORM	26.15	29.00	19.9	11.3%	20.5	11.9	3.3%
GNE	OUTPERFORM	3.52	3.38	29.5	10.2%	19.6	12.3	3.9%
KMD	OUTPERFORM	1.26	1.65	-40.7	58.4%	15.7	5.1	3.9%
SKL	OUTPERFORM	3.33	3.50	49.2	8.5%	18.8	11.0	4.7%

Source: Forsyth Barr analysis

The A2 Milk Company (ATM)

We view ATM as an attractive longer-term growth story, looking through short-term pressure from channel realignment (given the under pressure daigou trade), with our confidence boosted by recent proprietary channel checks in the key offline market in China. This channel will overtake daigou in importance from FY21E, with a material runway of opportunity still ahead (given low current market share of ~2.2%). 2021 is unlikely to be smooth sailing, however, at current valuation metrics (12m forward PE of ~21x adjusted for its cash position, or ~19x also adjusting for US losses), we believe you are being more than compensated for the risks. Free cashflow is strong, returns attractive and ATM has a large net cash position.

EBOS (EBO)

We are attracted to EBO's mix of defensive characteristics and solid growth outlook, helped by some structural tailwinds (ageing population, humanisation of pets, increasing consumer focus on health & wellness). The company is well-run, with a history of attractive returns and consistently strong cash conversion. A healthy balance sheet, and our forecasts for an improving free cashflow profile, means optionality should continue to grow; with acquisitions an area of value add historically.

Genesis Energy (GNE)

We believe there is an increasing chance NZAS will remain open for longer, making GNE's dividend attractive in a low interest rate environment. GNE has experienced a positive start to FY21 with dry conditions resulting increased thermal generation. We also believe GNE has the potential to be an ESG winner given (1) its significant carbon-reducing goals and (2) it is likely to sell its Kupe oil and gas field stake.

Kathmandu (KMD)

KMD offers exposure to continued strength in consumer activity with a possible recovery trade from further easing of restrictions internationally through its Rip Curl business. KMD's brands are well recognised with a technical rather than fashion offering, leveraged to favourable purchasing trends (outdoor recreation). In addition, KMD has valuation upside through its growth strategy to leverage its wholesale channel experience with Rip Curl to grow the Kathmandu brand internationally.

Skellerup (SKL)

SKL's earnings are delivered through a mixture of defensive agri linked exposure and a diverse range of industrial products which includes exposure to potable water and construction, both of which are positively linked to signalled fiscal stimulus. Recent commentary references a healthy pipeline of product development, with a number of projects where customers have already committed capital towards development, providing near-term growth. SKL's low capex growth model, strong free cash flow, and robust balance sheet support an attractive dividend yield.

Five key themes for 2021

Theme #1: Supportive macro environment

It feels good to be in New Zealand at the moment. We're virus free and the economy is gearing up into a sustained recovery from the 2020 trough that was significantly shallower than the economists expected earlier in the year. While some sectors remain hard hit (i.e. higher education, tourism), others are more than compensating. The backdrop is supportive to a continued strengthening into 2021 given the combination of:

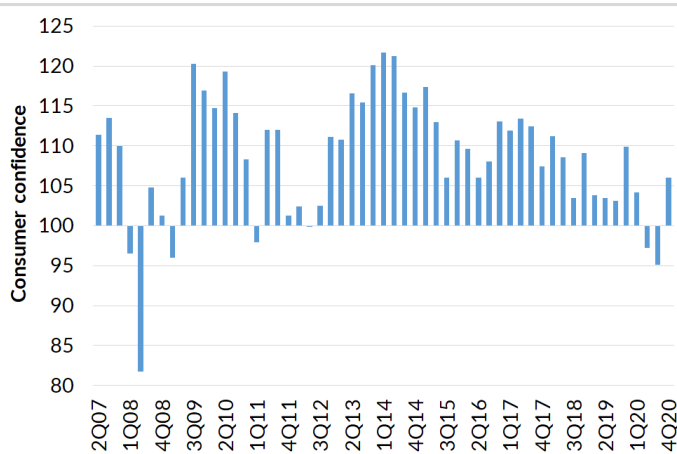
- Low interest rates, likely to stay low for some time
- Increased savings through COVID-19
- Robust business capex intentions
- House prices going through the roof
- Consumer confidence rebounding
- Rising job ads

During a period of many unknowns and relative uncertainty, there is scope for the macro to disappoint (we're particularly conscious of the tug of war between an improving macro and the hype of vaccine roll-out as discussed in theme #3 below – these are not mutually exclusive) and impatience to set in from borders being closed for longer. However, the ability of markets to look beyond the immediate future bodes well for growth/cyclical stocks over the course of 2021.

While the global backdrop is not as rosy as it is in New Zealand, similar directional characteristics are evident. Private consumption is generally robust, low interest rates have boosted asset prices (i.e. housing in particular) creating additional wealth, and unemployment levels are far better than feared in the midst of initial COVID-19 restrictions.

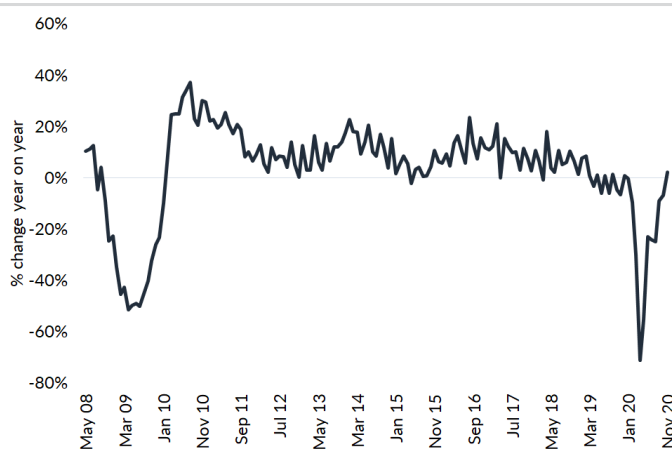
We, therefore, like exposure to recovery (SKL) and reopening (KMD), but not highly leveraged vaccine plays as outlined below.

Figure 2. NZ consumer confidence has rebounded



Source: Westpac, Forsyth Barr analysis

Figure 3. "Jobs Online" survey shows market recovery



Source: Forsyth Barr analysis, MBIE NOTE: based on Seek, TradeMe, Education Gazette

Theme #2: From virus to vaccine

If 2020 was the year of the virus, 2021 is hopefully the year of the vaccine. Inoculations have already begun in the UK and US, and will start soon in other countries. This is good news that plays to economic recovery and the reopening of the most impacted of global sectors. However, as hype cycles go, the vaccine roll-out is now close to the peak of inflated expectations, in our opinion. We expect sectors (i.e. travel and tourism) and stocks most exposed to the vaccine roll-out to experience better buying opportunities through the year.

Why do we say this? There are a variety of risks/issues associated with vaccine roll-out:

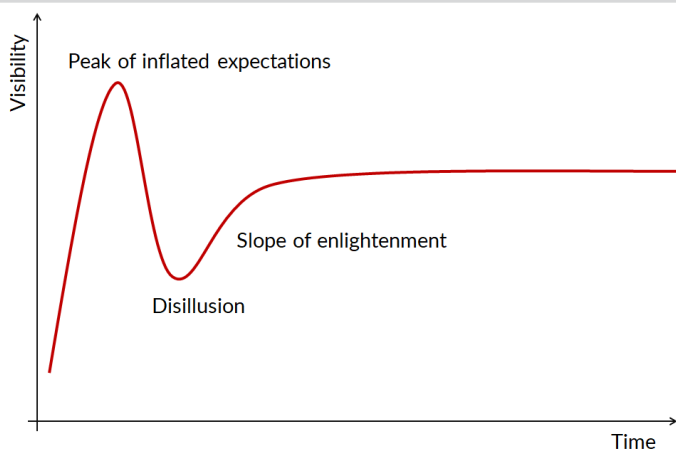
- **Delivery:** Vaccine delivery will take time as there are potential issues of speed and scale when it comes to mass producing vaccines. Common bottlenecks can occur at the fill/finish and delivery stages. New Zealand will only get its first vaccine doses from March 2021 at the earliest. The government has yet to announce its vaccine roll-out plan, which we expect to stretch into 2022 and beyond. It has acquired two vaccines to-date (1.5m doses of the two dose Pfizer vaccine and up to 5m doses of the single dose Janssen vaccine) but may require more.

- **Acceptance:** Some people may be reluctant to take a new vaccine. To protect the entire population from the virus — achieving herd immunity when enough people are protected that a virus dies out — a certain proportion of people need to be immune. This threshold varies (for measles it's 96% of people, for polio it's only 80%) and is determined by factors including the vaccine efficacy and virus's infectiousness. For COVID-19, modelling suggests the figure is 60–70%. A recent US Gallop survey suggests 58% of people are willing to be vaccinated today, with 26% preferring to wait to make sure it's safe.
- **Durability:** Efficacy rates (of the Pfizer and Moderna vaccines) have surprised on the upside but durability is unknown. How long protection lasts for will only be answered over time. COVID-19 will remain in global circulation for many years to come, in our opinion. By comparison the measles vaccine is readily available internationally, has been around for over 50 years, and has relatively high compliance and efficacy of 95%–99%. Yet in 2018 there were ~10m cases of measles globally, including some in New Zealand.
- **Side effects:** Risk of serious side effects emerging from mass inoculations should not be discounted from any new vaccines rolled-out particularly given the speed of development and testing in this instance. Historically approved vaccines have been withdrawn after the later discovery of severe side effects.
- **Strategy shift:** Domestically, New Zealand's strategy will need to move to containment from elimination eventually. Only one virus (smallpox) has ever been eradicated by vaccination. Therefore, it's likely that some ongoing level of COVID-19 infection will continue regardless of the success of vaccines. Notwithstanding government commentary around travel bubbles opening in the first quarter of 2021, we expect the border approach to remain one of 'high control' with limited risk tolerance for the foreseeable future, which could mean New Zealand is an eventual laggard in the overall recovery from COVID-19.

While we accept that there are many other vaccines in development/testing (than the Pfizer and Moderna vaccines referred to above), this may hinder rather than help the overall outcome. Different vaccines will have different efficacy and durability levels. Some may have serious side effects and will be withdrawn. Any negative vaccine news may impact acceptance levels.

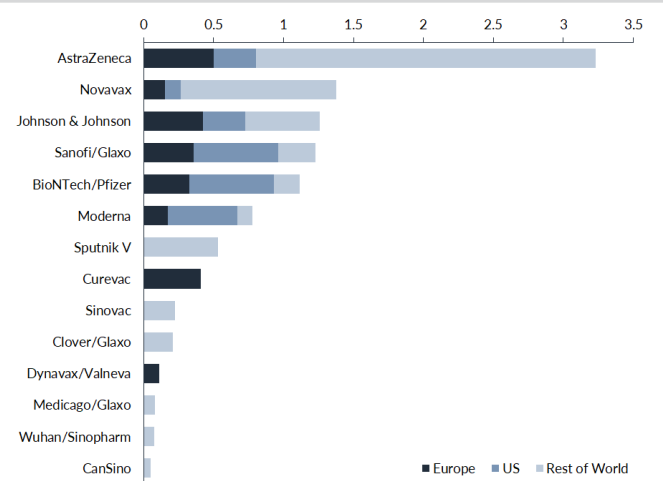
We, therefore, exclude any highly vaccine leveraged stocks from our top five ideas for 2021.

Figure 4. Hype cycle for vaccine roll-out



Source: Forsyth Barr analysis

Figure 5. Vaccine doses under contract



Source: Forsyth Barr analysis, Airfinity

Theme #3: Potential M&A opportunities

COVID-19 impacted the level of M&A activity in 2020, with the NZX losing just Metlifecare (MET) and Abano (ABA), while Infratil (IFT) has recently knocked back a bid from Australian Super. Looking ahead, with cheap debt, cashed-up private equity players, and a general shift up the risk curve for many sovereign funds, we see scope for a greater level of M&A activity in 2021.

Our M&A screen for stocks under our coverage as shown in Figure 6 suggests the most likely targets (in alphabetical order) are: The A2 Milk Company (ATM), Gentrack (GTK), Kathmandu (KMD), Infratil (IFT), Pacific Edge (PEB), Heartland (HGH), Sky TV (SKT), Tourism Holdings (THL), Tilt Renewables (TLT) and Z Energy (ZEL). In Figure 7 we also highlight the next 10 most likely targets. Our analysis combines a number of quantitative screens together with analyst overlay.

Among our top five ideas for 2021, ATM, KMD, EBO and SKL are all potential M&A candidates.

The inherent difficulty in assessing the attractiveness of potential targets to potential suitors reflects the various different characteristics that the latter are seeking. One of the drivers of the Metlifecare (MET) acquisition in 2020 was the use of MET as a platform for allocating more capital in New Zealand. Other targets that may fall into this category include other smaller cap aged care

names Arvida (ARV) and Oceania (OCA), TLT, and Stride Property Group (SPG). TLT in particular has an M&A catalyst in the form of IFT's strategic review of its stake in the company, which may result in divestment.

Figure 6. M&A screen: Most likely targets (in alphabetical order)

Code	Share price vs CY19 ave	FCF yield Fcst 2	FCF margin vs 5yr ave.	Fcst2 net debt/EBITDA	Share register (-ve screen)#	OIO/political (-ve screen)#
ATM	-3.3%	+4.7%	+14.8%	0.0x	0	0
GTK	-69.4%	+2.8%	-79.1%	0.0x	0	0
KMD	-24.6%	+10.3%	-23.9%	0.0x	0	0
IFT	+35.0%	n/a	n/a	0.0x	0	4
PEB	+342.9%	-1.0%	+92.8%	0.0x	0	0
HGH	+0.3%	n/a	n/a	0.0x	0	0
SKT	-74.2%	+11.9%	-65.2%	0.0x	0	0
THL	-37.9%	+0.5%	-89.2%	2.3x	0	0
TLT	+88.2%	+0.4%	+100.0%	1.1x	0	0
ZEL	-42.5%	+5.3%	-52.6%	1.9x	0	0

Source: Forsyth Barr analysis # 0 =no issue, 10=no chance of deal NOTE: IFT's share price relative is based on the price immediately prior to the Australian Super bid announcement

Figure 7. Next 10 most likely targets (in alphabetical order)

Code	Share price vs CY19 ave	FCF yield	FCF margin vs 5yr ave.	Fcst2 net debt/EBITDA	Share register (-ve screen)#	OIO/political (-ve screen)#
CVT	-2.7%	+4.5%	+100.0%	0.5x	0	2
EBO	+13.3%	+5.5%	+66.3%	0.6x	1	0
FPH	+96.9%	+2.2%	+27.5%	0.0x	0	0
FRE	+21.2%	+5.6%	+2.4%	0.7x	0	0
KPG	-23.0%	+6.0%	+2.9%	6.1x	0	0
PGW	-24.4%	+5.9%	+100.0%	0.6x	0	0
SKC	-16.7%	+6.2%	+26.1%	1.6x	0	3
SKL	+42.8%	+5.0%	+11.0%	0.4x	0	0
SPG	+2.6%	n/a	n/a	5.2x	0	0
SPK	+10.8%	+7.1%	+16.8%	1.1x	0	0

Source: Forsyth Barr analysis # 0 =no issue, 10=no chance of deal

Divestment opportunities

In addition to M&A with NZX companies being targets we also consider M&A for part divestments among our universe. Potential business disposals include:

- CVT: Has a handful of businesses that are considered non-core and are carried on the balance sheet at NZ\$0m
- FBU: Expected to sell Rocla in Australia
- FRE: Potential disposal of various Information Management businesses
- GNE: Is undertaking a strategic review of its 46% stake in Kupe
- IFT: Further to the initial approach from Australian Super, IFT announced it was reviewing its investment in TLT
- MFT: Recently admitted that CaroTrans was non-core
- SKL: Its automotive business is considered non-core
- SPK: Potentially could sell and leaseback infrastructure assets such as datacentres, cell towers, and telco exchanges, which are selling at firm cap rates around the world. Would help support SPK's A- debt rating
- WHS: Possible disposal of underperforming retail assets including Torpedo 7

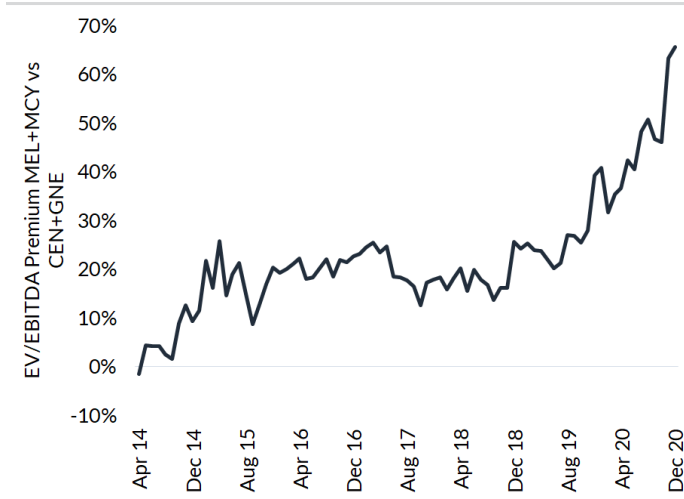
Theme #4: Climate change investing

Climate changing investing to date has had a meaningful impact on the performance of some sectors and some companies both globally and domestically. In New Zealand for example, Meridian (MEL) and Mercury (MCY) have experienced significant valuation re-ratings compared to Genesis (GNE) and Contact (CEN) reflective, in part, to their 100% renewable electricity generation (refer to Figure 8).

The growing valuation differential reflects the two key aspects of climate change investing: (1) a negative screening or exclusion based approach that has dominated ESG investing to date (i.e. coal), and (2) a more scientific approach to combating climate change that reward companies with low, no, or reducing emissions. The second point is increasingly the future of climate change investing, in our opinion. Please refer to our recent report *ESG with a Capital "E": Part of the Problem or Part of the Solution?*, dated 7 December 2020, for more information.

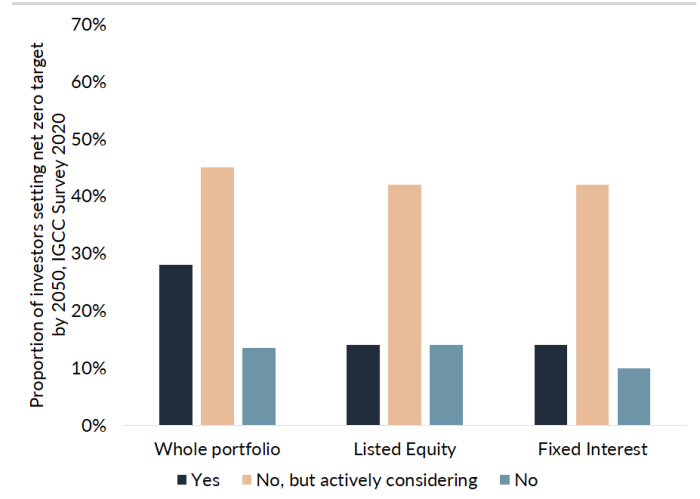
Our top five picks plays this theme through GNE, which has recently announced a strategic review of its Kupe holding and its strategic intent to be carbon neutral by 2050.

Figure 8. ESG winners vs ESG target for exclusions can have dramatic implications on valuation



Source: Forsyth Barr analysis, Bloomberg consensus estimates

Figure 9. 80%+ of the ANZ investing community either have already, or are considering net zero emissions targets...



Source: Forsyth Barr analysis, IGCC

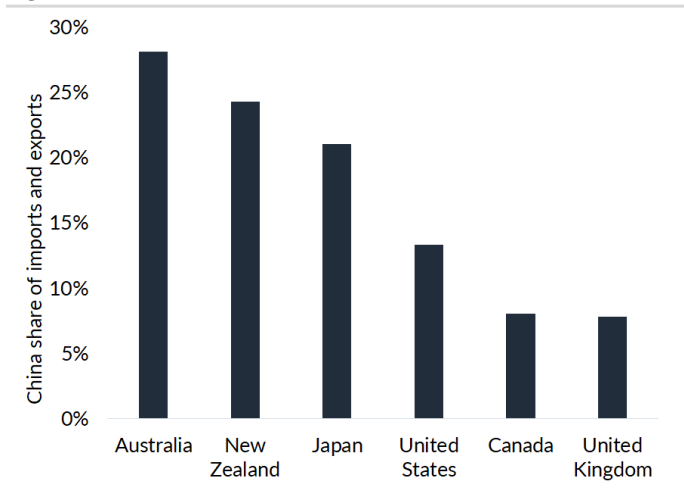
Theme #5: China assertiveness

China is increasing its assertiveness through a combination of political, military and economic means. It has been a key winner from COVID-19 having handled its outbreaks relatively quickly with strict control measures. Consequently, the domestic economic toll was short lived with less stimulus than other countries. China's approach to the South China Sea (militarisation), Hong Kong (legislative), its Indian (conflict) and Bhutan (encroachment) borders through 2020 suggest an even more assertive manner through 2021.

US Presidential Elect Joe Biden is unlikely to take a significantly different course from President Trump to China relations. While his approach may differ visually (less brinkmanship, more predictability and solidarity with other allies), he's unlikely to dial-back tariffs, at least in the short term.

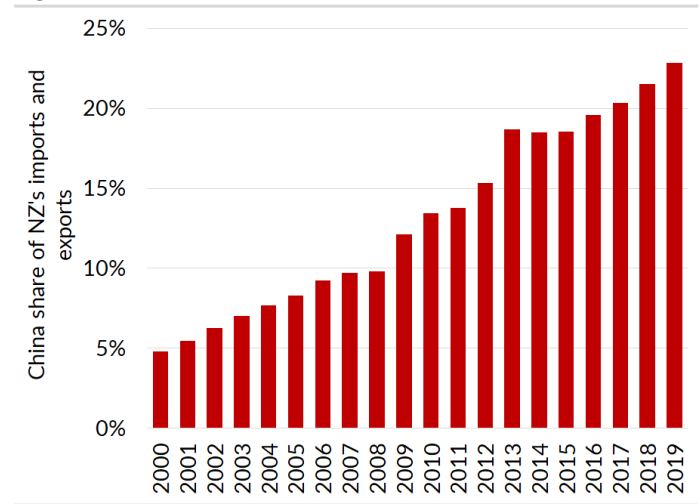
Like the US, other countries are also reassessing their economic reliance on China and seeking greater supply chain diversification. In contrast, New Zealand has increased its reliance on China as a trading partner over recent years; which represents ~26% of our exports and ~23% of our imports.

Figure 10. China % of exports + imports, selected countries



Source: International Trade Centre, Forsyth Barr analysis. Goods only, 2019.

Figure 11. China share of New Zealand's imports + exports



Source: Stats NZ, Forsyth Barr analysis

Growing Australian spat

China's increasing economic assertiveness has played out to Australia's detriment through 2020. The evolving trade war between the two has been brewing for several years but was ignited by Australia calling for a global inquiry into the origins of the coronavirus pandemic, including China's handling of the initial Wuhan outbreak. Initially barley exports were hit with an 80% tariff, then it banned beef from a number of Australian abattoirs and added quotas on coal. Since then lobster and wine have also been hit.

The trade war has had little direct implications at this stage for NZX companies. However, we are conscious it could in several ways: (1) other Australian export categories could get caught up in tariff hikes, (2) New Zealand's China exports are threatened by it politically siding with Australia, and/or (3) Chinese consumers perceiving New Zealand brands to be Australian.

A common misconception for The A2 Milk Company (ATM) is that it manufactures infant milk formula in Australia which is exported to China. ATM's IMF is manufactured in New Zealand. Its Chinese label product is imported directly to China, while English label goes through 'free trade zones' (from New Zealand) and via the daigou trade (through Australia). While China could apply tariffs/sanctions to IMF from Australia the informal nature of the daigou channel may make this difficult to implement. Our recent proprietary channel checks in China also showed very high recognition (91%) that a2 is sourced from New Zealand. In short – it is the relationship between China and New Zealand that matters most. We, therefore, at least at this stage, consider the risk of increased China assertiveness over Australia impacting ATM as relatively modest, in our opinion. Consequently, we are happy to include ATM within our top five picks for 2021.

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