

# Meridian Energy

## COVID-19 Limits Growth Marginally

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### OUTPERFORM

We are upgrading our Meridian Energy (MEL) rating to OUTPERFORM from NEUTRAL. We expect MEL to perform well in an investment environment that will refocus on income after the near-term COVID-19 issues subside. MEL has the strongest earnings track record in the sector, with tailwinds from recent 3Q20 performance offsetting near-term COVID-19 effects. We lift our target price +40cps (+9.1%) to \$4.80.

#### Figure 1. What's changed

|                           |   |
|---------------------------|---|
| <b>FY20/FY21 EBITDAF:</b> | Changed +\$6m/- \$8m (+0.7%/-1.0%) to \$870m/\$799m |
| <b>Target price:</b>      | Increased +40cps (+9.1%) to \$4.80                  |
| <b>Rating:</b>            | Upgraded to OUTPERFORM from NEUTRAL                 |

| NZX Code           | MEL                 | Financials: Jun/             | 19A   | 20E   | 21E   | 22E   | Valuation (x)     | 19A  | 20E  | 21E  | 22E  |
|--------------------|---------------------|------------------------------|-------|-------|-------|-------|-------------------|------|------|------|------|
| Share price        | NZ\$4.48            | NPAT* (NZ\$m)                | 481.3 | 505.1 | 444.2 | 453.8 | EV/EBITDA         | 15.4 | 14.9 | 16.4 | 16.1 |
| Target price       | NZ\$4.80            | EPS* (NZc)                   | 18.8  | 19.7  | 17.3  | 17.7  | EV/EBIT           | 23.0 | 23.4 | 26.8 | 25.8 |
| Risk rating        | Low                 | EPS growth* (%)              | 33.4  | 5.0   | -12.1 | 2.2   | PE                | 23.9 | 22.7 | 25.8 | 25.3 |
| Issued shares      | 2563.0m             | DPS (NZc)                    | 21.3  | 21.6  | 21.6  | 21.3  | Price / NTA       | 2.1  | 2.2  | 2.3  | 2.5  |
| Market cap         | NZ\$11,482m         | Imputation (%)               | 66    | 65    | 65    | 70    | Cash div yld (%)  | 4.8  | 4.8  | 4.8  | 4.8  |
| Avg daily turnover | 1,661k (NZ\$7,879k) | *Based on normalised profits |       |       |       |       | Gross div yld (%) | 6.0  | 6.0  | 6.0  | 6.1  |

#### Upgrading on expected investor refocus on income

We believe that the electricity sector is becoming increasingly attractive relative to other market opportunities and MEL is the largest and lowest cost generator in the sector. Thinking beyond COVID-19, we expect investments that offer a robust dividend will be sought after. In addition, traditional stocks that were previously viewed as safe havens, such as property, SkyCity and airports, face greater downside issues than the electricity stocks. We have, therefore, lowered MEL's target gross dividend yield (-0.75% to 5.0%) and lifted our target multiples modestly (adjusted PE up +2.5x to 28.5x), which has the effect of lifting our target price +40cps (+9.1%) to \$4.80. We are upgrading to OUTPERFORM.

#### Strong near-term operating results provide minor FY20 earnings upgrade, COVID-19 impacts FY21 more

MEL's operating performance in 3Q20 has been strong, particularly given the headwind it faced from the HVDC constraints. It continues to grow its retail book and grow retail margins. COVID-19 has tempered that earnings growth slightly. MEL has the greatest exposure to the small medium enterprise (SME) segment which has lowered the retail sales volume growth we would have otherwise made. From FY21 we have also increased operating costs to allow for an expected increase in bad debts.

Australia also had a stronger than expected 3Q20 performance. In addition, COVID-19 restrictions has resulted in stronger residential demand, benefiting its Powershop business. However, falling wholesale electricity prices has had a negative impact on its generation business, which is most evident in FY21 and beyond outlook.

The net effect of these adjustments has seen our FY20 EBITDAF forecast increase +\$6m to \$870m, but our FY21 EBITDAF forecast reduce -\$8m to \$799m.

**Meridian Energy Limited (MEL)**

Priced as at 06 May 2020 (NZ\$)

**4.48**

| <b>12-month target price (NZ\$)*</b>   |         |         |         |         |         | <b>Spot valuations (NZ\$)</b>          |                                    |               |               |               |               |
|--|---------|---------|---------|---------|---------|--|------------------------------------|---------------|---------------|---------------|---------------|
| Expected share price return            |         |         |         |         |         | 1. DCF                                 |                                    |               |               |               | 3.69          |
| Net dividend yield                     |         |         |         |         |         | 2. Market multiple                     |                                    |               |               |               | 4.97          |
| Estimated 12-month return              |         |         |         |         |         | 3. Dividend yield                      |                                    |               |               |               | 5.35          |
|  |         |         |         |         |         |  |                                    |               |               |               |               |
| <b>Key WACC assumptions</b>            |         |         |         |         |         | <b>DCF valuation summary (NZ\$m)</b>   |                                    |               |               |               |               |
| Risk free rate                         |         |         |         |         |         | 2.00%                                  | Total firm value                   |               |               |               | 11,267        |
| Equity beta                            |         |         |         |         |         | 0.84                                   | (Net debt)/cash                    |               |               |               | (1,817)       |
| WACC                                   |         |         |         |         |         | 6.8%                                   | Less: Capitalised operating leases |               |               |               |               |
| Terminal growth                        |         |         |         |         |         | 1.5%                                   | Value of equity                    |               |               |               | 9,451         |
|  |         |         |         |         |         |  |                                    |               |               |               |               |
| <b>Profit and Loss Account (NZ\$m)</b> |         |         |         |         |         | <b>Valuation Ratios</b>                |                                    |               |               |               |               |
| Sales revenue                          | 2018A   | 2019A   | 2020E   | 2021E   | 2022E   | EV/EBITDA (x)                          | 2018A                              | 2019A         | 2020E         | 2021E         | 2022E         |
| Normalised EBITDA                      | 3,297.0 | 4,104.0 | 3,330.4 | 3,397.8 | 3,400.6 | EV/EBIT (x)                            | 19.2                               | 15.4          | 14.9          | 16.4          | 16.1          |
| Depreciation and amortisation          | 666.0   | 838.0   | 870.0   | 798.7   | 812.9   | PE (x)                                 | 32.1                               | 23.0          | 23.4          | 26.8          | 25.8          |
| Normalised EBIT                        | (21.0)  | (276.0) | (314.4) | (310.7) | (306.1) | Price/NTA (x)                          | 31.8                               | 23.9          | 22.7          | 25.8          | 25.3          |
| Net interest                           | 398.0   | 562.0   | 555.6   | 488.0   | 506.8   | Free cash flow yield (%)               | 2.4                                | 2.1           | 2.2           | 2.3           | 2.5           |
| Associate income & other               | (81.0)  | (83.0)  | (83.6)  | (81.5)  | (80.3)  | Net dividend yield (%)                 | 1.6                                | 4.9           | 3.9           | 4.4           | 4.4           |
| Tax                                    | (19.0)  | (14.0)  | (10.0)  | (22.0)  | (22.0)  | Gross dividend yield (%)               | 4.3                                | 4.8           | 4.8           | 4.8           | 4.8           |
| Minority interests                     | (95.0)  | (133.0) | (129.2) | (107.7) | (113.2) | Interest cover EBIT (x)                | 5.4                                | 6.0           | 6.0           | 6.0           | 6.1           |
| Reported NPAT                          | 0       | 0       | 0       | 0       | 0       | Interest cover EBITDA (x)              |                                    |               |               |               |               |
| Abnormals/other                        | 203.0   | 332.0   | 332.9   | 276.8   | 291.2   | Net debt/ND+E (%)                      | 4.7                                | 6.6           | 6.5           | 5.7           | 6.0           |
| Adjusted normalised NPAT               | 157.8   | 149.3   | 172.3   | 167.4   | 162.6   | Net debt/EBITDA (x)                    | 8.2                                | 10.1          | 10.4          | 9.8           | 10.1          |
| Normalised EPS (cps)                   | 360.8   | 481.3   | 505.1   | 444.2   | 453.8   | Net debt/EBITDA (x)                    | 71.3                               | 76.9          | 88.1          | 103.9         | 124.3         |
| DPS (cps)                              | 14.1    | 18.8    | 19.7    | 17.3    | 17.7    | Key Ratios                             | 2.2                                | 1.7           | 1.8           | 2.1           | 2.1           |
|  | 19.2    | 21.3    | 21.6    | 21.6    | 21.3    | Return on assets (%)                   |                                    |               |               |               |               |
|  |         |         |         |         |         | Return on equity (%)                   | 4.4                                | 5.7           | 5.8           | 5.1           | 5.4           |
|  |         |         |         |         |         | Return on funds employed (%)           | 4.3                                | 6.1           | 6.1           | 5.3           | 5.9           |
|  |         |         |         |         |         | EBITDA margin (%)                      | 4.6                                | 5.9           | 5.8           | 5.3           | 5.7           |
|  |         |         |         |         |         | EBIT margin (%)                        | 20.2                               | 20.4          | 26.1          | 23.5          | 23.9          |
|  |         |         |         |         |         | Capex to sales (%)                     | 12.1                               | 13.7          | 16.7          | 14.4          | 14.9          |
|  |         |         |         |         |         | Capex to depreciation (%)              | 7.5                                | 1.7           | 2.2           | 2.2           | 1.7           |
|  |         |         |         |         |         | Imputation (%)                         | n/a                                | 28            | 25            | 27            | 21            |
|  |         |         |         |         |         | Pay-out ratio (%)                      | 68                                 | 66            | 65            | 65            | 70            |
|  |         |         |         |         |         | Operating Performance                  | 136                                | 113           | 110           | 125           | 120           |
|  |         |         |         |         |         | Hydro generation                       | 2018A                              | 2019A         | 2020E         | 2021E         | 2022E         |
|  |         |         |         |         |         | Wind generation                        | 11,266                             | 12,326        | 12,564        | 11,946        | 11,701        |
|  |         |         |         |         |         | <b>Total NZ generation (GWh)</b>       | 1,263                              | 1,244         | 1,471         | 1,430         | 1,430         |
|  |         |         |         |         |         | GWAP (\$/MWh)                          | <b>12,528</b>                      | <b>13,570</b> | <b>14,035</b> | <b>13,376</b> | <b>13,131</b> |
|  |         |         |         |         |         | Overseas generation (GWh)              | 83                                 | 123           | 79            | 80            | 77            |
|  |         |         |         |         |         | Overseas GWAP (\$/MWh) (NZD)           | 581                                | 730           | 660           | 712           | 809           |
|  |         |         |         |         |         | Overseas customer numbers (000)        | 151                                | 96            | 122           | 99            | 82            |
|  |         |         |         |         |         | NZ electricity customers (000)         | 97                                 | 110           | 137           | 156           | 167           |
|  |         |         |         |         |         | Average usage per cust (MWh/yr)        | 291                                | 302           | 324           | 335           | 343           |
|  |         |         |         |         |         | Mass market volumes                    | 13.5                               | 13.2          | 13.7          | 13.7          | 13.8          |
|  |         |         |         |         |         | Time of use volumes                    | 3,824                              | 3,901         | 4,284         | 4,521         | 4,668         |
|  |         |         |         |         |         | <b>Total fixed price volumes (GWh)</b> | 2,157                              | 2,338         | 3,060         | 3,128         | 2,972         |
|  |         |         |         |         |         | NZAS sales                             | 5,011                              | 5,310         | 5,354         | 5,338         | 5,449         |
|  |         |         |         |         |         | Sell CFDs                              | 5,011                              | 5,310         | 5,354         | 5,338         | 5,449         |
|  |         |         |         |         |         | Buy CFDs                               | 2,278                              | 2,239         | 2,302         | 2,002         | 2,002         |
|  |         |         |         |         |         | <b>Total Sales (GWh)</b>               | (2,222)                            | (1,965)       | (2,399)       | (1,947)       | (1,947)       |
|  |         |         |         |         |         | Average FPV price (\$/MWh)             | <b>11,047</b>                      | <b>11,823</b> | <b>12,601</b> | <b>13,043</b> | <b>13,144</b> |
|  |         |         |         |         |         | LWAP (\$/MWh)                          | 105                                | 105           | 109           | 111           | 110           |
|  |         |         |         |         |         | LWAP/GWAP                              | 88                                 | 132           | 83            | 85            | 81            |
|  |         |         |         |         |         | Lines losses (%)                       | 1.06                               | 1.07          | 1.05          | 1.06          | 1.05          |
|  |         |         |         |         |         |  | 5.3                                | 5.9           | 4.9           | 5.5           | 5.5           |

## Forecast changes

Figure 2. Forecast changes

|                             | FY20         | FY20         |             | FY21         | FY21         |              | FY22         | FY22         |             |
|-----------------------------|--------------|--------------|-------------|--------------|--------------|--------------|--------------|--------------|-------------|
|                             | Old          | New          | Chg         | Old          | New          | Chg          | Old          | New          | Chg         |
|                             | \$m          | \$m          | %           | \$m          | \$m          | %            | \$m          | \$m          | %           |
| NZ Energy Margin            | 1,139        | 1,140        | 0.1%        | 1,052        | 1,065        | 1.2%         | 1,041        | 1,059        | 1.7%        |
| Australia Energy Margin     | 111          | 116          | 4.7%        | 110          | 102          | -7.1%        | 113          | 106          | -6.0%       |
| <b>Energy margin</b>        | <b>1,250</b> | <b>1,256</b> | <b>0.5%</b> | <b>1,162</b> | <b>1,167</b> | <b>0.4%</b>  | <b>1,154</b> | <b>1,165</b> | <b>0.9%</b> |
| Other revenue               | 26           | 26           | 0.0%        | 29           | 29           | 0.0%         | 29           | 29           | 0.0%        |
| Transmission costs          | (123)        | (123)        | 0.0%        | (88)         | (88)         | 0.0%         | (84)         | (84)         | 0.0%        |
| Operating costs             | (290)        | (290)        | 0.1%        | (296)        | (309)        | 4.4%         | (291)        | (297)        | 2.1%        |
| <b>EBITDAF</b>              | <b>864</b>   | <b>870</b>   | <b>0.7%</b> | <b>807</b>   | <b>799</b>   | <b>-1.0%</b> | <b>808</b>   | <b>813</b>   | <b>0.6%</b> |
| Depn & amort                | (314)        | (314)        | 0.0%        | (311)        | (311)        | 0.0%         | (306)        | (306)        | 0.0%        |
| <b>EBIT</b>                 | <b>550</b>   | <b>556</b>   | <b>1.1%</b> | <b>496</b>   | <b>488</b>   | <b>-1.7%</b> | <b>502</b>   | <b>507</b>   | <b>0.9%</b> |
| Net interest                | (84)         | (84)         | -0.1%       | (81)         | (82)         | 0.9%         | (80)         | (80)         | 0.4%        |
| FV mvmts, assoc inc, other  | (10)         | (10)         | 0.0%        | (22)         | (22)         | 0.0%         | (22)         | (22)         | 0.0%        |
| <b>Pre-tax profit</b>       | <b>456</b>   | <b>462</b>   | <b>1.3%</b> | <b>394</b>   | <b>384</b>   | <b>-2.3%</b> | <b>400</b>   | <b>404</b>   | <b>1.0%</b> |
| Tax                         | (128)        | (129)        | 1.3%        | (110)        | (108)        | -2.3%        | (112)        | (113)        | 1.0%        |
| <b>NPAT</b>                 | <b>329</b>   | <b>333</b>   | <b>1.3%</b> | <b>283</b>   | <b>277</b>   | <b>-2.3%</b> | <b>288</b>   | <b>291</b>   | <b>1.0%</b> |
| <b>Normalised NPAT</b>      | <b>314</b>   | <b>318</b>   | <b>1.4%</b> | <b>268</b>   | <b>261</b>   | <b>-2.4%</b> | <b>272</b>   | <b>275</b>   | <b>1.1%</b> |
| <b>FB adjusted NPAT</b>     | <b>501</b>   | <b>505</b>   | <b>0.9%</b> | <b>451</b>   | <b>444</b>   | <b>-1.4%</b> | <b>451</b>   | <b>454</b>   | <b>0.7%</b> |
| Dividend (cps)              | 21.5         | 21.6         | 0.6%        | 21.5         | 21.6         | 0.6%         | 21.2         | 21.3         | 0.5%        |
| Normalised EPS              | 12.3         | 12.4         | 1.4%        | 10.4         | 10.2         | -2.4%        | 10.6         | 10.7         | 1.1%        |
| <b>Operating statistics</b> |              |              |             |              |              |              |              |              |             |
| NZ generation (GWh)         | 14,117       | 14,035       | -0.6%       | 13,419       | 13,376       | -0.3%        | 13,175       | 13,131       | -0.3%       |
| FPVV sales (GWh)            | 7,242        | 7,344        | 1.4%        | 7,342        | 7,649        | 4.2%         | 7,316        | 7,640        | 4.4%        |
| Customer numbers (000)      | 320          | 324          | 1.2%        | 331          | 335          | 1.2%         | 338          | 343          | 1.2%        |
| GWAP (\$/MWh)               | \$90.1       | \$78.6       | -12.8%      | \$96.3       | \$80.1       | -16.8%       | \$86.9       | \$76.6       | -11.8%      |

Source: Forsyth Barr analysis

## Investment Summary

Our rating is **OUTPERFORM**. MEL has been the strongest electricity performer in recent years and its low cost generation assets provides it with a strong defensive position. Its dividend yield is attractive, although we do not expect any near-term growth as it includes a significant special dividend component.

### Business quality

- **Low risk, modest growth industry:** Electricity demand is inelastic and the industry is well positioned to benefit from NZ electrifying transport and industrial processes.
- **Strong generation position:** Most of the value within the electricity sector lies within the generation assets. MEL is the largest generator in New Zealand, producing ~32% of New Zealand’s electricity and controls ~50% of New Zealand’s hydro storage. It is also the lowest cost generator.
- **Track record:** Since listing in 2014, MEL has demonstrated an ability to unlock value and has lifted underlying operating earnings ~+33%.

### Earnings and cashflow outlook

- **Earnings fall after FY20:** We expect earnings to fall in FY21 after two remarkable years of well above average hydro generation and high wholesale electricity prices. We expect transmission benefits to be offset by a gradually declining wholesale electricity price.
- **Cash flow strong in near-term:** Limited electricity demand growth means capital expenditure is limited, resulting in strong free cash flows.

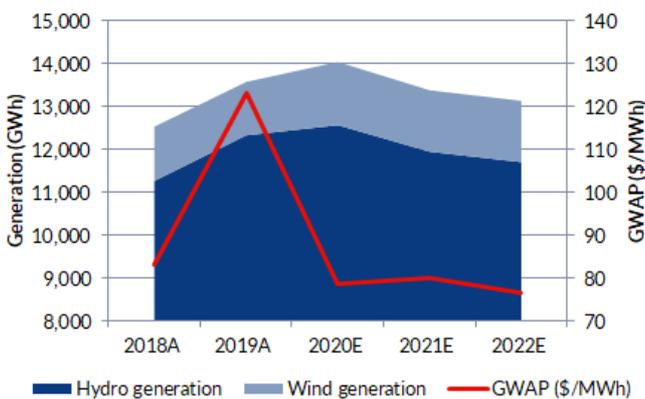
### Financial structure

- **Balance sheet:** Management recognises that surplus cash is better with shareholders. MEL currently has spare capacity on its balance sheet and has in place a capital management plan that is gradually lifting gearing.
- **Dividends:** MEL’s strong free cash flow enables it to pay high dividends, which are currently elevated due to the capital management plan.

### Risk factors

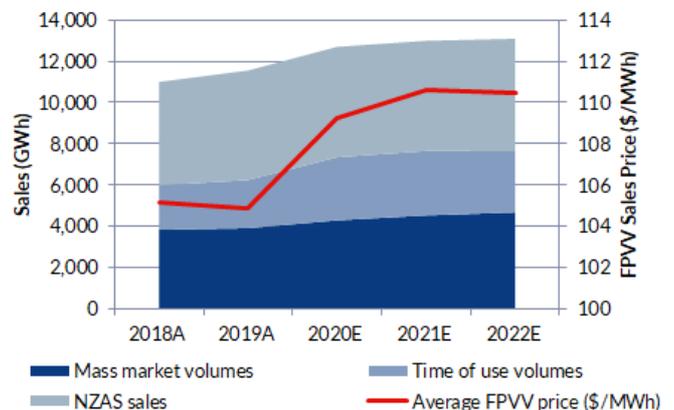
- **Political/regulatory:** The 2014 election and recent Electricity Price Review (EPR) highlighted the political/regulatory risks inherent in the sector. Whilst the EPR gave the sector a thumbs up in most areas, the political risk is unlikely to ever disappear.
- **NZAS risk:** NZAS has indicated it is undertaking a strategic review, raising the possibility it may close. In our view, the smelter is unlikely to close (less than 10% chance).

**Figure 3. Generation and average price received**



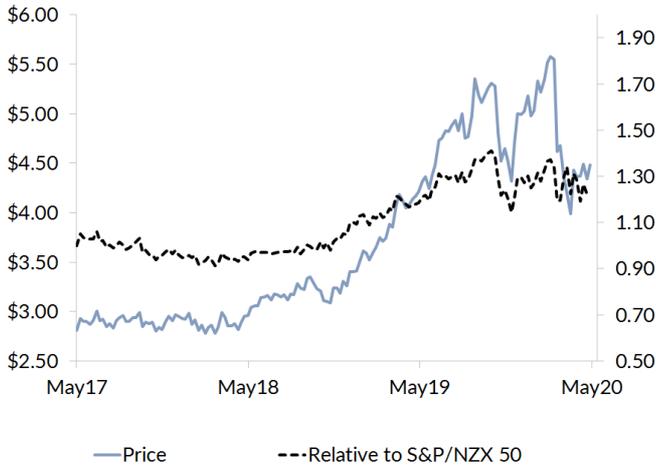
Source: MEL, Forsyth Barr analysis

**Figure 4. Retail sales volumes and average retail price**



Source: MEL, Forsyth Barr analysis

**Figure 5. Price performance**



Source: Forsyth Barr analysis

**Figure 6. Substantial shareholders**

| Shareholder | Latest Holding |
|-------------|----------------|
| NZ Govt     | 51.0%          |

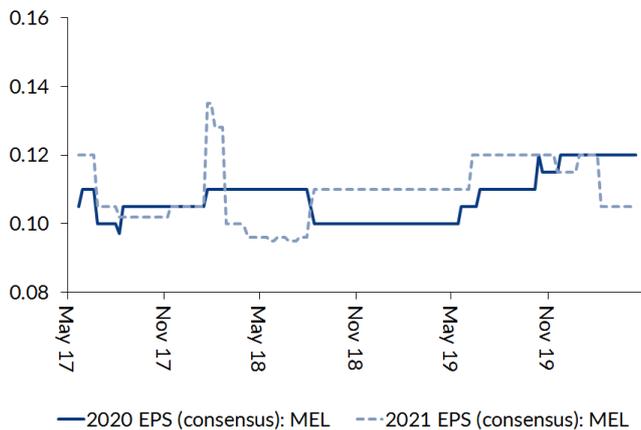
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

**Figure 7. International valuation comparisons**

| Company  | Code          | Price           | Mkt Cap (m)       | PE                   |              | EV/EBITDA    |              | EV/EBIT      |              | Cash Yld    |            |
|--|---------------|-----------------|-------------------|----------------------|--------------|--------------|--------------|--------------|--------------|-------------|------------|
| (metrics re-weighted to reflect MEL's balance date - June) |               |                 |                   |                      |              |              |              |              |              |             |            |
|  |               |                 |                   | 2020E                | 2021E        | 2020E        | 2021E        | 2020E        | 2021E        | 2021E       |            |
| <b>Meridian Energy</b>                                     | <b>MEL NZ</b> | <b>NZ\$4.48</b> | <b>NZ\$11,482</b> | <b>22.7x</b>         | <b>25.8x</b> | <b>14.8x</b> | <b>16.2x</b> | <b>23.2x</b> | <b>26.4x</b> | <b>4.8%</b> |            |
| Contact Energy*  | CEN NZ        | NZ\$6.30        | NZ\$4,524         | 20.1x                | 18.5x        | 12.6x        | 11.8x        | 25.2x        | 22.8x        | 6.2%        |            |
| Genesis Energy*  | GNE NZ        | NZ\$2.85        | NZ\$2,957         | 18.7x                | 15.1x        | 11.7x        | 10.4x        | 31.6x        | 24.8x        | 6.1%        |            |
| Mercury*   | MCY NZ        | NZ\$4.59        | NZ\$6,246         | 27.2x                | 23.7x        | 14.9x        | 14.3x        | 25.5x        | 24.1x        | 3.5%        |            |
| Trustpower*  | TPW NZ        | NZ\$6.32        | NZ\$1,978         | 22.6x                | 19.4x        | 13.2x        | 12.1x        | 16.6x        | 14.9x        | 5.4%        |            |
| AGL ENERGY   | AGL AT        | A\$17.09        | A\$10,752         | 13.2x                | 13.2x        | 6.5x         | 6.5x         | 10.1x        | 10.2x        | 5.7%        |            |
| INFIGEN ENERGY   | IFN AT        | A\$0.53         | A\$514            | 13.9x                | 16.1x        | 6.2x         | 6.7x         | 10.2x        | 11.8x        | 3.8%        |            |
| ORIGIN ENERGY  | ORG AT        | A\$4.89         | A\$8,612          | 8.5x                 | 17.8x        | 4.9x         | 6.5x         | 11.4x        | 20.2x        | 3.9%        |            |
| <b>Compcop Average:</b>                                    |               |                 |                   | <b>17.7x</b>         | <b>17.7x</b> | <b>10.0x</b> | <b>9.7x</b>  | <b>18.7x</b> | <b>18.4x</b> | <b>4.9%</b> |            |
| <b>EV = Current Market Cap + Actual Net Debt</b>           |               |                 |                   | <b>MEL Relative:</b> | <b>28%</b>   | <b>46%</b>   | <b>48%</b>   | <b>66%</b>   | <b>24%</b>   | <b>44%</b>  | <b>-2%</b> |

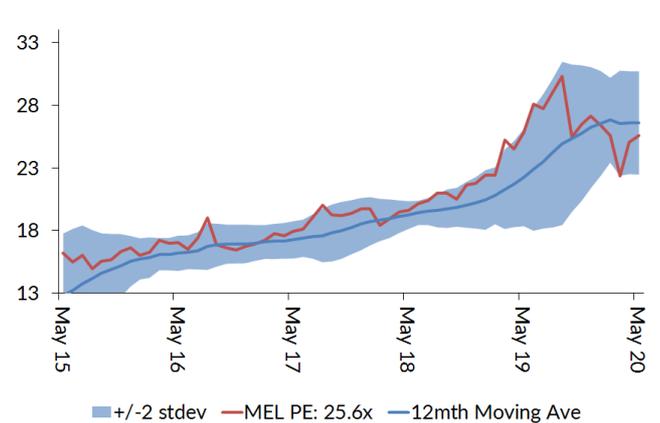
Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compcop metrics re-weighted to reflect headline (MEL) companies fiscal year end

**Figure 8. Consensus EPS momentum (NZ\$)**



Source: Forsyth Barr analysis

**Figure 9. One year forward PE (x)**



Source: Forsyth Barr analysis

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