

# Wealth Weekly

## Rebuilding Balance Sheets

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The spread of COVID-19 is showing signs of possibly peaking here and in parts of Europe, but the path ahead remains uncertain. Companies are looking to shore up balance sheets to repair damage done and prepare for the economic uncertainty ahead. Investors can expect to be called on to contribute more capital and share in the pain of lower profits through dividend cuts. We see strong demand ahead for those stocks that maintain distributions to shareholders.

**Capital raising and dividend cutting season is upon us**

This week kicked off with **Auckland Airport announcing a jumbo \$1.2 billion capital raising**. That followed Kathmandu's \$207m raising last week, while in Australia we've so far seen companies as diverse as Cochlear, Webjet, NEXTDC, Flight Centre and Reece hold their hands out for more money from shareholders. We expect many more to come.

Capital raisings aren't the only financial cost to shareholders at the moment. **A lot of dividends were already put on ice in the February results season, and we expect more to follow.** Kiwi Property Group cancelled its final dividend to conserve capital amid the difficult environment its tenants face. Most companies will see earnings decline, many substantially. Furthermore, in an environment where workers are being made redundant, having wages cut, or being subsidised by the government, companies will have to carefully balance being a good social citizen with making profits and paying dividends.

**NZ companies that are best placed to maintain dividends** include the likes of utilities (Contact Energy, Genesis Energy, Meridian Energy, Mercury NZ, Trustpower, Vector), telcos (Chorus, Spark), healthcare (Ebos, Vital Healthcare), and food producers (Scales).

**Themes of the week**

**The lock-downs introduced across many countries over the last month may well turn out to have been the "Lehman moment" at which this crisis peaked.** Infection rates in the United States and the United Kingdom continue to get worse, but in Italy and Spain the numbers show signs of peaking. **Domestically, the flattening of the infection curve provides a reason for optimism.** Once infection numbers start declining, the next question on investors' minds will be how long restrictions will have to remain in place for and what the "new normal" that follows might look like. Analysts' earnings estimates have got further to fall and valuations haven't declined as far as they did in the past. But equally, past crises weren't accompanied by quite the level of fiscal and monetary stimulus we are seeing now, which might limit the downside in both earnings and valuations.

The Reserve Bank of New Zealand (RBNZ) has followed European peers and banned New Zealand incorporated banks from paying dividends until the current crisis is over. But **the RBNZ went further and also stopped the expected early redemption of two bank capital securities**, although distributions on these securities will continue at reasonably attractive levels.

One tactic for investors to get through the uncertainty is to **focus on quality companies in relatively defensive sectors that can navigate well through these challenging conditions.** Playing the cyclical rebound is harder, but three Australian cyclical stocks we believe should come out the other side of the crisis ok and that look oversold are Lendlease, James Hardie and Macquarie Group.

**The week ahead**

**The market's focus will remain on the spread of the virus.** Economic statistics will be bad, but that alone won't surprise the market. Extreme levels of jobless claims in the United States over the last two weeks barely registered as investors focussed on signs the pandemic may be peaking. Oil markets will be worth watching again as OPEC and Russia try to get the US to cut production. There will almost certainly be more capital raisings and dividend cuts to come.

## More Hits to Dividends Ahead

Given the environment of low interest rates and term deposit rates, yield thirsty investors will be wondering where to get income from. Equity dividends are an obvious, convenient and cost-effective source of cashflows for investors.

### Prudence and politics

In the current very uncertain economic environment, company boards are more justified than ever in erring on the side of caution when deciding whether to pay dividends (and how much), buy back shares or raise capital. In the banking sector, the decision has been taken out of boards' hands; regulators including the Bank of England, European Central Bank and Reserve Bank of New Zealand have told or asked banks to refrain from paying dividends, in order to support the stability of the financial system.

Corporate social responsibility has been a rising theme over the last decade. The difficult economic and operating environment due to COVID-19 now brings it into even sharper focus. This pressure will be particularly acute where companies are receiving government assistance or making workers redundant, or where suppliers are being impacted.

Consequently, we expect that prudence, optics and politics will heavily influence how listed company boards navigate decisions about dividends and capital management for the next year or two.

### Peak payout ratios

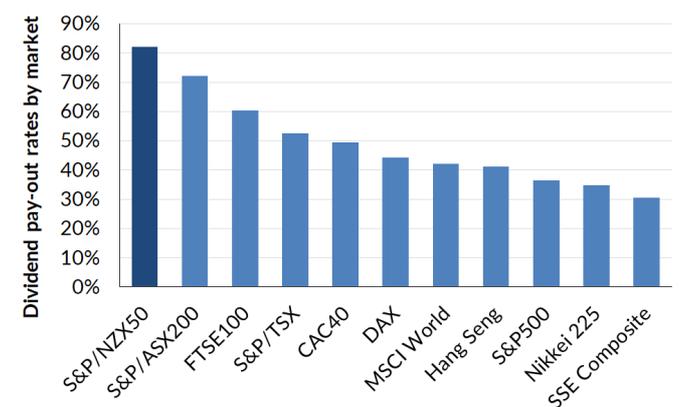
Over the past decade, median pay-out ratios for the NZX 50 have climbed from the low 70% range to the low 80% range (Figure 1), and they are high relative to other markets. Given balance sheet and social responsibility pressures, we think these payout ratios are set to decline sharply, similar to what we saw in the global financial crisis.

**Figure 1. Median divi pay-out ratio history for the S&P/NZX50**



Source: Forsyth Barr analysis

**Figure 2. NZ pay-out rates are very high versus other markets**



Source: Bloomberg, Forsyth Barr analysis

Add to the lower payout ratios the impact of lower earnings, and investors will likely receive less income for the foreseeable future. The host of dividend suspensions in the February reporting season reflected cash preservation by companies exposed to COVID-19 challenges more than the politics, but they set the scene for further suspensions over the next 12 months.

### Some sectors should be more immune than others

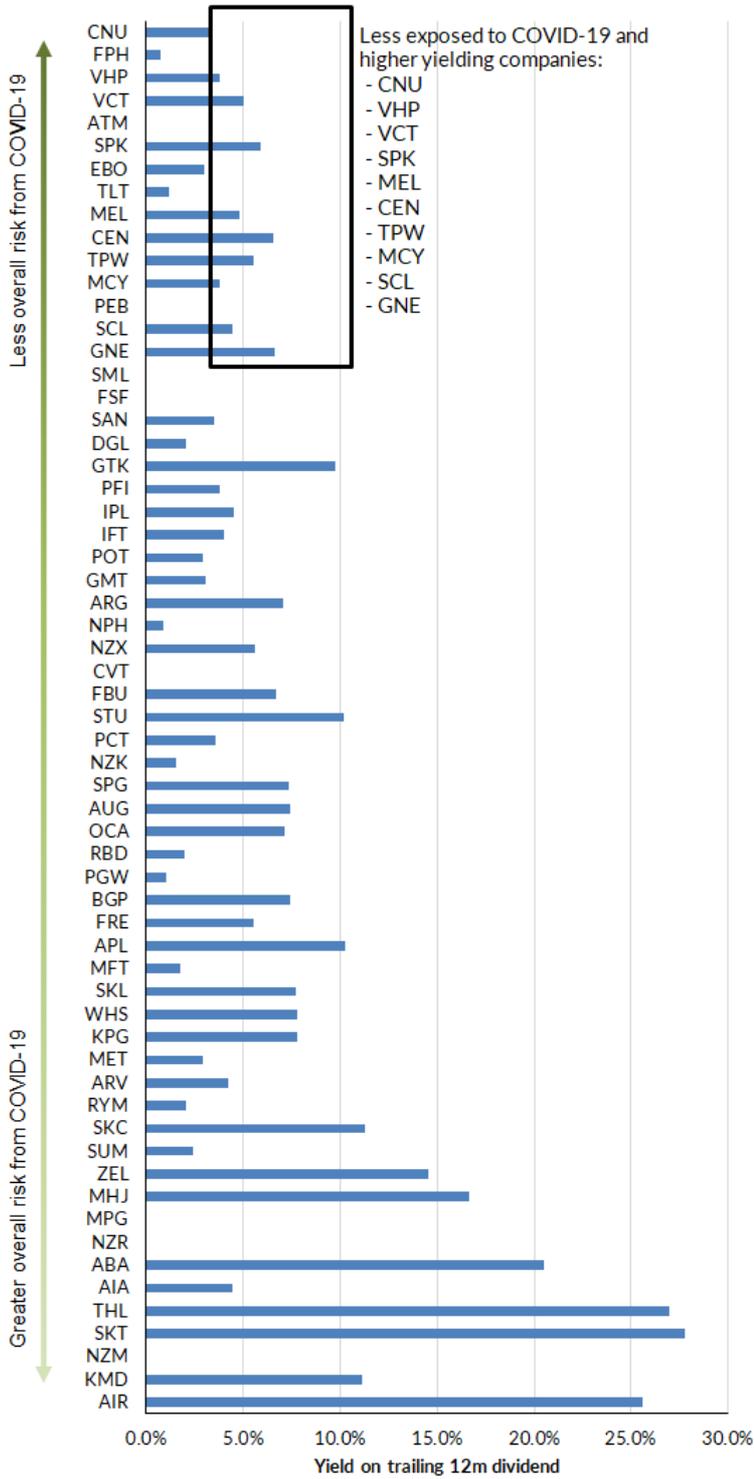
This environment raises the question of which companies will be well-placed to maintain their dividends. In Figure 3 (on the following page) we have screened our NZ stock universe for dividend yield and COVID-19 risks. Dividend payers that are relatively less affected by the COVID-19 epidemic and containment measures include the utilities (**Contact Energy, Genesis Energy, Meridian Energy, Mercury NZ, Trustpower** and **Vector**) and the telecommunication companies (**Chorus** and **Spark**).

### How much does it matter to wealth creation?

Lower dividends are disappointing. But fortunately, beyond their convenience and the positive signals they send, dividends don't change the equation of whether a stock is a good investment or not (all other things being equal). If a company pays a dividend, the stock's value instantly falls by the amount of the dividend paid; conversely, if a company retains the cash it would otherwise have paid out in dividends, the value of the stock will stay higher and the company will be able to reinvest the retained cash in growth opportunities, which (provided the board and management do a good job!) should in turn generate higher future cashflows. Investors who need income can sell a sliver of the (more highly valued) stock to generate a distribution for themselves.

For more details, please see *Equity Strategy – The Dividend Hit Has Only Just Started*, published on 4 April.

**Figure 3. Screening NZ stocks for dividend yield and COVID-19 risks**



Source: Forsyth Barr analysis

# Themes of the Week

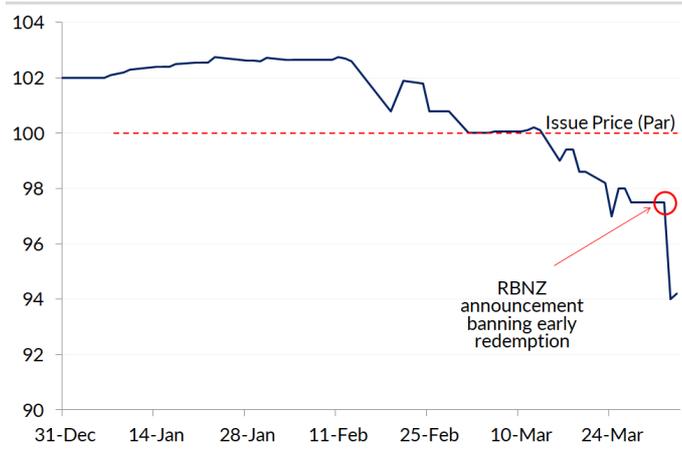
## Fixed Interest

### The RBNZ play hard ball

The Reserve Bank of New Zealand (RBNZ) continues to be on the front foot as it tries to head off the economic impacts of COVID-19. The central bank has banned New Zealand incorporated banks from paying dividends until the current crisis is over, which will particularly impact the big four banks who paid around NZ\$2.4bn in dividends (to their Australian parents) in 2019. This move follows similar moves in the UK and Europe; however, the decision to stop the expected early redemption of Capital Securities ANBHB and KCFHA issued by ANZ and Kiwibank (Kiwi Capital Funding) is an extra step compared to other jurisdictions. Investors in these securities – which would mainly be mums and dads – will now rely on the RBNZ granting permission to ANZ and Kiwibank under the Regulatory Event clause, otherwise the next call date for both securities is May 2022. Distributions on these two securities will continue.

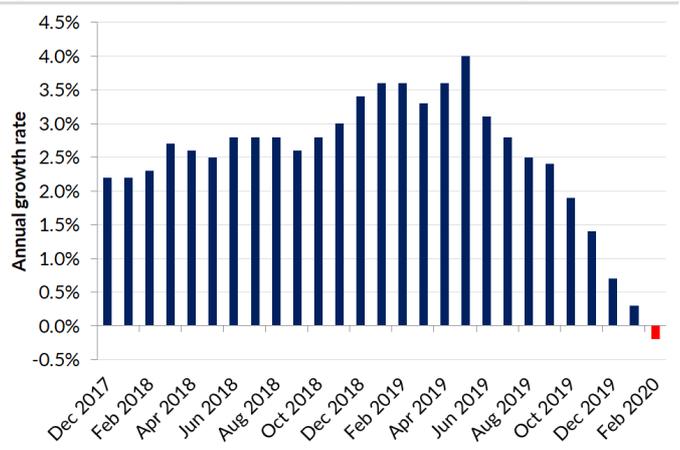
This move by the RBNZ most likely impacted the Australian Tier One market as well, with credit spreads widening by around +100bp after trending down for a couple of weeks. All eyes move to the Australian regulators to see if they will follow suit. The dilemma for Australia is the income these banks produce (ordinary dividends) and the distributions from the ~A\$40bn of Tier One securities which are also mainly held by retail investors. In a time when the government is basically handing money out to its citizens, stopping dividends and distributions would seem at odds with this policy.

**Figure 4. ANBHB Price**



Source: Forsyth Barr analysis, Thomson Reuters

**Figure 5. Annual growth rate of agricultural lending**



Source: Forsyth Barr analysis, RBNZ

### The RBNZ were told

The latest lending statistics released by the RBNZ show that lending to the agricultural sector turned negative in February as banks scaled back lending in this sector, most likely due to the new capital requirements announced in December 2019. There is lots of anecdotal evidence that banks have been pulling back their lending in this sector for several months, however, with the COVID-19 crisis now placing extreme pressure on SME's and households, which sector is likely to be impacted in the months ahead?

## Macro Strategy

### How might earnings and valuations play out from here?

The crucial moment in this pandemic for the global economy was the point when the governments of significant western countries put their respective populations – and therefore economies – into lock-down. After China, which already went down this route in January, this happened from mid-March. As of this weekend, eight US states were still not in shut-down mode. Japan has just announced a state of emergency. So the shutdowns of late-March to early April can probably be regarded as the "Lehman moment" of this crisis.

### Earnings forecasts likely to fall before rising again

As is usual in major downturns, analysts are likely to forecast a worst-case scenario, and so earnings in many sectors should be expected to plunge through 2020. Institutional investors will be applying their own valuation multiples to these earnings forecasts to arrive at guesstimates of fair values.

The optimistic scenario would assume that the health, economic, and financial hits all improve as the year progresses. If we see a peak in global infection and mortality rates (perhaps by mid-year), and economies are allowed to slowly re-open, then 2020 earnings will matter less and less. It will be 2021 earnings that the market starts to discount, as it did in 2009 – the recession year after the Lehman moment in which the global financial crisis peaked.

### Where to for valuations?

In developed markets, cyclically-adjusted P/E valuations (which take the current price divided by the average of the last 10 years of earnings per share) are still relatively elevated, certainly compared to the GFC and the first half of last decade. Do P/E multiples need to drop to levels seen in the GFC trough (which occurred about 6 months after Lehman collapsed)?

One factor that suggests multiples might not fall that far is the unprecedented fiscal and monetary responses to the crisis from governments and central banks. The scale of the support so far is huge, with more probably to come. This would justify valuations troughing at a higher level than last time.

### Defensives, winners and rebounders

A sensible tactic for long-term equity investors in this unpredictable environment is to focus on **quality stocks in relatively defensive sectors**. These stocks would not have fallen the most, but they may still be cheaper than they were, and such companies can navigate through the crisis well and form a solid part of portfolios for the long-term.

Many winners from the pandemic – stocks that are seeing increases in demand – have already risen to reflect this. Some of the increased demand may be permanent, but a lot of it will be one-off. Beneficiaries include:

- Consumer staples companies such as supermarkets and pharmacies, which can barely stock shelves fast enough to meet demand
- Parts of the healthcare sector that are seeing billions of government money poured in to procure products (it's not all upside for healthcare though, as some companies will see temporarily reduced demand as elective procedures are postponed)
- Communication services companies offering internet and video streaming
- Providers of technology such as cloud computing to support working from home (but suppliers of big-ticket enterprise software and small & medium enterprise software might see softer demand).

Industrials and materials suppliers should get a lift if the proposed infrastructure packages get off the ground.

Playing the rebound in cyclical sectors is challenging given the uncertainty about how long the pandemic-induced economic downturn will persist and therefore how low earnings will go. Many companies will recover, but there is a minefield of dividend cuts, capital raisings, restructurings and unfortunately probably the odd bankruptcy to get through first.

The worst-affected industries in this crisis are already clear: airlines, airports, hotels, restaurants, discretionary retailers and oil companies are obviously feeling the pain. The oil sector rebounded last week on hopes that talks between Saudi Arabia and Russia might lead to a truce in the oil price war. But energy analysts are fairly unanimous in believing that unrealistically large production cuts – including by producers like the US which haven't historically limited their output – would need to be agreed to, to bring markets towards equilibrium, given how weak demand currently is due to COVID-19 lock-downs around the world. That said, the extreme oil futures price patterns we have been seeing recently have historically indicated a bottom and portended a recovery in prices. A contrarian bet could include energy at \$20-30/barrel, which should recover once the global economy turns the corner.

## Australian Equities

### Portfolio Ideas

Last we presented four Australian stock ideas: **APA** (APA), **Qube** (QUB), **Scentre Group** (SCG) and **CSL** (CSL), which we again re-iterate as members of both our Australian Executable Portfolio and our broader Australian Equity Model Portfolio. This week we have identified three companies that we feel have been oversold and represent good value for risk at current prices: **James Hardie** (JHX), **Lendlease** (LLC), and **Macquarie Group** (MQG).

**James Hardie:** JHX makes fibre cement for houses. Its main exposure is to the US market (~70% of revenue), with Australia making up less than 15% of revenue. In the US, the Cyber & Infrastructure Security Agency (CISA) of the US Department of Homeland Security listed new housing construction and repair services as part of essential critical infrastructure, allowing JHX to continue to supply materials to the market. In our view, JHX has the ability to navigate headwinds from COVID-19 given its strong balance sheet and a reasonable proportion of variable operating costs. JHX has a track record of being oversold during difficult times and an impeccable track record of coming through tough trading periods in great shape. We feel the same should be true post the COVID-19 challenges.

**Lendlease:** In our opinion the recent sell-down in property developer LLC's share price (from A\$19.00 to ~A\$10.50) over the past few weeks in response to COVID-19 related challenges appears excessive. We believe LLC has the balance sheet liquidity to manage the short term financial impact on its business, and we see it as offering good value for risk at its current price. LLC provides investors with a broad property exposure through:

- Geographical Spread: Australia (60%), US (27%), Europe (10%) and Asia/Pacific(3%)
- Earnings Spread: Investment Management (46%), Development (36%) & Construction (18%)

**Macquarie Group:** We believe financial services group MQG should prove relatively resilient (compared with the major banks) because over 50% of our assessed value of MQG is underpinned by its funds management business, Macquarie Asset Management (MAM). We also see MQG as being at the forefront of helping corporates across Australasia in managing their liquidity (debt and/or equity) requirements throughout COVID-19 challenges. We are reviewing MQG for inclusion into the Australian Equity Model Portfolio as we believe MQG offers better medium term growth prospects and faces far fewer external criticisms than the major banks.

## Research Worth Reading

### New Zealand research

#### **Arvida Group (ARV.NZ) – Needs Based**

We have reduced our near-term ARV earnings forecasts based on a scenario that assumes very soft conditions for sales of retirement units over the next six months and no development activity, and then a recovery over the following 18-24 months. We remain confident of ARV's integrated needs-based business model in the long-term and its financial strength. However, significant uncertainties remain with regard to the operating environment and economic recovery. **OUTPERFORM.**

#### **Freightways (FRE.NZ) – Feeling the Chill**

FRE's revenue is falling dramatically during the domestic COVID-19 lockdown, but profitability is partially protected by a variable contractor base, wage subsidy support from the government, and a temporary reduction in employee wages. The economic ramifications of the lockdown will likely suppress medium-term demand, spilling the earnings impact into FY21 and beyond. Earnings downgrades are partially mitigated by accretion from the recently completed Bill Chill acquisition. FRE trades at a one year forward PE of ~16x on depressed earnings, which looks fair on a historical view of FRE's relative valuation. **NEUTRAL.**

#### **Investore (IPL.NZ) – Super Essential**

Investore Property has benefited in recent weeks from its defensive qualities and its exposure to its 'essential' supermarket businesses. While IPL has arguably less upside in a recovery scenario than some of the other more retail and office focussed NZ listed property vehicles that have been heavily sold off, we remain with an **OUTPERFORM** rating and continue to like the strongly defensive characteristics amid the current economic and property valuation uncertainty. (Published by Forsyth Barr)

#### **Kiwi Property Group (KPG.NZ) – Capital Raise Via Dividend Cut**

KPG surprised the market and cut its large 2H20 dividend to prudently manage gearing levels. There remains considerable uncertainty with regard to how KPG's retail assets track near-term and also what happens with its FY20 portfolio revaluation, and we expect the news flow to remain challenging. We downgrade our rating to **UNDERPERFORM** and we have cut our 1H21 dividend forecasts.

#### **Sanford (SAN.NZ) – Navigating the Conditions**

SAN's market diversification and sustainable protein product slate should make it comparatively more defensive to navigate the COVID-19 demand shock. SAN highlighted impacts to-date from COVID-19, including (1) reduced operating capacity as a result of distancing policies, and (2) changes to consumer purchasing behaviour, with retail sales surging following a collapse in the foodservice channel. We have lowered our target price to NZ\$7.70 from NZ\$8.35 (-7.8%), reflecting a combination of revised earnings forecasts and lower market multiples. SAN offers attractive earnings growth and is trading on a 13x 12-month forward PE ratio. **OUTPERFORM.**

#### **SKYCITY (SKC.NZ) – Managing Cash with Leadership from the Top**

SKC's plan to lower cash burn by reducing capital and operating expenditure while its properties are closed and in expectation of weak demand thereafter appears sensible. There will be a large near-term earnings shock, but the magnitude and duration are still unclear. We believe SKC can navigate COVID-19 (admittedly with some battle scars), with its asset base and long-term monopoly casino licences providing comfort of value above current market pricing. **OUTPERFORM.**

#### **Summerset Group (SUM.NZ) – No Sunset at Summerset**

Although near-term uncertainties remain, including investor sentiment towards the sector given the COVID-19 outbreak and how long it will be until residential sales transact, sector share prices have declined substantially and already factor in a highly negative outlook. We remain confident of SUM's long term business model. **OUTPERFORM.** (Published by Forsyth Barr)

## Australian research

### **Amcor (AMC.AX) – Conference call feedback**

AMC appears well positioned to manage through the prevailing uncertain market environment. In Ord Minnett's view, Amcor should benefit from the surge in demand for at-home food consumption. ACCUMULATE. (Published by Ord Minnett)

### **Cleanaway Waste Management (CWY.AX) – Conference call feedback**

CWY CEO Vik Bansal and CFO Brendan Gill participated in a conference call, and in this note Ord Minnett provides a summary of the key points. ACCUMULATE. (Published by Ord Minnett)

### **Ramsay Health Care (RHC.AX) – Assessing the impact of partnering with Government**

In the last week, Government intervention has changed the Australian private hospital landscape in the short term. Firstly, suspension of non-urgent elective surgeries which understandably caused RHC to withdraw FY20 earnings guidance. Then the Government announced a partnership with the private hospital sector offering an agreement to ensure their viability, in return for maintenance and capacity during the COVID-19 response. In this environment, it is impossible to accurately forecast near-term earnings. Importantly, we believe that the debt position of the company is strong, and that at the other end of this crisis, the relative value of hospital infrastructure will be enhanced. Maintain Buy. (Published by Citi)

### **ResMed (RMD.AX) – Ventilator opportunity**

Ords believes RMD can ramp up production of Bi-Level devices to meet demand for non-invasive ventilation due to the pandemic and the shortage of ventilators. This could offset the expected drop in new sleep patients. HOLD. (Published by Ord Minnett)

### **Scentre Group – A path to better times – upgrade to Neutral**

The challenging COVID-19 situation is undermining the viability of retail tenants' businesses worldwide. Landlords have indicated they will partner with tenants in order to "share the pain", and this is reflected in the withdrawal of guidance. UBS upgraded SCG to NEUTRAL (with a reduced target price of A\$1.53), with the current share price implying a ~40% decline in asset prices despite a balance sheet that can withstand the expected future volatility. NEUTRAL. (Published by UBS)

### **Transurban (TCL.AX) – Cutting forecasts for 3-month disruption and upgrading to Buy**

TCL's toll road assets are not immune from the COVID-19 shock. UBS now forecasts ~15% p.a. cashflow growth over the medium term, albeit off a lower base as the economy recovers. Despite this lower growth outlook, UBS believes investors will continue to value the long duration growth profile (weighted average concession expiry of 2052), comparatively low-risk growth, and optionality for future growth in its existing metropolitan networks. BUY. (Published by UBS)

## International research

### **Apple (AAPL) – UBS Evidence Lab inside: Service Survey Keeps Us Bullish, But Cut Ests & PT On Lower iPhone Units**

The second version of the UBS Evidence Lab annual Apple services survey is very bullish for wearables, shows solid customer engagement for TV+ and Arcade in particular, and highlights iPhone's recurring revenue model. UBS cut its target price due to lower estimates and competitor multiples, but sees this pullback as a solid buying opportunity. BUY. (Published by UBS)

### **Microsoft (MSFT) – Diving into Model, 2008-9 Precedent and Granular Cuts to Ests**

Citi has gone through the 14 segments of the MSFT business and 11 revenue types to check the company's inventory exposure during this time of uncertainty, and "gut-checked" this against exposure to stressed industries and small businesses. While the 2008-09 GFC is clearly a different event, Citi has gone line-by-line and factored in a GFC-lite impact, resulting in a -3% reduction to FY20 EPS estimates and -7% to FY21. NEUTRAL. (Published by Citi)

### **Tencent (700) – Takeaways from investor meeting**

UBS believes management's tone has improved due to its reorganisation and new initiatives following a period of intense regulatory and competitive pressure. Long term, Tencent has more ways to monetise WeChat through innovation in short and medium length videos, and in ecommerce through payments and eventually ads. BUY. (Published by UBS)

**Figure 6. Calendar**

Date	New Zealand	Australia	International
6-Apr	ANZ Commodity Price Index	MI Inflation MoM ANZ Job Advertisements MoM	UK: Construction PMI (Mar)
7-Apr	NZIER Business Confidence (Q1) NZIER QSBO Capacity Utilization	AIG Services Index (Mar) Exports MoM (Feb) Imports MoM (Feb) Trade Balance (Feb) RBA Interest Rate Decision (Apr)	
8-Apr	GlobalDairyTrade Price Index	Home Loans MoM Invest Housing Finance MoM RBA Chart Pack Release	US: JOLTs Job Openings (Feb)
9-Apr		RBA Financial Stability Review	US: Crude Oil Inventories US: FOMC Meeting Minutes UK: GDP MoM & YoY UK: Manufacturing Production (Feb) Kraft Heinz Foods 4Q19
10-Apr			Tesco FY20

Source: Bloomberg

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