

F&P Healthcare

Unmasking ResMed's 1Q21 Result

CHELSEA LEADBETTER CFA

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

MATT MONTGOMERIE

matt.montgomerie@forsythbarr.co.nz
+64 9 368 0124

UNDERPERFORM

Competitor commentary and recent data points continue to reinforce the material tailwinds in F&P Healthcare's (FPH) Hospital segment. There is no change to our view that the 1H21 result (on 25 November) will be exceptional, and that the company's 'guide' for FY21 is conservative (our forecasts are already above this). FPH is a high quality growth company and a material beneficiary of COVID-19. Earnings momentum is strong, although it becomes more challenging as consensus better reflects this, it begins to cycle larger numbers and when Hospital equipment and IV consumable sales fade from elevated levels. Nonetheless, COVID-19 is likely to continue to dominate the discussion near-term, with the 1H21 result likely too early for any insights into where to thereafter. At ~50x 12 month forward PE, we see better value growth stocks in both the NZ market and globally, albeit acknowledge momentum is on FPH's side while COVID-19 continues to be a factor globally.

NZX Code	FPH	Financials: Mar/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$35.00	NPAT* (NZ\$m)	287.3	408.7	399.2	451.8	PE	70.0	49.3	50.7	45.0
Target price	NZ\$32.50	EPS* (NZc)	50.0	71.0	69.1	77.8	EV/EBIT	52.9	36.3	37.3	32.9
Risk rating	Medium	EPS growth* (%)	37.0	41.9	-2.7	12.7	EV/EBITDA	45.5	32.3	32.7	29.2
Issued shares	574.2m	DPS (NZc)	27.5	39.0	41.4	46.7	Price / NTA	22.3	18.3	16.2	14.3
Market cap	NZ\$20,097m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.8	1.1	1.2	1.3
Avg daily turnover	845.1k (NZ\$24,507k)	*Based on normalised profits					Gross div yld (%)	1.1	1.5	1.6	1.9

Key take-outs from ResMed's 1Q21 release

ResMed (RMD) reported a strong 1Q21 result, well ahead of consensus, underpinned by another quarter of elevated ventilator sales (albeit materially down sequentially), a steady recovery in the sleep business and strong cost control. Key take-aways: (1) the sleep industry has fared better than initial expectations, helped by home testing and strong resupply, (2) ventilator demand is slowing materially, (3) the industry price landscape is expected to be benign for at least the next three years, with an alleviation of pressure due to Competitive Bidding Round 2021 being abandoned for sleep products.

COVID-19; are the 'best days' behind it?

COVID-19 is far from over, with second (and third) waves in a number of countries driving a spike in cases, including US and Europe. The path to 'steady-state' business for FPH is unlikely to be straight. While the recent resurgence in COVID-19 cases globally has translated to a lift in hospitalisations, at this stage the rates of hospitalisation are below levels experienced previously (March-June). We do not profess to be able to predict the path from here, and view hospitalisations as most relevant to COVID-19 related demand (particularly consumables). There is no change to our view FPH will currently still be seeing very strong demand for its products.

Implications for FPH – no change to our view that the FY21 'guide' is conservative; expecting an exceptional 1H21 result

FPH will (unsurprisingly) report an exceptional 1H21 result on 25 November, underpinned by stellar revenue growth (we forecast revenue of NZ\$880m, +54%), with FPH's Hospital products being used as a front-line therapy for COVID-19 globally.

In August FPH provided an updated 'guide' for FY21 (revenue ~NZ\$1.61bn; NPAT NZ\$365–385m) based on a set of assumptions, including that COVID-19 hospitalisations steadily return to normal by the end of CY20. There is no change to our view that this is conservative and recent data points reinforce that view. Our (and market) expectations are accordingly above FPH's 'guide', with NPAT of NZ\$409m (consensus NZ\$399m). We expect an upgrade to the company's 'guide' at the upcoming result, if not before.

Fisher & Paykel Healthcare Corporation (FPH)

Prised as at 30 Oct 2020 (NZ\$) **35.00**

12-month target price (NZ\$)*	32.50
Expected share price return	-7.1%
Net dividend yield	1.2%
Estimated 12-month return	-6.0%

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	0.77
WACC	5.2%
Terminal growth	1.5%

Spot valuations (NZ\$)	
1. DCF	34.02
2. Compco	25.60
3. n/a	n/a

DCF valuation summary (NZ\$m)	
Total firm value	19,947
(Net debt)/cash	0
Less: Capitalised operating leases	(207)
Value of equity	19,739

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	1,070.4	1,263.7	1,705.3	1,673.1	1,868.4
Normalised EBITDA	329.3	440.3	620.2	611.4	684.3
Depreciation and amortisation	(41.7)	(61.0)	(68.1)	(74.4)	(77.1)
Normalised EBIT	292.6	379.3	552.1	537.0	607.3
Net interest	0.8	(1.7)	(1.1)	(0.4)	0.5
Associate income	0	0	0	0	0
Tax	(82.0)	(83.2)	(142.3)	(137.5)	(155.9)
Minority interests	0	0	0	0	0
Normalised NPAT	209.2	287.3	408.7	399.2	451.8
Abnormals/other	0	0	0	0	0
Reported NPAT	209.2	287.3	408.7	399.2	451.8
Normalised EPS (cps)	36.5	50.0	71.0	69.1	77.8
DPS (cps)	23.3	27.5	39.0	41.4	46.7

Growth Rates	2019A	2020A	2021E	2022E	2023E
Revenue (%)	9.1	18.1	34.9	-1.9	11.7
EBITDA (%)	6.4	33.7	40.9	-1.4	11.9
EBIT (%)	8.5	29.6	45.5	-2.7	13.1
Normalised NPAT (%)	10.0	37.3	42.2	-2.3	13.2
Normalised EPS (%)	9.5	37.0	41.9	-2.7	12.7
Ordinary DPS (%)	9.4	18.3	41.8	6.2	12.8

Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	329.3	440.3	620.2	611.4	684.3
Working capital change	6.7	(14.3)	(67.4)	5.1	(31.0)
Interest & tax paid	(82.7)	(95.9)	(143.4)	(137.8)	(155.4)
Other	0	0	0	0	0
Operating cash flow	253.3	330.1	409.4	478.7	497.9
Capital expenditure	(125.7)	(155.7)	(165.0)	(116.0)	(167.5)
(Acquisitions)/divestments	0	0	0	0	0
Other	0	(9.7)	(7.3)	(7.8)	(8.1)
Funding available/(required)	127.6	164.7	237.1	354.9	322.3
Dividends paid	(114.6)	(146.4)	(191.4)	(232.4)	(255.7)
Equity raised/(returned)	2.1	0	0	0	0
(Increase)/decrease in net debt	15.1	18.3	45.7	122.5	66.5

Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Working capital	159.0	203.6	271.0	265.9	296.9
Fixed assets	601.4	710.6	803.2	838.3	919.6
Intangibles	61.5	73.9	88.5	105.2	124.3
Right of use asset	0	24.7	24.2	23.7	23.2
Other assets	109.1	136.5	136.0	135.5	135.0
Total funds employed	931.0	1,149.3	1,322.9	1,368.6	1,499.1
Net debt/(cash)	(54.4)	(42.2)	(87.9)	(210.4)	(277.0)
Lease liability	0	33.6	36.2	38.0	39.4
Other liabilities	72.2	181.4	184.0	185.8	187.2
Shareholder's funds	913.2	976.5	1,190.8	1,355.2	1,549.5
Minority interests	0	0	0	0	0
Total funding sources	931.0	1,149.3	1,322.9	1,368.6	1,499.1

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

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	60.9	45.5	32.3	32.7	29.2
EV/EBIT (x)	68.5	52.9	36.3	37.3	32.9
PE (x)	95.8	70.0	49.3	50.7	45.0
Price/NTA (x)	23.5	22.3	18.3	16.2	14.3
Free cash flow yield (%)	0.6	0.9	1.2	1.8	1.6
Net dividend yield (%)	0.7	0.8	1.1	1.2	1.3
Gross dividend yield (%)	0.9	1.1	1.5	1.6	1.9

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	n/a	>100x	>100x	>100x	n/a
Interest cover EBITDA (x)	n/a	>100x	>100x	>100x	n/a
Net debt/ND+E (%)	-6.3	-4.5	-8.0	-18.4	-21.8
Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	24.2	26.0	32.6	31.0	32.1
Return on equity (%)	22.9	29.4	34.3	29.5	29.2
Return on funds employed (%)	26.8	33.0	40.2	35.6	37.3
EBITDA margin (%)	30.8	34.8	36.4	36.5	36.6
EBIT margin (%)	27.3	30.0	32.4	32.1	32.5
Capex to sales (%)	11.7	12.3	9.7	6.9	9.0
Capex to depreciation (%)	366	322	301	192	269
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	64	55	55	60	60

Operating Performance	2019A	2020A	2021E	2022E	2023E
Sales revenue (NZ\$m)					
Hospital	642	801	1,215	1,133	1,283
Growth (%)	12	25	52	(7)	13
Homecare	421	457	486	535	580
Growth (%)	6	9	6	10	8
Core products - total	1,064	1,259	1,700	1,668	1,864
Distributed products	7	5	5	5	5
Total sales	1,070	1,264	1,705	1,673	1,868

Cost breakdown and margins					
Gross profit (NZ\$m)	716	836	1,080	1,094	1,220
Gross margin (%)	67	66	63	65	65
R & D costs (NZ\$m)	(100)	(119)	(130)	(137)	(153)
SG&A costs (NZ\$m)	(286)	(277)	(330)	(346)	(383)
Key line items to call out					
R&D tax credit (incl. as offset to tax)	n/a	13	15	15	17
Litigation costs within SG&A	(23)	0	0	0	0

Currency					
NZDUSD spot rate	0.68	0.65	0.64	0.64	0.64
NZDEUR spot rate	0.59	0.58	0.56	0.56	0.56
USD hedging - % cover			85	60	45
USD hedging - average rate			0.65	0.65	0.64

Insights from recent competitor results and industry data

In this report we utilise competitor results & commentary, industry anecdotes and industry data points to help us to understand the current landscape for FPH. There is no doubt COVID-19 will provide a material tailwind in the near-term, however, there remains a reasonable margin of error in the extent and duration of this benefit and data points are fluid.

Key take-outs

- **Sleep apnea industry data points:** Demand is slowly returning, with the worst of the COVID-19 impact likely past. The recent decision to not proceed with Competitive Bidding 2021 (CB21) should also alleviate near-term price pressure in the key US market.
 - New patient diagnosis continues to show signs of recovery, although the extent varies by market. Resupply and the use of telehealth/remote monitoring has seen the industry perform better than initial expectations. RMD suggested the underlying CPAP recovery remained down 'mid single digits' with the expectation of steady sequential improvements from here.
 - CB21 has been abandoned for sleep products. No details have been released on the next steps although RMD expects at least a three year period with no change to current reimbursement (albeit with annual inflation adjustment) — a positive for the sector.
 - New products: Homecare dealers are spoilt for choice. RMD has been particularly active, with another new mask in September.
 - Online data suggests FPH is slowly rebounding from a four year low in market share seen in 1Q20. RMD remains the clear market leader, although Phillips and FPH have begun to chip slowly away at its lead in recent quarters.
- **COVID-19:** Second (and third) waves across a number of countries has seen a spike in cases — and a lift in hospitalisations, albeit not to the same rate as earlier. There is no change to our view FPH will still be seeing very strong demand for its Hospital products.
- **Higher freight costs:** This is being absorbed by most companies in the current environment and hasn't shown signs of abating yet.
- **Limited ability to forecast or provide detailed outlook.** Management teams still grappling with a wide range of feasible scenarios.

Next data points (in NZ time)

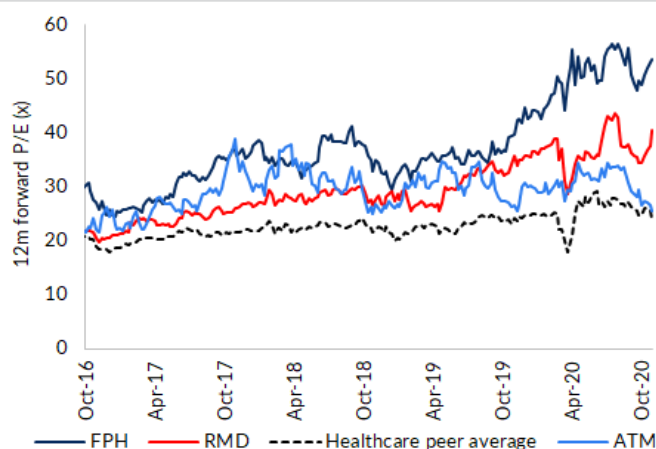
- **Vapotherm 3Q result — 5th November:** Key competitor to FPH in high flow nasal cannula oxygen therapy. Guidance provided in August was for 3Q revenue of \$24–28m (+122–159% YoY).
- **Adapth Health 3Q result — 5th November:** Homecare dealer, with operations in 35 US states.
- **US Medtrade — 4th and 5th November:** Key Homecare industry conference, where new products are sometimes showcased.
- **FPH 1H result — 25th November:** We expect an exceptional result, driven by stellar revenue growth (1H21E NZ\$880m, +54%).

Valuation snapshot

There is no doubt FPH is well positioned, with products continuing to be in high demand and ample runway for long term earnings growth. Earnings momentum is strong, although it becomes more challenging as consensus better reflects this, it begins to cycle larger numbers and when Hospital equipment and IV consumable sales fade from elevated levels.

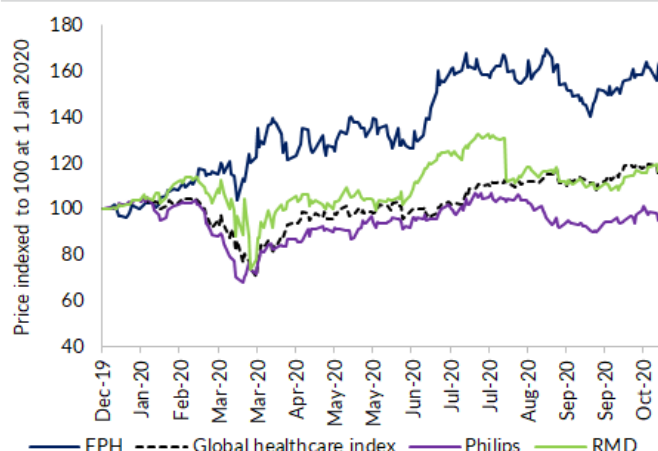
FPH was already one of the most expensive global medical device companies (growth adjusted and absolute) leading into COVID-19 and has significantly outperformed peers in 2020. FPH's PE of ~50x is nearly 2x its 10 year average and compares to global peers at ~24x. We see better value growth stocks in both the NZ market and globally.

Figure 1. FPH 12 month forward PE versus peers



Source: Forsyth Barr analysis, Bloomberg NB: Healthcare peer average includes 12 large US listed medical device peers

Figure 2. FPH price performance versus peers in 2020



Source: Forsyth Barr analysis, Bloomberg NB: Global healthcare index = Dow Jones US Select Medical Equipment Index

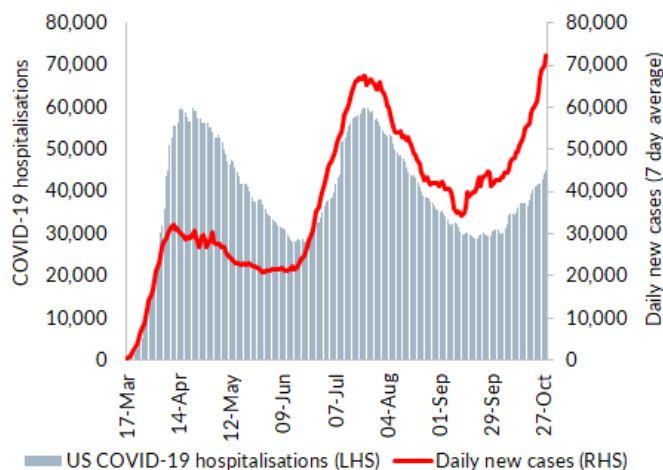
COVID-19 related insights

COVID-19 related demand has provided a significant boost to the results of FPH and a number of global competitors we monitor. Second (and third) waves across a number of countries globally have seen a spike in cases – and a lift in hospitalisations, albeit not to the same rate as earlier. There is no change to our view FPH will currently be seeing very strong demand for its Hospital products.

Data and competitor insights

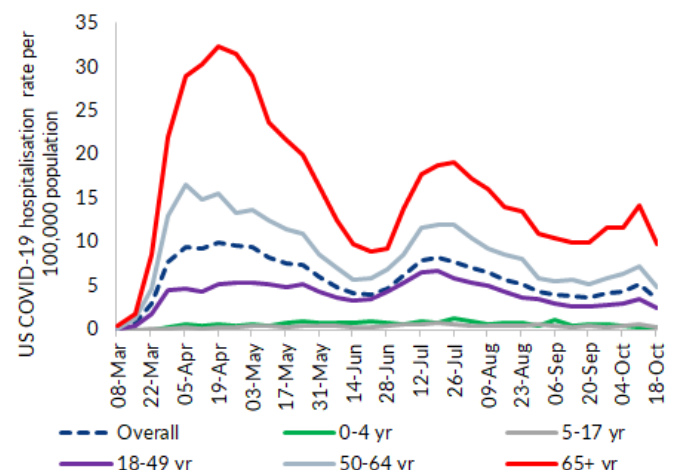
- **Competitor commentary and anecdotes:** Direct quantitative read-through is difficult, given the very different product mix and limited product breakdown.
 - The need for ventilators is decreasing. RMD reported 3Q20 COVID-19 related demand of US\$32m, 4Q20 of US\$125m, 1Q21 of US\$40m and expects the COVID-19 impact on ventilator sales to be "minimal" in 2Q21. A number of other companies have also seen cancelled ventilator orders in the US, with officials indicating they expect to have enough to cope with second waves.
 - Headwinds from lockdowns on new patient diagnosis are easing, as countries begin to adapt to living with COVID-19.
- **COVID-19 data points:** Cases have continued to climb in recent weeks, with a surge evident in both Europe and the US. This has translated to a lift in hospitalisations. We don't profess to forecast the path of COVID-19 and the resulting impact on hospitalisations. However, recent evidence and competitor insights suggest that despite the spike in cases due to second (and third) waves, the impact on hospitalisations (and the resulting demand for product) has been less pronounced. This could reflect (1) shifting patient demographics, (2) better awareness, understanding and triaging, (3) recognising and treating symptoms earlier, (4) increased variety and availability of treatments, (5) the experience of clinicians, doctors and nurses learning how to treat patients – this has been empirically evident across other global epidemics through time.

Figure 3. US COVID-19 hospitalisations



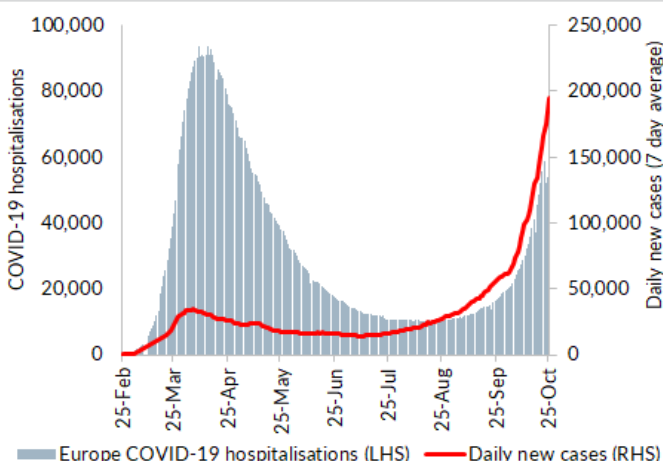
Source: Forsyth Barr analysis, COVID tracking, European CDC

Figure 4. US COVID-19 hospitalisation rates



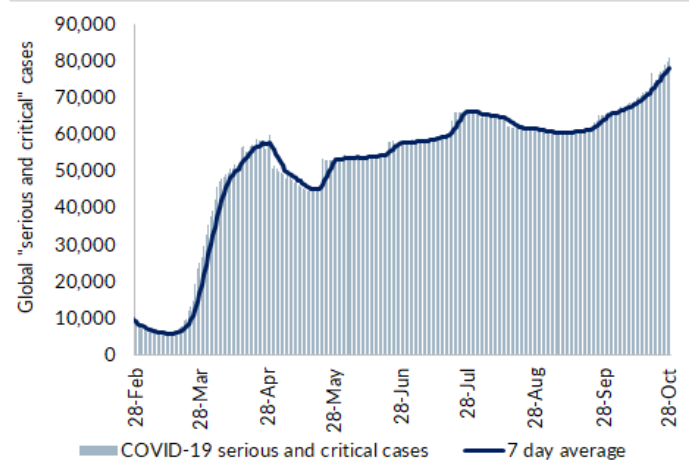
Source: Forsyth Barr analysis, US CDC

Figure 5. Europe COVID-19 hospitalisations



Source: Forsyth Barr analysis, European CDC

Figure 6. Global serious and critical cases



Source: Forsyth Barr analysis, Worldometers

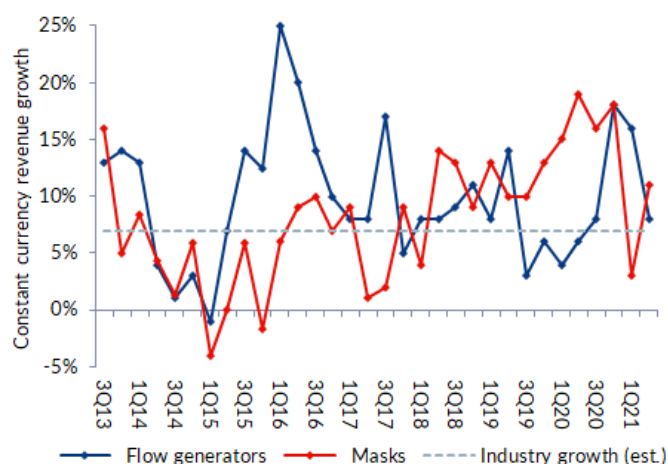
Recent data and insights of relevance to FPH's Homecare segment

FPH's Homecare segment is currently dwarfed in focus by Hospital, however, it still makes up c. 30% of group revenue. The sleep industry has fared better than initial expectations, with demand slowly returning as countries are adapting to living with COVID-19.

Competitor insights

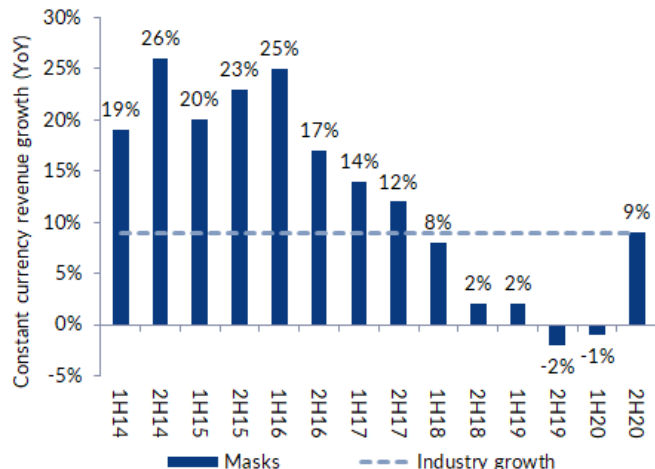
- **Phillips 3Q20:** Minimal comparable insight given differing product mixes, although Phillips reported "double digit" growth in Sleep and Respiratory Care, primarily due to strong ventilator sales as a result of COVID-19. Minimal colour was provided on its sleep apnea business except that "sleep apnea categories have suffered this year because of the pandemic", although the expectation is for the sleep business to get a big boost in FY21.
- **ResMed 1Q21:** RMD reported a strong 1Q21 well ahead of consensus (by ~+25%), helped by another quarter of elevated ventilator sales (albeit materially down sequentially), a steady recovery in the sleep business and strong cost control.
 - ▢ **Masks:** +11% growth in constant currency terms, a strong uplift from 4Q20 and returning to levels prior to COVID-19. Growth was strong in both the Americas (+12%) and Rest of World (+8%)
 - ▢ **Flow generators:** Growth slowed from recent levels, although was still strong at +8% (Americas +6% and Rest of World +11%)
 - ▢ **Gross margins:** +80bp margin expansion driven by favourable product mix and FX benefits, outweighing higher air freight costs
 - ▢ **COVID-19 impact:** Ventilator demand remains elevated (US\$40m in 1Q21), albeit down from the spike seen in 4Q20 (~US\$125m), with RMD commenting the need for ventilators is decreasing over time. RMD suggested the underlying CPAP recovery remained down 'mid single digits' with the expectation of steady sequential improvements going forward

Figure 7. ResMed quarterly revenue growth



Source: Forsyth Barr analysis, Company reports

Figure 8. FPH OSA masks – revenue growth



Source: Forsyth Barr analysis, Company reports

Competitive Bidding Round 21 not proceeding – positive for the sector

Key US public health insurer, CMS, announced it will not proceed with Competitive Bidding (CB) Round 21 for 13 product categories, including CPAP. The industry had been lobbying strongly for this decision which should alleviate near-term price pressure. Details are scarce on the next steps although RMD suggested the probable outcome is at least a three year period (until January 2024) with no changes to current reimbursement (albeit with annual inflation adjustment) – a positive for the sector.

Backdrop of Competitive Bidding (CB) and where to now?

CB is the longstanding tender process in the US, run by CMS, with the objective of achieving more cost effective pricing from the homecare dealers for various products/services. This price pressure has historically (partially) flowed through to manufacturers including FPH and RMD. CMS price cuts were typically used as a basis for commercial insurers also lowering sector reimbursement. CB 2021 was expected to see greater pressure than usual for OSA masks.

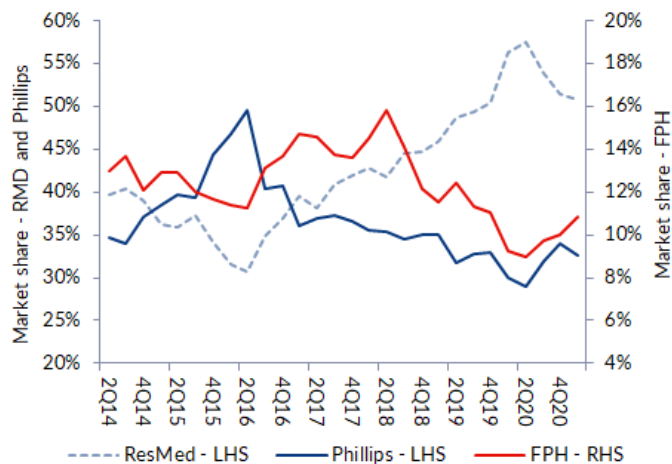
CMS says tenders in CB 2021 for the bid categories did not achieve the expected savings. As an interim measure (until April 2021) CMS will retain existing arrangements which allows Medicare eligible suppliers (DME) willing to meet previous CB pricing to continue. CMS concurrently issued a Proposed Rule which could see an interim modest 'inflation type' increase. CB is a programme which is mandated by legislation, hence, cannot be discarded. CMS will now undertake a review.

Online data

Relevant industry data is scarce, albeit CPAP.com publishes sales data for self-pay consumers. While this is a very small segment of the US market (we estimate <3%) it can provide a gauge of consumer preference, one key driver of mask selection.

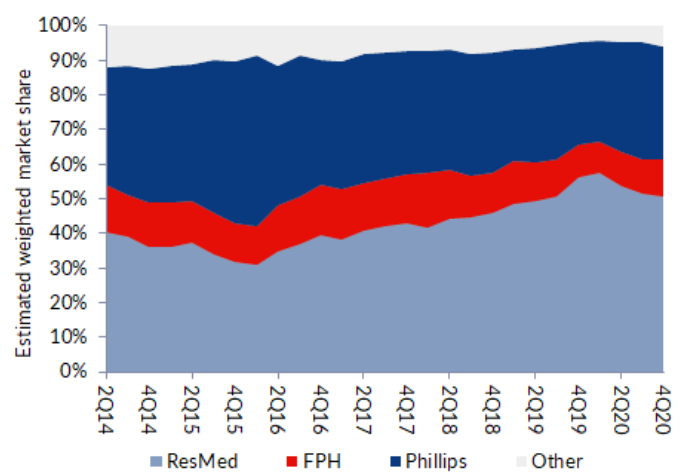
Online data has shown strong market share gains for RMD over the past four years, at the expense of all other players (including Phillips and FPH), albeit recent quarters have seen a noticeable shift in momentum towards Phillips. FPH's market share reached a four year low in all mask categories in 1Q20, with gradual improvements seen since then.

Figure 9. Weighted average market share trends



Source: Forsyth Barr analysis, CPAP.com

Figure 10. Weighted average market share by manufacturer

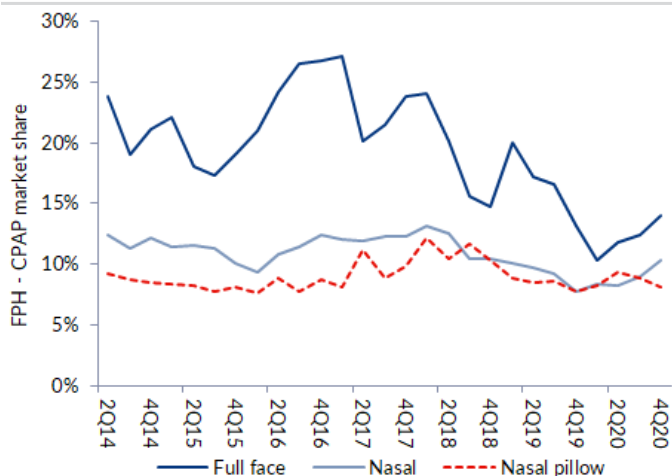


Source: Forsyth Barr analysis, CPAP.com

Mask category breakdown

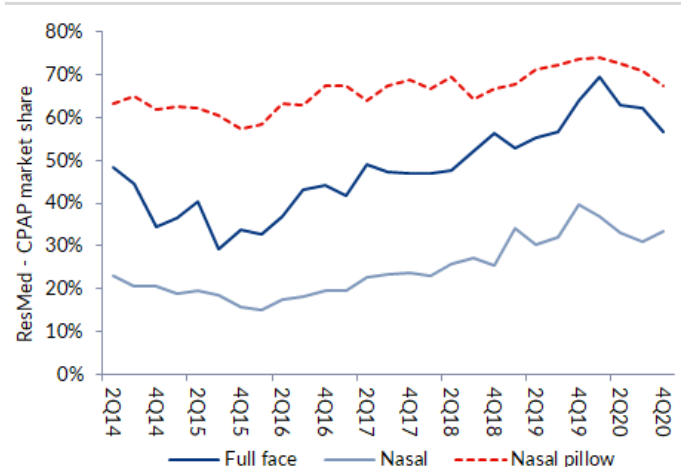
- **Nasal masks:** The largest, most competitive segment, with an estimated c. 40% share of the mask market. Phillips is the clear market leader, albeit RMD has been taking share over the past few years. FPH lost market share over 2018/2019, reaching a low of 7.7% in 4Q19. The launch of F&P Evora in 1Q20 has helped change the trajectory, with share tracking at 10.3% in 4Q20.
- **Full-face:** Historically FPH has had the most success in full-face masks, although a hiatus of new products saw its share materially decline to a 1Q20 low of 10.3% (vs a 1Q17 peak of 27%). The launch of F&P Vitera in 3Q19 has helped change the trajectory, although share remains well below levels achieved in the past. ResMed has been the main market share winner, helped by new products, although Phillips has regained strong momentum in recent quarters with a material lift in share (market share gain of +5.6% since 4Q19) at the expense of RMD (market share loss of -7.1% since 4Q19). Historically, this category has seen meaningful volatility in quarterly market share, so we are cautious to extrapolate or read into the recent shift in momentum as yet.
- **Nasal pillows:** RMD is the clear market leader, with a share of ~68%. The company has grown share steadily in recent years, although growth has plateaued recently with Phillips, and to a lesser extent FPH, gaining positive momentum at RMD's expense.

Figure 11. CPAP market share by mask category – FPH

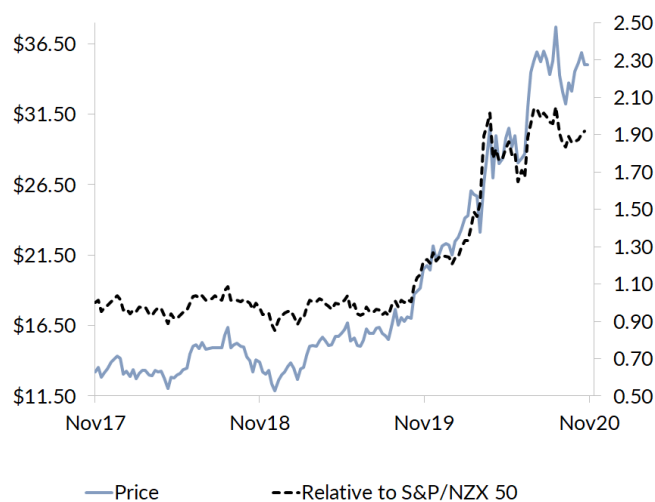


Source: Forsyth Barr analysis, CPAP.com

Figure 12. CPAP market share by mask category – ResMed



Source: Forsyth Barr analysis, CPAP.com

Figure 13. Price performance


Source: Forsyth Barr analysis

Figure 14. Substantial shareholders

Shareholder	Latest Holding
The Vanguard Group	5.3%
BlackRock Investment Management	5.0%

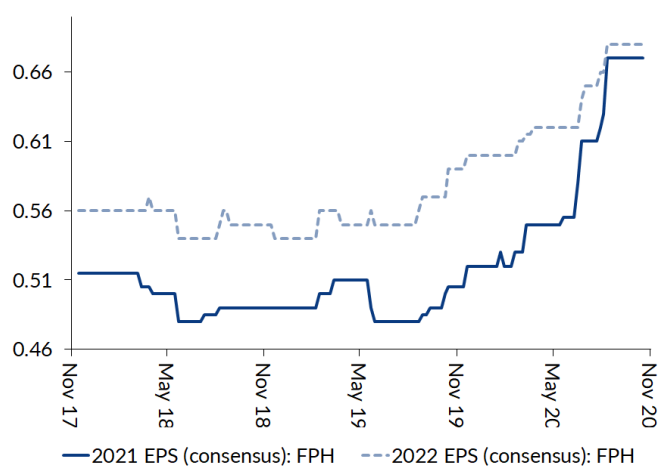
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 15. International valuation comparisons

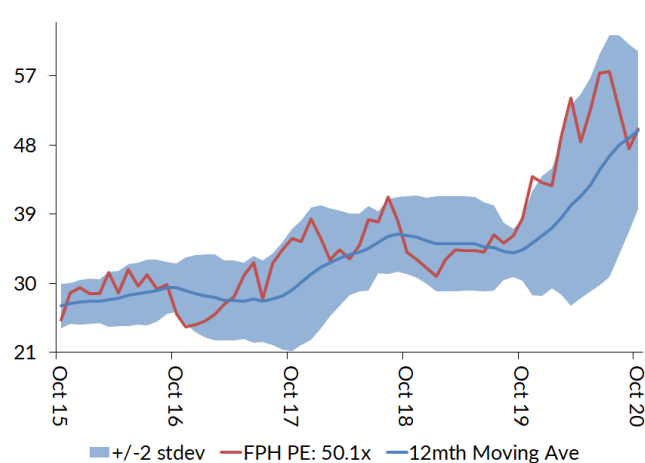
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect FPH's balance date - March)										
F&P Healthcare	FPH NZ	NZ\$35.00	NZ\$20,097	49.3x	>50x	32.3x	32.8x	36.3x	37.3x	1.2%
RESMED INC	RMD US	US\$191.94	US\$27,815	39.9x	36.5x	27.7x	26.0x	32.6x	30.2x	0.9%
TELEFLEX INC	TFX US	US\$318.23	US\$14,819	29.2x	23.9x	23.1x	18.6x	28.4x	22.1x	0.4%
BOSTON SCIENTIFIC CORP	BSX US	US\$34.27	US\$49,029	28.9x	19.9x	22.3x	16.8x	27.9x	19.9x	0.0%
BECTON DICKINSON AND CO	BDX US	US\$231.13	US\$66,997	20.9x	17.8x	16.1x	14.1x	19.3x	16.8x	1.8%
Compco Average:				29.7x	24.5x	22.3x	18.9x	27.1x	22.2x	0.8%
FPH Relative:				66%	n/a	45%	74%	34%	68%	51%

EV = Current Market Cap + Actual Net Debt

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

Figure 16. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 17. One year forward PE (x)


Source: Forsyth Barr analysis

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