

Vector

UNDERPERFORM

Imputing a Lower Gross Dividend — FY19 Result Review

Vector (VCT) produced a mixed FY19 result, with EBITDA up +3% to \$486m. Two thirds of the growth was from an accounting change and there was a -\$47m write-off of a recently acquired asset. As expected, VCT declared a fully imputed final dividend of 8.25cps, although we believe the dividend is under pressure due to the low interest rate environment.

What's changed?

- **Earnings:** FY20 EBITDA increased +\$13m to \$499m
- **Target Price:** Target price unchanged at \$3.20
- **Rating:** UNDERPERFORM rating retained

Meter business the only real shining light in dull FY19 result

VCT's metering business delivered EBITDA growth of +\$12m and with accounting changes adding a further +\$11m; putting into context the +\$16m EBITDA growth VCT achieved in FY19. Gas Trading had a difficult year as VCT was impacted by the Pohokura gas outage and the Network division faced lower gas regulatory earnings and higher maintenance costs. However, the biggest disappointment was the E-Co Products business, acquired in early 2017. VCT has written down its book value -\$47m, ~50% of the acquisition cost. Normalised NPAT of \$130m was -\$1m lower than the pcp, with higher depreciation costs offsetting the increase in EBITDA.

No formal FY20 guidance due to regulatory uncertainty

With the Commerce Commission's (ComCom) final electricity price reset decision due late November, VCT has not provided earnings or dividend guidance. The low interest rate environment is problematic for VCT given its importance in the regulatory WACC and therefore electricity price reset decision. Other important factors in the price reset are the opex and capex allowances that VCT will be given.

Fully imputed dividend may become a thing of the past

VCT again said its dividend policy will be reviewed following the ComCom decision. However, it also reiterated the importance of maintaining its BBB credit rating. After further consideration, we believe VCT will continue to grow its headline dividend, but will no longer fully impute the dividend. At year end VCT had prepaid \$105m of tax and it is questionable how long VCT can keep prepaying tax in order to pay a fully imputed dividend. We have lifted our FY20 dividend forecast +0.25cps to 16.75cps, but assume it will be 70% imputed.

Positive earnings forecast changes, but capex is increasing too

We have lifted our FY20 EBITDA forecast +\$13m to \$499m, mainly due to differences in the FY19 result flowing into later years. However, there is little change to our valuation, as we have also lifted our capex assumption (+11%) as the metering business looks to grow faster than previously forecast.

Investment View

Our rating is UNDERPERFORM. Whilst Vector (VCT) offers a solid dividend yield there is some downside risk to the gross dividend from low interest rates impacting on the electricity regulatory price reset. At this point in time we prefer other high yielding investments over VCT.

NZX Code	VCT
Share price	NZ\$3.61
Target price	NZ\$3.20
Risk rating	Low
Issued shares	995.8m
Market cap	NZ\$3,595m
Average daily turnover	199.9k (NZ\$701k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	129.5	138.0	115.1	116.8
EPS* (NZc)	13.0	13.9	11.6	11.7
EPS growth* (%)	-1.5	6.6	-16.6	1.5
DPS (NZc)	16.5	16.8	17.0	17.3
Imputation (%)	100	70	70	70

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	10.8	10.9	11.3	10.8
EV/EBIT	19.2	19.8	21.6	20.7
PE	27.8	26.1	31.3	30.8
Price / NTA	3.7	3.8	4.0	n/a
Cash dividend yield (%)	4.6	4.6	4.7	4.8
Gross dividend yield (%)	6.3	5.9	6.0	6.1

*Historic and forecast numbers based on underlying profits

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Vector Limited (VCT)		Priced as at 23 Aug 2019: NZ\$3.61					June year end				
Forsyth Barr valuation						Valuation Ratios					
Valuation methodology						Blend of DCF and dividend growth					
12-month target price (NZ\$)*						2018A 2019A 2020E 2021E 2022E					
3.20						Spot valuations (NZ\$)					
Expected share price return						EV/EBITDA (x)					
-11.4%						10.9 10.8 10.9 11.3 10.8					
Net dividend yield						EV/EBIT (x)					
4.7%						18.7 19.2 19.8 21.6 20.7					
Estimated 12-month return						PE (x)					
-6.7%						27.3 27.8 26.1 31.3 30.8					
1. DCF						Price/NTA (x)					
2. Dividend growth						3.4 3.7 3.8 4.0 4.3					
3. n/a						Free cash flow yield (%)					
n/a						0.1 -2.0 -2.2 -2.7 -2.0					
Key WACC assumptions						DCF valuation summary (NZ\$m)					
Risk free rate						Total firm value					
2.00%						5,553					
Equity beta						(Net debt)/cash					
0.92						2,667					
WACC						Value of equity					
6.3%						2,886					
Terminal growth						Shares (m)					
1.5%						996					
Profit and Loss Account (NZ\$m)						Capital Structure					
2018A 2019A 2020E 2021E 2022E						2018A 2019A 2020E 2021E 2022E					
Sales revenue						Interest cover EBIT (x)					
1,311 1,310 1,340 1,342 1,381						2.4 2.4 2.6 2.2 2.1					
Normalised EBITDA						Interest cover EBITDA (x)					
542 565 583 577 601						4.1 4.2 4.6 4.2 4.1					
Depreciation and amortisation						Net debt/ND+E (%)					
(226) (247) (262) (276) (287)						49.4 53.4 55.8 58.5 60.9					
Normalised EBIT						Net debt/EBITDA (x)					
316 318 322 301 313						4.4 4.7 5.0 5.5 5.7					
Net interest						Key Ratios					
(131) (133) (126) (137) (147)						2018A 2019A 2020E 2021E 2022E					
Associate income						Return on assets (%)					
(2) 1 1 1 1						5.4 5.3 5.1 4.6 4.7					
Tax						Return on equity (%)					
(54) (53) (56) (47) (48)						5.4 5.6 6.0 5.1 5.3					
Minority interests						Return on funds employed (%)					
(2) (1) (3) (3) (3)						4.7 4.5 4.4 3.9 4.0					
Normalised NPAT						EBITDA margin (%)					
131 129 138 115 117						41.3 43.1 43.5 43.0 43.5					
Abnormals/other						EBIT margin (%)					
17 (47) - - -						24.1 24.3 24.0 22.4 22.7					
Reported NPAT						Capex to sales (%)					
148 83 138 115 117						29.5 31.9 37.8 36.8 34.5					
Normalised EPS (cps)						Capex to depreciation (%)					
13.2 13.0 13.9 11.6 11.7						171 170 194 179 166					
DPS (cps)						Operational Performance					
16.3 16.5 16.8 17.0 17.3						2018A 2019A 2020E 2021E 2022E					
Growth Rates						Electricity throughput (GWh)					
2018A 2019A 2020E 2021E 2022E						8,442 8,410 8,529 8,655 8,787					
Revenue (%)						Electricity connections (000)					
6.9 -0.1 2.3 0.2 2.9						563 571 579 587 595					
EBITDA (%)						Volume/customer (MWh)					
0.9 4.3 3.2 -1.1 4.1						15.1 14.8 14.8 14.8 14.9					
EBIT (%)						Price (\$/MWh)					
-6.4 0.8 1.0 -6.5 4.3						49.6 50.4 49.0 46.3 47.3					
Normalised NPAT (%)						Gas distribution (PJ)					
-12.8 -1.5 6.6 -16.6 1.5						14.5 14.4 14.7 14.9 15.1					
Normalised EPS (%)						Gas connections (000)					
-12.8 -1.5 6.6 -16.6 1.5						109 112 113 115 117					
DPS (%)						Volume/customer (GJ)					
1.6 1.5 1.5 1.5 1.5						134 130 130 130 130					
Cash Flow (NZ\$m)						Natural gas sales (PJ)					
2018A 2019A 2020E 2021E 2022E						18.3 16.1 15.6 15.1 14.7					
EBITDA						Liquid sales (tonnes)					
542 565 583 577 601						77,656 79,170 84,965 85,595 85,249					
Working capital change						Liquigas tolling (tonnes)					
(9) (31) 28 4 (2)						183,540 152,206 149,162 146,179 143,255					
Interest & tax paid						Smart meters (000)					
(186) (203) (184) (185) (196)						1,406 1,558 1,753 1,928 2,083					
Other						Total meters (000)					
44 17 - - -						1,730 1,875 2,064 2,233 2,381					
Operating cash flow						Smart meter %					
390 348 427 396 403						81 83 85 86 87					
Capital expenditure						Divisional Revenue (NZ\$m)					
(387) (418) (507) (493) (476)						2018A 2019A 2020E 2021E 2022E					
(Acquisitions)/divestments						Electricity					
(9) (7) - - -						704 707 697 673 690					
Other						Gas Transport					
- (2) - - -						55 53 56 57 59					
Funding available/(required)						Gas Trading					
(6) (79) (79) (97) (73)						290 284 300 301 300					
Dividends paid						Technology					
(164) (164) (167) (169) (172)						274 275 298 320 341					
Equity raised/(returned)						Corporate/Intersegment revenue					
- - - - -						(12) (9) (10) (10) (10)					
Increase/(decrease) in net debt						Total Revenue					
170 243 246 267 245						1,311 1,310 1,340 1,342 1,381					
Balance Sheet (NZ\$m)						Divisional EBITDA (NZ\$m)					
2018A 2019A 2020E 2021E 2022E						2018A 2019A 2020E 2021E 2022E					
Working capital						Electricity					
24 54 27 22 25						383 403 401 380 391					
Fixed assets						Gas Transport					
3,996 4,185 4,430 4,647 4,835						46 43 45 46 48					
Intangibles						Gas Trading					
1,397 1,355 1,355 1,355 1,355						34 31 32 30 28					
Other assets						Technology					
81 136 136 137 137						132 142 161 177 192					
Total funds employed						Corporate					
5,497 5,729 5,947 6,161 6,352						(53) (55) (56) (56) (57)					
Net debt/(cash)						Total EBITDA					
2,367 2,773 3,019 3,286 3,531						542 565 583 577 601					
Other non current liabilities						Customer contributions					
672 645 639 638 637						72 79 84 82 80					
Shareholder's funds						Adjusted EBITDA					
2,441 2,332 2,308 2,253 2,198						470 486 499 495 521					
Minority interests											
18 17 20 22 25											
Total funding sources											
5,497 5,768 5,985 6,199 6,390											

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

FY19 result review

Figure 1. Summary FY19 result

12 months ending 30 June (\$m)	FY18	FY19	% Chg	FB	Diff	Commentary
Networks	359	367	2%	358	9	Up moderately on pcp with average pricing higher than our forecast
Gas Trading	34	31	-9%	32	(1)	Difficult year with Pohokura gas outage impacting on earnings
Technology	130	142	9%	148	(6)	Growth all from meters, with HRV one-off restructuring costs a negative
Corporate/other	(53)	(55)	2%	(56)	2	
Adjusted EBITDA	470	486	3%	482	4	
Capital contributions	72	79	11%	89	(9)	Up +\$7m on pcp, but lower than forecast
Group EBITDA	542	565	4%	570	(5)	
Depreciation & amortisation	226	247	9%	241	6	Increase due to accounting changes, capex and accelerated depreciation
EBIT	316	318	1%	329	(11)	
FV of chg in fin. instruments	3	(3)		(0)	(2)	
Equity Earnings	(2)	1		1	(0)	
Asset impairment	-	(47)		-	(47)	Asset write-down of E-Co Products business
Net Interest	(131)	(133)	2%	(132)	(1)	Net interest costs flat on pcp, with higher debt and IFRS 16 offsetting rate fall
Pretax	187	137	-27%	198	(61)	
Tax Expense/(Benefit)	37	53	43%	54	(2)	
NPAT	150	84	-44%	143	(59)	
Minority Interests	(2)	(1)		(2)	1	
REPORTED PROFIT	148	83	-44%	141	(59)	
Abnormal items	(17)	47		-	47	
Normalised NPAT	131	130	-2%	141	(12)	Flat on pcp, but lower than forecast
Normalised EPS	13.2	13.0	-2%	14.2	(1.2)	
Final dividend per share	8.00	8.25	3%	8.3	0.00	Small +0.25cps increase in final dividend as forecast
Dividend per share	16.25	16.50	2%	16.50	0.00	Modest increase in FY19 dividend

Source: VCT, Forsyth Barr analysis

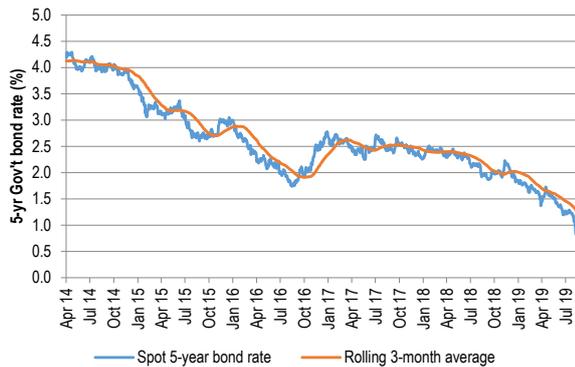
Key points

- FY19 EBITDA of \$486m was in the middle of VCT's \$480m to \$490m guidance range, and +\$16m higher than the pcp. However, accounting policy changes (mainly the adoption of IFRS 16) lifted EBITDA +\$11m, (+\$5m in Networks, +\$2m Gas Trading and +\$3m Technology).
- The Networks earnings growth was all from electricity (and accounting policy changes), with gas revenue down on the pcp. FY19 is the first full year of the lower 2017 gas price reset decision impacting earnings.
- Gas Trading had a difficult year, with the Pohokura gas outage, lower Liquigas throughput and higher Kapuni processing facility maintenance all impacting on earnings.
- The Technology division again led VCT's growth, with the smart meter roll-out adding +\$12m of EBITDA, partially offset by E-Co Products down -\$4m, taking it into a loss situation, although one-off restructuring costs are a large part of that.
- Capital contributions, which are difficult to forecast, were -\$9m lower than estimated and the main cause of VCT's Normalised NPAT miss vs. our forecast.
- Depreciation and amortisation costs increased +\$21m on FY18 with IFRS 16, asset growth and accelerated depreciation on some assets all having an impact.
- One of the disappointing aspects of the result was the -\$47m asset write-down of E-Co Product (the HRV business is a core part of this). VCT paid ~\$100m a little over two years ago for the business, hence, the write-down is disappointing with respect to both timing and size.
- Normalised NPAT of \$130m was down very slightly on the pcp, with higher depreciation charges offsetting the higher EBITDA result.
- VCT declared a final fully imputed dividend of 8.25cps (as forecast).
- Net debt increased +\$250m to \$2.63b with VCT still experiencing high levels of capex. FY19 capex totalled \$425m, +10% up on the pcp.

Outlook

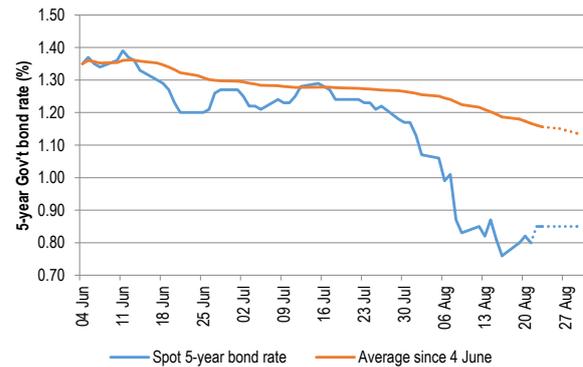
VCT is clearly concerned about the upcoming electricity price reset, which is understandable given the current interest rate environment. Since the start of the risk free rate setting period at the beginning of June, 5-year Government bond rates have fallen ~0.5% from ~1.35% to ~0.85%. The average for the three months to the end of August looks like it will be ~1.13%.

Figure 2. 5-year bond rate since last electricity price reset



Source: RBNZ, Forsyth Barr analysis

Figure 3. 5-year bond rate since 4 June 2019



Source: RBNZ, Forsyth Barr analysis

No comment on future dividend policy

As anticipated, VCT again stated that its dividend policy will be reviewed following the ComCom's final electricity price reset decision on 28 November. Whilst interest rates are critical to the regulatory WACC and are now known, the capex and opex allowance are also key inputs to the final price reset decision.

In addition, VCT is lobbying the ComCom for two late regulatory changes. First, it wants to remove indexation due to VCT's high upcoming capex profile. Second, it wants the cost of debt calculation in the WACC to be based on a rolling 5-year or a rolling-10 year basis as opposed to a spot basis. Both of these changes would increase near-term cash flows and both have regulatory precedent elsewhere.

In our view, VCT is unlikely to get these changes in this electricity price reset decision. Both issues are input methodology decisions that the ComCom decided on in the recent past. However, it is possible VCT may get respite if it tried for a customised price path (CPP), as opposed to the default price path (DPP). Asking for a CPP is not without risk, as it is a time-consuming process and there is no guarantee VCT would end up with a better outcome than the DPP.

Dividend considerations

VCT's Board has several key considerations when it comes to deciding its future dividend path:

- 1) **The desire of VCT's 75% shareholder, Entrust, to maintain a flat trust cheque to Auckland electricity consumers** (which is currently \$350/year). Maintaining a flat consumer trust cheque requires VCT to increase its dividend ~+0.25cps per annum due to increasing consumer numbers.
- 2) **Maintaining VCT's credit rating**, which is currently BBB. VCT has stated it wants to maintain its BBB rating, hence, it needs to watch its credit metric carefully, the key metric being FFO/net debt.
- 3) **The ability to fully impute dividends**. For several years VCT has been prepaying tax so it can fully impute its dividends. However, prepaid tax now totals \$105m — effectively two years of tax payments.

Prior to the FY19 result we assumed a flat dividend of 16.5cps for the next electricity regulatory period (5 years), as we did not believe VCT could maintain a growing dividend without risking a credit rating downgrade.

After further consideration, we suspect a more likely decision for VCT is to continue paying a headline growing dividend, but to stop fully imputing the dividend. The cash flow effect for VCT is the same as holding the dividend flat, as it pays less income tax (as opposed to a lower cash dividend). From the Trust's perspective, it will require a one-off drop in the annual cheque it can pay, but then it should be able to be maintained in absolute terms. We estimate that VCT will drop its imputation level from 100% to 70%.

Forecast changes

VCT provided no formal FY20 EBITDA guidance given the electricity price reset. We have increased our FY20 EBITDA forecast +\$13m to \$499m. The changes we have made to our forecasts factor in:

- The better than expected Networks performance (although the uplift is relatively short-lived given the electricity price reset decision due)
- Higher than expected roll-out of smart meters in Australia — VCT has guided to 135,000 installations in Australia and 195,000 in total. This impacts on both capex and Technology EBITDA forecasts going forward
- Higher depreciation charges
- Dividend and imputation changes as noted above

Figure 4. Forecast changes

\$m	FY20			FY21			FY22		
	Old	New	Chg %	Old	New	Chg %	Old	New	Chg %
Total Revenue	1,341	1,340	0%	1,344	1,342	0%	1,377	1,381	0%
Total Costs	769	757	-2%	775	765	-1%	788	780	-1%
EBITDA									
Networks	352	362	3%	341	345	1%	356	359	1%
Gas Trading	31	32	5%	29	30	4%	28	28	-1%
Technology	161	161	0%	173	176	2%	183	191	4%
Corporate/other	(57)	(56)	-3%	(58)	(56)	-3%	(59)	(57)	-3%
Adjusted EBITDA	486	499	3%	485	495	2%	508	521	3%
Capital contributions	86	84	-3%	84	82	-3%	82	80	-3%
Group EBITDA	573	583	2%	569	577	1%	590	601	2%
Depreciation	247	262	6%	254	276	9%	260	287	11%
EBIT	325	322	-1%	315	301	-5%	330	313	-5%
Net Interest	(123)	(126)	2%	(132)	(137)	3%	(141)	(147)	4%
Equity Income	1	1	-40%	1	1	-40%	1	1	-40%
Pretax	203	196	-3%	184	164	-10%	190	167	-12%
Tax Expense/(Benefit)	56	56	0%	51	47	-7%	52	48	-9%
NPAT	147	140	-5%	133	118	-12%	137	119	-13%
Minority Interests	(3)	(3)	0%	(3)	(3)	0%	(3)	(3)	0%
REPORTED PROFIT	145	138	-5%	131	115	-12%	135	117	-13%
Capital expenditure	456	507	11%	445	493	11%	429	476	11%
EPS	14.6	13.9	-5%	13.1	11.6	-12%	13.6	11.7	-13%
Dividend (cps)	16.50	16.75	2%	16.50	17.00	3%	16.50	17.25	5%
Dividend imputation	100%	70%	-30%	100%	70%	-30%	100%	70%	-30%

Source: Forsyth Barr analysis

Investment summary

Our rating is **UNDERPERFORM**. Whilst Vector (VCT) offers a solid dividend yield there is some downside risk to the gross dividend from low interest rates impacting on the electricity regulatory price reset. At this point in time we prefer other high yielding investments over VCT.

Business quality

- **Regulation:** ~75% of VCT's EBITDA earnings are regulated by the ComCom; hence, the regulatory settings are VCT's key value driver. The nature of regulated earnings is generally stable and predictable earnings.
- **Interest rates:** Within the current regulatory settings the most important factor impacting earnings is the regulatory WACC and within that, interest rates. The next price reset takes effect from April 2020.

Earnings and cash flow outlook

- **Electricity price reset:** In 2019 the ComCom will reset regulated electricity price paths. A key variable is interest rates, which will be set in the three month period to 31 August 2019. Following May's draft determination and falling interest rates, we believe there is some modest downside risk to regulatory earnings.
- **Smart meter roll-out:** VCT is the number one provider of smart meters in New Zealand with its AMS brand. The smart meter roll-out has been a major source of earnings growth and will continue to be until FY19.
- **New energy businesses:** VCT acquired a solar business (PowerSmart), and a home products business (E-Co Products operating under the HRV, EES, and HVACHero brands) in 2017. To date the businesses have underperformed expectations, leading to an asset write-off in FY19.

Company description

VCT owns and operates the Auckland electricity distribution network and the Auckland gas distribution network. It has ~560,000 electricity and ~108,000 gas connections. The Networks division provides most (~75%) of VCT's operating earnings which are regulated by the Commerce Commission. Unregulated businesses include a natural gas trading business, LPG business, a share in the Kapuni processing plant, telecommunications business, solar business, HRV ventilation business and metering business. AMS is the largest smart metering business in New Zealand. VCT also owns 60% of Liquigas. VCT's majority shareholder is the Entrust which owns 75%.

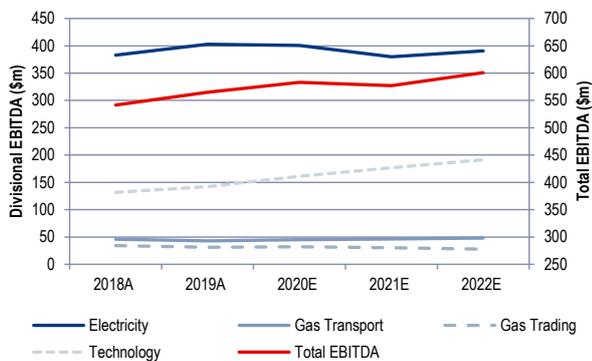
Financial structure

- **Balance sheet:** Relative to most other listed businesses VCT is highly geared; however, its regulatory earnings provide a high degree of certainty.
- **Capital structure:** VCT is 75% owned by Entrust, constraining VCT's growth options. VCT's requirement to pay slowly increasing dividends limits its investment opportunities to high yielding investments.

Key risks

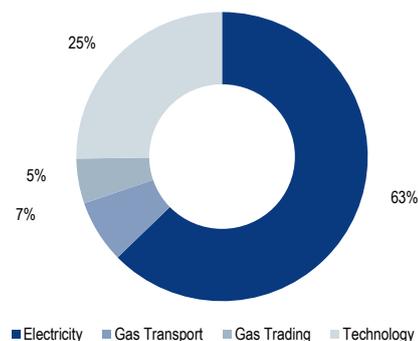
- **Regulation:** Negative regulatory settings are a key earnings risk. We view the current level of risk as medium.
- **Disruptive technology:** Solar roll-out may reduce lines company demand, although any impact is at least 10 years away. VCT is investing in solar and batteries to minimise the threat from new technology.

Figure 5. Divisional EBITDA



Source: VCT, Forsyth Barr analysis

Figure 6. FY20E EBITDA breakdown



Source: VCT, Forsyth Barr analysis

Figure 7. Substantial Shareholders

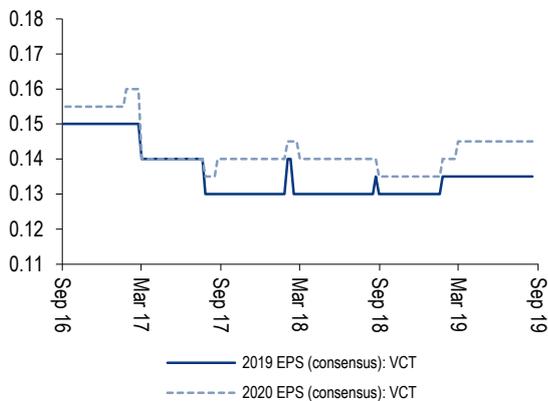
Shareholder	Latest Holding
Entrust	75.1%

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

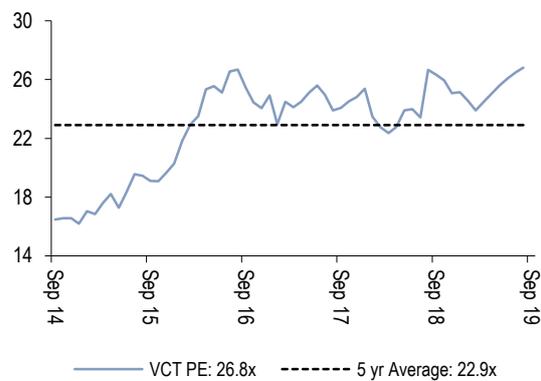
Figure 8. International Compcos

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
				2020E	2021E	2020E	2021E	2020E	2021E	
<i>(metrics re-weighted to reflect VCT's balance date - June)</i>										
Vector	VCT NZ	NZ\$3.61	NZ\$3,595	26.1x	31.3x	10.7x	10.9x	19.5x	20.8x	4.7%
APA Group	APA AT	A\$10.89	A\$12,849	37.4x	33.6x	13.6x	13.2x	21.7x	20.8x	4.8%
AusNet Services	AST AT	A\$1.80	A\$6,623	24.3x	23.8x	12.1x	11.6x	19.7x	18.6x	5.9%
Spark Infrastructure Group	SKI AT	A\$2.36	A\$3,970	34.8x	43.8x	14.8x	15.5x	16.2x	18.7x	6.1%
Compcpo Average:				32.2x	33.7x	13.5x	13.4x	19.2x	19.4x	5.6%
<i>EV = Current Market Cap + Actual Net Debt</i>				VCT Relative:	-19%	-7%	-20%	-19%	+1%	+8%

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

Figure 9. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 10. 12 Month Forward PE


Source: Forsyth Barr analysis

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