FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | GAMING | CASINO & TOURISM OPERATOR

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SKYCITY
Assessing Closure Risk

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

OUTPERFORM

SKYCITY's (SKC) market capitalisation has fallen by ~NZ$1.2bn since the COVID-19 outbreak took hold in China, substantially larger than our various scenarios of the risk/cashflow impact. We acknowledge newsflow likely gets worse before it gets better (including the possibility of a temporary closure). However, we expect a recovery in gaming spend from any shock and there is no change to its attractive asset base with monopoly long-term casino licences. To put it another way, the NZ$1.85 decline in SKC's share price compares to our estimated casino closure cost of ~NZ$0.07/month.

NZX Code	SKC
Share price	NZ$2.18
Target price	NZ$3.65
Risk rating	Medium
Issued shares	667.2m
Market cap	NZ$1,454m
Avg daily turnover	687.1k (NZ$2,588k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	173.0	82.4	104.2	148.2
EPS* (NZc)	25.6	12.2	15.2	21.2
EPS growth* (%)	0.9	-52.2	24.1	39.6
DPS (NZc)	20.0	15.0	15.0	20.0
Imputation (%)	100	100	100	100

*Based on normalised profits

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	5.5	8.8	7.4	6.2
EV/EBIT	7.4	14.7	11.7	9.2
PE	8.5	17.8	14.4	10.3
Price / NTA	4.1	11.3	6.3	6.3
Cash div yld (%)	9.2	6.9	6.9	9.2
Gross div yld (%)	12.7	9.6	9.6	12.7

Rapid deterioration in the backdrop in recent weeks/days

Our on-the-ground observations over the past week suggest visitation appears to still be healthy ("perhaps a small dent") at SKYCITY Auckland. However, with increasing 'social distancing' protocols we do now expect to see an impact on consumer activity levels, including casino visitation. Temporary casino closure is also now a real risk, in our view.

Assessing closure risk; taking a 'stab' at the short-term impact in forecasts (acknowledging high margin of error)

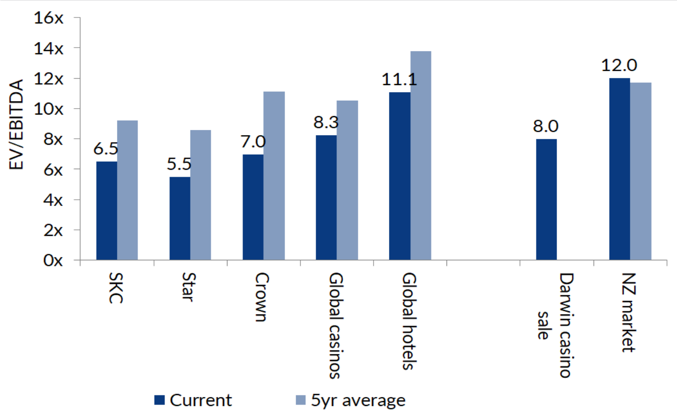
Under a 'worst case' temporary closure (i.e. no revenue or offsets) we estimate cash burn of c. NZ$48m/month. We assess balance sheet capacity could withstand a 6 month closure, although USPP debt (~NZ$341m) adds risk if closure wasn't looked through. We incorporate a period of disruption in our near-term forecasts (2m closure + 3m pressure) and temporary dividend reduction. We are likely to be wrong given the high margin of error but see it is as prudent to incorporate the risk. We also expect there are offsets we haven't incorporated. We view any disruption as temporary and believe SKC's material de-rate more than compensates for risks.

Figure 1. Working through 'worst case' scenarios

	1 month	3 months	6 months
Cash burn (assuming no revenue or offset)			
Fixed opex	(31.1)	(93.4)	(186.8)
Cash interest	(3.7)	(11.0)	(22.0)
Capex	(13.3)	(40.0)	(80.0)
Total	(48.1)	(144.4)	(288.8)
per share	(0.07)	(0.22)	(0.43)
Base level EBITDA (when back to normal)	300.0	300.0	300.0
Prior FY20E net debt	704.9	704.9	704.9
Adjusted net debt for loss over closure period	753.1	849.3	993.7
Net debt to EBITDA	2.5x	2.8x	3.3x

Source: Forsyth Barr analysis

Figure 2. EV/EBITDA vs peers and history



Source: Forsyth Barr analysis, Bloomberg

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SKYCITY Entertainment Group Ltd (SKC)

Priced as at 17 Mar 2020 (NZ$)	2.18

12-month target price (NZ$)*	3.65
Expected share price return	67.4%
Net dividend yield	6.9%
Estimated 12-month return	74.3%

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.99
WACC	8.1%
Terminal growth	1.5%

Profit and Loss Account (NZ$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	998.6	1,011.6	717.9	872.2	1,003.7
Normalised EBITDA	**338.2**	**342.7**	**229.1**	**288.5**	**344.3**
Depreciation and amortisation	(94.4)	(89.9)	(91.4)	(105.7)	(113.2)
Normalised EBIT	**243.8**	**252.8**	**137.7**	**182.8**	**231.1**
Net interest	(12.5)	(10.2)	(21.6)	(38.0)	(25.3)
Associate income	0	0	0	0	0
Tax	(61.5)	(69.6)	(33.7)	(40.5)	(57.6)
Minority interests	0	0	0	0	0
Normalised NPAT	**169.8**	**173.0**	**82.4**	**104.2**	**148.2**
Abnormals/other	(0.3)	(28.4)	253.1	0	0
Reported NPAT	**169.5**	**144.6**	**335.5**	**104.2**	**148.2**
Normalised EPS (cps)	25.4	25.6	12.2	15.2	21.2
DPS (cps)	20.0	20.0	15.0	15.0	20.0

Growth Rates	2018A	2019A	2020E	2021E	2022E
Revenue (%)	6.9	1.3	-29.0	21.5	15.1
EBITDA (%)	5.6	1.3	-33.1	25.9	19.3
EBIT (%)	8.2	3.7	-45.5	32.7	26.4
Normalised NPAT (%)	10.5	1.9	-52.3	26.4	42.2
Normalised EPS (%)	8.5	0.9	-52.2	24.1	39.6
Ordinary DPS (%)	0.0	0.0	-25.0	0.0	33.3

Cash Flow (NZ$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	**338.2**	**342.7**	**229.1**	**288.5**	**344.3**
Working capital change	72.8	19.1	9.6	(13.5)	8.9
Interest & tax paid	(157.4)	(147.2)	(77.3)	(88.6)	(105.0)
Other	0	0	0	0	0
Operating cash flow	**253.6**	**214.5**	**161.4**	**186.5**	**248.2**
Capital expenditure	(261.0)	(320.1)	(361.5)	(156.0)	(183.0)
(Acquisitions)/divestments	(47.3)	224.9	129.0	0	0
Other	0	0	0	0	0
Funding available/(required)	**(54.7)**	**119.3**	**(71.1)**	**30.5**	**65.2**
Dividends paid	(85.1)	(127.1)	(127.1)	0	(139.7)
Equity raised/(returned)	0	(37.3)	(20.0)	0	0
(Increase)/decrease in net debt	**(139.8)**	**(45.0)**	**(218.2)**	**30.5**	**(74.4)**

Balance Sheet (NZ$m)	2018A	2019A	2020E	2021E	2022E
Working capital	(161.7)	(172.4)	(181.9)	(168.5)	(177.4)
Fixed assets	1,498.6	1,436.3	1,541.5	1,606.3	1,542.1
Intangibles	831.8	798.4	784.5	769.9	754.6
Right of use asset	0	0	0	0	0
Other assets	107.2	220.0	115.1	115.1	115.1
Total funds employed	**2,275.9**	**2,282.3**	**2,259.1**	**2,322.8**	**2,234.3**
Net debt/(cash)	433.0	504.3	722.5	692.0	766.4
Lease liability	0	0	0	0	0
Other liabilities	684.8	622.0	621.8	621.8	472.4
Shareholder's funds	1,158.0	1,156.0	914.8	1,009.0	995.5
Minority interests	0	0	0	0	0
Total funding sources	**2,275.9**	**2,282.3**	**2,259.1**	**2,322.8**	**2,234.3**

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

Spot valuations (NZ$)	
1. DCF	3.50
2. Sum of the parts (current)	3.40
3. Sum of the parts (w project upside)	3.92

DCF valuation summary (NZ$m)	
Total firm value	2,771
(Net debt)/cash	(368)
Less: Capitalised operating leases	0
Value of equity	2,403

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	5.4	5.5	8.8	7.4	6.2
EV/EBIT (x)	7.5	7.4	14.7	11.7	9.2
PE (x)	8.6	8.5	17.8	14.4	10.3
Price/NTA (x)	4.5	4.1	11.3	6.3	6.3
Free cash flow yield (%)	-0.5	-7.3	-13.8	2.1	4.5
Net dividend yield (%)	9.2	9.2	6.9	6.9	9.2
Gross dividend yield (%)	12.7	12.7	9.6	9.6	12.7

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	19.5	24.8	6.4	4.8	9.1
Interest cover EBITDA (x)	27.1	33.6	10.6	7.6	13.6
Net debt/ND+E (%)	27.2	30.3	44.1	40.7	43.5
Net debt/EBITDA (x)	1.3	1.5	3.1	2.4	2.2

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	9.6	9.9	5.5	7.1	9.2
Return on equity (%)	14.7	15.0	9.0	10.3	14.9
Return on funds employed (%)	11.9	11.1	5.9	7.9	9.6
EBITDA margin (%)	33.9	33.9	31.9	33.1	34.3
EBIT margin (%)	24.4	25.0	19.2	21.0	23.0
Capex to sales (%)	26.1	31.6	50.4	17.9	18.2
Capex to depreciation (%)	318	418	466	171	187
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	79	78	123	99	94

Operating Performance	2018A	2019A	2020E	2021E	2022E
Total revenue (incl gaming GST)					
Auckland	584.60	606.60	501.45	596.97	655.99
Hamilton	60.70	61.80	54.20	62.86	67.44
Other NZ	13.00	13.20	11.79	13.71	14.72
Adelaide (A$)	149.00	148.70	123.78	156.98	186.00
Darwin (A$)	110.80	83.30	0	0	0
IB	160.30	190.50	94.50	122.51	169.08
Revenue (incl gaming GST)	**1,101.02**	**1,118.96**	**791.63**	**960.95**	**1,104.86**
EBITDA breakdown					
Auckland	260.70	267.90	229.26	263.63	292.74
Hamilton	26.90	26.90	17.91	25.66	29.30
Other NZ	2.10	2.30	0.67	2.37	3.16
Adelaide (A$)	22.50	21.00	14.39	29.08	34.35
Darwin (A$)	25.10	19.00	0	0	0
IB	32.60	41.70	10.22	12.38	32.49
Corporate costs	(33.00)	(34.70)	(38.00)	(39.90)	(41.90)
Other	(2.84)	(3.96)	(6.00)	(6.18)	(8.00)
Total EBITDA	**338.2**	**342.7**	**229.1**	**288.5**	**344.3**
NZDAUD	0.92	0.94	0.95	0.95	0.94
Capitalised interest	22.90	30.32	22.03	10.00	22.00

Assessing the risk vs market pricing

The world has changed dramatically over the past week or so — we are now in uncharted territory. The key risk to SKC is the domestic backdrop and ultimately consumer behaviour (which could be dictated by containment/self-quarantine measures). We don't profess to be able to forecast the pace or extent of the spread of COVID-19 or government responses, particularly 'social distancing' policies. However, we do now expect to see an impact on consumer activity levels, including casino visitation. The possibility of temporary casino closures cannot also be ruled out.

SKC's market capitalisation has fallen by ~NZ$1.2bn since the COVID-19 outbreak took hold in China. This is substantially larger than our various scenarios of the risk/cashflow impact. We expect a recovery in gaming spend from any shock, and this could also be aided by government stimulus measures. Nonetheless, we expect newsflow may get worse before it gets better.

Observations to date

What we have observed so far is visitation still appears healthy, albeit potentially a "small dent", at SKYCITY Auckland. Closures/restrictions have started in offshore markets, while Australian casino operators are doing their best to remain open by introducing voluntary 'social distancing' (capacity reduction). Things are evolving quickly so we will continue to monitor the situation.

Global casino response to date — temporary restrictions/closures

- Macau casinos were forced to close for 15 days in February. Gross gambling revenue was down -87.8% YoY for February 2020.
- A number of casinos in the US have temporarily shut including all casinos in Las Vegas. Timelines are unclear and will no doubt be reassessed along the way.
- Both Star and Crown have just announced restrictive 'social distancing' policies. This includes (1) deactivation of every second gaming machine and electronic table game; (2) restricting player numbers and distancing patrons at seated table games; (3) restricting patrons in various food & beverage and conference facilities.

Our observations on the ground at SKYCITY Auckland during multiple visits over the past week

- A hand sanitiser station was installed at the casino entrance over the weekend.
- Our observations and anecdotes suggest casino visitation has been broadly consistent with usual levels over the past week, with suggestions of only slight weakness. Demographic mix appears consistent with history.
- Restaurants/bars in the broader precinct were busy/near peak capacity over the weekend (13/14 March).

Scenarios on closure risk

Under a worst case scenario (i.e. no revenue or offsets) we estimate cash burn of c. NZ$48m per month for SKC. We assume a large portion of SKC's costs are fixed (estimate c. 70%) and this doesn't factor in any offset or scaling back. Another reference point is the closure of the Auckland casino for ~3 days in 1H20 impacted gross profit (and we expect EBITDA) by NZ$1.6m or NZ$0.5m/day.

SKC's share price has declined ~NZ$1.2bn since the initial COVID-19 outbreak in China. This appears out of step with the risks. Even if we see a mandated closure, SKC has current balance capacity to support a closure of six months (or potentially up to nine months at a stretch, by our assessment). The key risk is SKC's USPP debt (~NZ$341m). We are unsure of the exact covenants, however, expect any meaningful closure (>2 months) would create issues for rolling 12m EBITDA assuming the closure situation was not looked through. There is some risk a capital raise would be required to resolve this.

Figure 3. Working through potential closure scenarios

	1 month	3 months	6 months	12 months
Cash burn (assumes no revenue or offsets and no scaling back of fixed costs)				
Fixed opex (excludes gaming tax, marketing and modest variable costs across other areas)	(31.1)	(93.4)	(186.8)	(373.6)
Cash interest	(3.7)	(11.0)	(22.0)	(44.0)
Capex	(13.3)	(40.0)	(80.0)	(160.0)
Total	(48.1)	(144.4)	(288.8)	(577.6)
Base level EBITDA (when back to normal)	300.0	300.0	300.0	300.0
Prior FY20E net debt	704.9	704.9	704.9	704.9
Adjusted net debt for loss over closure period	753.1	849.3	993.7	1,282.5
Net debt to EBITDA	2.5x	2.8x	3.3x	4.3x

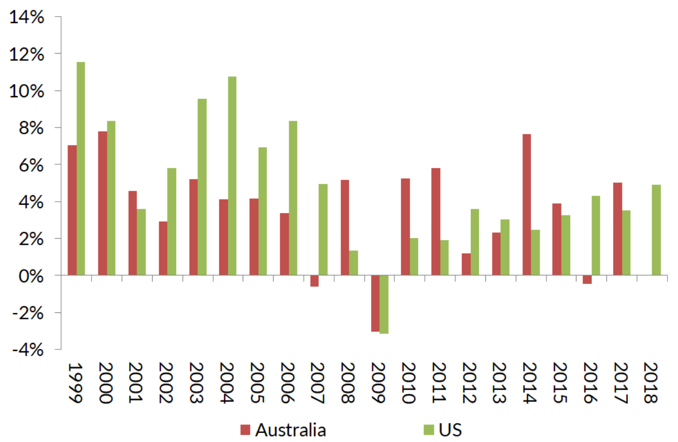
Source: Forsyth Barr analysis

Casino spend has been largely resilient historically

Data through history across multiple geographies suggests gaming spend has been somewhat resilient through the cycle, with no obvious boom or bust cycles, albeit not recession proof or immune to a slowdown. During the GFC spending declines in casino and gaming spend across various markets were broadly within the -5% to -10% range. VIP spend is considerably more volatile (and reliant on international tourists being able to land in their private jets, particularly from China).

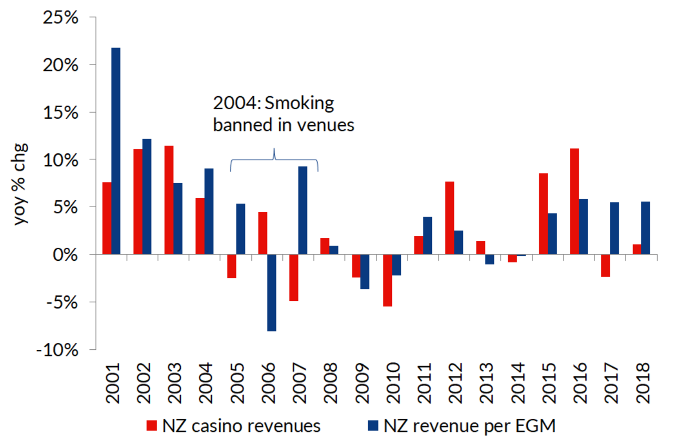
Government stimulus measures can also be supportive to a recovery in spend from any shock.

Figure 4. Australia and US gaming revenue YoY growth



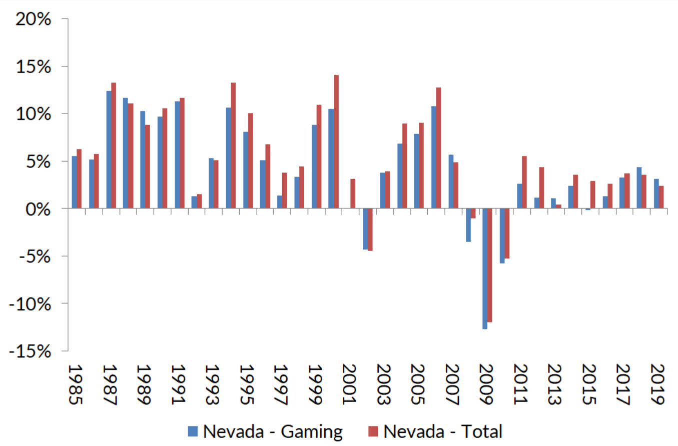
Source: Forsyth Barr analysis

Figure 5. NZ gaming and casino revenue through the cycle



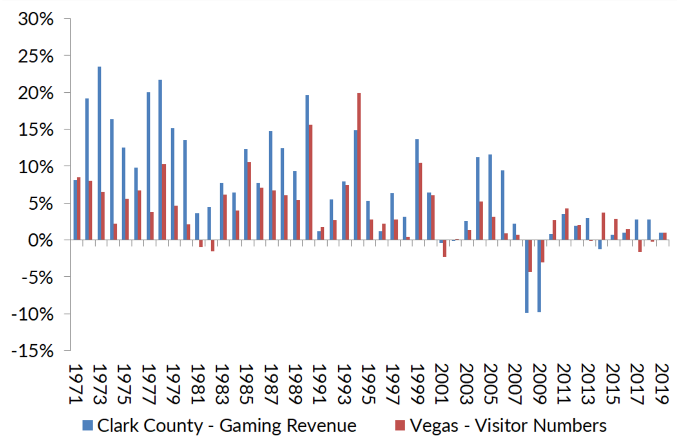
Source: Forsyth Barr analysis

Figure 6. Nevada YoY growth in gaming and total spending



Source: Forsyth Barr analysis

Figure 7. Vegas YoY growth in gaming and visitor numbers



Source: Forsyth Barr analysis

Earnings revisions

Acknowledging significant limitations in forecasting the current situation, we have put through short-term earnings downgrades to take into consideration the potential risks. We will likely be wrong, particularly given it is contingent on factors which are near impossible to forecast, including the pace or extent of the spread of COVID-19 and NZ/Australian government responses.

We have assumed (1) a two month closure of operations and (2) three months of restrictions, over FY20/21E. Our scenario during the closure period is what we consider a 'worst case', with no revenue, no offsets and assuming no reduction in fixed costs. We expect there are a number of levers that could ultimately drive a better result than this, including (1) driving some revenue from its hotels from materially lower room rates; (2) any cost-out initiatives; (3) any government support. We also assume a temporary dividend cut during our assumed pressure period to ensure balance sheet flexibility. We assume earnings return to 'normal' (i.e. our original expectations) thereafter, with our 2H21E/FY22E EBITDA forecast largely unchanged.

We lower our target price to NZ$3.65 (prior NZ$3.80) which accounts for our assumed period of disruption/closure, including the cash impact of losses during our assumed two month closure period.

Figure 8. Earnings revisions — incorporating a temporary closure into our base case

	FY19A		FY20E			FY21E			FY22E	
NZ$m	**Actual**	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**
Total revenue excl gaming GST	1,011.6	864.9	717.9	-17.0%	946.1	872.2	-7.8%	1,003.2	1,003.7	0.1%
Normalised EBITDA	**342.7**	**287.8**	**229.1**	**-20.4%**	**318.8**	**288.5**	**-9.5%**	**343.7**	**344.3**	**0.2%**
Normalised profit	173.0	122.5	82.4	-32.7%	124.4	104.2	-16.2%	143.5	148.2	3.2%
Normalised EPS (cps)	25.6	18.2	12.2	-32.7%	18.1	15.2	-16.2%	20.6	21.2	3.2%
Dividend per share (cps)	20.0	20.0	15.0	-25.0%	20.0	15.0	-25.0%	20.0	20.0	0.0%

Source: Forsyth Barr analysis

Investment Summary

SKYCITY (SKC) is one of the largest gaming operators in Australasia. Earnings and valuation are driven by Auckland, which makes up ~70% of group EBITDA. SKC has two major growth projects underway in Auckland and Adelaide which are large, complex, and challenging, but directly relate to its core expertise. Valuation levels are attractive, more than compensating for the risks. OUTPERFORM.

Business quality

- **Monopoly assets:** SKC has a casino monopoly in all its markets and significant term on its exclusive casino licences.
- **Increasingly capital intensive platform**, given a fairly mature industry and a need to continually diversify and refresh its offering to retain relevance and drive visitation.

Earnings and cashflow outlook

- **Earnings outlook:** EBITDA and cashflow are our preferred metrics to monitor, with complexity through NPAT given the project and NZICC fire accounting. We expect a lacklustre near-term underlying EBITDA profile, with upside as major projects are completed. We see near-term downside risk from 'social distancing' policies in response to COVID-19 or potential for temporary casino closures. In the medium-term we see areas of upside risk.
- **Project execution:** Two major capital projects are underway in Auckland and Adelaide. Achieving a satisfactory return on capital is the challenge given the substantial capital being spent. Adelaide in particular raises questions given perennial disappointment from the property through history.

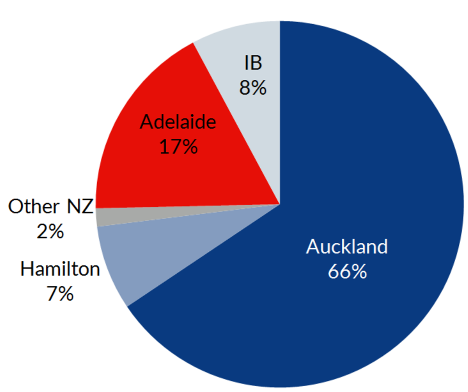
Financial structure

- **Gearing:** SKC has committed to a BBB- credit rating and 'efficient capital allocation' is a key strategic priority. There are a number of moving parts influencing gearing with capex for its two capital projects, asset divestments (carparks, Darwin), COVID-19 'social distancing' policies and future growth plans to build out destination precincts surrounding its casinos.
- **Yield:** SKC offers a solid dividend yield with upside risk after project completion. We see risk of a short-term dividend suspension should we see a temporary casino closure.

Risk factors

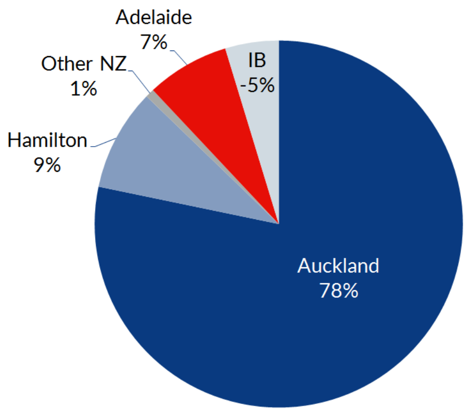
- **Gaming regulation:** Unexpected regulatory and taxation changes.
- **Mature local gaming market:** The local grind gaming market is not only mature but vulnerable to changing entertainment spending patterns.

Figure 9. Revenue breakdown FY19 (cont. operations)



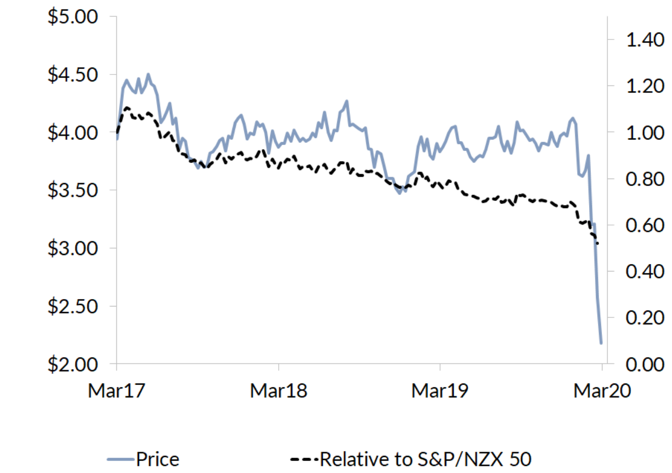
Source: Forsyth Barr analysis, company reports

Figure 10. EBITDA breakdown FY19 (cont. operations)



Source: Forsyth Barr analysis, company reports

Figure 11. Price performance



Source: Forsyth Barr analysis

Figure 12. Substantial shareholders

Shareholder	Latest Holding
Sumitomo Mitsui Trust Holdings	10.0%
Lazard	8.5%
Commonwealth Bank of Australia	8.2%
BlackRock Investment Management	7.1%
Investor Mutual	7.1%
Colonial First State	5.4%

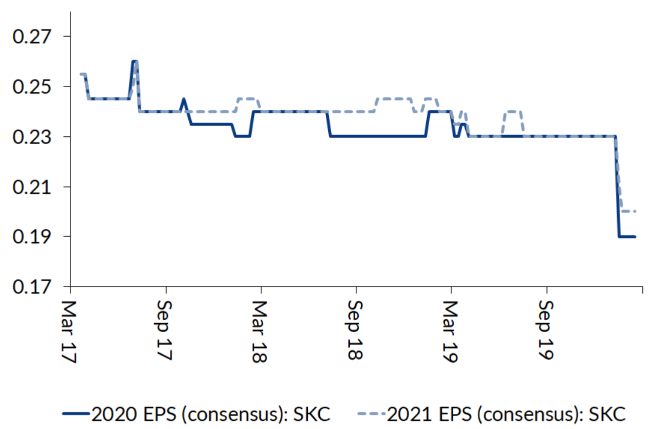
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 13. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect SKC's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
SKYCITY	**SKC NZ**	**NZ$2.18**	**NZ$1,454**	**17.8x**	**14.4x**	**8.5x**	**6.8x**	**14.2x**	**10.7x**	**6.9%**
CROWN RESORTS	CWN AT	A$7.16	A$4,848	15.5x	15.9x	7.2x	6.9x	11.7x	12.1x	8.4%
TABCORP HOLDINGS	TAH AT	A$2.67	A$5,408	14.5x	14.1x	8.4x	8.3x	12.9x	12.5x	7.9%
STAR ENTERTAINMENT GRP/T	SGR AT	A$2.08	A$1,908	8.4x	8.2x	5.8x	5.4x	10.0x	8.3x	9.9%
GENTING MALAYSIA BHD	GENM MK	RM2.10	RM11,856	10.2x	10.4x	5.8x	5.6x	9.7x	9.5x	7.7%
KANGWON LAND INC	035250 KS	KRW19800.00	KRW4,236,022	12.2x	10.5x	5.0x	4.5x	5.2x	4.9x	4.9%
			Compco Average:	**12.2x**	**11.8x**	**6.4x**	**6.1x**	**9.9x**	**9.5x**	**7.7%**
EV = Current Market Cap + Actual Net Debt			**SKC Relative:**	**46%**	**21%**	**33%**	**10%**	**43%**	**13%**	**-11%**

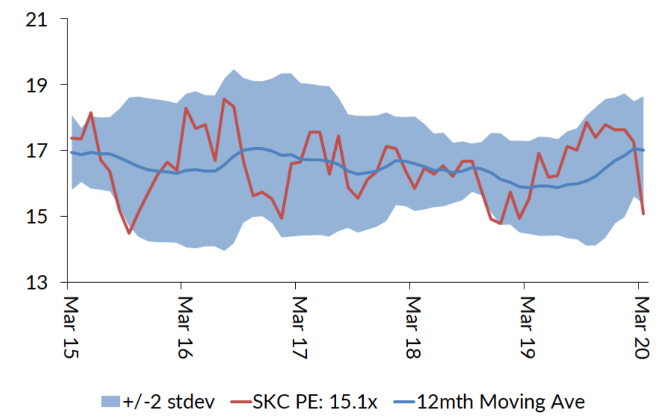
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (SKC) companies fiscal year end

Figure 14. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 15. One year forward PE (x)



Source: Forsyth Barr analysis

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