

# Wealth Weekly

## Electricity (S)melt Up?

## WEALTH MANAGEMENT RESEARCH

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In recent months electricity stocks have been driven higher by something other than fundamentals. Meridian Energy and Contact Energy in particular appear to have benefitted from a wave of purchasing by renewable energy funds, which have found favour with investors in the US who are betting on a return to more environmentally-aware policy settings under a Democrat-led government. To what extent that investment trend continues to exert upward pressure on their valuations remains an open question. What is more concrete is that Rio Tinto's deferral of the closure of the NZ Aluminium Smelter to late 2024 or beyond is positive for the electricity generators, leading us to upgrade our numbers across the board — although in some cases not enough to justify recent stock price rises.

### Smelter to stay open for longer

Rio Tinto last week accepted Meridian Energy's offer of a lower electricity price for the NZ Aluminium Smelter (NZAS), and will now continue operating at Tiwai Point until at least 31 December 2024. The electricity companies (particularly Meridian) will absorb the \$100m "cost" of providing lower power prices to the smelter.

**The deal is positive for the electricity sector** as it provides greater certainty of demand and reduces the chance of a retail price war for the next four years. **All of our medium-term earnings, dividend forecasts and target prices have increased. The biggest winner from the latest smelter news is Genesis Energy, which is rated OUTPERFORM.**

But recent strong sector performance, which appears attributable to buying as a result of inflows into renewable energy exchange-traded funds, means most stock prices are already up with our valuations. We have downgraded our rating on Contact Energy to NEUTRAL, where it joins Trustpower, while Meridian Energy and Mercury NZ are rated UNDERPERFORM due to their already high valuations.

### Themes of the week

Inflation has remained muted around the world following substantial monetary and fiscal stimulus in response to the pandemic. Persistently low inflation and still low interest rates (more on those below) are placing governments under pressure to spend and invest more to offset the contraction in economic activity due to the global third wave of the pandemic. **The Democratic "blue wave" in the US has increased the odds of more generous government spending there, which should support growth. But risks remain from a sub-optimal COVID-19 vaccine rollout and further virus mutations.**

**While New Zealand wholesale and government interest rates are still cheap, they have more than doubled from their September lows** and are back to the levels they were at when the pandemic escalated in March. The Reserve Bank of NZ has its work cut out for it in 2021, balancing the need to support consumer price inflation and employment while not further stoking the house price mania.

The managers of the Worldwide Healthcare Trust, New York-based OrbiMed, provided an update on the implications for the healthcare sector from the recent US elections. In summary, **the election outcome is less positive for investors in the sector (big pharma in particular) than a split Congress would have been, but the narrow results limit the political risks**, removing an overhang on the sector.

### Looking ahead

The US earnings season got underway last week with several major US banks reporting better than expected earnings, but their stock prices were punished because revenues missed expectations. After a public holiday in the US on Monday for Martin Luther King Jr Day, reporting will continue this week with Bank of America, Halliburton, Netflix, Procter & Gamble, IBM and Intel. Locally, Oceania Healthcare will report on Friday.

## Electricity Sector

### Return of the Smelter

Rio Tinto's (RIO) decision to extend the life of the NZ Aluminium Smelter (NZAS) to at least 31 December 2024 is a significant positive for the sector. All of our medium-term earnings and dividend forecasts and target prices have increased as we roll back the NZAS closure implications from our forecasts (Figure 1).

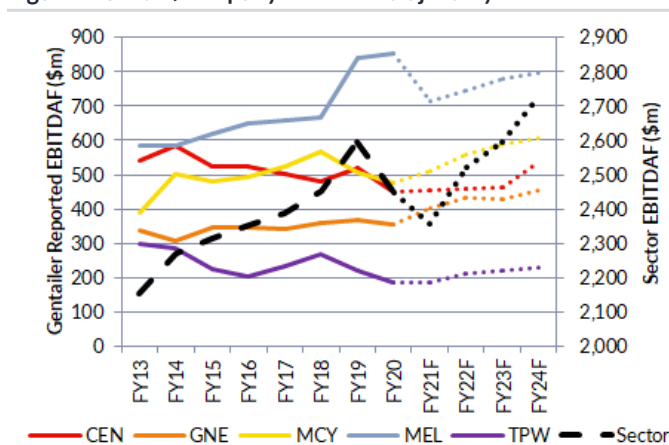
- With Meridian Energy (MEL) providing the bulk (80%) of the discounted power, it has the least upside and is rated UNDERPERFORM, along with Mercury NZ (MCY).
- Genesis Energy (GNE) is the greatest beneficiary, with the largest earnings, dividend and target price (up +15% to NZ\$3.90) increases. It is also our preferred electricity sector stock, being the only one with an OUTPERFORM rating.
- We have downgraded our Contact Energy (CEN) rating to NEUTRAL following its recent strong share price performance.

Figure 1. Summary company valuation metrics and changes

Company	Price	Target	Target	Rating	FY21 Metrics			EBITDAF	Summary changes				
		Price	Return		EV/EBITDA	PE	Gross div yield	FY21 NZ\$m	FY21 EBITDAF	Target Price	Rating		
CEN	\$9.55	\$9.10	-0.9%	NEUTRAL	17.3	28.4	4.6%	456	-\$7m	-1.6%	+\$0.50	+6%	▼
GNE	\$3.70	\$3.90	10.1%	OUTPERFORM	15.0	27.1	6.3%	405	+\$1m	0.3%	+\$0.52	+15%	-
MCY	\$6.92	\$5.85	-12.9%	UNDERPERFORM	20.7	34.9	3.4%	511	+\$9m	1.8%	+\$0.48	+9%	-
MEL	\$7.87	\$5.55	-27.3%	UNDERPERFORM	30.0	48.4	2.8%	715	-\$56m	-6.6%	+\$0.05	+1%	-
TPW	\$8.78	\$8.10	-3.9%	NEUTRAL	18.1	33.9	5.4%	189	-\$4m	-1.9%	+\$0.60	+8%	-

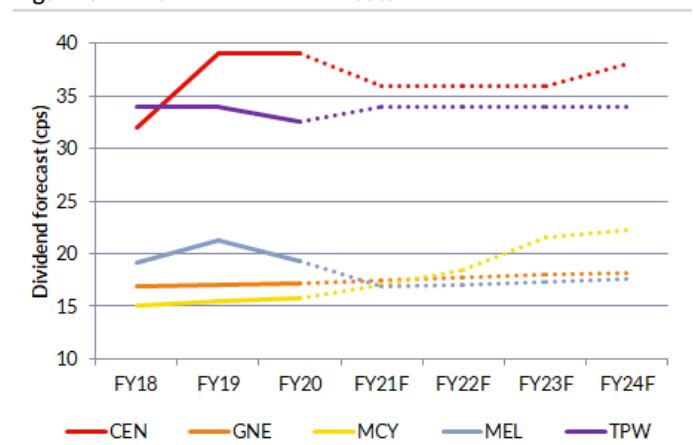
Source: Forsyth Barr analysis

Figure 2. Sector/company EBITDAF trajectory



Source: Company reports, Forsyth Barr analysis

Figure 3. Revised dividend forecasts



Source: Forsyth Barr analysis

### Factors driving the forecast changes

The main factors driving our forecast changes are:

- MEL and CEN's discounted electricity offer, which impacts FY21 to FY24 earnings (negative)
- Generation changes; South Island generation no longer constrained and thermal generation continues at the current level
- Retail price increases instead of retail price decreases – current wholesale electricity prices (both spot and futures) remain elevated
- Generation development to commence – CEN will build its 150MW geothermal project and MEL its ~170MW wind project.

### What may happen after 2024?

The electricity deal ends on 31 December 2024 (refer to our note *Four More Years* for the details). It is difficult to make a call now on what will happen after 2024, and as usual with NZAS, there are several different scenarios. However, with environmentally friendly aluminium becoming increasingly important, we believe there is a good chance RIO will try to extend the deal beyond 2024 on current terms. One of MEL's (and CEN's) key tasks is to find additional, preferably lower-South Island electricity demand. This will improve MEL's negotiating position and minimise the downside effects if NZAS were to close in four years.

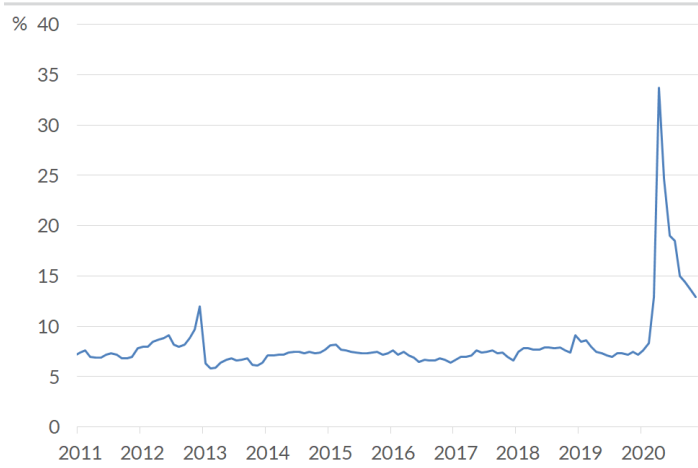
## Themes of the Week

### Macro Snapshot

#### A tidal wave of fiscal support

The economic and financial response to the pandemic last year was an extraordinary level of monetary and fiscal stimulus. While many people lost their jobs and small businesses had to shut down, the combination of income support, supplementary unemployment payments, interest free business loans, tax breaks, and cash handouts — at the same time discretionary spending was reduced as consumers stayed home — meant that household savings actually soared to record high levels (Figure 4).

**Figure 4. US personal savings rate**



Source: US Bureau of Economic Analysis, Refinitiv

These savings were deployed by consumers globally in the second half of last year once lockdowns were eased. This wave of consumption, particularly for technology items to assist remote working and living, and household goods, as the nesting thematic took hold, drove a recovery in industrial production in the US, Europe, and Asia. The manufacturing boom continued into the end of the year despite a more deadly third wave of the pandemic sweeping across the northern hemisphere.

#### Government support a potential tidal wave

With interest rates hovering as low as they can go and inflation still below central banks' target levels, the pressure has been growing for governments to spend and invest more. This means government fiscal deficits will remain wide and central banks will likely continue to buy substantial amounts of bonds to fund these deficits while keeping interest rates down.

The 'Blue Wave' election outcome in the US — with Democrats controlling the White House and the House of Representatives and Senate by narrow majorities — has the potential to shift US policy towards increased government spending, which should continue to support economic activity.

President-elect Joe Biden has laid out a US\$1.9t emergency relief plan to help steer the US economy out of the pandemic and start the rebuild of the US economy. The European Union has already adopted the largest stimulus package ever at €1.8t to help rebuild post-COVID-19 Europe.

In both Europe and the US, financial stimulus is being directed towards climate change solutions, alternative/green technology and transportation options, digitisation of the broader economy, and significant investment in healthcare and education. The Australian and New Zealand governments have already committed to large infrastructure stimulus packages, while China's investment-led approach to recovery last year helped kick-start renewed demand for a broad range of commodities. The lift in commodity prices is consistent with stronger global demand and a broadening out in activity.

#### Pandemic remains a brake on activity

This relatively optimistic macro outlook is tempered by the deteriorating pandemic situation, lockdown extensions and the slower than expected rollout of vaccines. If the virus mutates faster than vaccines can be deployed, rolling lockdowns may be necessary for longer than we currently expect, which would be a negative for growth.

### Upside risk to interest rates? Not so fast

The other risk to the markets would be a return of inflation and higher interest rates. While inflationary expectations have risen, these haven't yet been matched by inflation outcomes, which continue to track below official targets globally. Long-term bond yields have increased in recent weeks and global yield curves have steepened up – consistent with an improving economic outlook, rising inflationary expectations, and/or increasing supply.

But central banks continue to ensure monetary policy will remain extremely stimulatory for some time. Most major central banks are also expected to continue expanding their balance sheets by increasing asset purchases, effectively underwriting the borrowing demands of governments.

The growing debt mountain may also act as a constraint on any pre-emptive reversal of expansionary monetary policies. Financial markets reacted badly in late 2018 when the US Federal Reserve started to reduce purchases of assets from the market and indicated rates would start rising. Any attempt to taper policy settings would be even more challenging now as the borrowing needs of governments have gone up substantially following the pandemic crisis.

Expansionary government policies should remain highly stimulatory and support the ongoing recovery in the global economy. While some individuals and companies may face increases in taxes and regulatory oversight, the offset should hopefully be stronger growth opportunities.

**A recession caused by rising inflation and higher interest rates remains the biggest threat to equity markets. But as long as progress continues in the fight against the pandemic, and as the impact from the massive stimulus packages announced to date roll through the global economy, a recession looks unlikely in 2021.**

## Fixed Interest

### A lot of money borrowed to stand still

It seems odd to comment on interest rates rising when most wholesale and government bond yields remain at or below 1%, but a recent rise has reversed all of the work the Reserve Bank of New Zealand (RBNZ) has done post the March sell-off to lower interest rates. As at the end of November, the RBNZ has spent nearly NZ\$50bn via its Large Scale Asset Purchase scheme designed to keep interest rates low. The newly created Funding for Lending Programme (FLP) is now also underway with NZ\$1.04bn already drawn by New Zealand financial institutions at the very low borrowing rate of 0.25%. However, we are yet to see any meaningful fall in the lending rates offered to potential borrowers or any credit growth.

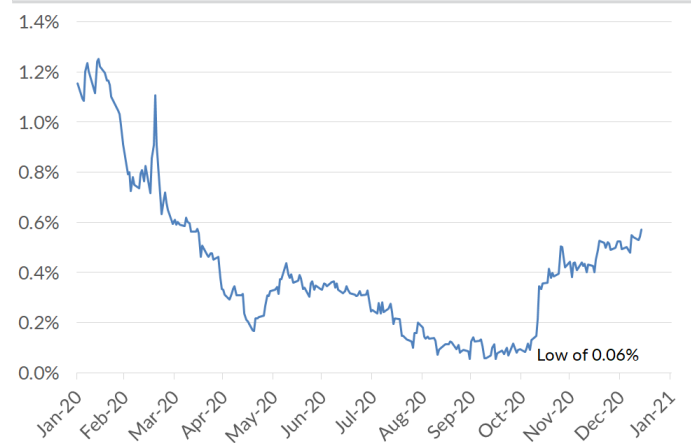
With the economic data being nowhere near as bad as the first forecast immediately post the March/April lockdown, the jury is still out on the prospects for 2021. The RBNZ's balancing act of creating inflation, supporting maximum sustainable employment and responding to pressure to help fix out of control house price inflation is something to watch in 2021.

**Figure 5. NZGB (10yr) nearly at pre-lockdown levels**



Source: Forsyth Barr analysis, Refinitiv

**Figure 6. Swap rates – Still low but well above its lows**



Source: Forsyth Barr analysis, Refinitiv

## Funds

### **Worldwide Healthcare (WWH.L) – Georgia Senate Run-Off Outcome – The Impact on Healthcare (fund manager commentary)**

Political risk has been an overhang for the healthcare sector since at least 2016, when US presidential candidate Hillary Clinton planned to crack down on unwarranted drug price increases. Sector valuations have remained relatively attractive. Following the surprise Democrat wins in the runoff election for the Georgia seats in the US Senate, the managers of Worldwide Healthcare Trust (WWH.L) last week provided an update on their views of the political implications for the sector.

Investors did not hesitate to buy healthcare stocks in the days immediately after Georgia election. Judging by that initial market reaction, the election outcome may have been a clearing event for healthcare stocks, perhaps removing the last overhang on the sector. On the other hand, some generalist investors may still be loath to step into large cap pharma/biotech stocks (which WWH is underweight in its portfolio) anytime soon given perceived political uncertainty for the sector.

The Democrat majorities are so narrow in both the House of Representatives (222 seats, vs 218 needed for a majority) and US Senate (50 seats out of 100, plus 1 casting vote; but a 10 vote majority is needed to pass controversial measures) that radical policy proposals like “Medicare for All” simply could not pass. There are an important number of moderate Democratic members of Congress who would cross the aisle to vote with Republicans rather than support industry-harming healthcare bills.

President-elect Biden’s focus is not healthcare industry reform but rather COVID-19, the economy, infrastructure, tax reform, executive and branch staffing. With the healthcare industry scoring PR points by providing a key defence against COVID-19 (even while resisting calls from India and South Africa to ease patent rules for pandemic vaccines), it would be difficult for the Biden Administration to propose significantly damaging drug pricing policies. Yet some incremental changes to drug pricing are likely, such as through an Executive Order – perhaps by reducing out-of-pocket expenses for patients, or tinkering with Medicare Part B (outpatient) pricing, rather than any sweeping cuts.

## Research Worth Reading

### New Zealand

#### Electricity Sector – Four More Years – NZAS Open For Longer

Rio Tinto (RIO) has announced it has accepted Meridian Energy's (MEL) lower electricity price offer and will continue operating NZAS until at least 31 December 2024, with the electricity contract terminating at that point in time. Interestingly, there is currently no deal with the government, with discussions ongoing. The deal is a positive for the sector as it provides certainty for the next four years.

#### Michael Hill International (MHJ) – 2Q21 Sales Checkout

MHJ's 2Q21 trading update highlights robust trading through the holiday period, underpinned by sustained margin improvement, and same store sales growth across all markets and channels. MHJ's 1H21 EBIT guidance of A\$56m to A\$60m was ahead of our prior expectations, and we made material upgrades to our near-term forecasts. MHJ also announced payment of its (previously deferred) AUD1.5cps 1H20 dividend. Given earnings strength and a net cash position, we see scope for a further dividend announcement at its interim result in February. We maintain our OUTPERFORM rating, with MHJ showing signs of execution on its strategy, while providing investors with an attractive dividend yield. OUTPERFORM. (Published by Forsyth Barr)

#### NZX FY20 Preview – Full Steam Ahead

Our analysis of NZX's monthly operating metrics suggests the company has performed strongly during 2H20, particularly in the Issuer Relationship and Wealth Technologies divisions. We raised our target price to NZ\$2.25 due to 1) improved short term operating metrics across the business, 2) an increase to the assumed size of a key funds-under-management contract to NZ\$18b (previously was NZ\$12b) in the Wealth Technologies division, and 3) marginally increased our longer term total capital raised assumptions given recent success, renewed focus and promising pipeline of capital raises in the Issuer Relationships division. OUTPERFORM. (Published by Forsyth Barr)

### Australia

#### Aristocrat Leisure (ALL.AX) – 2021 outlook

Ord Minnett has performed a correlation analysis for all of ALL's digital games worldwide, comparing the total downloads on iPhone devices to reported digital revenues in respective periods. The analysis suggests the first-half FY21 performance from ALL is tracking quite tightly, with a -20% decline in downloads on a year ago. In this note Ord Minnett outlines their predictions for the land-based and digital businesses in 2021. These, combined with expectations of Identifier for Advertisers (IDFA\*), and real-money gambling and iGaming disruption, keeps Ord Minnett positive on the stock at the current share price. ACCUMULATE. (Published by Ord Minnett)

#### Newcrest Mining (NCM.AX) – Havieron first funding approved

In Ord Minnett's view, NCM is set for an improved 2021, and newsflow from growth projects Havieron and Red Chris will play an important role. In a first step, the board has approved US\$146m for the first stage of the Havieron project, for the construction of the box cut, exploration decline and associated surface infrastructure. This should keep the project on track for delivery of a pre-feasibility study (PFS) in late 2021 and first production within three years. ACCUMULATE. (Published by Ord Minnett)

#### ResMed Inc (RMD.AX) – Healthcare conference feedback

Ord Minnett's global research counterparts hosted ResMed's CEO Michael Farrell and a number of key executives from the management team for a presentation and Q&A session. The focus was on the group's strategic goals, with management reiterating the aspiration to improve "250 million lives in 2025", requiring double-digit annualised growth in the number of patients treated. LIGHTEN. (Published by Ord Minnett)

### International

#### Boston Scientific (BSX.N) – 4Q and 1Q COVID Pressure; Medsurg, PI, and Watchman Momentum; CRM, IC, Neuro Drags

BSX 4Q preliminary revenues of US\$2.71b missed consensus of US\$2.86b. Looking forward, BSX did not provide 2021 guidance, expecting to do that in February, but did acknowledge pandemic pressure has continued in the first quarter. BSX reiterated an ex

COVID-19 goal of +6–8% organic growth, noting its business mix has improved over the past two years and highlighting a track record of +7% growth in the years pre COVID-19. Given a shift to faster growth markets, BSX estimates its served market growth will be +5–6% in 2022 vs. +5% in 2019, with a goal to grow faster than this. BUY. (Published by UBS)

#### **FedEx (FDX.N) – Don't Miss the Forest for the Trees; IR Chat Takeaways**

Citi hosted a fireside chat with FDX's Investor Relations team and came away quite positive about the story. The messaging suggested investors need to be patient with Ground margin improvement, particularly in F3Q. However, Citi thinks short-term concerns with Ground margins do not take into account that pricing has inflected higher due to ecommerce and is not likely to backslide. It also ignores a credible path in which Express strength from tight air capacity lingers much longer than the next few quarters. Ground delivering for Express is also in the early innings and the company suggested that its ShopRunner acquisition could be the game changing initiative that Citi noted a few weeks ago. BUY. (Published by Citi)

#### **Global Health Care Sector – Longing for a Connection**

Already a large and complex environment, the healthcare sector appears ripe for change. In this report we reveal our long-term view for investing within the healthcare sector by: 1) outlining our thesis of the thematic trends we believe are set to reshape/disrupt the healthcare sector; 2) providing a brief overview of the healthcare sector; and 3) identifying global companies that we feel are favourably positioned to benefit from these trends. We define these companies as "connected healthcare" companies. These companies are exposed to conditions with higher growth rates, facilitate the interoperability of healthcare data, and/or reduce healthcare systems' inefficiencies. (Published by Forsyth Barr)

#### **Intel – CEO Transition Amid Technical Challenges; Remains A Top Idea For 2021**

INTC announced that Pat Gelsinger (current CEO of VMWare) will replace Bob Swan as CEO effective 15 February. The company also pre-announced December-quarter results will be above guidance (as UBS suggested in a previous note) and indicated that it has made "strong" progress on its 7nm process development and will include an update on its earnings call. INTC remains one of UBS's top ideas in the US semiconductor sector for 2021. BUY. (Published by UBS)

#### **Qualcomm (QCOM.O) – Qualcomm Acquiring Nuvia for ARM Based Data-Centric Chips. It's a Second Attempt and an Expensive One. Reiterate Buy.**

QCOM announced it is acquiring NUVIA for approximately US\$1.4b before working capital and other adjustments. Even though the acquisition is a second attempt by QCOM to possibly add ARM-based data center chips, Citi believes this is the right move for QCOM due to the synergy that QCOM can build using its 5G modem portfolio and ARM-based servers for edge computing. Citi reiterated its BUY rating on QCOM and would add to positions on weakness. BUY. (Published by Citi)

#### **Thermo Fisher Scientific (TMO.N) – Raising 4Q20 Organic Growth Guidance to +50% from +40% Previously**

TMO provided an update to its 4Q20 preliminary organic growth estimate, now expecting organic growth of +50% on the quarter relative to the previous preannouncement of +40% on 1 December. Citi believes the guidance update was expected by the market given the significant increase in COVID-19 testing volumes late in the quarter. This is a repeat of the experience in 3Q20, when reported organic growth significantly exceeded guidance from a month earlier. NEUTRAL. (Published by Citi)

#### **Visa Inc. (V.N) – Visa and Plaid Go Separate Ways, Maintain Partnership**

The timing of the announced termination of V's acquisition of Plaid was a surprise, but the fact of it is understandable given the time and resources that would have been dedicated to a protracted court battle with the Department of Justice. V forgoes direct ownership of the Plaid data network and the ability to embed more deeply in this context with fintech companies. However, a deep partnership with Plaid remains (V is also an investor and would benefit from other exits Plaid might choose), as do revenue opportunities via payment initiation and other value-add services and fintech distribution. While sub-optimal, the acquisition termination removes an overhang that was prominent in investor conversations, and permits a re-focus on the core business. BUY. (Published by Citi)

## Calendar

Figure 7. Calendar

Date	New Zealand	Australia	International
18-Jan			US: Martin Luther King Jr Day CN: GDP (Q4) CN: Industrial Production (Dec)
19-Jan	NZIER Business Confidence (Q4) NZIER QSBO Capacity Utilisation (Q4) Electronic Card Retail Sales (Dec) HIA New Home Sales		UK: BoE Gov Bailey Speaks EU: German ZEW Eco Sentiment (Jan)
20-Jan	GlobalDairyTrade Price Index	Westpac Consumer Sentiment (Jan) BHP 1H20 Operational Review	CN: PBoC Loan Prime Rate UK: CPI (Dec) EU: CPI (Dec) Bank of America 4Q20 Halliburton 4Q20 Netflix 4Q20 ASML 4Q20
21-Jan	External Migration & Visitors (Nov) Permanent/Long-Term Migration (Nov) RBNZ Offshore Holdings (Dec)	MI Inflation Expectations Employment Change (Dec) Participation Rate (Dec) Unemployment Rate (Dec) Woodside 4Q20	US: Crude Oil Inventories US: President Joe Biden Speaks US: Philadelphia Fed Manufacturing Index (Jan) JP: BoJ Monetary Policy Statement JP: BoJ Outlook Report UnitedHealth 4Q20 Procter & Gamble 2Q21
22-Jan	Business NZ PMI (Dec) CPI (Q4) Oceania Healthcare 1H21	Manufacturing PMI Services PMI Retail Sales Senex Energy 2Q21	US: Building Permits (Dec) US: Initial Jobless Claims UK: Retail Sales (Dec) UK: Composite PMI (Jan) UK: Manufacturing PMI (Jan) UK: Services PMI (Jan) EU: ECB Interest Rate Decision (Jan) EU: German Manufacturing PMI (Jan) IBM 4Q20 Union Pacific 4Q20 Intel 4Q20
23-Jan	CFTC NZD Speculative Net Positions	CFTC AUD Speculative Net Positions	US: Existing Home Sales (Dec) US: Crude Oil Inventories Schlumberger 4Q20

Source: Forsyth Barr analysis



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