

# Wealth Weekly

## Business Models Ageing Gracefully?

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Labour's election victory over the weekend came as no surprise to the market. Increased investment in infrastructure and training, and Resource Management Act reform could benefit corporate New Zealand, while tougher environmental and employment policies and higher income taxes could raise costs for resource and labour intensive sectors. The combination of loose fiscal and monetary policy already looks to have heated up the housing market. That provides breathing space for the listed aged care developers, which we have recently reviewed in some detail.

**Aged care business models evolving**

**The attraction of New Zealand's aged care sector centres on its near unique business model** of recycling capital while building up an annuity income stream; for every 100 dollars the operators invest in villages, they recoup 100 dollars through the sale of occupational rights agreements (ORAs), which also deliver a growing annuity stream and near "infinite" return on actual invested capital – or so the theory goes. In practice this has become increasingly difficult to achieve as operators acquire more expensive land and undertake increasingly complex and time-consuming builds. Net debt is growing across the sector and cash conversion of earnings is declining. **Is the business model broken?**

**No it isn't. Overall we believe the sector remains attractive.** COVID-19 has delivered two earnings tailwinds for the sector:

- The listed operators navigated the pandemic's impact on its residents well, and feedback from residents and families has been positive – burnishing the sector's image and driving increased demand for aged care units at a time when COVID-19 remains a threat.
- Low interest rates and the lockdown-inspired "nesting" phenomenon appear to have driven a rise in house prices, which sets the sector up for several years of healthy profits from new developments and the resale of ORAs at higher prices

But we do believe it has become harder for the operators to recycle capital, and scrutiny of underlying earnings has become more important. In our [review of the aged care sector](#), published last week, we focussed on the aged care companies' annuity earnings and cash recovery. Following this analysis, **we reiterated our OUTPERFORM rating on Summerset** – our preferred stock in the sector.

**We upgraded Oceania Healthcare to OUTPERFORM, while noting its potential upside comes with risks.** We downgraded Ryman Healthcare and Arvida to NEUTRAL, primarily on valuation grounds but also on weaker fundamentals in some respects relative to Summerset. On page 2 we outline our investment views on these companies.

**Themes of the week**

The Reserve Bank is currently developing the Funding for Lending Programme by which it will, as the name suggests, provide money directly to the banks to lend out – the big question is to which borrowers? To small and medium businesses? Or will it all flow into mortgages?

**We re-initiated coverage of Heartland Group Holdings last week with an UNDERPERFORM rating.** Heartland provides a range of banking services including personal and motor loans, reverse mortgages, business loans and rural financing. The company faces a number of regulatory, competitive and economic headwinds, in our opinion.

The September quarter reporting season got underway in the northern hemisphere last week. **Johnson & Johnson, LVMH and Taiwan Semiconductor delivered better than expected results**, while earnings from the major US banks were mixed.

**Looking ahead**

Earnings reports this week will continue with **Halliburton, Netflix and IBM** on Tuesday, **Abbott Labs** on Thursday, **Microsoft** on Friday and **Amazon, Gilead, Illumina and Visa** on Saturday. **CSL** will hold an investor R&D briefing on Wednesday. **AGM** season continues with **Auckland Airport** and **Comvita** having meetings on Wednesday.

## NZ Listed Aged Care Sector

### Different Times Call for Different Measures

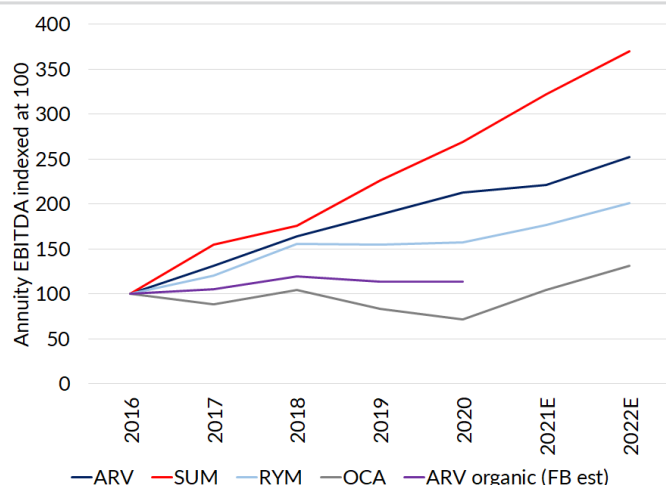
Overall we remain positive on the aged care stocks as a group. The COVID-19 crisis, somewhat unexpectedly, appears to have turned into a double win for the aged care operators; we believe rising demand for units and high house prices are likely to drive strong earnings growth for several years.

#### Earnings are not what they seem

The aged care operators' innovative approach to reporting underlying earnings makes earnings comparisons challenging. Our preferred approach when evaluating the sector is annuity earnings (Figure 1), i.e. earnings excluding profits from property developments. This approach highlights some diverging fortunes. Summerset (SUM) has continued to grow at a pace of 20% + pa, while growth has slowed materially for Ryman Healthcare (RYM) over the last few years and organic growth has never really taken off for Arvida (ARV) or Oceania (OCA).

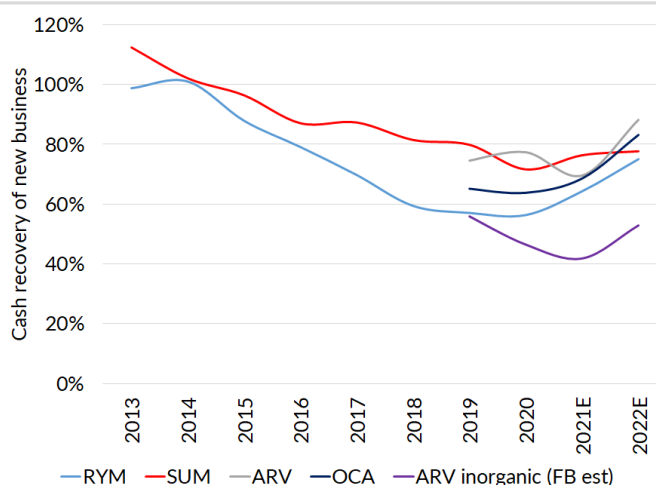
Looking ahead, we expect growth to improve for the latter three, but we still expect RYM and ARV to grow slower than SUM while we expect OCA to grow the fastest in the sector as it has reached an inflection point in how it charges for care; we expect annuity earnings to almost double for OCA over the next three years.

**Figure 1. Annuity EBITDA (indexed to 100 in 2016)**



Source: Forsyth Barr analysis

**Figure 2. Cash recovery of capex (3 year average with 1 year lag)**



Source: Forsyth Barr analysis

#### Rising capex vs sales = higher debt

Cash recovery of capex through new unit sales has decreased (Figure 2), driving up net debt up across the sector. We believe the recent house price bounce has bought the sector time and we see no near-term problem with the increasing debt levels. However, we believe the decline in cash recovery is partly structural; longer lead times, higher cost of building care facilities and higher land prices have all contributed to the lower cash recovery, and these factors are here to stay. As such, we believe the market will reward companies that can show a high degree of cash recovery.

#### A preference for aged care operators exposed to a buoyant market

In a buoyant market with strong demand for privately funded care and increasing house prices our preference is for SUM and OCA, which we believe can deliver developments quickly to the market and show strong growth in annuity earnings without applying too much balance sheet pressure.

#### Summerset: Strong cash recovery and growth at relatively attractive valuation (OUTPERFORM)

- With a strengthening development and sales track record, a focus on fast-to-develop broad acre sites and the largest land bank in the sector (around seven years worth), SUM provides quality exposure to the aged care sector's positive industry dynamics. SUM has delivered the fastest organic earnings growth of the listed aged providers, with annuity earnings growing 20%+ over the last five years – twice the growth rate of the sector. Together with OCA, SUM has had the best cash recovery from its expansionary capex. There remains significant growth potential from positive demographic trends and expansion into Australia with the

acquisition of further sites in Victoria, a largely untapped market. We see SUM as best positioned to deliver growth from its existing asset portfolio while recovering its capex.

- Despite its sector-leading outlook, SUM is valued at a material discount to the long-time sector leader RYM on our preferred valuation metric of EV/Annuity EBITDA, and at only a modest premium to ARV.

**Oceania Healthcare: Turnaround story (OUTPERFORM)**

- Compared to its peers, OCA has a more Auckland centric portfolio and stronger focus on care. OCA has the highest charges which exposes it to falling demand, but gives leveraged exposure to an up-cycle. It also has an older and more diverse portfolio mix, which provides some challenges and opportunities. OCA is in the midst of a multi-year transformation programme. Its future growth prospects are centred on replacing older aged-care facilities with new high end facilities, and converting/developing care beds into care suites. The sale of these care beds/suites under Occupational Rights Agreements could be a good way to recover capex.
- As a turnaround story, OCA is a higher risk proposition for investors, but we believe it also offers greater upside if the transformation succeeds.

**Arvida: Earlier in the pivot to selling care suites (NEUTRAL)**

- ARV traditionally had a pure needs-based portfolio. It is growing through acquisitions and brownfield development, through which it is moving towards providing a "continuum of care offering" similar to that of RYM. Like OCA, ARV is also pursuing a strategy of developing and selling care suites through Occupational Rights Agreements, which should improve cash recovery, but it is earlier in the process than OCA.
- ARV has the highest dividend yield in the sector, but has also raised the most equity to fund its acquisitions. We see some upside in ARV, but believe the market needs to grow comfortable with its ability to pivot to care suites and form a clearer picture on organic growth before ARV can enjoy a re-rating up towards the valuations of SUM and RYM.

**Ryman Healthcare: Fully valued quality operator (NEUTRAL)**

- RYM is the largest operator in the aged care sector and is leveraged to the rapidly ageing population and growing demand for retirement village living and aged care in New Zealand and Victoria. RYM's strong brand, fully integrated villages and care expertise help it attract a needs-based, defensive customer base. It has a market leading earnings growth track record since listing in 1999, but the last three years have seen a slowdown. While we expect RYM (and ARV) to also deliver good growth over the coming years, we believe RYM's core competitive advantage of lower fees, more comprehensive care offering and higher occupancy will be less of a differentiator in the near term. Increased build times and expansion into Australia have resulted in RYM's gearing rising to the highest in the sector. We expect to see continued meaningful increase in net debt as we believe RYM is still 12–18 months away from cash recovery of the multi-year capex outlay in Australia.
- We view RYM shares as fully valued.

## Themes of the Week

### Fixed Interest

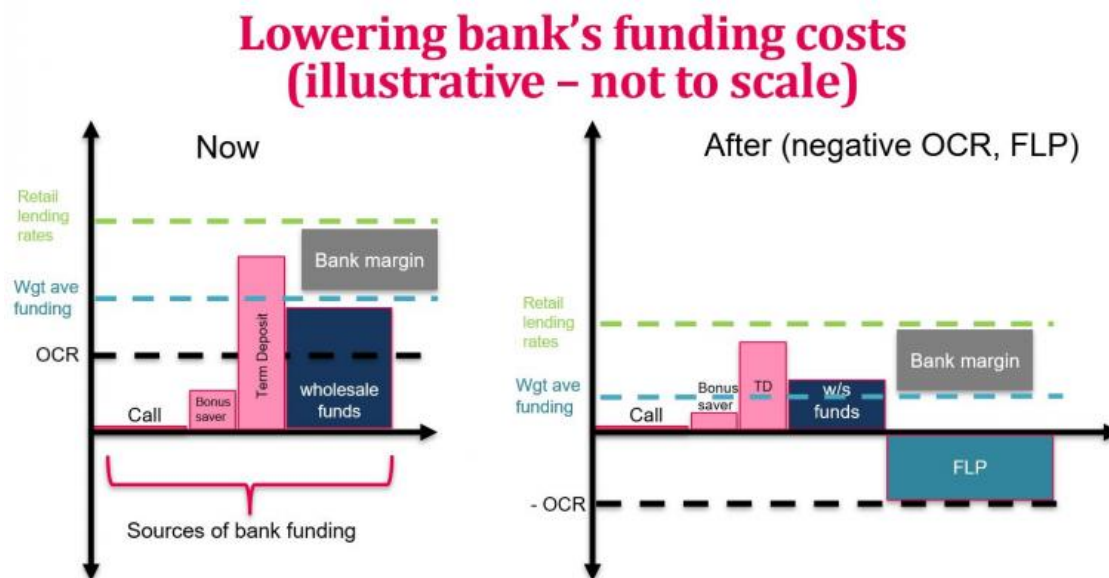
#### How the FLP may work

The Reserve Bank of New Zealand (RBNZ) is working on its Funding for Lending (FLP) Programme and is set to release details in the RBNZ's Financial Stability report due on 25 November. The FLP is a programme where the RBNZ funds retail banks directly – in theory reducing the cost of funds for the banks. The flow-on effect is that banks can then (in theory, anyway) reduce their lending interest rates, allowing cheap(er) credit to flow throughout the economy.

The possibility of such a lending programme leads us to ask a couple of questions: Will the banks be required to lend the funds to a certain sector? Is there demand for credit at this uncertain time (other than in the already red hot residential housing market)?

The RBNZ has indicated that it would prefer to attach less conditions to its FLP, which would leave it to the banks to use the very cheap funding for whatever purpose they see fit. This didn't work so well following the Global Financial Crisis (GFC), with banks preferring to fix up their own balance sheets first, but New Zealand banks are in a pretty good financial position; the question is more around asset bubbles, with house price inflation already becoming an issue.

Figure 3. More cheap funds on the way?



Source: RBNZ

### NZ Equities

#### Heartland Group Holdings (HGH.NZ) – In the Heart of the Storm

We [initiated coverage](#) of Heartland Group Holdings (HGH) with an UNDERPERFORM rating and target price of NZ\$1.35.

HGH faces Net Interest Margin (NIM) pressure, slowing receivable loan growth, an increasing cost to income ratio and elevated impairment expenses, in our opinion. We also believe there are number of regulatory, competitive and economic headwinds ahead. This is corroborated by discussions with reverse mortgage brokers, car finance companies, competitors and industry experts.

Currently HGH holds just 1% of total bank assets in New Zealand, while in comparison the four largest Australian banks hold a combined 89% of the New Zealand market. HGH has a higher funding cost than peers and focusses on providing more niche, higher risk products with higher yields. This is evidenced by generating the highest NIM across banks operating in New Zealand.

Our ROE driven target price implies a lower P/BV multiple than HGH is currently trading on.

## International Equities

**Johnson & Johnson (JNJ.N) — 3Q20 a nice beat, outlook positive, fundamentals solid**

**JNJ is a diversified global developer, manufacturer and marketer of pharmaceuticals, medical devices and consumer health products.** JNJ has a consistent mid-single-digit earnings growth history. The company operates 230 businesses in 60 countries and sells its products globally.

**JNJ's 3Q20 revenue surprised positively**, up +1.7% year-on-year to US\$21.1m. Its Pharmaceuticals segment benefited from growth in seven key drugs, with Oncology being the best performing category. Consumer Health was bolstered by growth in e-commerce sales and inventory re-stocking across retailers. The weakest segment was Medical Devices, which has been substantially impacted by COVID-19-related declines in Orthopaedics, Surgery, and Vision. **Recent trends are showing improvement and we expect to see a solid recovery in Medical Device sales over the next 12 months.** Outside of the US, JNJ is gaining good sales growth via China, particularly in the Medical Device segment where Chinese sales grew +17% yoy.

JNJ expects to continue to deliver above-market growth in its Pharmaceuticals segment (51% of group sales). For the Medical Devices segment (32%), we assume procedures are able to continue throughout the year despite COVID-19, leading to double-digit sales growth. In Consumer Health (17%), we expect market share growth and strength in e-commerce channels due to COVID-19.

**JNJ has proved its ability to acquire and divest assets in its healthcare portfolio, maintain a strong balance sheet, and continue to pay an attractive dividend. We think JNJ's fundamentals look robust at current prices, with shares trading on a 12-mth forecast PE of c.17x, and expectations for +7% p.a. EPS growth.**

**LVMH Moët Hennessy Louis Vuitton (LVMH.PA) — Portfolio of diversified luxury brands proving relatively defensive**

**LVMH is a French multinational luxury goods conglomerate** with over 70 prestigious brands sold through 4,900 retail stores worldwide. It is a global leader in luxury fashion and leather goods through Louis Vuitton and Christian Dior; champagne and spirits through its 66% stake in Moët & Hennessy (the rest of which is held by Diageo); and in perfume and cosmetics through Sephora. LVMH has a long track record of successfully growing brands and integrating newly acquired brands into its global network. LVMH's strength in unrelated product categories provides some diversification.

**LVMH surprised the market with better than expected 3Q20 results.** Group sales were down -7% year-on-year, but improved significantly quarter-on-quarter as lockdowns eased, and there was a trend of consumers spending up on luxury goods given they couldn't spend on travel and other experiences. Importantly, LVMH's Fashion & Leather Goods and Wines & Spirits segments, which collectively make up 80% of EBIT, were ahead of expectations. Its smaller segments (Watches & Jewellery, Selective Retailing, and Perfumes & Cosmetics) were slightly below expectations. **The company confirmed that the encouraging signs of recovery observed in June continued through the 3Q in all regions** and most notably in the US and Asia, where sales increased yoy.

We are encouraged by the promising signs of recovery and are expecting a sequential improvement in 4Q20 for LVMH. While consensus numbers are still below where they were before COVID-19, we think they could prove to be conservative. **We continue to like LVMH as a long-term holding for portfolios for its defensive growth profile, underpinned by its portfolio of well-managed brands.** Additionally, LVMH's strong track record of capital allocation offers potential upside from opportunistic M&A.

**Taiwan Semiconductor Manufacturing Co (TSM.N) — Record revenue and future growth in leading-edge technologies**

**TSM is the world's first dedicated semiconductor foundry and has consistently been at the leading edge of semiconductor chip fabrication.** As a result TSM has captured c.56% market share of semiconductor fabrication.

**TSM reported a good 3Q20 result at the end of last week.** Revenue of NT\$356.4bn (US\$12.1bn) represented +22% growth YoY — a record quarterly high and in excess of guidance. EPS (NT\$5.3) also reached all-time highs. Looking forward to 4Q20, TSM's guidance implies FY20 earnings will reach NT\$19.90, equating to +49% YoY growth.

There has been some concern about what the US Huawei ban would mean for TSM, however, the company appears to have successfully occupied the spare capacity for now. Management also reaffirmed a positive outlook for TSM and the industry as a whole as the digital transformation triggered by COVID-19 will accelerate demand in the 5G and high-performance computing (HPC) segments. **Both segments require leading-edge technology and TSM is well positioned to capture the benefits of this trend.**

## Research Worth Reading

### New Zealand

#### Equity Strategy – Emphatic Election Win for Labour

The New Zealand Labour Party will enter its second consecutive term of government having won the 2020 general election conclusively; it is the first party under the MMP (Mixed Member Proportional) system to win an outright majority. Its ~49% share of the vote, versus National at ~27%, gives it its best election result in 50 years. At this preliminary stage it has 64 seats in the 120 seat parliament, which is unlikely to change materially when the final result is announced in early November after 'special' votes have been counted. While the NZ First 'handbrake' on government decision making will no longer feature, the centrist nature of the Ardern-led Labour Party, means the corporate outlook is largely unchanged and we see no material impact on markets. (Published by Forsyth Barr)

#### Chorus (CNU) – Incremental Regulatory Wins

There were incremental improvements for CNU in the Commerce Commission's first set of final decisions on the "input methodologies" which feed into the regulatory determination for CNU's new ultra-fast fibre broadband (UFB) network. There remains uncertainty around the final outcome of the UFB regulatory process (which will not be concluded until 3Q/4Q 2021), however, each step forward should further build confidence in the strong free cash flow and substantial lift in dividend once the UFB network is complete. OUTPERFORM. (Published by Forsyth Barr)

#### Contact Energy (CEN) – Alas, It is Not to Be: CEN Unlikely to Enter MSCI NZ Index

It appears unlikely CEN will enter the MSCI NZ Index as further analysis of MSCI's convoluted index inclusion rules indicate the hurdle is higher than first thought. We calculate CEN's current hurdle price as ~NZ\$8.60 and with the 10 business day pricing period starting Monday, 19 October, it appears unlikely that CEN will make the cut at this index review. Whether CEN is in the MSCI index or not does not change our view that CEN offers better value than the other electricity stocks. OUTPERFORM. (Published by Forsyth Barr)

#### Mainfreight (MFT) – Flight to Quality

MFT reported a preliminary 1H21 result in tandem with its Tauranga investor day, which suggests an upgrade to full year consensus estimates given market share wins and strong margin performance, particularly in Australia. We made material upgrades to our near-term earnings estimates to reflect stronger than anticipated first-half performance. MFT is due to report its full 1H21 result on 11 November 2020. OUTPERFORM. (Published by Forsyth Barr)

#### Z Energy (ZEL) – More Small Steps – September 2020 Volumes

ZEL reported strong September 2020 sales volumes, up +5% on September 2019 (excluding jet and marine volumes) and +14% on August 2020. One of the most encouraging aspects is that all of the petrol and diesel markets had volume increases. Nevertheless, in our view ZEL needs several more months to demonstrate to the market it has turned the corner. ZEL remains a long-term value play. OUTPERFORM. (Published by Forsyth Barr)

### Australia

#### Afterpay (APT.AX) – UBS SnapShot: Finalisation of AUSTRAC external audit

APT has received the final notification from AUSTRAC following its Independent Audit Report, which was finalised in November 2019. AUSTRAC has decided it will not be taking any further regulatory action against APT, noting that APT has now updated its AML/CFT compliance framework and financial crime function, having satisfactorily completed all required remediation activity. SELL. (Published by UBS)

#### Amcor (AMC.AX) – North America beverage data

Nielsen released data for the four weeks to 3 October. North American beverage volumes remain a key focal point for AMC. Overall, Ord Minnett views this data as mixed, with moderating growth in beverage and weak trends for sports drinks offset by continued strong growth in packaged food sales. ACCUMULATE. (Published by Ord Minnett)

**CSL (CSL.AX) – AGM update results in guidance narrowed ~2% higher**

CSL narrowed its FY21 NPAT guidance range to US\$2,170–2,265m – this equates to a ~2% upgrade. The market is focussed on levels of plasma collection, which have been much lower during the pandemic. Citi is forecasting that plasma collection returns to pre COVID-19 levels by October 2020. CSL commented that COVID-19 restrictions are expected to constrain plasma collections, and add to plasma collection costs, although there are multiple initiatives underway to mitigate this impact. BUY. (Published by Citi)

**Telstra (TLS.AX) – Upping dividend forecasts post AGM**

Commentary from the TLS chairman suggests a strong desire to maintain a 16cps dividend, and a willingness to temporarily exceed ordinary payout parameters in FY21. New UBSe DPS forecasts imply TLS will pay out ~94% of EPS in FY23 (vs. a payout policy of 70–90%), relative to old UBSe, which implied an 82% payout on FY23E EPS. BUY. (Published by UBS)

**Senex Energy (SXY.AX) – SXY Now FCF Positive, Upside Risk to Guidance at Strategy Day**

Citi sees upside risk to SXY's steady-state free cash flow guidance of A\$70–90m at the upcoming strategy day, as prior guidance didn't include facility expansions. Citi models this upside risk at A\$31m. Taking the midpoint of SXY's guidance and adding this upside implies a 24% FCF yield. Considering the assets in Citi's view are completely de-risked, SXY remains a very compelling investment opportunity. BUY/HIGH RISK. (Published by Citi)

**Viva Energy Group (VEA.AX) – Trading update**

VEA provided a third-quarter CY20 trading update, with retail and commercial volumes lower than Ord Minnett's forecast, while the refining operating earnings (EBITDA) loss was worse. The decision on the future of the Geelong refinery beyond the first quarter of CY21 has been pushed back from October to December. ACCUMULATE. (Published by Ord Minnett)

**International****Apple (AAPL.O) – iPhone 12 Launches with 5G Across the Lineup; Availability a Couple of Weeks Later than Expected**

At a widely anticipated event, which was a month later than the usual mid-September iPhone launch, AAPL launched the iPhone 12 as well as the HomePod mini. As indicated in Citi's preview for the event, the iPhone 12's screen size, camera features and pricing are in line with expectations. AAPL will report September quarter earnings on 29 October. Citi has a BUY rating on AAPL stock and a \$125 target price. BUY. (Published by Citi)

**Medtronic (MDT.N) – A Different Tone: Letting the Pipeline Do the Talking**

MDT hosted an impressive Analyst Day where, like the 1Q21 earnings call, the tone reflected a change in tempo. In five short months CEO Geoff Martha seems to have coalesced the organisation to not only focus on the product but also accelerate sustainable revenue growth. Should the formula consistently deliver higher revenue growth rates through both internal investment and targeted tuck-in acquisitions and leverage them to 8% EPS growth, it will be following a proven path whereby higher revenue growth translates into higher stock multiples. BUY. (Published by Citi)

**Walt Disney (DIS.N) – Major Reorganization Puts DTC Front and Center**

DIS has announced a major reorganisation. The thrust of the change is to split content creation from content distribution and to put all distribution responsibilities under a single leader with profit & loss responsibility. Citi suspects this change is designed to accelerate DIS's pivot into the streaming market. DIS will hold an Investor Day on 10 December. BUY. (Published by Citi)

## Calendar

Figure 4. Calendar

Date	New Zealand	Australia	International
19-Oct			EU: ECB President Lagarde Speaks CN: GDP (Q3) CN: Industrial Production (Sep) CN: Retail Sales (Sep)
20-Oct	NZIER Business Confidence (Q3) NZIER QSBO Capacity Utilization (Q3)	RBA Assist Gov Kent Speaks RBA Meeting Minutes South 32 1Q20 Operating Review BHP Group 1Q20 Operating Review Origin Energy AGM	US: Federal Reserve Chair Powell Speaks EU: ECB President Lagarde Speaks CN: PBoC loan Prime Rate Halliburton 3Q20 Netflix 3Q20 IBM 3Q20
21-Oct	Credit Card Spending Auckland International Airport AGM Comvita AGM	Melbourne Institute Leading Index Sydney Airport Sep Traffic CSL R&D Investor Briefing Orora AGM AGL Energy AGM	US: Building Permits (Sep) UK: Consumer Price Index (Sep)
22-Oct		RBA Assist Gov Debelle Speaks NAB Quarterly Business Confidence APA Group AGM Webjet AGM	US: Crude Oil Inventories UK: Retail Sales UK: BoE Gov Bailey Speaks Abbott Laboratories Q320
23-Oct	Trade Balance Exports and Imports Consumer Price Index (Q3)	Manufacturing PMI Services PMI Santos 3Q20 Operating Review Qantas Airways 1Q20 Woodside Petroleum 3Q20 Ops Review AMP 3Q20 Insurance Australia Group AGM	US: Initial Jobless Claims US: Existing Home Sales (Sep) UK: Retail Sales (Sep) UK: Composite/Manufacturing/Services PMI (Oct) EU: German Manufacturing (Oct) EU: German Business Climate Index Microsoft 1Q21 Intel 3Q20
24-Oct	CFTC NZD Speculative Net Positions	CFTC AUD Speculative Net Positions	Visa 4Q20 Illumina 3Q20 Amazon.com 3Q20 Gilead Sciences 3Q20

Source: Forsyth Barr analysis

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