

Wealth Weekly

Positive Earnings, Negative Stock Prices

WEALTH MANAGEMENT RESEARCH

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With the bulk of the NZ reporting season complete, five companies have beaten our analysts' earnings expectations for every one company that missed. You wouldn't know it from looking at recent stock performances though. The NZX 50 index fell -6.9% in February, dragged down by large, defensive and growth stocks amid rising bond yields (together with some negative stock-specific news), while small, cyclical and value stocks held up comparatively well.

Mostly solid performances from preferred stocks

Last week's company results included The a2 Milk Company, Genesis Energy, Precinct Properties NZ, Spark NZ, Summerset Group and Vital Healthcare Property, among others.

- As had been signalled recently, **a2 Milk's 1H21 result was materially below the prior year** (primarily due to COVID-19 related headwinds). The focus, however, was on management's further lowering of FY21 guidance — the third cut since September. We remain confident in ATM's longer-term brand positioning and growth potential, but **the reduced guidance highlights the uncertain outlook, leading us to downgrade the stock to NEUTRAL.**
- **Genesis Energy's record 1H21 operating profit was better than we expected** and reflected improved performance across all business segments. It prompted management to upgrade earnings guidance for the full year. We've lifted our forecast slightly but with interest rates rising our target price has come down (a similar pattern is playing out across other stocks too). Our rating remains OUTPERFORM.
- **Precinct Properties' earnings were above our expectations** as lower tax expense more than offset lower rents and higher operating costs than we had estimated due to one-off effects related to COVID-19 and Commercial Bay. **We lifted our rating from NEUTRAL to OUTPERFORM** to reflect a better earnings outlook and more attractive valuation metrics relative to other listed property vehicles.
- **Spark delivered another very sound performance**, navigating reduced roaming revenues due to border closures and intensifying competition in broadband to deliver stable operating earnings. The company is reviewing whether to sell some of its infrastructure assets, which we view as sensible given the prices such assets are fetching internationally. We've retained an OUTPERFORM rating.
- **Summerset Group reported a solid FY20 result, in-line with guidance.** One area of weakness relative to our expectations was that costs rose largely in line with revenues (after excluding COVID-19 related expenses). **Strong share price performance has led us to downgrade our rating to NEUTRAL.**
- **Vital Healthcare Property reported a solid 1H21 ahead of our expectations**, largely due to better net rental income. We have increased our earnings forecasts for FY21-23 based on updated currency assumptions and lower tax. The negative impact of higher interest rates on our valuation offset the boost from higher property prices, and **we downgraded the stock to NEUTRAL.**

Themes of the week

Bond investors seem increasingly concerned by the potential for inflation to eat away at their returns in the longer-term, with 10-year government bond yields rising over the last month to levels that were last seen before COVID-19 spread around the world. Meanwhile central bankers (including New Zealand's) are keeping short-term rates firmly on the floor. **The Reserve Bank last week played the same tune as other central banks around the world, doubling down on its expansionary monetary policy** — notwithstanding the Minister of Finance's desire that the central bank take into account the sustainability of house prices.

Looking ahead

Earnings season takes a breather for a few weeks, leaving investors to focus on macro developments like bond yields, the OPEC meeting scheduled for early Friday NZ time, attempts to get a stimulus bill through the US Senate, and progress on vaccinations.

NZ Equities

Reporting season roundup

Below we highlight last week's corporate results from some of our preferred stocks.

The a2 Milk Company (ATM) – 1H21 – Third Strike; Downgrade to NEUTRAL

ATM suffered a material (-39%) contraction in sales of its English-labelled infant formulas. This was attributed to COVID-19 related challenges such as the availability of daigou, a margin squeeze and the build-up of excess inventory due to lower demand. The weakness in English-label sales outweighed strength in sales of Chinese-labelled product.

ATM's third downgrade to FY21 guidance was a further unwelcome reminder of the limited visibility ATM has into its opaque channels to market. Management also rescinded its medium-term EBITDA margin target of 30%, ostensibly to give the new CEO time to reassess it.

The downgrade cycle has materially dented investor confidence in the near-term outlook for ATM, which will take time to rebuild. We remain positive on ATM's longer-term brand positioning and growth potential, particularly in large offline channels in China. **But for now there is too much uncertainty in the short-term outlook for us to maintain an OUTPERFORM rating, and we have downgraded the stock to NEUTRAL.**

Genesis Energy's (GNE) – Foiling at High Speed – Record 1H21 Result

All of GNE's operating segments contributed to the +30% increase in 1H21 operating earnings vs. 1H20. Strong Retail margin growth, lower fuel costs and improved Wholesale trading margins, and the lack of any Kupe outages all lifted operating earnings.

Following the strong 1H21, GNE has upgraded its FY21 operating profit guidance by +3.7% (at the mid-point of the range). We have raised our forecasts to reflect the strong FY21 result. We see further potential earnings upside if wholesale market conditions remain dry.

GNE expects to receive 15 project proposals in mid-March to replace its thermal generation with renewables. Reading between the lines it is likely that both Contact Energy's Tauhara and Mercury NZ's Turitea developments are involved in the process, which would be positive because it would reduce the risk of excess capacity being built in the near-term.

Rising interest rates have offset the effect of strong earnings on our valuation, leading us to trim our target price by -15cps to NZ\$3.85. **We have retained our OUTPERFORM rating.**

Precinct Properties NZ (PCT) – 1H21 Result – Prime Time

PCT's 1H21 Available Funds From Operations (AFFO, an earnings metric used in the property sector) was +5.7% ahead of our estimate. Lower tax expense more than offset a softer operating outcome due to lower rent (mostly due to COVID-19) and higher operating costs (due to higher leasing activity). The company maintained its dividend guidance.

PCT's portfolio has fared well despite COVID-19 pressures, with portfolio fundamentals remaining solid, and operations tracking broadly in-line with expectations. **While we expect that the Auckland and Wellington office markets will experience some softness in the coming year, PCT is in good shape to withstand these pressures** given its best-in-class offering, portfolio under-renting, high quality corporate and government tenants, structured rent growth, and a 7.7 year weighted average lease term.

We have lifted our rating from NEUTRAL to OUTPERFORM based on a better earnings outlook and attractive valuation metrics, as PCT is trading at a smaller premium to NTA and offering a higher gross dividend yield than the average in the property sector.

Spark NZ (SPK) – 1H21 – Paddling Hard Below the Surface

SPK's underlying operating earnings were ahead of our expectation (excluding the impact of refunds for overcharging customers who moved from copper to fibre). Key features of the result included:

- A resilient contribution from mobile as customers continued to trade up, with underlying growth offsetting the loss of international roaming
- Thinner broadband margins, which SPK expects to remain under pressure as it tries to retain its market share in the face of more intense competition
- Further cost efficiencies

Management tweaked FY21 guidance only modestly, while affirming that the dividend will remain at 25cps (in line with our expectations). Our forecasts are little changed.

SPK is reviewing whether to keep or sell its infrastructure assets. We view this as sensible given the high valuations being placed on such assets globally, and the entry of new players into the NZ market which reduces SPK's strategic rationale for owning datacentres, exchanges, and sub-sea cables. We suspect a sale of mobile assets is unlikely given the network advantage and barrier to entry they provide.

We continue to see appeal in SPK's consistent delivery, solid market position (particularly mobile), A- rated balance sheet, and attractive dividend yield. Our rating remains OUTPERFORM.

Summerset Group (SUM) – Travel and Arrival – Downgrade to NEUTRAL

SUM's FY20 result included many moving parts including one-off COVID-19 related costs. Adjusting for this, costs grew largely in line with revenue, which was slightly disappointing given a substantial proportion of the growth related to re-sale gains, which do not come with meaningful direct costs.

Reported pre-sales and guidance for new unit deliveries were strong, which is positive for the bottom line growth outlook in FY21, but higher costs have prompted us to lower our "annuity" operating earnings estimates.

We view SUM as a long term structurally attractive stock because of the company's sector-leading long term growth prospects (driven by strong cash recovery of capex, a large and diversified land bank, and a high proportion of immature villages). The opening of new villages looks likely to result in costs rising as fast or faster than revenues, keeping a lid on operating margins. **At its current valuation we consider SUM to be fairly valued and view a further re-rating as unlikely in the medium term.** We have downgraded our rating from OUTPERFORM to NEUTRAL.

Vital Healthcare – 1H21 – Healthy Result, Healthy Valuation

VHP's strong top line was largely driven by acquisitions and development income. Like-for-like net property income grew +1.5% and rent reviews delivered a +2.1% uplift. Revaluation gains raised VHP's NTA from NZ\$2.38 a year ago to \$2.55.

VHP's portfolio metrics remained very solid, with occupancy of 99.1% and a weighted average lease expiry of 19.0 years. 98% of leases are subject to structured rent reviews.

We expect VHP's portfolio to continue to provide investors with a defensive property exposure. The trust's development plans underpin good distribution growth prospects (we forecast growth of +3% per annum to FY23); however, this is largely priced into the shares in our view. **With VHP trading broadly in line with our NZ\$3.15 12-month target, we lower our rating from OUTPERFORM to NEUTRAL.**

Themes of the Week

Fixed Interest

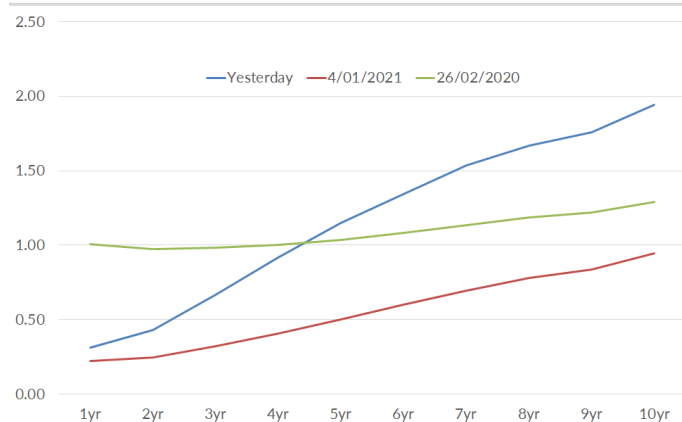
Reserve Bank reiterated its dovish tune — and that its focus is not on house prices

The highly anticipated Reserve Bank of New Zealand (RBNZ) Monetary Policy Statement (MPS) is now history, with the Governor delivering a fairly dovish statement. **The central bank left the Official Cash Rate (OCR) on hold at 0.25% and said "prolonged monetary stimulus will be maintained for sometime yet"**. Whilst the market didn't react on the day, it did so a couple of days later when Governor Orr doubled down and reiterated that the OCR was going nowhere for a considerable time.

The RBNZ was also thrown a curve ball from the Minister of Finance, who now requires the RBNZ to assess the impact of its monetary policy decisions on sustainable house prices. While there was much fuss regarding this new development, the Governor reiterated that "we remain **only focussed** on maintaining low and stable consumer price inflation and contributing to maximum sustainable employment...".

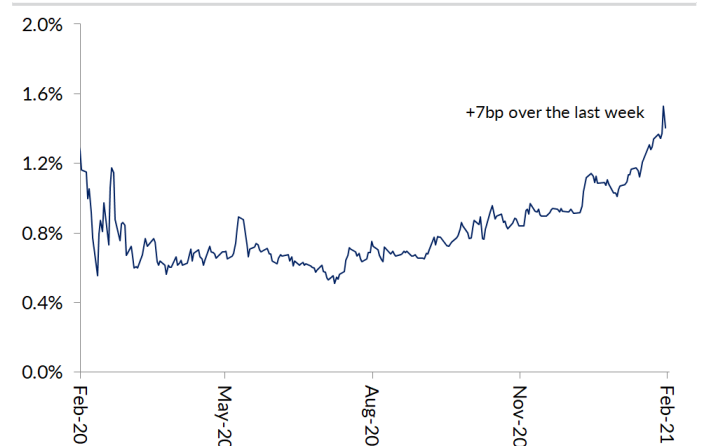
With its comments and outlook, the Reserve Bank has joined other central banks around the globe with a very similar message that monetary stimulus is going nowhere anytime soon. The market believes otherwise and hence longer-term interest rates have risen sharply in recent weeks. It would be a brave move to take on the likes of the US Federal Reserve, which can use its considerable power to move markets.

Figure 1. NZ Swap curve, YTD, 1yr ago



Source: Forsyth Barr analysis, Refinitiv

Figure 2. US 10yr yield



Source: Forsyth Barr analysis, Refinitiv

Research Worth Reading

Asset Allocation

Asset Allocation — Remain Positioned for Growth

Record levels of proposed government spending at the same time as central banks remain committed to allowing economies to run above potential sets up a powerful stimulus partnership. Progress with vaccinations should see a gradual normalisation of activity, with the sectors hardest hit by the pandemic potentially recovering strongly by year-end. New Zealand border and travel restrictions are likely to remain for most of 2021, which also underpins our view that record levels of monetary support will continue until the pandemic is perceived to be under control. As we outlined in last week's Wealth Weekly, we have recommended reduced exposure to bonds, cash, NZ equities and listed property, maintained a small overweight to Australia, and increased our overweight to global equities. In this Asset Allocation report we have provided greater detail on the macroeconomic outlook underpinning our recommendations.

New Zealand

Tourism Holdings (THL) — 1H21 — Ready for More Action

We upgrade THL to NEUTRAL from UNDERPERFORM given the equally balanced risks between recovery potential and opportunities, and further equity dilution from prolonged losses. The company reported a challenged 1H21 result, reliant on domestic only rentals as a result of border closures, partially offset by booming vehicle sales. An underlying post-tax loss of -NZ\$2.7m was its first since 1H12. Rental demand has been significantly impacted by border restrictions, particularly in New Zealand, where domestic rentals have historically been a smaller proportion of the customer mix. This will play out to a greater extent in 2H21; we expect losses to deepen further. The strength of vehicle sales has provided THL the relative luxury of a strong balance sheet with negligible net debt at period end and allows scope for reinvestment in fleet ahead of an anticipated recovery, for which THL is well placed. (Published by Forsyth Barr)

Mercury (MCY) — Turitea Turbulence Shrugged Off — 1H21 Result

MCY's 1H21 result was a good one given low generation volumes, although it was also boosted by some one-off gains. 1H21 EBITDAF of NZ\$294m was +NZ\$36m better than 1H20 and +NZ\$26m better than our forecast. However, the outlook is mixed. The positive aspect is MCY targeting +NZ\$30m of FY22 EBITDAF uplift from various initiatives, albeit details are light. The downside is an FY21 EBITDAF guidance fall of -NZ\$15m to NZ\$520m due to weak hydro inflows over the past month and Turitea wind farm completion delays. Whilst our medium-term forecasts have increased, our target price is -25cps lower to NZ\$5.75 due to higher interest rates lifting our cost of capital assumption. UNDERPERFORM. (Published by Forsyth Barr)

Meridian Energy (MEL) — Joining the Development Train — 1H21 Result

There were no surprises in MEL's 1H21 result and even the announcement it is progressing its Harapaki wind farm was expected. The result itself was strong, albeit EBITDAF of NZ\$422m is -9% lower than the record prior period. The interim dividend of 5.7cps was flat on 1H20 and investors should not expect significant dividend growth as MEL (and the sector generally) moves into a development phase. From a value perspective, rising interest rates are a headwind for yield investments such as MEL and we have cut our target price -8% to NZ\$5.10. UNDERPERFORM. (Published by Forsyth Barr)

Port of Tauranga (POT) — 1H21 — Foiling Upwind in Choppy Water

POT's 1H21 result was impacted by shipping industry congestion which has lowered productivity, added costs and pressured margins, though performance was ahead of expectations. Industry congestion is likely to remain through 2H21, albeit POT will be cycling easier lockdown restrictions comparatives, therefore, profit growth should accelerate. POT has upgraded its FY21 NPAT guidance from a previous, very conservative, range. Medium-term growth is limited by capacity constraints as the port becomes increasingly reliant on the Southern Wharf extension to facilitate growth. The recent rise in bond rates provides a key valuation challenge for POT. Historically its one year forward valuation multiples (PE, EV/EBITDA etc) have been highly inversely correlated to bond rate movements. Now trading at ~50x one year forward PE, POT is subject to the risk of valuation multiples decreasing, in our opinion. UNDERPERFORM. (Published by Forsyth Barr)

Australia

APA Group (APA.AX) – First-half FY21 result review, upgrade to Buy

APA reported first-half FY21 net profit of A\$162m versus Ord Minnett's A\$166m forecast. Operating earnings (EBITDA) of A\$823m were +1% above the previous period. An unfranked interim dividend of 24cps was declared. Management reaffirmed full-year guidance, implying second half EBITDA would be between A\$822m and A\$842m. The growth strategy was also unchanged, with management continuing to assess organic and inorganic growth opportunities. Ord Minnett believes the recent weakness in the share price has been driven by the significant increase in benchmark interest rates. While macro drivers could still represent a near-term headwind, Ord Minnett believes the current price looks attractive given APA's stable, predictable earnings. BUY (from HOLD). (Published by Ord Minnett)

Ramsay Health Care (RHC.AX) – First-half FY21 result review

RHC reported a first-half FY21 core net profit of A\$201m versus Ord Minnett's A\$196.6m forecast. Australia earnings missed Ord Minnett's estimates but other regions were ahead. A fully franked interim dividend of 48.5cps was declared, which was a positive surprise. In the absence of further COVID shutdowns, Ord Minnett believes RHC's Australian business is well positioned to deliver a solid recovery over 2021, with reports from multiple industry sources confirming an uplift in activity. The UK and European operations are still managing the COVID-19 crisis, but the various government support programmes should ensure earnings are maintained. ACCUMULATE. (Published by Ord Minnett)

International

American Tower Corporation (AMT.N) – Solid visibility into LT double-digit AFFO/sh growth

4Q results were solid, beating UBS's estimates by +3-5% while the 2021 outlook was largely in-line. Management expects US organic growth to remain subdued at ~+3% in 2021 and just +1% in 2022 as Sprint churn occurs, before reaching +5% thereafter, driving a +4% organic revenue CAGR (vs. the prior UBS estimate of +4.6%). Much of the outlook is supported by contractual guarantees and management has not assumed any meaningful contribution from DISH Network's planned 5G buildout, which UBS believes could provide an additional catalyst to spend over time. Combined with International growth +2% above the US, this is expected to support double-digital AFFO/share and dividend growth. BUY. (Published by UBS)

Walt Disney Co (DIS.N) – New Segments Offer Wonderful Clarity

DIS's new reporting segments are a vast improvement to the prior presentation. Citi has rebuilt its model to align with the firm's new disclosures. There are two implications. First, DPEP (Parks and Consumer) margins will be ~+3.2% higher due to the elimination of the inter-segment revenue share with DMED (Studio). Second, risks to downward estimate revisions from Content Licensing are smaller than Citi expected, since this segment only has ~10% EBIT margins. BUY. (Published by Citi)

Salesforce (CRM.N) – A Much Cleaner Print

Coming on the back of a surprisingly small October-quarter beat that contributed (along with the acquisition of Slack) to a material underperformance in CRM shares, the January-quarter result was much stronger and cleaner and in UBS's view should help support investor sentiment. Backlog or current remaining performance obligation (cRPO) growth of +20% beat the +16% guidance, CRM raised its April-quarter revenue guidance by +US\$170m, April-quarter cRPO growth guidance of +19% was above UBS's +18% estimate, and the initial FY22 operating margin guidance of +17.7% was at the high end of the framework offered at the December investor day. CRM is 5x the size of Workday, trades at a material discount, and yet is posting similar growth. BUY. (Published by UBS)

Stellantis (STLA.MI) – Looking at the accounting not the stars, consensus >15% too low

Following a period of restriction Citi resumes coverage of STLA, which was formed from the merger of Fiat Chrysler Automobiles with Peugeot maker Groupe PSA. While the shares are a consensus BUY among brokers given the obvious attractions of its self-help prospects (€5b in synergies are expected over a five-year period), Citi believes current market estimates are yet to reflect the details of the merger document fully. At the same time Citi believes STLA's focus on smaller vehicles leaves it less exposed to structural disruption than peers, suggesting it is one of the true value plays in the European auto sector, with the shares trading at 2022 free cashflow yield of over 15% and at 3x EV/EBIT vs peers' 5x valuations. Citi sees limited downside and significant potential upside should its consensus-leading forecasts be achieved. BUY. (Published by Citi)

Calendar

Figure 3. Calendar

| Date | New Zealand | Australia | International |
|-------|--|---|--|
| 1-Mar | | AIG Manufacturing Index (Feb) Manufacturing PMI Melbourne Institute Inflation Gauge ANZ Job Advertisements Business Inventories Company Profits Pre-Tax (4Q) Home Loans Invest Housing Finance Commodity Prices | UK: Manufacturing PMI (Feb) EU: German Manufacturing PMI (Feb) CN: Manufacturing PMI (Feb) CN: Caixin Manufacturing PMI (Feb) |
| 2-Mar | Terms of Trade Index (4Q) | Building Approvals (Jan) Current Accounts (4Q) Net Exports Contribution (4Q) Private House Approvals (Jan) RBA Interest Rate Decision (Mar) RBA Rate Statement | US: ISM Manufacturing PMI (Feb) EU: ECB President Lagarde Speaks EU: CPI (Feb) EU: German Unemployment Change (Feb) |
| 3-Mar | GlobalDairyTrade Price Index Building Consents (Jan) ANZ Commodity Price Index | AIG Construction Index (Feb) Services PMI GDP (4Q) RBA Chart Pack Release | UK: Composite PMI (Feb) UK: Services PMI (Feb) |
| 4-Mar | | Exports & Imports (Jan) Trade Balance (Jan) Retail Sales (Jan) | US: ADP Nonfarm Employment Change (Feb) US: ISM Non-Manufacturing PMI (Feb) US: Crude Oil Inventories UK: Annual Budget Release UK: Construction PMI (Feb) |
| 5-Mar | | AIG Services Index (Feb) | US: Initial Jobless Claims |
| 6-Mar | CFTC NZD Speculative Net Positions | CFTC AUD Speculative Net Positions | US: Nonfarm Payrolls (Feb) US: Unemployment Rate (Feb) US: Federal Budget |

Source: Forsyth Barr analysis

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