

Skellerup Holdings

Rubber Meets the Road – Re-initiate as OUTPERFORM

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OUTPERFORM

We re-initiate on Skellerup Holdings (SKL) with an OUTPERFORM rating and an NZ\$2.40 target price. SKL is trading at a discount to the market (14x 12 month forward PE) and offers investors an attractive dividend yield backed by a strong balance sheet. SKL is an industrial manufacturer with large industry exposures to the dairy, potable and waste water, and infrastructure sectors. The Industrial division offers medium-term upside as it targets (1) increased exposure to the OEM (original equipment manufacturer) channel, and (2) EBIT margin expansion through improved pricing and operational efficiencies. Its Agri division is facing headwinds in domestic markets, which it aims to offset through growth into lower margin international markets. We see earnings risk in the near-term in the face of a cyclical downturn, but conservative gearing and low capex model provides some flexibility during periods of short-term turbulence or cash flow timing variability.

NZX Code	SKL	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$2.04	NPAT* (NZ\$m)	29.1	26.2	27.3	28.5	EV/EBITDA	8.8	8.7	8.4	8.1
Target price	NZ\$2.40	EPS* (NZc)	14.9	13.5	14.0	14.6	EV/EBIT	10.3	11.0	10.6	10.2
Risk rating	Medium	EPS growth* (%)	5.5	-9.7	3.9	4.3	PE	13.7	15.1	14.6	14.0
Issued shares	194.8m	DPS (NZc)	13.0	13.0	13.0	13.5	Price / NTA	3.1	3.1	3.0	2.9
Market cap	NZ\$397m	Imputation (%)	50	50	50	50	Cash div yld (%)	6.4	6.4	6.4	6.6
Avg daily turnover	146.4k (NZ\$320k)	*Based on normalised profits					Gross div yld (%)	7.6	7.6	7.6	7.9

Earnings exposure more resilient than it has been in the past

COVID-19 and the ensuing economic fallout add additional uncertainty to SKL's outlook. However, the company's earnings exposure is more defensive to a recessionary environment than it has been in the past, in our view. SKL has reduced its exposure to commodity markets, and we suspect the portion of its Agri business earnings driven by capital projects are now lower, with dairy conversions at a low. Whilst a cyclical element remains, SKL may benefit from increased fiscal stimulus targeted at aged water infrastructure, partially offsetting a downturn in other sectors. In addition, the bulk of SKL's Agri business is in consumable products for use in the global dairy industry.

Targeting growth through OEM contract wins and margin expansion

SKL is targeting growth through its Industrial division, leveraging its technical expertise in polymer compounds and manufacturing to solve specific component production challenges for OEM (original equipment manufacturer) customers. OEM growth represents a capital light growth model with an element of customer lock-in enabling more earnings stability. We expect to see some margin contraction near-term as a result of COVID-19 disruption, with margin recovery and longer term expansion to be achieved through changes to product mix and cost driven efficiencies.

Balance sheet strength provides support to attractive dividend yield

SKL is post investment cycle and is more conservatively geared than the last cycle. Its strong balance sheet provides flexibility to support its dividend during periods of short-term turbulence or customer project delays and the ability to pursue opportunistic acquisitions.

Skellerup Holdings (SKL)

Priced as at 16 Jun 2020 (NZ\$)

2.04

12-month target price (NZ\$)*	2.40
Expected share price return	17.6%
Net dividend yield	6.4%
Estimated 12-month return	24.0%

Spot valuations (NZ\$)	
1. DCF	2.20
2. Relative valuation	2.40
3. n/a	n/a

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	1.10
WACC	8.7%
Terminal growth	1.5%

DCF valuation summary (NZ\$m)	
Total firm value	429
(Net debt)/cash	(37)
Less: Capitalised operating leases	(61)
Value of equity	332

Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	240.4	245.8	242.6	249.0	258.0
Normalised EBITDA	47.2	48.9	49.7	50.9	52.5
Depreciation and amortisation	(7.5)	(7.1)	(10.7)	(10.6)	(10.6)
Normalised EBIT	39.8	41.8	39.0	40.3	42.0
Net interest	(1.9)	(1.8)	(2.0)	(1.9)	(1.9)
Associate income	0	0.0	0	0	0
Tax	(10.6)	(11.0)	(10.7)	(11.2)	(11.6)
Minority interests	0	0	0	0	0
Normalised NPAT	27.3	29.1	26.2	27.3	28.5
Abnormals/other	0	0	0	0	0
Reported NPAT	27.3	29.1	26.2	27.3	28.5
Normalised EPS (cps)	14.1	14.9	13.5	14.0	14.6
DPS (cps)	11.0	13.0	13.0	13.0	13.5

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	9.1	8.8	8.7	8.4	8.1
EV/EBIT (x)	10.8	10.3	11.0	10.6	10.2
PE (x)	14.4	13.7	15.1	14.6	14.0
Price/NTA (x)	3.1	3.1	3.1	3.0	2.9
Free cash flow yield (%)	5.8	6.1	9.0	8.3	7.9
Net dividend yield (%)	5.4	6.4	6.4	6.4	6.6
Gross dividend yield (%)	7.2	7.6	7.6	7.6	7.9

Growth Rates	2018A	2019A	2020E	2021E	2022E
Revenue (%)	14.3	2.2	-1.3	2.6	3.6
EBITDA (%)	16.2	3.6	1.5	2.5	3.2
EBIT (%)	21.1	5.1	-6.7	3.3	4.1
Normalised NPAT (%)	23.2	6.5	-9.7	3.9	4.3
Normalised EPS (%)	23.2	5.5	-9.7	3.9	4.3
Ordinary DPS (%)	15.8	18.2	0.0	0.0	3.8

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	21.4	23.4	19.3	21.5	22.6
Interest cover EBITDA (x)	25.4	27.4	24.6	27.1	28.3
Net debt/ND+E (%)	15.1	17.0	14.3	12.6	11.5
Net debt/EBITDA (x)	0.7	0.7	0.6	0.5	0.5

Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	47.2	48.9	49.7	50.9	52.5
Working capital change	(3.8)	(8.5)	3.7	0.1	(2.6)
Interest & tax paid	(15.1)	(11.5)	(12.8)	(13.0)	(13.5)
Other	0	0	0	0	0
Operating cash flow	28.3	28.9	40.6	37.9	36.4
Capital expenditure	(5.4)	(4.6)	(5.0)	(5.1)	(5.2)
(Acquisitions)/divestments	0.9	(8.2)	0	0	0
Other	0	0	(3.6)	(3.7)	(3.8)
Funding available/(required)	23.8	16.2	32.0	29.2	27.5
Dividends paid	(19.3)	(24.3)	(25.3)	(25.3)	(25.3)
Equity raised/(returned)	0	2.4	0	0	0
(Increase)/decrease in net debt	4.5	(5.7)	6.7	3.8	2.1

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	15.8	16.3	14.3	14.7	15.2
Return on equity (%)	15.8	16.3	14.6	15.0	15.4
Return on funds employed (%)	14.4	14.5	13.1	13.7	14.3
EBITDA margin (%)	19.6	19.9	20.5	20.4	20.4
EBIT margin (%)	16.5	17.0	16.1	16.2	16.3
Capex to sales (%)	2.3	1.9	2.1	2.0	2.0
Capex to depreciation (%)	73	64	47	48	49
Imputation (%)	86	50	50	50	50
Pay-out ratio (%)	78	87	96	93	92

Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Working capital	67.9	76.1	72.4	72.4	74.9
Fixed assets	93.4	91.3	89.4	87.7	86.3
Intangibles	46.0	49.5	49.5	49.5	49.5
Right of use asset	0	0	19.0	19.5	20.0
Other assets	6.4	7.6	7.6	7.6	7.6
Total funds employed	213.6	224.4	237.8	236.6	238.3
Net debt/(cash)	30.7	36.6	29.9	26.0	23.9
Lease liability	0	0	16.2	16.9	17.5
Other liabilities	10.6	9.5	12.4	12.4	12.4
Shareholder's funds	172.3	178.4	179.3	181.3	184.4
Minority interests	0	0	0	0	0
Total funding sources	213.6	224.4	237.8	236.6	238.3

Operating Performance	2018A	2019A	2020E	2021E	2022E
Revenue by segment					
Agri	89.0	88.8	88.8	90.5	92.3
Industrial	151.5	157.2	154.0	158.7	165.8
Total revenue (incl. eliminations)	240.4	245.8	242.6	249.0	258.0
EBIT by segment					
Agri	22.8	22.8	22.6	22.6	22.6
Industrial	20.8	22.9	20.0	21.4	23.2
Total EBIT (incl. overheads)	39.8	41.8	39.0	40.3	42.0
EBIT margin by segment					
Agri (%)	25.6	25.7	25.5	25.0	24.5
Industrial (%)	13.7	14.6	13.0	13.5	14.0
Total (%)	16.5	17.0	16.1	16.2	16.3

OUTPERFORM

We re-initiate coverage on Skellerup (SKL) with an OUTPERFORM rating and a 12-month target price of NZ\$2.40.

Skellerup (SKL) – A brief description

SKL develops, manufactures, and distributes technical rubber products and vacuum pump systems. The company owns and operates a number of key brands across various sectors with products sold globally. SKL has two key operating segments:

- **Agri** – Design and production of a range of essential dairy consumables including liners, tubing, and filters. Within Agri is SKL's footwear business which produces the Red Band gumboot and a range of specialist safety boots.
- **Industrial** – Develops and manufactures specialist products and components, and vacuum pump systems. Products are generally critical components used in a broad range of applications. Water & waste, and Roofing makes more than half of Industrial revenue.

Investment summary

SKL is trading on undemanding multiples (14x forward PE ratio) and offers an attractive dividend yield in a low interest rate environment. Although earnings and therefore dividend risk exists, we view its current trading metrics as attractive given 1) its earnings are more defensive to a change in economic backdrop than it has been in the past, 2) current share price attributes little earnings growth, limiting downside from strategy execution missteps, and 3) conservatively geared balance sheet.

The Industrial division offers medium-term earnings growth upside as it targets 1) increased exposure to OEMs (original equipment manufacturers), and 2) EBIT margin expansion through improved pricing and operational efficiencies. Its Agri division is facing growth headwinds in domestic markets, which it aims to offset through growth into lower margin international markets. We see earnings risk in the near-term in the face of a cyclical downturn but a conservative balance sheet and low capex growth model provides some flexibility during periods of short-term turbulence or contract timing variability.

What we like

- **Attractive valuation** – SKL is trading at a record discount to the New Zealand market, 14x 12 month forward PE versus the market median at 24x. In addition, its forecast 6.5% cash dividend yield is attractive in a low interest rate environment. We note earnings risk, although see growth avenues as improving industry/business exposure and a strong balance sheet to support short term volatility.
- **Improving earnings exposure** – SKL's earnings exposure is more resilient to a recessionary environment than it has been in the past, in our opinion. Recent growth has been led by OEM business, which tends to be stickier with less customer churn, while industry exposure has expanded with a focus on health care and potable water. The high regulatory standards of these industries creates natural barriers to entry.
- **OEM margin expansion** – SKL is targeting margin expansion through its Industrial division, leveraging its technical strength in polymer compounds, agility in product/process development, and manufacturing expertise to solve specific component production challenges for OEM customers.
- **Agri market position** – SKL is a market leader in the global dairy industry, and counts international competitors amongst its customers, highlighting the strength of its products. The quasi consumable nature of its Agri products provides some protection against short-term downturns.

What we don't like

- **Limited transparency** – The nature of OEM business means both the size and timing of business is difficult to forecast. In addition, SKL produces a number of different product lines, with a wide range of sector exposure.
- **Exposure to commodity markets** – A portion of SKL's earnings are exposed to commodity markets (e.g. oil & gas, dairy, iron ore). This has led to significant earnings volatility in the past during periods of market correction in commodity prices.
- **Slowing dairy markets** – We suspect the Australasian market is close to peak cow (environmental limits) and therefore see downside risk to SKL's largest market.

Risk weighting medium

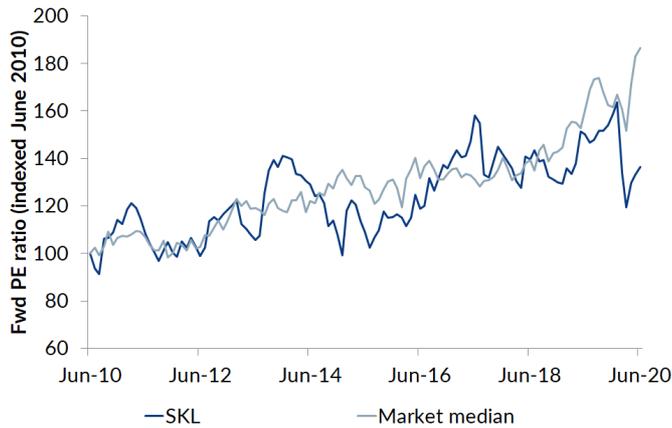
We apply a medium risk weighting. SKL has earnings exposure to a number of commodity driven industries, which in the past have led to periods of earnings volatility. Over time diversification of SKL's business lines into more OEM driven business and consumable products has reduced earnings volatility. Key risks include:

- **Global trade** – SKL develops products in multiple locations, including China and Vietnam, with exports to the US, Europe, and Asia. Rising trade tensions could lead to disruption of SKL's operations and reduce price competitiveness.
- **FX** – SKL's earnings are increasingly internationally driven, with higher exposure to swings in currency.
- **Commodity prices** – Whilst diversification has occurred, SKL still has reasonable exposure to both the milk and oil price. Fluctuations in these commodity prices can impact earnings.

Attractive valuation

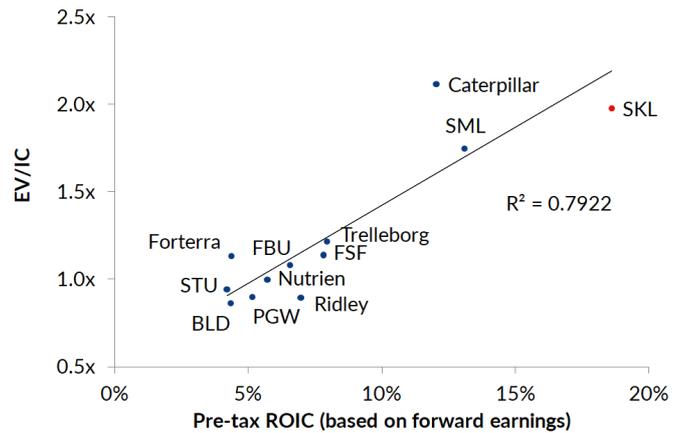
SKL is trading on attractive valuation multiples (14x forward PE), and at a record discount relative to the market (~40% vs 10 year average of ~25%). Although we note direct peer comparisons are difficult given the diverse nature of the business, SKL has lagged recent peer performance (Figure 3, we use a 2 year forward multiple in attempt to look through COVID-19 related distortions).

Figure 1. SKL fwd PE ratio vs the market



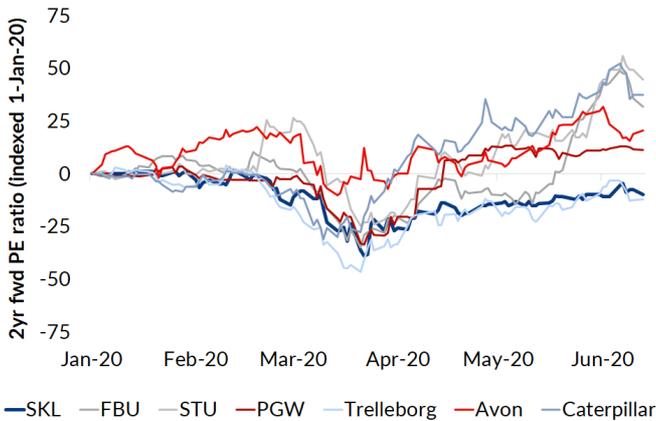
Source: Bloomberg, Forsyth Barr analysis

Figure 2. EV vs. ROIC



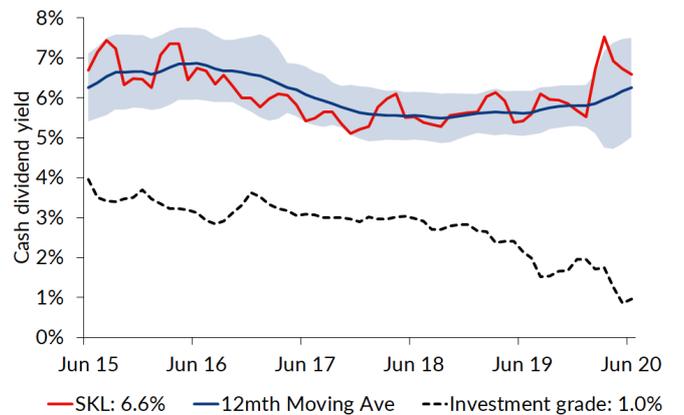
Source: Bloomberg, Forsyth Barr analysis

Figure 3. SKL forward PE ratio vs peers



Source: Bloomberg, Forsyth Barr analysis

Figure 4. SKL cash yield vs investment grade yield

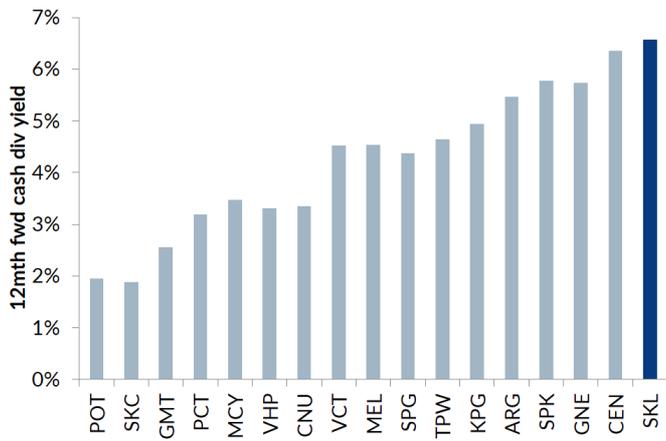


Source: Bloomberg, Forsyth Barr analysis

Attractive dividend

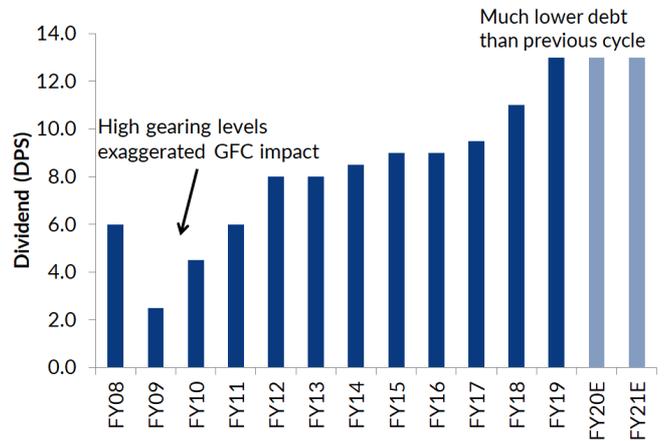
SKL's current cash dividend yield is 6.5%. SKL's dividend yield premium relative to investment grade yield and defensive yield stocks has expanded over the last 12 months (Figure 4). Balance sheet headroom (net debt/EBITDA 1.2x), limited capex requirements (capex 2.0% of sales), and a solid, free cash flow yield provide some support against a short term downturn or timing issues with new business. Whilst earnings risk exists, we note that SKL's earnings exposure is more resilient to a recessionary environment than it has been in the past, and view growth avenues as improving industry exposure.

Figure 5. 12-month forward cash dividend yield (FB)



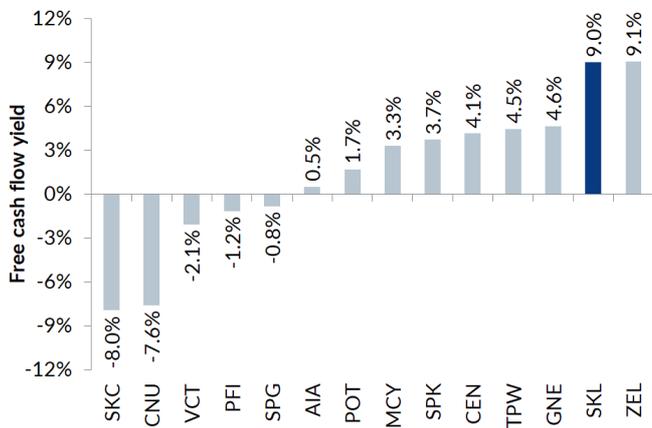
Source: Bloomberg, Forsyth Barr analysis

Figure 6. Strong track record of growing dividends



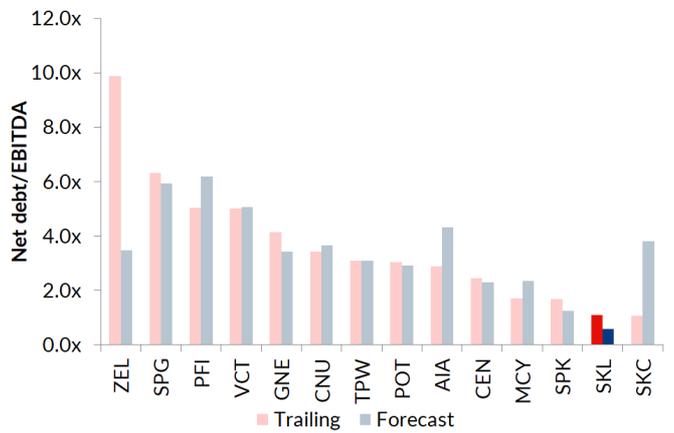
Source: Bloomberg, Forsyth Barr analysis

Figure 7. 12-month forward free cash flow yield (consensus)



Source: Bloomberg, Forsyth Barr analysis

Figure 8. Net debt / EBITDA (consensus)



Source: Bloomberg, Forsyth Barr analysis

Improving stability of earnings

COVID-19 and the ensuing economic fallout add additional uncertainty to SKL's outlook. In our view the company's earnings exposure is more resilient to a recessionary environment than it has been in the past. In addition, its strong balance sheet provides flexibility to support its dividend yield during periods of short-term turbulence or variability in cash flow timing and ability to pursue opportunistic acquisitions.

COVID-19 related impacts

As at 1H20, COVID-19 was yet to have a meaningful impact on SKL's business, with earnings tracking ahead of the prior year period. Whilst we expect the various lockdown policies across its manufacturing markets (New Zealand, China, Vietnam, Italy, and the UK) to have reduced operating capacity, this was likely to have been limited and only a temporary impact. Of greater concern is the impact to end customer demand.

- We view earnings from the oil & gas sector as most at risk near term, which we estimate represent c. 5% of earnings. Oil prices have collapsed in response to a supply battle between major producers in combination with a lower demand outlook, which is likely to weigh on US fracking production. SKL's vacuum pump systems are used in the transportation of water to fracking sites in the Permian Basin and Eagle Ford; however, earnings were already at suppressed levels as a result of the US-China trade tariffs.
- Growth opportunities from new/additional OEM (original equipment manufacturer) products are likely to experience a short-term delay, in our opinion, as a result of COVID-19 disruption.
- SKL operates in a number of sectors exposed to cyclical downturns, including automotive and construction, representing c. 20% of FY19 revenue. We suspect these sectors may come under pressure over the medium-term.
- Providing some positive offset is SKL's exposure to potable and waste water (c. 35% revenue). Fiscal stimulus targeted at aged water infrastructure would be a tailwind for earnings.

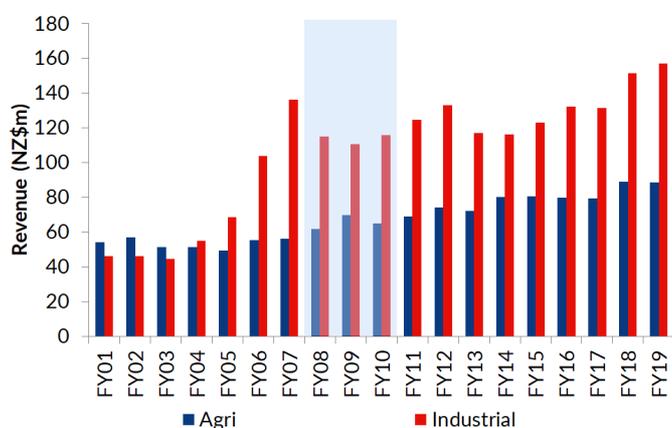
We have made negative revisions to earnings reflecting COVID-19 disruption and related economic uncertainty. We outline those changes in the Valuation section on page 18 of this report.

Global Financial Crisis look through

Post COVID-19, and as the global economy enters a recessionary environment, parallels to the global financial crisis (GFC) become more relevant.

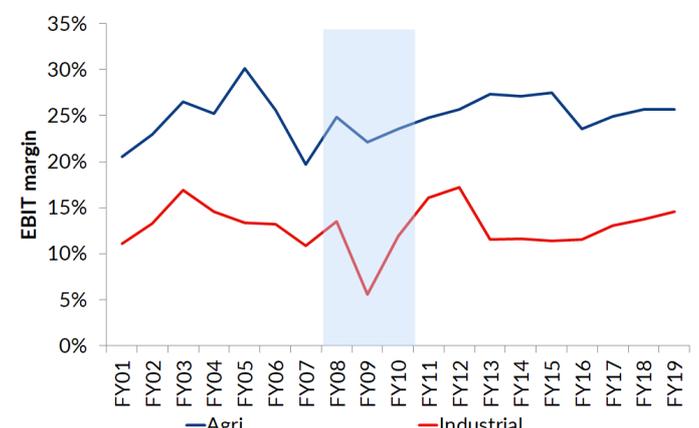
- Agri – The Agri business was relatively defensive through the GFC with earnings predominantly driven by the manufacture and distribution of essential consumable products, such as liners and tubing for use in the dairy industry. Weak global milk price weighed on farm capital expenditure.
- Industrial – Demand conditions across a range of industrial technical polymer products softened. Products exposed to commodity markets such as iron ore experienced a sharp decline and weighed significantly on EBIT margin.

Figure 9. SKL revenue profile



Source: Company reports, Forsyth Barr analysis

Figure 10. SKL EBIT margin



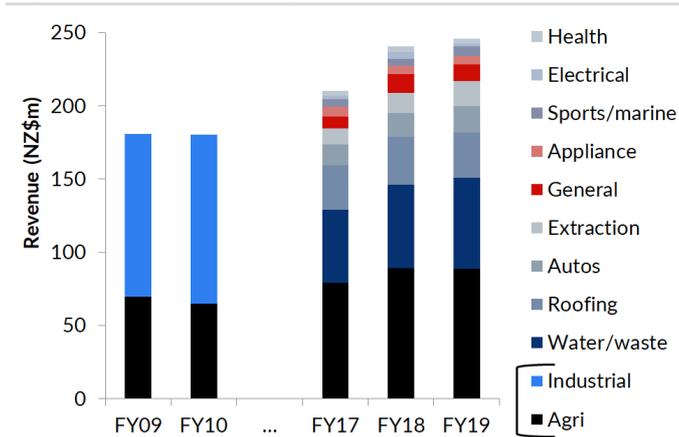
Source: Company reports, Forsyth Barr analysis

Earnings exposure improved; Operating model changed

SKL has been targeting more resilient earnings streams through its focus on Original Equipment Manufacturer (OEM) customers whilst also decreasing its business exposure to markets driven by commodity prices, such as iron ore and oil. In addition, commodity prices were significantly higher ahead of the last economic downturn. SKL's operating model has improved, embedding itself into the OEM production process, supplying often critical products. We expect this to translate to a stickier customer relationship and more robust earnings streams. Counter cyclical earnings support may also exist through opportunities in potable water, where fiscal stimulus could provide an uplift should countries invest into improving aged water infrastructure.

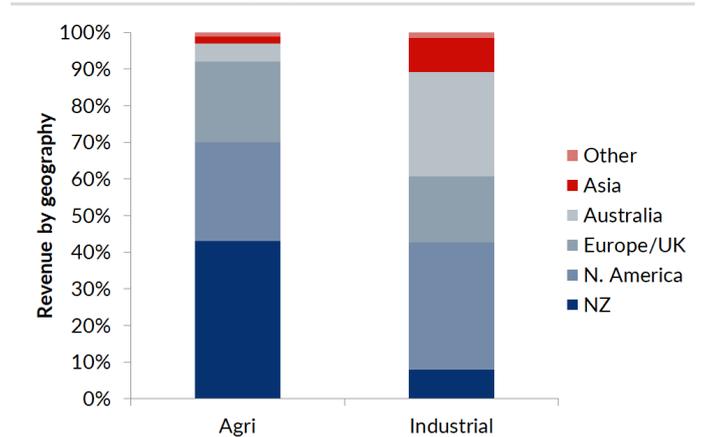
Half of SKL's earnings are derived through its Agri business, with the quasi consumable nature of its Agri products providing some protection against short-term downturns. SKL is a market leader in the Australasian dairy industry and counts international competitors amongst its customers, highlighting the strength of its products. Although on farm capital spend remains a driver of sector earnings, we suspect capital goods as a portion of total sales is lower than prior cycles with less dairy conversion occurring.

Figure 11. Revenue by category



Source: Company reports, Forsyth Barr analysis

Figure 12. Revenue by geography



Source: Company reports, Forsyth Barr analysis

Earnings becoming more defensive...

OEM (original equipment manufacturer) business tends to be stickier with less customer churn and can offer more stable cash flows. A long design journey and embedded processes create an element of customer lock in.

- **Long design journey** – Issue identification through concept to tooling and ultimately manufacturing is a long process. This time loss creates a significant incentive for customers to not switch providers regularly.
- **Chemistry is difficult to reverse engineer** – Many of SKL's products contain innovative use of compounds to successfully meet the challenge faced by the OEM. These compounds can be difficult to reverse engineer, creating a competitive moat.

Expertise in food safety standards and medical applications creates competitive advantage

Specific target industries such as potable water, dairy, and healthcare are subject to strict health safety regulations. These can act as a barrier to entry and represent a competitive advantage for SKL, which has developed both expertise and reputation (albeit adds reputational risk should SKL misstep).

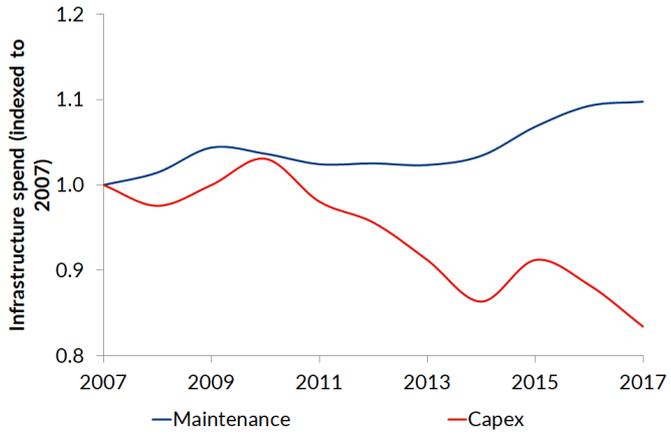
SKL is well positioned, particularly as food and safety standards continue to become more stringent, given the company's background in rubber chemistry and ability to develop and adapt new products due to changing standards. Increased standards also reduce competition from cheaper alternative products.

Counter cyclical opportunities provide some offset recessionary risk

SKL is well positioned to benefit from a lift in US fiscal stimulus, given under investment in water infrastructure (an area likely to see stimulus). Recession driven stimulus may help reduce the cyclical nature of the business.

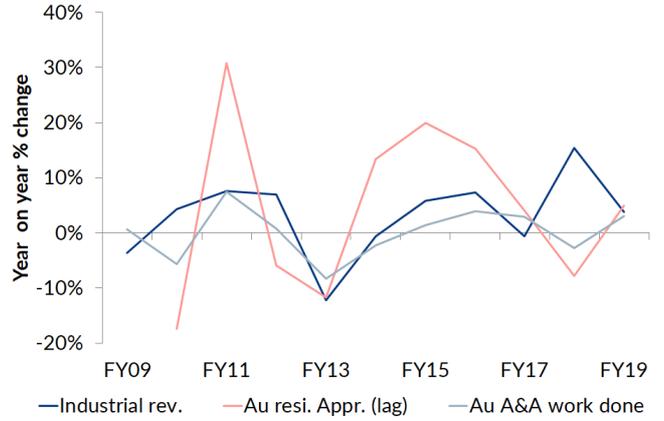
We anticipate future demand for potable water to rise due to population growth, urbanisation, and increasing living standards. SKL's Gulf Rubber business stands to benefit from an increased demand in potable water through the sale of its water supply and sewerage system products such as O-rings, washers, pipe gaskets and valves.

Figure 13. US infrastructure spend



Source: CBO, Forsyth Barr analysis

Figure 14. Industrial earnings linked to housing construction



Source: Forsyth Barr analysis

The OEM model and margin expansion

SKL is increasingly driving growth through its Industrial division, leveraging its technical expertise in polymer compounds, tooling design, and manufacturing expertise to solve specific component production challenges for OEM (original equipment manufacturer) customers. Stepping through COVID-19 disruption, we expect Industrial earnings growth to be led by additional OEM contract wins. Margin expansion provides upside to our forecasts.

We are attracted to OEM led growth, given:

- **Capital light** – OEM customers typically provide the upfront investment into development and product tooling, allowing SKL to operate a relatively capital light model.
- **Customer lock in** – SKL's products are often small but critical components that face rigorous testing, this creates an element of customer lock in given the switching costs involved. SKL is effectively able to embed itself into the customer product manufacturing process and importantly into the product development process, which can help drive future growth.
- **Margin opportunity** – SKL's pricing strategy to focus on value rather than cost enables room for margin expansion.
- **Earnings stability** – A focus on OEM customers provides an element of earnings stability that has been absent in prior cycles

Limited visibility but recent success provides a level of confidence

The nature of OEM business means both the size and timing of business is difficult to forecast. SKL produces a number of different product lines, with a wide range of sector exposure, and gaining meaningful insight into future cash flows is challenging.

SKL has had recent success winning business with leading global tap ware companies (Moen, Kowler). We understand SKL has a number of possible OEM opportunities at various stages with both existing relationships and new customers (e.g. GoJo), providing a degree of confidence that its OEM growth strategy should deliver future growth.

Figure 15. Industrial forecast summary (NZ\$m)

	FY17	FY18	FY19	FY20E	FY21E	FY22E
Revenue	131.2	151.5	157.2	154.0	158.7	165.8
growth	-0.6%	15.4%	3.7%	-2.0%	3.0%	4.5%
EBIT	17.1	20.8	22.9	20.0	21.4	23.2
growth	12.3%	21.4%	9.9%	-12.5%	7.0%	8.4%
EBIT margin	13.1%	13.7%	14.6%	13.0%	13.5%	14.0%

Source: Company forecasts, Forsyth Barr analysis

The OEM process and SKL's position

SKL's Industrial business is targeted at providing technical solutions to OEM customers, in which it believes it has a competitive advantage through superior delivery times of solutions to customers. However, the process from problem identification to production can be lengthy, with time frames often outside of SKL's control.

- **Problem:** OEM customer engages SKL to solve an issue. Often it's a design issue with a small but critical part of a larger product.
- **Concept:** SKL aims to deliver prototype solutions to customers in a shorter time frame than competitors, often six to eight weeks.
- **Tooling:** The customer typically pays for tooling required at SKL's owned or contracted manufacturing plant to produce the product. This enables SKL to operate a relatively capital light model and creates stickiness with the customer.
- **Production:** Production commences. Alongside the initial price negotiated, SKL relies on operating efficiencies overtime to enable margin expansion and strengthen its competitive position.

Intellectual property

The intellectual property associated with the concept and tooling largely sits with SKL and cannot be exactly replicated elsewhere. In addition, reverse engineering chemistry is difficult and creates a competitive moat. One of SKL's competitive advantages is its team of highly skilled and experienced rubber chemists that are able to develop and adapt new products to changing standards. This ability to adapt, combined with tooling design and process knowledge, contribute to the company's competitive moat.

Capital light model

Product innovation occurs alongside the customer, enabling SKL to operate a capital light investment model (low capex requirements). The costs associated with both the development and product tooling sit with the customer.

Figure 16. Capex as % of sales – SKL vs. peers

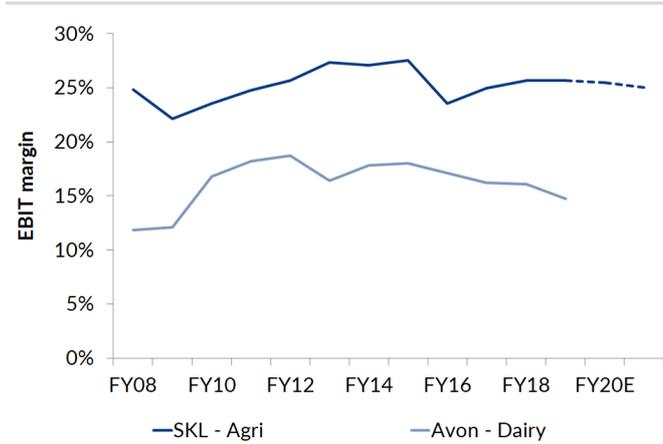
	FY15	FY16	FY17	FY18	FY19	FY20E	FY21E
SKL	9.9%^	18.2%^	5.8%	2.2%	2.2%	2.0%	2.0%
Trelleborg	5.0%	4.0%	4.3%	5.4%	5.0%	3.7%	4.3%
Avon Rubber	2.4%	2.5%	1.6%	2.0%	2.3%	4.5%	3.5%
Forterra	2.0%	4.0%	3.3%	3.4%	3.5%	2.4%	2.8%

Source: Bloomberg, Forsyth Barr analysis, ^SKL elevated capex due to Project Viking, * consensus forecast

Targeting margin expansion

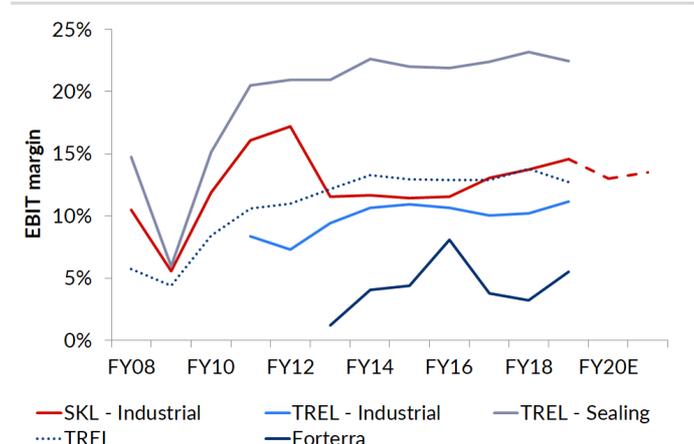
SKL is targeting margin expansion in its industrial division, with an aspirational goal of 20% EBIT margin by FY24 (FY19 14.6%). Whilst we see opportunities for margin expansion through better upfront pricing and changes to product mix, we view this target as ambitious given (1) competitor margins, SKL generally already achieves above peer margins, and (2) manufacturing location, with shipping costs and more recently tariff impacts. Our forecasts assume Industrial EBIT margin expansion to 15.2% by FY22, and with limited visibility into future cash flows we leave margins flat over the remainder of our explicit forecast period.

Figure 17. SKL commands higher margin than key peers



Source: Company reports, Forsyth Barr analysis

Figure 18. SKL expanding industrial margins



Source: Company reports, Forsyth Barr analysis

Margin expansion depends on initial pricing and operational efficiencies achieved

When competing for business initial pricing is critical. SKL has a focus on pricing on value not cost which has helped enable the company to attract better margins than competitors. Adding to the competitive advantage is the speed to respond, with turnaround times from consultation to concept much faster than the market (more agile).

SKL's ability to reduce cost is critical to then maintaining and growing margins within the business. Generally speaking, OEM contracts face periodic price renegotiations. Creating operational efficiencies through the production process is, therefore, essential to maintaining margins.

Production in market on the cards

SKL margin expansion is to some degree limited by its manufacturing base, with product predominantly produced in New Zealand, China, and Vietnam. Recovery of both freight and more recently tariff expenses can make SKL's products less competitive. SKL is exploring moving some production in market in the future as it balances higher labour costs against freight.

Upside from additional OEM business – valuation sensitivities

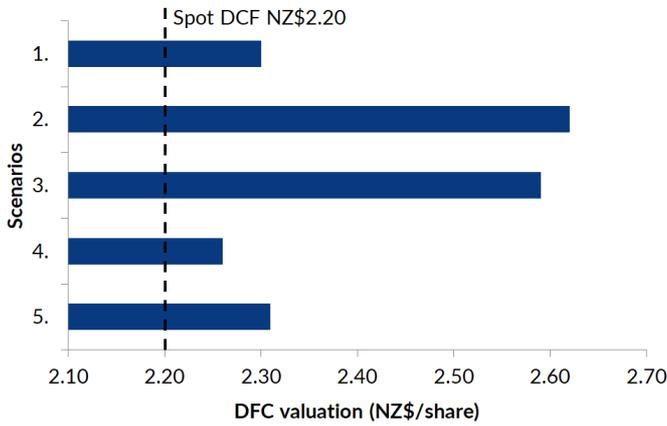
A single OEM customer can be sizable and therefore meaningful for valuation. Due to the nature of OEM business, customer acquisition can be a long process, with a high degree of uncertainty around customer growth and cash flow timing. Sensitivity analysis provides some context (Figures 19 and 20 illustrate DCF impact by scenario below).

- 1. Lifting our base case Industrial EBIT assumption by +1.0% across the explicit forecast period lifts our DCF valuation +4.5%.

- 2. SKL has an aspirational Industrial EBIT margin target of 20%. If we factor in margin expansion to 20% by FY24 our spot DCF valuation lifts +19%.
- 3. Linear Industrial EBIT margin expansion to 20% by terminal lifts our valuation +17%.
- 4. A single Industrial OEM customer providing a revenue uplift of +NZ\$10m (+6.4%) at FY19 Industrial margins lifts our spot valuation +2.7%.
- 5. SKL's international Agri business also targets OEM contracts. A single Agri OEM customer providing a revenue uplift of +NZ \$10m (+11.3%), at similar margins to our base case, lifts our spot valuation +5.0%.

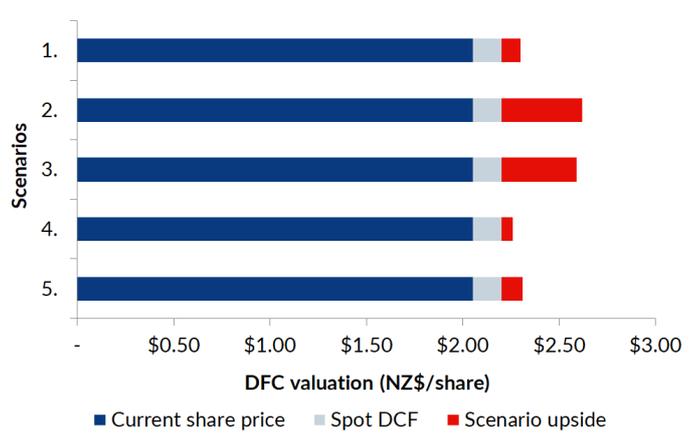
We currently assume steady Industrial revenue growth CAGR of +2.0% over our explicit 10 year forecast period combined with limited EBIT margin expansion.

Figure 19. DCF scenario analysis



Source: Forsyth Barr analysis

Figure 20. DCF scenario analysis

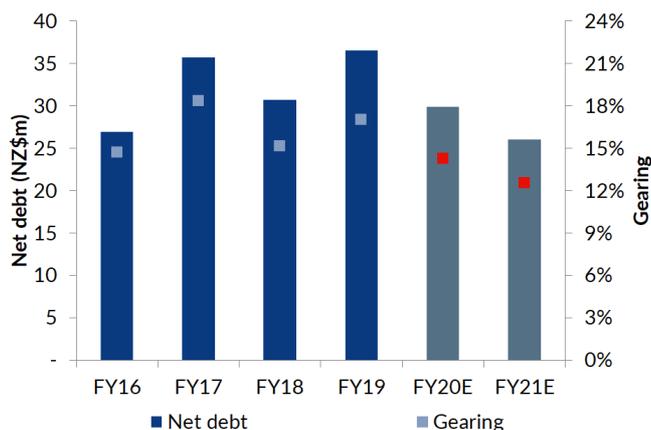


Source: Forsyth Barr analysis

Balance sheet headroom

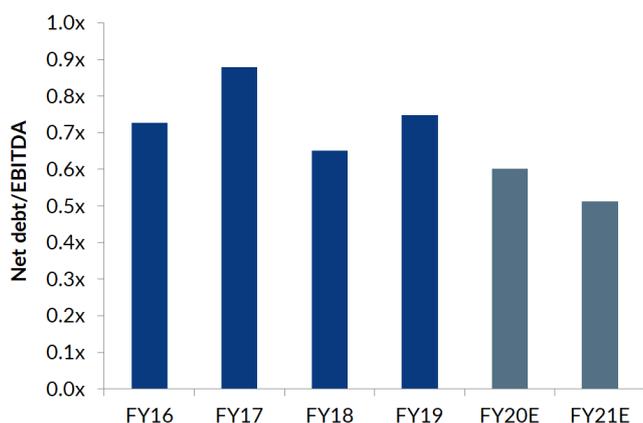
SKL's financial gearing is relatively undemanding, given it is post investment cycle and operates a capital light model (capex c. 40% of depreciation). This provides (1) flexibility to support its dividend yield during periods of short-term turbulence or contract timing and (2) the ability to pursue bolt-on acquisitions which add technical expertise or relationships to be leveraged for future growth.

Figure 21. Gearing



Source: Forsyth Barr analysis

Figure 22. Net debt/EBITDA



Source: Forsyth Barr analysis

Acquisitive growth adds technical expertise and expands relationships

SKL has highlighted acquisitive opportunities as a key area of growth, with recent acquisitions being small bolt-on companies that add further expertise or access to additional customer sets. We expect this to continue to be a feature of SKL's earnings growth, with ambitions to grow its presence in the medical devices industry and increase its Agri market share in the US and Europe. In addition, we see scope for an acquisition linked to US based manufacturing of existing products, such as its vacuum pump systems.

SKL's recent track record

SKL has made a number of acquisitions in recent periods, including:

- **Sim Lim (July 2018, 35% purchase ~NZ\$1.6m)** – Adds liquid silicone rubber capability, targeting the healthcare market. US based.
- **Nexus Foams (April 2019, NZ\$6.5m)** – NZ based supplier of high performance foam, supporting existing Ultralon business and targeting growth in the healthcare market.
- **Silclear (November 2019, NZ\$7.0m)** – UK based company, supplying silicone products for use in the dairy and medical industries. Targeting dairy growth in international markets.

Case study: Silclear

SKL acquired Silclear in late 1H20, and although small from an earnings contribution perspective (we estimate a 12-month EBIT contribution of ~NZ\$1m, SKL FY20E EBIT NZ\$43.5m), is expected to provide a platform for further growth. Silclear is a UK based company that designs and manufactures cured silicone products for use in the dairy and medical industries.

- **Well aligned with existing business:** Silclear fits well with SKL's existing business and offers additional expertise in the silicone space. The focus on the dairy and medical industries means the products are subject to higher regulatory standards (i.e. food grade & medical), which aligns well with SKL's current strategy.
- **European exposure with room to grow:** We expect SKL to leverage its existing relationships in Europe to grow Silclear. New Zealand and Australia represent relatively mature markets for SKL, with Europe highlighted as a key growth area for SKL's Agri business. Silclear has achieved +76% international sales growth over the past three years, with 88% of sales now occurring outside of the UK
- **Undemanding valuation:** We estimate SKL paid ~5.5x EV/EBIT for Silclear, well below SKL which is trading at 9.7x.

A degree of cyclicality remains

The nature of OEM contract business means both the size and timing of business is difficult to forecast. SKL produces a number of different product lines, with a wide range of sector exposure, and gaining meaningful insight into future cash flows is challenging.

Whilst acknowledging earnings growth is being derived in industries with more predictable cash flows, we remain cognisant of the cyclical and commodities earnings exposure.

Construction

Housing – SKL's Gulf and DEKS businesses are exposed to housing construction and renovation activity through the sale of dektite flashing systems and components used in bathroom ware. We estimate this represents c. 15% of earnings.

Commodity exposure

- **Oil & gas** – c. 50% (in normal times) of SKL's Masport vacuum pump sales are exposed to oil and gas (the remainder liquid waste), and are used in the transportation of water to and from fracking sites. The bulk of the exposure is to US oil fracking activity in (Texas Permian Basin & Eagle Ford).
 - The recent development of an oil price war between OPEC and Russia has sent oil prices into a material decline. This is likely to have a significant impact on US shale activity, which requires a US\$50-US\$60/barrel breakeven price. However, we suspect earnings were already suppressed from the impact of the US-China trade war tariffs (SKL produces vacuum pumps at its China factory).
- **Iron ore** – Flexiflo products are exposed to the iron ore mining industry through the sale of chute lining systems. Weak iron ore prices lower mining activity and also see maintenance deferred.
- **Milk** – ~80% of Agri earnings are directly linked to milk volumes through the sale of liners and tubing. A portion of the remaining earnings is also indirectly exposed to dairy through the sale of its Red Band gumboots into the agriculture sector.
 - Agri earnings are driven more by consumables than investment, so its unlikely to see a big drop in earnings if commodity prices are low, instead a slow burn away as herd sizes decline.

Agri growing offshore, domestic getting tougher

Agri earnings growth is likely to be driven through market share gains in international markets and through its range of technical footwear products. The Australasian dairy market is facing headwinds in the form of declining herd numbers, making growth difficult. SKL has a market leading position in both the New Zealand and Australian dairy markets, with those markets making up 48% (FY19) of Agri revenue. We believe opportunity to gain market share still exists in international markets, namely in Europe and North America. Albeit, given the more fragmented nature of those markets, growth is likely to be at a lower margin.

Pre COVID-19 SKL was targeting FY20E Agri EBIT ahead of FY19, however, we suspect risk sits to the downside and a result in line with the prior period would be a solid outcome. We forecast a decline in EBIT growth in FY20E, reflecting the increasingly challenging market dynamics in New Zealand and Australia and the lower margin nature of international markets.

Figure 23. Agri forecasts summary (NZ\$m)

	FY17	FY18	FY19	FY20E	FY21E	FY22E
Revenue	79.2	89.0	88.8	88.8	90.5	92.3
growth	-0.5%	12.4%	-0.3%	0.0%	2.0%	2.0%
EBIT	19.8	22.8	22.8	22.6	22.6	22.6
growth	5.3%	15.5%	-0.2%	-0.7%	0.0%	0.0%
EBIT margin	24.9%	25.6%	25.7%	25.5%	25.0%	24.5%

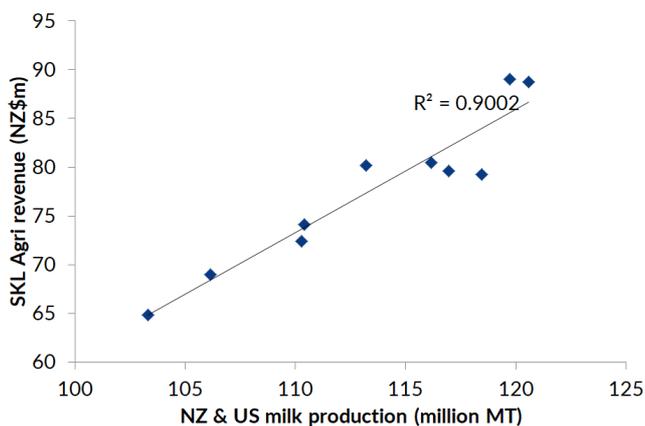
Source: Forsyth Barr analysis

Earnings relatively defensive – Milkings main driver, limited impact on SKL from reduced farmer spend

SKL's Agri revenue illustrates a reasonable correlation with the number of milkings (Figure 24). The bulk of SKL's Agri revenue is derived from the sale of non-discretionary milking products such as liners and tubes, with SKL the second largest producer globally behind Avon Rubber. In New Zealand, milking liners are generally replaced twice a year and tubes every second year. Farmers have some flexibility to delay any non-urgent spend, however, given the consumable nature of the product we view this as fairly limited. As a result, SKL is initially insulated from any downturn in farmer confidence, to the extent that it doesn't result in farm conversions and a reduction in herd count.

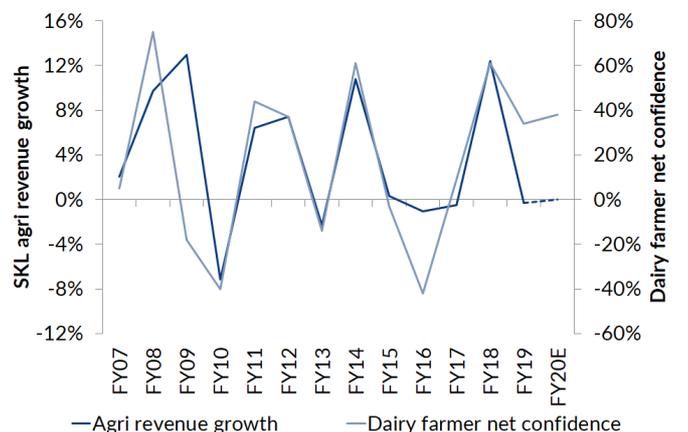
Earnings tend to peak across June and July, a quiet period for southern hemisphere dairy farmers. SKL's financial year end is June, which can lead to timing issues.

Figure 24. Correlation of SKL Agri revenue vs NZ & US milk production



Source: Company reports, DCANZ, Forsyth Barr analysis

Figure 25. Dairy net confidence (12 month lag) vs Agri revenue growth

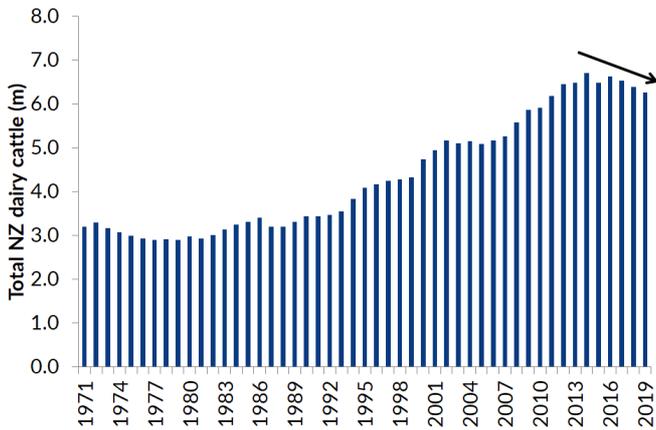


Source: Company reports, Rabobank, Forsyth Barr analysis

Domestic backdrop challenging – beyond peak herd

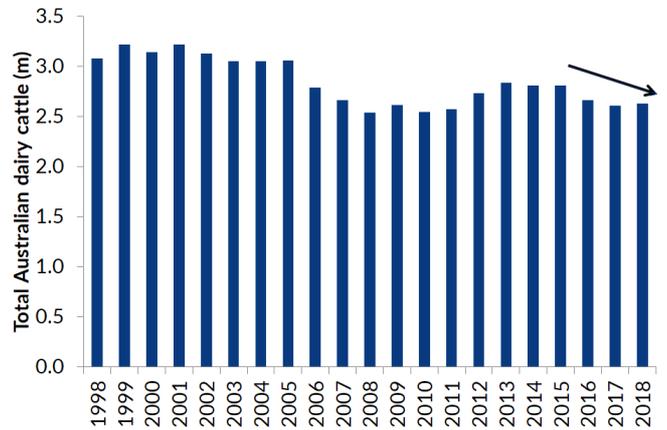
The outlook for the New Zealand and Australian dairy industry appears difficult with environmental and water usage headwinds. Herd sizes in both markets have been declining in recent years, with the trend expected to continue, in our opinion. Whilst farm productivity gains may occur, offsetting to some extent the decline in herds, we expect SKL to achieve limited growth in the New Zealand and Australian markets.

Figure 26. New Zealand dairy herd numbers have peaked



Source: Stats NZ, Forsyth Barr analysis

Figure 27. Australian dairy cattle



Source: ABS, Forsyth Barr analysis

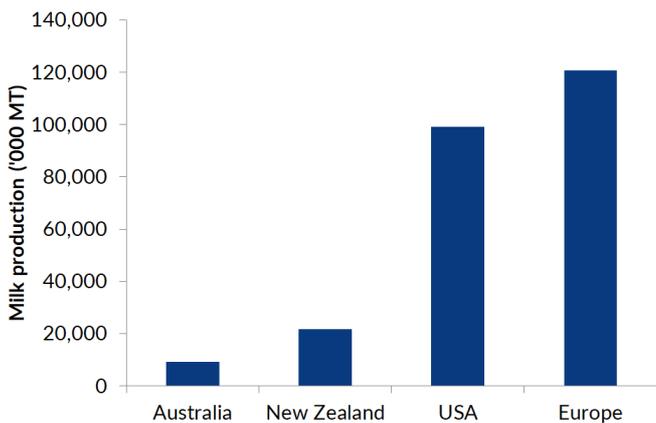
Agri growth to be driven in offshore markets

International markets will become increasingly important drivers of Agri growth going forward. However, supply dynamics in those markets suggest sales growth is likely to come at the expense of margin, with margin contraction expected.

SKL is targeting market share gains in developed dairy markets in the US and Europe, where it already has established distribution networks. Whilst SKL has a majority share in both Australia and New Zealand, its positions in the US (>30% market share) and Europe (>25% market share) is much smaller, and the large size of these markets (~25% and ~45% respectively of global milk liner sales) makes these attractive growth opportunities.

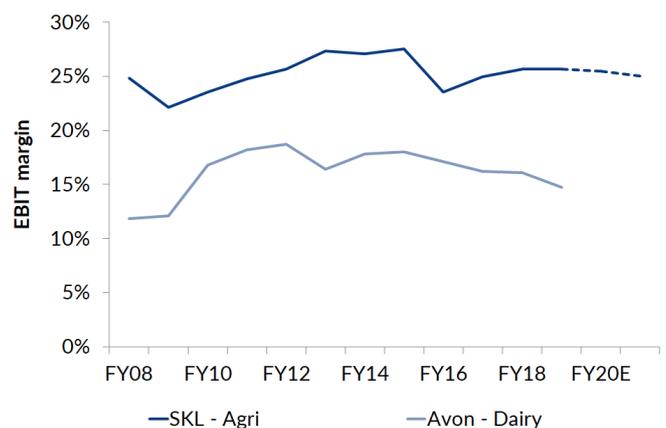
Whilst SKL sells some of its own brand product (New Zealand manufactured) in the US through its Conewango business, it also sells into the OEM channel, which is inherently lower margin. In Europe a large portion of the market is OEM, with SKL selling no own brand product at this stage. Therefore, growth into these markets will negatively impact the margin mix.

Figure 28. Milk production by region (2019)



Source: DCANZ, USDA, EuroStat, Dairy Australia, Forsyth Barr analysis

Figure 29. SKL commands higher margin than key peer



Source: Company reports, SKL, AVON, Forsyth Barr analysis

International market backdrop

- **Factory farm model** — This is a higher intensity operation, and as a result, the convention for the replacement of milking liners is every five to six weeks (twice a year in pastoral farm models like New Zealand). This also lifts commodity exposure with a factory model heavily exposed to the price of corn used in feedstock.
- **Competitor set** — Avon is the largest producer of dairy liners in the world, with SKL second. Avon has significant market share in both the US and Europe. In recent years growth has delivered a shift away from OEM customers and into own brand. Despite own brand growth, Avon has experienced relatively flat margins. We expect this is due to the fragmented nature of the US market and therefore see limited scope for SKL to extract margin expansion in that market.
- **Other growth markets exist** — Namely in Asia and Latin America, where SKL already sells limited product. Unlikely to be a major contributor to growth in the short to medium term, these markets offer a longer term growth opportunity.

Impact on margin

We expect to see margin contraction over the forecast period as SKL grows its earnings contributions from offshore markets. Margin contraction is to be driven by (1) higher freight costs, reflecting manufacturing in New Zealand, and (2) the more fragmented nature of Northern Hemisphere markets means they are lower margin.

To assist with international growth aspirations SKL is considering options for in market manufacturing of its dairy products. Given the size of dairy filters and the geographic remoteness of New Zealand, freight costs weigh on margins. Shifting production in market should improve the competitiveness of SKL's offering in international markets.

Valuation and earnings changes

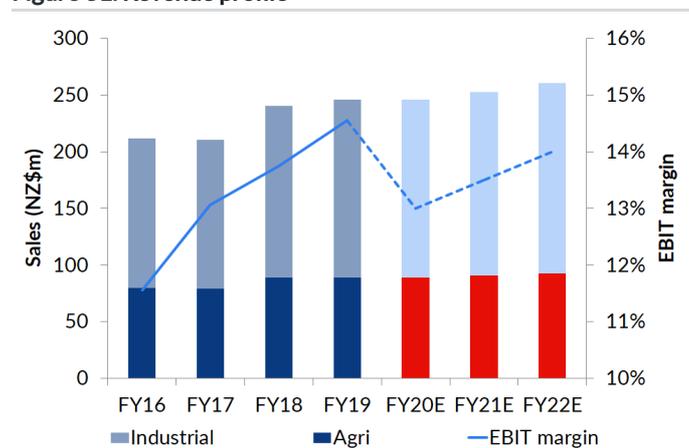
We have made negative revisions to our near-term earnings profile reflecting elevated uncertainty in relation to COVID-19 and the weaker economic backdrop. We have lowered our Industrial growth assumptions on the expectation that limited travel movements are likely to lead to delays in original equipment manufacturer (OEM) contract timing, and accounting for a drop in revenue exposed to US fracking. In addition, we lower our Agri assumptions on the basis farmers are likely to be cautious in the near-term and may be more likely to delay consumable product replacement.

Figure 30. Earnings changes (NZ\$m)

	FY20E			FY21E			FY22E		
	old	new	% chg	old	new	% chg	old	new	% chg
Revenue	255.3	242.6	-5.0%	261.1	249.0	-4.6%	265.4	258.0	-2.8%
EBIT	42.5	39.0	-8.1%	44.1	40.3	-8.7%	45.0	42.0	-6.7%
Normalised NPAT	28.7	26.2	-8.5%	30.0	27.3	-9.0%	30.7	28.5	-7.2%
EPS (cps)	14.7	13.5	-8.5%	15.4	14.0	-9.0%	15.7	14.6	-7.2%
DPS (cps)	13.0	13.0	-	13.5	13.0	-3.7%	14.0	14.0	-

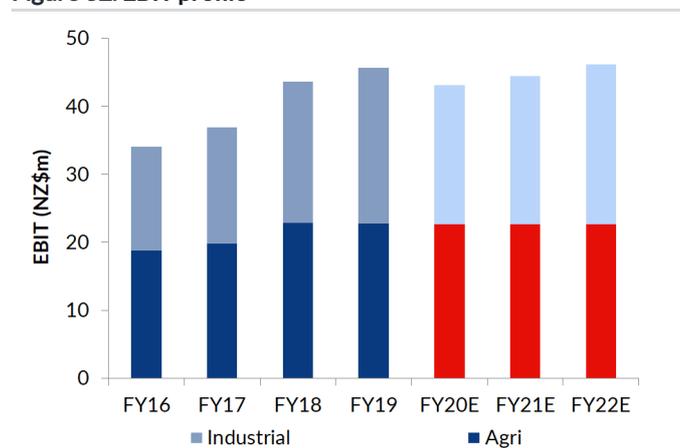
Source: Forsyth Barr analysis

Figure 31. Revenue profile



Source: Company reports, Forsyth Barr analysis

Figure 32. EBIT profile



Source: Company reports, Forsyth Barr analysis

Target price NZ\$2.40

Our 12-month target price is NZ\$2.40. We derive our target price using an average of our DCF and peer multiple valuation, rolling this forward at our assessed cost of equity (9.8%) less 12-month forward dividends.

Figure 33. Valuation and target price summary (NZ\$ per share)

	Spot valuation	Rolled forward	Less fwd div	Target price
DCF	2.20			
Peer multiple	2.40			
Average	2.30	2.51	(0.11)	2.40

Source: Forsyth Barr analysis

Discounted cash flow analysis

Our spot DCF for SKL is NZ\$2.20. We apply a two stage DCF using our ten-year explicit forecast and a terminal value from FY29. We apply a terminal growth rate assumption of +1.5%.

Figure 34. DCF and WACC assumptions

NZ\$m	PV	FY20	FY21	FY22	FY23	FY24	FY25	FY26	FY27	FY28	FY29	Terminal	
EBITDA		49.7	50.9	52.5	54.0	55.0	55.7	56.4	57.2	58.0	58.8	59.7	
Current tax paid		(10.7)	(11.2)	(11.7)	(12.1)	(11.9)	(12.1)	(12.3)	(12.5)	(12.7)	(12.9)	(13.1)	
Interest tax shield		(0.6)	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)	(0.6)	(0.6)	
Working capital		3.7	0.1	(2.6)	(1.9)	(1.2)	(1.3)	(1.3)	(1.3)	(1.4)	(1.4)	(1.4)	
Net investment		(5.0)	(5.1)	(5.2)	(5.2)	(5.3)	(5.4)	(5.5)	(5.5)	(5.6)	(5.7)	(5.7)	
FCFF		37.0	34.2	32.6	34.2	36.0	36.4	36.8	37.3	37.8	38.3	38.9	
PV FCFF	525.5	38.4	32.6	28.6	27.6	26.8	24.9	23.1	21.5	20.1	18.7	263.1	
Equity valuation		Weighted cost of capital											
Enterprise value	525.5	Risk free rate						2.0%	Target D/(D+E)		16.0%		
Less net debt (cash) & capitalised leases	97.1	Market risk premium						7.5%	WACC		8.7%		
Equity value	428.5	Asset beta						0.95					
Valuation/share (NZ\$)	2.20	Cost of equity						9.7%					

Source: Forsyth Barr analysis

Sensitivity analysis

We outline the DCF sensitivity to our WACC and terminal growth assumptions below.

Figure 35. DCF sensitivity

Terminal growth rate		WACC				
		6.7%	7.7%	8.7%	9.7%	10.7%
rate	0.5%	2.11	2.07	2.02	1.98	1.94
	1.0%	2.19	2.15	2.10	2.06	2.02
	1.5%	2.11	2.15	2.20	2.26	2.35
	2.0%	2.40	2.35	2.30	2.26	2.22
	2.5%	2.52	2.47	2.43	2.39	2.35

Source: Forsyth Barr analysis

Inherent difficulty in forecasting contract timing/size; Scenario analysis providing context

SKL's diverse nature of its cash flows and high degree of uncertainty around customer growth and cash flow timing creates inherent difficulty in forecasting earnings growth. To provide context we have outlined three scenarios for earnings growth going forward.

Base case – DCF NZ\$2.20

Our base case assumes a temporary earnings hit (FY20E EBIT -6%) in relation to COVID-19. This is driven primarily by 1) lower vacuum pump sales, 2) infrastructure and OEM project delays, and 3) flat Agri growth. In FY21 and beyond we assume Agri growth resumes, although at low levels and with some margin compression as growth is driven in lower margin international markets. We assume some Industrial growth with additional infrastructure spending offsetting cyclical weakness elsewhere.

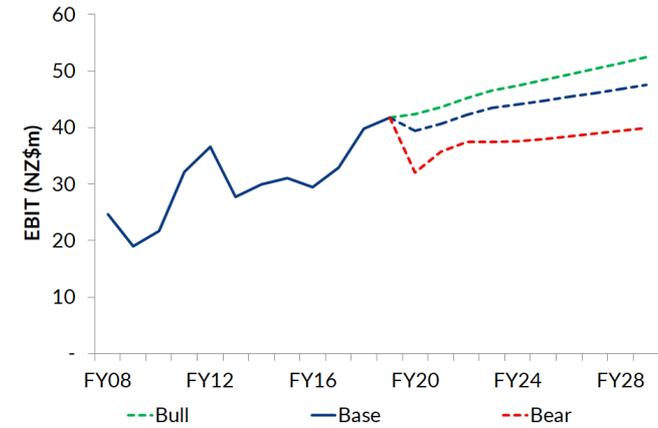
Bear case – DCF NZ\$2.04

Our bear case assumes a significant near-term earnings hit (FY20E EBIT -23%) with margin compression in addition to growth missteps in the Industrial division and a decline in cyclical related earnings such as construction and oil, and gas exposed earnings. Over the medium to long term we assume limited Agri growth in combination with margin decay as international growth offsets lower domestic milk volumes (declining dairy herd in New Zealand).

Bull case – DCF NZ\$2.37

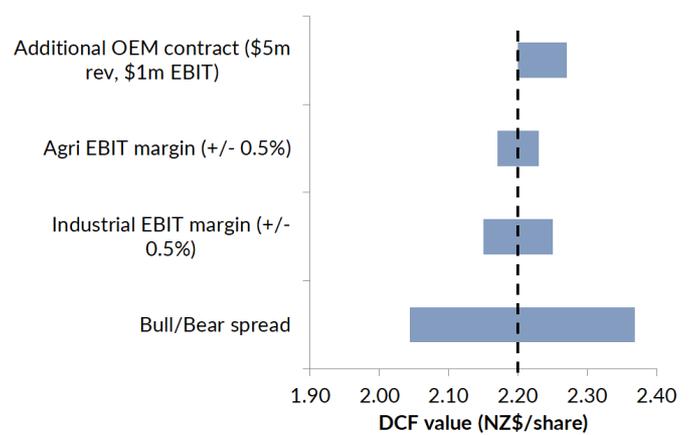
Our bull case assumes limited impact from COVID-19 with flat growth near-term (FY20E EBIT +1.3%) followed by an earnings uplift driven by 1) additional OEM contract wins and a lift in fiscal stimulus spend benefiting its potable water business, and 2) execution on international Agri growth strategy.

Figure 36. EBIT scenarios



Source: Company reports, Forsyth Barr analysis

Figure 37. Valuation scenarios



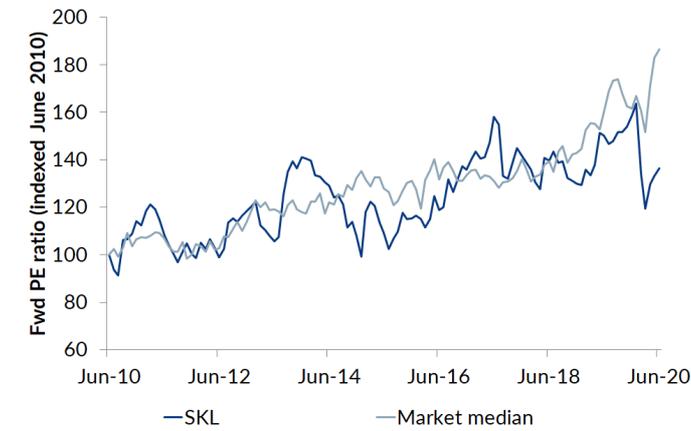
Source: Forsyth Barr analysis

Peer analysis

Our spot relative valuation for SKL is NZ\$2.40.

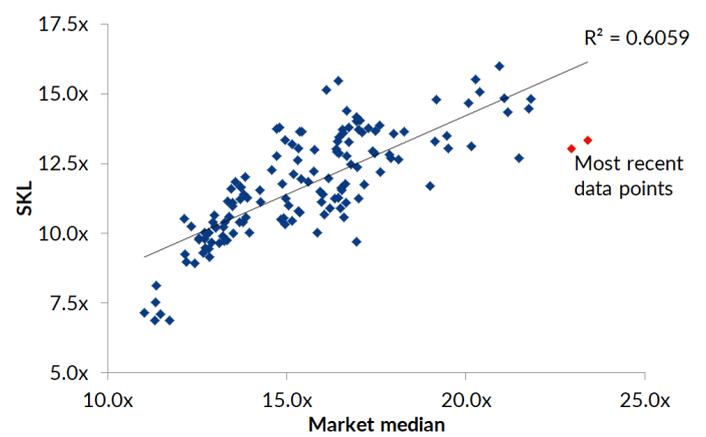
SKL is an industrial cyclical stock with a global exposure to both infrastructure and agriculture spend. Our relative valuation uses a forward PE ratio and is equally weighted to the S&P NZX 50 and a group of comparable listed companies.

Figure 38. SKL fwd PE ratio vs the market



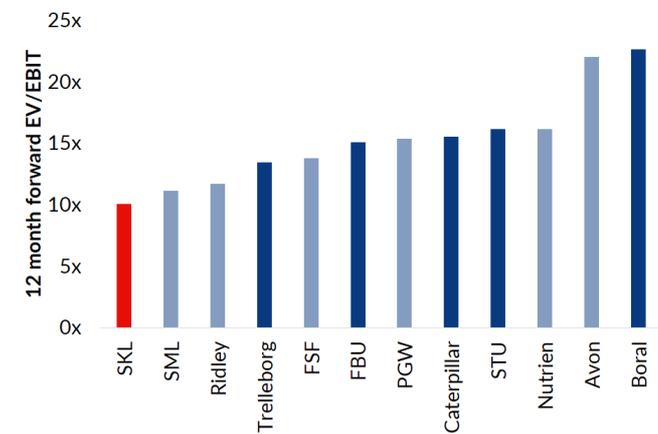
Source: Bloomberg, Forsyth Barr analysis

Figure 39. SKL fwd PE ratio vs the market



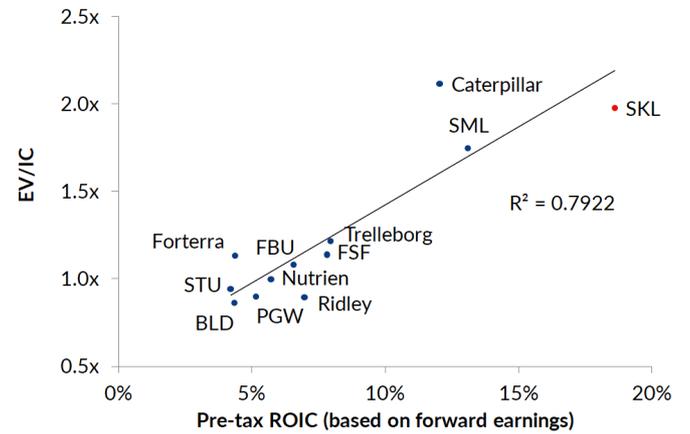
Source: Bloomberg, Forsyth Barr analysis

Figure 40. SKL 12m forward EV/EBIT versus peers



Source: Bloomberg, Forsyth Barr analysis

Figure 41. EV vs. ROIC



Source: Bloomberg, Forsyth Barr analysis

Investment Summary

Skellerup Holdings (SKL) contains a globally diversified range of businesses that manufacture highly technical products for the Agricultural and Industrial sectors. Growth is linked to long-run demand for key commodities (mainly dairy, iron ore, and oil/gas), civil construction, and utility spending. SKL's Agri division operates in a number of mature markets, with growth expected to come from market share gains offshore, namely the US. SKL's Industrial division is generating robust growth through OEM (original equipment manufacturer) business wins. We continue to rate management highly and like its longer-term growth prospects. A new customer or contract would likely result in a meaningful lift in earnings. **OUTPERFORM.**

Business quality

- **OEM lock in:** SKL often supplies small but essential products. OEMs have sizeable sales orders; additional OEM customers materially increase sales and offer a more stable earnings flow.

Earnings and cashflow outlook

- **Global dairy volumes:** Best practice is for SKL's consumable rubber products to be replaced periodically by farmers. Replacement is based on the number of milkings.
- **Construction and water utility spending:** Sales in Gulf Rubber, the largest Industrial business unit, will be driven by increased construction and utility spending.
- **Regulatory changes:** Health and food safety concerns in some jurisdictions have resulted in regulated raw materials used in rubber manufacture. Increased health and food safety standards should benefit SKL given its strong reputation and chemist expertise.
- **EBIT margins:** SKL has been improving its EBIT margins, highlighting operating leverage with respect to fixed costs. Improving the Industrial division margins represents an opportunity.

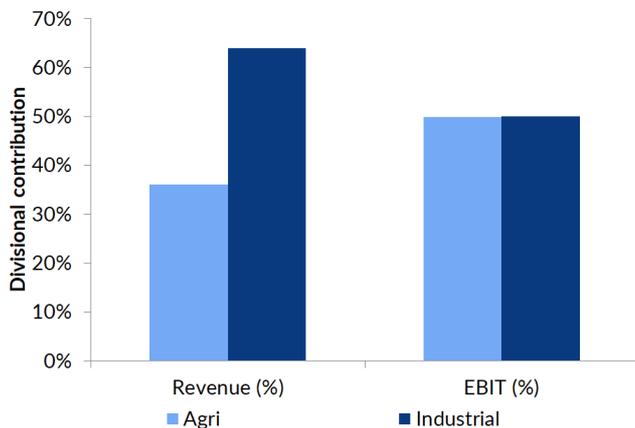
Financial structure

- **Balance sheet:** SKL has balance sheet headroom (17% geared) to pursue possible bolt-on acquisitions.

Risk factors

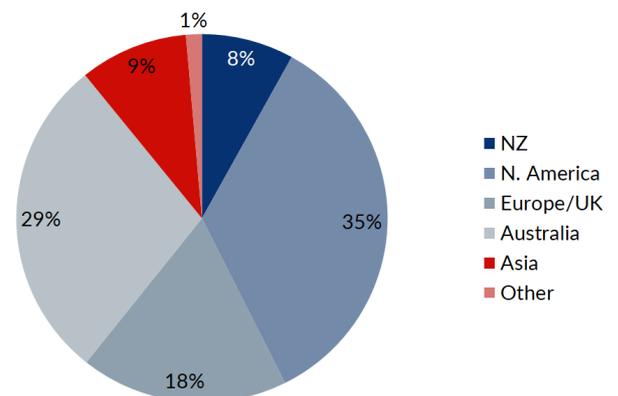
- **Commodity exposure:** Although SKL has been actively working to reduce commodity exposure, a reasonable portion of SKL's sales are tied to commodity markets. Swings in the price of commodities such as milk, iron ore, and oil & gas, can have an impact on product sales.
- **Trade risk:** SKL products are produced across the world (New Zealand, China, Vietnam, and Italy). SKL relies on efficient trade routes when pricing for contracts.

Figure 42. Revenue and EBIT by division (FY19)



Source: Company reports, Forsyth Barr analysis

Figure 43. SKL revenue by geography



Source: Company reports, Forsyth Barr analysis

Figure 44. Price performance



Source: Iress, Forsyth Barr analysis

Figure 45. Substantial shareholders

Shareholder	Latest Holding
Sir Selwyn John Cushing	6.5%
ACC	5.0%

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

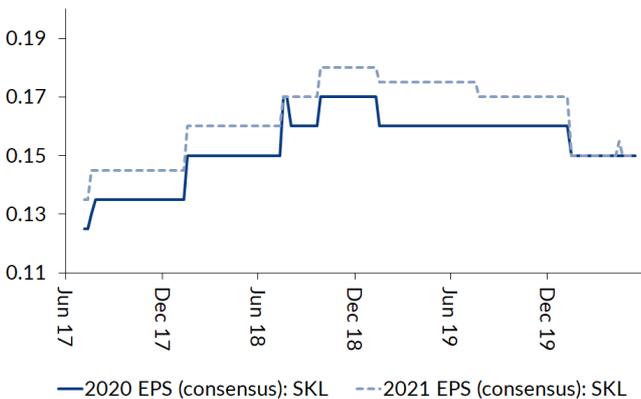
Figure 46. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
Skellerup Holdings	SKL NZ	NZ\$2.04	NZ\$397	15.1x	14.6x	8.7x	8.5x	11.1x	10.8x	6.4%
AVON RUBBER PLC	AVON LN	£30.60	£949	39.9x	26.2x	24.7x	17.0x	37.0x	21.7x	1.1%
TRELLEBORG AB-B SHS	TRELB SS	kr132.90	kr36,025	<0x	13.1x	13.6x	8.9x	34.6x	13.6x	3.5%
PGW Wrightson*	PGW NZ	NZ\$2.67	NZ\$202	14.1x	11.6x	<0x	<0x	<0x	<0x	6.7%
NUTRIEN	NTR CN	US\$49.90	US\$28,436	29.2x	25.6x	11.0x	10.4x	21.8x	19.9x	3.6%
METRO PERFORMANCE GLASS	MPG NZ	NZ\$0.21	NZ\$39	3.6x	4.2x	4.1x	4.6x	8.2x	9.6x	0.0%
Steel & Tube Holdings*	STU NZ	NZ\$0.65	NZ\$108	24.9x	9.4x	3.6x	3.0x	8.7x	5.7x	9.2%
Compcpo Average:				22.3x	15.0x	11.4x	8.8x	22.1x	14.1x	4.0%
SKL Relative:				-32%	-3%	-23%	-3%	-50%	-24%	58%

EV = Current Market Cap + Actual Net Debt

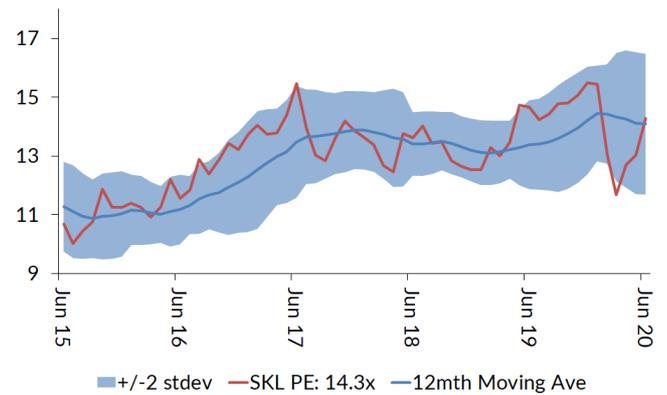
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcpo metrics re-weighted to reflect headline (SKL) companies fiscal year end

Figure 47. Consensus EPS momentum (NZ\$)



Source: Bloomberg, Forsyth Barr analysis

Figure 48. One year forward PE (x)



Source: Iress, Forsyth Barr analysis

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