

# Equity Strategy

## Institutional Model Portfolio

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The post COVID-19 world will be subject to lower growth and low interest rates, in our opinion, which will create scarcity value among higher quality income and growth companies. Growth will be hampered by higher debt, potential tax increases, unemployment, reduced labour mobility/lower immigration, demographic headwinds, and de-globalisation. The latter may ultimately create inflation, but in the meantime rates will stay low in order to stimulate (some) demand and incentivise investment. Consequently, investors will value income and structural growth, and will be happy to pay a premium for doing so. This view, together with market composition, helps explain the expensive nature of the NZ market (now at 29.4x one year forward PE vs. MSCI World at 18.2x). We retain a bias to higher quality income and growth names, and rotate our yield exposures to the more defensive end of the spectrum. Our biggest overweight remains The a2 Milk Company (ATM).

**Property less defensive**

Property doesn't appear as defensive as previously thought. The COVID-19 experience will likely lead to cap rate expansion (given higher asset betas and lower gearing) and therefore valuation and ultimately rent roll reductions across the sector. While the sector has materially underperformed, we see no need for a rapid re-entry and retain a material underweight position.

**Portfolio changes; increasing cash, MFT, and reducing underweights in MEL and MCY**

We extend our overweight sector call on electricity generator/retailers, by reducing underweights on Meridian (MEL), and Mercury (MCY). We retain overweight positions in Contact (CEN), and Genesis (GNE). We move to overweight in Mainfreight (MFT) given its high quality growth attributes and significant long term opportunities across its global platform, are at a reasonable price. We also add to our cash position following the strong market bounce. We will look to deploy cash in the event of a market correction.

**Exiting NZK; lower positions in AIA and IFT**

We lower our weighting in Auckland Airport (AIA) to underweight from benchmark to reflect strong performance following its equity raise last month and structural challenges the aviation sector has in its recovery from COVID-19. We also reduce our overweight position in Infratil (IFT), given recent outperformance and the narrowing of its discount to NAV to normal levels (~20%). We complete the removal of NZ King Salmon (NZK) from the portfolio, which we started last month, given the social distancing risks attached to its higher margin food service channel, even in a post-lockdown world.

**Figure 1. Forsyth Barr Institutional model portfolio summary**

Market breakdown	Benchmark	Active weight	Portfolio
<b>Defensive yield</b>	<b>48.2%</b>	<b>-2.0%</b>	<b>46.2%</b>
Utilities	14.6%	+2.6%	17.2%
Property	8.8%	-5.1%	3.8%
Other defensive yield	24.8%	+0.5%	25.3%
<b>Structural growth</b>	<b>45.1%</b>	<b>+1.5%</b>	<b>46.6%</b>
Aged care	7.7%	+1.1%	8.8%
Other structural growth	37.4%	+0.3%	37.7%
<b>Cyclicals</b>	<b>6.6%</b>	<b>-2.5%</b>	<b>4.1%</b>
Cash	0.0%	+3.1%	3.1%
<b>Total</b>	<b>100.0%</b>	<b>0.0%</b>	<b>100.0%</b>

Source: Forsyth Barr analysis NOTE: The portfolio includes a cash weighting of 3.1%

## Institutional model portfolio

The Forsyth Barr institutional model portfolio is outlined in Figure 2. We incorporate 24 stocks together with a ~3% nominal cash holding. All portfolio holdings are ~1.0% or more, unless (1) we are adding new positions, or exiting positions, in less liquid stocks, or (2) existing positions are diluted by relative underperformance.

**Figure 2. The Forsyth Barr institutional model portfolio**

Code	Portfolio weight	Active weight	12m fwd PE	12m fwd cash dividend yield	Rating
ATM	17.4%	+4.1%	33.3x	0.0%	OUTPERFORM
FPH	12.4%	-2.9%	49.7x	1.3%	UNDERPERFORM
SPK	9.3%	+1.8%	19.5x	5.7%	OUTPERFORM
CEN	6.6%	+2.3%	18.0x	6.3%	OUTPERFORM
RYM	5.5%	+0.8%	37.1x	1.3%	OUTPERFORM
AIA	5.1%	-1.4%	340.1x	0.0%	NEUTRAL
MEL	4.6%	-0.5%	24.5x	4.9%	NEUTRAL
GNE	3.7%	+2.4%	15.3x	6.2%	OUTPERFORM
CNU	3.6%	+0.7%	60.5x	3.5%	OUTPERFORM
MFT	3.4%	+0.5%	27.9x	1.4%	OUTPERFORM
IFT	3.2%	+0.5%	n/a	3.5%	OUTPERFORM
Cash	3.1%	+3.1%	n/a	n/a	n/a
EBO	2.6%	+0.2%	19.2x	3.7%	NEUTRAL
SKC	2.6%	+1.0%	29.2x	2.4%	OUTPERFORM
SAN	2.4%	+1.9%	13.1x	3.3%	OUTPERFORM
MCY	2.3%	-0.3%	23.0x	3.6%	NEUTRAL
ARV	2.1%	+1.5%	18.5x	3.0%	OUTPERFORM
VHP	1.9%	+1.1%	22.7x	3.6%	OUTPERFORM
FBU	1.7%	-1.1%	19.7x	3.8%	NEUTRAL
ZEL	1.4%	+0.3%	25.8x	6.9%	OUTPERFORM
SUM	1.2%	-0.1%	27.7x	1.1%	OUTPERFORM
TLT	1.0%	+1.0%	24.4x	0.0%	OUTPERFORM
PFI	1.0%	-0.1%	25.2x	2.8%	OUTPERFORM
FRE	0.9%	-0.1%	18.6x	4.0%	NEUTRAL
ARG	0.9%	+0.0%	15.4x	4.5%	NEUTRAL

Source: Forsyth Barr analysis

Our portfolio is less expensive on a one year forward PE basis than the market and provides a slightly higher level of EPS growth, whilst also providing a similar level of income (on a cash basis).

**Figure 3. Portfolio characteristics vs. the S&P/NZX 50 (based on Forsyth Barr estimates)**

	12m fwd PE	12m fwd cash div yield	12m fwd EV/EBITDA	12m-24m EPS growth*
FB Institutional Model Portfolio	28.8x	2.6%	15.4x	11.8%
S&P/NZX 50	29.4x	2.7%	15.1x	9.4%

Source: Forsyth Barr analysis

\*quoted at a median level due to Auckland Airport (AIA) distorting weighted estimates

## Key active weights

We outline our key active weights in Figure 4 where weightings are 1.5% or greater relative to the benchmark.

**Figure 4. Key active weights**

Code	Active weight	Rationale
<b>Key over-weights</b>		
ATM	+4.1%	Unique growth story with penetration still low of a large (and growing) addressable market. Strong free cash flow, high return and a large net cash position. Optionality from new products/markets.
GNE	+2.4%	Defensive characteristics, long-term steady growth outlook and strong yield. Provides best near-term earnings growth as long-term expensive take or pay gas contracts roll off.
CEN	+2.3%	Defensive characteristics, long-term steady growth outlook and strong yield. Risk of NZAS closure is low. Has one of the best development projects in the country with its Tauhara geothermal option.
SAN	+1.9%	Value strategy with upside should it execute on stated target of NZ\$1 EBIT/kg. Attractive PEG. Long-term optionality around additional aquaculture water space backed by Government support. Protein theme.
SPK	+1.8%	Attractive dividend yield. Relative earnings resilience to COVID-19 crisis and recessionary conditions. Strong execution track record consistently, with solid A- rated balance sheet.
ARV	+1.5%	Needs based business model plus strong structural growth from its pipeline of brownfield and green field sites with wide geographic diversification.
<b>Key under-weights</b>		
FPH	-2.9%	High quality, long-term growth story. However, we struggle to justify valuation levels (~50x PE) which are elevated against any benchmark (even when growth adjusted).
GMT	-2.3%	Well place Auckland centric portfolio but trading at a substantial premium to its NTA and wider sector metrics.
POT	-2.0%	COVID-19 risks made clear in removal of FY20 guidance. Risk to FY21 earnings also given supply chain disruption. Upper North Island study unlikely to lead to meaningful benefits for POT.
PCT	-1.6%	Office exposure increases its susceptibility to cyclical swings. Cashflow outlook muted despite subdued supply outlook for office assets in Wellington and Auckland.

Source: Forsyth Barr analysis

## Portfolio Changes

We have made a number of changes to our portfolio as summarised in Figure 5.

**Figure 5. Portfolio changes**

Code	Portfolio move	Weighting change	New portfolio weight	Rationale
AIA	Sell	-1.0%	5.1%	Strong bounce post equity raise, dividend holiday, long dated recovery
IFT	Sell	-0.8%	3.2%	Discount to NTA has closed to normal (~20%) levels
NZK	Sell (Exit)	-0.6%	0.0%	Second stage of full exit given social distancing concerns in new norm
MCY	Buy	+0.4%	2.3%	Adding to safe defensive overweight
MEL	Buy	+0.4%	4.6%	Adding to safe defensive overweight
MFT	Buy	+0.6%	3.4%	High quality structural growth company at more affordable price
Cash		+1.0%	3.1%	Market bounce allows profit taking

Source: Forsyth Barr analysis

**Figure 6. Forsyth Barr Institutional model active weights relative to benchmark (priced as at 4 May 2020)**

Thematic/company	Active weight	Price (NZ\$)	12m fwd PE	12m fwd divi yld*	12-24m EPS growth	Rating
<b>Defensive yield</b>	<b>-2.0%</b>					
<b>Utilities</b>	<b>+2.6%</b>					
CEN	+2.3%	\$6.19	18.0x	6.3%	2.4%	OUTPERFORM
GNE	+2.4%	\$2.83	15.3x	6.2%	20.1%	OUTPERFORM
MCY	-0.3%	\$4.50	23.0x	3.6%	6.6%	NEUTRAL
MEL	-0.5%	\$4.39	24.5x	4.9%	-1.7%	NEUTRAL
TPW	-0.4%	\$6.54	20.2x	5.2%	6.4%	OUTPERFORM
VCT	-0.8%	\$3.51	28.2x	4.7%	-0.9%	NEUTRAL
<b>Property</b>	<b>-5.1%</b>					
ARG	+0.0%	\$1.06	15.4x	4.5%	0.4%	NEUTRAL
GMT	-2.3%	\$2.26	32.7x	2.4%	3.9%	NEUTRAL
IPL	-0.4%	\$1.70	21.3x	4.5%	3.0%	OUTPERFORM
KPG	-1.4%	\$0.96	13.1x	5.4%	2.0%	UNDERPERFORM
PCT	-1.6%	\$1.53	22.4x	3.1%	-2.2%	NEUTRAL
PFI	-0.1%	\$2.22	25.2x	2.8%	0.9%	OUTPERFORM
SPG	-0.5%	\$1.51	15.3x	4.7%	11.8%	NEUTRAL
VHP	+1.1%	\$2.34	22.7x	3.6%	2.4%	OUTPERFORM
<b>Other defensive yield</b>	<b>+0.5%</b>					
AIA	-1.4%	\$5.85	340.1x	0.0%	459.9%	NEUTRAL
CNU	+0.7%	\$7.04	60.5x	3.5%	-1.1%	OUTPERFORM
IFT	+0.5%	\$4.47	n/a	3.5%	n/a	OUTPERFORM
POT	-2.0%	\$6.75	44.5x	2.1%	8.4%	UNDERPERFORM
RBD	-0.4%	\$12.05	81.8x	0.0%	123.5%	NEUTRAL
SKC	+1.0%	\$2.45	29.2x	2.4%	106.5%	OUTPERFORM
SPK	+1.8%	\$4.42	19.5x	5.7%	3.2%	OUTPERFORM
ZEL	+0.3%	\$3.03	25.8x	6.9%	185.8%	OUTPERFORM
<b>Structural growth</b>	<b>+1.5%</b>					
<b>Aged care</b>	<b>+1.1%</b>					
ARV	+1.5%	\$1.35	18.5x	3.0%	41.8%	OUTPERFORM
MET	-0.7%	\$4.24	12.9x	1.4%	18.4%	NEUTRAL
OCA	-0.4%	\$0.73	11.3x	4.9%	31.6%	NEUTRAL
RYM	+0.8%	\$12.12	37.1x	1.3%	52.4%	OUTPERFORM
SUM	-0.1%	\$5.82	27.7x	1.1%	81.4%	OUTPERFORM
<b>Other structural growth</b>	<b>+0.3%</b>					
ATM	+4.1%	\$19.97	33.3x	0.0%	20.1%	OUTPERFORM
EBO	+0.2%	\$22.00	19.2x	3.7%	7.4%	NEUTRAL
FPH	-2.9%	\$28.15	49.7x	1.3%	9.4%	UNDERPERFORM
FRE	-0.1%	\$6.60	18.6x	4.0%	18.3%	NEUTRAL
GTK	-0.1%	\$1.47	50.4x	1.5%	164.5%	OUTPERFORM
MFT	+0.5%	\$36.31	27.9x	1.4%	29.6%	OUTPERFORM
NZK	+0.0%	\$1.95	16.1x	3.0%	33.3%	OUTPERFORM
SCL	-0.6%	\$4.80	20.3x	4.4%	8.6%	NEUTRAL
SKL	-0.3%	\$1.95	12.8x	6.9%	2.6%	n/a
SML	-0.5%	\$6.83	13.6x	0.0%	17.5%	NEUTRAL
TLT	+1.0%	\$3.15	24.4x	0.0%	-5.9%	OUTPERFORM
<b>Cyclicals</b>	<b>-2.5%</b>					
AIR	-0.7%	\$1.27	-15.0x	8.7%	n/a	UNDERPERFORM
FBU	-1.1%	\$3.56	19.7x	3.8%	40.9%	NEUTRAL
FSF	-0.4%	\$3.70	12.7x	4.1%	18.6%	n/a
HGH	-0.6%	\$1.14	n/a	n/a	n/a	n/a
KMD	-0.4%	\$0.75	n/a	n/a	n/a	RESTRICTED
NZR	-0.2%	\$0.90	-6.9x	0.0%	n/a	UNDERPERFORM
NZX	-0.3%	\$1.26	22.9x	4.8%	9.4%	n/a
SAN	+1.9%	\$7.06	13.1x	3.3%	20.5%	OUTPERFORM
SKT	-0.1%	\$0.30	12.8x	0.0%	61.6%	NEUTRAL
THL	-0.1%	\$1.31	-18.2x	1.2%	n/a	UNDERPERFORM
<b>Cash</b>	<b>+3.1%</b>					

Source: Bloomberg, Forsyth Barr analysis \*cash dividend yield NOTE: PPH (active weight -0.8%), VGL (-0.2%), ANZ (-0.3%) and WBC (-0.4%) not included in the above table.

## Valuation

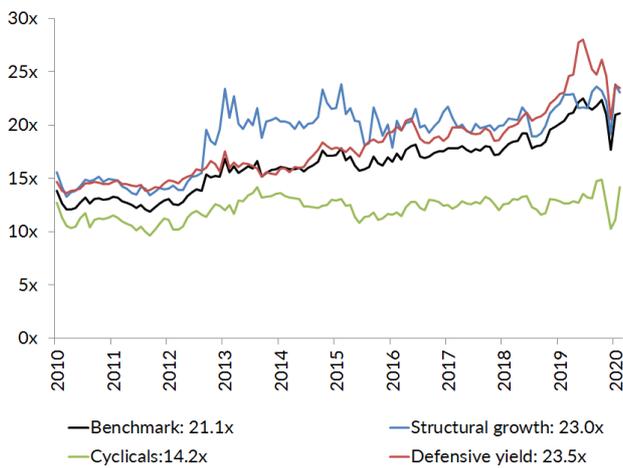
- A substantial price recovery from March lows and updated consensus earnings means market valuations are nearing pre COVID-19 levels.
- Lower rate outlook is supportive to defensive yield type stocks.
- Cyclical valuations look cheap but beware of the value trap, particularly with recessionary conditions ahead.

**Figure 7. Market valuation metrics (based on consensus earnings estimates)**

Thematic	12mth fwd PE		12mth fwd EV/EBITDA		12mth fwd cash divi yield	
	Ave.	Wghtd ave.	Ave.	Wghtd ave.	Ave.	Wghtd ave.
Cyclicals	14.2x	15.4x	5.6x	5.6x	5.1%	5.6%
Defensive yield	23.5x	23.9x	14.0x	12.7x	4.4%	4.3%
Structural growth	23.0x	33.8x	14.6x	18.2x	2.6%	1.4%
<b>Market</b>	<b>21.1x</b>	<b>28.4x</b>	<b>12.5x</b>	<b>14.4x</b>	<b>3.9%</b>	<b>3.1%</b>

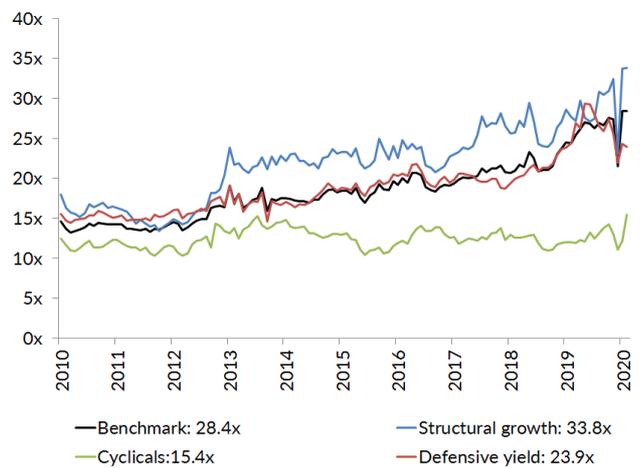
Source: Forsyth Barr analysis, Bloomberg

**Figure 8. Consensus 12m fwd PE – average**



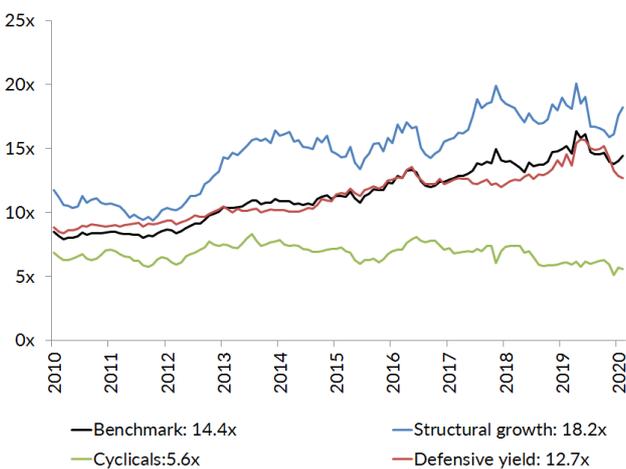
Source: Forsyth Barr analysis, Bloomberg

**Figure 9. Consensus 12m fwd PE – weighted average**



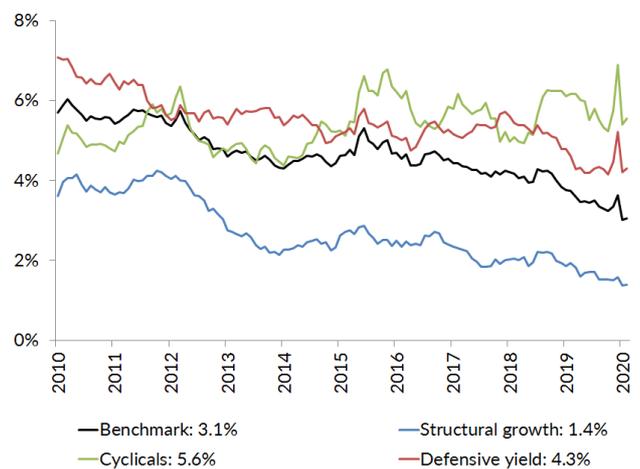
Source: Forsyth Barr analysis, Bloomberg

**Figure 10. Consensus 12m fwd EV/EBITDA – weighted average**



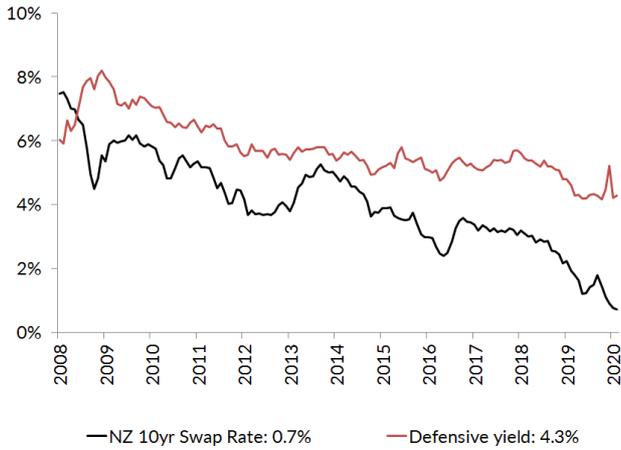
Source: Forsyth Barr analysis, Bloomberg

**Figure 11. Consensus cash dividend yield – weighted average**



Source: Forsyth Barr analysis, Bloomberg

**Figure 12. Defensive yield cash dividend yield vs. 10yr bond**



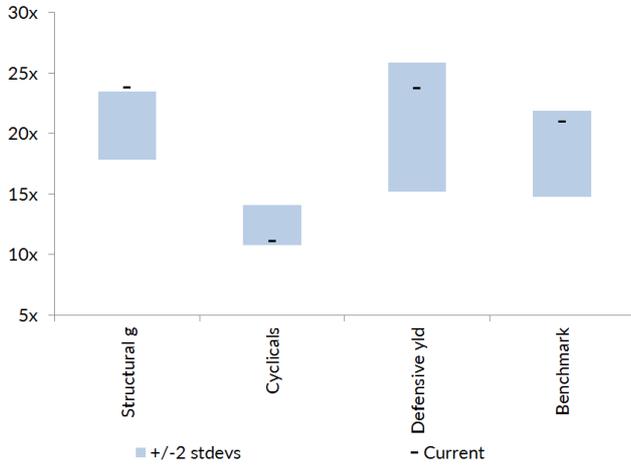
Source: Forsyth Barr analysis, Bloomberg

**Figure 13. Defensive yield cash div yield and 10yr bond diff.**



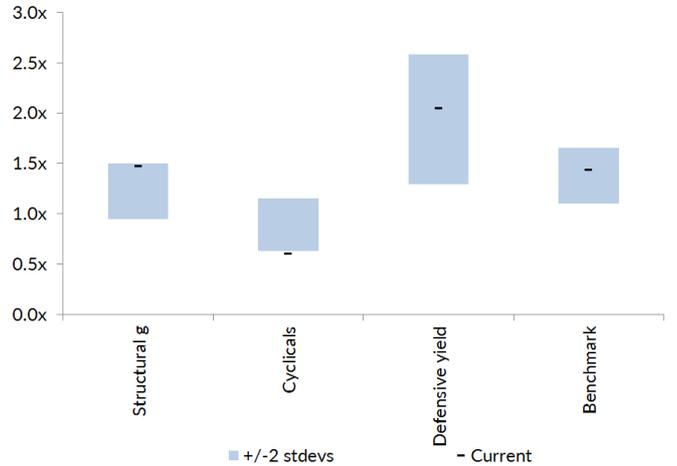
Source: Forsyth Barr analysis, Bloomberg

**Figure 14. Consensus 12m fwd PE vs. historic (five year) average**



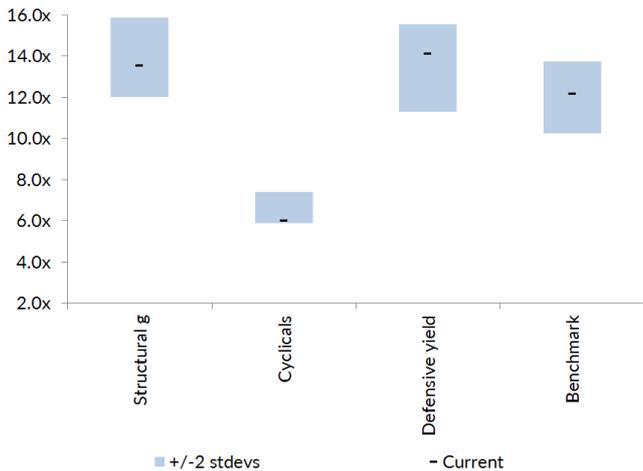
Source: Forsyth Barr analysis, Bloomberg

**Figure 15. 12m fwd PEG vs. historic (five year) average**



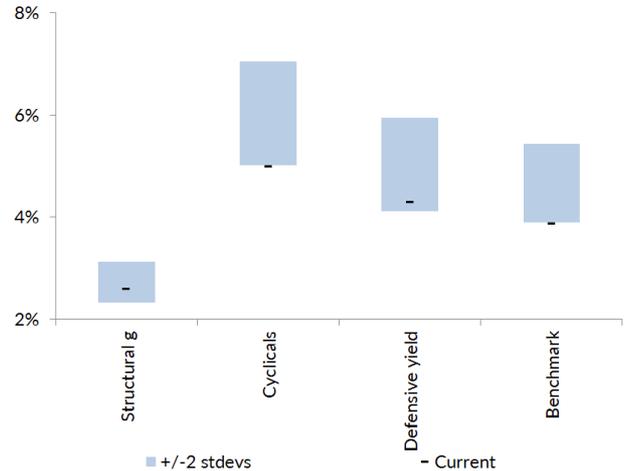
Source: Forsyth Barr analysis, Bloomberg

**Figure 16. 12m fwd EV/EBITDA vs. historic (five year) average**



Source: Forsyth Barr analysis, Bloomberg

**Figure 17. 12m fwd cash div. yield vs. historic (five year) average**



Source: Forsyth Barr analysis, Bloomberg

## Earnings

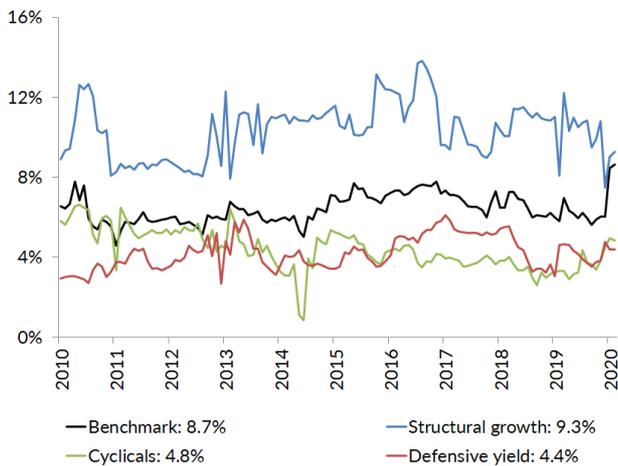
- Consensus earnings expectations have been cut for year one, which is exaggerating the growth in year two.
- Defensive yield earnings growth outlook remains solid.
- Margins appear to remain firm across the market.

**Figure 18. Market earnings estimates (based on consensus earnings estimates)**

Thematic	12-24mth Revenue growth		12-24mth EBITDA growth		12-24mth EPS growth		12-24mth OCF growth	
	Ave.	Wghtd ave.	Ave.	Wghtd ave.	Ave.	Wghtd ave.	Ave.	Wghtd ave.
Cyclicals	4.8%	4.3%	9.5%	9.9%	13.1%	14.3%	16.1%	12.8%
Defensive yield	4.4%	2.5%	9.7%	10.9%	7.2%	6.9%	7.1%	5.2%
Structural growth	9.3%	12.1%	15.3%	14.6%	13.9%	15.0%	17.6%	16.5%
<b>Market</b>	<b>8.7%</b>	<b>10.3%</b>	<b>11.5%</b>	<b>12.5%</b>	<b>10.7%</b>	<b>11.6%</b>	<b>12.9%</b>	<b>11.4%</b>

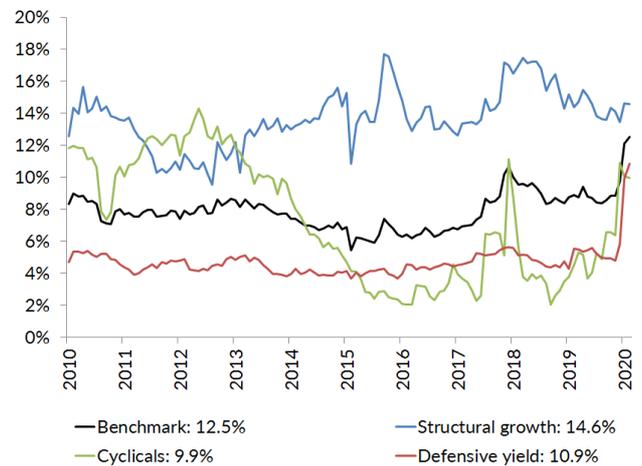
Source: Forsyth Barr analysis, Bloomberg

**Figure 19. 12–24m revenue growth – average.**



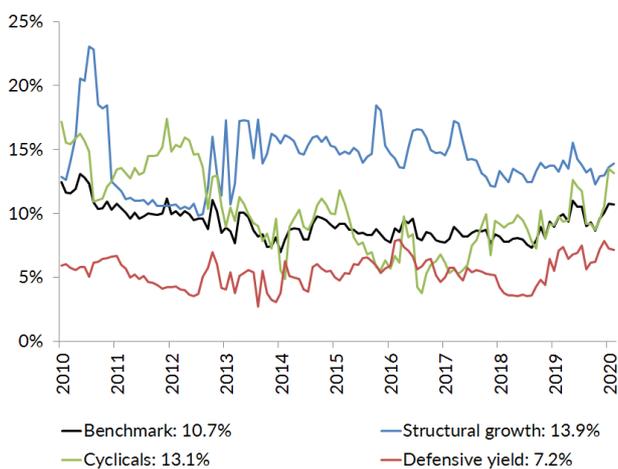
Source: Forsyth Barr analysis, Bloomberg

**Figure 20. 12–24m EBITDA growth – weighted average.**



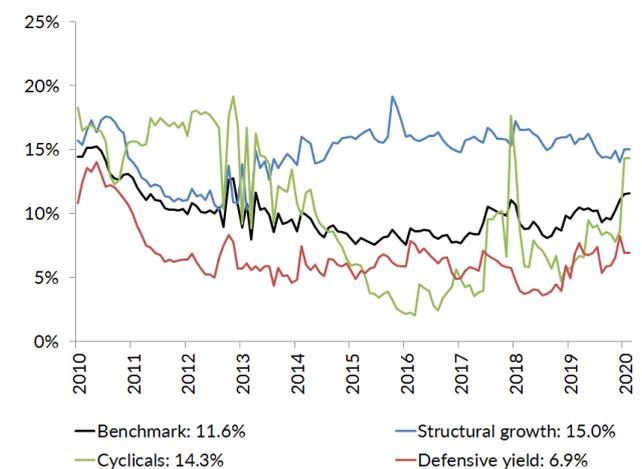
Source: Forsyth Barr analysis, Bloomberg

**Figure 21. 12–24m EPS growth – average**



Source: Forsyth Barr analysis, Bloomberg

**Figure 22. 12–24m EPS growth – weighted average**

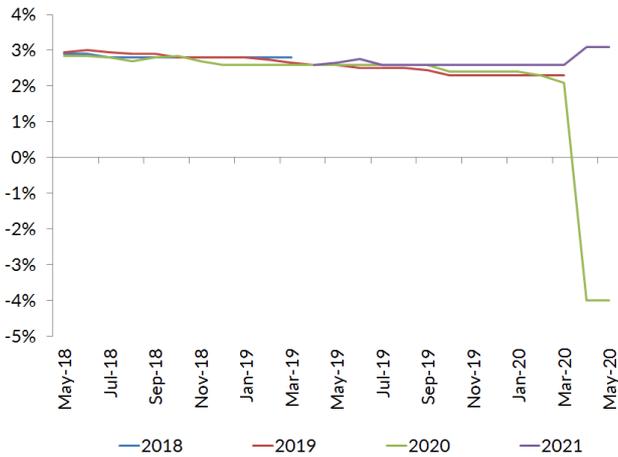


Source: Forsyth Barr analysis, Bloomberg

## GDP and interest rates

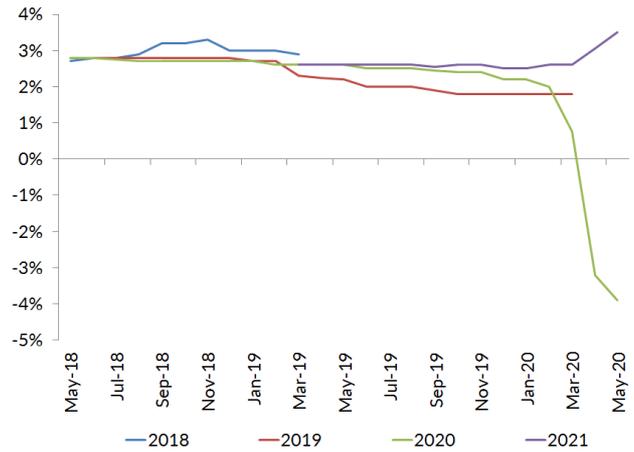
- GDP expectations for 2020 have plummeted in light of the significant impact of COVID-19.
- The yield curve has steepened in light of a reduction in near term rates. Longer term rates remain significantly lower than where they were historically.
- Domestic and global inflation has been steady in recent years.

**Figure 23. New Zealand consensus GDP growth forecast**



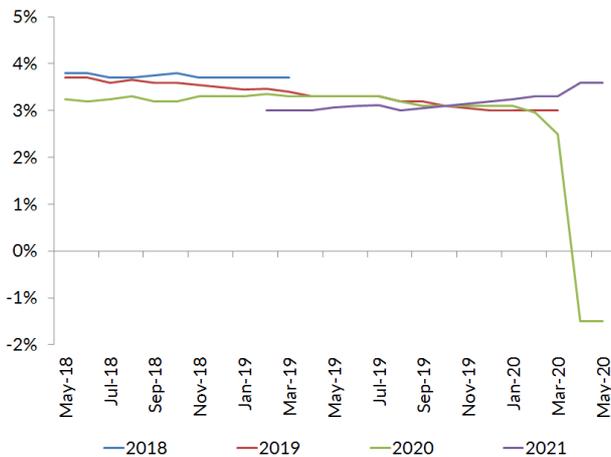
Source: Forsyth Barr analysis, Bloomberg

**Figure 24. Australia consensus GDP growth forecast**



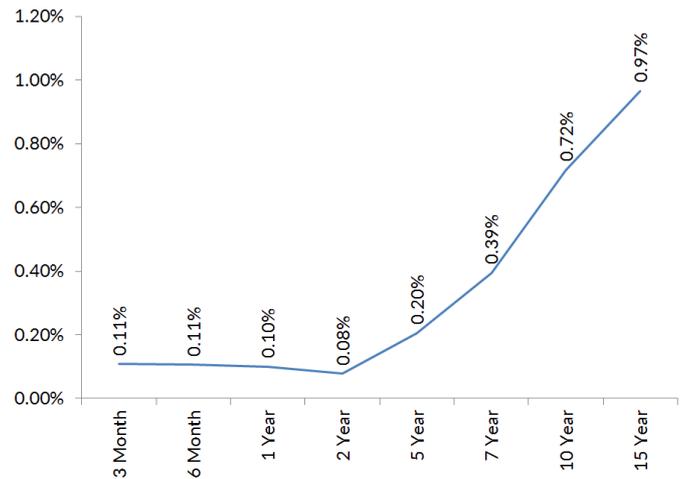
Source: Forsyth Barr analysis, Bloomberg

**Figure 25. World consensus GDP growth forecast**



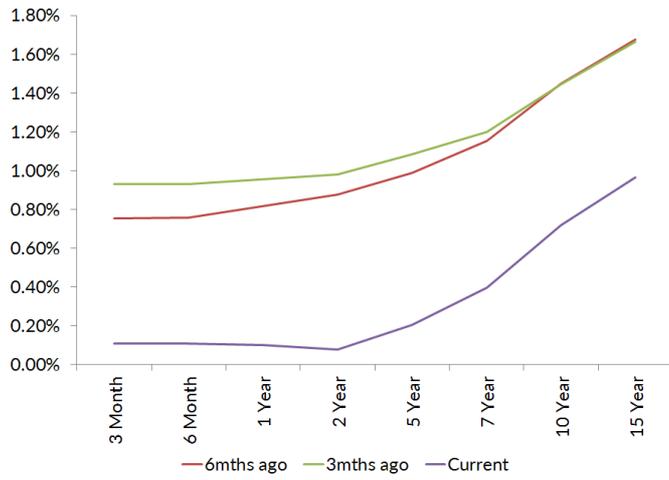
Source: Forsyth Barr analysis, Bloomberg

**Figure 26. NZ yield curve – current**



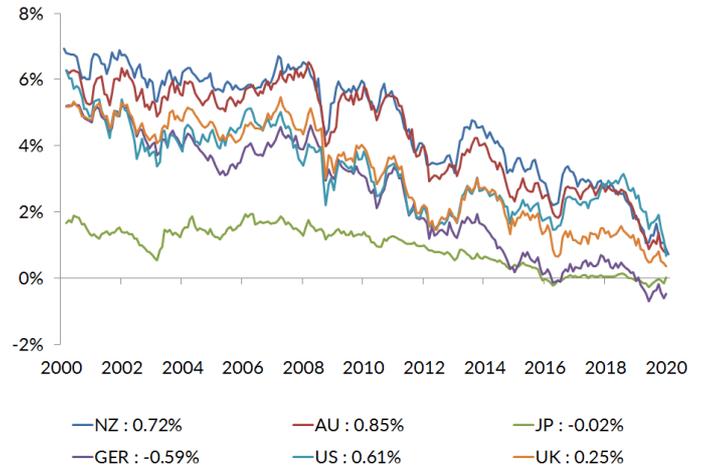
Source: Forsyth Barr analysis, Bloomberg

**Figure 27. NZ yield curve – 6 month trend**



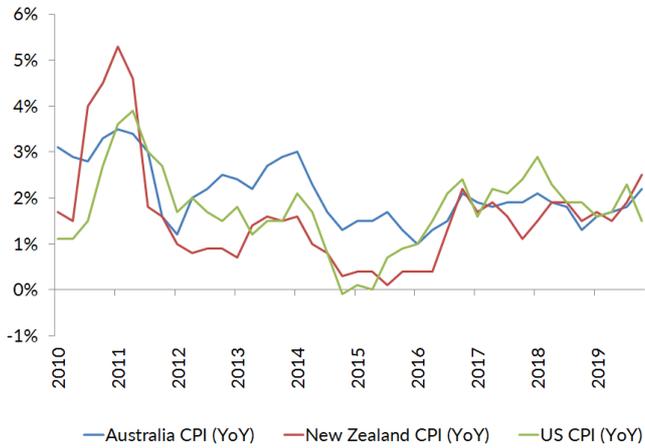
Source: Forsyth Barr analysis, Bloomberg

**Figure 28. Global 10yr bond yields**



Source: Forsyth Barr analysis, Bloomberg

**Figure 29. Consumer price index (CPI)**



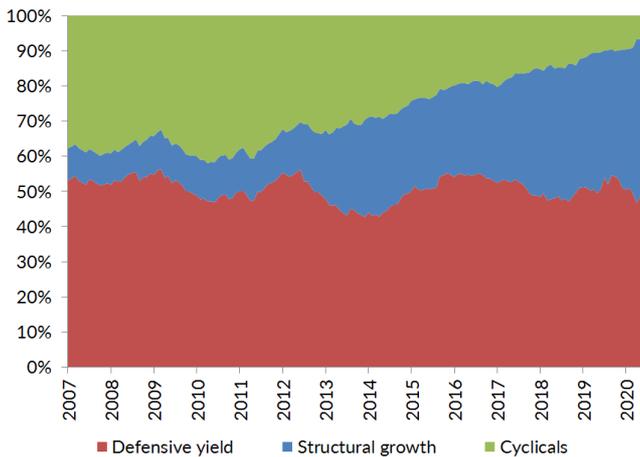
Source: Forsyth Barr analysis, Bloomberg

## Other NZ market charts

- International ownership of the S&P/NZX 50 appears to have stabilised after a period of sustained growth.
- Gearing levels across the market have been rising in recent years. COVID-19 is likely to create major gearing challenges for some corporates, which may require recapitalisations.
- Forward payout ratios have fallen substantially in recent weeks.

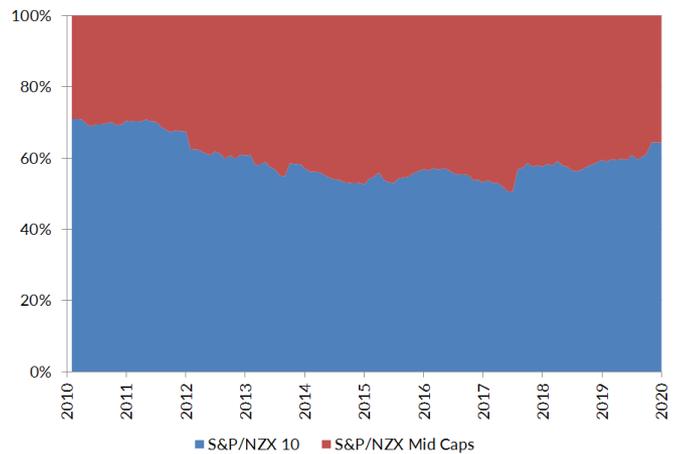
### Market Structure

**Figure 30. S&P/NZX 50 structure by thematic**



Source: Forsyth Barr analysis, Bloomberg,S&P DJI

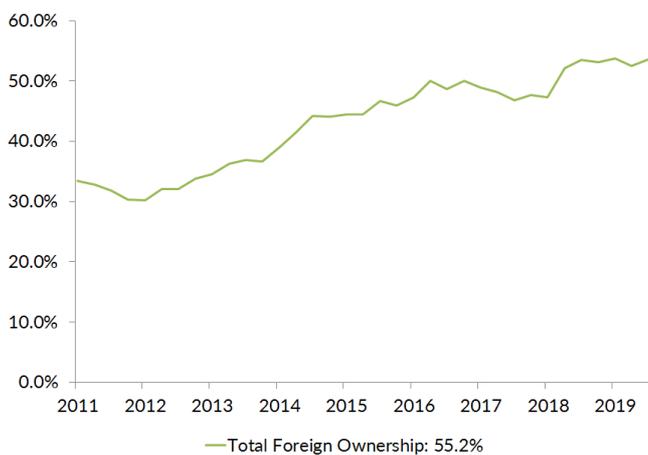
**Figure 31. S&P/NZX 50 structure by size**



Source: Forsyth Barr analysis, Bloomberg,S&P DJI

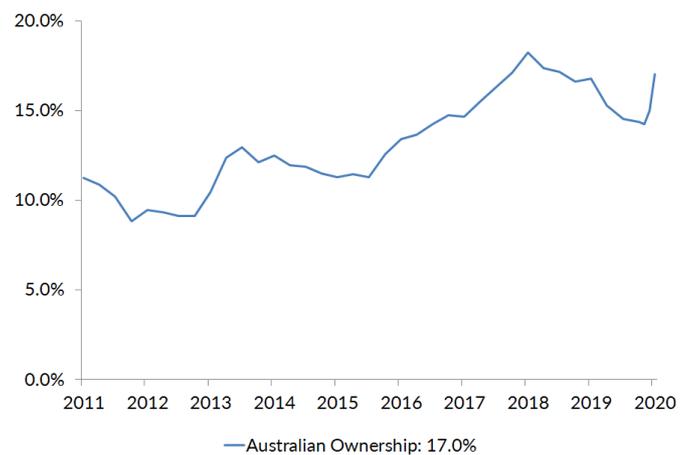
### Market Ownership

**Figure 32. Total foreign ownership of the S&P/NZX 50**



Source: Forsyth Barr analysis, Stats NZ

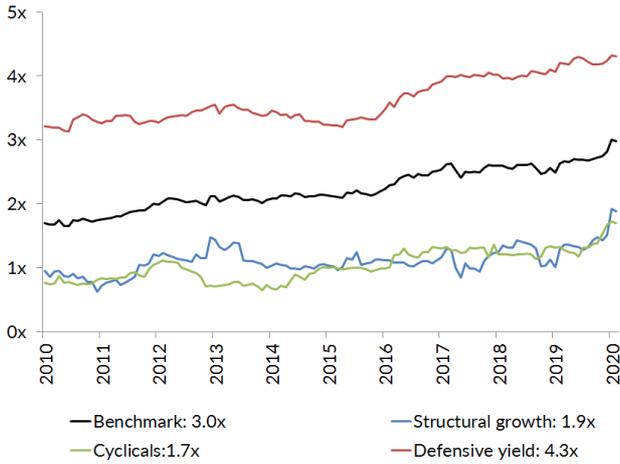
**Figure 33. Australian Ownership of the S&P/NZX 50**



Source: Forsyth Barr analysis, ASX

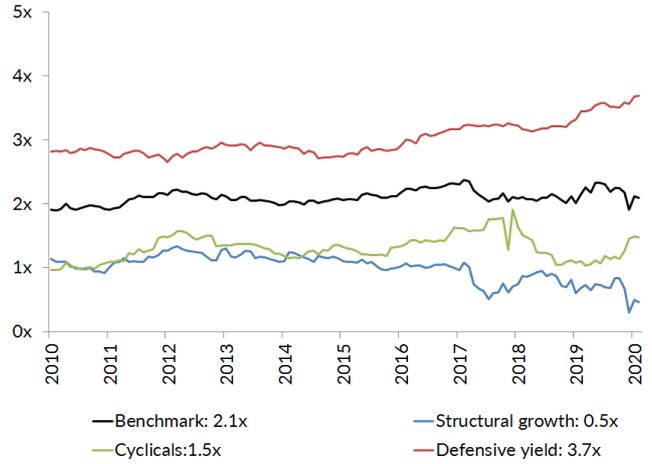
**Capital Structure**

**Figure 34. 12mth fwd ND/EBITDA – average**



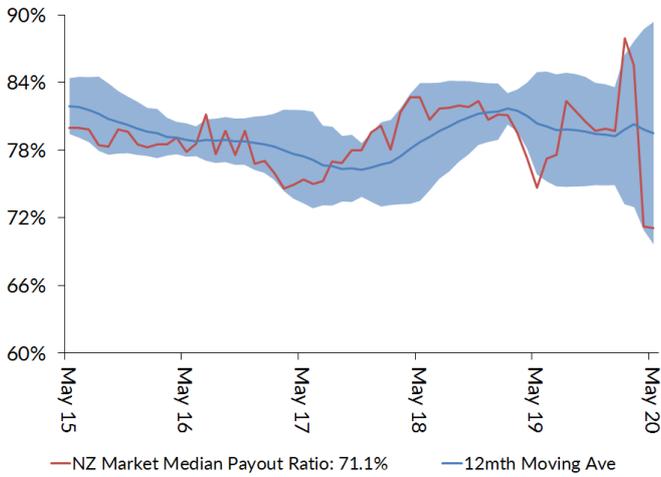
Source: Forsyth Barr analysis, Bloomberg

**Figure 35. 12mth fwd ND/EBITDA – weighted average**



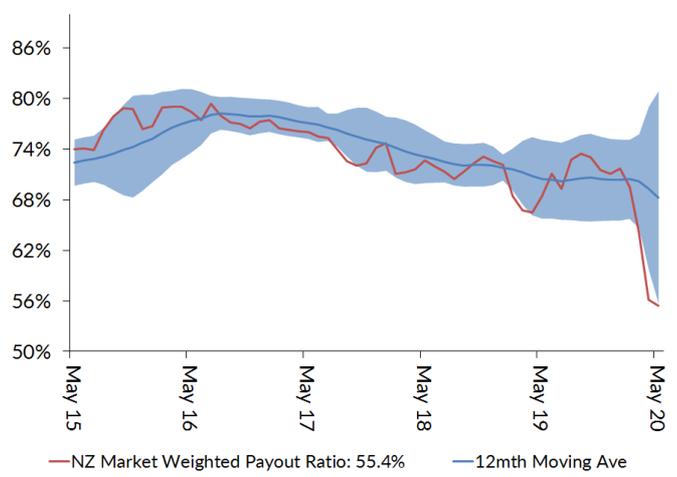
Source: Forsyth Barr analysis, Bloomberg

**Figure 36. 12mth fwd EPS pay-out ratio – average**



Source: Forsyth Barr analysis, Bloomberg

**Figure 37. 12mth fwd EPS pay-out ratio – weighted average**



Source: Forsyth Barr analysis, Bloomberg

### **Forsyth Barr institutional model portfolio rules**

- The Forsyth Barr Institutional model portfolio is monitored on a continuous basis.
- Company ratings are factored into portfolio decisions but weightings can reflect other portfolio considerations.
- Companies with UNDERPERFORM ratings can still be held in the portfolio but will normally have portfolio weightings that would be lower than the benchmark weighting.
- Companies not researched by Forsyth Barr or associated research partners with weightings above 2%, and where no view is held, would be held at a benchmark weighting.
- The portfolio can participate in IPO and 2POs but weightings would initially be limited to the lower of the desired weighting or such holding that could realistically be obtained by bidding into the process.
- The portfolio will reflect strategic biases.
- The portfolio targets portfolio holdings of approximately 25 companies.

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