

F&P Healthcare

Unmasking ResMed's 3Q20 Result

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UNDERPERFORM

Insights from ResMed's (RMD) 3Q20 result support our view of strong tailwinds for F&P Healthcare's (FPH) Hospital segment, albeit temporary headwinds for sleep apnea diagnosis. RMD reported another quarter of market share gains in the key masks category, albeit market anecdotes suggest FPH's recent new products have modestly improved its growth trajectory – in line with our expectations of a return to industry growth rates for its Homecare segment from 2H20E. FPH offers a well-articulated, attractive long-term growth story and the COVID-19 pandemic will provide near-term earnings tailwinds. However, FPH remains one of the most expensive global medical device companies (growth-adjusted and absolute) and its valuation is also elevated vs history and Australasian growth peers. We see better value for risk elsewhere.

NZX Code	FPH	Financials: Mar/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$28.35	NPAT* (NZ\$m)	209.2	278.5	324.7	355.5	EV/EBITDA	49.2	38.6	32.7	29.8
Target price	NZ\$18.50	EPS* (NZc)	36.5	48.4	56.2	61.2	EV/EBIT	n/a	44.1	36.9	33.6
Risk rating	Medium	EPS growth* (%)	9.5	32.6	16.0	8.9	PE	n/a	n/a	n/a	46.4
Issued shares	572.8m	DPS (NZc)	23.3	31.0	36.0	39.5	Price / NTA	n/a	n/a	n/a	n/a
Market cap	NZ\$16,238m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.8	1.1	1.3	1.4
Avg daily turnover	715.5k (NZ\$15,471k)	*Based on normalised profits					Gross div yld (%)	1.1	1.5	1.8	1.9

Key take-outs in this edition

- **RMD 3Q20 result:** The result was ahead of consensus and indicative of market share gains across both masks and flow generators. RMD reported 3Q20 constant currency revenue growth of +17%, or ~+12% adjusting for COVID-19 related demand, well ahead of industry growth. Gross margins were also modestly higher.
- **Other recent data points:** There is nothing to change our view that RMD is currently in pole position in the key masks category, supported by continued market share gain. Online data shows a slight change in fortunes in the most recent quarter in favour of Phillips, and to a lesser extent FPH.
- **COVID-19 insights:** Both RMD and FPH are direct beneficiaries of the COVID-19 pandemic. RMD reported a material spike in ventilator orders, which contributed ~4.5% to 3Q20 revenue. RMD also commented on a material decline (double digit) in new patient diagnosis for sleep apnea, albeit higher resupply for masks.
- **Industry trends supportive:** Sleep apnea remains underdiagnosed globally, growing acceptance of virtual diagnosis, value of remote monitoring and increasing importance of respiratory related health.

Our read through for FPH – trends already reflected in our forecasts

Direct quantitative read-through from RMD's result is difficult, given the very different product mix and limited product breakdown. However, commentary supports our near-term expectations for strong tailwinds for FPH's hospital consumables and hardware sales, albeit modest temporary headwinds from new patient diagnosis in homecare, as a result of the COVID-19 pandemic. Recent industry data and anecdotes support a modest improvement in FPH's growth profile for sleep apnea masks, helped by early signs of success for its new products, however, the backdrop remains highly competitive, likely constraining new product upside for any manufacturer. All these thematic are already reflected in our near-term FPH forecasts.

In the longer-term, there is upside risk from greater adoption for FPH's 'new applications' (non-invasive ventilation and/or high flow oxygen therapy consumables) within its Hospital segment, albeit there is risk the competitive landscape is heightened given the current growing focus of a number of companies on this area.

Fisher & Paykel Healthcare Corporation (FPH)

Priced as at 01 May 2020 (NZ\$)

28.35

12-month target price (NZ\$)*						Spot valuations (NZ\$)					
Expected share price return						1. DCF					18.33
Net dividend yield						2. Compco					
Estimated 12-month return						3. n/a					n/a
Key WACC assumptions						DCF valuation summary (NZ\$m)					
Risk free rate					2.00%	Total firm value					10,668
Equity beta					0.77	(Net debt)/cash					0
WACC					7.0%	Less: Capitalised operating leases					0
Terminal growth					2.0%	Value of equity					10,668
Profit and Loss Account (NZ\$m)						Valuation Ratios					
Sales revenue	2018A	2019A	2020E	2021E	2022E	EV/EBITDA (x)	2018A	2019A	2020E	2021E	2022E
Normalised EBITDA	980.8	1,070.4	1,235.4	1,444.7	1,566.7	EV/EBIT (x)	52.4	49.2	38.6	32.7	29.8
Depreciation and amortisation	(44.6)	(41.7)	(53.0)	(56.9)	(61.2)	PE (x)	60.1	55.3	44.1	36.9	33.6
Normalised EBIT	309.4	329.3	420.2	496.2	544.0	Price/NTA (x)	85.0	77.6	58.6	50.5	46.4
Net interest	(2.1)	0.8	(1.7)	(0.8)	(1.9)	Free cash flow yield (%)	>100x	>100x	>100x	>100x	>100x
Associate income	0	0	0	0	0	Net dividend yield (%)	1.0	0.8	0.7	1.5	1.8
Tax	(77.6)	(82.0)	(97.0)	(113.9)	(125.4)	Gross dividend yield (%)	0.7	0.8	1.1	1.3	1.4
Minority interests	0	0	0	0	0	Interest cover EBIT (x)	1.0	0.8	1.5	1.8	1.9
Normalised NPAT	190.2	209.2	278.5	324.7	355.5	Interest cover EBITDA (x)	>100x	n/a	>100x	>100x	>100x
Abnormals/other	0	0	0	0	0	Net debt/ND+E (%)	>100x	n/a	>100x	>100x	>100x
Reported NPAT	190.2	209.2	278.5	324.7	355.5	Net debt/EBITDA (x)	-7.0	-6.3	-1.5	-5.6	-10.7
Normalised EPS (cps)	33.4	36.5	48.4	56.2	61.2	Key Ratios	n/a	n/a	n/a	n/a	n/a
DPS (cps)	21.3	23.3	31.0	36.0	39.5	Return on assets (%)	2018A	2019A	2020E	2021E	2022E
Growth Rates	2018A	2019A	2020E	2021E	2022E	Return on equity (%)	26.3	24.2	25.9	28.7	29.7
Revenue (%)	9.7	9.1	15.4	16.9	8.4	Return on funds employed (%)	25.0	22.9	26.9	27.7	27.0
EBITDA (%)	12.8	6.4	27.6	18.1	9.6	EBITDA margin (%)	28.0	26.8	28.8	30.6	31.1
EBIT (%)	12.4	8.5	25.5	19.7	9.9	EBIT margin (%)	31.5	30.8	34.0	34.3	34.7
Normalised NPAT (%)	12.4	10.0	33.1	16.6	9.5	Capex to sales (%)	27.5	27.3	29.7	30.4	30.8
Normalised EPS (%)	11.7	9.5	32.6	16.0	8.9	Capex to depreciation (%)	8.5	11.7	14.1	7.5	7.2
Ordinary DPS (%)	9.0	9.4	33.3	16.1	9.7	Imputation (%)	238	366	385	223	215
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Pay-out ratio (%)	100	100	100	100	100
EBITDA	309.4	329.3	420.2	496.2	544.0	Operating Performance	64	64	64	64	65
Working capital change	9.3	6.7	(30.5)	(32.1)	(18.7)	Sales revenue (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Interest & tax paid	(70.9)	(82.7)	(98.7)	(114.7)	(127.3)	Hospital	572	642	778	946	1,020
Other	0	0	0	0	0	Growth (%)	14	12	21	22	8
Operating cash flow	247.8	253.3	290.9	349.5	398.0	Homecare	398	421	452	494	542
Capital expenditure	(83.2)	(125.7)	(174.3)	(108.4)	(113.2)	Growth (%)	4	6	7	9	10
(Acquisitions)/divestments	0	0	0	0	0	Core products - total	970	1,064	1,230	1,440	1,562
Other	(100.0)	0	0	0	0	Distributed products	11	7	5	5	5
Funding available/(required)	64.6	127.6	116.7	241.0	284.8	Total sales	981	1,070	1,235	1,445	1,567
Dividends paid	(102.5)	(114.6)	(156.0)	(193.7)	(219.4)	Cost breakdown and margins					
Equity raised/(returned)	1.8	2.1	0	0	0	Gross profit (NZ\$m)	650	716	827	964	1,048
(Increase)/decrease in net debt	(36.1)	15.1	(39.4)	47.3	65.4	Gross margin (%)	66	67	67	67	67
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E	R & D costs (NZ\$m)	(95)	(100)	(114)	(129)	(137)
Working capital	158.6	159.0	189.5	221.7	240.4	SG&A costs (NZ\$m)	(246)	(286)	(293)	(339)	(367)
Fixed assets	476.4	601.4	730.4	790.2	850.7	Key line items to call out					
Intangibles	50.4	61.5	61.5	61.5	61.5	R&D tax credit (incl. as offset to tax)	n/a	n/a	14	16	16
Right of use asset	0	0	0	0	0	Litigation costs within SG&A	(16)	(23)	(1)	0	0
Other assets	94.6	109.1	141.1	141.1	141.1	Currency					
Total funds employed	780.0	931.0	1,122.6	1,214.4	1,293.7	NZDUSD spot rate	0.71	0.68	0.61	0.62	0.63
Net debt/(cash)	(49.9)	(54.4)	(15.0)	(62.4)	(127.8)	NZDEUR spot rate	0.61	0.59	0.58	0.58	0.58
Lease liability	0	0	0	0	0	USD hedging - % cover			90	80	40
Other liabilities	68.5	72.2	104.2	104.2	104.2	USD hedging - average rate			0.67	0.66	0.66
Shareholder's funds	761.4	913.2	1,033.4	1,172.6	1,317.2						
Minority interests	0	0	0	0	0						
Total funding sources	780.0	931.0	1,122.6	1,214.4	1,293.7						

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

ResMed 3Q20 – read through for FPH

In this edition of Unmasking ResMed's Result, we look at the 3Q20 ResMed (RMD) result release with a focus on any insight or implications we see for FPH. Given the limited market data available for FPH's two core divisions, Homecare and Hospital, we use RMD's quarterly releases to look for insight into the Obstructive Sleep Apnea (OSA) market for FPH's Homecare division. Homecare/OSA makes up ~40% of FPH revenue.

Key take-outs

- **Recent competitor data points:** Quarterly results show a strong result from RMD and "positive" growth from Phillips. There is nothing to change our view that RMD is currently in pole position in the key OSA masks category. Recent anecdotes support an improved growth profile for FPH, helped by its new products, as already incorporated in our near-term forecasts.
- **COVID-19 insights:** Both RMD and FPH are direct beneficiaries of the COVID-19 pandemic. Quantitative read-through from RMD's result is not possible, given the very different product mix and limited product breakdown. However, commentary supports our near-term expectations for strong tailwinds for FPH's hospital consumables and hardware sales, albeit modest temporary headwinds from new patient diagnosis in homecare. In the longer-term, there is upside risk from greater adoption for non-invasive ventilation and/or high flow oxygen therapy, albeit there is risk the competitive landscape is heightened given the focus of a number of companies on this area.
- **Online data:** While acknowledging limitations of extrapolation (online purchases are only a small part of the market) nonetheless, trends show meaningful market share gain for RMD over recent years, at the expense of both FPH and Phillips. FPH's market share reached a four year low in all mask categories in 4Q19/1Q20, although 2Q20 does show a small improvement.
- **New products:** Homecare dealers are spoilt for choice with a suite of new products over the past 12 months, with RMD particularly active (and successful). FPH is now looking to play catch up to drive a rebound in growth in its sleep segment, helped by two recent new mask launches with early signs encouraging.
- **Competitive bidding (CB):** This impacts product pricing for ~25% of US customers. Industry is lobbying for a delay to CB 2021 due to the COVID-19 pandemic. Any delay would likely be a small positive for FPH, given the downside risk for mask pricing.

Valuation snapshot

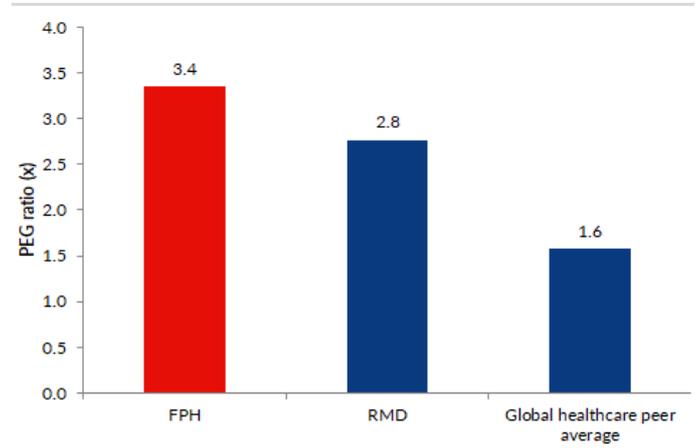
FPH offers a well-articulated, attractive long-term growth story. There is no doubt the company is well positioned in the current environment, with products in high demand (and vital for critical patients) and a strong balance sheet. However, we struggle to justify current valuation metrics (even when taking its strong growth profile into consideration), with valuation metrics elevated versus history, Australasian growth peers and global healthcare compcos. While it is difficult to foresee a catalyst for a de-rating, particularly given near-term earnings momentum, we see better value for risk elsewhere.

Figure 1. PE relative – FPH relative to RMD



Source: Forsyth Barr analysis, Bloomberg

Figure 2. FPH versus global healthcare compcos



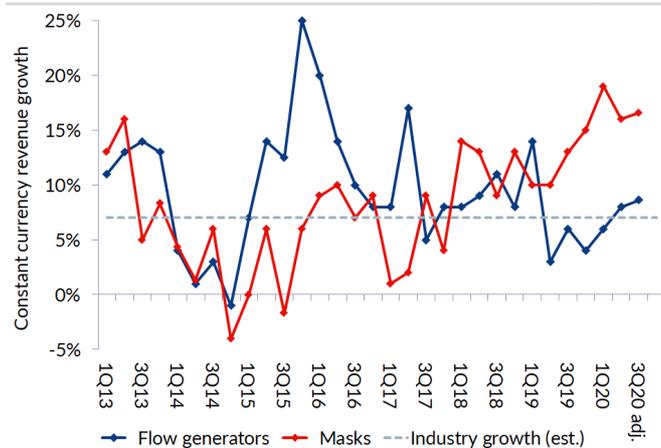
Source: Forsyth Barr analysis, Bloomberg

Industry data in more detail

Competitor sales growth insights

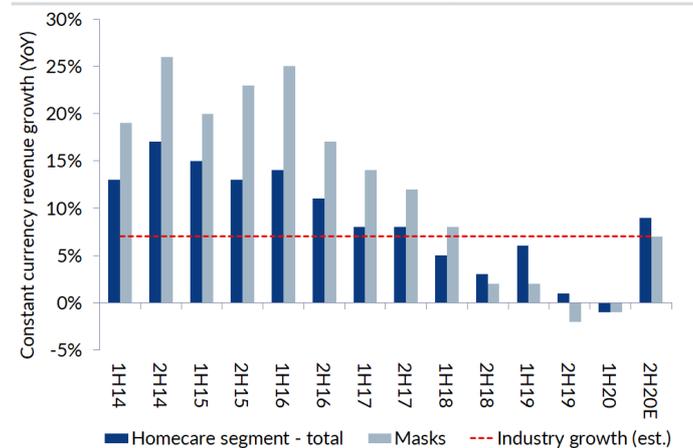
- **ResMed's 3Q20 result points to market share gains across both masks and flow generators (refer Figure 3)**
 - **Masks:** Another quarter of clear market share gain. RMD reported global growth of +18% in constant currency (CC) in 3Q20 (+17% Americas; +22% Rest of World). Adjusting for the small boost of COVID-19 on ventilator mask sales, we estimate 'like for like' CC global growth of +17%, materially ahead of industry growth of c. +9%. Key drivers are: market share gains, improved adherence and better re-supply rates.
 - **Flow generators:** RMD reported 3Q20 CC growth of +18% (+8% Americas; +29% Rest of World). The company saw a material spike in ventilator sales as a result of COVID-19. Adjusting for this, we estimate 'like for like' CC growth of c. +9%, also supportive of market share gains given estimated industry growth of +5%.
 - **Gross margins:** +70bp margin expansion YoY, helped by product mix and manufacturing efficiencies.
- **Phillips 1Q20:** Phillips reported double-digit growth in Sleep & Respiratory Care, primarily due to strong shipments of respiratory devices driven by COVID-19. Minimal colour was provided on its sleep apnea business except that growth was "positive" and "don't expect any uptick in sleep business as a result of COVID-19".

Figure 3. ResMed quarterly constant currency revenue growth



Source: Forsyth Barr analysis, ResMed company reports. We have adjusted 3Q20 to exclude the estimated boost of COVID-19 on ventilator sales

Figure 4. FPH constant currency revenue growth (OSA masks)



Source: Forsyth Barr analysis, Company reports

COVID-19 insights from RMD's result

COVID-19 provided a boost to RMD's result. The key areas of interest and relevance to FPH were (1) a material decline in new patient diagnosis for sleep apnea, (2) higher resupply for sleep apnea masks, (3) a spike in hardware sales. Quantifying the read-through is difficult, but commentary is consistent with our near-term expectations for strong tailwinds in hospital consumables and hardware, albeit modest temporary headwinds in homecare.

Key take-outs from RMD's release of interest

- **3Q20 revenue boost:** RMD disclosed a US\$35m contribution from unprecedented levels of demand for ventilators as a result of COVID-19, a boost of ~+4.5% to group revenue.
- **Outlook unclear:** Reliant on the global prevalence and responses to COVID-19. No revenue guidance was provided by RMD for Q4 given "high uncertainty in the current environment".
- **Hospital hardware:** RMD produced >52,000 ventilators during the quarter, a threefold increase on 2Q19. This includes non-invasive ventilators (NIV), Bi-Level devices and invasive ventilators (IV).
 - **Relevance to FPH:** Industry feedback suggests the majority of the recent new hardware orders in the US have been Bi-Level or NIV. This is important as the attachment rate for heated humidification hardware, of which FPH has a market share of ~75%, is materially lower (0-10% attachment rate for heated humidification for NIV ventilators vs ~70% attachment for IV ventilators).
- **Sleep apnea:**
 - **New patients:** RMD noted a double-digit decline in diagnosis in those markets impacted by COVID-19, as sleep clinics closed and a shift in some staff to treat COVID patients. This is expected to be a headwind for devices in Q4. For masks, the installed base/resupply is >80% of sales.

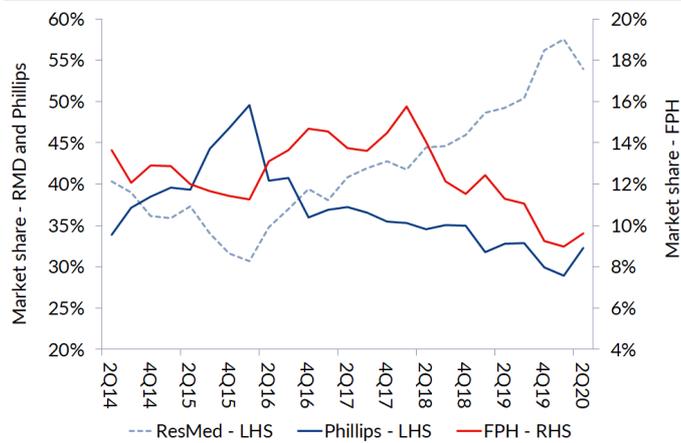
- Resupply: RMD saw an increase during the quarter for masks & accessories resupply supported by increased focus on respiratory-related health from patients and resupply focus from homecare dealers.
- Impact likely temporary: There is no change to the prevalence of sleep apnea, which remains underdiagnosed globally. There is a backlog of diagnostic activity and clinics/physicians are looking to increase in home testing and remote offerings.
- **Potential structural change:** Importance of digital health, growing acceptance of virtual diagnosis, value of remote monitoring, importance of respiratory related health. RMD also indicated it expects to see greater use of non-invasive ventilation on a medium to long-term basis.
- **Competitive bidding 2021:** This impacts pricing for ~25% of US customers. Non-invasive ventilators have been removed from this round. Industry has been lobbying for a delay across the other product categories. Any delay would likely be a small positive for FPH, given the downside risk for mask pricing.

Online data

Relevant industry data is scarce, albeit CPAP.com publishes sales data for self-pay consumers. While this is a very small segment of the US market (we estimate <3%) it can provide a gauge of consumer preference, one key driver of mask selection.

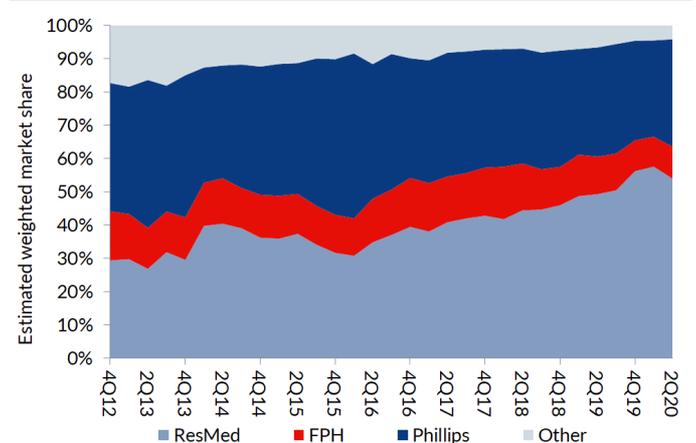
Online data has shown strong market share gains for ResMed over the past four years, at the expense of all other players (including Phillips and FPH), albeit 2Q20 shows a modest decline. FPH's market share reached a four year low in all mask categories in 4Q19/1Q20, although 2Q20 does show a small improvement.

Figure 5. Weighted average market share trends



Source: Forsyth Barr analysis, CPAP.com

Figure 6. Weighted average market share by manufacturer

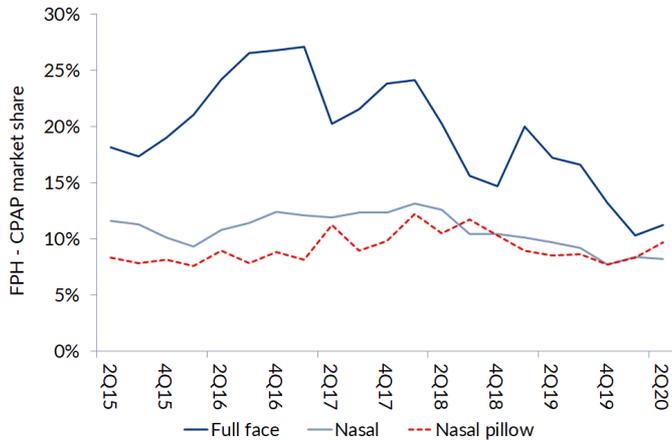


Source: Forsyth Barr analysis, CPAP.com

Mask category breakdown

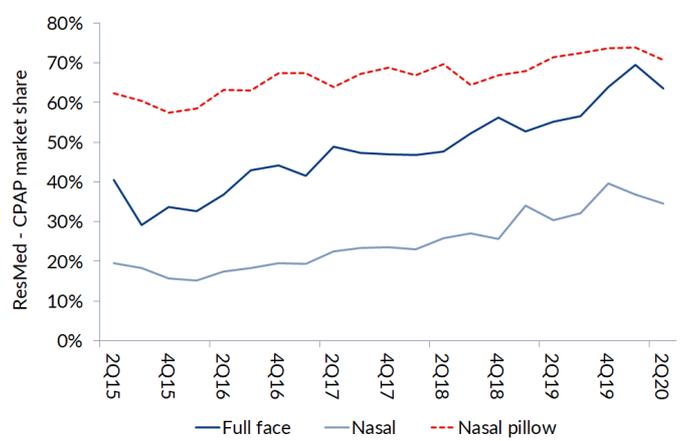
- **Nasal masks:** The largest, most competitive segment, with an estimated c. 40% share of the mask market. Phillips is the clear market leader, albeit RMD has been taking share over the past few years. FPH market share has been on a modest downward trajectory over the past two years, reaching a low of 7.7% in 4Q19, albeit appears to have stabilised, picking up slightly to 8.2% in the most recent quarter.
- **Full-face:** The smallest category, albeit has gained share in the past few years and now makes up ~34% of the market. Historically FPH has had the most success in full-face masks, although a hiatus of new products has seen its share steadily fall in recent quarters to 11% (vs. a 1Q17 peak of 27%), although this is slightly above the low of 10% in 1Q20. RMD has been the key beneficiary, helped by new products, although Phillips has regained momentum in the most recent quarter with a material lift in share at the expense of RMD. Historically, this category has seen meaningful volatility in quarterly market share, so we are cautious to extrapolate or read into the recent shift in momentum as yet.
- **Nasal pillows:** RMD is the clear market leader, with a share of ~71%. The company has more than doubled its share of this segment over the past five years, although 2Q20 bucked this trend with Phillips, and FPH to a lesser extent, getting some positive momentum at the expense of RMD.

Figure 7. CPAP market share by mask category – FPH



Source: Forsyth Barr analysis, CPAP.com

Figure 8. CPAP market share by mask category – ResMed



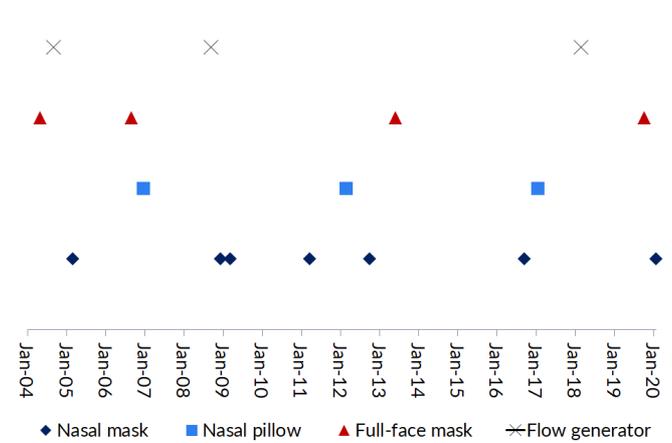
Source: Forsyth Barr analysis, CPAP.com

New product landscape

Ongoing success and growth in OSA masks is typically reliant on regular new product launches. Anecdotal feedback and data points suggest both Phillips and RMD have delivered a step forward in their mask offerings over the past couple of years, with RMD in particular enjoying material market share gains as a result.

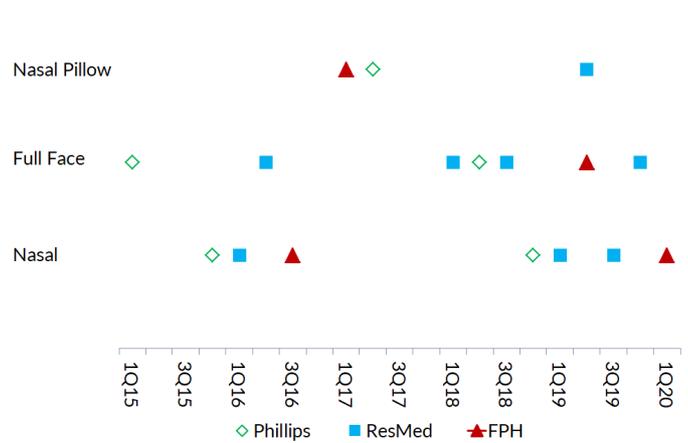
Homecare dealers are currently spoilt for choice with a highly competitive landscape. The past 18 months has seen five new masks from RMD, two from Phillips and two from FPH.

Figure 9. FPH estimated product launch timing



Source: Forsyth Barr analysis, Company reports

Figure 10. Est. mask launch by category for key manufacturers



Source: Forsyth Barr analysis, Company reports

Investment Summary

F&P Healthcare (FPH) has developed specialised expertise in heated humidification that forms the basis of its strong market position in the hospital and growing presence in homecare. It has progressively widened its addressable market through new applications which is a key driver of an attractive, long-term, double-digit profit growth outlook. However, valuation metrics are elevated versus history and global peers, even when adjusting for this growth profile. **UNDERPERFORM.**

Business quality

- **Track record:** FPH has created value through continued product innovation and progressively widening its addressable market with new applications of its technology to serve more patient groups and provide more products per patient.
- **Strong market position:** FPH's business model is supported by a high portion of recurring revenue (>85%) and strong global market position (including c. 75% share in the invasive ventilation market; c. 15% in sleep apnea and growing presence in areas where FPH is working to change clinical practice).
- **Attractive industry backdrop:** FPH operates in markets with high barriers to entry and where adoption curves are long. Structural trends are also supportive (ageing population, global focus on lowering healthcare costs and improving diagnosis rates).

Earnings and cashflow outlook

- **Near-term two speed growth path:** Hospital continues to deliver standout results, while Homecare is more moderate following a period of new product hiatus. Changing the latter trajectory is reliant on new products being successful.
- **Long-term growth thesis attractive:** FPH has a long runway of organic growth opportunities, particularly in the Hospital segment where clinical evidence continues to build for new applications

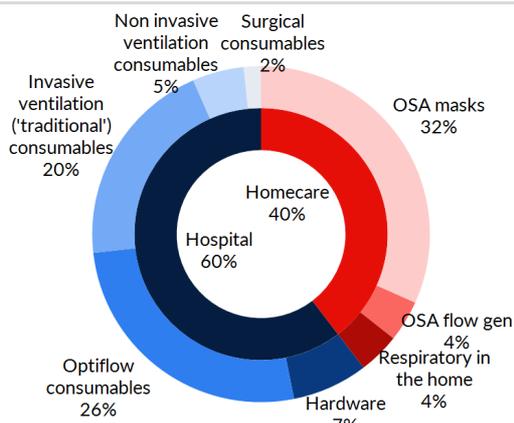
Financial structure

- **Balance sheet:** FPH's target gearing range of -5% to +5% ensures flexibility for events like product recalls or hedging opportunities. We expect it to remain within this range near-term.

Risk factors

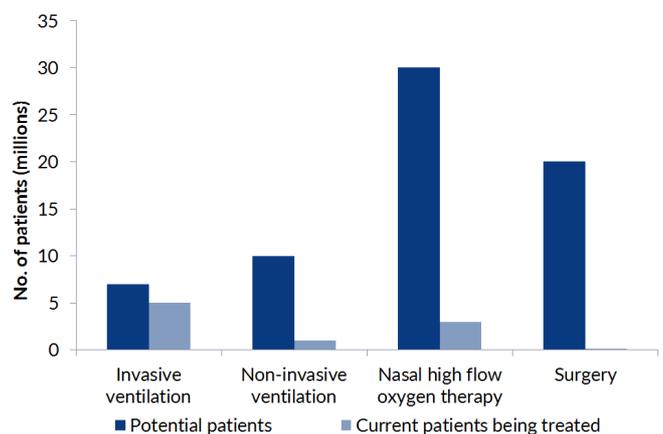
- **Change in technology or medical treatments:** May result in some products becoming obsolete or cause it to incur costs to implement new technologies. There is some risk mitigation given FPH's diversified offering.
- **Litigation or a need to defend its intellectual property:** This can be an expensive exercise.

Figure 11. Revenue breakdown by segment (est.)



Source: Forsyth Barr analysis, Company reports

Figure 12. Global market penetration in RAC / Hospital segment



Source: Forsyth Barr analysis, Company reports

Figure 13. Price performance



Source: Forsyth Barr analysis

Figure 14. Substantial shareholders

Shareholder	Latest Holding
The Capital Group Companies	6.4%
The Vanguard Group	5.3%
BlackRock Investment Management	5.0%

Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

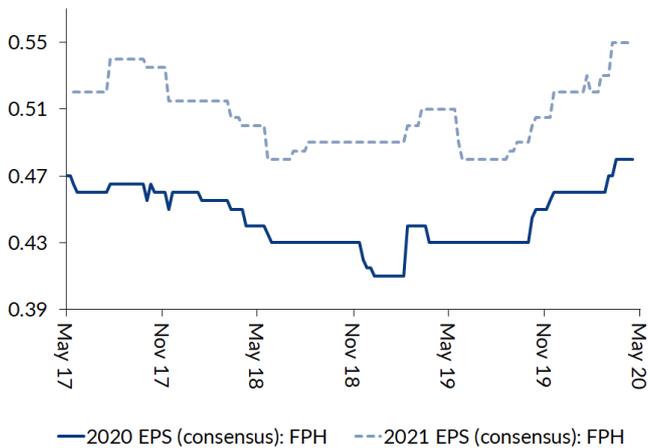
Figure 15. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
F&P Healthcare	FPH NZ	NZ\$28.35	NZ\$16,238	>50x	>50x	38.5x	32.6x	44.1x	36.8x	1.3%
RESMED INC	RMD US	US\$158.22	US\$22,881	42.4x	35.1x	27.8x	24.5x	33.4x	28.6x	1.0%
TELEFLEX INC	TFX US	US\$340.27	US\$15,779	34.0x	31.7x	26.0x	24.3x	n/a	n/a	0.4%
BOSTON SCIENTIFIC CORP	BSX US	US\$35.93	US\$50,273	15.6x	28.0x	22.7x	20.3x	37.2x	27.5x	0.0%
BECTON DICKINSON AND CO	BDX US	US\$261.92	US\$71,026	44.7x	22.2x	19.9x	16.3x	38.5x	23.2x	1.4%
Compc Average:				34.2x	29.3x	24.1x	21.3x	36.4x	26.5x	0.7%
FPH Relative:				n/a	n/a	60%	53%	21%	39%	78%

EV = Current Market Cap + Actual Net Debt

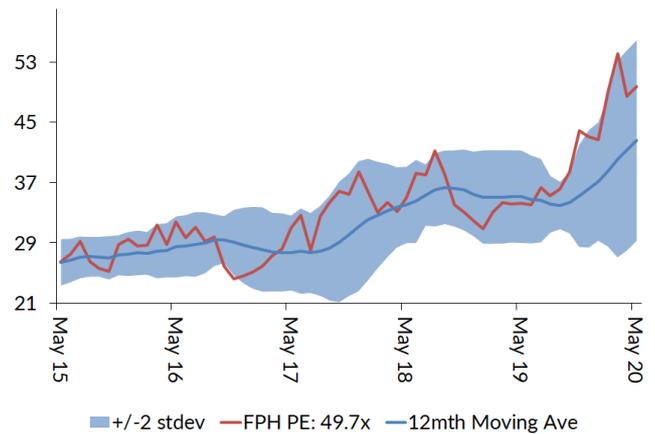
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compc metrics re-weighted to reflect headline (FPH) companies fiscal year end

Figure 16. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 17. One year forward PE (x)



Source: Forsyth Barr analysis

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