

# Kathmandu Holdings

**NEUTRAL**

## FY19 Result — On the Right Track

Kathmandu (KMD) reported a solid FY19 result ahead of expectations, underpinned by Oboz, which provided its first full 12 month contribution. Sales across the core brand were flat (after currency) with a positive Australian result offsetting a weak period in New Zealand; however, continued cost control and sales mix benefits enabled higher margins. Looking forward, we view the risk/reward as balanced given (1) a tougher backdrop facing the core Australasia business with rising cost and competition, and (2) a high degree of uncertainty in earnings contributions from its international expansion; but noting (3) positive Oboz momentum and possible international upside should execution on this growth path be faster/stronger than anticipated. **NEUTRAL.**

### What's changed?

- **Earnings:** FY20E/FY21E NPAT up +1%/+5% reflecting improved cost control, albeit offset slightly in FY20 due to unfavourable FX movements
- **Target Price:** Increased to NZ\$2.95 from NZ\$2.65
- **Rating:** NEUTRAL

### Strong FY19 result led by Oboz

KMD continues to exhibit strong operational execution, reporting earnings ahead of expectations. Australia was a highlight with sales growth accelerating in 2H19 despite cycling a strong prior period; however, this was offset by a drop in New Zealand sales with warmer weather impacting the sale of seasonal product. Headline sales growth of +10% was driven almost entirely by a 12 month contribution from Oboz which is gaining traction with key wholesale accounts (pro forma sales growth of +30%). A reduction in the cost of doing business was also a contributor to improved earnings with limited rent increases and a higher sales mix weighting towards the higher margin wholesale channel.

### Continued reduction in debt levels; dividend upside

KMD continues to reduce debt, down -39% on the prior year period to NZ\$19.3m, underpinned by strong operating cash flow. The conservative balance sheet provides KMD with flexibility for possible future bolt-on acquisitions or increased distributions to shareholders. KMD announced a fully imputed final dividend of 12cps, ahead of our expectations. Given the low levels of gearing we have lifted our forecast dividends.

### Strong start to the year

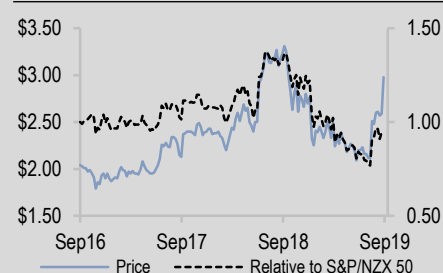
KMD has not provided guidance for FY20 at this stage; however, it has highlighted the particularly strong start to the year, which is likely benefitting from cooler weather and a pull through of seasonal sales. KMD remains well positioned in terms of its core Australian and New Zealand business, albeit headwinds limit near-term growth. While it is gaining momentum in its international business, a possible source of upside for investors, it is worth noting the high degree of uncertainty in future earnings contributions and worsening macro backdrop.

### Investment View

KMD has a strong brand and market leading position in Australasia with its loyalty database and vertically integrated model also key strengths. KMD operates in a competitive sector and earnings are seasonal. The core business is in good shape, with focus now on the opportunity for the brand further afield. International is the key area of focus, with material capital committed to accelerate growth plans. Our rating is **NEUTRAL.**

NZX Code	KMD
Share price	NZ\$2.98
Target price	NZ\$2.95
Risk rating	High
Issued shares	226.0m
Market cap	NZ\$674m
Average daily turnover	193.9k (NZ\$491k)

### Share Price Performance



Financials: July	19A	20E	21E	22E
NPAT* (NZ\$m)	56.8	57.7	62.3	64.9
EPS* (NZc)	25.1	25.5	27.6	28.7
EPS growth* (%)	4.8	1.5	8.1	4.1
DPS (NZc)	16.0	17.0	18.0	19.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	7.0	6.9	6.4	6.2
EV/EBIT	8.3	8.2	7.6	7.3
PE	11.9	11.7	10.8	10.4
Price / NTA	12.0	8.9	6.9	n/a
Cash dividend yield (%)	5.4	5.7	6.0	6.4
Gross dividend yield (%)	7.5	7.9	8.4	8.9

\*Historic and forecast numbers based on underlying profits

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Kathmandu (KMD)					Priced as at 18 Sep 2019: NZ\$2.98					July year end									
Forsyth Barr valuation					Valuation Ratios					2018A	2019A	2020E	2021E	2022E					
Valuation methodology		Weighted DCF and sum of the parts valuation			EV/EBITDA (x)					7.7	7.0	6.9	6.4	6.2					
					EV/EBIT (x)					9.3	8.3	8.2	7.6	7.3					
12-month target price (NZ\$)*		2.95	Spot valuations (NZ\$)			PE (x)					12.4	11.9	11.7	10.8	10.4				
Expected share price return		-1.0%	1. DCF	2.44		Price/NTA (x)					20.9	12.0	8.9	6.9	5.7				
Net dividend yield		5.8%	2. Sum of the parts		2.55	Free cash flow yield (%)					8.7	6.8	7.7	8.8	9.1				
Estimated 12-month return		4.8%	3. n/a		n/a	Net dividend yield (%)					5.0	5.4	5.7	6.0	6.4				
					Gross dividend yield (%)					7.0	7.5	7.9	8.4	8.9					
Key WACC assumptions			DCF valuation summary (NZ\$m)			Imputation (%)					100	100	100	100	100				
Risk free rate		2.00%	Total firm value		709	Pay-out ratio (%)					63	64	67	65	66				
Equity beta		1.16	(Net debt)/cash		(19)														
WACC		10.5%	Value of equity		689	Capital Structure					2018A	2019A	2020E	2021E	2022E				
Terminal growth		1.5%	Shares (m)		226	Interest cover EBIT (x)					70.6	28.9	88.8	>100x	n/a				
					Interest cover EBITDA (x)					84.8	34.2	>100x	>100x	n/a					
					Net debt/ND+E (%)					6.9	4.2	1.3	-2.6	-6.5					
					Net debt/EBITDA (x)					0.3	0.2	0.1	n/a	n/a					
Profit and Loss Account (NZ\$m)					2018A	2019A	2020E	2021E	2022E	Key Ratios					2018A	2019A	2020E	2021E	2022E
Sales revenue		497	546	563	580	599	Return on assets (%)					12.2	14.2	13.9	14.6	14.5			
Normalised EBITDA		90	100	100	106	109	Return on equity (%)					12.1	13.0	12.5	12.9	12.9			
Depreciation and amortisation		(15)	(15)	(16)	(16)	(16)	Return on funds employed (%)					13.3	12.9	12.7	13.4	13.7			
Normalised EBIT		75	84	84	90	93	EBITDA margin (%)					18.0	18.2	17.7	18.3	18.2			
Net interest		(1)	(3)	(1)	(0)	1	EBIT margin (%)					15.0	15.4	14.9	15.5	15.5			
Associate income		-	-	-	-	-	Capex to sales (%)					3.4	2.9	3.7	3.0	3.0			
Tax		(23)	(24)	(25)	(27)	(28)	Capex to depreciation (%)					112	103	133	108	108			
Minority interests		-	-	-	-	-	Operating Performance					2018A	2019A	2020E	2021E	2022E			
Normalised NPAT		51	57	58	62	65	Divisional sales (NZ\$m)												
Abnormals/other		-	-	-	-	-	New Zealand					143	139	141	144	147			
Reported NPAT		51	58	58	62	65	Australia					334	339	349	356	368			
Normalised EPS (cps)		24.0	25.1	25.5	27.6	28.7	International (incl Oboz)					21	68	73	80	84			
DPS (cps)		15.0	16.0	17.0	18.0	19.0	Total store sales					497	546	563	580	599			
					Gross profit					315	332	337	347	356					
					Gross margin					63	61	60	60	59					
Growth Rates					2018A	2019A	2020E	2021E	2022E	Divisional EBITDA (NZ\$m)									
Revenue (%)		11.7	9.7	3.1	3.1	3.3	New Zealand					35	34	31	32	31			
EBITDA (%)		26.7	10.9	0.2	6.2	3.1	Australia					58	60	59	59	62			
EBIT (%)		31.2	12.7	-0.4	6.9	3.3	International (incl Oboz)					2	9	13	18	20			
Normalised NPAT (%)		33.2	12.2	1.5	8.1	4.1	Unallocated					(5)	(3)	(3)	(4)	(4)			
Normalised EPS (%)		28.4	4.8	1.5	8.1	4.1	Total EBITDA					90	100	100	106	109			
DPS (%)		15.4	6.7	6.3	5.9	5.6	EBITDA margins (%)												
Cash Flow (NZ\$m)					2018A	2019A	2020E	2021E	2022E	New Zealand					24.6	24.5	22.1	22.0	20.9
EBITDA		90	100	100	106	109	Australia					17.3	17.6	16.8	16.7	17.0			
Working capital change		6	(9)	(1)	(2)	(2)	International (incl Oboz)					8.9	13.4	18.0	23.0	23.4			
Interest & tax paid		(21)	(29)	(26)	(27)	(28)	Total EBITDA margin					18.0	18.2	17.7	18.3	18.2			
Other		-	-	-	-	-	Currency assumptions												
Operating cash flow		76	62	73	76	79	NZDAUD					0.95	0.92	0.95	0.94	0.95			
Capital expenditure		(17)	(16)	(21)	(17)	(18)	NZDGBP					0.56	0.52	0.52	0.53	0.51			
(Acquisitions)/divestments		(83)	(22)	-	-	-													
Other		(22)	22	-	-	-													
Funding available/(required)		(46)	46	52	59	61													
Dividends paid		(27)	(34)	(38)	(41)	(43)													
Equity raised/(returned)		49	-	-	-	-													
Increase/(decrease) in net debt		25	(12)	(13)	(18)	(19)													
Balance Sheet (NZ\$m)					2018A	2019A	2020E	2021E	2022E										
Working capital		53	62	63	65	67													
Fixed assets		64	60	66	67	68													
Intangibles		390	386	386	386	386													
Other assets		27	5	5	5	5													
Total funds employed		534	514	520	523	526													
Net debt/(cash)		31	19	6	(12)	(31)													
Other non current liabilities		82	52	52	52	52													
Shareholder's funds		420	442	461	483	505													
Minority interests		-	-	-	-	-													
Total funding sources		534	514	520	523	526													

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

## FY19 in line with expectations

KMD reported a strong FY19 result with earnings above the top end of the guidance range and ahead of consensus. FY19 NPAT of NZ\$57.6m, up +14% on the prior year period was driven by a combination of Oboz, which experienced continued growth and provided a full 12 month contribution, and a strong Australian result, offsetting a weaker period in New Zealand.

Figure 1. Result summary (NZ\$m)

	FY18A	FY19A	% chg	ForBarr
Sales Revenue	497.4	545.6	+9.7%	546.6
Gross Profit	315.5	332.5	+5.4%	332.0
Gross Margin	63.4%	60.9%	-2.5ppts	60.7%
<b>EBIT</b>	<b>74.8</b>	<b>84.3</b>	<b>+12.7%</b>	<b>83.1</b>
Profit Before Tax	73.7	81.4	+10.4%	81.2
<b>Normalised Profit</b>	<b>50.7</b>	<b>56.8</b>	<b>+12.2%</b>	<b>56.4</b>
Underlying EPS (cps)	24.0	25.1	+4.6%	25.0
DPS (cps)	15.0	16.0	+6.7%	15.0

Source: Company reports, Forsyth Barr analysis

### Target price and investment view

Our target price increases to NZ\$2.95 from NZ\$2.65 (+11%), driven by revisions to earnings, peer multiple expansion and time value of money.

KMD continues to exhibit strong operational execution with a track record of delivery over the last four years in what has been a historically volatile business. Looking forward, we see the risk/reward as balanced, with headwinds domestically (cost, competition) albeit potential upside should execution on its International expansion be faster/stronger than anticipated. We retain our NEUTRAL rating.

### Earnings changes

We have made minor revisions to our earnings estimates in FY20 with positive drivers offset by a lower gross margin assumption as a result of unfavourable FX moves. Increases to earnings forecasts in later years reflect (1) lower cost of doing business assumption, given scale benefits, good rent negotiations, and as a result of mix shift towards higher margin wholesale; and (2) a higher earnings base following a better than expected FY19 result. Additionally, we have increased our dividend assumptions given the considerable balance sheet headroom.

Figure 2. Earnings changes (NZ\$m)

	2020E			2021E			2022E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Sales	564.3	562.7	-0.3%	587.0	580.2	-1.2%	n/a	599.3	n/a
<b>EBIT</b>	<b>83.3</b>	<b>83.9</b>	<b>0.8%</b>	<b>86.0</b>	<b>89.8</b>	<b>4.4%</b>	<b>n/a</b>	<b>92.8</b>	<b>n/a</b>
<b>Normalised NPAT</b>	<b>57.1</b>	<b>57.7</b>	<b>1.1%</b>	<b>59.6</b>	<b>62.3</b>	<b>4.6%</b>	<b>n/a</b>	<b>64.8</b>	<b>n/a</b>
Underlying EPS (cps)	25.2	25.5	1.2%	26.3	27.6	4.7%	n/a	28.7	n/a
DPS (cps)	15.0	17.0	13.3%	16.0	18.0	12.5%	n/a	19.0	n/a

Source: Forsyth Barr analysis

## Key result issues

### 1) Slowing New Zealand business offset by Australia

KMD's core brand saw flat sales year on year (+2.1% in constant exchange rates) with a late start to winter in New Zealand weighing on performance and offsetting a good result in Australia.

### Divisional insights

- **Australia:** Australia was a highlight in the period, up in the second half with FY19 SSS growth of +2.7%. This was particularly encouraging given the strong comp it was cycling. Continued store optimisation and Summit Club membership (up +15%) helped drive traffic.
- **New Zealand:** SSS decline accelerated in New Zealand, down -3.9% in FY19, with the later start to winter impacting the key seasonal sales period.
- **Online:** Online sales up +9.2%; now comprise 10.1% of direct to consumer sales (FY18 9.4%).

#### Recent trading and outlook

KMD did not provide formal guidance at this stage, although highlighted a particularly strong start to the year. In the seven weeks to 15 September constant currency Group SSS is up +6.1%, led by New Zealand SSS growth of +12%. Recent trading in New Zealand likely represents a pull through of later seasonal sales, helped by cooler weather combined with discounting activity (lower margin impact). We note that 1Q trading represents a small portion of full year sales. We expect further gross margin contraction into FY20, impacted by negative FX movements.

Figure 3. Australia SSS and gross margin



Source: Company reports, Forsyth Barr analysis

Figure 4. New Zealand SSS and gross margin



Source: Company reports, Forsyth Barr analysis

## 2) Conservative balance sheet provides options

KMD's conservative balance sheet provides the company with the flexibility to undertake possible bolt-on acquisitions or return capital to shareholders, with management indicating the company is open to exploring options as they appear. Low gearing levels underpin our lift in dividend pay-out ratio assumptions.

The company continued to reduce debt levels in FY19, down -39% to NZ\$19.3m, underpinned by strong operating cash flow in 2H19 (NZ\$77.8m vs NZ\$74.0m in 2H18). We estimate KMD will be net cash in FY21.

#### Capex guidance

KMD provided FY20 capex guidance of ~NZ\$21m (FY18 NZ\$16m), evenly split between ongoing store optimisation and refurbishments, and investment into systems.

## 3) International expansion

Earnings growth in FY19 was underpinned by a strong Oboz result with pro forma sales up +30% on the prior year period. Growth was driven by (1) continued traction with key accounts such as REI, (2) a relaunch of its core Sawtooth franchise, and (3) improving sell through via the independent outdoor channel.

KMD recently launched its Kathmandu brand in the North American wholesale channel, with orders secured for 45 doors and five online sites (including REI and Walmart's Moosejaw). Although the orders are not considered to be material in FY20, international expansion is a key area of upside with sell through and repeat orders in subsequent seasons indicators of brand reception in what is a competitive market place.

## FY19 result summary

Figure 5. FY19 result summary

	FY18A	FY19A	% chg	Comments
<b>Profit and Loss Account</b>				
Sales	497.4	545.6	+9.7%	Led by Oboz, core brand sales up +0.1%
Cost of Sales	(182.0)	(213.1)	-17.1%	
<b>Gross Profit</b>	<b>315.5</b>	<b>332.5</b>	<b>+5.4%</b>	<b>Gross margin contraction to 60.9% (FY18 63.4%)</b>
SG&A Costs	(225.7)	(232.9)	-3.2%	Mix benefit from wholesale channel growth
<b>Total EBITDA</b>	<b>89.8</b>	<b>99.6</b>	<b>+10.9%</b>	
Depreciation & Amortisation	(15.0)	(15.3)	-2.1%	
<b>EBIT</b>	<b>74.8</b>	<b>84.3</b>	<b>+12.7%</b>	<b>Above top end of guidance range</b>
Net Interest	(1.1)	(2.9)	-175.3%	High interim debt levels (16% gearing)
Profit Before Tax	73.7	81.4	+10.4%	
Tax	(23.1)	(23.7)	-2.9%	Effective tax rate 29.2%
<b>Normalised NPAT</b>	<b>50.7</b>	<b>56.8</b>	<b>+12.2%</b>	
Reported NPAT	50.7	57.6	+13.7%	
Underlying EPS	24.0	25.1	+4.8%	
DPS	15.0	16.0	+6.7%	Fully imputed 2H19 dividend of 12cps
<b>Balance Sheet &amp; Cashflow</b>				
Operating Cashflow	75.6	61.7	-18.4%	
Fixed Assets	63.5	60.3	-5.0%	FY20 capex guidance of ~NZ\$21m
Working Capital	52.6	62.4	+18.6%	Largely driven by lift in inventory
Net Debt	31.4	19.3	-38.5%	Underpinned by strong cash flow, gearing now 4%
Shareholders Equity	420.4	442.1	+5.2%	
Inventory	111.9	122.8	+9.7%	Inventory levels impacted by FX and phasing of product launch
Stockturn	1.83x	1.81x	n/a	Steady at good levels
<b>Divisional Analysis</b>				
Sales - Australia	333.7	338.7	+1.5%	Up +4.5% in constant currency (SSS up +2.7%)
Sales - New Zealand	143.0	138.6	-3.1%	SSS down - 3.9%
Sales - OBOZ	16.1	64.0	+297.3%	North America pro forma growth of +28%
<b>Total Sales</b>	<b>497.4</b>	<b>545.6</b>	<b>+9.7%</b>	<b>Core brand up +2.1% in constant currency</b>

Source: Company reports, Forsyth Barr analysis

## Investment summary

Kathmandu Holdings (KMD) has a strong brand, market leading position and its vertically integrated model is a key strength. The key area of optionality is KMD's international expansion strategy, with Oboz expected to help accelerate this pathway. We view risk/reward as broadly balanced, with upside potential if delivery of international earnings moves faster. **NEUTRAL**.

### Earnings and cash flow outlook

- **Store rollout:** The long-term target Australasian store footprint is 180, up from its current 167 stores (119 Australia: 48 NZ).
- **International expansion strategy:** This is the key avenue of optionality for growth with its 'capital light' wholesale model. Oboz provides a platform in the US, and KMD is also trialling with a UK and Swedish retailer.
- **Oboz acquisition:** The strategy is to leverage Oboz's wholesale relationships in the US market while also providing a less seasonal product line in the form of footwear.
- **NZDUSD and hedging:** Given the competitive retail backdrop and price conscious consumer, we don't expect retailers to be able to pass on the full impact of unfavourable FX movements.

### Business quality

- **Strong base:** KMD has a strong brand, vertically integrated model, valuable loyalty database and a market leading position. Continued investment in IT will also support growth and working capital management.
- **Management:** Execution over the last three years has been strong, with the company delivering a turnaround in its profit trajectory.
- **Briscoe Group's stake:** BGP's full takeover offer in 2015 was unsuccessful; however, it has maintained an 18.9% stake.

### Financial structure

- **Gearing:** Gearing has fallen to ~4% due to strong operating cash flows following a short-term increase associated with the Oboz acquisition.

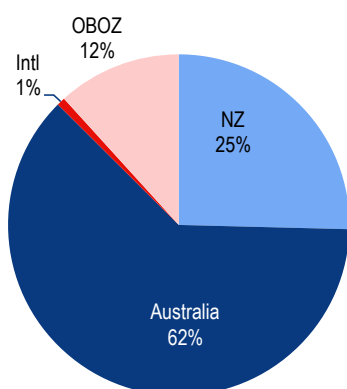
### Risks factors

- **Earnings predictability:** A risk given the high seasonality and lumpy nature of earnings which are weighted to its winter sale.
- **Consumer sentiment and cost inflation:** Deterioration in economic conditions. Cost inflation, particularly rising wages and rent.

### Company description

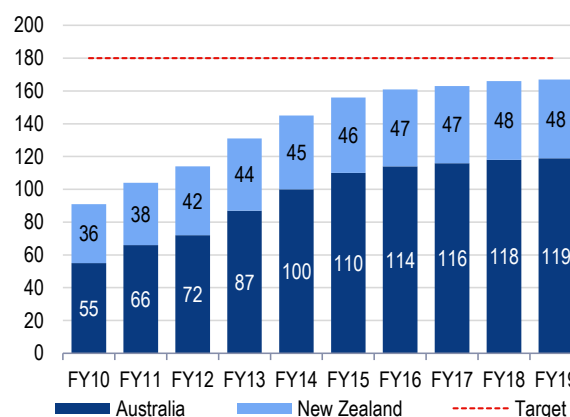
Kathmandu is the largest Australasian travel and adventure clothing and equipment retailer, with 119 stores in Australia and 48 in New Zealand and plans to expand its Australasian footprint to 180 stores. The company is looking to expand in International markets through wholesale and online channels, supported by the recent acquisition of Oboz. KMD offers a wide range of products, including specialist technical products, lifestyle products and general merchandise.

Figure 1. FY18 revenue breakdown



Source: Forsyth Barr analysis, Company reports

Figure 2. Australasian store footprint



Source: Forsyth Barr analysis, Company reports



**Figure 6. Substantial Shareholders**

Shareholder	Latest Holding
Briscoe Group	18.9%
Harbour Asset Management & Jarden Securities Limited	13.5%
TA Universal	12.0%
Commonwealth Bank of Australia	6.3%
ACC	5.0%

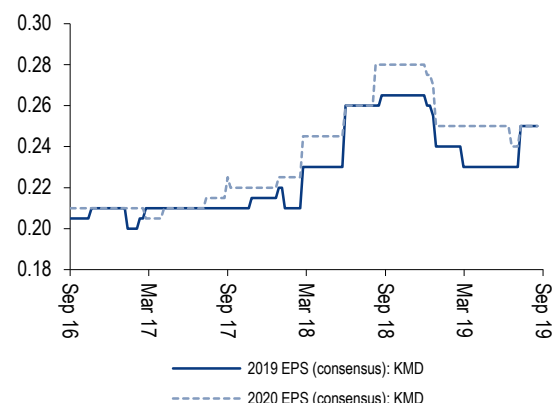
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

**Figure 7. International Compco**

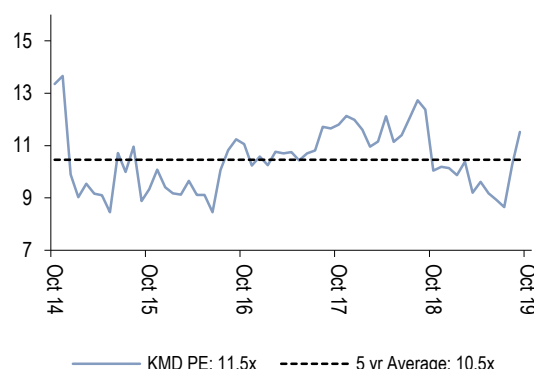
Company	Code	Price	Mkt Cap	PE	EV/EBITDA	EV/EBIT	Cash D/Yld
<i>(metrics re-weighted to reflect KMD's balance date - July)</i>							
<b>Kathmandu Holdings</b>	<b>KMD NZ</b>	<b>NZ\$2.98</b>	<b>NZ\$674</b>	<b>11.7x</b>	<b>10.8x</b>	<b>6.9x</b>	<b>6.0%</b>
Briscoe Group *	BGP NZ	NZ\$3.69	NZ\$819	12.6x	12.8x	7.7x	6.1%
Michael Hill Intl *	MHJ NZ	A\$0.55	A\$213	8.4x	8.3x	4.1x	9.5%
Restaurant Brands NZ *	RBD NZ	NZ\$10.70	NZ\$1,335	26.3x	23.3x	13.1x	0.0%
The Warehouse Group *	WHS NZ	NZ\$2.29	NZ\$794	10.8x	10.0x	5.8x	7.0%
Dick's Sporting Goods Inc	DKS US	US\$38.37	US\$3,468	11.1x	10.7x	10.0x	3.1%
Premier Investments	PMV AT	A\$15.35	A\$2,432	19.0x	17.1x	12.2x	4.9%
VF Corp	VFC US	US\$87.16	US\$34,709	24.5x	21.6x	18.7x	2.3%
Columbia Sportswear Co	COLM US	US\$97.77	US\$6,605	19.5x	17.6x	12.3x	1.2%
<b>Compco Average:</b>				<b>16.5x</b>	<b>15.2x</b>	<b>10.5x</b>	<b>4.3%</b>
<b>KMD Relative:</b>				<b>-29%</b>	<b>-29%</b>	<b>-34%</b>	<b>+42%</b>

EV = Current Market Cap + Actual Net Debt

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

**Figure 8. Consensus EPS Momentum**


Source: Forsyth Barr analysis, Bloomberg

**Figure 9. 12 Month Forward PE**


Source: Forsyth Barr analysis

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