

# Wealth Weekly

## Heavyweights Throwing Light Punches

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With the US election turning from news into noise, attention is on the worsening second wave of COVID-19 in the Northern Hemisphere and the measures required to keep it under control, offset by hopes that vaccines will soon become available. Locally, two of our listed heavyweights, A2 Milk and Ryman Healthcare, had events last week, and we downgraded our rating on a third, Meridian Energy.

**From infant formula to aged care**

**The a2 Milk Company reiterated its FY21 guidance at last week's annual meeting.** There are reportedly indications of "early green shoots" in the daigou infant formula sales channel into China. That channel had been under pressure amid the pandemic, overshadowing strong performance in a2's direct sales. We expect a return to growth from 2H21. Investors remain focussed on the risk of downgrades to FY21 earnings guidance and estimates, which is unlikely to be resolved until we get greater clarity on the return of activity in the daigou channel. **Beyond this short-term earnings risk, we see an attractive medium-term growth runway.** Our confidence in this was boosted by our recent surveys in China. Our rating remains OUTPERFORM.

Retirement village giant **Ryman Healthcare on Friday reported a weak 1H21 result.** Its underlying earnings and annuity EBITDA were down significantly compared to last year, as COVID-19 related restrictions weighed on sales. The relatively weak cash inflows relative to ongoing capital expenditure resulted in net debt increasing by NZ\$300m since the FY20 result. Management remains positive, guiding to a record cash inflow in 2H21, and is optimistic on the company's long-term ability to recover almost all its capex while also growing underlying earnings by +15% pa. Our rating on RYM remains NEUTRAL. **We expect the market to look through the weak result and focus on FY22, when we expect a return to double-digit growth.**

**We downgraded our Meridian Energy rating from NEUTRAL to UNDERPERFORM following its recent share price surge,** which came despite no new news and coincided with an increase in interest rates (which should be negative for yield stocks like Meridian). Meridian is now trading on a record low cash dividend yield of 2.8% (or 3.6% gross, which is a record low premium over 10-year interest rates). Other yield and electricity investments offer better value, in our view. Meridian is a best in class electricity generator, but given its expensive valuation **we currently prefer Genesis Energy or Contact Energy for their higher yield,** or at a stretch Mercury NZ for a modestly more attractive valuation.

**Themes of the week**

**Bond issuance has picked up just as the year draws towards a close.** Chorus, Infratil and Ryman Healthcare are among the issuers. While the bonds offer higher interest rates than term deposits, they also come with longer tenors and higher credit risk. The liquidity of NZDX-listed bonds is a key advantage over term deposits, particularly with long investment terms.

**The newsflow on COVID-19 vaccines has remained positive.** Pfizer and BioNTech confirmed their vaccine was as effective as Moderna's in preventing COVID-19 illness, and filed a request for Emergency Use Authorisation with the US Food & Drug Administration, which should take a few weeks to evaluate the risks and benefits. AstraZeneca/Oxford University released interim results yesterday showing efficacy of 62% to 90% depending on the dosing regime given. They will submit the data for regulatory approval immediately. Pfizer's vaccines could be ready for distribution from mid-December and AstraZeneca's after January. Questions remain about timelines for scaling up manufacturing and distribution, how long immunity will last, and what proportion of a population has to be vaccinated to achieve herd immunity and end the pandemic.

**Looking ahead**

Results are due this week from Arvida, F&P Healthcare and several property vehicles, and numerous companies are holding AGMs. The RBNZ will publish its bi-annual Financial Stability Report on Wednesday.

## New Zealand Equities

### The a2 Milk Company (ATM.NZ) – Baby Steps Forward

The key issues creating debate among investors in ATM are when growth will return and whether there is an earnings downgrade still to come – despite management's reiteration of guidance and reports of incremental positive signs in the daigou channel. Forecasting this is made difficult by the rapid shift in sales from the daigou to the direct channels. But **our analysis suggests the share price is already factoring in around 70% of the risk of an earnings downgrade**. Even if it eventuated, we see attractive value in the stock.

What did we learn from last week's annual meeting?

- **"Early green shoots" in the Daigou channel:** The pressure in the daigou channel is now well known, due to a suite of compounding issues including COVID-19 border restrictions, surplus channel inventory, pantry de-stocking, high freight costs, low reseller margins, and packaging concerns (due to COVID-19). We expect the disruption to moderate gradually over time, with early positive signals of turning a corner (e.g. lower channel inventory, stabilisation in prices).
- **No change to the growth trajectory of ATM's key growth engine, the Mother & Baby Store channel:** ATM reiterated growth is "strong" and ATM's market share has gradually risen from 1.7% last December to 2.2% in September, which still leaves ample runway for growth. Our recent survey of offline channels was positive for ATM, with high quality perceptions for NZ-sourced infant formula.
- **Performance in the Singles Day Shopping Festival was encouraging,** with only moderate discounting and double digit growth for ATM (amid lacklustre growth in the category more broadly).
- **Other areas of the business are delivering growth,** including other nutritional products and liquid milk in Australia.

We made small tweaks to our estimates following the annual meeting, but our target price remains unchanged at NZ\$23. **We believe ATM's valuation remains attractive**, particularly given its strong free cashflow generation and high returns. We have retained our OUTPERFORM rating.

### Ryman Healthcare (RYM.NZ) – 1H21 Result – RADs to the Rescue?

**RYM's annuity EBITDA (its operating earnings excluding gains from new unit sales) has been largely stable for three years.** Our reduced forecasts imply only modest growth (+4%) in annuity EBITDA in FY21. **The recent growth stagnation after a decade of double-digit growth is partly due to the pace of development slowing** from c.+10-15% previously to +7-8% in recent years. **But of equal importance, we believe, is reduced profitability within the care business as costs grow faster than revenues – both due to COVID-19 and (we suspect) as the trends of the last few years continued.**

We have cut our FY21/22 annuity EBITDA estimates, but **expect a return to double-digit growth in FY22**, with strong growth in Australia, reversal of some COVID-19 related costs and strong re-sale gains.

RYM has added ~NZ\$600m in net debt over the last year, which is ~3x its annuity EBITDA, as build times for its new villages extended and sales slowed partly due to COVID-19 disruptions, particularly in Victoria. **We were left with the impression that reducing the pace at which debt accumulates is a key priority.**

RYM also announced a new pricing model for care beds in New Zealand, similar to in Australia, where residents can choose to pay a one-off Refundable Accommodation Deposit (RAD) as a lump sum instead of a weekly fee. **We consider the RAD product to be attractively priced for residents as it effectively offers them the equivalent of c.~5% pa tax-free "interest".** We see potential for it to raise NZ\$500m+ for RYM over time. **It will come at the cost of lower ongoing care earnings and cashflows, but by alleviating pressure on the company's balance sheet it should reduce the risk of having to slow construction activity.**

Our target price has decreased by 25cps to NZ\$13.75 due to our lower earnings forecasts. Our rating remains NEUTRAL while we look forward to stronger cashflows in FY22.

### Meridian Energy (MEL.NZ) – Gravity Defying Hydro

On no news flow, **MEL's share price has surged +23% since the end of September 2020 to record highs over NZ\$6.00.** Counterintuitively for a low-growth yield stock, this increase coincided with a +0.36% increase in the 10-year swap interest rate to 0.86% (its highest level since early June 2020). **MEL is an expensive defensive stock**, in our view, offering a cash dividend yield of just 2.8% (3.7% gross), and with dividend growth likely to be muted in the next few years (at best).

The market appears to be assuming that the NZ Aluminium Smelter will remain open. Whilst that appears the most likely scenario, it is not a fait accompli. Following the strong share price run, **there is now asymmetric risk to the downside if the smelter closes and limited/no share price upside if Rio Tinto decides to keep NZAS open for longer**. Our current FY21 dividend forecast of 16.9cps is unlikely to increase if NZAS remains open beyond August 2021, because it is at the top end of MEL's dividend payout policy range if our average earnings estimate for an NZAS-stays-open scenario eventuates, and because MEL would require capital to build its Hawkes Bay wind farm development. We do not expect MEL to reinstate its capital management program (i.e. the 4.88cps special dividend).

Strong October operating performance led us to lift our target price by +6cps to NZ\$5.50, -8% below the current price. Our rating is UNDERPERFORM.

**We prefer Genesis Energy** (rated OUTPERFORM, 4.4% cash dividend yield, 6.1% gross yield) **and Contact Energy** (rated OUTPERFORM, 4.1% cash dividend yield, 5.0% gross yield). Mercury NZ is rated NEUTRAL with a 2.9% cash dividend yield and 4.0% gross yield.

## Themes of the Week

### Fixed Interest

#### Typical year-end flurry of issuance

As is so often the case, the fourth quarter of any calendar year produces a flurry of corporate bond issuance for investors to consider. Over the past week or so we have seen Chorus successfully refinance its May 2021 NZ\$400m bond issuance, Infratil opened a tap issue on its 2026 NZDX quoted bond and Ryman Healthcare announced it is considering either a 6 or 8 year bond issuance.

The pipeline of issuance may not end there with a couple more corporates also rumoured to be on the way. The options on the table are interesting for two reasons:

- First, potential investors will need to assess if the returns on offer are suitable for the tenor and credit being offered. **Whilst there is no doubt the coupons are higher than term deposits, the durations of the investments are also considerably longer than a term deposit. Liquidity is an investor's friend in this situation, and a key benefit of NZDX-quoted bonds over term deposits.**
- Secondly, if the Reserve Bank of New Zealand (RBNZ) is about to launch its Funding for Lending Programme (FLP) and provide NZ\$28bn worth of cheap lending to banks, why aren't these funds being offered to the corporates? Each of these corporates will have extensive bank facilities with one (or more) of the big four banks. Is it a case of the banks not intending to use the FLP? Or is it that the banks intend to use the FLP for other lending, i.e. housing?

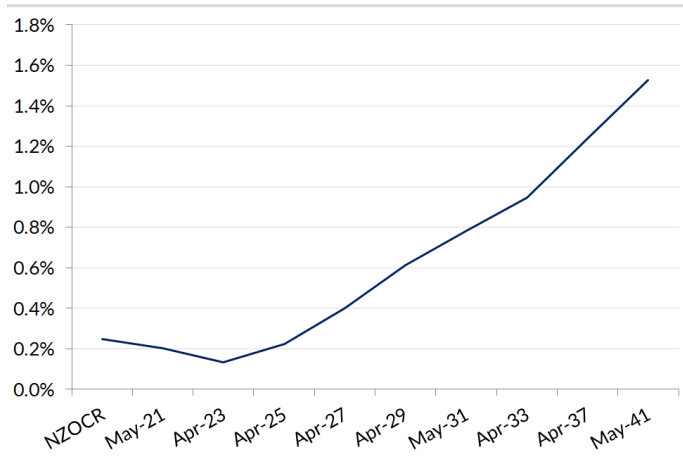
**Forsyth Barr Limited has been appointed as a Joint Lead Manager to Chorus's and Infratil's bond offers and will receive fees for undertaking this role including a fee based on the amount of bonds subscribed for by its clients. The offer is only being offered to investors who are resident in New Zealand. Full details of the offer are contained in the terms sheets. Potential investors should read the terms sheets thoroughly.**

#### RBNZ under fire, is it fair?

The RBNZ is being heavily criticised for fuelling an already red-hot housing market, but is that fair? Yes and no would be a fair answer. The RBNZ has a mandate to maintain price stability (i.e. control inflation) and to support the maximum sustainable level of employment. It is not responsible for government policies that have led to house price pressures over many years. The RBNZ is, however, responsible for maintaining financial stability. In fact **this week the central bank will release its bi-annual Financial Stability Report outlining the risks to the financial stability of New Zealand. What will it say around the housing market?** Is launching an FLP the best policy at present?

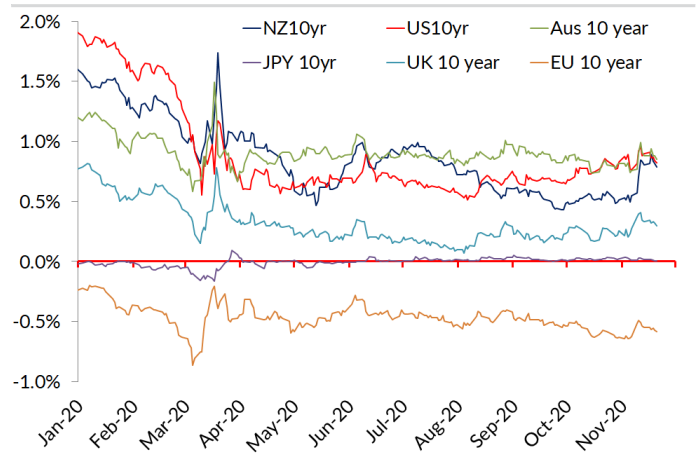
The ongoing talk around the loan-to-value ratio being implemented is just a sideshow, given the banks themselves are already abiding by such internal rules. Some would argue it is not up to the RBNZ to tell the banks how to operate successfully, given they have been doing it for over 100 years in many cases. Others would point to past failures of financial institutions here and overseas as evidence that cautious regulatory oversight does them good...

Figure 1. NZ Government Bond yield curve



Source: Forsyth Barr analysis, Refinitiv

Figure 2. Global 10yr interest rates



Source: Forsyth Barr analysis, Refinitiv

## Research Worth Reading

### New Zealand

#### Investore (IPL) – 1H21 Result – Waiting for an LFR Restock

IPL reported a solid 1H21 result, with AFFO ahead of our expectations largely due to lower than expected maintenance capex. Over the period strong demand for large format retail properties led to tightening capitalisation rates and strong revaluations. While this has benefitted shareholders, competitive bidding and scarce supply has made IPL's growth-via-acquisition strategy more challenging in the near-term. We remain confident that acquisitions will drive better-than-peers' earnings growth, and believe this will prove attractive vs. a low growth sector. **OUTPERFORM.** (Published by Forsyth Barr)

#### Napier Port (NPH.NZ) – FY20 Result – Sitting Lower in the Water

NPH's FY20 result provided few surprises, though outlook commentary highlights a more subdued backdrop for FY21 and perhaps lower earnings capacity in later years than we previously expected. In particular, we forecast greater compression of medium/longer term return on capital given its reliance on pricing to lift returns, which may be less forthcoming than anticipated and suspect the next material pricing move may not be until 6 Wharf is completed in 2022. We recognise that returns will benefit from a volume rebound associated with 1) cruise ships returning, and 2) the wall of wood, though both of these are well known by investors. NPH trades at a material one year forward EV/EBITDA discount (~17x vs ~32x) to Port of Tauranga (POT), which reflects its inferior return on capital and POT's more attractive strategic/competitive positioning in the Upper North Island with scope for further container market share gains. We retain a **NEUTRAL** rating.

### Australia

#### Aristocrat Leisure (ALL.AX) – FY20 Result – Digital & Gaming Ops drive strong result

ALL delivered underlying NPATA of A\$477m, +10% ahead of Citi's estimate of A\$434m and slightly ahead of consensus of A\$470m. The beat was largely driven by the top line, with 1) stronger than expected momentum in North American gaming operations across both the Class II and Class III segments; and 2) the continued scaling of RAID bookings. The performance from these two segments more than offset lower than expected performances from ANZ and International Class III. **BUY.** (Published by Citi)

#### Charter Hall Group (CHC.AX) – Pitt Street site development potential

According to The Australian Financial Review, CHC has been selected as the preferred party to acquire the Telstra Exchange on Pitt Street in Sydney for A\$280m based on a sale and leaseback agreement for 10 years. Ord Minnett sees this as a long-term redevelopment opportunity with a secure income stream, which CHC can acquire at a very high incremental margin. The transaction highlights CHC's ability to raise and deploy capital, and the long-term development potential embedded in many of its assets over a 10–30 year horizon. **ACCUMULATE.** (Published by Ord Minnett)

### International

#### Apple (AAPL.O) – App Store commission reduction likely hits FY 2022 profits by ~1% at most based on our analysis

AAPL announced a new developer program targeted at "small businesses" and "independent developers". At the core of the program is a reduced 15% commission vs. 30% current commission if the app developer earned up to US\$1m in proceeds during the previous calendar year. The programme launches on 1 January 2021. **NEUTRAL.** (Published by UBS)

#### Abbott Laboratories (ABT.N) – Updated ABT Interactive Testing Tool; Testing Ramp Continues, May Begin to Fall off in Late '21

Since UBS's last update in mid-September, several developments have changed the potential outlook for the COVID-10 testing market. The durability of revenue streams from detection testing and antigen testing will depend on a number of factors, including: a) the time it will take to broadly disseminate vaccines and people's willingness to take them; b) the use cases for testing as employers want workers back in the office and for private entities like airlines and entertainment venues that may require testing for entry. UBS continues to like shares of ABT, with a resilient business in an uncertain period, and some of the best growth drivers in medtech. UBS sees ABT's premium valuation as more reflective of a safety premium. **BUY.** (Published by UBS)

**Johnson & Johnson (JNJ.N) – JNJ's Analyst Day, the Rise of Digital Surgery**

After years of R&D, JNJ stands on the threshold of a portfolio of robotic offerings across lung cancer, orthopaedics, and general surgery, plus others that are in process. These drivers supplement a Medical Device franchise turnaround story already underway, in which management has invested more than US\$10b over the last several years to first stabilise and then accelerate growth to reach above market growth rates beginning next year. Robotic surgery is less than 2% of the 50m procedures that are performed worldwide each year, so while JNJ will not be first to market, it expects to add meaningful value and expand the category. BUY. (Published by Citi)

**NVIDIA (NVDA.O) – Data Center Outlook In-Line with Our Preview; Remain Buy-Rated**

NVDA reported October quarter revenue of US\$4.7b, above Citi and consensus estimates of US\$4.4b. Within that gaming increased +37% q/q and data centres +8% q/q. NVDA guided to January quarter revenue of US\$4.8b, above Citi's forecast for US\$4.2b and consensus of US\$4.4b. NVDA stock is up +128% YTD, while the SOX semiconductor index is up +37%. Citi believes the stock is likely to pull back and consolidate as key catalysts like the Ampere launch and Arm Holdings deal announcement have played out, and before broad recovery in data centre demand in the April quarter (when Citi expects +15% q/q growth). Longer-term, if the Arm deal closes in 16 months, Citi sees a bull case for the shares up to US\$800 on expansion of the serviceable available market to US\$250b by 2023. BUY. (Published by Citi)

**Palo Alto Networks (PANW.N) – Updating Estimates Following 1Q21 Earnings**

Citi believes 1Q21 nicely displayed the PANW bull thesis, namely stable product revenue with subscription strength. More visibility into top-line dynamics should help to show returns on significant merger & acquisition spending. With 70K mostly mid and large enterprise customers that trust PANW with on-premise security, Citi sees ample opportunity to grow in cloud and ultimately be one of the leaders in this market as cloud security technology ultimately consolidates. BUY. (Published by Citi)

**Siemens (SIEGn.DE) – Earnings cut on non-core impacts; cost savings story intact with several upcoming catalysts**

UBS believes the transformation story of SIEGn is not over yet. There is still a timeline full of catalysts (beyond results), including the sale of Flender and the Varian acquisition expected to be completed in 1HFY21, the Capital Markets Day in May-2021, and progress on the cost savings targets by September 2021. The core of SIEGn is now focused on four business segments, which in UBS's view have interesting long term growth trends. The stock continues to trade attractively at c.13x forward EV/EBIT. BUY. (Published by UBS)

## Calendar

Figure 3. Calendar

Date	New Zealand	Australia	International
23-Nov	<b>Retail Sales (3Q)</b> Goodman Property 1H21 Kiwi Property Group 1H21 Metro Performance Glass 1H21	<b>Manufacturing PMI</b> <b>Services PMI</b> Ampol Investor Day	<b>JP: Labor Thanksgiving Day</b> <b>DE: German Manufacturing PMI (Nov)</b> <b>UK: PMI (Nov)</b>
24-Nov	Arvida 1H21	<b>RBA Assist Gov Debelle Speaks</b> Ramsay Healthcare AGM	<b>DE: German GDP (3Q)</b> <b>DE: German Ifo Business Climate Index (Nov)</b> <b>GY: German Manufacturing PMI (Nov)</b>
25-Nov	<b>RBNZ Financial Stability Report</b> <b>RBNZ Gov Orr Speaks</b> Asset Plus 1H21 F&P Healthcare 1H21 Stride Property 1H21 (tentative) Tower FY20 Turners Automotive 1H21 Abano Group SSM Delegat Group AGM Fletcher Building AGM Kathmandu AGM Synlait Milk AGM	<b>Construction Work Done (3Q)</b> Shopping Centres Australia AGM	<b>US: CB Consumer Confidence (Nov)</b> <b>EU: ECB President Lagarde Speaks</b> Medtronic 2Q21
26-Nov	<b>Trade Balance (Oct)</b> <b>Exports (Oct)</b> <b>Imports (Oct)</b> Argosy 1H21 Eroad 1H21 Gentrack FY20 Pacific Edge 1H21 The Warehouse Group AGM	<b>Building Capital Expenditure (3Q)</b> <b>Plant/Machinery Capital Expenditure (3Q)</b> <b>Private New Capital Expenditure (3Q)</b> Evolution Mining AGM Qube Holdings AGM Shopping Centres AGM	<b>US: Core Durable Goods Orders (Oct)</b> <b>US: GDP (3Q)</b> <b>US: Initial Jobless Claims</b> <b>US: New Home Sales (Oct)</b> <b>US: Crude Oil Inventories</b> <b>US: FOMC Meeting Minutes</b> Deere & Co 4Q20
27-Nov	Evolve Education 1H21 Pushpay share split		<b>US: Thanksgiving Day</b> <b>EZ: ECB Monetary Policy Statement</b>

Source: Forsyth Barr analysis

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