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CHANGING OF THE GUARD

FEATURE ARTICLE: FOREIGN INVESTMENT IN NEW ZEALAND PRIMARY SECTORS

Foreign ownership, particularly of rural land, is a controversial and emotive topic. A huge proportion of New Zealand's comparative advantage resides in our land and the income generated from it. As such, there is strong interest in maintaining local ownership. A firm but fair regulatory framework is key. Yet New Zealand also needs to recognise the many benefits that foreign ownership can bring in the form of capital, market access, innovation and opening up untapped opportunities. Current angst over foreign ownership also deflects attention from New Zealand's poor saving record, resulting reliance on foreign saving and poor relative investment returns. A more proactive stance towards saving and investing is an important part of any policy solution.

THE MONTH IN REVIEW

Warm summery conditions since November have seen many areas of the country turn from being too wet to dry in a short period of time. Dry conditions can have varying impacts on different sectors depending on severity and timing.

RURAL PROPERTY MARKET

The rural property market is currently at an interesting juncture. There are mixed valuation signals stemming from the different outlooks for sector earnings, regulatory change on a number of fronts, tighter bank lending criteria and supply/demand dynamics. The dairy market has the most cautious tone.

KEY COMMODITIES AND FINANCIAL MARKET VARIABLES

We see modest upside for the NZD as most of the bad news is already acknowledged. We remain constructive on the global growth outlook. Not only should that mean any domestic growth hiccup is not long-lasting; historically a positive global picture has been consistent with a rising NZD. While New Zealand's commodity price cycle has run out of steam and changing supply dynamics are providing a turning point for some sectors, a positive growth backdrop in major markets provides an offset.

BORROWING STRATEGY

Indicative rural lending rates have changed only modestly, with the curve steepening slightly. The floating rate remains the lowest on offer, and continues to look attractive given our view that the OCR is on hold until late next year (at least). In saying that, with long-term rates still near historic lows, they do admittedly offer some value for borrowers looking for more certainty. But with plenty of uncertainty over the global growth and inflation outlook, some ongoing caution about fixing is warranted.

ECONOMIC BACKDROP

Our views on the economic outlook have become more nuanced. While we retain a broadly constructive view of the medium-term growth picture, we have turned more circumspect near term, and see a heightened chance of a growth wobble. Above-trend growth is hard to achieve when the most cyclical part of the economy (housing) looks set to remain soft.

EDUCATION CORNER: PATHWAYS TO FARM BUSINESS OWNERSHIP

Farm succession and attracting or retaining talent remains challenging for many with a primary sector business. With this in mind we take a look at the three main pathways to farm ownership in the Red Meat sector: equity partnership, leasing and share farming. The initial steps to formation, challenges, benefits and keys to success for arrangements apply equally to other primary sector businesses too.

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SUMMARY

Foreign ownership, particularly of rural land, is a controversial and emotive topic. In this article we look at the broader issues. A huge proportion of New Zealand's comparative advantage resides in our land and the income generated from it. As such, there is strong interest in maintaining local ownership. A firm but fair regulatory framework is key. Yet, New Zealand also needs to recognise the many benefits that foreign ownership can bring.

Foreign ownership in the rural land sphere has been very influential in the forestry, viticulture and pipfruit sectors – these sectors wouldn't be where they are today without it. Despite common perceptions, foreign ownership has been less influential in sectors such as dairy and meat & fibre. While there is angst about land ownership, foreign investment beyond the farm-gate has arguably been much more significant in influencing sector direction. This is especially so for the beverage (69% of turnover) and processed food (60%) sectors, but is true for all to some extent. Without it, the growth in independent milk companies, many wineries or pipfruit businesses wouldn't have been nearly as great.

With the political breeze clearly favouring a more restrictive stance, it will be interesting to see how far the pendulum swings. If it swings too far, there could be immediate implications for asset valuations in sectors where foreign investment has been the greatest – namely forestry, pipfruit, viticulture and large-scale operations. But perhaps more importantly, there would likely be negative long-term implications for high-growth sectors that would struggle to meet their aspirations. There could be negative impacts on productivity, innovation, market access, infrastructure and wages across some of New Zealand's key business sectors.

Current angst over foreign ownership deflects attention from the heart of the issue: New Zealand's poor saving record, resulting reliance on foreign saving and poor relative investment returns. A more proactive stance towards saving is an important part of the solution.

Access to capital is fundamental to our long-term prosperity. It is as imperative as trade flows, but with a longer-term impact. We need to attract capital to our productive businesses from both local sources and from offshore. At the same time we must find ways to improve our offshore investment returns. As with inward investment, the opportunity around partnering or co-investing to de-risk global markets may be a sensible way to achieve this.

TAKING THE EMOTION OUT

In our travels around the country, we are constantly asked for our opinion on foreign ownership of New Zealand land and businesses. There are wider issues to think about when tackling the topic. In this article, we outline the broader issues surrounding the debate and put it into context.

OBSERVATION 1: FOREIGN OWNERSHIP IS NOTHING NEW

The big picture

There is always a fear that selling New Zealand assets to foreign investors will result in ceding control and a loss of sovereignty. Another common argument is that "selling the family jewels" will leave New Zealanders owning very little in their own country. A huge proportion of New Zealand's comparative advantage resides in the land beneath our feet. The standard argument is that the sale of it undermines the next generation's earning capacity, with the returns on the land accruing offshore as opposed to locally. You can see this in New Zealand's balance of payments figures, which show net international liabilities currently sitting at 57% of GDP – albeit this is well below its peak of 84% of GDP in 2009. The net cost to the country from that large stock of international liabilities (either via interest payments or dividends that flow offshore) totalled the princely sum of $9 billion in the last year – a non-trivial sum that would of course be much better in our own pockets!

Foreign investment in New Zealand is nothing new though, and it should be remembered that it is not just equity – the majority is actually debt. As at 31 March 2017, the latest data available shows total foreign investment stood at $373bn (excluding financial derivatives and reserve assets), compared to $75bn in 1992. Of that, only $113bn is direct investment – of which nearly half is owned by Australians. The second-largest foreign direct investors in New Zealand are the Americans, with the Chinese (including Hong Kong) third on the list. Our direct foreign investment, at 43% of GDP, is slightly above the OECD average, but about average for a small, open, advanced economy.

At the same time New Zealand has $220.5bn of offshore investment, with $36bn of direct investments. The direct component equates to 14% of GDP, which is low compared to all other OECD countries (average 36%), and low in particular for a small, open, advanced economy. This reflects the lack of large companies in New Zealand with the capacity to invest offshore. It also indicates that we are yet to make the most of the

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opportunities presented by better market access and globalisation trends. Most of New Zealand's investment abroad is to Australia (50%) and comes from our manufacturing (36%) and wholesale trade (22%) sectors.

Table 1: Foreign investment in New Zealand (as at 31 March 2017)

Country	Direct investment		Portfolio and other		Total investment	
	$bn	%	$bn	%	$bn	%
Australia	53.3	47%	54.7	21%	108.1	29%
United Kingdom	5.5	5%	53.7	21%	59.1	16%
US	8.2	7%	28.2	11%	36.4	10%
Japan	5.3	5%	5.5	2%	10.7	3%
Hong Kong	6.3	6%	3.8	1%	10.1	3%
Netherlands	4.1	4%	4.5	2%	8.6	2%
China	1.1	1%	5.5	2%	6.6	2%
Singapore	4.6	4%	1.7	1%	6.3	2%
Switzerland	0.9	1%	1.5	1%	2.4	1%
France	0.1	0%	0.3	0%	0.4	0%
Other	23.6	21%	100.3	39%	124.0	33%
Total	**113.0**	**100%**	**259.8**	**100%**	**372.7**	**100%**

Source: ANZ, Statistics NZ

By sector, foreign investment is most concentrated in the financial and insurance services sector, which accounts for around half of the total. Ultimately most of this reflects the banking sector's role as the intermediary in channelling the saving of foreigners to New Zealand households to purchase houses, given an insufficient domestic saving performance. Foreign investment in public administration (aka government debt used to fund public services, infrastructure, utilities etc) and the manufacturing sector are the second and third-largest areas of foreign investment, accounting for 14% and 7% of total investment respectively. **In fact foreigners currently hold 58% of the government securities available on the secondary market (which excludes debt held by the RBNZ and EQC). The amount of foreign investment in New Zealand's agricultural sector is actually relatively small, at $7.6bn, or around 2% of total foreign investment.**

Of course, most of the recent controversy about foreign investment has been its direct effect on Auckland house prices and to what extent this should be restricted, or completely banned. **In the primary sector space, the controversy that usually arises is when a landmark or an 'iconic' piece of land is to be sold into foreign ownership.** New Zealand's total agriculture and forestry land area is currently estimated to be around 14.4 million hectares (last census in 2012). How much of this is in foreign hands is difficult to know as there is no complete register as yet (i.e. sales and purchases through time), but the new government is proposing one, in time.

Primary sector view

What we do know from analysing land transactions approved by the Overseas Investment Office (OIO), is that since 2001 there have been approximately 2,480 in total (nearly 2000 for freehold land, the rest leased). **These approvals have involved a gross[1] land area of 2.186m hectares, of which a net 0.958m hectares (44%) was proposed to go into direct foreign ownership** (two thirds freehold, one third lease by area). This highlights many of the foreign ownership approvals are often joint ventures with New Zealand companies.

Table 2: Foreign investment in New Zealand land since 2001

OIO Land Sale Consents			
Calendar year	Number of approvals*	Net land area (ha)	Gross land area (ha)
2001	228	64,421	98,861
2002	245	35,800	77,347
2003	207	26,393	36,157
2004	155	55,166	410,144
2005	172	51,498	165,518
2006	145	270,508	396,962
2007	125	16,580	90,355
2008	126	38,696	70,562
2009	156	32,242	158,644
2010	102	31,830	47,551
2011	142	91,681	217,126
2012	110	33,870	51,634
2013	115	80,083	128,173
2014	145	27,879	40,791
2015	118	32,879	79,897
2016	124	39,971	82,713
2017 YTD	62	28,271	33,768
Total	**2,477**	**957,768**	**2,186,203**

* Number of approvals includes an element of double counting as adds freehold and non-freehold applications together when in reality some transactions include both, but are split out separately in the collected statistics.
Source: ANZ, Overseas Investment Office

While it is unknown whether or not this land was actually sold; whether the foreign investor subsequently became a resident; and/or resold to another foreign investor or a New Zealander, at face value **it indicates that 15% of the total agriculture and forestry land in New Zealand has involved some form of foreign investment since 2001.**

[1] Net land area represents the total land area proposed to be transferred into foreign ownership, while gross land area is what has been consented for an entire venture. For example, a 50:50 joint venture between a NZ-owned and foreign-owned company that purchases 100ha mean that the gross land area approved is 100 ha, while the net land area is only 50 ha.

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Splitting approvals by land type since 2005 (as far back as we have data) **shows 58% of the gross area approved by the OIO was forestry-related, 31% agriculture and 10% other/lifestyle.**

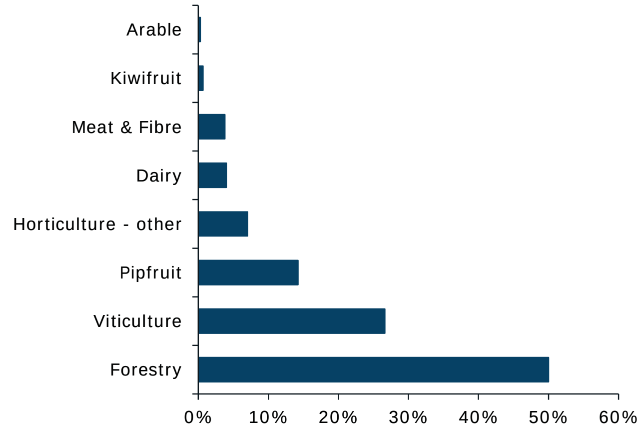
Forestry stands out. Indeed, since 2005 the cumulative gross area approved for foreign investment represents 50% of New Zealand's total forestry area. While the net area approved for foreign ownership would be lower than this (we don't have data), estimates of actual foreign ownership range from 60% to 75% of the total forestry area. This is the highest level of any land use. This is the highest level of any land use and one reason the new government appears to be taking a less restrictive stance compared with other land uses under its new directive to the OIO.

The cumulative gross foreign investment approvals for viticulture and pipfruit account for the next highest proportion of their land area, at 27% and 14% respectively. In both cases the majority of the activity was concentrated amongst a handful of large multinational corporates. Other horticulture (vegetables etc) was higher than we expected at 7% of estimated land area. However, foreign investment in meat & fibre and dairy land since 2005 represented only 4% of total area, likely a lot lower than the general perception.

Of course it also needs to be remembered the 'net' aggregate land area that was approved for foreign ownership was only 44% of the total gross figure, but we don't have it broken down by land type.

The bottom line is that outside of forestry, viticulture and pipfruit, the area of direct land sold to foreign investors in the past 12 years seems to have been relatively small. This is not meant to trivialise the issue, but rather to put it in perspective. **Of course, the real issue is that such effects accumulate over time,** so if you add up the land area sold over a longer period of time you start getting into some chunky numbers.

Figure 1: Cumulative gross foreign investment as % of total area by major land use since 2005



Source: ANZ, Overseas Investment Office, Statistics NZ

That said, both the number of foreign investor transactions approved and the associated area seems to have actually dipped in recent years. In fact, since the further tightening in foreign investment rules in 2011 the average number of transactions approved each year has dropped by 24% and the gross area by 33%. So the perception of a sustained trend higher in approvals seems misplaced.

Table 3: Area of gross foreign investment by major land use since 2005

Year	Forestry	Meat & Fibre	Dairy	Arable	Viticulture	Pipfruit	Kiwifruit	Horticulture – other	Lifestyle	Total
2005	140,695	877	11		1,637			4	358	143,581
2006	107,923	46,520	499	626	937	39		8	103	156,655
2007	67,478	6,486	516	163	134	62		510	39	75,388
2008	20,365	31,158	828		272	0		6		52,628
2009	58,602	42,094	1,289		859	57	38	661	415	104,015
2010	109,744	19,180	5,482		1,059			122	85	135,672
2011	83,420	85,027	3,526		2,257			243	35	174,508
2012	29,929	6,919	11,593		306	696		463	5	49,910
2013	100,385	63,825	32,981		1,174	123		375	7	198,871
2014	6,371	6,186	18,418		2,630	1,017	40	149		34,811
2015	42,200	23,482	4,823		1,590		59	272		72,426
2016	114,929	20,195	15,933		1,232	155	37	689		153,169
2017	12,002	14,264	426		318	18	6	17		27,051
Grand total	**894,042**	**366,212**	**96,325**	**789**	**14,403**	**2,167**	**180**	**3,518**	**1,047**	**1,378,685**

Source: ANZ, Overseas Investment Office

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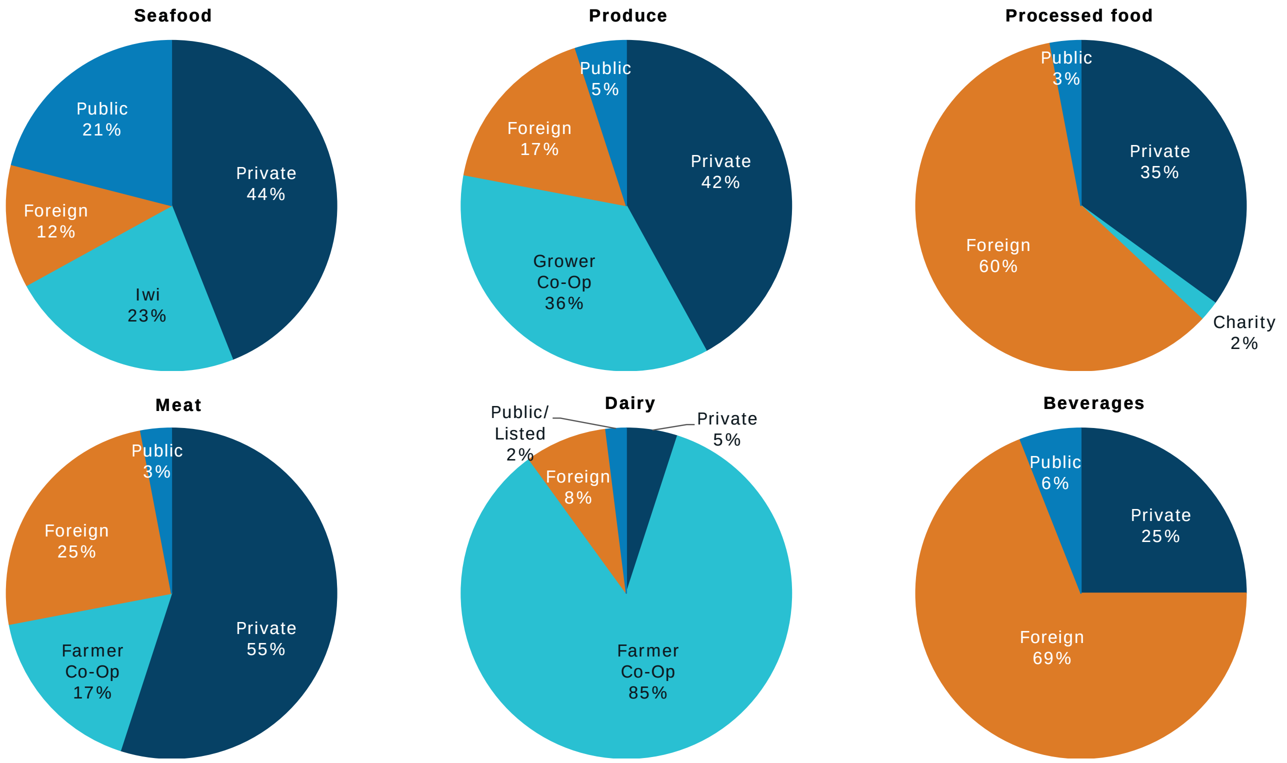
Figure 2: Beyond the farm-gate ownership by sector turnover, % of turnover/sales, 2016



Source: Food & Beverage Information Project – Coriolis

The only thing that will truly put the debate into perspective is a foreign registry of land, so we await that with interest.

Beyond the farm-gate

While the spotlight is often turned on foreign investment in land, in most sectors there has, in fact, been a higher penetration in businesses beyond the farm-gate. The same arguments around ceding control, locking up the supply chain, "selling the family jewels", unduly inflating asset valuations, loss of returns, exploitation etc can just as easily be levelled here too.

Analysis by Coriolis and the Government showed the share of foreign ownership by turnover of different sectors at the start of 2017. **By turnover, the highest proportion of foreign ownership was for the beverage sector, at 69%, followed closely by processed food, at 60%. Further down the ladder were meat (25%), produce (17%) and seafood (12%). Dairy had the lowest foreign investment share at 8%.** This is unsurprising given Fonterra's position in the marketplace, but perhaps what is surprising is that all of the other non-cooperative milk companies have some form of foreign ownership with offtake/processing arrangements. And of course Fonterra has some foreign ownership now, as its change of capital structure to somewhat of a cooperative hybrid has allowed some. Without this foreign investment the likes of the independent milk companies and sectors such as pipfruit and viticulture would not have grown into what they represent today. Many of these sectors have strong growth prospects too and provision of capital, channels to market, and other IP from foreign partners will be critical in fulfilling their potential.

In total there are estimated to be about 9,650 enterprises operating in New Zealand with some foreign investment (about 2% of enterprises), but these businesses employ around 464,700 people (around 22% of the total employee count). So many of these businesses are among the country's largest and on average are often more productive, with higher wages than their domestic counterparts.

OBSERVATION 2: DO WE NEED THEM MORE THAN THEY NEED US?

The debate around foreign investment seems to often be premised with the starting assumption that it is ultimately "bad" for New Zealand. This argument suffers from several misconceptions and inconsistencies.

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First, statistical and empirical evidence generally points to foreign direct investment bringing substantial economic benefits. This can manifest in areas such as opening up markets and introducing new capital and expertise, innovation and knowledge. Indeed, a Treasury paper last year[2] and many others have noted a number of other positive effects from foreign investment beyond just the provision of capital to invest and better economic growth potential. These include:

1. **Better productivity** – research consistently shows that firms with foreign investment outperform domestic firms on a range of metrics, including firm size (employment), productivity, and average wages.
2. **Higher wages and more employer opportunity** – foreign-owned businesses can bring increased skills and expertise to the New Zealand market, which can spill over to other firms via labour mobility, improving agglomeration of skills in New Zealand.
3. **Exit opportunity for entrepreneurs** – FDI provides an exit opportunity for entrepreneurs who may not have the resources or the desire to continue to grow their business beyond a certain point.
4. **Spillover effects** – domestic businesses may be able to learn from and mimic the productivity-enhancing features of foreign-owned firms. Downstream businesses may benefit from transaction-based spillovers such as improved access to technology, or customised products or services. Upstream businesses may benefit from additional demand for their products.
5. **More consumer choice** – foreign-owned businesses can provide competition, spurring innovation and providing consumers with more choice at lower prices (boosting welfare). These competition effects are likely to be important in small markets such as New Zealand, particularly in the non-tradable sectors.
6. **Integration with global supply network** – better integration can bring a range of benefits such as new business opportunities, supply chain efficiencies, enhanced market access and new linkages with international knowledge networks for both import and export companies.
7. **Technology spillovers** – perhaps the most important benefit, with companies having access to the latest innovations, technologies, new processes and know-how. Multinational and larger companies tend to spend more on research and development, often leading to new technology development and continuous improvement.

All up, there are a range of studies by various economic institutions (OECD, World Bank, International Monetary Fund etc) that conclude foreign investment provides real net benefits to economies – especially small, open and trade-dependent ones such as New Zealand. However, to reap the maximum benefits, we require an appropriately balanced regulatory framework that provides incentives for technology transfer, human skill development, productivity-enhancing investment (including environmental, market access/integration and other intangibles foreign businesses can provide). The same principles apply to land ownership, where the World Bank has backed the practice of countries selling large tracts of agricultural land to overseas investors, but with the caveat being that host countries need to demand much more from investors in terms of improving farm productivity, surrounding rural communities' livelihoods, environmental performance and upskilling of locals.

Second, the argument that foreign investment is 'bad' ignores a basic reality check: our poor savings culture. By definition, the fact this country runs a current account deficit means that our domestic savings performance is insufficient to fund our investment needs. We therefore rely on foreign capital to fill the void, which can either come through borrowing or through equity (i.e. selling off assets). The last time we ran an annual current account surplus was in 1973. We have been in the red ever since!

Hence, we have had to borrow or sell assets in order to balance the books, and in New Zealand's case most of it has been borrowing (of our net international liability position, 95% of it is debt). However, we are now at an interesting juncture. The ability of the economy to borrow internationally to fund a saving shortfall is being challenged by increased regulatory scrutiny of the banking sector, or from warnings by credit rating agencies. More onus therefore falls on boosting domestic saving. The alternative would be lower investment, which would clearly have implications for productivity and growth. **Imagine where we would be without the $113 billion invested to date?**

[2] Mark Holden (August 2016). "Economic impacts of foreign direct investment", Treasury Insight. Another paper of interest Makin A, Zhang, W and Scobie G (July 2008) "The contribution of foreign borrowing to the New Zealand economy", Treasury Working Paper 08/03

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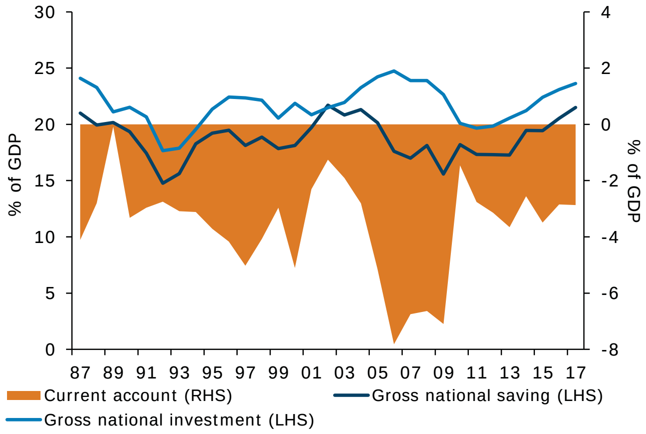
Figure 3: National gross saving and investment

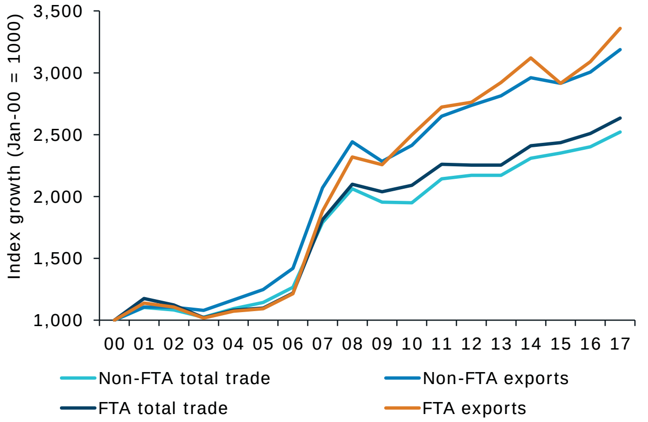


Source: ANZ, Statistics NZ

Third, New Zealand is a huge beneficiary of trade liberalisation and the breaking down of trade barriers. Hence it would be somewhat ironic to be putting up non-tariff barriers in relation to restricting capital flows or taking an aggressive stance in spirit. Of course the world is not a fair place in regard to trade. But over time things have moved in New Zealand's direction, with the signing of a number of free trade agreements that have brought tremendous economic benefit of late. We have been staunch supporters of free trade and the principles behind it, leading from the front. Some would say we're too far in front, but we won't get into that debate.

The real issue is one of consistency. If New Zealand is truly going to stand tall in its pursuit and arguments with other nations in regards to trade liberalisation, we can't really be seen to be breaking down barriers with one hand but erecting them with the other. One of the key risks the global and New Zealand economies face over the coming years stems from rising protectionism triggered by fallout around Brexit and the potential for the new US administration to take a tough stance on global trade. There are a number of moving pieces here, but New Zealand has already lost some of its first-mover advantage in Asia, as both European and South/North American competitors pivot to China and Japan more quickly. New Zealand needs to maintain a leadership position in such an environment - otherwise we will be run over. Trade in goods, services and investment all go hand-in-hand in these agreements.

Figure 4: Growth from trade with free trade partners outperforms all others over last 10 years



Source: ANZ, Statistics NZ

Fourth, we are in catch-up mode regarding infrastructure needs associated with the surge in New Zealand's population since 2012. **There is a long list of investment projects designed to alleviate bottlenecks so the economy can reach its future growth aspirations.** For example, Tourism Industry Aotearoa recently released a report outlining infrastructure gaps that need addressing to support growth. This includes the significant investment needed to build more visitor accommodation and boost the capacity of our airports. The kiwifruit sector is set to grow rapidly and needs more packhouse, coolstore and shipping capacity. To plant an extra 1 billion trees and process more logs locally requires a number of new investments and expertise. Public infrastructure needs to be upgraded and the government plans to ramp up the supply of affordable housing.

All this means we not only need to attract more capital, but also more skilled workers and foreign businesses to help do the work in a timely and cost-effective manner, given the construction sector's current bottlenecks. There would seem to be an opportunity to learn from models employed by other markets, including Canada and the United Kingdom, where the likes of central government procurement teams procure all major public projects, engaging with domestic and global partners and suppliers. The end outcome is more private investment, lower-cost projects and higher-performing solutions.

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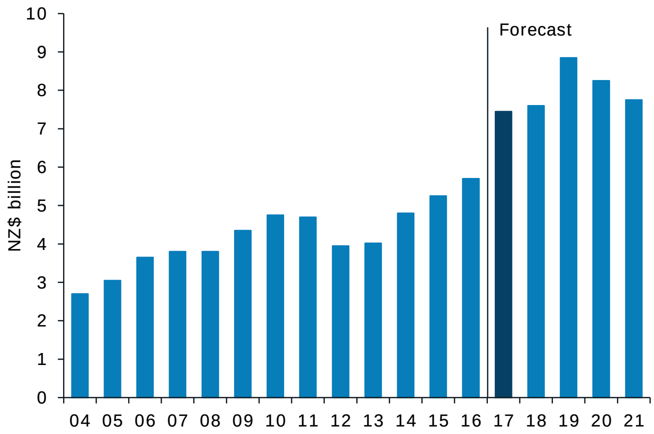
Figure 5: Public infrastructure investment



Source: ANZ, NZ Treasury

Fifth, foreign investors and businesses have choices on where to put their money to work. Foreign investors' motivations for investing in the primary sectors vary but have generally included:

- extending 'value added' categories;
- increasing existing scale;
- improving efficiency;
- securing supply (often counter seasonal to home markets);
- consolidating a product leadership position;
- high growth sectors;
- diversification; and
- supply chain integration.

We are no doubt one of the lucky countries, given our safe and stable political and legal environment. It's easy to do business here, there are world-class industries and we have an enviable lifestyle. But we are also a small economy at the bottom of the Southern Ocean and asset valuations across a range of investments currently look stretched (i.e. are too high) on a range of measures.

When you aren't enjoying the lifestyle, for example you're a multinational business with many shareholders, it's much more about the economic returns. Therefore most foreign investors have little interest in bidding up asset valuations (i.e. land etc) beyond their economic return. Indeed, to make it worthwhile, returns often need to be higher than other countries to beat other countries' extra government incentives, as well as justify the extra effort, smaller opportunities and distance from home/core markets. Occasionally there will be an element of amenity, or lifestyle value attached. But this is no different to many New Zealand investors and is usually from a specific individual who wants to reside here long-term.

OBSERVATION 3: IT IS NOT A FREE-FOR-ALL FOR FOREIGN INVESTORS

New Zealand has rather liberal foreign investment rules by international standards, but that does not mean it is a free-for-all. While the general rules may be liberal, when it comes to purchasing 'sensitive' land, the OIO has stringent tests. Broadly speaking, 'sensitive' land is currently defined as any non-urban land greater than 5 hectares, and where foreign ownership or control is greater than 25%. The complicating factor is there are variations where land adjoins rivers, lakes, reserves, foreshore and the like. It applies to freehold purchases, leases, crown pastoral leases, or any other interest of more than 3 years.

In order to receive approval to purchase sensitive land the foreign investor needs to:

- demonstrate financial commitment, business experience and acumen relevant to the investment;
- be of good character and meet visa/permit criteria related to the Immigration Act (i.e. no criminal record etc);
- show that the investment benefits New Zealand – in particular, create and retain New Zealand jobs, introduce new technology or business skills, increase export revenue, improve productivity, increase primary products' value-add and protect or enhance environmental/amenity values of the investment; and
- show that the relevant land has been offered for acquisition on the open market to persons who are not overseas persons.

Once consent has been granted, the OIO may require the purchaser of the land to provide information for compliance monitoring purposes. So it is not a case of foreign investors doing whatever they please once they have been granted approval.

On top of this, government ministers have the power to veto overseas investment applications. This was first introduced six years ago under the "benefit test to New Zealand" following a review. Put simply, an additional "economic interest" factor was introduced that allows ministers to consider whether economic interests are adequately safeguarded and whether the investment provides opportunity for New Zealand participation, oversight or involvement. These rules effectively extended the existing regime, but have included a more direct political element. With the change to a new centre-left government

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it will be interesting to see how far the pendulum swings. At present the breeze is certainly blowing toward a more interventionist stance, but to what extent is yet to be fully tested.

We won't go into the relative merits of a more interventionist approach, but will rather restrict our attention to three comments.

First, a typical justification for government intervention is normally centred on what economists refer to as a 'market failure' of some description. There doesn't currently appear to be market failure in the sense of a free-for-all going on in terms of foreign investment in 'sensitive' land. In fact, as we noted earlier, the average number of approvals each year has actually dropped 24% and gross area by 33% since the above changes were introduced in 2011. Many are joint ventures with New Zealand interests attached too. Additionally, where foreign investment has had the highest penetration of a sector, such as forestry, pipfruit and viticulture, asset valuations are more in line with sustainable economic returns than in other sectors, such as meat & fibre. And many of the smaller sectors that have experienced high growth (with further to come) have needed foreign investment and expertise to fulfil their potential. The likes of the viticulture and pipfruit sectors would not be in the strong position they find themselves in today without it.

Second, a more interventionist stance would need to be counter-balanced by proactive steps on the savings and investment front to replace the foregone capital. Indeed, the more restrictive is any proposed foreign direct investment framework, the more imperative it would be for a savings policy to fill the void (see more on the primary sector capital gap on page 11). It is simply untenable to put up proposals that restrict foreign ownership but not have the appetite to address our national saving shortfall. There appears to be limited political appetite for compulsory savings. But if we restrict foreign ownership and don't address our savings shortfall, New Zealand's living standards will suffer.

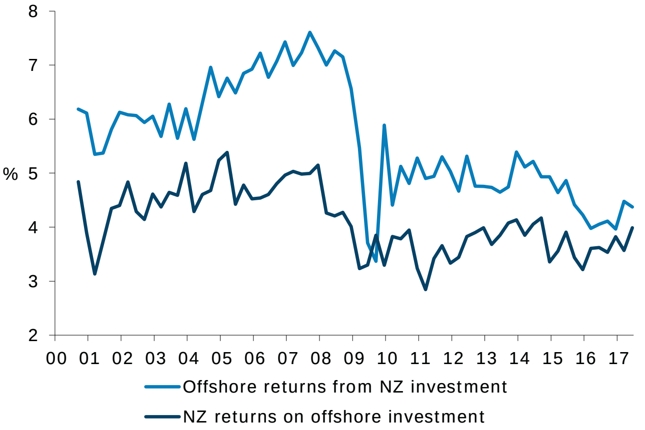
Third, having specific ministers decide on individual foreign investments in many ways is akin to having a single decision maker in regard to monetary policy (i.e. the Governor), as opposed to a full voting committee with published minutes. It works well while you have someone of high quality in place. But there are no guarantees. It would seem ironic to be doing away with the single decision maker for monetary policy on one hand, but using ministerial veto in a heavy handed way on foreign investors in land and businesses on the other. **Such an approach would lead to a lack of transparency, potentially deterring investors.**

All up, with foreign investors having jumped through all the above hoops, alongside the high direct costs and time/effort required to gain approval, **they have a much higher hurdle to climb over compared to local investors.** Like most regulatory regimes there are of course limitations and "blind" spots. But as a general proposition the current framework appears to work reasonably well.

OBSERVATION 4: WE ARE FOREIGN INVESTORS TOO

Too often, the debate around foreign investment ignores the other side of the equation. **We are foreign investors too, and are increasingly accumulating assets abroad** as the likes of KiwiSaver funds and the NZ Superannuation Fund look for investment opportunities. As mentioned earlier, New Zealand currently has $220.5bn invested offshore, of which $36bn is direct investment (mostly in Australia). The trouble is, this is low relative to the size of our economy, at only 14% of GDP. It compares with the OECD average of 36%. The fact it is low, especially relative to the size of the stock of our international liabilities, largely reflects our poor savings rate, the poor returns that our offshore investments have achieved (relative to the returns foreigners have achieved locally – discussed more below) and what we have done with the proceeds of "selling the family jewels".

Figure 6: Annualised international investment returns



Source: ANZ, Statistics NZ

When we have sold land and other assets to foreigners, it hasn't been given away for free. A New Zealand resident receives the proceeds from any sale of a business, asset or rural land to foreigners. It is what they decide to do with the proceeds that matters. The seller can pay down debt, spend it, or re-invest in other areas (either domestically or offshore) that can generate a future income stream.

FEATURE ARTICLE: FOREIGN INVESTMENT IN NEW ZEALAND PRIMARY SECTORS

Judging from our long-running track record of running current account deficits, it seems that a decent proportion of it has been spent. A bigger issue – and one that does not seem to rate much of a mention – is how we are managing our foreign investments.

As mentioned above, **the returns on our offshore investments have tended to be less than foreign investors have been able to generate from their investments in New Zealand.** That is, not only do we not save enough, what savings we do have that are invested overseas tend to generate inferior returns. Whereas foreigners appear to get the cash cows, we've had a track record of picking up the dogs with fleas. In saying that, the returns foreigners have been earning on their New Zealand investments has been lower since the global financial crisis, largely because interest rates have fallen and the majority of foreign investment in New Zealand is debt.

Nevertheless, if the returns on New Zealand assets overseas had been equal to those generated by foreign-owned New Zealand companies since 2000, **the amount of income we got from offshore would have been higher by around $2bn a year and the current account deficit lower by around 1% of GDP each year.** When cumulated over a longer period of time you are talking about a huge change in the stock of external debt, or the amount of assets we would hold relative to liabilities – $36bn worth, in fact.

To put it in perspective, with that foregone $36bn NZ.Inc could now have held offshore the equivalent of:

- the market capitalisation of the five-largest listed companies on the New Zealand share market; or
- nearly 30% of the entire market capitalisation of the New Zealand share market; or
- around 40% of the dairy land in New Zealand.

Such simple calculations highlight the importance of relative returns, but also how quickly low returns or poor investment decisions can spiral into significant sums. Moreover, these calculations only start from 2000.

OBSERVATION 5: THERE ARE OTHER ISSUES TO THINK ABOUT

We should not underestimate the role that demographics will play going forward. The farming community is ageing. How does the seller extract maximum value, while at the same time potentially ensuring the likes of family interests continue? Over time we are going to have to see different ownership structures and transition models put in place. Such dynamics are going to complicate the picture but are essential if the transition of knowledge and wealth creation from generation to generation is going to take place in a seamless fashion. The picture is further complicated when you consider the sectoral knowledge and skills that have been built up over decades. How this institutional skill-base is preserved will be a key challenge going forward.

Interlinked to some degree are the stretched valuations of some land uses. **Capital gains have formed a significant proportion of the returns farmers have received for some time**, but this looks more challenging moving forward due to a number of factors.

1. **Current valuations looked stretched on a range of metrics.** The likes of an average dairy business has gone from a valuation of $20/kg MS to low-$40/kg MS over the last 20 years. This has pushed up underlying debt levels – debt/EBIT averages 10 to 12, compared with a multiple of 3 to 4 in many other businesses. Average meat & fibre cash returns have been a measly 1-2% per year over the last 10 years. Gold kiwifruit orchards have recently broken the $1m per canopy hectare mark.
2. **Interest rates are biased gradually higher.** This tailwind is disappearing for all asset prices. Finance is now one of largest direct costs for dairy even though it has reduced by 33% since the global financial crisis due to the fall in interest rates.
3. **Dairy industry maturity.** Farmers/investors often get carried away during an expansion phase and with rising valuations. New dairy conversions have collapsed since the downturn in milk price and new regional council rules on fresh water.
4. **General asset market environment is stretched** (i.e. housing, equity market valuations etc). Historical correlations suggest housing softness would likely spill over into rural land. Most exposed are lifestyle properties and businesses in areas surrounding large cities, and spill overs seen into the likes of kiwifruit land.
5. **Environmental constraints on intensification**, especially for livestock, reducing easy land-use change opportunities and productivity potential.
6. **Banking behaviour changed with tightened lending criteria** due to dairy downturn and regulatory pressures (i.e. RBNZ capital and risk model review, rating agency views).

FEATURE ARTICLE: FOREIGN INVESTMENT IN NEW ZEALAND PRIMARY SECTORS

It's always difficult to know what might happen to asset valuations if foreign investment in land was completely removed. Certainly those sectors where activity has been the greatest, such as forestry, viticulture and pipfruit, would be most exposed to a correction, while others such as dairy, kiwifruit and meat & fibre would be less so. **But there is a risk that banning foreign investment at a time of high listings and the other dynamics listed above could trigger a more fundamental shift in valuations.** A rapid correction in house values wouldn't be advantageous for the NZ economy, and the same can be said for primary sector valuations.

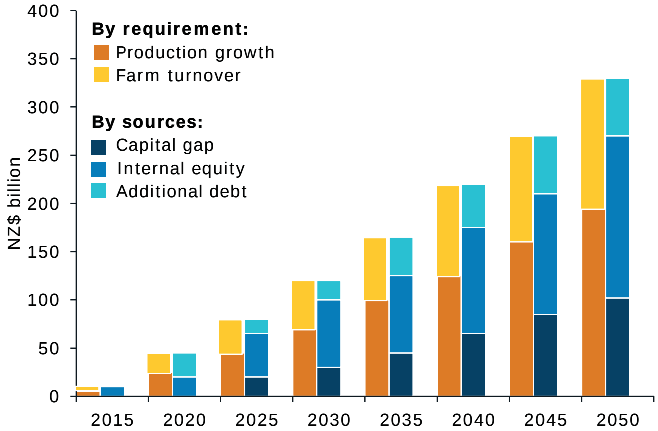
Lastly, more capital is required to speed up industry change to remain fighting fit and address environmental/social challenges. Areas where additional capital and foreign expertise wouldn't go amiss include: supercharging high growth areas/sectors; speeding up product transformation and further 'value-add' activities; improving the performance of supply chains; increasing scale and market integration; investment off-shore to service larger markets 365 days of the year; more research & development; creation of new on-farm productivity innovations; and more investment to solve environmental/social challenges associated with different land uses.

Under the existing rules, foreign investors already need to go above and beyond local investors in many of these areas. Unlocking medium-term value creation requires a lot more investment in these and other areas. Foreign direct investment can help in a number of them, though it is not a magic bullet.

The reality is, when you start to add these dynamics together there is a large capital gap that needs additional dollars for a pile of reasons: intergenerational transfer, high growth in areas such as horticulture and forestry, recapitalisation of dairy balance sheets, investment to meet environmental/social standards, productivity improvements, infrastructure needs (i.e. irrigation) and fund investment needs beyond the farm-gate.

To highlight the size of this capital gap the ANZ Greener Pasture report[3] looked at different export growth scenarios out until 2050 and the sectors' capital requirements to achieve this using current asset valuations and retained earnings at the time.

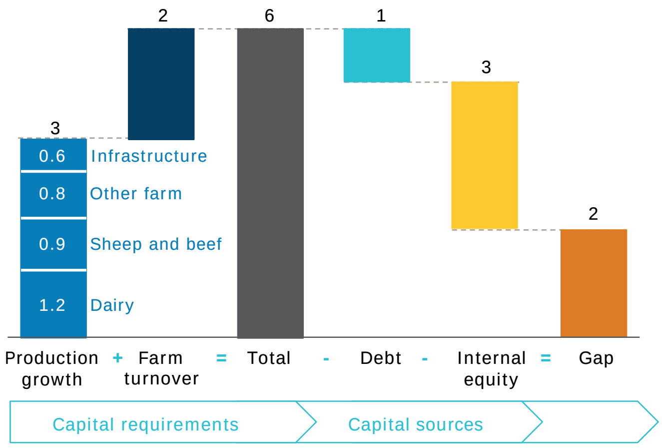
Figure 7: New Zealand primary sector capital requirements in 2050 (Real $ 2011)



Source: ANZ, ABARES, MPI, Capital IQ, Port Jackson

The base case showed that to achieve real value growth of 2.1% per annum until 2050, $210 billion of capital would be required to grow production/value and $130 billion for intergenerational succession/ farm turnover – a total of $340 billion. Some of this is expected to be funded via debt and retained earnings, but **a capital gap of $110 billion, or $2.8 billion per year was identified.** This analysis was completed in 2011, but remains just as relevant today with real export value growth having run above this at 2.4% per annum since then. A lot of this growth has been either debt, or retained earnings funded. Retained earnings are certainly a sustainable source of capital, but continued debt funding for the likes of dairy is not.

Figure 8: New Zealand primary sector capital gap in year one



Source: ANZ, ABARES, MPI, Capital IQ, Port Jackson

[2] ANZ Insight: Greener Pastures – The global soft commodity opportunity for Australia and NZ. www.anz.co.nz/rural/rural-news-insight

FEATURE ARTICLE: FOREIGN INVESTMENT IN NEW ZEALAND PRIMARY SECTORS

Whatever way the pie is cut we still believe there is a large capital gap if export value growth is to be maintained at current rates. If foreign investment is reduced/eliminated, then the gap becomes larger and creates an even bigger onus on domestically-sourced capital to fill the gap. While our savings culture has improved, there still isn't nearly enough to fill this gap plus all the country's other competing needs – i.e. general infrastructure and housing catch-up.

THE UPSHOT

We have a natural parochial bias in supporting local ownership of New Zealand's comparative advantage – agribusiness. This is particularly the case given still-favourable long-term prospects and many areas of high-growth potential.

But such understandable parochialism needs to be measured and read in conjunction with numerous reality checks. Foreign direct investment can bring huge economic benefits. The argument that foreign ownership is "bad" for New Zealand, or that there is a free-for-all occurring, lacks robust evidence. At the heart of the issue is New Zealand's reliance on foreign savings, our poor relative investment returns, and the primary sector's large capital gap that needs to be filled. Fix these and the issue of foreign ownership becomes secondary.

New Zealand is making progress in this regard, but we are set for a long journey. With the political breeze clearly favouring more restrictive foreign ownership rules, the onus is on the government to balance that with a more proactive stance towards boosting domestic saving and finding ways to fill the primary sector's capital gap. In the absence of such countering forces, significant restriction of foreign direct investment would risk leaving New Zealand less productive and poorer.

THE MONTH IN REVIEW

SUMMARY

Warm summery conditions since November have seen many areas of the country turn from being too wet to dry in a short period of time. Dry conditions can have varying impacts on different sectors depending on severity and timing. At present, production expectations are little changed in the livestock sector, but if dry conditions extend this will weigh on milk supply but increase meat production. In the horticulture space there are mixed fortunes, but positive flowering conditions are expected to support average to above-average sized crops.

MOTHER NATURE

It's gone from being too wet to dry in a short space of time for many areas. Summer temperatures arriving early and continuous days of sunshine over most of the country have sapped soil moisture and pasture growth with it. However, conditions are 'patchy' with thunderstorms helping hold dry conditions at bay in areas such as the central North Island. The areas currently most affected by dry conditions are the lower North Island, unirrigated areas on the east coast of South Island and Southland. At the moment it isn't panic stations, but if sunny conditions extend into the New Year this will start to have a more material effect, especially for crops and livestock production.

DAIRY

We estimate milk production is currently tracking around 1.5% ahead of the same time last year. This is in line with market expectations of a 1-3% gain for the entire season.

Last year's poor spring aside, the largest variation in New Zealand's milk supply tends to occur in the summer/autumn periods. **If pasture conditions continue to deteriorate in unirrigated areas then supply will be placed under further pressure. How long and severe the dry conditions are would be key.** Last year saw rain arrive just in time for the end of summer and provided a bountiful autumn. This extended the number of days cows were milked, supporting late summer/autumn milk flow. So if this early dry spell does extend into the New Year there could be an outsized impact from any moves to dry off early, or reduce the number of milkings. That said, cash flow is much better than recent years (despite the recent pay-out downgrade). This allows more supplementary feed to be utilised, providing more durability to milk supply.

MEAT AND FIBRE

A record lambing led to a nearly 2% boost in the size of this year's lamb crop to 23.7m head. The result was driven primarily by a near-9% jump in the North Island lambing percentage to 128%. There were good climatic conditions and ewe condition for most North Island regions both at mating time and during lambing. In the South Island the lambing percentage was steady, with most regions (except Southland) experiencing a rise.

Current industry expectations are that there will be little change in this year's lamb production as more hoggets are retained. This seems likely with ewe numbers having dropped 12% over the last several years and high farm-gate returns prompting some rebuilding. Of course seasonal conditions will need to play ball too.

Beef production was slow in mid-to-late spring as earlier wet conditions reduced prime and bull beef growth rates. However, some catch-up has started to occur as growth rates improved through November and pasture conditions deteriorated in the lower North Island.

ARABLE

Maize planting is now complete after a slow start. Crops are in reasonable shape in the upper North Island, but are in need of rain in the lower regions. **There has been a big increase in the area of planted barley (+60% AIMI)** this season in response to better dairy demand and low silos. The feed wheat and milling grade area are both slightly lower (-4/5%). Crops planted early on when there was adequate moisture during the development phase seem to be doing okay, but those planted later in drylands areas will suffer without more significant rain.

HORTICULTURE

The grape crop in Marlborough has seen low incidence of frost damage, but bunch floret numbers are average to 15% below normal. **However, an outstanding flowering period in all varietals (5 to 10 days earlier than normal) and the current hot/dry conditions are setting things up for an early crop of excellent quality and size.**

In the kiwifruit sector winter chill was average and the wet conditions through to spring impacted some Hicane applications, as well as causing a higher number of Psa incidents. **This meant a lower number of flowers, but very good pollination conditions are expected to compensate somewhat.**

In the pipfruit sector a 5-10% y/y increase in the 2018 crop is expected. The increase is driven by an expansion in the harvested area as previous plantings reach maturity and early season growing conditions have been favourable, but there is still a way to go.

FORESTRY

High export log prices are encouraging the early harvesting of some forests. Total log production is tracking 7% ahead of the five-year average and log exports are 17% above their five-year average too. The uplift appears to be mainly smaller forestry owners who are selling cutting rights to exporters to unlock current value. Some of these exporters are harvesting at a younger age than normally would be the case when a log is used for domestic processing/purposes.

RURAL PROPERTY MARKET

SUMMARY

The rural property market is currently at an interesting juncture. There are mixed valuation signals stemming from the different outlooks for sector earnings, regulatory change on a number of fronts, tighter bank lending criteria and supply/demand dynamics.

The dairy market has the most cautious tone. Nationwide there is currently a high number of listings, with more to come. From a buyer's perspective there is caution related to environmental regulations, tighter bank lending standards and a higher hurdle for foreign investment. Tougher market conditions for mid-to-large scale dairy businesses are expected due to the tightening in foreign investment criteria and a limited domestic pool of buyers.

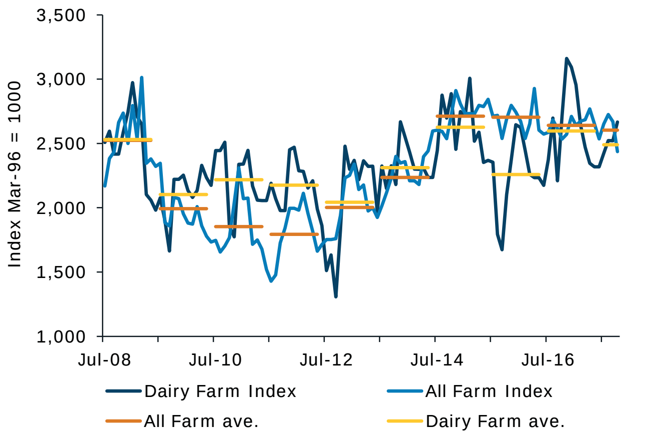
It's a more vibrant market for other land uses, largely due to rosy earnings outlooks. In the horticulture space strong cash-income, more corporate-type and Māori investment, a diminishing area of suitable land in key regions, sector expansion and migration out of expensive urban areas in search of lifestyle options are all combining in various measures to support valuations. Finishing and grazing valuations are being supported by near-record farm-gate prices for sheepmeat, venison and beef. Forestry valuations have pushed up due to high returns, the prospect of higher carbon prices and new government incentives to plant trees.

The latest REINZ data shows the average all-farm price continues to hover between $26,000 and $28,000/ha. The adjusted REINZ index shows a similar picture, with little change in the past 2½ years. **In contrast, turnover has been running around 10% below the 10-year average**, in part due to a late start to the spring market with wet conditions and general election delaying listings. By farm type, turnover since mid-2017 has reduced for finishing, grazing, arable, horticulture and lifestyle properties. This signals a broader-based reduction in sales activity beyond one sector.

FARM SALES BY FARM TYPE

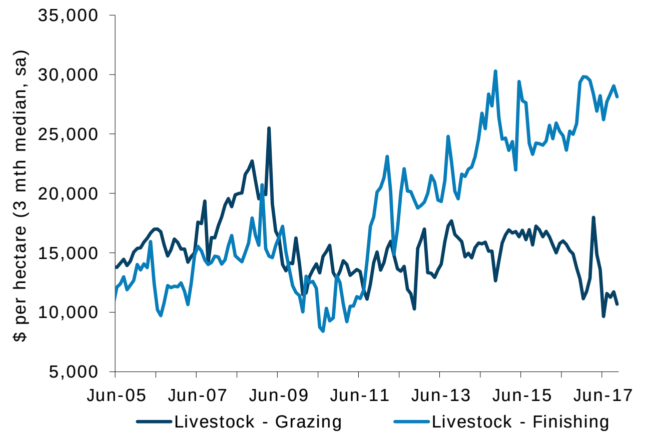
3-Month Seasonally Adjusted		Current Period	Previous Period	Last Year	10-Year Average	Chg. P/P	Chg. Y/Y	Chg. P/10yr
Dairy	Number of Sales	63	77	53	57	↓	↑	↑
	Median Price ($ per ha)	40,200	43,200	41,100	35,200	↓	↓	↑
Livestock – Finishing	Number of Sales	123	135	103	72	↓	↑	↑
	Median Price ($ per ha)	28,100	29,000	25,900	19,800	↓	↑	↑
Livestock – Grazing	Number of Sales	82	81	168	173	↑	↓	↓
	Median Price ($ per ha)	10,700	11,700	14,000	15,300	↓	↓	↓
Horticulture	Number of Sales	37	36	63	42	↑	↓	↓
	Median Price ($ per ha)	390,100	230,300	201,100	165,800	↑	↑	↑
Arable	Number of Sales	25	19	35	22	↑	↓	↑
	Median Price ($ per ha)	39,600	40,800	46,400	34,700	↓	↓	↑
All Farms ex. Lifestyle	Number of Sales	333	353	453	393	↓	↓	↓
	Median Price ($ per ha)	25,600	28,100	26,300	23,400	↓	↓	↑
Lifestyle	Number of Sales	1,768	1,765	2,229	1,563	↑	↓	↑
	Median Price	643,000	612,000	568,000	494,000	↑	↑	↑

Figure 1. REINZ farm price indices



Source: ANZ, REINZ

Figure 2. Farm sales, median price



Source: ANZ, REINZ

RURAL PROPERTY MARKET

An interesting question is, is the capital gains gig up for the livestock sector? Over a very long period capital gains have formed an important part of overall returns to land owners. Indeed, over the last 10 years dairy sector returns have averaged 10% per annum and capital gains have accounted for 5.5%. It's even more lopsided in the meat & fibre space with total returns averaging 10% per annum, but with capital gains accounting for 8% of this! In many cases the gain in cash return from a switch to dairy, better productivity and/or higher returns have been quickly capitalised into land values. As sure as day follows night an element of this will continue, but there are a number of wider forces that could well combine to dampen this effect:

1. **Current valuations look stretched on a range of metrics.** An average dairy business has gone from a valuation of $20/kg MS to low-$40/kg MS over the last 20 years. A lot of this has been debt funded, pushing Debt/EBIT to between 10 and 12. This compares with a multiple of 3 to 4 in many other businesses. Average meat & fibre cash returns have been a measly 1-2% per annum over the last 10 years, creating a range of succession issues.
2. **Interest rates are biased gradually higher, so this tailwind is fading.**
3. **Dairy industry maturity.** Farmers/investors often get carried away during an expansion phase and with rising valuations. New dairy conversions have collapsed since the downturn in milk price and ongoing implementation of fresh water regulations by regional councils.
4. **General asset market environment is stretched** (i.e. housing, equity market valuations etc). Housing softness typically spills over into rural land – indeed, an element of which has recently been noted for lifestyle properties (off high levels).
5. **Environmental constraints on intensification, especially for livestock**, reducing easy land-use change opportunities and productivity gains.
6. **Tighter bank lending standards** in response to the dairy downturn and regulatory pressures (i.e. RBNZ capital and risk model review, rating agency views).
7. **Higher hurdle for foreign investment.**

As a combination these dynamics should act as a dampening effect on capital gains for at least the next several years, if not longer. They also make it more difficult for the market to absorb any future income shocks such as the recent dairy downturn, without a knock-on impact to valuations.

In many ways most of these factors have been acting as a cap for some time. At present the focus is on the high number of dairy businesses listed for sale. Vendors' selling motivations vary, but generally are linked to some financial stress caused by the downturn, no family succession plan, and/or increasing compliance not being an owner's cup of tea. From a buyer's perspective there is caution related to environmental regulations, tighter bank lending standards to navigate and foreign investor uncertainty. So while sales prices are generally fairly steady across most regions, there is plenty for both sides of the divide to consider. This may well see lower turnover, rather than reduced land prices in the immediate future.

In sharp contrast, the valuations for finishing and grazing properties remain robust, but aren't pushing higher either (note the REINZ data shows a decline for grazing land prices, but this is compositional). Record farm-gate prices for lamb, beef and venison seem to be helping, as do options for other future land uses, such as Manuka, horticulture or forestry. For now, a large part of the market seems to be conveniently ignoring forthcoming environmental costs and stretched valuations.

All that said, the powerful effect that lifting earnings and a high-growth phase for an industry can have on asset valuations is clearly demonstrated by the horticulture sector at present.

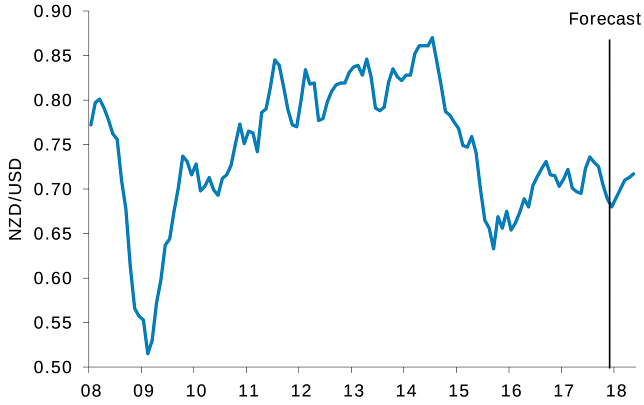
Gold kiwifruit prices are the poster child, with good orchards fetching $850,000/ca ha and some in excess of $1m/ca ha – this before lifestyle value, buildings and crop. At the same time three years ago the average price was $425,000-$500,000/ca ha. The increase has been driven by higher future revenue expectations (for both yield and per-tray returns), a diminishing area of suitable land, and investment from corporates, iwi and lifestyle. Green kiwifruit orchard prices have pushed slightly higher to around $400,000-$450,000/ca ha too. Bare land development is between $125,000-$150,000/ca ha.

In the pipfruit space prices have stabilised in Hawke's Bay recently with water consents a key determining factor given the recent water conservation order application. **Average pipfruit valuations are sitting around $115,000/ha, but there are wide variations** depending on irrigation infrastructure, location, size and consent conditions.

ECONOMIC INDICATORS

EXCHANGE RATES	Current Month	3 Mth Trend	Last Year	Chg. M / 3M	Chg. Y / Y
NZD/USD	0.689	0.720	0.715	↓	↓
NZD/EUR	0.587	0.609	0.662	↓	↓
NZD/GBP	0.521	0.547	0.575	↓	↓
NZD/AUD	0.904	0.912	0.948	↓	↓
NZD/JPY	77.71	80.03	77.38	↓	↑
NZD/TWI	70.87	73.18	76.87	↓	↓

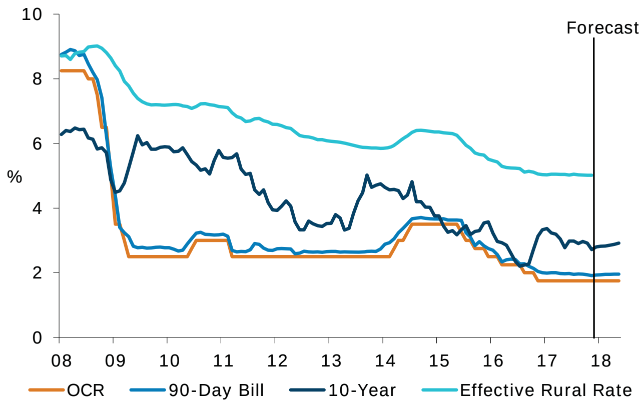
Figure 1. NZD buys USD



Source: ANZ, Bloomberg

NZ INTEREST RATES	Current Month	3 Mth Trend	Last Year	Chg. M / 3M	Chg. Y / Y
Official Cash Rate	1.75	1.75	1.75	↔	↔
90 Day Bill Rate	1.91	1.95	2.04	↓	↓
2 yr	1.87	1.96	2.09	↓	↓
3 yr	1.98	2.11	2.27	↓	↓
5 yr	2.32	2.48	2.49	↓	↓
10 yr	2.72	2.93	3.13	↓	↓
Effective Rural Rate	5.02	5.02	5.06	↔	↓
Agricultural Debt ($b)	60.60	60.53	59.13	↑	↑

Figure 2. Key interest rates



Source: ANZ, RBNZ

We believe much of the bad news that has propelled the NZD lower is now largely 'in the price'. While we are circumspect on the near-term growth picture as the economy grapples with a soft housing market and weaker business sentiment (as a new political direction creates some unease), and as it transitions in terms of its growth drivers with capacity pressures biting, we believe these factors are reasonably well appreciated.

In fact, we see modest upside for the NZD. We remain constructive on the global growth outlook. Not only should that mean any domestic growth hiccup is not long-lasting; historically a positive global picture has been consistent with a rising NZD. Favourable global liquidity and volatility conditions should ensure a reasonable environment for carry remains. In addition, with the terms of trade effectively at all-time highs and the NZD now below our estimates of structural fair value, making a valuation case for moves lower is hard to justify.

A more pronounced turn in the global liquidity cycle will eventually drive a move further south, but that is not on the cards just yet. As global central banks are eventually forced to respond to less inflation headroom, the current benign global carry conditions will be challenged. That will put the NZD back on the defensive. However, we see that as more of a story for the second half of 2018.

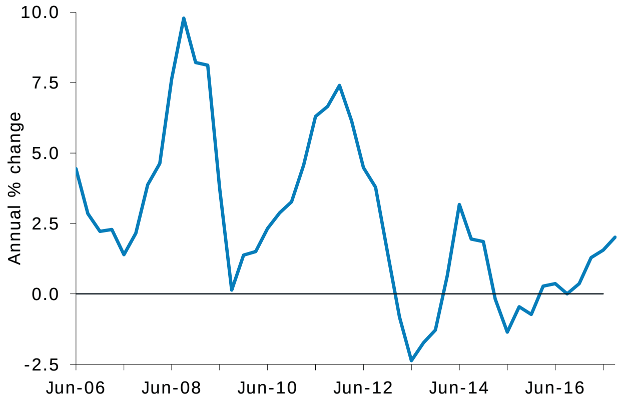
For interest rates, the range-trading environment that has defined movements at the short end over the past six or so months is expected to persist into the first half of 2018. If anything, we do see some scope for yields to fall a little in the near term given our more circumspect views on the growth picture. However, with signs of more cost-push inflation emerging, we continue to expect that the next move in the OCR will be a hike, probably from late 2018 (although there are plenty of questions surrounding this). That will not only ensure the downside in yields is limited, but see yields move gradually higher as that first hike approaches.

At the longer end of the curve, one of the main stories over recent years has been spread compression. However, we believe that story has now run its course. We are certainly not expecting spreads to widen back to anywhere near historical norms, but with the new Government's higher spending plans, together with some likely slippage versus current fiscal targets, we suspect a ramp-up in local gross bond supply will present a slightly less favourable local bond market environment, and drive a modest widening in interest rate spreads. With US rates expected to gradually lift over the course of 2018, we forecast New Zealand 10-year yields to more or less follow suit.

ECONOMIC INDICATORS

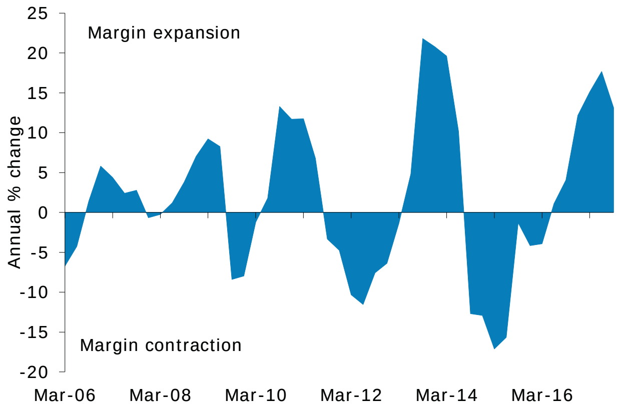
INFLATION GAUGES					
Annual % change	**Current Qtr**	**Last Qtr**	**Last Year**	**Chg. Q/Q**	**Chg. Y/Y**
Consumer Price Index	1.9	1.7	0.4	↑	↑
Farm Input	2.0	1.6	0.0	↑	↑
Net Imp. Margins PPI	13.1	17.7	4.1	↓	↑

Figure 1. Farm input inflation gauge



Source: ANZ, Statistics NZ

Figure 2. Annual net implied margins PPI ag/forestry/fishing (outputs – inputs)



Source: ANZ, Statistics NZ

Evidence of broad-based price pressure remains tentative and mixed. On top of this, secular global forces (technology, increased global brand penetration and winner-takes-all business models, deleveraging, and a more mobile labour force) are continuing to alter the inflation-generating process in poorly understood ways. But we do still forecast a gradual lift in inflation.

In a large part this is due to likely cost-push inflation from the labour market. With headline inflation up off lows and skill shortages prevalent, some of the tradition drivers of wage inflation were already pointing upwards. However, some of the policies of the new Government (minimum wage hikes, migration tightening and possible workplace relations changes) are likely to accentuate moves.

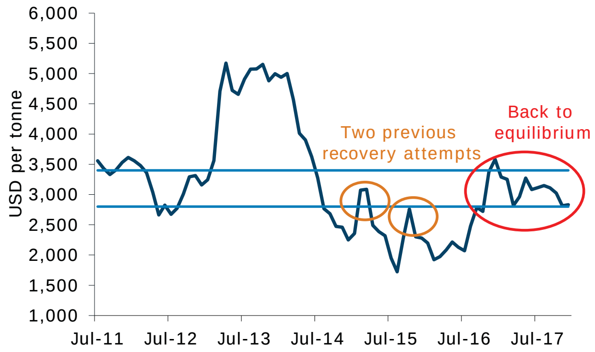
There should be a little more tradable inflation too, which is showing up in fuel, feed and fertiliser prices. While structural deflationary forces persist, the lower NZD, cycle higher in global commodity prices creating supply-chain margin pressures, and some signs that general inflation is finally showing signs of lifting modestly as labour markets tighten, should all translate into a little more imported inflation. After averaging zero since 2010, annual tradable inflation is forecast to average 0.8% and 0.9% in 2018 and 2019 respectively. Overall, it means that **we see headline inflation hovering around 2% for the next couple of years.**

Farmers will also be watching regulatory cost pressures. While the pendulum had already swung higher in many areas related to the environment, health & safety and animal welfare standards, there is likely more in the pipeline as the new Government implements its climate change, migration, work place and water-quality rules.

Producer margins had another strong quarter, rising 4.3% q/q in September. In annual terms net margins expanded 13.1% y/y. The September quarter lift was led by a 4.7% increase in output prices, with input prices increasing only 0.5% q/q. The lift in output prices was led by a 7.4% q/q improvement for horticulture and fruit growing. This was driven by better kiwifruit prices due to a smaller crop and general produce being in short supply due to the wet autumn/winter period. The livestock sector featured strongly again too, with dairy (6.1% q/q) and sheep & beef (5.8% q/q) output prices not too far behind the performance of horticultural produce. All other sectors experienced a lift in output prices during the September quarter, highlighting a solid domestic and broad-based global demand backdrop. **Input prices were relatively well contained across all sectors. This meant the higher output prices flowed through to better net margins for all except forestry (-0.5% q/q).** Dairy (6.3% q/q) and sheep & beef (5.2% q/q) net margins ended up outperforming horticulture (5.0% q/q) due to lower input cost pressures.

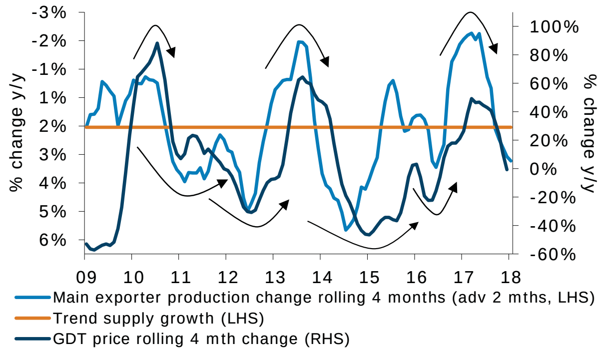
KEY COMMODITIES: DAIRY

Figure 1: Whole milk powder prices



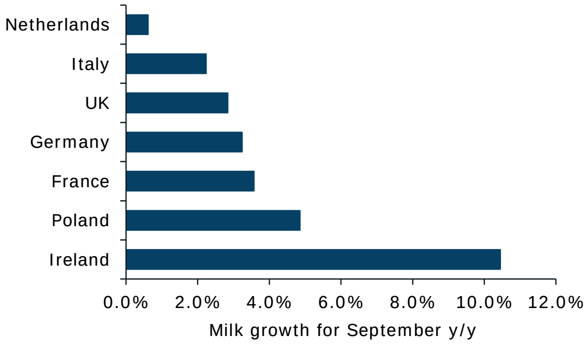
Source: ANZ, GlobalDairyTrade

Figure 2: Milk production growth vs GDT prices



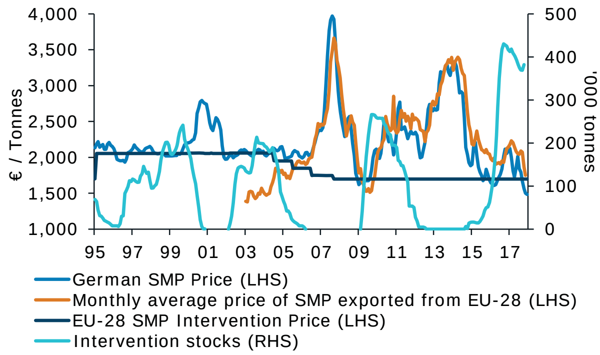
Source: ANZ, Dairy Aus, DCANZ, CLAL, Datum, USDA

Figure 3: EU milk supply growth by major producer



Source: ANZ, European Commission

Figure 4: EU skim milk powder stockpile and prices



Source: ANZ, CLAL, European Commission

Broad-based weakness in all dairy product prices has occurred recently with a synchronised upswing in global milk supply. Global milk supply by all major exporters has expanded in recent months. In aggregate we have it running at 3.0%, which is twice the long-run average of 1.5%. The increase is being driven primarily by favourable farm-gate returns in many regions, but also good feed conditions in many cases too. Historically this sort of milk growth has led to around a 30% reduction in GDT prices, so the 10% decline to date is relatively mild.

Whole milk powder prices have managed to hold the key level of USD2,800/t recently. As previous cycles have shown this has often acted as a critical level for turning points (figure 1). Near term, this level should continue to hold with NZ milk supply under pressure, lower prices stimulating demand in more price-sensitive markets, and the seasonal peak for GDT supply having passed. However, a substantial rebound above USD3,000/t seems unlikely with reports of inventory levels well above last year in China. Year-to-date imports of WMP into China have increased 18% y/y to 418,000t. Equally, near-term milk flow in NZ and GDT WMP supply (+14% y/y for next three months) remains above the same time last year.

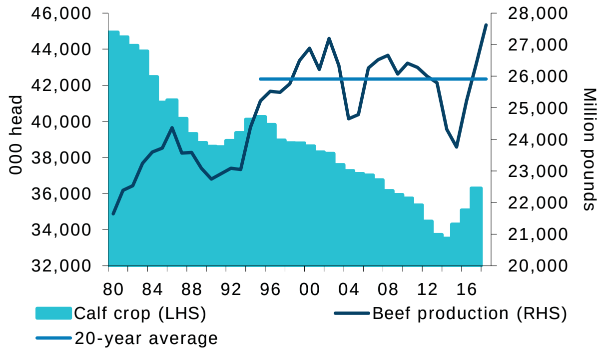
The skim milk powder (SMP) market has turned lower again as European milk supply has rebounded and it has become clear the European Commission won't act as the same backstop going forward. Farm-gate prices across the EU have averaged 33% more over the last quarter versus the same period a year ago. This has fuelled broad-based growth across most of the region, but crucially a rebound in France and Germany, where milk supply struggled during the first half of 2017. These areas tend to be the homes of processors that are more export orientated, increasing competitive pressure for NZ. **Equally important, the European Commission looks to be moving toward a tendering system for intervention product during the seasonal peak – effectively removing the price floor for SMP.** The main objective is to avoid adding more product to the existing stockpile (ca 380k t) at a time when the EU budget is under pressure due to Brexit and competing priorities. This has recently seen German SMP prices collapse below the intervention level of EUR1,698/t.

Milkfat prices have come under more pressure recently as seasonal demand for butter moderated, some substitution effects kicked in with higher retail prices, and global milk supply lifted. The demand picture remains rosy, but higher Northern Hemisphere milk supply could push prices lower through early 2018.

Our forecast range remains $6.25-to-$6.50/kg MS for 2017/18. Year-to-date we have the milk price tracking the bottom of this range with around 60% of product sold. Very early indications for next season are pointing toward a high $5-to-$6/kg MS range. It's crucial that USD2,800/t for WMP continues to hold for these to be achievable; otherwise the next stop is the mid-to-low USD2,000/t range.

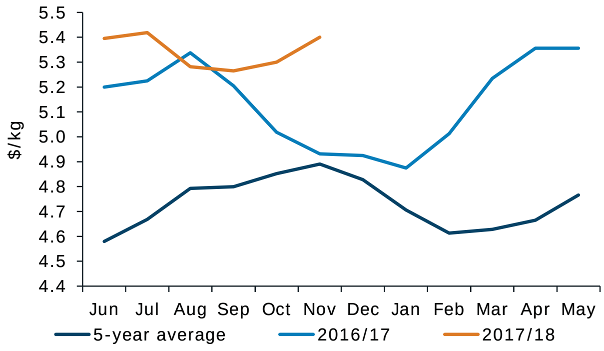
KEY COMMODITIES: BEEF AND LAMB

Figure 1: US calf crop and beef production



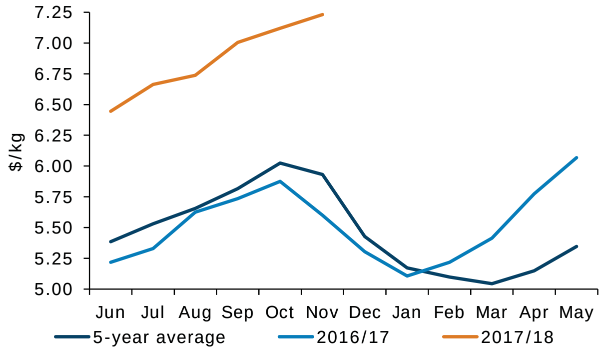
Source: ANZ, USDA

Figure 2: New Zealand farm-gate bull beef prices



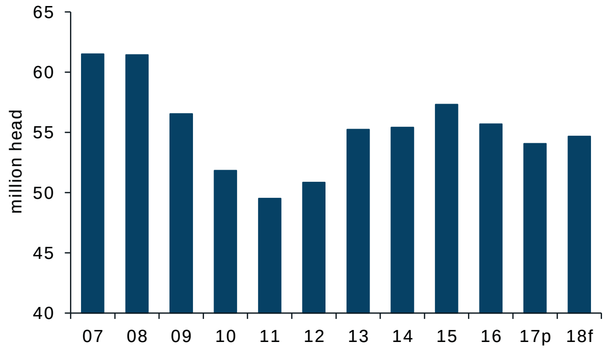
Source: ANZ, Beef + Lamb NZ, Statistics NZ

Figure 3: New Zealand farm-gate lamb prices



Source: ANZ, AgriHQ

Figure 4: Total UK, NZ and Australian lamb supply



Source: ANZ, Beef + Lamb New Zealand

Beef markets have remained remarkably resilient, but will be more sternly tested in early 2018. Seasonal supply is now lifting more aggressively in NZ and Chinese New Year demands have been fulfilled. A slow start to the season for NZ bull beef supply and a pull-back in Australian turn-off as rain arrived in Queensland/ NSW supported both local procurement premiums and US manufacturing prices in November. However, local bull beef turnoff has increased as target weights are hit and pasture growth has slowed with drier conditions. We expect overall dairy bull/steer production to increase this year as higher farm-gate returns and earlier low milk prices have encouraged the rearing of more dairy calves. Dairy cull cow supply is expected to lift more than last year in Q2 too as cull rates and autumn conditions normalise.

US supply will remain a focal point. The USDA recently boosted its production forecasts for 2018 to a 4.6% y/y increase. This reflects higher feedlot placements and expectations of heavier weights. If delivered, this would be the largest amount of beef ever produced by the US, surpassing 2002. The US consumer needs to eat plenty of burgers, which is currently odds on, given the buoyant employment market and recent household wealth gains.

Elsewhere, local prime beef supply is expected to be tight with a lagged impact of a nearly 6% decline in the number of traditional beef cows over the past three years. Local and Asian demand for prime cuts should support pricing more than manufacturing beef too.

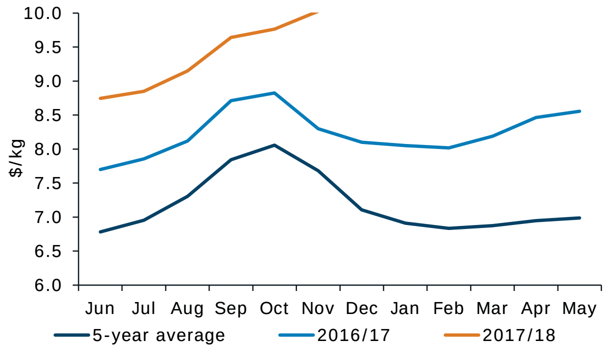
Sheepmeat markets look like they will continue to outperform through to 2018/19. Critically, supply expectations from NZ, UK and Australia have all recently been pared back. Combined with low frozen inventory levels to start the season this should continue to support farm-gate prices in the low to mid-$6/kg range through the first half of 2018.

Expectations had been for a bounce-back in exportable sheepmeat supplies in 2018, but these have recently been reduced. While there have been larger lamb crops in the UK, Australia and NZ, **higher retentions** in response to better farm-gate returns and record-high fine wool prices in Australia **are expected to see production increase by only 1% to 55.67 m head in 2018.** Combined with a solid demand environment, especially from North America, China and Europe this is expected to provide enough inter-market competition to support prices at historical highs.

The main risks at present are a hangover in Chinese demand post New Year celebrations (i.e. recently bought mutton stock isn't cleared, weighing on frozen lamb pricing) **and importer/customer substitution to other meat proteins.** If these risks were to eventuate and NZ lamb supply is higher than expected, this would start to weigh on farm-gate pricing more substantially post UK Easter orders in February.

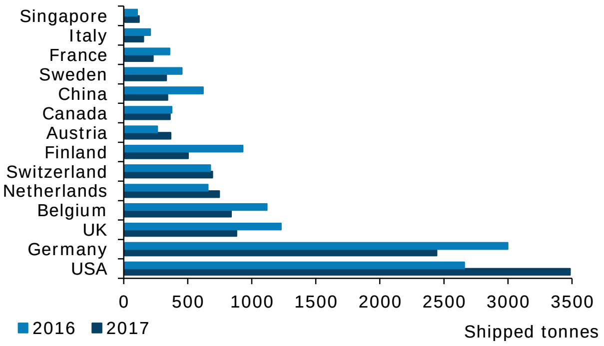
KEY COMMODITIES: VENISON AND WOOL

Figure 1: NZ farm-gate venison prices



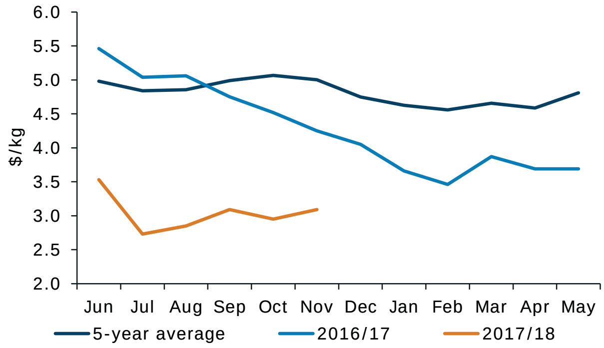
Source: ANZ, AgriHQ.

Figure 2: Venison exports to major markets



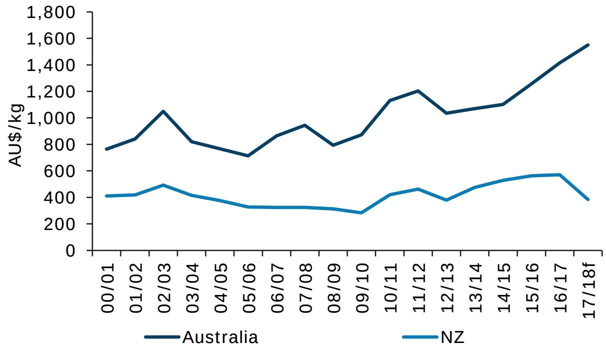
Source: ANZ, Statistics NZ, DINZ

Figure 3: Coarse fibre wool prices



Source: ANZ, Wool Services International

Figure 4: NZ vs Australian wool prices



Source: ANZ, ABARE

Venison schedule prices hit all-time highs in October and have, unusually, continued to push higher post the chilled European season closing. This trend has been accentuated in the South Island due to intense procurement pressure. Very tight supply, low inventory levels, a more favourable NZD, less wild game competition and inter-market competition have all combined to push schedule prices to record highs. The main risk is that wholesale and retail prices get stretched too far, risking substitution on the part of chefs and end consumers.

New Zealand venison production remains tight, with supply through the seasonal peak 11% below the year before. In annual terms it continues to track around 8% behind. **We suspect the lows for supply are close, but there will be no material increase until 2018/19 due to breeding hind retentions and lower weaner numbers carried into 2017/18.**

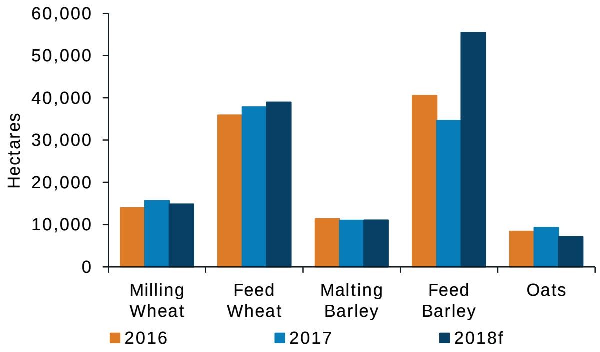
In-market demand signals remain strong across both Europe and the US. A broader-based pick-up across the European economy should support foodservice demand in 2018. The US market continues to grow, capitalising on trends of rising demand for natural grass-fed, high-quality, healthy proteins that do not have antibiotics, are not genetically modified, and have no hormone growth promotants. **All up, normal seasonal dynamics are set to see a more muted pull-back than normal into the low-$9/kg range in 2018.**

Fine wool prices have rocketed higher as low inventory levels of raw/semi-processed product and high consumer demand for 'athleisure' and outdoor garments combine. The finer wool types, particularly merino, meet the requirements of the growing market for "next to skin" clothing, which targets the outdoor and athleisure market. Alongside steady demand for traditional woven and knitwear garments such as suits, this has pushed up demand significantly. This growth in demand has driven prices to record highs in Australia, as fine wool types that can meet these markets specification make up nearly 50% of the Australian clip.

In contrast, finer wool types account for only around 6-8% of New Zealand's exports. While there has been some spill-over from fine to mid-micron wool types, coarse-micron prices remain in the doldrums. Targeted, short-term buying, usually from China, coupled with favourable currency movements, are the only factors that tend to drive any positive price improvement from auction to auction. However, with seasonal supply set to steadily increase from here and high inventories remaining, there could well be further downside pressure over coming months. In time we believe excess inventories will clear with better housing market activity in Europe and US. This will allow a more sustained price improvement, but this still looks some way off.

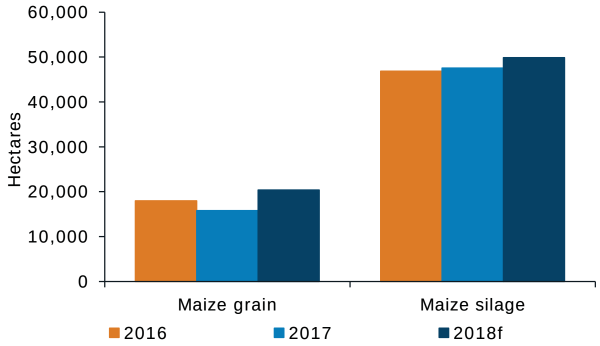
KEY COMMODITIES: GRAINS

Figure 1: Local grain planting intentions



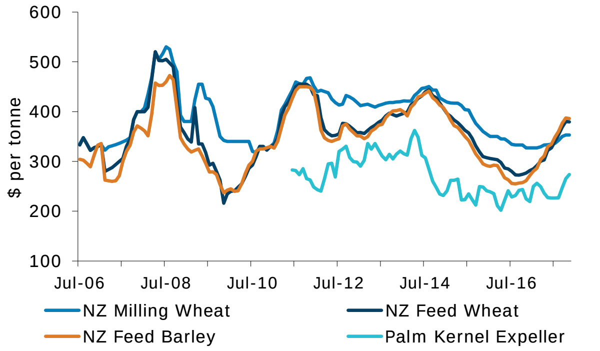
Source: ANZ, Foundation for Arable Research

Figure 2: Local maize planting intentions



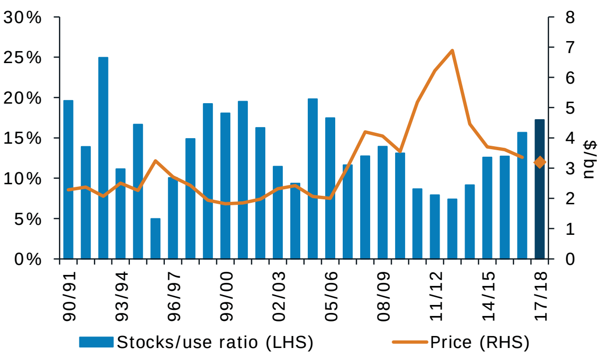
Source: ANZ, AgriHQ

Figure 3: Local grain prices



Source: ANZ, USDA

Figure 1: US corn stock/use vs price



Source: ANZ, USDA

The push higher in local grain prices looks to have run its course. Given the tight local feed situation, especially in the North Island, there could be a push higher if dry conditions extend into the New Year period. Otherwise prices are likely to start to moderate with farm-gate dairy prices having pulled back and as the new season harvest arrives.

The latest Arable Industry Marketing Initiative (AIMI) shows a 22% y/y increase in the total sown area of grain for harvest in 2018. The big uplift in sown area has been for feed barley (+60% y/y) and maize grain (+30% y/y). Of course dry weather in many areas has started to cause some concern about yields, but conditions appear patchy from region to region. Crops planted early on when there was adequate moisture during the development phase seem to be doing okay, but those planted later in drylands areas will suffer without more significant rain. **All up there are still expectations of a substantial increase in feed barley and maize grain, but this could be tempered by lower yields if dry conditions persist.**

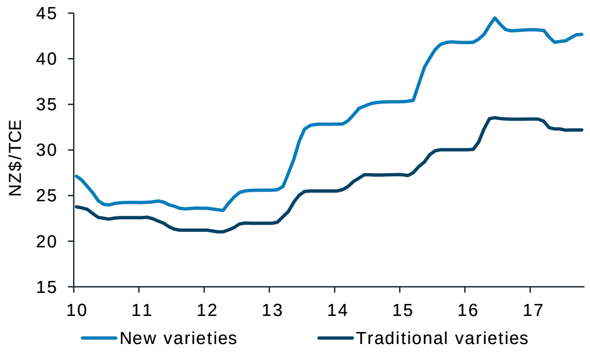
The tight forage market, especially in the North Island, is expected to add to demand for palm kernel (PKE) and grain. To what extent will depend on how pasture conditions evolve. The wet winter/early spring followed by a dry snap has led to a shortage of grass silage, baleage and hay. With no maize silage available for some time a feed gap has opened up. In the short term dairy farmers are likely to reach for PKE as Fonterra's new standards and deductions for using it don't kick in until September 2018. PKE imports are back to levels last seen in 2015 and are well ahead of 2016 (+72%). This suggests there are adequate onshore supplies, but prices could still press higher as production in South East Asia has been lower this year and is not expected to increase in the short term.

Longer term, with the introduction of Fonterra's new Fat Evaluation Index test and deductions for different grades, farmers are trying to work out what it means for their farm system. Some are testing different feed mixes and alternatives, such as corn pellets. Some of the other imported feed types are of a similar price to palm kernel on a 'per unit of protein' basis, so these are likely to form part of the solution.

Globally, grain prices remain pinned down by ample stocks. However, the lower NZD has seen imported feed costs rise, which takes some pressure off local prices. In the US, end corn stocks are expected to build despite a reduction in production this year, as consumption has not kept up. As a result carryover stocks have continued to build in the last three years. However, USDA has lowered its estimates for global corn stocks to be 11.5% below last year due to tighter balances in Mexico and China.

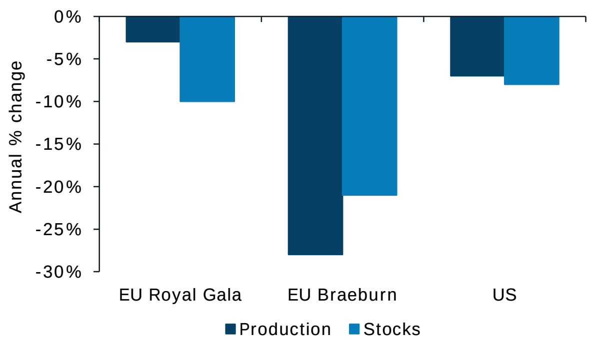
KEY COMMODITIES: HORTICULTURE

Figure 1: Pipfruit prices



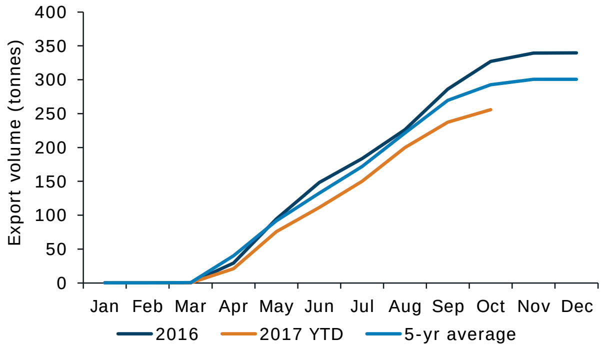
Source: ANZ, Statistics NZ

Figure 2: EU and US pipfruit production & stocks 2017



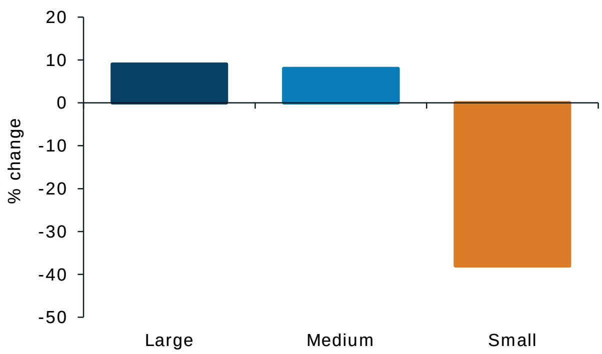
Source: ANZ, Pipfruit NZ, WAPA

Figure 3: Sales progress of Green kiwifruit supply



Source: ANZ, Statistics NZ

Figure 4: YTD wine sales progress by enterprise size



Source: ANZ, NZ Winegrowers

In the pipfruit sector a 5-10% y/y increase in the 2018 crop is forecast. The increase is driven by an expansion in the harvested area as previous plantings reach maturity and early-season growing conditions have been favourable, but there is still a way to go. An early and substantial winter chill period combined with no real cold snaps during bud burst in August and September set things up well. This was then followed by a good flowering and pollination period, leading to a high-volume fruit set. However, incorrect fungicide spray was used on some orchards, causing new season fruit to drop off trees. Affected orchards will be unable to sell fruit overseas too. The biggest impact is expected on Royal Gala, Galaxy and Koru varieties.

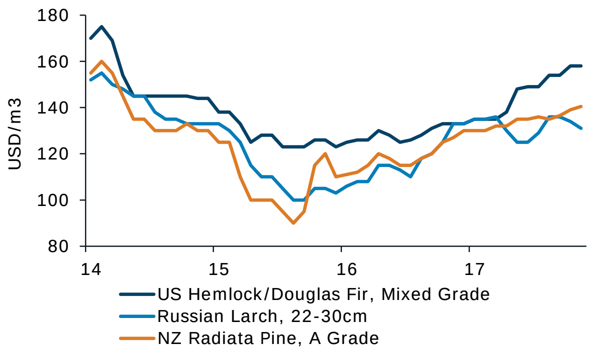
Pipfruit prices have remained fairly steady in 2017/18. Improved pricing in Europe diverted some fruit away from Asian destinations. Frosts reduced the European crop by 21% y/y in 2017. The effects varied by region and variety, but both Poland and Italy – the two largest producers – were particularly affected. Both Braeburn (-28%) and Golden Delicious (-18%) supply was reduced, but Gala performed better (-3%). Lower European production means less supply will be carried forward into the start of NZ's 2018 selling window. Combined with a lower currency, Europe is likely to remain attractive early on. Long term, Asia will reassert itself as the new plantings over the last four years of varieties more attractive to Asian tastes reach maturity and export volumes increase.

In October Zespri upgraded their orchard gate price forecast for the 2017 crop. Green is expected to return $6.23/tray and Gold $9.73/tray. Growers have received nearly 90% of this so far. Average orchard revenue for Green growers is expected to be $55,800/ ha (+4% y/y), with the higher per-tray returns helping to offset lower yields. Average orchard revenue for Gold is expected to lift to $110,500/ ha (+12% y/y). A higher per-tray return provides the boost, with yields steady.

Wine sales year-to-date (+2% y/y litres) have continued to hold up so far despite a smaller 2017 crop and low carryover stocks. The US market has seen volumes drop 7% y/y, but UK and Australian volumes have each picked up 3% y/y. The remaining export markets' volumes have dropped 0.5% y/y. A more favourable NZD/GBP and NZD/AUD likely partly explains the move. However, there has also been a continuation of the trend of shipping more bulk wine to the UK, but a smaller harvest has seen bulk wine exports to the US and Australia drop off. In contrast, packaged wine exports to the US have held steady, increased in Australia, and declined to the UK. One of the interesting aspects of 2017/18 has been the softness in small wineries' export sales, which have plunged 38% y/y. This is likely to reflect the poorer harvest for wineries outside the Marlborough region and perhaps solid cellar door sales reducing the need to export.

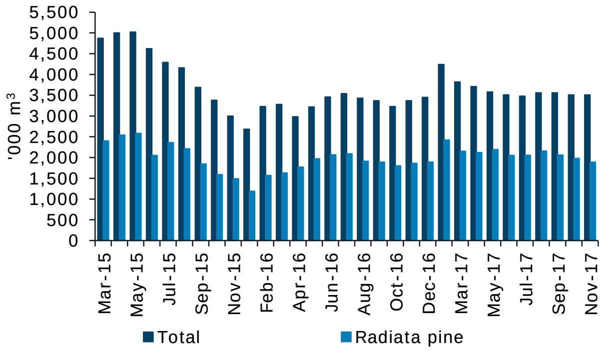
KEY COMMODITIES: FORESTRY AND OIL

Figure 1: China softwood log prices



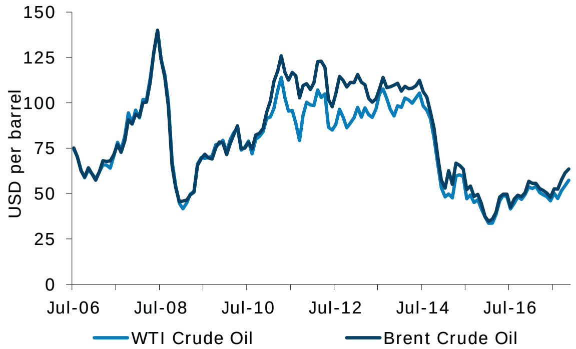
Source: ANZ, Wood Markets

Figure 2: China softwood log inventory



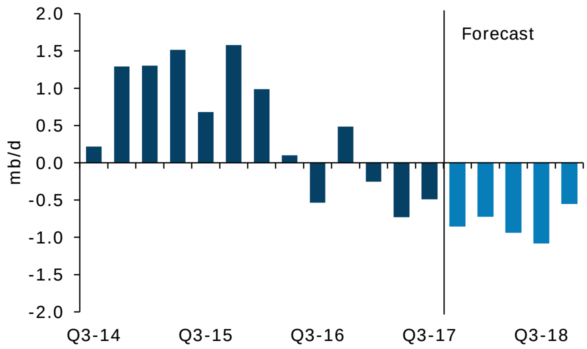
Source: ANZ, Wood Markets

Figure 3: Oil prices



Source: ANZ, Bloomberg

Figure 4: Global oil market balance



Source: ANZ, EIA, OPEC, Bloomberg

Domestic and export log and lumber prices both continue to track favourably. This is expected to remain the case into the Chinese New Year period. In-market export prices have pushed slightly higher and NZD movements have been favourable. However, increased shipping costs have kept wharf-gate return steady. Structural log prices have pushed up to new records ($130/t) on solid domestic demand and a shortage of supply in some areas. Pruned log prices ($180/t) continue to track in line with last year and 20% above the five-year average. This has been the case of most of 2017.

NZ log production and export volumes are strong. Total log production is tracking 7% ahead of the five-year average and log exports are 17% above their five-year average too. In China log stocks on port have been fairly steady, but radiata pine stocks have tracked slightly lower to 1.85 million m^3. Offtake has been fairly steady too signalling business-as-usual into the Chinese New Year period when there is often a reset. New Zealand has maintained its number one log supplier status to China with year-to-date imports up 14% y/y. Elsewhere, a lot of focus remains on the North American market and slipover into Asia. From a NZ perspective, the US market looks like an opportunity with an improving new-build housing market, increased taxes on Canadian imports, tight domestic supplies and possibility of more infrastructure spending.

In the oil market prices have increased as OPEC extended production curbs until the end of 2018. In fact, there was more than expected with Nigeria and Libya also brought under the agreement.

In an effort to appease Russia's concerns about pushing prices too high and acceding more market share to US shale oil producers, members agreed to review the curbs at the next OPEC meeting. This will provide the option to remove the constraints if inventories are back to the five-year average that Saudi Arabia is aiming for.

We view the new agreement as a positive for the oil market. It removes much ambiguity about direction in 2018. Assuming US shale oil output rises to 6.3mb/d by the end of next year resulting in second half production of 10mb/d in 2018 the market still moves into a sizeable deficit based on average demand growth rates over the past two quarters.

This should see inventories levels (on a days-of-consumption basis) fall below Saudi Arabia's target during the first half of 2018. However, we suspect Saudi Arabia would rather over-tighten the oil market than risk prices falling again. Therefore, we expect the production agreement to run its course over 2018.

BORROWING STRATEGY

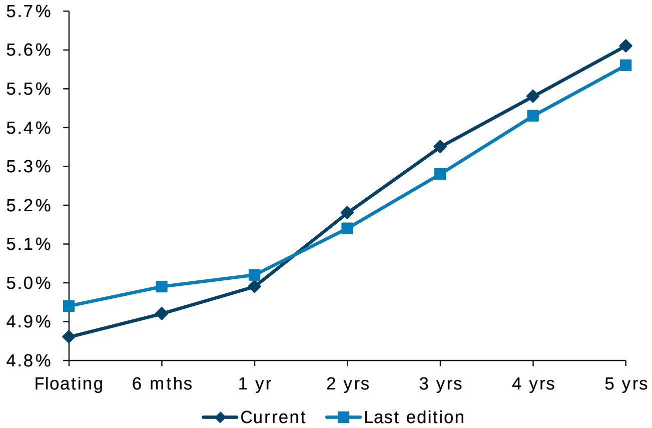
SUMMARY

Indicative rural lending rates have changed only modestly since our last edition, with the curve steepening slightly. The floating rate remains the lowest, and continues to look attractive given our view that the OCR is on hold until late next year (at least). In saying that, with long-term rates still near historic lows, they do admittedly offer some value for borrowers looking for more certainty. But with plenty of uncertainty over the global growth and inflation outlook, some ongoing caution refixing is warranted.

OUR VIEW

Indicative rural rates have changed only modestly since our last edition (Figure 1). On average, shorter-term rural rates are slightly lower, while rates for longer terms are slightly higher, leaving the curve modestly steeper overall (0.75%pts separate the floating rate and the 5-year rate, compared to 0.65%pts previously).

Figure 1. Indicative rural lending rates



Source: ANZ, Bloomberg

Since our last edition, our forecasts for the Reserve Bank OCR have not changed. With the economy expected to continue to grow around trend on average, domestic inflation pressures forecast to gradually lift – in part due to likely cost-push inflation pressures from the labour market – and other global central banks slowly removing stimulus as their economies improve (eventually weighing on the NZD), we continue to see the next move in the OCR being a hike. We have pencilled the first hike occurring in late 2018. All else equal, that suggests floating rates will remain steady for around the next year, allowing borrowers to continue to enjoy low floating rates (which are the cheapest point on the curve) for a while yet.

However, the timing of OCR hikes is highly uncertain, and we see the risks skewed towards a later move as opposed to earlier (which is what the RBNZ is telling us too). That is especially given our views on the possibility of the soft housing market weighing on near-term growth prospects but also on the ongoing lack of clear signs of pick-up in inflation both here and abroad. That reinforces once again that time remains on the side of borrowers. But not only that, any tightening cycle likely to be modest and gradual relative to previous cycles (i.e. "neutral" rates are lower), which should temper the desire to fix.

Even so, with longer-term interest rates still at low levels, it is worthwhile to ask the question whether there is any value in adding to hedges (i.e. fixing for 3-5 years). While that value has perhaps reduced a little since our last edition, given longer-term rates have risen slightly, breakevens still portray a message that interest rates would not need to rise by much over the next few years before one might regret not having fixed.

Rural Lending Rates (incl. typical margin)		Breakeven rates			
Term	**Current**	**in 6mths**	**in 1yr**	**in 2 yrs**	**in 3 yrs**
Floating	4.86%				
6 months	4.92%	5.07%	5.27%	5.61%	5.80%
1 year	4.99%	5.17%	5.36%	5.70%	5.87%
2 years	5.18%	5.35%	5.53%	5.78%	6.01%
3 years	5.35%	5.50%	5.64%	5.90%	
4 years	5.48%	5.63%	5.77%		
5 years	5.61%				

Consider, for example, the choice between fixing for 2 years or 4 years. Break-evens show that the 2 year rate would need to rise by only 0.60%pts (from 5.18% to 5.78%) over the next 2 years before a pair of back-to-back 2-year fixes ended up costing more than a single 4-year fix. **That's not hard to envisage given how low rates are in a historical context. The trouble is, expecting rates to rise just because they are low has been an expectation for some time now,** and one that has been dashed time and time again!

Our forecasts do have New Zealand interest rates rising slowly from here. However, we will repeat a message from our last edition; for a number of reasons (global uncertainties, elevated asset valuations, excessive leverage, flat Phillips curves), **some caution is warranted with regard to taking strong views on where interest rates are headed.**

We continue to favour a disciplined approach (i.e. adding to cover on dips etc), but we are also mindful of the complex global economic picture. These complexities will not just impact interest rates, but business prospects too, and when things change, flexibility can be as important as certainty.

ECONOMIC BACKDROP

SUMMARY

Our views on the economic outlook have become more nuanced. While we retain a broadly constructive view on the medium-term growth picture, we have turned more circumspect near term, and see a heightened chance of a growth wobble. That wobble is not expected to turn into something longer-lasting, but it certainly marks us out as less upbeat than the likes of the Treasury and RBNZ. Above-trend growth is hard to achieve when the most cyclical part of the economy (housing) looks set to remain soft. We are still biased towards OCR hikes in time. However, the combination of growth only around trend, a soft housing market, but the likelihood of some cost-push inflation is a complicated mix, meaning there are plenty of question marks regarding the timing of hikes.

OUR VIEW

The chance of the economy experiencing a near-term growth wobble has increased. Even prior to the recent period of political uncertainty, we were mindful of the economy potentially experiencing something of a growth air-pocket over the second half of 2017 and into early 2018 as it transitions in terms of some of its growth drivers while simultaneously facing headwinds from a softer housing market, a turn in the credit cycle and broadening capacity pressures. Recent data (retail spending, business sentiment, agricultural production etc) and anecdote (especially the likes of spending on big-ticket items) are all looking consistent with a wobble.

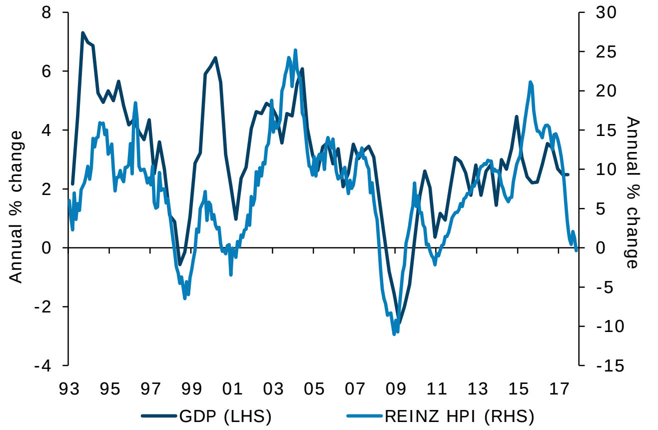
But we don't believe this growth wobble will be long-lasting. Yes, the economic cycle is reasonably mature; firms are telling us that finding skilled staff is still a huge problem. That is not something that can be resolved quickly. Housing market weakness looks set to persist, and hence so too the risks of broader spill-overs to the rest of the economy. **However, there are still reasons for optimism regarding the medium-term outlook.**

Our optimism rests on the following: Financial conditions have eased courtesy of the lower NZD and still-elevated commodity prices. Structural metrics (like the current account deficit), are in far better shape than they have typically been at this point in the cycle. When at extremes, imbalances can exacerbate any downturn. The global growth backdrop is solid, so it would be unusual for the New Zealand economy to embark on an entirely different path. And despite some previous growth drivers peaking (construction and migration), alternative growth drivers will emerge, with fiscal stimulus the obvious #1 candidate.

So while our story is admittedly more nuanced, we are happy to retain a broadly positive medium-term outlook, with growth returning to more or less trend rates. Notwithstanding the near-term risks, we forecast annual growth up towards 3% by the end of 2018, and averaging 2½-3% over the next couple of years overall. That is certainly not a negative picture, but does mean we are less optimistic on the growth outlook than the likes of the Treasury and RBNZ.

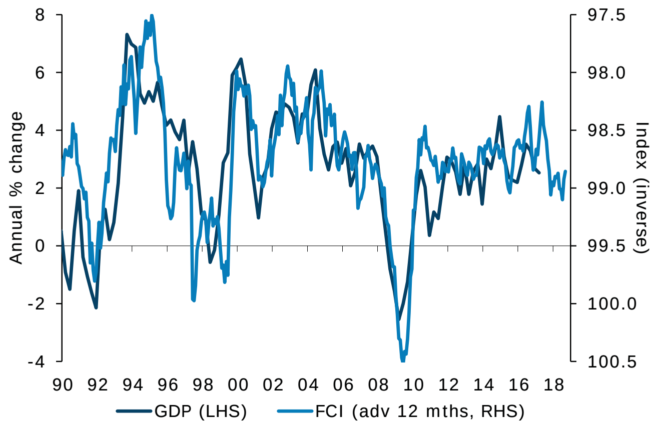
We are also still biased towards OCR hikes in time. Our more circumspect views regarding the near-term growth picture, together with expectations of soft housing market activity persisting, complicate the story. But growth around trend, together with signs of more cost-push inflation from the labour market, is something that officials will eventually respond to, gradually. But plenty of questions remain surrounding timing.

Figure 1. House prices vs real GDP growth



Source: ANZ, Statistics NZ, REINZ

Figure 2. Financial conditions and GDP



Source: ANZ, Statistics NZ, Bloomberg

EDUCATION CORNER: PATHWAYS TO FARM BUSINESS OWNERSHIP

SUMMARY

Farm succession and attracting or retaining talent remains challenging for many with a primary sector business. With this in mind, we take a look at the three main pathways to farm ownership in the Red Meat sector: equity partnership, leasing and share farming. The initial steps to formation, challenges, benefits and keys to success for arrangements also apply to other primary sector businesses.

INTRODUCTION

Farming – like a host of industries – faces succession and demographic challenges. This will lead to consolidation and alternative ownership models, including corporatisation across the industry over time. Farm succession is unique to each individual situation and market conditions will be relevant (i.e. land prices) too, but there is, broadly speaking, still a strong desire in the agri space to pass the business on to family. However, the old farm succession model of passing the farm to the eldest son has largely become outdated as mums' and dads' values on fairness, equality, equity and retirement needs have changed and high land valuations have made family succession more challenging to engineer. There is no "one size fits all" solution and the reality is that many succession plans simply don't work. The three key ingredients for a successful transition of the farm to the next generation are: a shared family vision, a strong profitable business and the separation of roles within the business during the transition process.

Equally, if talented people are to be brought in and retained, appropriate incentives need to be in place to drive this. This is like any other industry or profession where new talent needs to be attracted, fostered, nurtured, incentivised and retained to provide business continuity and new ideas and drive performance. On some levels the challenges for red meat and other primary sector businesses are more acute when you consider a) anticipated labour resources to meet different industry's growth goals, b) growing sophistication across the entire supply chain, c) the likely natural attrition rate of an industry as demographics kick in and d) the natural desire to own the land (which is pricey) as well as work it.

So with this in mind, we take a look at some of the partnership options to facilitate succession, or attract and retain talent. While these have been developed through the Red Meat Profit Partnership with red meat farmers in mind, they also apply to other primary sector businesses.

EQUITY PARTNERSHIPS

What are they?

An equity partnership (EP) is an agreement between individuals who pool their capital, skills and resources. Doing this, 'the Partnership' has the potential to achieve greater revenue and business growth than the partners could achieve as individuals. Further, it can free up time and/or capital for one or both parties to invest in family and activities off-farm.

An EP can be created through an existing legal structure, or by setting up a new entity. In a new entity, the individuals have a share of the business based on what they have invested. Profit is split based on an agreed percentage (post any owner salaries).

Who could use this option?

- Families looking to bring in the next generation.
- Employers who have a good staff member they would like to keep in the business for a longer term.
- Someone with excess cash interested in investing in a farm, but not necessarily getting involved in the day-to-day operations.
- A farm manager with a small amount of capital who may have the skills to take the business forward.

Benefits

Some of the benefits to partners entering an equity partnership are:

- They gain ownership in a farm business (which may otherwise have been out of reach).
- Pooled resources and skills can improve profitability and enable each owner to purchase or lease other blocks or opportunities.
- The ownership percentage (%) by either/all parties is flexible.
- They have the ability to increase their ownership percentage (%) over time.
- The ability to increase an entering party's equity over a period of time – this provides an incentive to improve business performance.
- Gain scale and perhaps grow your business faster than going it alone.
- Reduce individual capital requirements and spread the risk involved with investing in the rural sector.

EDUCATION CORNER: PATHWAYS TO FARM BUSINESS OWNERSHIP

- Access capital to fund development projects to improve business performance and/or achieving personal/family goals.
- Release equity tied up in your farm for succession and retirement-planning purposes.

Challenges

Some of the challenges in using an equity partnership are:

- The risks that apply to the rest of an industry are likely to still apply to equity partnerships. For example, health and safety, market supply, animal health, drought etc.
- Lack of good communication systems and/or variance in goals between the partners may cause friction.
- Selecting the right partner.
- If this is a partnership between an existing owner and a new partner, the owner's potential resistance to change can be an issue.
- Lack of profitability or lack of good financial management is a serious risk. Strong financial management skills and systems must be in place within the business.
- If the expected length of the partnership is too short, true benefits may not be realised. The cost of establishment could outweigh the benefits.
- Entering and exiting an equity partnership can be time consuming and cause issues. Start with the end in mind. Ensure your establishment documentation outlines entry and exit strategies clearly.

Key steps to formation

Identify a potential partner. This could be:

- A child/parent.
- Current employee/employer.
- Through asking your network for suggestions (e.g. other farmers, banker, consultant, accountant etc).

Potential partners need to discuss and understand:

- Each other's goals and aspirations (both short and long term).
- Timeframes (how long they are expecting to be involved).
- What each partner can contribute (e.g. skills, cash, stock, equipment etc).
- Expectations around:
  - Profit and splitting the share of this
  - Salaries/bonuses
  - Capital expenditure (e.g. tracks, equipment etc)
  - Overtime
  - Staff performance
  - Productivity on farm
  - Involvement of spouses/partners on farm
  - Health and Safety
  - Staff (e.g. recruitment)
  - Communication systems

Once partners are confirmed, identify:

- Are there any skills the parties do not have, where it may be useful to bring in a third-party advisor?
- Develop budgets showing potential profit.
- A business plan – this may include some key metrics you are hoping to meet.
- Role/job descriptions.

Look at the various options structures for achieving the outcomes to the questions above. Understand whether an equity partnership is the best option – consider what other options are available. You may need to talk to an advisor at this point.

Key elements needed for success

- The right mix of personalities, skills, cash, stock, and equipment from the various parties.
- The parties need to have similar values and beliefs, particularly around farm systems, environmental and people management etc
- Regular formal and informal communication between the parties.
- Clear legal agreements that define each party's role.
- A documented Business Plan.
- The combination of skills and additional capital will enable changes to be made to the farm business. These changes need to result in higher levels of productivity and profitability to justify the change in business structure.
- Have a clear exit strategy right from the start – start with the end in mind!

EDUCATION CORNER: PATHWAYS TO FARM BUSINESS OWNERSHIP

LEASING

What is it?

Leasing occurs as a contractual agreement between a land owner and a tenant to lease the land and its fixtures. The transaction between the two parties is normally for a fixed period of time.

The lease agreement can cover:

- Maintenance and ownership of chattels.
- Capital vs maintenance responsibility.
- Fertiliser requirements.
- Permissible activity on the land.
- Any further party requirements i.e. regressing development.

Who could use this option?

Owners who:

- Want to hold the farm for the next generation.
- Currently have no obvious successor.
- Are not interested or able to continue day-to-day farming.
- Want to spend more time off-farm.

Lessees who:

- Do not have a large amount of capital to invest in land but want to have a farm business.
- Would rather work on their own, than work for an employer.
- Could use another entity structure (e.g an equity partnership) to grow the business without buying more land.

Benefits

Some of the benefits to partners entering a leasing agreement are:

- Fixed-term arrangement.
- Fixed price, so provides certainty for both parties and also for financiers providing funding.
- Limited interactions between parties and these interactions can be outlined in the lease agreements – this can limit the impact of any relationship breakdown.
- Leases are fairly well understood by most parties due to being widely used through various industries.
- Cash flow is spread over the life of the lease, rather than required upfront.
- In most cases the lease costs will be fully deductible for tax purposes. However, for the owner the lease payments are likely to be taxable (as an income stream).

Challenges

Some of the challenges in using the leasing model are:

- Farm maintenance and monitoring – clarifying who is responsible.
- Lease agreements that are not fit for purpose, or contain details that the parties do not fully understand.
- No capital gain for Lessee.
- There is a risk to the Lessee of having to buy stock at a high price then sell at a low price at the end of the lease period (therefore not making any money).
- The Lessee is unlikely to think about the long-term welfare of the farm if it is a short-term lease. They may try and maximise short-term productivity at the expense of the longer term.
- May be hard to agree on a lease price. The price must be set at a rate that will enable both parties to prosper.
- Size of farm may not allow economies of scale and initial set up for lessee could be high (e.g. equipment required).

Key steps to formation

Some initial steps are listed below.

Owner

- Look at your current profit, including salary. Compare this return to what you would receive from leasing the property.
- Get a market estimate for the value of the lease.
- Decide on the term of the lease you would be comfortable with.
- Review your property and the current state of paddocks (fertility, pasture quality), races, plant, buildings, facilities etc.
- Advertise or ask for offers of interest.

Lessee

- Prepare a business plan which could look at:
  - Long-term aspirations.
  - Type of farm you would like to lease (size and land type).

EDUCATION CORNER: PATHWAYS TO FARM BUSINESS OWNERSHIP

- – If you require staff to assist you in managing the lease block.
- – Whether you will be required full-time.
- – A financial budget/cashflow.

- Research what lease blocks are available.
- Meet with your bank to discuss financing if required.

Together

You will need to work through various terms of an agreement together e.g.

- Term of lease.
- Maintenance vs capital expenses.
- Payment terms.
- Monitoring and communication.
- Right of renewal.
- If you will use an independent advisor to monitor the maintenance of the farm.
- Engage with professionals in order to finalise the lease, e.g lawyers and accountants.
- Remember, to be successful, a lease needs to be beneficial to both parties.

Key elements needed for success

- Clear written agreement between the owner and lessee. If the agreement is not clear on issues around payment, length, exit, maintenance, responsibilities, communication etc, this can cause friction.
- A lease price that both owner and lessee are happy with and allows both parties to be successful.
- Potentially the use of an independent third party to review maintenance of the property (e.g. six-monthly reviews of fencing, buildings and tracks).
- The right time period on the lease – if it is too short it won't be worth the lessee investing.
- Have an independent party assess the condition of the farm, plant and infrastructure at the start of the lease period and annually thereafter, to monitor it is being maintained to the standard agreed within the lease terms and conditions.

SHARE FARMING

What is it?

Share farming is a system of farming where two parties (the landowner and share farmer) each provide a differing level of asset and labour to a farming business and receive a return according to the proportion of these contributions.

The idea is that each party contributes something that complements the other. Typically the land owner provides the infrastructure (the land, buildings etc) and the share farmer provides livestock, plant, and labour. However each situation can be tailored to meet the needs of the parties involved.

Share farming operates two separate businesses within one farming operation. This means individual finances remain separate but requires a contractual agreement.

Who could use this option?

- A competent farm manager with capital to invest in farming.
- A landowner wanting to reduce their involvement on farm.
- A landowner wanting to provide a stepping stone or incentive for a proven high-quality staff member.
- A family looking to transfer roles within the business as part of a succession plan.

Benefits

Some of the benefits to partners entering a share farming arrangement are:

Flexible

- A share farming agreement can be tailored to meet the specific needs of the parties involved.

Landowner

- Helps secure and retain high-quality labour.
- Increase farm performance.
- Release capital from the farming business.
- Reduce or remove involvement in farm operations and/or management.
- Able to retain some management control depending on the agreement.
- Share the financial benefits of a good season.

EDUCATION CORNER: PATHWAYS TO FARM BUSINESS OWNERSHIP

Share farmer

- Pathway for increased investment in farming over time.
- Able to get additional financial reward for high performance.
- Grow management and governance capability.
- Potential mentoring from landowner to accelerate development.
- High return on equity.
- Share the risk of a bad season.

Challenges

Some of the challenges in using the share farming model are:

- Relationship – you must be compatible. It doesn't mean you will always agree but you must be able to work through the difficult situations and communicate – much like a marriage.
- Poor performance – when performance is below expectation it costs both parties money. Early identification of the issue is important and is best done through monitoring and reporting against key performance indicators, joint farm walks at an agreed frequency, and the use of a farm consultant at key times.
- Entry and exit - investing time and money into a formal agreement when entering a share farming arrangement will ensure a smoother journey and eventual exit. Make sure your agreement is in Plain English so you understand it and can use it along the way.
- Agree on profit sharing – there is no standard way to do this, so it needs to be negotiated with a win-win mindset.

Key steps to formation

Some initial steps are listed below:

Landowner

- Build a plan - What are you trying to achieve? Goals and objectives. Financially what do you need from the business?
- Understand the existing business.
- Production, cost structure, EFS, farm strengths, weaknesses, and development required.
- Identify a trusted advisor with the skills to help you through the process.
- Define the role and person you are looking for – advertise and/or network.

Share farmer

- Set your goals and objectives – define where you want to be in 5-10 years.
- Identify where you are now – equity position, skills, what you have to offer.
- Identify areas that need further development and how you will address these.
- Network – talk with farmers, professionals, friends and make them aware of your plans.
- Work hard and make sure you are doing the best you can in your current role – this is your CV.

Key elements needed for success

- Compatible people – will require a strong working relationship.
- Sound understanding of the existing performance of the business and historical returns.
- A formal agreement understood by all parties that sets the terms of engagement.
- Agreed strategy for the property for the term of the agreement.
- Seek independent advice for setting up the agreement and monitoring adherence to the agreement.

KEY TABLES AND FORECASTS

FX RATES	ACTUAL			FORECAST (END MONTH)						
	Oct-17	Nov-17	15-Dec	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
NZD/USD	0.684	0.683	0.699	0.71	0.72	0.69	0.67	0.66	0.65	0.65
NZD/AUD	0.893	0.903	0.911	0.89	0.88	0.90	0.91	0.92	0.93	0.93
NZD/EUR	0.587	0.574	0.593	0.62	0.65	0.62	0.58	0.56	0.54	0.54
NZD/JPY	77.56	76.79	78.45	83.8	83.5	77.3	69.7	68.6	65.0	65.0
NZD/GBP	0.515	0.505	0.520	0.53	0.53	0.50	0.49	0.48	0.47	0.47
NZ TWI	71.4	70.9	73.8	74.0	75.2	72.4	69.7	68.5	67.2	67.2

INTEREST RATES	ACTUAL			FORECAST (END MONTH)						
	Oct-17	Nov-17	15-Dec	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.25	2.25	2.25
NZ 90 day bill	1.94	1.91	1.86	1.95	1.97	2.07	2.34	2.50	2.50	2.59
NZ 10-yr bond	2.92	2.72	2.74	2.85	3.05	3.25	3.40	3.45	3.50	3.50
US Fed Funds	1.25	1.25	1.50	1.50	1.75	2.00	2.25	2.25	2.50	2.50
US 3-mth	1.38	1.48	1.59	1.75	2.05	2.20	2.45	2.45	2.45	2.45
AU Cash Rate	1.50	1.50	1.50	1.50	1.75	2.00	2.00	2.00	2.00	2.00
AU 3-mth	1.69	1.74	1.77	1.80	2.00	2.30	2.40	2.40	2.40	2.40

ECONOMIC INDICATORS	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
GDP (% q/q)	0.8	**0.4**	**0.5**	**0.6**	**0.9**	**0.9**	**0.8**	**0.7**	**0.7**	**0.7**
GDP (% y/y)	2.5	**2.2**	**2.3**	**2.3**	**2.4**	**2.9**	**3.2**	**3.3**	**3.1**	**2.8**
CPI (% q/q)	0.0	0.5	**0.4**	**0.5**	**0.2**	**0.6**	**0.3**	**0.7**	**0.6**	**0.8**
CPI (% y/y)	1.7	1.9	**1.9**	**1.4**	**1.6**	**1.7**	**1.5**	**1.7**	**2.1**	**2.3**
Employment (% q/q)	-0.1	2.2	**-0.5**	**0.5**	**0.4**	**0.4**	**0.3**	**0.3**	**0.3**	**0.3**
Employment (% y/y)	3.1	4.1	**2.8**	**2.1**	**2.6**	**0.8**	**1.6**	**1.4**	**1.3**	**1.2**
Unemployment Rate (% sa)	4.8	4.6	**4.7**	**4.6**	**4.5**	**4.5**	**4.4**	**4.4**	**4.4**	**4.4**
Current Account (% GDP)	-2.9	**-2.6**	**-2.6**	**-2.3**	**-2.5**	**-2.8**	**-3.0**	**-3.1**	**-3.0**	**-3.0**
Terms of Trade (% q/q)	1.4	0.8	**-1.5**	**-1.6**	**-0.8**	**0.0**	**0.1**	**0.1**	**0.1**	**0.1**
Terms of Trade (% y/y)	10.1	12.4	**4.6**	**-1.0**	**-3.1**	**-3.9**	**-2.2**	**-0.5**	**0.4**	**0.5**

Figures in bold are forecasts. q/q: Quarter-on-Quarter, y/y: Year-on-Year

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