

Wealth Weekly

RBNZ — Rates “to remain low”

The Reserve Bank of New Zealand (RBNZ) wrong footed the market for the second successive time by leaving the Official Cash Rate (OCR) on-hold at 1%. Whilst the experts are debating whether it should have cut by -25bp or not, the big picture is clear. The RBNZ stated it expects “interest rates will need to remain at low levels for a prolonged period” creating a challenging backdrop for investors.

Interest rates near 5,000-year lows is a unique investing challenge

The market was expecting the RBNZ to cut the OCR by another -25bp. It surprised by pausing, following the recent tacks of both the US Federal Reserve and the Reserve Bank of Australia. The RBNZ acknowledged it was a close call, and has significantly lowered its expected NZ economic growth outlook, but has taken a wait-and-see approach believing the low level of interest rates and government spending will help stimulate economic activity during 2020.

Experts are now debating whether the RBNZ’s outlook is too optimistic, and whether it will have to cut again early next year. The big picture, however, remains that low rates are likely to persist for the foreseeable future. Globally inflation remains modest, and most countries’ interest rates are at or near record lows. In today’s integrated global financial system, it is difficult for any country to stand out from the crowd. Higher interest rates vs. the rest of the world would mean a higher exchange rate which would hurt economic activity and employment.

The current interest rate environment is helpful for borrowers, but unfortunately not for savers. Many investors will be tempted to shift away from fixed income, and look for higher returns elsewhere. In our view, however, fixed income continues to play an important role in investment portfolios: (1) ensuring medium-term financial needs are able to be met, and (2) reducing the volatility of an overall portfolio’s returns. A focus on quality and liquidity is important to ensure fixed income plays lives up to these goals when required.

For those investors seeking yield who are able to tolerate a higher level of risk, our preferred NZ defensive yield exposures are Spark (SPK), Contact Energy (CEN), Genesis Energy (GNE), and Chorus (CNU). Our preferred NZ property exposures are Kiwi Property Group (KPG), Vital Healthcare Property Trust (VHP), and Investore (IPL).

Themes of the week

Easing economic fears, generally positive results through company reporting season, and Central Banks’ accommodative policies helped drive the US equity market to a record high last week. In NZ, sound results from Infratil and Sanford left us feeling comfortable with our positive investment views on both companies. Mainfreight also delivered healthy profit growth, despite the challenges of slowing economic growth across its markets, once again highlighting the quality of company management.

Looking ahead

Globally much of the market’s focus remains on the details of US-China trade talks. Locally we are in the midst of company reporting and annual meetings season, with this week including a2 Milk, Arvida, and Ryman Healthcare in NZ, and Aristocrat, APA Group, Lendlease, Goodman Group, and Sonic Healthcare in Australia. On Tuesday, the Commerce Commission announces its draft decision on the “inputs methodologies” which feed into the regulation of Chorus’s fibre broadband network.

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In this week’s report...

- The RBNZ surprised the market by not cutting interest rates
- Central banks face a dilemma; we expect interest rates to at low levels for the foreseeable future
- Sound results from Infratil and Sanford leave us comfortable with our positive views
- Afterpay delivered a positive trading update
- Yield curves have steepened as the economic outlook has improved

The Central Bank Dilemma

The RBNZ's decision to hold interest rates follows similar 'on-hold' decisions from the Reserve Bank of Australia (RBA), US Federal Reserve (Fed), and the European Central Bank (ECB). While the ECB did cut its official cash rate from -0.40% to -0.50%, the move was largely symbolic. The messaging was clear – negative rates were not working to lift growth and inflation, and are possibly doing more harm than good. Ironically, the private sector savings rate has surged in the Euro Area, contrary to macro assumptions used by central bankers when setting interest rates so low.

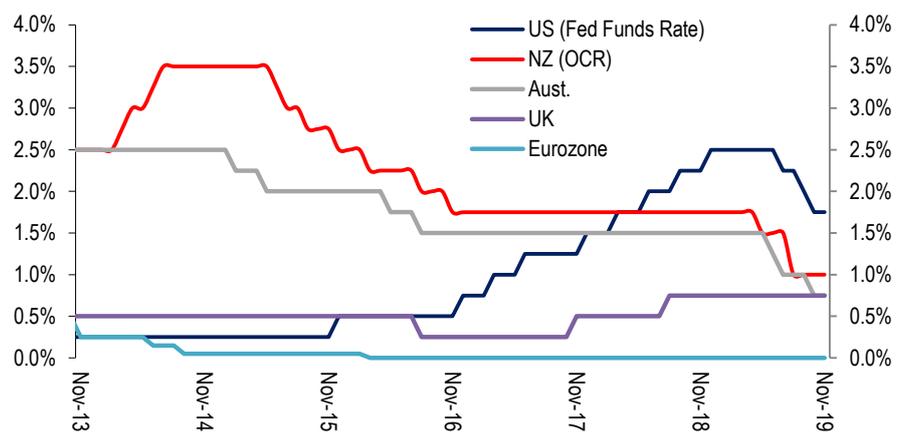
Central bank policy has evolved around certain macro economic assumptions. These include:

- Lower interest rates should stimulate demand via credit channels — people and companies will borrow more.
- Increasing the supply of credit (“quantitative easing” or QE), will lower its cost, and lead to higher demand.
- Higher demand will close output gaps via falling unemployment.
- Once full employment is achieved, wages will rise as employers compete for skilled staff.
- Rising wages and import costs due to weaker currencies will exert an upward direction on inflation.
- Market excess and inflation above target can be offset by interest rates being re-set at higher levels.

Is the current monetary policy theory broken?

This is all very good in **theory**. But the reality has been quite different since the Global Financial Crisis (GFC). Following the end of the housing-led expansion that led up to the GFC, capital has flowed not into productive or growth generating investments, but into financial and real assets. The financial markets have been globalised, and, as a consequence, all markets have been affected by the 'race to the bottom' in interest rates – or the global reach for yield. This has benefited asset prices, and widened the gap between the asset owners (haves) and non-asset owners (have-nots), and contributed to the political instability we are experiencing today.

Figure 1. Central Bank interest rates



Source: Forsyth Barr analysis, Bloomberg

Increasing risks of financial instability

Globally, trend growth rates and inflation have been falling for the last few decades. Partly this is structural (demographics, globalisation, technology and innovation, debt), and partly this is due to inappropriate policies.

Monetary policy has been used by successive governments in most developed economies to protect economic growth, because it is cheaper and easier to cut interest rates and print money, than it is to legislate for regulatory and supply side reforms. Monetary policy is quick acting but short lasting, whereas political reforms, while more difficult to achieve, are longer lasting.

Debt, debt and more debt

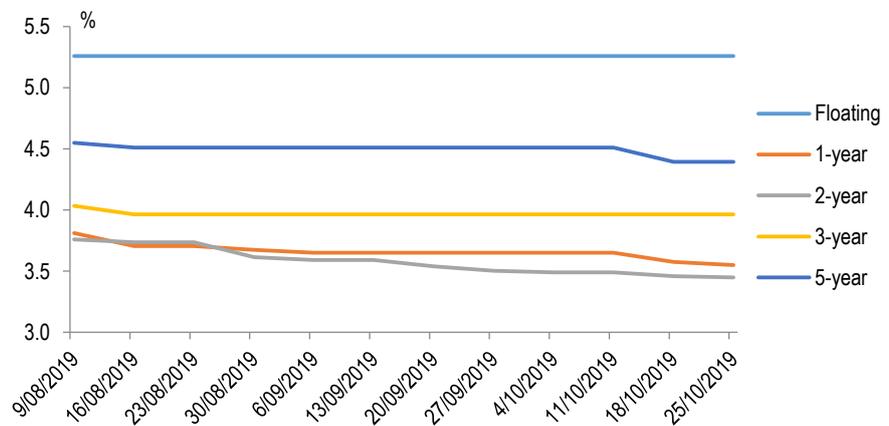
Inflation has failed to materialise during the current expansion because the world is already awash with debt. The most prolific borrowers in the world at the moment are governments (rightly so at current rates), and non-bank financials, including corporates. When debt-to-income ratios climb, at some point lower interest rates have no effect in increasing the demand for credit. What's worse is that the average credit quality of borrowers declines.

Central bank financial stability reports are now recognising the increasing share of new debt going to sub-investment grade (more risky) companies. These companies are generally not great drivers of growth – yet they are able to re-finance at decreasing rates of interest. These debt binges are being fuelled by central bank policies which encourage lenders to provide the finance in their global reach for yield and income.

In a material economic slowdown, many of these corporate borrowers will be unable to finance their debt servicing costs, let alone principal repayments. This is the dilemma central banks now face – recognising that printing money and keeping interest rates historically low has failed to generate inflation and sustainable economic growth. But normalising policy will seriously undermine a highly indebted corporate world and banking sector. Market tantrums are real, and can do a lot of damage to the real economy.

Individuals and corporates can only borrow so much.

Figure 2. Retail mortgage rates are not matching RBNZ OCR cuts



Source: Forsyth Barr analysis, RBNZ MPS

Policy reflation

While the Fed and ECB have both indicated further interest rate cuts are unlikely in the current economic environment, both have announced renewed expansions to their balance sheets. This means both major central banks are purchasing bonds again, effectively acting as the lender of first resort to the global economy.

This is a key reason why interest rate curves have steepened again. While many businesses still see limited opportunities for business investment (hence cash hoarding or using capital for buybacks and dividends), the pick-up in broad money supplies in both Europe and the US, should flow through to more robust economic activity – as long as the banks are willing to lend.

And all this means...

So, our outlook for the next few quarters is for yield curves to remain positive, activity to pick up slowly, but for interest rates to remain low. The lack of inflation and structural headwinds to the global economy mean a blow-out in bond prices (rapidly rising interest rates) is both unsustainable and unlikely.

With interest rates so low and little room to move for Central Banks, QE is back on.

Themes of the week

Equities

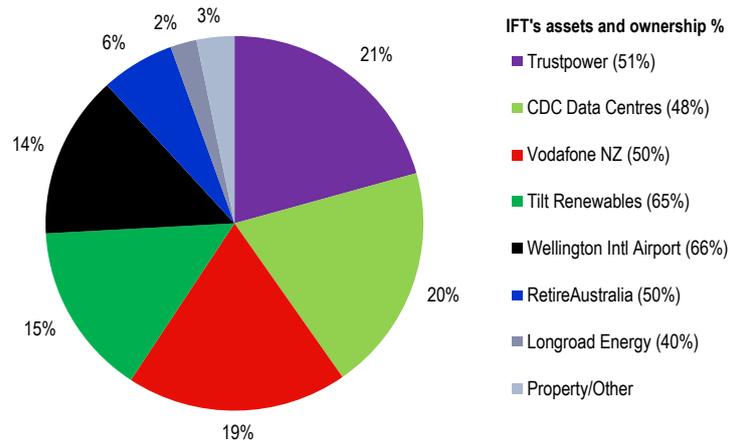
Infratil — a consistent performer

Infratil (IFT) has reshaped its portfolio over the last six months, refocussing on five core investments; Trustpower, Vodafone NZ, CDC Data Centres, Tilt Renewables and Wellington Airport. It has sold four smaller businesses and bought 50% of Vodafone NZ. IFT's investment thesis is to focus on sectors with positive long-term trends that are not exposed to cyclical downturns.

In the very near future, the potential sale of Tilt Renewables' Snowtown II wind farm in Australia is a possible positive catalyst, with high-priced recent wind farm transactions suggesting upside to our current valuation. Over the next two to three years, we see positive earnings growth coming from Tilt Renewables completing the development of two wind farms, CDC Data Centres continuing to build and contract out its Canberra and Sydney data centres, and Vodafone NZ lifting margins towards industry average. We expect these three businesses to deliver increasing cash flows that will help grow dividends for shareholders.

IFT's investment track record has been very strong over the past decade and investors have benefited from total shareholder returns of 19% per annum over that period. We expect it to continue to perform well in the low interest rate environment. Our rating is OUTPERFORM.

Figure 3. Infratil's assets weighted by value



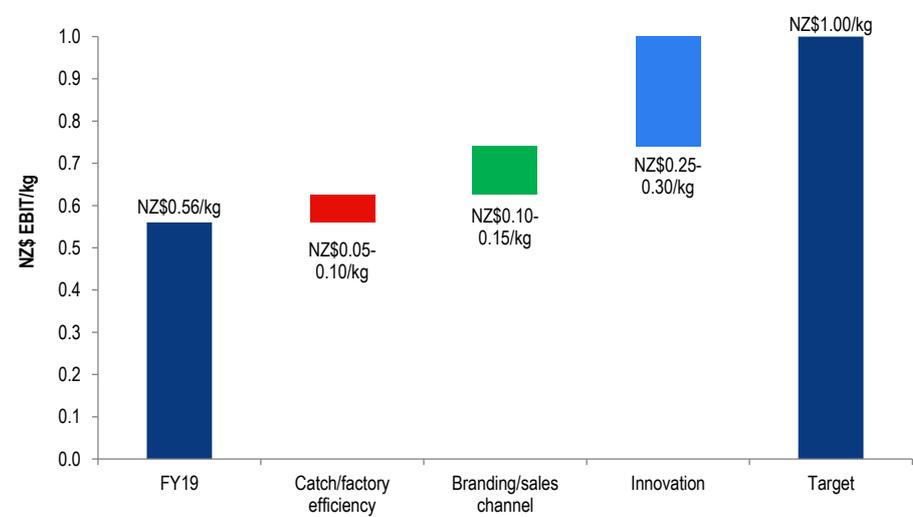
Source: Forsyth Barr analysis

Sanford — high quality NZ seafood

In recent years, NZ seafood company Sanford (SAN), has looked to shift focus from catching and producing volume, towards a focus on maximising the value it earns from its products. It is aspiring to grow its EBIT per kg from NZ\$0.56/kg today to NZ\$1.00/kg by FY23 though:

- **Catch and factory efficiencies** including capturing and maintaining the best quality seafood, and use of more sustainable catch methods such as precision seafood harvesting (PSH).
- **Branding and improving sales channels** such as premium food service, with Sanford branded product now highlighted on top end restaurant menus.
- **Product innovation** opening up additional markets such as nutraceutical and cosmetics as well as advancements in aquaculture breeding technology as evidence by its world leading spatNZ mussel hatchery.

Figure 4. Sanford's aspirations to grow the value it extracts from its products



Source: Forsyth Barr analysis

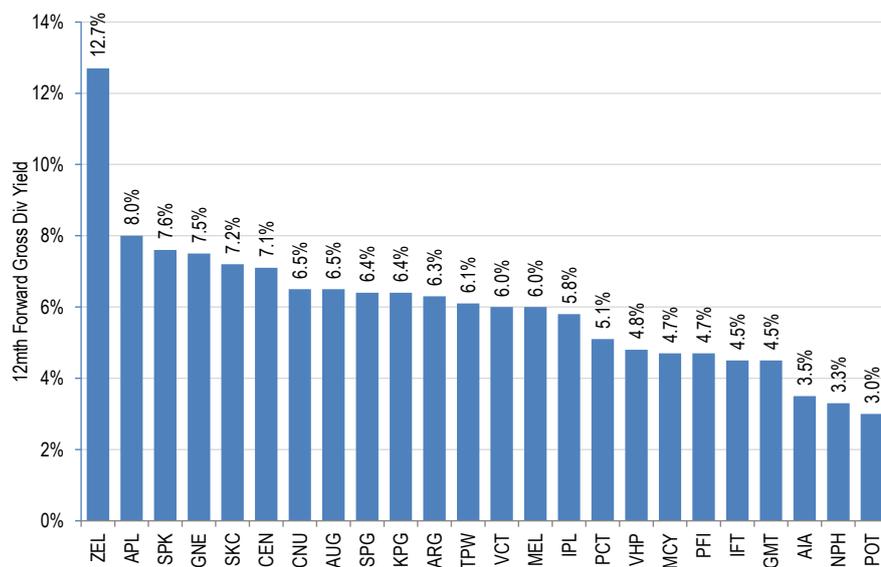
Last week SAN reported its FY19 results, reporting a +2c tick up in EBIT/kg to NZ\$0.56/kg. The year saw a number of challenges including (1) an extended outage of its largest fishing vessel, (2) warmer waters contributing to more intense algae blooms, disrupting aquaculture operations, and (3) a decline in Hoki catch. Looking forward we remain positive on the growth prospects, and believe the company is well positioned to deliver growth through increased branded product sales and a normalisation of vessel disruption.

We maintain a positive view on SAN. It offers investors exposure to the company's unique seafood quota asset and extensive aquaculture operations. On a FY20E PE of 13x SAN is attractively valued vs. the broader market.

Defensive yield – in a low interest rate environment, investors will continue to pursue yield

At last week’s Monetary Policy Announcement the Reserve Bank of New Zealand stated it expects “interest rates will need to remain at low levels for a prolonged period”. For those investors seeking yield who are able to tolerate a higher level of risk, our preferred NZ defensive yield exposures are Spark (SPK), Contact Energy (CEN), Genesis Energy (GNE), and Chorus (CNU). Our preferred NZ property exposures are Kiwi Property Group (KPG), Vital Healthcare Property Trust (VHP), and Investore (IPL).

Figure 5. NZ defensive yield stocks: 12-month forward gross yield



Source: Forsyth Barr analysis

Afterpay’s positive trading update; but on a 200x PE, how high is too high?

APT held its Annual General Meeting, where it provided a trading update and the announcement of an unexpected A\$200m placement to US-based technology investor, Coatue.

APT’s trading update was largely positive, highlighting a strong start in its UK operations, with over 400k active customers since launch and ~A\$100m in underlying sales in the four months to 31 October. Total underlying sales reached A\$2.7bn in the four months to 31 October, up +110% on pcp, and active customers increased to 6.1m, up +32% since June. APT also announced strategic partnerships with eBay and Mastercard in Australia.

The A\$200m placement to Coatue at A\$28.50 per share came as a surprise, and was seen as unorthodox by some investors. The placement is dilutionary and follows a series of recent capital raisings. APT noted the funding will be used to help retailers attract high value customers as it rapidly expands in the US and UK markets.

APT is a polarising company with shares trading on a 12-month forward PE of >200x. Analyst recommendations are largely in the BUY camp; however, UBS has a SELL rating and target price of A\$17.60, citing competitive and regulatory risks. An update on the probe by anti-money laundering agency AUSTRAC, which remains ongoing, will be delivered later this month

Fixed Interest

Steeper Yield Curves

Macro sentiment has improved over the past month as the news flow has turned positive. The US and China appear close to an agreement to de-escalate the trade war, Brexit has been pushed out to 2020, manufacturing indicators look to have stabilised in some key economies, notably China, and employers continue to add to their payrolls.

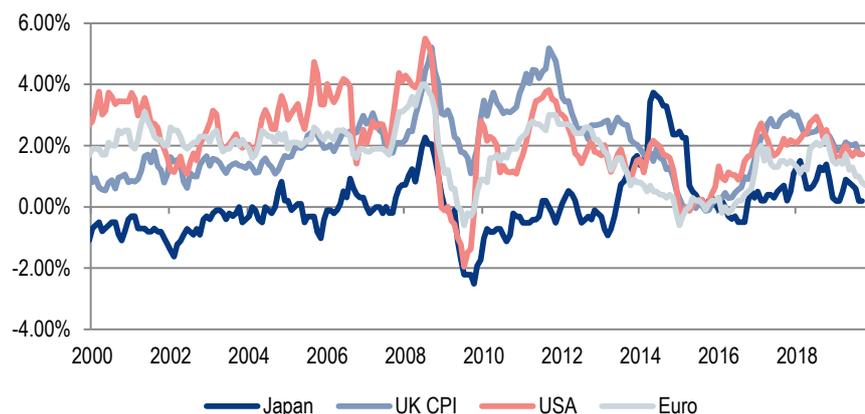
In tandem with the more positive outlook, the Fed and ECB have also renewed their efforts to reflate their respective economies. Official cash rates have been cut again and asset purchases recommenced. Policy reflation and an improving macro environment have been reflected in an increasingly 'risk-on' market view.

This includes a steepening in yield curves around the world. The US 10-year Treasury note has rebounded from 1.44% in early September, to 1.83%. (As recently as November 2018, the US 10-year rate was 3.24%). In New Zealand, the 10-year government bond yield, which was as high as 3.45% in early 2017, fell to 1.0% in early October, and has now risen to 1.38%.

But the numerous predictions of a 'normalisation' of interest rates throughout the current economic expansion, have failed to materialise. For most economies, long-term interest rates remain below where they were at the start of the expansion in 2009. Every time interest rates have looked like rising above the secular downward trend-line in bond yields, the market has not coped well. Notwithstanding the inability of most economies to cope with higher interest rates, inflation has also failed to materialise.

Is the recent rebound in global interest rates the start of a trend or only temporary?

Figure 6. G4 CPI annual percent change



Source: Forsyth Barr analysis, Datastream

Despite flooding the global economy with excess liquidity, in response to the Global Financial Crisis (GFC), central banks have failed to sustain inflation at, or above the 2.0% targets. The unconventional policies now seem to be losing their effectiveness, with a perverse phenomenon in Europe of rising savings ratios simultaneously when interest rates are negative.

Stronger global growth and policy reflation should result in higher long-term yields for bonds. However, while positive for some sectors, notably financials, any back-up in yields is likely to be limited.

Trend growth rates continue to fall

Trend-rates of growth have been falling around the world for several decades. GDP expansion is a combination of labour market growth plus gains in productivity. Most developed economies are already operating at full employment, while ageing demographics will continue to shrink the size of the working age populations in many regions, including Europe and much of Asia.

Figure 7. US GDP growth, annual percent change



Source: Forsyth Barr analysis, Datastream

The secular drivers of growth have also changed. Manufacturing and industrialisation were the key drivers of growth through the 1990's and early 2000's; with China joining the WTO and the East joined the West in embracing globalisation. Housing carried the baton through the years 2002 – 2008, which ended with the GFC. Since then, capital has been funnelled into financial assets. This latest trend has pushed inflation lower, financial asset prices higher and widened the gap between asset owners and the rest. Consumption, rather than investment of capital is contributing to the slowing of trend growth rates. Over time, this is deflationary, and a key reason why global bond yields will not back up too far (note the trend for inflation in developed economies as shown in Figure 5.).

Will productivity make a comeback?

The structural trend in interest rates is still falling based on the trend rates of growth. The risk to this view is if we see a market uplift in productivity. Productivity (or at least the measurement of it) has been pretty weak for the last decade. But it's also likely the digital boom hasn't been reflected in many of the official statistics. How do you measure all the changes we are seeing thanks to the internet, smart phone and app technology?

The next industrial revolution, where the physical world is connected to smart intelligence via Artificial Intelligence (AI), 5G, 6G, Robotics, 3D manufacturing and virtual reality, will likely transform most industries leading to generating more, with far less traditional inputs.

A productivity growth surge may already be happening, and eventually lead to steeper yield curves, although productivity growth is inherently deflationary. But the measurement of any efficiency gains is likely to lag, capping the upside potential for long-term interest rates in the short-term.

Bonds remain an important asset class

In this environment, with equity indices at record highs, the bigger risk to investors in bonds is not a blow out in prices, but deterioration in quality. Trends in non-performing loans, credit deterioration (from investment grade to "high yield"), and debt associated with borrowers with already high levels of debt, should be monitored closely. If something seems too good to be true, it probably is. While duration can be reduced, and credit quality monitored closely, now is not the time to be chasing the highest yields, nor should investors be getting out of bonds altogether.

As borrowers further down the credit spectrum borrow, a credit event remains the key risk.

Research Worth Reading

New Zealand

Abano Healthcare Group (ABA): Tooth Fairy Arrives

ABA is party to a takeover offer at NZ\$5.70/share, via scheme of arrangement. The scheme has board support and the transaction's barriers appear low. NEUTRAL.

Infratil (IFT): Gearing Up for Cash Returns — 1H20 Result

IFT's 1H20 result contained no surprises. We maintain our positive view with near-term upside from the potential sale of the Snowtown II wind farm at a good price and by FY22 its portfolio will be generating lots of cash. OUTPERFORM.

Mainfreight (MFT): 1H20 Result — Blue Chip

MFT reported a robust 1H20 result, with net profit up +11%, despite slowing cyclical tailwinds (particularly in Australasia), again highlighting the company's quality attributes. The result was driven by margin expansion; geographically in Europe and the Americas, and product-wise in Warehousing and Air & Ocean. MFT's underlying growth profile remains strong. However, at ~25x one year forward PE this appears priced in. NEUTRAL.

Sanford (SAN): FY19 Result — Navigating Choppy Waters

SAN continued to show signs of execution on its value-add strategy in FY19, albeit headline growth was weighed down by a number of headwinds including a one off vessel outage. Outlook commentary appears positive heading into FY20. We continue to like SAN given (1) its strategy of moving up the value chain, (2) undemanding valuation at 13x forward PE, and (3) possible upside from aquaculture opportunities. OUTPERFORM.

Australia

Afterpay Touch Group (APT.AX): AGM business update and \$200m placement

APT's business update showed a strong start in the UK, with >400k active customers since launch and ~\$100m in underlying sales in the 4 months to 31 Oct. US active customers were tracking ahead of UBSe (Oct-19: 2.6m). APT also announced partnerships with eBay and Mastercard in Australia. Maintain SELL, with significant execution risks to consensus expectations. (Published by UBS)

Aristocrat Leisure (ALL.AX): RAID to underpin double-digit FY21e earnings growth

We believe Aristocrat offers double-digit organic earnings growth from FY19e-FY21e on a sub-20x PER. BUY. (Published by Citi)

CSL (CSL.ASX): R&D Day 2019 - previewing the pipeline

Ahead of its annual R&D Day (on 4-Dec-19), we preview the key potential updates CSL could provide across its new therapeutic framework: (1) Immunology and Neurology; (2) Haematology and Thrombosis; (3) Transplant; (4) Respiratory; & (5) Cardiovascular and Metabolic. Maintain BUY. (Published by UBS)

Goodman Group (GMG.AX): Pressure building on a guidance upgrade in Feb

In our view, GMG is on track to meet our +12% FY20 EPS growth vs. guidance of +9% growth) given (1) underlying fundamentals remain strong, (2) AUM is tracking ~3 months ahead of our forecasts, and (3) development WIP is on track to hit A\$5b by year end. Maintain BUY. (Published by Citi)

REA Group (REA.AX): First-quarter FY20 result review

REA reported 1Q FY20 revenue and operating earnings significantly below our forecasts and consensus. This is despite the decline in listings being in line with our expectations, as steeper declines in Sydney and Melbourne, and worse revenues from the developer, commercial and media segments, pressured the top line. LIGHTEN. (Published by Ord Minnett)

Santos Ltd (STO.AX): WA/NT site trip: Clearer gas monetization pathways, stronger FCF

We have come back more positive on STO's ability to monetise its various gas resources in WA and NT, given the strategic and competitive benefits that its infrastructure positions command. NEUTRAL. (Published by Citi)

Xero Limited (XRO.AX): UBS Evidence Lab Survey: Structural drivers intact, but a long way to go in the USA

The UBS Evidence Lab survey found that the intent of Desktop users to migrate to the Cloud increased in 2019 versus 2018. The survey also found further evidence that accountants are the key gatekeeper for SME accounting choices, which helps validate XRO's partner strategy. Of 305 SMBs surveyed in the USA, none were XRO users, however the US opportunity remains large and XRO remains focused on executing its partner 'playbook'. SELL. (Published by UBS)

International

Alibaba Group Holding (BABA): Another Record 11.11 GMV at Rmb268.4bn; +25.7% YoY

2019 marks the 11th Alibaba's Singles' Day (Nov.11) anniversary; the spectacular shopping event once again broke its last year record with 2019 GMV settled through Alipay at Rmb268.4bn, up 25.7% from Rmb213.55bn in 2018. BUY. (Published by Citi)

NVIDIA (NVDA.US): Raising TP to \$245; Remain Buy-Rated on New Product Cycle Appeal in 2020

NVDA beat consensus October quarter EPS, but guided to January quarter revenue slightly below expectations but with higher gross margins. We believe NVDA offers the best programmable data centre computing platform that can be scaled with a high software moat. BUY. (Published by Citi)

Salesforce.com Inc (CRM.US): Can Upcoming Catalysts Revitalize CRM's Stock Performance Into Year End?

We think CRM can continue its strong performance into CY20 as recent M&A gets fully digested, numbers look conservative into H2F20, the UK CMA is set to rule on the DATA deal by 11/29, and Dreamforce / Salesforce's upcoming analyst day on 11/20 provides an opportunity for the company to get investors excited about positive trends in the business. BUY. (Published by UBS)

Tencent Holdings (0700.HK): Social Ads Offset Media Ads; Global Games Contribute Growth

Tencent reported a soft quarter driven by weaker-than-expected media ad revenues and slightly slower smartphone games revenues growth. On the positive side (1) social ad reaccelerated to +32% yoy; 2) Cloud revenue increased +80% yoy and fintech achieved double digit operating margins, and 3) revenue contribution from overseas games reached teen % of total games. Looking forward, we believe the near-term growth likely to be driven by sustainable growth of social ads, fintech and business services segment and overseas games revs. Maintain BUY. (Published by Citi)

Economics/Strategy

US Economics Weekly: Cold weather, lukewarm outlook, hot markets

After moving aggressively a week ago to price-out cuts and price-in some probability of hikes, Treasury yields settled a bit lower last week, appropriately reflecting (in our view) an outlook for solid US growth, but with still mainly downside risk.

While these risks were evident in weaker-than-expected data from China, in the US solid retail sales and soft manufacturing production (even after adjusting for the autoworkers strike) were as expected. Shelter prices slowed in core CPI – but core PCE remains on-track to obtain +2.0% inflation in 1H20.

Our base case remains for the Fed to stay on-hold in December and through 2020, but with some significant probability of cuts should activity slow. Hikes are much less likely, even if activity picks up. (Published by UBS)

Calendar

Figure 8. Calendar

	New Zealand	Australia	International
18-Nov	Kiwi Property 1H20 result Vista Group investor day	RBA Meeting Minutes	US: NAHB Housing Market Index EU: Current Account
19-Nov	Arvida Group 1H20 result a2 Milk ASM Napier Port FY19 result Chorus – Commerce Commission draft input methodologies announcement	Sonic Healthcare ASM WiseTech Global ASM Mirvac Group ASM REA Group ASM Woodside Petroleum Investor Day Qantas Airways Investor Day	US: Building starts and permits
20-Nov	Argosy Property 1H20 result Precinct Properties ASM Serko 1H20 result Tower FY19 result	Aristocrat Leisure FY19 result Sydney Airport October stats Goodman Group ASM Lendlease Group ASM	Home Depot 3Q20 result Medtronic 2Q20 result Oracle ASM Novo Nordisk Capital Markets Day
21-Nov	AFT Pharmaceuticals 1H20 result Foley Wines ASM Ryman Healthcare 1H20 result Government Finance Statistics	ALS 1H20 result Qube ASM BlueScope Steel ASM	Target 3Q20 result Lowe's Companies 3Q20 result News Corp ASM Salesforce.com Investor Day Campbell Soup ASM L Brands 3Q20 result US: Existing Home Sales US: Initial Jobless Claims
22-Nov	EROAD 1H20 result Kathmandu ASM Warehouse Group ASM	APA Group ASM ResMed ASM CBA Manufacturing PMI	Baxter International 3Q19 result Macy's 3Q20 result Intuit 1Q20 result US: Philadelphia Fed Manufacturing Index EU: Consumer Confidence EU: Markit Manufacturing PMI
23-Nov			US: Markit Manufacturing PMI
25-Nov	Abano Healthcare ASM Metro Performance Glass 1H20 result Stride Property Group 1H20 result		

Black – company news, Red – economic news
Source: Forsyth Barr analysis

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