FNZC

# Property for Industry Limited

## Senior Secured Fixed Rate Bond

**7 November 2017**

**The Product Disclosure Statement dated 2 November 2017 and the Indicative Terms Sheet sets out the terms of this senior, secured, fixed rate bond offer and should be read fully before you make a decision to invest. A copy is available from your adviser on request.**

## Executive Summary

Property for Industry Limited (PFI) has announced the terms of an offer of up to $100 million ($75 million with the ability to accept another $25 million in oversubscriptions) of 28 November 2024 senior, secured, fixed rate bonds (PFI010). The indicative margin has been set at 1.65-1.80%pa over the seven-year swap interest rate, which would imply an interest rate of 4.52-4.67%pa if it were set today. However, a minimum interest rate has been set at 4.55%pa. The actual interest rate will be set on 10 November 2017.

PFI is a NZX listed property company with a $1.2 billion industrial property portfolio, 82% of which is located in Auckland. PFI has solid portfolio metrics with gearing of 32.3%, 99.6% occupancy and a weighted average lease term of 5.4 years.

To date, PFI has successfully executed its strategy of purchasing assets where value add opportunities exist through re-development or re-leasing. We view this growth strategy as positive, with limited emphasis on development activities given the arguably later stage of the property cycle. Since PFI's portfolio consists of both prime and secondary industrial property assets, we believe its portfolio is more susceptible to a downturn in Auckland's industrial market, or a sustained economic downturn relative to its larger listed property peers. Although in its defence, PFI's portfolio has the lowest average asset value in the sector of $13 million per property, implying a higher level of liquidity should a downturn occur. We forecast PFI's gearing to remain prudently around the 30% level, similar to its larger listed peers. However, we believe that PFI's portfolio inherently carries somewhat more risk than its peers. This reflects PFI's smaller scale, largely single industry (industrial) and location (Auckland) exposure, asset quality with a number of secondary assets and a less diversified funding base. Therefore, in combination with PFI's current and forecast financial ratios we believe that PFI would probably achieve a BBB- credit rating if it were rated.

The indicative margin of 1.65-1.80%pa on the PFI010 issue appears to represent fair value relative to comparable securities such as KPG020 and GMB040 trading at spreads of 1.54% and 1.40%, respectively. However, the term to maturity of seven years is longer than we would prefer. Consequently, for those investors seeking an unrated security for a diversified debt portfolio where a longer term to maturity is warranted, we believe that the PFI010 issue should be considered.

# Summary Features

| Issue Code | Amount on Issue $m | Minimum Holding $ | Holding Increment $ | Maturity | Coupon % | Interest Payment |
|---|---|---|---|---|---|---|
| PFI010 | up to 100 | 5,000 | 1,000 | 28 Nov 2024 | 4.52-4.67 | feb/may/aug/nov |

Source: PFI, FNZC

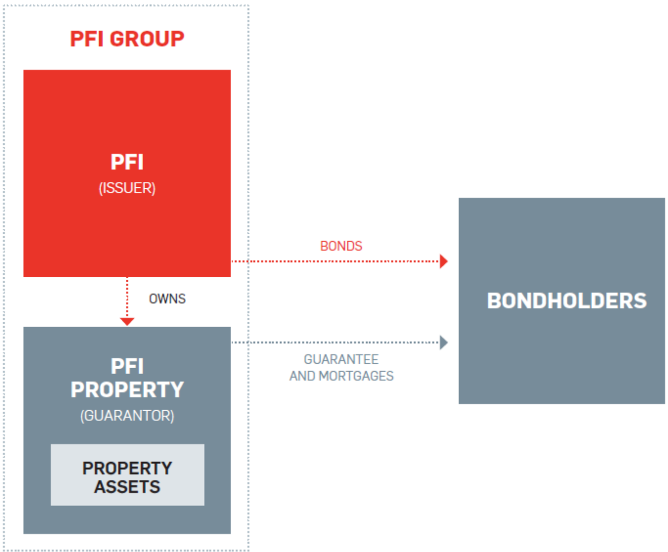
* PFI has announced the terms of an offer of up to $100 million of senior, secured, fixed rate bonds (PFI010). The indicative margin has been set at 1.65-1.80%pa over the 7-year swap interest rate, which would imply an interest rate of between 4.52-4.67%pa if it were set today. A minimum interest rate has been set at 4.55%pa.

**Issuer** Property for Industry Limited (PFI).

**Issuer Credit Rating** Not rated.

**Type of Security** Senior, Secured, Fixed Rate Bonds.

**Guarantors** P.F.I. Property No. 1 (PFI Property, a subsidiary of PFI) over the mortgaged properties, which will have a total value of approximately $1.14 billion.




Source: PFI

**Bond Covenant** PFI must ensure the Loan to Value Ratio is no more than 50% at all times. A breach of the Loan to Value Ratio, which is not remedied within 13 months, will be an Event of Default.

**Dividend Stopper** PFI is not permitted to make any distribution if an Event of Default is continuing or if it would result in an Event of Default. For examples of an Event of Default, refer to page 12 of the Product Disclosure Statement.

**Early Bird Interest** Payable at the Interest Rate on successful applications for the time between when the money is banked and the Issue Date. Early Bird Interest will be paid within five business days after the Issue Date.

**Listing** NZDX*.

**Supervisor** Public Trust.

| | |
|---|---|
| **Security Trustee** | New Zealand Permanent Trustees limited |
| **Registry** | Computershare Investor Services Limited. |

*Application has been made to NZX for permission to quote PFI010 bonds on the NZX Debt Market and all of the requirements of NZX relating thereto that can be complied with on or before the date of this document have been duly complied with. However, NZX accepts no responsibility for any statement in this document. The NZDX is a registered market operated by NZX, which is a registered exchange, regulated under the Financial Markets Conduct Act 2013.

# Key Issuer Information

## Issuer Profile

Property for Industry (PFI) is an internally managed New Zealand listed property vehicle (LPV) that owns a $1.2 billion portfolio of prime and secondary grade industrial properties throughout New Zealand. PFI holds 82% of its portfolio in Auckland, with smaller exposures in Mount Maunganui, Wellington, Christchurch and New Plymouth.

Recently, PFI acquired a portfolio of nine properties for $69.5 million in a sale and leaseback deal from Transport Investments Limited (TIL). The acquired properties are 100% occupied and have a passing yield of 7.22%. The properties' weighted average lease term (WALT) sits at 13.9 years, with 15-year lease terms on seven of the properties. Of the nine assets acquired, seven are leased to TIL, with the remaining two properties leased to NZ Post, Aviagen, and Rockgas.

## Principal Risks

PFI is subject to general business, operational and financial risks that may have a material impact on the financial position of PFI. In addition, there are a number of specific risks, which include:

- **Financial risks** – This includes the risk that PFI has insufficient funds to meet its operational expenses, capital commitments and to refinance debt when it falls due for repayment. Any increase in interest rates will increase PFI's interest cost, which will have an adverse impact on profit.
- **Insurance risk**– PFI maintains insurance cover for natural disasters for material damage to its properties and for business interruption, which would mitigate some of the impact of any such event. There is a future risk that certain cover cannot be renewed or that full cover is not provided.
- **Property market risk** – Adverse changes in property market conditions in NZ, specifically Auckland where most of the assets are located, may impact the value of PFI's assets and the amount of income its properties can generate. PFI is able to mitigate this risk somewhat through its exposure to industrial property, which is relatively more defensive over the long term, diversification of its portfolio income through a large number of properties and relatively low tenant concentration.
- **Direct property risk** – Specific risks to the rental income and/or the market value of specific properties including unforeseen capital expenditure or material repairs and maintenance costs that are not recoverable from tenants, changes in leasing terms, the financial strength of PFI's major tenants and obsolescence risk.
- **Development risk** – Potential risks associated with property development include the impact of industrial disputes, inclement weather causing delays, cost escalation, unforeseen construction difficulties and unexpected problems such as hazardous materials or environmental problems. PFI's development strategy is largely focussed on maximising the utilisation of surplus land. This development typically lower risk than pure green field developments.

## Financial Performance

| Year end 31 December | 2014 Actual | 2015 Actual | 2016 Actual | 2017 Forecast | 2018 Forecast | 2019 Forecast |
|---|---|---|---|---|---|---|
| Net Rental Income $m | 63.8 | 66.9 | 71.1 | 72.8 | 78.5 | 80.4 |
| EBITDA $m (1) | 55.1 | 55.9 | 61.0 | 64.8 | 72.5 | 74.3 |
| Reported Net Profit $m | 59.9 | 72.8 | 34.1 | 36.6 | 42.0 | 43.4 |
| Adjusted Net Profit $m (2) | 30.5 | 29.6 | 34.1 | 36.6 | 42.0 | 43.4 |
| Total Capital Expenditure $m | -0.7 | 69.8 | 10.0 | 71.4 | 6.0 | 3.7 |

Source: PFI, FNZC

Notes: 1. EBITDA is earnings before interest, tax, depreciation, amortisation, change in fair value of financial instruments, impairment.
2. Reported net profit after tax adjusted for one off items (including impairments, property revaluations and change in value of financial investments).

In its most recent profit result in August, PFI reported net property income (NPI) of $35.7 million for 1H17, which was broadly in line with expectations and 1.4% up on 1H16. Market conditions remain supportive in the industrial sector with a healthy level of activity, a scarcity of land in Auckland, continuing low levels of vacancy placing upward pressure on market rentals and minimal incentive payable. This is expected to flow into PFI's 2H17 profit where 13% of its portfolio is subject to various events (market rent reviews, lease expiries and vacancy) which should benefit from the market related rental growth. Additionally, PFI's recent internalisation of its management contract should see a decline in operating costs, which is positive.

PFI's portfolio metrics remain solid with occupancy of 99.6% and a weighted average lease term (WALT) of 5.4 years. PFI continue to make progress on its near-term leasing expiries, reducing expiries to 1.4% through to 31 December 2017 (from 11.2% as at 31 December 2016). PFI's FY19 lease expiries are somewhat elevated at around 16%. However, we are relatively confident PFI will manage this risk well ahead of expiry. The recently acquired TIL portfolio adds to PFI's strong metrics with 100% occupancy, a WALT of 13.9 years and rents at market levels.

PFI's acquisition/development strategy remains focussed on sourcing assets that have value-add development opportunities. We believe this strategy is sensible given current market dynamics and pricing within the secondary industrial space. The TIL acquisition was a good example with the site coverage of assets acquired averaging 25% (ranging from 13% - 46%), implying future development potential exists. However, this is likely to depend somewhat on TIL's requirement to expand, hence near-term development appears unlikely.

The acquisition/development strategy results in a relatively modest capital expenditure profile, apart from the lumpy acquisitions observed in FY15 ($56.9 million) and FY17 ($69.5 million). PFI have typically funded its strategy through raising new equity capital and property divestment. PFI remains with around 5% (or $55 million) of its asset base defined as 'non-core', which it may look to divest should attractive opportunities arise.

## Financial Ratios

| Year end 31 December | 2014 Actual | 2015 Actual | 2016 Actual | 2017 Forecast | 2018 Forecast | 2019 Forecast |
|---|---|---|---|---|---|---|
| **Operational ratios** | | | | | | |
| EBITDA/Revenue | 86.4% | 83.6% | 85.7% | 89.0% | 92.4% | 92.5% |
| Return on Capital Employed | 6.0% | 6.0% | 5.8% | 5.6% | 6.0% | 6.0% |
| **Fixed Charge Ratio** | | | | | | |
| EBITDA/Interest x (1) | 2.9 | 2.7 | 3.4 | 3.5 | 3.7 | 3.7 |
| EBIT/Net Interest Expense x | 3.0 | 2.9 | 3.4 | 3.6 | 3.7 | 3.7 |
| **Asset Protection (Gearing)** | | | | | | |
| Total Debt/Total Debt + Equity | 35.6% | 33.5% | 30.6% | 31.2% | 30.1% | 29.2% |
| **Cashflow Ratios** | | | | | | |
| Total Debt/EBITDA x | 8.3 | 5.8 | 5.4 | 5.5 | 5.1 | 4.9 |
| Funds from Operations/Total Debt | 8% | 11% | 10% | -1% | 11% | 12% |
| Discretionary Cashflow/Total Debt | 0% | -20% | -1% | -31% | 1% | 2% |
| Operating Cashflow/Total Capital Expenditure x | -16.8 | 0.5 | 3.4 | -0.1 | 7.0 | 11.9 |

Source: PFI, FNZC

Notes: 1. Interest includes capitalised interest.

Following the merger with Direct Property Fund (DPF) in 2013, which more than doubled the value of PFI's portfolio, and a number of acquisitions, PFI now has an appropriate amount scale from which to leverage its asset base. This, and the internalisation of the management, should drive the improved operating margin (EBITDA/revenue) forecasts above, thereby helping to close the gap with PFI's larger sector peers. The return on capital employed largely reflects the yields generated through the properties held in the portfolio, which has incrementally trended down in the low interest rate environment. This ratio is forecast to recover as PFI continue to optimise its portfolio through its recent acquisitions and further divestments.

With new developments and acquisitions generating additional income for PFI, EBITDA growth has continued to outpace interest expense growth. In part, this reflects proportionally lower growth in debt levels and the lower cost of debt. As a result, PFI's interest cover (EBITDA/net interest plus capitalised interest) improved to 3.4x in FY16, with further improvement expected.

The gearing ratio (total debt/total debt + equity) was 30.1% as at 30 June 2017. When adjusted for the TIL acquisition and associated $70 million equity raising, the pro-forma gearing is 32.3%. We believe this remains comfortable for PFI and is very much in line with its sector peers. Further capital recycling and the expectation PFI will restart its dividend reinvestment programme should provide it with adequate funding capacity to maintain its current gearing level over the forecast period. Bondholders can also take comfort that the new debt issuance will be used to repay existing bank funding as opposed to increasing PFI's debt.

PFI's "total debt / EBITDA" has improved on increased earnings relative to debt. Meanwhile "funds from operations / total debt" has remained relative stable, with the exception of FY17 which was affected by the $42 million internalisation payment. The other two ratios have been much more volatile due to the impact of investments/divestments.

## Bond Covenant

The financial covenant limits the ability of the PFI to borrow money secured by property to no more than 50% of the total value of mortgages properties. It is effectively a Loan to Value Ratio (LVR) of no more than 50%. The pro forma LVR was 33.1% as at 30 June 2017, which is comfortably below the 50% threshold. PFI's LVR differs slightly from its gearing level of 32.3%, which is based on the total value of the property portfolio that included $31.1 million of properties not mortgaged as at 30 June 2017.

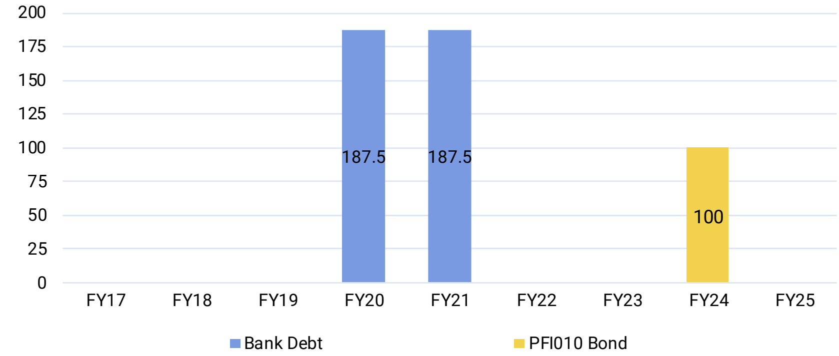
| Year end 31 December | 2013<br>Actual | 2014<br>Actual | 2015<br>Actual | 2016<br>Actual | 1H17<br>Actual |
|---|---|---|---|---|---|
| Covenant - Loan to Value Ratio | 39.3% | 36.8% | 34.3% | 31.5% | 33.1% |

Source: PFI, FNZC

## Debt Maturity Profile

The graph below shows the debt maturity profile for PFI. Assuming PFI issues $100 million of PFI010 bonds, the proceeds will be used to repay existing bank debt, resulting in a more diversified funding base:

Pro Forma Debt Maturity Profile as at 30 June 2017 ($m)




Source: PFI, FNZC

## Credit Rating

We have undertaken a brief analysis of PFI's potential credit rating using the criteria used by Standard & Poor's, comparing PFI with other listed property companies and using high-level information.

PFI have recently completed the acquisition of nine industrial properties from Transport Investments Limited (TIL) in a sale and leaseback deal. To date, PFI has successfully executed its strategy of purchasing assets that may be lower quality, on softer yields, and/or with shorter lease terms where value add opportunities exist through a re-development or the re-leasing process. We view this approach as sensible given the current market pricing within the industrial property sector. Over recent years, the Auckland Industrial market has seen significant firming in yields and associated rising asset values, with rental rates increasing from $110 square metre three years ago to $125-135 square metre currently.

Given PFI's portfolio consists of both prime and secondary industrial property assets, we believe its portfolio is more susceptible to any downturn in Auckland's industrial market, or a sustained economic downturn, relative to its larger listed property peers. This has the potential to affect PFI in many ways, from negatively impacting rental income, asset values, occupancy rates, expected development margins and leasing outcomes. In saying that, despite the single sector exposure of PFI, the portfolio has the lowest average asset value in the sector of $13 million per property, implying a higher level of liquidity. Hence, PFI should be able to adequately manage any pressure on gearing and balance sheet capacity through asset sales should a significant property downturn occur.

In order to execute its acquisition/development strategy, PFI have a number of options available to raise funds, including raising equity as it did in FY15 ($49.5 million) and November 2017 ($69.5 million), divesting non-core assets or re-introducing its dividend reinvestment programme. We view PFI's growth strategy as positive, with limited emphasis on development activities given the arguably later stage of the property cycle. This also applies to our view on PFI's gearing, which we forecast to remain around the 30% level, similar to its larger listed property peers and well under PFI's upper gearing limit of 40%. We are increasingly confident given PFI's intention to transition to a more sustainable distribution policy where dividends will align more with cash earnings.

Operating conditions within the industrial property sector remain favourable as sustained economic growth supports solid tenant demand. This has resulted in a very high occupancy rate of 99.6%, an extended weighted average lease term (WALT) of 5.4 years and a recent history of reasonably stable operating income and profit margins. We observe that PFI has a good level of headroom in its bond covenant – a 33% decline in the value of PFI's mortgaged property assets would still not breach the LVR covenant. However, we believe that PFI's portfolio inherently carries more risk than its larger listed peers. This reflects PFI's smaller scale, largely single industrial property and Auckland location exposure, asset quality with a number of secondary assets and a less diversified funding base.

Based on the preceding qualitative factors and PFI's current and forecast financial ratios we believe that PFI would probably achieve a BBB- credit rating if it were rated. We note that this is one notch lower than the BBB credit rating which Standard & Poor's has assigned Goodman Property Trust (GMT), although the GMT Bond Issuer securities are rated BBB+ which reflects the structure of its special purpose vehicle. It is also one notch lower than where we assess Kiwi Property Group (KPG) and Precinct Properties (PCT) would achieve a credit rating, if they were rated.

Continued on next page.

# Investment View

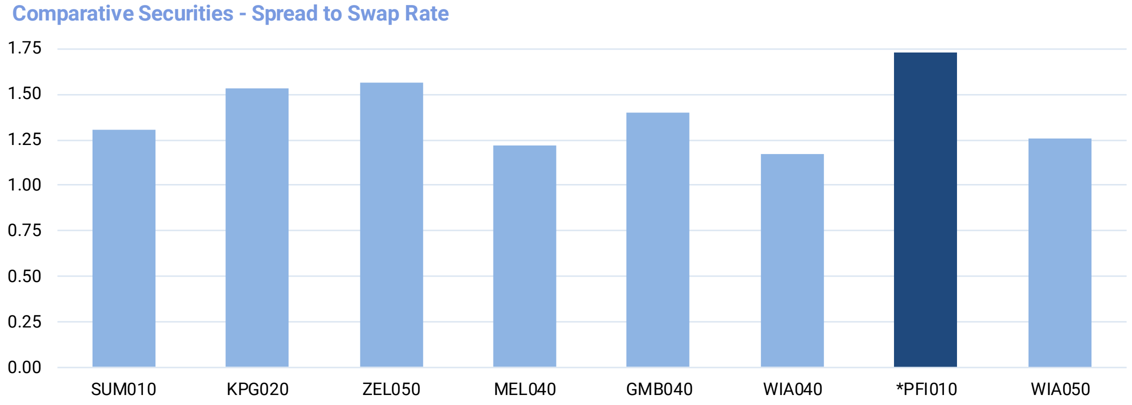
| Issue Code | Maturity Date | Yield | Spread to Swap Interest Rate |
|---|---|---|---|
| PFI010 | 28 Nov 2024 | 4.52-4.67 | 1.65-1.80 |

Source: PFI, FNZC

* The indicative margin has been set at 1.65-1.80%pa over the 7-year swap interest rate, which would imply an interest rate of between 4.52-4.67%pa if it were set today. A minimum interest rate has been set at 4.55%pa.

## Comparative Securities

The following securities are all unsubordinated (senior) debt securities.




Source: PFI, Thomson Reuters, FNZC

| Issuer | Security Code | Credit Rating (1) | Maturity Date | Spread to Swap Interest Rate % | Indicative Liquidity |
|---|---|---|---|---|---|
| Summerset | SUM010 | Not rated | 11/07/2023 | 1.30 | Good |
| Kiwi Property Management | KPG020 | Not rated | 07/09/2023 | 1.54 | Medium |
| Z Energy | ZEL050 | Not rated | 01/11/2023 | 1.57 | Low |
| Meridian Energy | MEL040 | BBB+ | 20/03/2024 | 1.22 | Medium |
| GMT Bond Issuer | GMB040 | BBB+ | 31/05/2024 | 1.40 | Very low |
| Wellington International Airport | WIA040 | BBB+ | 05/08/2024 | 1.18 | Low |
| **Property for Industry** | ***PFI010** | **Not rated** | **28/11/2024** | **1.73** | **New issue** |
| Wellington International Airport | WIA050 | BBB+ | 16/06/2025 | 1.26 | Good |

Source: PFI, Thomson Reuters, FNZC

Notes: 1. Current credit ratings are from Standard & Poor's (S&P).
2. The indicative margin on the PFI010 issue has been set at 1.65-1.80% over the swap interest rate. The midpoint of this range is shown in the above graph and table.
3. This comparison is limited to the spread to swap rate chart above and the summary issuer table above it. It is not, nor is intended to be, a comparison of the key feature of each issuer.

While PFI does not have a credit rating we expect that it would probably achieve a BBB- credit rating if it were rated (see discussion above). It is worth noting the credit rating of fellow listed property companies in the above table: 1) Goodman Property Trust (GMT) has a credit rating of BBB, although the GMT Bond Issuer (GMB) bonds are rated BBB+ which reflects the structure of the special purpose vehicle used to issue the bonds. 2) Kiwi Property Group (KPG) and Precinct Properties (PCT) do not have a credit rating, but we expect that they would probably achieve a BBB credit rating if it were rated.

We expect the features of the new PFI010 issue (new property issuer, non-bank and smaller issue size of up to $100 million) will attract good investor interest. Therefore, we believe the final spread will likely be set at lower end of the indicative range of 1.65-1.80%, potentially triggering the minimum interest rate of 4.55%pa (margin of 1.68%).

In analysing the new PFI010 issue, the most comparable securities in the market are the other listed property sector securities – KPG020 and GMB040. The unrated KPG020 security is currently trading at spread of 1.54%. If the PFI010 margin is set at 1.68%, we believe it represents a fair premium given KPG020 is more than 12 months shorter in term and is assessed to be of slightly better credit quality. The BBB+ rated GMB040 security is trading at a spread of 1.40%, which appears appropriate given the transparency that comes with a Standard and Poor's credit rating. Consequently, the PFI010 offer appears to represent fair value for a new issue relative to these comparable securities.

As expected, the potential 1.68% margin for PFI010 is materially higher than the 1.20-1.25% spread at which the MEL040, WIA040 and WIA050 securities currently trade. We believe that this reflects their BBB+ credit rating and PFI010 offering a small premium as a new issue. Hence, PFI010 appears to offer fair value relative to other debt securities. It is worth noting that the yields at which 'BBB' rated bonds trade have been impacted by the lack of supply of debt securities for investment. This has resulted in downward pressure on yields, particularly for unrated 'BBB' bonds with a term to maturity longer than four years. Consequently, the premium earned on unrated securities remains modest relative to rated securities.

In general, we remain cautious on securities which have terms to maturity longer than five years, given the recent interest rate volatility and our expectation that long-term interest rates will gradually rise. Consequently, we believe that companies wishing to issue debt securities with terms to maturity of five years or more should provide investors with a higher margin to compensate for investing for a longer term at a time when interest rates are rising and markets are volatile. The indicative margin for PFI010 appears to compensate for this. While the indicative margin for PFI010 appears fair value, the term to maturity of seven years is longer than we would prefer. However, for those investors seeking a security for a diversified debt portfolio where a 7-year term to maturity is warranted, we believe that the PFI010 bonds should be considered.

Finally, it is worth noting that the liquidity on some of the securities listed above is low, and thus may not be able to be purchased at the spreads indicated. Being a new issue, this is not anticipated to be a problem for investors looking to invest in the PFI010 security.

## FNZC Wealth Management Research

**Tim Agar**

**Vice President, Research Analyst**

**7 November 2017**

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A Disclosure Statement is available on request, free of charge.


## First NZ Capital Securities Limited

**Auckland**

| | | |
|---|---|---|
| Level 39, ANZ Centre, | Freephone | 0800 805 584 |
| 23-29 Albert Street | Phone | +64 9 302 5500 |
| PO Box 5333, Auckland | Fax | +64 9 377 6761 |

**Wellington**

| | | |
|---|---|---|
| Level 14, ANZ Centre, | Freephone | 0800 800 968 |
| 171 Featherston Street | Phone | +64 4 474 4400 |
| PO Box 3394, Wellington | Fax | +64 4 496 5311 |

**Havelock North**

| | | |
|---|---|---|
| Level 1, The Village Exchange, | Freephone | 0800 562 543 |
| 1 Havelock Road | Phone | +64 6 877 9074 |
| PO Box 28153,Havelock North | Fax | +64 6 877 9079 |

**Victoria Park, Auckland**

| | | |
|---|---|---|
| Victoria Park Office, | Freephone | 0800 805 584 |
| 95 Union Street, Freemans Bay | Phone | +64 9 307 5702 |
| Auckland 1010 | | |

**Christchurch**

| | | |
|---|---|---|
| Level 1, | Freephone | 0800 123 053 |
| 148 Victoria Street, | Phone | +64 3 336 5373 |
| PO Box 25258, Christchurch | Fax | +64 3 336 5375 |

**Nelson**

| | | |
|---|---|---|
| Level 1, 6 Akersten Street | Freephone | 0800 502 828 |
| 6 Akersten Street | Phone | +64 3 548 8319 |
| PO Box 114, Nelson | Fax | +64 3 548 0593 |