MORNINGSTAR®

New Zealand Share Market Outlook

Telecommunications offers the most opportunity in a fully priced market

- The New Zealand market is trading around our fair value estimates and we have more negative recommendations than positive.
- Telecommunications offers the most value. Chorus is cheap by our measurement but pending regulatory decisions raise the level of uncertainty.
- Healthcare firms in our coverage are generating strong operating performance with limited sensitivity to the modest-growth economy but each of these now trades above fair value.
- We encourage holdings in high-quality companies providing sustainable above-average yields but their popularity has resulted in limited scope to purchase these cheaply.

There are few buying opportunities in the New Zealand market following a strong run this year. The market is very close to fair value, as demonstrated by the median price/fair value of the 27 stocks in our coverage universe of 1.04. Most stocks are in the hold zone and we are finding outright buy and sell calls hard to come by. There are more stocks trading in negative recommendation territory than positive. In fact, we have only one accumulate and seven reduces.

Five of the seven reduce recommendations are moat companies that have risen strongly in a market seeking quality. We think the focus on moat companies trading at reasonable prices continues to be the most advisable approach, but, given where the market is, patience is required and it is wise to have some excess cash available to take advantage of opportunities as they arise.

Chorus CNU is our one positive recommendation but regulatory changes create a high uncertainty environment. The regulator, the Commerce Commission, came out with a much lower than expected draft wholesale broadband price decision in early December but we expect a better outcome post industry consultation. The commission itself highlighted shortcomings in its methodology which included only two comparable international markets – Denmark and Sweden.

Given depressed interest rates globally, quality companies providing sustainable and above average yields will continue to be popular for a while yet. Though in the hold zone, Telecom New Zealand TEL, SkyCity SKC, Warehouse Group WHS and Fisher & Paykel Healthcare FPH have sustainable yields above 5% so are worthy of retention in diversified portfolios.

Telecommunications is the cheapest sector

Across our coverage, telecommunications stands out as offering the greatest opportunities for purchases. Two main themes are playing out – regulatory wholesale pricing uncertainty is weighing on Chorus CNU while Telecom will continue to defend market share from a larger competitor in Vodafone in the retail sector. For Chorus, we expect discussions between industry players and the regulator to lead to a better outcome in the final decision, as was the case for wholesale copper price. However, the final decision is not expected until mid-2013 which will likely prevent Chorus' share price from converging on our fair value in the near term.

In the retail market, we expect competition to increase. Telecom's market share in the fixed line business has been pressured for some time and we expect this to continue in the next year. As noted earlier, the acquisition of TelstraClear by Vodafone in July has strengthened Vodafone's competitive position. While it will take some time to integrate the two businesses, we expect Vodafone to benefit from increased scale going forward. In our view, rationalisation of costs could flow through to lower retail pricing and a more competitive market.

While Telecom's return is likely to be pressured in the near term, there is no change to our positive long-term view. Upfront capital investments, coupled with low population and dominant positions by existing players act as barriers to entry. We expect Telecom to compete more aggressively in the mobile market. Higher costs from handset subsidies, mainly in smartphones, and value included in post-paid plans could reduce margin

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Our most preferred New Zealand stocks

Code	Name	Morningstar Recommendation	Fair Value $	Economic Moat	Fair Value Uncertainty
CNU	Chorus	Accumulate	3.60	Narrow	High
NPX	Nuplex Industries	Hold	3.50	None	High
SKC	SkyCity	Hold	4.00	Narrow	Medium
SKT	Sky Network Television	Hold	5.50	Wide	High
TEL	Telecom NZ	Hold	2.50	Narrow	Medium

in the short term. However, by putting smartphones in users' hands, we expect the strategy to lift data usage and drive revenue growth over the long term. Rollout of the 4G network is not immediate with auction for additional spectrum scheduled in 2013. Trials are underway and Telecom is expected to launch its service late 2013/early 2014.

Healthcare is one of the most expensive areas

The healthcare sector consists of three companies – Ryman Healthcare RYM, Fisher & Paykel Healthcare FPH and EBOS EBO. We project good earnings growth from each business but their prices are trading above our fair value estimates.

Ryman is New Zealand's largest retirement village operator. The company has grown rapidly over the last decade thanks to solid sector fundamentals and brilliant management execution. We believe Ryman Healthcare's profits will double in the next five years as it significantly increases the number of retirement units and beds in New Zealand and constructs it first village in Australia.

FPH manufactures respiratory devices and consumables used in invasive and non invasive ventilation. The company has also branched out into oxygen therapy, humidity therapy and surgical humidification. We expect the firm to achieve double-digit growth in the medium term through volume growth in both respiratory and sleep apnea products.

EBOS is a leading distributor of medical and pharmaceutical products to a broad spectrum of healthcare markets in NZ and Australia. The industry is highly fragmented and subjected to the whims and fancies of district health boards and funding agencies. As a result, EBOS has to constantly reinvent itself to stay ahead of competition and respond to the fast changing needs of customers.

Consumer is expensive too

The consumer services sector encompasses retailing and other discretionary industries such as gambling and media. Overall, consumer spending in NZ remains lacklustre despite low interest rates. High debt levels racked up by consumers during the boom years of 2002-2008 stultified household balance sheets. As a result, consumers have imposed their own austerity measures. The recent surge in house prices could provide a fillip to consumer spending. However, we expect little house price appreciation in the near term, particularly given expensiveness relative to global peers. Any further rate reductions are unlikely to meaningfully improve housing affordability.

Against this economic backdrop, we expect discretionary retailers to struggle while retailers exposed to food and other essentials should fair better.

The slowdown in discretionary spending is also hurting gambling and media companies. Sky City SKC, which is the only listed casino company on the NZX, is bucking the trend by winning market share from pubs and clubs. In addition, it has been successful in attracting a high number of international VIP players to its Auckland property. In the media space, SKY Network Television SKT is performing much better than its free-to-air counterparts which are more reliant on advertising revenue. SKT's subscription-based business model is proving to be somewhat immune to economic headwinds.

Our most preferred New Zealand stocks

Chorus CNU

Chorus is New Zealand's largest telecommunications infrastructure owner. Copper is dying a long and lingering death, replaced by fibre cable which Chorus and the government are in joint venture to roll out. Fibre to the node has been completed and work is progressing to extend the network to the home. As most of its assets are near monopolies, wholesale pricing is regulated and with a number of decisions yet to be finalised, the landscape is highly uncertain. This is a relatively cheap, narrow moat business offering a generous yield over 9%, but uncertainty is high. The regulator, the Commerce Commission, came out with a much lower than expected draft wholesale broadband price decision in early December which would sharply reduce the revenue potential from what we previously forecast. We expect a better outcome post industry consultation. The commission itself highlighted shortcomings in its methodology which included only two comparable international markets – Denmark and Sweden.

Nuplex NPX

The health of the global economy will continue to dictate demand for Nuplex's products given leverage to manufacturing and construction end markets. While this makes short-term predictability difficult and could mean a stagnant share price during 2013, we continue to expect NPX to deliver growth over the longer term in Asia, Europe and the Americas, through capacity expansion and productive innovation. While we forecast residential and construction markets to

Our least preferred New Zealand stocks

Code	Name	Morningstar Recommendation	Fair Value $	Economic Moat	Fair Value Uncertainty
BGR	Briscoe Group	Reduce	1.70	None	Medium
FBU	Fletcher Building	Reduce	6.50	None	High
RYM	Ryman Healthcare	Reduce	3.50	Narrow	Medium
TME	Trade Me Group	Reduce	3.40	Wide	Medium

rebound after hitting cyclical lows, the strong A$ and high labour costs continue to pressure the competitiveness of Australia's manufacturing industry, increasing the attractiveness of relocating offshore. Investments in Asia, particularly China and possibly India are likely to offer substantial long-term growth opportunities. Chinese resin demand is growing at 10% p.a. Even after rallying 38% in the last year, Nuplex still trades at a 14% discount to our fair value of NZD 3.50.

Sky Television Network SKT

SKT is the only pay-TV provider in NZ, catering to nearly half of NZ's population. The company's lineage of being part of the News Corp family together with a growing customer base puts it in a strong position to negotiate with overseas content suppliers. Furthermore, the company's dominance and scale, thanks to its first-mover advantage, make it a challenging proposition for potential new entrants. The company has achieved 8-9% growth in subscriptions historically and we expect this trend to continue for the foreseeable future given the relatively low penetration of pay-TV in NZ compared to other developed countries.

Sky City SKC

Sky City owns the highly lucrative Auckland casino, the biggest contributor to the firm's revenues and earnings. This property, along with those owned in Australia, have competitive advantages that primarily stem from local casino monopolies. The Auckland casino license is exclusive until 2021 while Adelaide and Darwin in Australia enjoy exclusivity until 2015 and 2026, respectively. Apart from monopoly licenses, the company's casinos are well managed and generate abundant cash flows and returns.

Telecom NZ TEL

Regulatory changes and increased competition reduced the quality of this once state-run monopoly. Regulatory pressure subsided after the Chorus demerger. TEL retains key assets in mobile and wireless networks, PSTN hardware and software; some national transport fibre and associated ducts and manholes; and 30 exchange buildings. Cash generation remains strong and cost cutting is helping fend off competitive pressures.

Our least preferred New Zealand stocks

Briscoe BGR

Briscoe is one of New Zealand's premier retailing groups operating the Briscoes, Rebel Sports and Living & Giving stores. The company holds an enviable brand presence in NZ due to an aggressive promotional stance, a broad geographical presence and an "everything under one roof approach" to its stores. The company has been performing exceptionally well of late and registering solid same-store sales growth despite a lacklustre retailing environment. Despite the firm's reasonably strong fundamentals, the shares are 31% overvalued compared to our intrinsic value of NZD 1.70 per share.

Fletcher Building FBU

The New Zealand construction market is finally showing signs of life, new housing being supported by recent reductions in official interest rates and a more meaningful amount of work from the Christchurch rebuild finally approaching. The completion of demolition work in Christchurch during 2013 will clear the way for the rebuild process, with estimates for as much as USD 24 billion to be spent over the next few years. The government alone is committing NZD 8.5 billion, helping local councils with infrastructure, roads, hospitals, schools and remediation of damaged land and houses. As New Zealand's largest construction company Fletcher Building FBU is best placed to benefit, but we think leverage to a recovery is being overestimated. The share price has increased more than 40% in the past year, now 25% above our fair value of NZD 6.50.

Ryman Healthcare

RYM is a well-managed company operating around 24 retirement villages in New Zealand. The company's strong brand reputation, due to its high standards of service and care, and low-cost position gives it a moat and differentiates it from other companies in the sector. In the long term, the company should immensely benefit from the demographic dividend resulting from New Zealand's fast-growing elderly population.

Trade Me TME

Trade Me is the pre-eminent auction website in NZ with virtually no competition. The company's online marketplace consists of 2.8 million members or nearly 67% of NZ's population, with nearly 1 million members logging on to the website every month. Such strong brand equity, coupled with limited competition and the continued migration of trade online, provides Trade Me with a sustainable competitive advantage.