

Scales

NEUTRAL

1H19 Result — Bearing Fruit

Scales (SCL) reported a tidy 1H19 result, largely in line with expectations, underpinned by particularly strong export volumes from Mr Apple. Whilst positive momentum within the Horticulture division is encouraging, the earnings growth outlook remains subdued given orchard redevelopment activity. Additionally, SCL's large capital headroom for a potentially transformational acquisition creates investment uncertainty, in our opinion. Reiterate NEUTRAL rating.

What's changed?

- **Earnings:** Minor changes across the explicit forecast period
- **Target Price:** Price cut to NZ\$4.65 from NZ\$4.75, primarily due to peer re-rating
- **Rating:** NEUTRAL

1H19 result underpinned by Horticulture

SCL reported Underlying EBITDA of NZ\$47.3m, flat on the prior period, supported by a strong Horticulture result, which continues to be the main driver of earnings.

- **Horticulture:** Achieved impressive export volumes, flat on the prior period, despite orchard redevelopment activity. Offsetting the volume uplift was margin compression as a result of smaller apple sizes and weak pricing in European markets.
- **Food Ingredients:** Meateor group volumes increased significantly (~2.5x) following the integration of Shelby and its joint venture with Alliance. SCL has reiterated its NZ\$25m EBITDA target, however, the path to achieving this target remains under-developed in our opinion. We have, therefore, taken a more conservative view on earnings growth.
- **Logistics:** SCL's Logistics business continues to track in the right direction, growing EBITDA +6% on the prior period, but remains small from a group context (~7% of group EBITDA).

SCL has reaffirmed its FY19 guidance of Underlying NPAT in the range of NZ\$32m to NZ\$37m, implying underlying EBITDA in the range of NZ\$49m to NZ\$55m. We have left our forecasts relatively unchanged at the top end of the guidance range (FY19E EBITDA NZ\$55m).

Acquisition uncertainty exists

Significant acquisition uncertainty exists. SCL has considerable capital headroom (we estimate ~NZ\$300m) with which to pursue possible transformational acquisitions. The company has previously indicated it is targeting vertically integrated agriculture companies with a China export focus. The broad spectrum of acquisition possibilities creates investment uncertainty, which combined with limited earnings growth during the redevelopment programme will continue to overhang the share price in the near term, in our opinion.

Investment View

SCL is an export focussed company offering investors broad exposure to New Zealand agriculture, with operations in horticulture and meat processing. Although pet food is a growing part of the business, annual apple harvest outcomes and global apple prices will remain key drivers of business performance in the near-term. NEUTRAL.

NZX Code	SCL
Share price	NZ\$4.50
Target price	NZ\$4.65
Risk rating	Medium
Issued shares	140.3m
Market cap	NZ\$631m
Average daily turnover	92.6k (NZ\$438k)

Share Price Performance



Financials: December	18A	19E	20E	21E
NPAT* (NZ\$m)	28.6	36.5	39.7	42.1
EPS* (NZc)	20.4	26.1	28.3	30.0
EPS growth* (%)	17.9	27.9	8.6	6.1
DPS (NZc)	19.0	20.0	20.0	21.0
Imputation (%)	100	100	100	100

Valuation (x)	18A	19E	20E	21E
EV/EBITDA	13.2	11.3	9.0	8.7
EV/EBIT	16.1	14.0	11.0	10.4
PE	22.1	17.3	15.9	15.0
Price / NTA	3.1	2.3	2.2	2.1
Cash dividend yield (%)	4.2	4.4	4.4	4.7
Gross dividend yield (%)	5.9	6.2	6.2	6.5

*Historic and forecast numbers based on underlying profits

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Scales Corporation (SCL)

Priced as at 28 Aug 2019: NZ\$4.50

December year end

Forsyth Barr valuation					Valuation Ratios										
Valuation methodology					DCF	2017A	2018A	2019E	2020E	2021E					
12-month target price (NZ\$)*					4.65	Spot valuations (NZ\$)									
Expected share price return	3.3%	1. DCF	4.50	EV/EBITDA (x)	14.7	13.2	11.3	9.0	8.7						
Net dividend yield	4.4%	2. Comparative multiples	4.40	EV/EBIT (x)	18.1	16.1	14.0	11.0	10.4						
Estimated 12-month return	7.8%	3. n/a	n/a	PE (x)	26.0	22.1	17.3	15.9	15.0						
Key WACC assumptions					DCF valuation summary (NZ\$m)										
Risk free rate	2.00%	Total firm value			561	Capital Structure									
Equity beta	0.99	(Net debt)/cash			84	2017A	2018A	2019E	2020E	2021E					
WACC	8.7%	Value of equity			645	Interest cover EBIT (x)	12.7	17.5	n/a	n/a					
Terminal growth	1.5%	Shares (m)			140	Interest cover EBITDA (x)	15.7	21.3	n/a	n/a					
Profit and Loss Account (NZ\$m)					2017A	2018A	2019E	2020E	2021E	Net debt/ND+E (%)	15.6	21.9	-36.7	-36.2	-38.2
Sales revenue	355.5	402.5	479.2	483.1	505.2	Net debt/EBITDA (x)					0.9	1.3	n/a	n/a	n/a
Normalised EBITDA	45.3	51.7	55.1	60.8	62.7	Key Ratios					2017A	2018A	2019E	2020E	2021E
Depreciation and amortisation	(8.6)	(9.2)	(10.8)	(11.2)	(10.1)	Return on assets (%)	10.7	10.3	10.2	11.0	11.2				
Normalised EBIT	36.7	42.5	44.3	49.5	52.5	Return on equity (%)	10.9	11.6	11.6	12.1	12.1				
Net interest	(2.9)	(2.4)	6.4	5.6	6.0	Return on funds employed (%)	12.5	12.6	11.6	12.5	12.7				
Associate income	-	-	-	-	-	EBITDA margin (%)	12.7	12.9	11.5	12.6	12.4				
Tax	9.3	11.0	14.2	15.4	16.4	EBIT margin (%)	10.3	10.6	9.3	10.3	10.4				
Minority interests	0.4	0.4	2.5	2.6	2.6	Capex to sales (%)	3.8	4.0	3.2	3.2	2.3				
Normalised NPAT	24.1	28.6	36.5	39.7	42.1	Capex to depreciation (%)	157	176	144	137	116				
Abnormals/other	7.1	16.5	93.2	-	-	Operating Performance					2017A	2018A	2019E	2020E	2021E
Reported NPAT	31.2	45.1	127.3	37.1	39.6	Horticulture	228.0	254.6	267.9	266.2	271.6				
Normalised EPS (cps)	17.3	20.4	26.1	28.3	30.0	Logistics	101.6	64.5	69.0	73.1	76.8				
DPS (cps)	19.0	19.0	20.0	20.0	21.0	Food Ingredients	68.9	83.1	142.2	143.7	156.7				
Growth Rates					2017A	2018A	2019E	2020E	2021E	Revenue split (division)					
Revenue (%)	-4.9	13.2	19.0	0.8	4.6	Total	399.1	402.5	479.2	483.1	505.2				
EBITDA (%)	-33.2	14.2	6.4	10.4	3.1	EBITDA split (division)									
EBIT (%)	-34.1	15.7	4.3	11.8	6.0	Horticulture	38.4	43.5	42.9	43.9	43.5				
Normalised NPAT (%)	-37.0	18.6	27.8	8.6	6.1	Logistics	3.3	4.9	5.2	5.5	5.8				
Normalised EPS (%)	-37.3	17.9	27.9	8.6	6.1	Food Ingredients	8.2	11.0	12.0	16.1	18.3				
Ordinary DPS (%)	5.6	0.0	5.3	0.0	5.0	Overheads	(4.5)	(7.6)	(5.0)	(4.7)	(4.8)				
Cash Flow (NZ\$m)					2017A	2018A	2019E	2020E	2021E	EBITDA margin (%)					
EBITDA	45.3	51.7	55.1	60.8	62.7	Horticulture	16.8	17.1	16.0	16.5	16.0				
Working capital change	(11.6)	(17.6)	1.7	(0.3)	(1.8)	Logistics	3.2	7.6	7.5	7.5	7.5				
Interest & tax paid	(12.2)	(13.5)	(7.8)	(9.9)	(10.4)	Food Ingredients	11.9	13.3	8.4	11.2	11.6				
Other	10.8	15.9	1.0	1.0	1.0	Total	11.4	12.9	11.5	12.6	12.4				
Operating cash flow	32.4	36.6	50.0	51.6	51.4	Apple volumes ('000 TCE)									
Capital expenditure	(13.5)	(16.3)	(15.4)	(15.4)	(11.8)	Premium varieties	1,616	1,901	2,095	1,987	2,058				
(Acquisitions)/divestments	(0.8)	(15.9)	163.9	-	-	Traditional varieties	1,929	1,966	1,727	1,611	1,532				
Other	-	-	-	-	-	Total	3,545	3,867	3,822	3,598	3,590				
Funding available/(required)	18.1	4.4	198.5	36.2	39.7	Food ingredients volumes									
Dividends paid	(25.3)	(25.6)	(32.2)	(28.0)	(28.0)	Profruit volume ('000 L)	5,579	6,219	6,219	6,219	6,219				
Equity raised/(returned)	0.2	0.1	-	-	-	Meateor ('000 mt)	27,663	29,028	107,751	115,684	123,350				
Increase/(decrease) in net debt	7.0	21.1	(166.2)	(8.2)	(11.7)										
Balance Sheet (NZ\$m)					2017A	2018A	2019E	2020E	2021E						
Working capital	23.4	41.1	39.4	39.7	41.5										
Fixed assets	228.9	150.6	148.3	160.6	168.8										
Intangibles	18.2	43.9	43.9	43.9	43.9										
Other assets	44.1	145.5	46.7	46.1	46.7										
Total funds employed	314.6	381.0	278.3	290.2	300.9										
Net debt/(cash)	40.8	69.0	(84.2)	(87.5)	(95.8)										
Other non current liabilities	51.9	62.1	45.0	45.0	46.4										
Shareholder's funds	221.5	246.3	313.9	329.2	346.7										
Minority interests	0.4	3.6	3.6	3.6	3.6										
Total funding sources	314.6	381.0	278.3	290.2	300.9										

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

FY19 result

Scales (SCL) reported a tidy 1H19 result with few surprises. Group Underlying EBITDA of NZ\$47.3m, flat on the prior period, was underpinned by a solid performance in its Horticulture division which remains the key driver of earnings. SCL has reaffirmed its FY19 guidance of Underlying NPAT in the range of NZ\$32m to NZ\$37m, implying underlying EBITDA in the range of NZ\$49m to NZ\$55m. The company has also guided to a full year dividend of at least 19cps.

Figure 1. Result summary (NZ\$m)

	1H18	1H19	% chg	Forsyth Barr
Revenue	220.1	278.0	26.3%	247.0
Underlying EBITDA	47.1	47.3	0.4%	48.3
Underlying EBIT	42.5	42.2	-0.7%	43.1
Underlying NPAT	29.3	30.1	2.7%	34.7
Reported NPAT	34.8	121.8	250%	n/a
Underlying EPS (cps)	21.0	21.5	2.4%	23.5

Source: Company reports, Forsyth Barr analysis

Target price and investment view

Our target price decreases to NZ\$4.65 from NZ\$4.75. The key driver of the drop in target price is our sum of the parts (SOTP) valuation, down -8% following a re-rating across its peer groups for all divisions. This more than offsets a +4% change to our DCF following earnings changes and a reduction in our WACC estimate (to 8.7% from 9.2%).

SCL's 1H19 result highlighted the strength of its Horticulture operation with Mr Apple achieving best in class yields and positive momentum in its target markets and varieties. However, we retain our NEUTRAL rating given 1) limited horticulture earnings growth as it undergoes a multi-year orchard redevelopment; 2) a still evolving strategy within its Food Ingredients business; and 3) the significant investment uncertainty given SCL's capital headroom to pursue a transformational acquisition and the broad range of possible outcomes.

Earnings changes

We have made fairly minor revisions to forecasts. A higher apple volume assumption in FY19 is effectively cancelled out by a lower margin assumption at the EBITDA level, which is being impacted by a combination of smaller fruit size and a pricing drag in European markets. Further out, we have lifted our apple pricing assumptions on the back of prices achieved in the markets of growing importance plus the weaker European harvest outlook, offset by a cut to our Food Ingredients assumptions and a reduction in interest rates driving lower interest revenue.

Figure 2. Earnings changes (NZ\$m)

	FY19			FY20			FY21		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	454.1	479.2	5.5%	470.0	483.1	2.8%	487.5	505.2	3.6%
EBITDA	55.0	55.1	0.1%	59.9	60.8	1.4%	62.0	62.7	1.1%
NPAT	37.0	36.6	-1.3%	39.7	39.7	-0.1%	42.3	42.1	-0.4%
EPS (cps)	26.4	26.1	-1.2%	26.7	26.5	-0.6%	28.5	28.2	-0.9%
DPS (cps)	20.0	20.0	0.0%	19.0	20.0	5.3%	20.0	21.0	5.0%

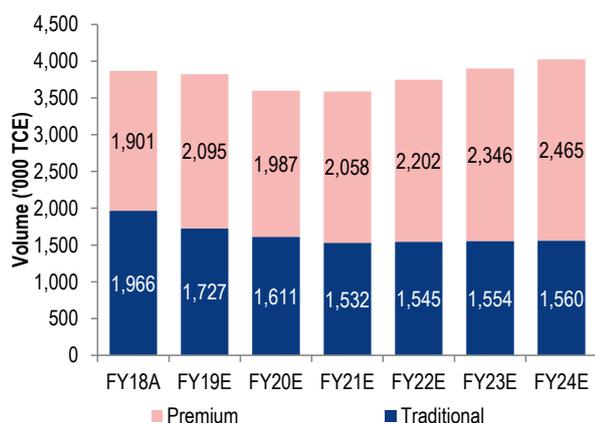
Source: Forsyth Barr analysis

Key result issues

1) Horticulture redevelopment bearing early fruit

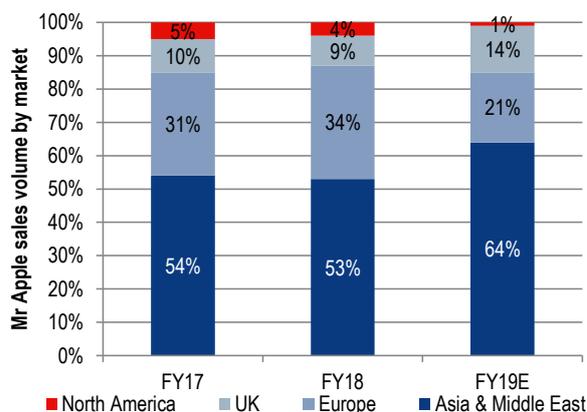
SCL's Horticulture division achieved impressive export volumes of 3,822k TCEs (tray carton equivalent), flat on the prior period and considerably ahead of forecasts, despite orchard redevelopment activity. Challenging weather conditions resulted in a smaller average apple size, which suggests a particularly strong yield on a fruit/per tree basis. At this point SCL remains comfortable with its long-term apple forecasts (Figure 3), which are expected to be suppressed over the medium-term as orchards are redeveloped out of traditional apples (Braeburn) and into premium varieties targeted at Asian markets (Figure 4). Commentary suggests positive traction for newly launched varieties Dazzle and Posy in the Asian markets.

Figure 3. Mr Apple sales volume forecasts



Source: Company reports, Forsyth Barr analysis

Figure 4. Mr Apple sales volume by market



Source: Company reports, Forsyth Barr analysis

Strong yields but margin contraction

Offsetting the stronger yields was margin contraction. SCL reported 1H19 EBITDA margin of 26%, down from 29% in the prior period. Smaller apple sizes mean more apples per TCE (a standardised export unit that typically weighs 18kg), which equates to a higher cost per TCE. Also creating a drag on margins was the poor pricing environment in Europe, following what had been a bumper Northern Hemisphere season.

Weaker forecast for European harvest

The outlook into the remainder of the year appears supportive for Mr Apple. Early forecasts for this year's European apple harvest suggest production will be down -20% on the prior year and -8% below the three year average. A smaller apple harvest should translate to less European stock entering the market and help price recovery.

2) Food Ingredients continues to evolve

The Food Ingredients business has gone through considerable change over the past 12-months, with SCL having purchased a business, partially sold another, and entered into a joint venture.

Figure 5. Food Ingredients structure



Source: Company reports, Forsyth Barr analysis

Path to NZ\$25m in EBITDA unclear

SCL has a stated division EBITDA target of NZ\$25m (FY19E NZ\$12m). Its time frame of “medium-term” and path to achieving the target remain non-specific, highlighting that growth may come from a mixture of organic and acquisitive opportunities. We take a more cautious view in regards to our forecasts.

- **Organic growth:** SCL is exploring possible partnerships in China to develop a white labelled finish product, such as canned wet food and kibble treats.
- **Acquisitive growth:** Security of long-term supply of premium red meat is a key concern for secondary processors, as it comes under pressure from declining herd numbers and alternative markets for offal. We suspect SCL may look to increase its supply of raw meat for pet food through acquisitions or partnerships.

3) Large cash balance creates investment uncertainty

Following recent divestments SCL has a considerable net cash position with additional balance sheet headroom allowing for a potentially transformational acquisition. We estimate SCL has capacity for ~NZ\$300m of acquisitions. SCL has indicated it is targeting agriculture companies that are vertically integrated, complement SCL’s existing competencies, and have a China export focus. The broad spectrum of acquisition possibilities creates investment uncertainty that will overhang the share price in the near-term, in our opinion.

SCL has illustrated its disciplined approach to investment, sticking to its financial (long-term ROCE of 15%) and non-financial investment hurdles (fully vertically integrated, alignment with core agriculture business). Whilst settlement of its major divestment only occurred in May 2019, the transaction was announced May 2018. We suspect over that time SCL has had a look at almost every New Zealand agriculture business that has been put on the block.

Result summary

Figure 6. 1H19 result summary (NZ\$m)

	1H18A	1H19A	% chg	Comment
Horticulture	143.8	159.5	11%	Export packout 79% (FY18 76%)
Food ingredients	45.5	80.7	77%	Uplift comes from inclusion of Shelby, volumes up ~2.5x
Logistics	30.6	37.5	23%	Increased sales resource in Melbourne
Revenue	220.1	278.0	26%	
COGS	(154.0)	(206.4)	34%	
Gross profit	66.1	71.6	8%	
Horticulture	41.3	41.3	0%	Margin fell to 26% from 29% due to smaller apples lifting cost/TCE
Food ingredients	6.2	5.1	-18%	Impacted by one-off NZ\$3m write down of inventory
Logistics	2.9	3.1	7%	EBITDA margin flat at 6%
Corporate	(3.3)	(2.2)	-33%	Reduced corporate costs with M&A activity in prior period
Underlying EBITDA	47.1	47.3	0%	Excludes IFRS 16 impact to Reported EBITDA of NZ\$5m
D&A	(4.6)	(5.0)	8%	FY19E capex NZ\$15m, 85ha redeveloped over FY19/FY20
Underlying EBIT	42.5	42.3	0%	
Tax & interest	(13.2)	(12.2)	-7%	
Underlying NPAT	29.3	30.1	2%	
Abnormals	5.4	91.7	n/a	Includes gain on sale of divestment of Polarcold & 50% of Meateor NZ
Reported NPAT	34.8	121.8	n/a	
Underlying EPS (cps)	21.0	21.5	3%	

Source: Company reports, Forsyth Barr analysis

Investment summary

Scales (SCL) is an export focussed company offering investors broad exposure to New Zealand agriculture, with operations in horticulture and meat processing. SCL aims to leverage exposure to a growing premium fruit market in Asia and a favourable macro backdrop for pet food. Following the settlement of its Polarcold business sale, SCL has a significant net cash balance and is pursuing potentially transformational acquisitions. We expect acquisition uncertainty will have an overhang on the share price. **NEUTRAL.**

Business quality

- **Competition:** The New Zealand apple industry primarily competes against other Southern Hemisphere producers such as Chile and South Africa.

Earnings and cash flow outlook

- **Horticulture drivers:** Apple prices are set in market with NZ grown apples typically achieving a price premium relative to competitors. A shift in focus to Asian markets and new varieties should lift group prices. Climatic outcomes typically drive tree yield, and harvest quantity and quality.
- **Food Ingredients drivers:** Both supply and customer contracts are typically negotiated annually with earnings driven by availability of rendered meat and ultimately herd cull. Recent business transactions increase surety around supply volumes.

Financial structure

- **Balance sheet headroom, acquisitions on the cards:** SCL has significant headroom on its balance sheet following asset divestments. The company has indicated that it intends to pursue acquisitive growth, both through smaller bolt-on and potentially larger transformational acquisitions.

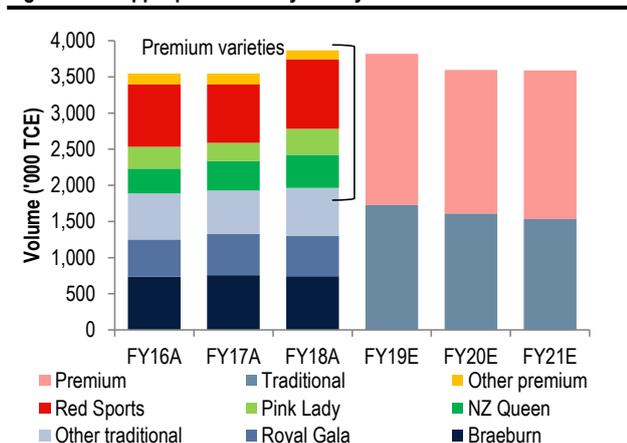
Risk factors

- **Climatic risks:** Extreme weather events, particularly during the key growing/harvest period, have the ability to negatively impact harvest volume and quality as well as herd cull numbers.
- **Bio-security risk:** As with any export focussed primary industry company, changes to the operating environment through the introduction of disease or pest could have a material impact on operating costs/market access.
- **Seasonal employment:** SCL has large seasonal employment requirements which can lead to labour shortages and create production bottlenecks. SCL's participation in the RSE scheme, which provides half of seasonal labour requirements, mitigates this risk to some extent.

Company description

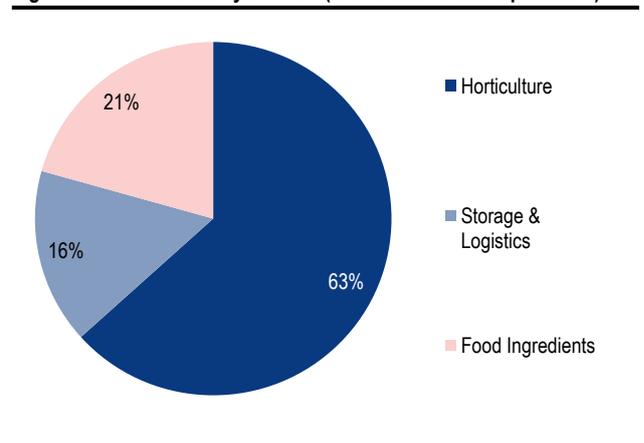
SCL is a diversified agricultural operator with business interests in horticulture and food ingredients. SCL's Mr Apple business is New Zealand's largest fully integrated grower, packer, and marketer of Apples, exporting ~5m TCE per annum. SCL's also operates Meateor, a meat processor for pet food ingredients and has a 50% interest in Profruit, a juice concentrate manufacturer.

Figure 7. Mr Apple production by variety



Source: SCL, Forsyth Barr analysis

Figure 8. FY18 revenue by division (excl. discontinued operations)



Source: SCL, Forsyth Barr analysis

Figure 9. Substantial Shareholders

Shareholder	Latest Holding
China Resources	15.4%
Harbour Asset Management & Jarden Securities Limited	8.4%

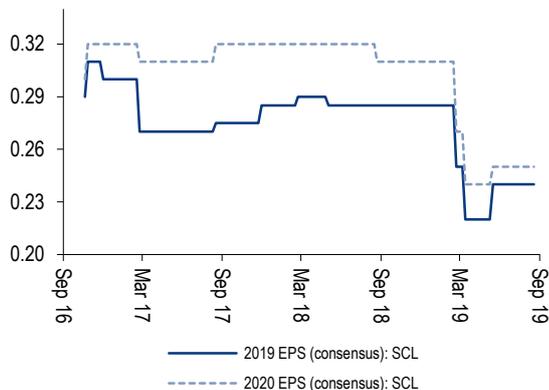
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 10. International Compcos

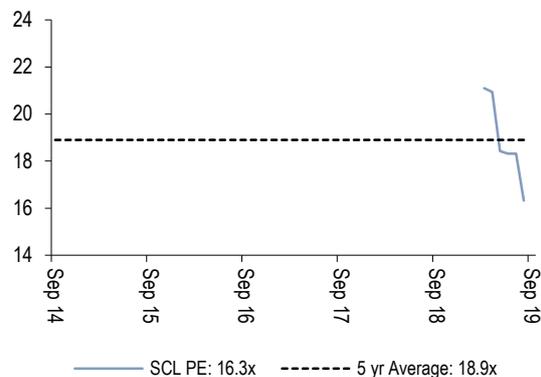
Company <i>(metrics re-weighted to reflect SCL's balance date - December)</i>	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
				2019E	2020E	2019E	2020E	2019E	2020E	
Scales	SCL NZ	NZ\$4.50	NZ\$631	17.3x	15.9x	12.7x	11.5x	15.8x	14.1x	4.4%
Delegat Group *	DGL NZ	NZ\$11.15	NZ\$1,128	21.9x	20.3x	14.0x	13.1x	16.6x	15.5x	1.7%
Sanford *	SAN NZ	NZ\$6.48	NZ\$606	14.1x	11.9x	8.3x	7.1x	11.2x	9.6x	3.5%
New Zealand King Salmon *	NZK NZ	NZ\$2.06	NZ\$285	20.8x	18.7x	10.8x	9.5x	14.6x	13.1x	2.7%
Comvita *	CVT NZ	NZ\$2.76	NZ\$137	<0x	13.0x	<0x	10.0x	<0x	14.3x	1.2%
Fonterra *	FSF NZ	NZ\$3.18	NZ\$5,126	21.2x	10.9x	9.1x	7.7x	16.4x	12.5x	4.7%
T&G Global	TGG NZ	NZ\$2.62	NZ\$321	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Compcos Average:				19.5x	15.0x	10.5x	9.5x	14.7x	13.0x	2.8%
SCL Relative:				-11%	+6%	+21%	+22%	+7%	+9%	+61%

EV = Current Market Cap + Actual Net Debt

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

Figure 11. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 12. 12 Month Forward PE


Source: Forsyth Barr analysis

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