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ANZ AGRI FOCUS

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INSIDE

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A WINNING FORMULA

FEATURE ARTICLE: EQUITY PARTNERSHIPS – A LOOK UNDER THE BONNET

One of the most popular farm structures in recent years has been equity partnerships. Critical success factors in an equity partnership are several: having a robust, achievable strategy for value creation; ensuring all the appropriate due diligence has been completed; having good relationships, common objectives and motivations between shareholders; having an appropriate business structure; ensuring there are robust business processes and systems in place; clear communication with regular meetings; and agreed procedures for entry/exit of shareholders, as well as for resolving any disputes.

THE MONTH IN REVIEW

It has become increasingly dry in many parts of the North Island. In contrast the South Island has had a pretty good run. Dairying is set to post new records for production, yields, price, revenue and bottom lines. It is steady as she goes in the meat and fibre sector. There is a smaller – but high quality – pipfruit crop with good sized fruit.

RURAL PROPERTY MARKET

The rural property market seems to have eased its foot off the gas pedal a touch since the New Year. Overall activity levels are still strong. However, prices have eased slightly and have been mixed across sectors. Prospects of a lower 2014/15 milk price, lifting interest rates and plenty of robust discussion on political and environmental regulatory risks seem to have returned a touch of realism.

KEY COMMODITIES AND FINANCIAL MARKET VARIABLES

Continued NZD strength is likely to keep the pressure on farm-gate prices in the near term, but as the 2014/15 season progresses we are forecasting a softening, which should provide some relief.

BORROWING STRATEGY

Indicative rural lending rates are up across the board, led by higher front-end rates. Longer-term rates have moved up by less, “flattening” the borrowing curve. As a result, even though the outright cost of fixing has risen, the relative cost of fixing for longer terms (versus floating) has declined. The decision to fix for longer terms has become more of a line call, with expectations for additional OCR hikes now built into the term structure. We prefer to hedge our bets, maintaining a portion of exposure to floating rates while splitting the remainder across several fixed-rate terms.

ECONOMIC BACKDROP

The economy is firmly into a broad-based expansion and we’re picking 3 percent plus growth over the coming two years. Despite a robust outlook, risks and vulnerabilities remain.

EDUCATION CORNER: CHINESE INFANT FORMULA MARKET AND THE WAVE OF REGULATORY REFORM

Infant formula can be characterised as a value-add product due to its defensible characteristics. Markets tend to be highly consolidated for such products. Much of NZ’s recent investment into infant formula has been based around the Chinese market, which is more fragmented than others due to rapid growth and less regulation. But repeated food safety incidents have triggered a wave of regulatory reform. While the direct impact of the reforms remain highly uncertain and dependent on their official interpretation by Chinese authorities, they are likely to have wider implications beyond the infant formula category.

FEATURE ARTICLE: EQUITY PARTNERSHIPS – A LOOK UNDER THE BONNET

SUMMARY

Equity partnerships have grown in popularity. We struggled to find any credible quantitative evidence about equity partnership success or otherwise. Logic would suggest returns are similar over the long run to the average farmer (3-7 percent return on assets, plus 5-10 percent capital gain per annum depending on the sector, although capital gain seems less certain in the future and is tied to productivity improvements). However, if the benefits of an equity partnership (i.e. scale, different skillsets) can be unleashed, then returns may well be higher than those of the average farmer. Anecdotally the majority of returns from equity partnerships have been in the form of capital appreciation rather than periodic cash dividends.

Critical success factors in an equity partnership are several: having a robust, achievable strategy for value creation; ensuring all the appropriate due diligence has been completed on an investment (including adequately assessing productivity potential and business risks); having good relationships, common objectives and motivations between shareholders; having an appropriate business structure; ensuring there are robust business processes and systems in place; clear communication with regular meetings; and agreed procedures for entry/exit of shareholders, as well as for resolving any disputes.

BACKGROUND

What is an equity partnership? Well it's a reasonably loose term, but usually it's a joint venture between a few (usually non-related) individuals who pool their capital to invest in a business venture. There is also the pooling of expertise and other resources, which can create additional benefits and wealth.

Equity partnerships in agriculture are not new. A number were started in the late 1970s and early 1980s to develop kiwifruit orchards and sheep and beef farms. They were established to take advantage of the government's agricultural incentive schemes and the taxation policy of the day. They took on both large financial (development) and policy risks, which were realised when economic reform began in December 1984. Most did not survive the period of reform and subsequently equity partnerships faded away as an ownership structure in agriculture. They were revived in the late 1990s as the restructuring, and then growth, of the dairy industry gained impetus. Better shareholder agreements and structures (i.e. management and governance setups) were also key drivers of their resurrection. **Today there are estimated to be over 1,000 non-related equity partnerships in existence, mostly in dairy, but also within the sheep and beef, cropping and viticulture sectors.**

SYNDICATED DAIRY FARM OWNERSHIP IN 2010-11

DairyNZ Region	Number of farms owned by a syndicate	% of regions farms	*Multiple farm syndicates residing in that region
Northland	44	4.1%	4
N. Waikato	74	2.9%	9
BoP / Central NI	32	2.7%	4
S. Waikato	67	5.3%	5
Taranaki	27	1.5%	6
Lower NI	84	7.7%	10
Top of SI	5	2.6%	0
Westland	33	8.8%	2
Canterbury	253	**24.9%**	28
Otago / Southland	207	**18.1%**	18
New Zealand wide	**826**	**7.1%**	**86**

* Multiple farm syndicates are only those where the same complete syndicate of investors owns or has a shareholding in other farms. Multiple farm syndicates can be a mix of land owning and sharemilking. Multiple farm syndicates mostly own farms in regions other than where they reside. MyFarm syndicated farms are recognised as individual farms even though they may have some investors in common. This also applies to several other investment groups that may have investors in common. Many syndicated farms are part of multiple farm portfolios of investments, by dairy farmers owning farms outright in a variety of ownership structures, or in other syndicates.

Sources: ANZ, DairyNZ

The shareholders in an equity partnership usually number less than 10 and may be any one or more of individuals, partnerships, trusts, or other companies. The joint venture can be set up in a number of ways and the right structure for one group may be completely different to another. Today equity partnerships, however they are structured, are being favoured for a variety of reasons. These include:

- **Opportunity to pool capital to overcome high capital requirements and in some cases low cash rates of return (i.e. sheep & beef).** Today the average economic size of a farm unit is considerably higher than back in the 1970s and 80s. The capital required to purchase an average-sized dairy farm is nearly $6.5 million (when Fonterra was formed it was a tad over $2 million) and $5 million for sheep and beef. But the targets of equity investors are often large-scale operations. To get one's hands on a new dairy conversion, which today averages between 600-800 cows, the capital requirement is likely to be well in excess of $10 million. So the pooling of capital is one way for a number of different investors to gain entry, expand an existing investment in agricultural assets, and minimise the risks associated with outright ownership.

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- **Provides additional opportunities for farmers to invest in a new sector and/or region.** This can allow a farmer to spread their risk related to factors such as weather, regulation, and sector-specific issues, and/or access lower-priced or better-quality assets. It can also help reduce the risk of high leverage associated with an individual purchase, especially of larger-scale businesses.
- **Achieve scale and grow faster than going it alone.** Scale can help improve efficiencies and returns, allows greater access to specialist skills on and off-farm, and provides an ability to leverage investments further than the norm (i.e. use more debt), depending on the desired motivations.
- **Maori farming businesses are collaborating to access new opportunities and expertise.** The recent ANZ Maori Business Key Insights report identified collaboration as one the main strategies Maori businesses are using to unlock new opportunities. Many are pooling capital to increase scale with a view to moving into other areas of the supply chain i.e. processing/marketing. Smaller parcels of land are also being pooled together to undertake development and create efficiencies. The joint ventures are also rekindling or strengthening whanau, hapu and iwi relationships. Whilst not all models are conventional equity partnerships they are all driven by the opportunity to realise greater outcomes collectively than could be achieved individually.
- **Vehicle for outside investors to gain a stake in the agriculture sector.** Foreign investors and New Zealanders who reside off-farm have become increasingly interested in New Zealand agricultural assets and investments over the past few years. This has been due to the food story (i.e. rising terms of exchange etc), but also because New Zealand is viewed as a world leader in the production, processing and marketing of many agricultural products. A well-managed investment in agricultural assets is being viewed as a “safe” option compared to other investments, with the yield (when cash and capital returns are considered) being commensurate with the risk.
- **From an outside investor’s perspective an equity partnership is an attractive and viable business alternative to direct farm ownership for several reasons**: it enables investors to purchase a business with greater scale than they would otherwise achieve on their own; gives investors the ability to benefit from the skills of other shareholders, including top-performing farm managers; allows investors to spread their capital and risk across a greater range of investments (i.e. be involved in more than one sector); and can help foreign investors gain approval to purchase agricultural assets by demonstrating the involvement of New Zealand interests.
- **Vehicle for first step and progression toward full farm ownership.** An equity partnership provides an opportunity for a newcomer to establish a stake in a farm business, which may then grow over time. It allows new entrants the ability to overcome the high capital requirements for entry into farm ownership, and leverage off the capital, experience and expertise of the other parties involved. Other investors involved benefit from having quality managers with “skin in the game”. The only problem now is a shortage of quality managers with money to invest. This is opening up opportunities for professional managers who may end up investing, but perhaps only several years down the track.

  In the likes of the meat and fibre or cropping sectors where there have historically been more limited avenues to enter into farm ownership (i.e. no sharemilking as in the dairy sector), and lower cash rates of return, equity partnership provides a viable and lower-risk option. **Generally the equity manager’s position is salaried, providing a higher level of income security and stability for families compared with purchasing a smaller block when starting out.**

  In the dairy sector there can also be more security and certainty than share milking, where livestock values and cash returns can fluctuate markedly according to seasonal and market conditions, making it difficult to build sufficient capital. In the situation of land prices increasing significantly faster than livestock values, this can also make it difficult for sharemilkers to build sufficient equity to purchase a farm. While anecdotal evidence suggests contestable (non-family) sharemilking positions are becoming more difficult to come by, the proportion of herds operated by sharemilkers has not changed much: in 2012/13 it was 35 percent, and ten years ago 37 percent. The decline in the availability of sharemilking positions seems more related to the decline in the overall number of herds, despite the rise in the number of cows, with larger herd sizes, farms, and capital requirements. Therefore equity farm propositions have become more popular.
- **Access capital to fund development projects to improve business performance.** There are many farm businesses that have all their capital tied up and find it difficult to release equity to fund development projects to improve business performance. Equity partnerships provide an opportunity for the introduction of new capital to fund development, and also involve different expertise to help improve financial performance.

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- **Access quality governance and expertise, as well as sharing knowledge.** The intellectual knowledge required to operate farm businesses, especially the productive side of managing pastures, plants, animals, climatic conditions, diseases, pests etc to achieve consistent production and returns, requires a high degree of specialist expertise. Equity partnerships allow all these skills and others to be brought together to enhance financial performance. The larger scale usually associated with equity partnerships often allows for a governance function, which can be used to provide oversight, access expertise, and guide strategic direction to create additional wealth. A governance function can also represent the different interests involved and help resolve any differences of opinion.
- **Release equity tied up in a farm business for succession and/or retirement.** Changing societal attitudes towards fairness and equality mean it's no longer the norm for the asset to go in its entirety to one person. With retirement needs having increased, and farm assets being divided between more family members, this has led to the need for more capital to achieve succession outcomes. Involving outside parties allows capital to be released from a farm business to ensure an equitable split can be achieved for all family members. It can provide an out for those family members who don't wish to be involved, or want some capital for other ventures. It can release capital to enable part or full retirement for those exiting. The expertise of the new equity partners can be used to help replace those leaving. Additionally, agreements can be formed to exit the business over a period of time with a steady release of capital.

HOW DO EQUITY PARTNERSHIPS WORK?

Well firstly it is about the investors coming together and ensuring there are commonly held goals, motivations and timeframes. Secondly, it is about undertaking the correct due diligence on any proposition and working out how it will create wealth. Thirdly, it is about robust structures and business processes being put in place to ensure the critical factors for success are executed and any risks appropriately managed.

Central to the success of an equity partnership is alignment of the investors' goals. During the formation period, and regularly throughout the lifetime of an equity partnership, it's healthy for the individual investors to test their alignment with the business strategy. The key considerations should include:

What are the objectives of the joint venture?

- Why are the parties joining together?
- Categorise the purpose and priority of the joint venture's goals.

What is the investment scope and timeframe for the venture?

- Short term (1 – 3 years) – develop and resell for capital gain (Be aware of tax implications though)?
- Medium term (3 – 5 years) – develop, improve production to a state where cash returns are being generated, then consider strategic alternatives, such as buying the neighbouring farm, or selling?
- Long term (5 years to perpetual) – either develop, improve production to a state where cash returns are being generated, or invest into existing profitable operation and hold?

Are each individual's investment objectives aligned with those of the other investors?

- Does the investment provide material risk to my own business?
- Does my personal position allow me to invest, or contribute human capital for that length of time?
- Do I require a return on the investment to support my own financial position?
- Do I perceive any personality clashes/conflicts of interest that may derail the equity partnership?

Will parties be locked in for an initial term for the protection of the business goals?

- What is an appropriate duration from the outset for investor capital to be locked in (commonly referred to as a sunset clause) to ensure investment goals are achieved?
- Should the shareholders also be prevented from competing with the joint venture?

How will the joint venture be funded?

- In times of low commodity prices, high levels of debt often reduce the ability to distribute dividends (if desired), and/or fund capital development/ acquisitions. That means the level of gearing will be depend on these desires.
- How much shareholder capital is available to satisfy the above? Do other investors need to be found before proceeding?
- Are there terms and conditions of any finance that need to be considered? For example loan repayment covenants could complicate the directors' ability to distribute dividends.

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- Do all, or any, of the shareholders have the ability to fund any further calls for capital? What impact would this have on business continuity and the balance of shareholdings held?

It is often good practice for the individual investors to complete their own investment goals in isolation then share them with the other investors to see how well aligned they are. This prompts good robust discussion around compatibility.

DUE DILIGENCE AND ESTABLISHING THE CRITICAL SUCCESS FACTORS

After common goals and timeframes have been established it is about finding the right proposition that aligns with these. This requires all the normal due diligence on a proposition. It also requires an understanding of what makes the business tick.

To do this an understanding of the following is required:

1. What are the inputs, process and outputs of the business?
2. For each of these, what are the key elements for value creation?
3. What must the business get right (critical success factors – CSFs) and what might go wrong (the key risks)?
4. How will the business get the critical success factors right, and mitigate the risks?

For a dairy farm investment, it may be decided the key elements are irrigation, or rainfall to grow a large volume of grass, buying stock feed at a reasonable price and "top 10%" farm management to covert grass and purchased feed to milk.

Critical success factors become rainfall, soil types, water rights, external feed sources, grazing contracts, potential staff skillsets, salaries and incentives, and financial oversight and controls.

You need to realistically evaluate these elements to ensure they are in place, or know the consequences if they are not.

Experienced advisors familiar with the type of business investment being looked at, and benchmarks showing the range of performance of similar businesses, become very important at this stage, even if an investor is familiar with the sector. They can help determine whether the proposed inputs, process and outputs can realistically be expected to generate the results expected.

All the usual due diligence should occur before jumping in the deep end. This includes the construction of a business plan showing returns and assumptions used, a capital expenditure budget and other future development plans, financial projections etc. Additionally, directors/equity managers should be researched, independent legal and financial advice should be sought on all structural, ownership and financial decisions, and there should be common objectives with other shareholders.

STRUCTURE AND BUSINESS PROCESSES

Legal Structure

Traditionally a limited liability company has been the most common ownership structure for equity partnerships. Shares are issued to each member according to the amount of capital each investor provides (not necessarily equal amounts). The equity partnership owns the land, plant and any stock, and employs a manager or sharemilker to run day-to-day activities. Often one of the partners is employed as the farm manager, or more commonly referred to as an equity manager. However, in recent times limited liability partnerships have become more popular due to it being easier to move capital in and out of the business and investors are taxed at their personal marginal tax rate. There are also other structure types, such as trusts. The right type of legal structure depends on a number of factors and professional advice should always be sought.

A company is a separate legal entity and it is mostly controlled by the directors, with certain key decisions made by the shareholders. It is simple to understand and manage, and is reasonably flexible regarding a change in shareholding.

For example, this is how an equity partnership under a company can be structured:

- A company is set up with a standard farming company constitution.
- All assets, including land, stock and plant, are owned and farmed by the company.
- Shareholding is based on the amount of share capital that individuals contribute to the set-up.
- Purchase of the assets is funded by shareholder capital and bank debt borrowed by the company.
- Shareholders' capital contribution may come from their own cash, or from borrowing against their own assets.

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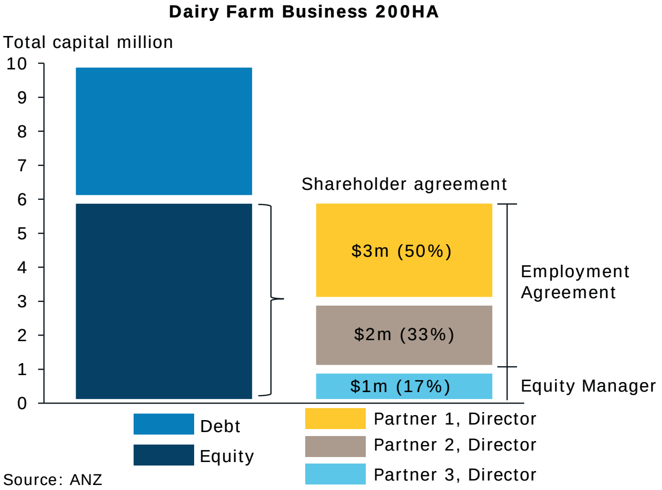
Below is a simple model of an equity partnership set up under a company structure to purchase a 200ha dairy farm.



Source: ANZ

In this example, three shareholders with varying levels of equity investment have pooled together their capital to purchase this farm. In funding the company, they have also used $4 million of bank debt. One of the investors is going to run the business and is referred to as the Equity Manager.

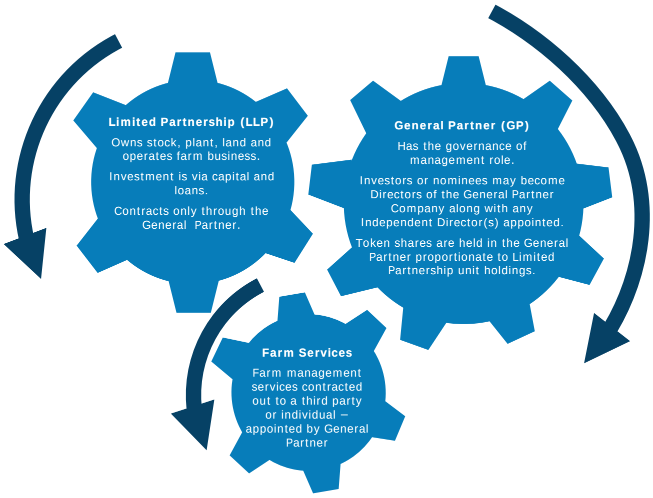
Once the capital structure of the equity partnership is established the investors then need to determine:

- The number and classes of shares.
- Issuing of shares and issue consideration.
- The voting rights of shareholders to elect representatives (Directors) onto the Board.
- The equality of voting rights (where unequal shareholding exists) in matters that go to the heart of the investment.

A limited partnership is slightly different. It consists of two classes of partner: a General Partner and the Limited Partners. In broad terms, the difference is that the General Partner is responsible for the management of the Limited Partnership, and Limited Partners invest into the Limited Partnership. A General Partner therefore performs a role similar to that of a manager of a company, and a Limited Partner is similar to a silent investor. A party cannot be both a General Partner and a Limited Partner, but there is no restriction on related parties (i.e. related companies in a group) being a General Partner and a Limited Partner in the same Limited Partnership.

The General Partner will be jointly and severally liable with the Limited Partnership for the debts and liabilities of the Limited Partnership. This means that in the event of a claim against the Limited Partnership, any residual liability of the Limited Partnership, after the assets of the Limited Partnership have been exhausted, will fall to the General Partner. For this reason, General Partners are almost always incorporated companies.

A Limited Partner's liability (similar to shareholders in a company), will be capped at that partner's contribution to the Limited Partnership, provided the Limited Partner(s) are not engaged in the management of the Limited Partnership. Holding shares in the General Partner is not in and of itself considered to be engaging in the management of the Limited Partnership. The following diagram illustrates how the Limited Liability Partnership structure is intended to operate and meets the requirements of the applicable legislation.



Guiding Documentation

Key aspects of an equity partnership are a binding Shareholders' Agreement signed by all shareholders, a well-developed business plan and employment agreements. Collectively these set out the joint venture's goals and how it will operate.

A binding Shareholders' Agreement is perhaps the most essential. It should anticipate the possible points of future disagreement and contain 'ground rules' for the procedures to be followed if shareholders cannot agree. It should include clauses on the following:

- Objectives and purpose of the partnership.
- Authority to make commitments on behalf of the venture.
- An indicative investment period (i.e. "sunset" clause) and a clear process to allow shareholders to exit, or transfer shares from the partnership.
- A share valuation process for changes of ownership.

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- Banking arrangements.
- Meetings and reporting standards. Reporting systems should be regular and timely, and provide all the information to which shareholders are entitled. This keeps all parties well informed and ensures there are no surprises. Transparency is an important aspect of successful equity partnerships.
- Voting procedure on major decisions (e.g. capital expenditure, leases, debt funding, investment in other companies).
- Disputes processes and how they are to be addressed.
- Appointment of Directors and an outline of the decision-making process and responsibilities between governance and management.
- Other clauses aimed at protecting individuals' property rights.
- An Individual Employment Contract for the manager or sharemilker, even if a shareholder. This includes a detailed contract and job description.

Roles of people in an equity partnership

In forming an equity partnership consideration needs to be given to the various roles to be performed within the business, the skill-set and availability of the shareholders to fulfill these roles, and external parties required to strengthen areas of perceived weakness.

Governance

Whether a company or partnership structure is used, a Board of Directors or Advisory Board is usually appointed.

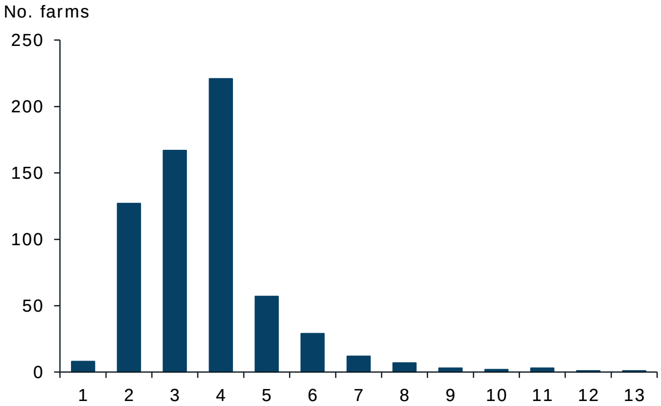
A Board of Directors is charged with the responsibility for determining the direction of the business. They do this by establishing the strategic plan (greater than one year) and then incorporating it into the farming policies and practices that the management and staff of the business apply at tactical (weekly-to-monthly) and operational (daily) management level.

Core functions of the Board include (but are not limited to):

- Establishing the equity manager's terms of employment;
- Establishing major farm policies;
- Ensuring quality financial reporting, cash flow projections and revisions, and farm production reports. Delivering these may be the responsibility of the farm manager, accountant or farm consultant;
- Completion of annual budgets, preparation of financial statements and general upholding of accounting records;
- Dividend distribution policy;
- Capital development planning and execution;
- Delegations of authority to create obligations on behalf of the company;
- Matters requiring approval by a special resolution:
  - Major transactions
  - Asset disposal/acquisition
  - Issue/transfer of shares
  - Borrowing or lending by the Company

An advisory board is a more informal group that can be structured to provide strategic direction but also offer advice to the management of an equity partnership. Unlike the Board of Directors, the advisory board does not have authority to vote on partnership matters, nor a legal fiduciary responsibility and is therefore more informal. An advisory board is used to benefit from the knowledge of others, but avoids the expense and formality of a Board of Directors.

Director numbers on syndicated dairy farms in 2010-11



Sources: ANZ, DairyNZ

Notes:

1. Of the eight syndicates that had only one director, one had a silent overseas investor, two were in receivership and five had a silent NZ investor who has since gone into receivership.
2. Some syndicates own multiple farms – hence the number of syndicate boards and syndicate farms was not the same.

In 2010-11 DairyNZ did some number crunching on the governance of syndicated (non-related partnerships) dairy farms in New Zealand. **Of 826 syndicated dairy farms identified by DairyNZ, the majority had some sort of board structure in place, with most (90 percent) having 2-5**

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directors involved. Interestingly though, only 7 percent involved independent directors. But the use of a board and independent directors was much higher than in family-owned companies at the time (only 3.8 percent). This may have changed though, as the ANZ Business Barometer from 2013 showed many more businesses (30 percent of respondents) using a board structure, as well as a much higher proportion using independent directors (62 percent of respondents who used a board involved at least one independent director). Very few syndicates at the time (14 percent) had succeeded in achieving ownership of multiple farm businesses, probably due to most being 'on-off' affairs. Joint ventures with more than one farm were more likely to use an independent director (25 percent).

Good governance is an integral part of a successful equity partnership, including bringing in specialist professional advice and discipline around many business functions.

Business Management

Proper business management is one of the most commonly underutilised processes in any business, let alone equity partnerships. In an equity partnership it is an ongoing collaboration between the Board of Directors, operational and financial management, and external advisors. The success of this collaboration is integral to an equity partnership achieving its investment goals.

The board delegates day-to-day operations to a management team, which usually consists of some combination of an equity manager, farm manager, and/or independent business manager. The management team is responsible for ensuring the plans are implemented. While the majority choose an equity partner to run day-to-day operations, the DairyNZ research for 2010-11 showed 44 percent of syndicated farms are managed by an entity without a shareholding in the syndicate. The rest are run by an equity manager on a salary (43 percent) and equity sharemilkers (12.5 percent).

TYPES OF OPERATORS OF SYNDICATED DAIRY FARMS

Type	NZ Total	% of Total
Equity Partner on Salary	361	43.3%
Equity Partner as HOSM	34	4.1%
Equity Partner as VOSM	70	8.4%
HOSM	73	8.8%
VOSM	97	11.6%
Salaried Manager	198	23.8%

Source: DairyNZ

The increase in popularity of equity partnerships has created a shortage of quality managers with money to invest. **This is opening up opportunities for professional managers, but we are also seeing a move from equity managers on a salary, to equity managers as variable-order sharemilkers.** The issue is that equity managers almost always take on a much bigger operation than they have experience with, and anecdotally the failure rate is high. New syndicates seem to be favouring having the equity manager on a variable order share milking (VOSM) contract, or as a contract milker, because these contracts have a limited period before they need to be re-signed. If the manager is not performing then it is easier to move on an equity manager on a VOSM contact, or a contract milker, than a salaried equity manager.

WHAT ARE THE RISKS?

Over the years, there have been both spectacularly successful and absolutely disastrous examples of equity partnership investment. For the absolute disasters there has never been one common denominator. But some of the more common factors have been:

- Inadequate equity funding and investors being tripped up during times of low commodity prices;
- Development projects that have not run to budget and time;
- Differences of opinions amongst investors that have not been able to be revolved; and
- Projects that have inaccurately assessed the potential of a business and not attained production and/or profit targets.

Many of the risks that exist for an equity partnership are the same that apply to a sector generally, be it sheep, beef, dairy, deer farming or growing. Sector and asset-specific risks include things such as commodity prices, input costs, regulation, biosecurity, weather, and the list goes on. The due diligence process is important to help understand these risks (as well as potential returns). **Other risks and benefits are related to the structure and the individuals involved.** Specific risks related to an equity partnership structure include:

1. **Loss of 100 percent control.** An equity partnership involves a number of individuals, and from time to time differences in opinions will arise. To manage this it is important shareholders have similar investment motivations and objectives from the outset. Additionally, regular reporting and a communication process should be in place between shareholders, governance and management. If

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conflict does arise, then there should be an agreed process to resolve it.

2. **Consideration of others' opinions and motivations.** Decisions may be a compromise and may not meet all the shareholders' expectations. Involving more opinions also inevitably leads to slower decision-making. Therefore, as mentioned above, it is important investors are on the same page from the outset with strong business processes in place. The flip side of considering other opinions and slower decision-making is that a good mix of skills and expertise can led to better and more balanced decision-making.
3. **Incompatibility risk.** This is always a risk, but control can be exercised by carefully choosing who is involved and doing the due diligence on partners before investing. In the case of incompatibility a clear, pre-determined pathway should be in the shareholders' agreement to provide an agreed exit option.
4. **Ability to exit.** Even when shareholders go into an equity partnership with common goals and expectations, circumstances can change. As it is a partnership, and investment in agricultural assets is often not overly liquid, it can be difficult to exit quickly. Therefore, it is important there is a clear process laid out for shareholders to exit should circumstances change.

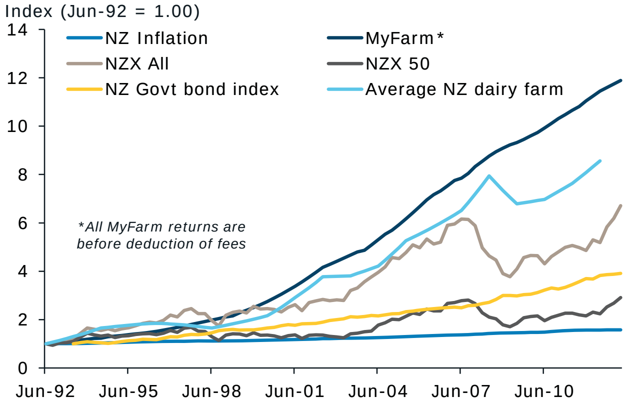
WHAT ARE THE POSSIBLE RETURNS?

Unfortunately we struggled to find any credible quantitative evidence about equity partnerships success or otherwise when it comes to returns. Anecdotally, the majority of returns from equity partnerships have been in the form of capital appreciation rather than periodic cash dividends. This is fine as long as shareholders understand this and there is an agreed mechanism to access the increased wealth when individual investors or the group requires it.

Logic suggests that in the long run, returns will be similar to those of the average farm owner (3-7 percent return on assets, plus 5-10 percent capital gain per annum, although capital gain seems less certain in the future and is tied to productivity improvements). In comparison, a HOSM agreement will generate on average a 20 percent return on assets, although there is a greater degree of annual variability in this figure. **However, like all things, there will be a distribution, and if the benefits of an equity partnership can be unleashed (i.e. extra scale, combined expertise etc), returns may well be higher than those of the average farmer.**

Some recent analysis conducted by independent economist John Savage for MyFarm certainly showed the outperformance of dairying as an investment class in recent times. Real dairying returns (capital and cash) have averaged 6.5 percent over the last 10 years. This compares with 4.7 percent on government bonds, 3.6 percent for the NZX50, and 4.7 percent of all companies in the NZX. MyFarm have managed to outperform the average for dairying in recent times, achieving an annual real return of 8.1 percent before fees are deducted.

Comparative nominal returns of different investments



Sources: ANZ, MyFarm, John Savage analysis

REAL ANNUAL % CHANGE IN INVESTMENT RETURNS	MyFarm*	NZX All	NZX 50	NZ Govt Bond Index	Dairy NZ
Mean Jun92-Jun12	10.78%	7.27%	2.71%	4.8%	9.79%
Mean Jun92-Jun02	13.49%	9.84%	1.84%	4.9%	13.14%
Mean Jun03-Jun12	8.06%	4.69%	3.58%	4.7%	6.44%

*All MyFarm returns are before deduction of fees

Sources: ANZ, MyFarm, John Savage analysis

MyFarm puts its recent outperformance down to a number of things:

- **They kept buying during the 2008-2011 period** and grew from circa 15 farms under management to around 40. These were better-priced assets as property prices were softer during this period.
- **Debt to debt + equity ratio is low – meaning that in low milk price years farms can still be operated for (medium-term) profit rather than farming to preserve cashflow.** This means they don't go through radical systems changes, reduce fertiliser spending, or change approach to herd or pasture improvement (the things that result in productivity growth).

FEATURE ARTICLE: EQUITY PARTNERSHIPS – A LOOK UNDER THE BONNET

- **Their portfolio is weighted toward Southland and Canterbury.** In the last six years these regions have outperformed the rest of New Zealand due to their productive capacity and have also been less affected by adverse weather events, in particular the droughts that have been seen in parts of the North Island.

MyFarm's strategy has been particularly focused on productivity improvement and buying land that will reward good performance from this facet of farm management. This provides one example of following a defined business strategy and unleashing the advantages of an equity partnership. **This is not to say MyFarm hasn't faced challenges though** with Andrew Watters admitting some mistakes, but saying the lack of ultimate performance has usually been a mis-match of property quality versus business plan projections (i.e. the farm was thought to be better than it turned out to be).

CONCLUSIONS

In summation, equity partnerships need to be well constructed, and considerable time and effort may be required during the set-up phase. However, the time spent getting the structure right at the start is well spent, as it's usually an indicator of success in the future. In particular, all potential issues should be recognised, addressed and reconciled from the beginning.

Key factors for successful equity partnerships include:

- Ensuring time is taken at the outset to do all the appropriate due diligence;
- Gathering advice from professionals on the various aspects of an investment;
- Understanding the value proposition of the investment;
- Clearly identifying and prioritising investors' needs;
- Taking care in choosing fellow investors with complementary attributes and similar motivations and timeframes;
- Understanding the needs of, and differences between, governance and management;
- Agreeing a business plan;
- Putting in place a shareholders' agreement, partnership agreement, or similar prior to investment;
- Including adequate entry and exit strategies in the shareholders' agreement; and
- Appropriately structuring debt and capital.

THE MONTH IN REVIEW

SUMMARY

It has become increasingly dry in many parts of the North Island. In contrast the South Island has had a pretty good run. Dairying is set to post new records for production, yields, price, revenue and bottom lines. It is steady as she goes in the meat and fibre sector. There is a smaller – but high quality – pipfruit crop with good sized fruit.

It has become increasingly dry in many parts of the North Island. The worst-affected regions are Northland, Waikato, Bay of Plenty and the Central North Island. Until recently the dry conditions had been more localised than last year's drought, but as more time passes without substantial rain, the dry conditions have broadened. There has been the odd bout of rain, but not enough to kick-start pasture growth. Many are starting to report low water tables from back-to-back dry summers. **The East Coast of the North Island is more comfortable for feed, but still in need of more rain for the autumn.**

In contrast the South Island has had a pretty good run. Marlborough had good rain at the end of March, after earlier becoming dry, which should help for the autumn. Canterbury dry-land areas also received good rain in mid-March and the rest is under irrigation. At the end of March, Otago and Southland were more comfortable for feed than the 6 months prior. Warmer-than-normal conditions and intermittent rain have set these regions alight.

DAIRY

It looks like it will be records all round for the NZ dairying sector in 2013/14. This is unique as there aren't too many seasons where there is a record for both production and the payout. Overall production to the end of February is tracking 6.5 percent ahead of last year, with the South Island slightly ahead of the North Island. On this basis, and looking at milk yields usually achieved over the last quarter, **it now looks possible total production will be up by nearly 9 percent y/y to 1.806 billion kg MS for 2013/14.** This would eclipse the previous record set in 2011/12 by 7 percent. **Perhaps more importantly, this means the average yield per cow will be close to 375 kg MS. Such a result would be a new record, and confirm above-trend productivity growth in the past few years.**

In the North Island where the dry conditions are starting to bite many are evaluating their options as the end of season approaches. Year-to-date production has been ahead of budget, but lower autumn production will probably bring it back in line with budgets, or just above, depending on Mother Nature. **The farm system being operated and individual situations are influencing decisions.** A few have recently dried off their entire herd, but most are looking to hang on. This has involved drying off low performers and shifting to once a day milking. Cows are still reported as being in good condition and many are feeding 80+ percent supplements as they await rain.

While there might not be a lot of grass, different decisions are being made versus this time last year. This is due to the better availability of supplement feed with more silage made earlier on, maize now being available, and better ability to source palm kernel extract, for which there was only a small spot market at the same time last year. While this is costing more, the other big difference is the affordability, with a $3.15/kg MS difference in the milk price between last year and is now a big incentive to extend lactation.

MEAT AND FIBRE

The meat and fibre sector looks to be steady as she goes. There is some evidence of higher stock turn-off in drier regions, but with the South Island and East Coast of the North being comfortable for feed there hasn't been a pronounced spike. **Year-to-date lamb slaughter is tracking slightly (-3%) behind last year. But the decline isn't as much as current industry forecasts** for an annual 8 percent drop in 2013/14. **This implies slaughter through-put could slow more dramatically in the autumn period**, especially if the dry conditions in the North Island dissipate.

In regard to the long-term picture, mutton slaughter has been stubbornly high, running 3 percent ahead of last year. The stark contrast to last year is that the increase is being driven out of the South Island (+13.5% ytd). There was a notable spike in January when lamb slaughter was lower than normal, so it could have just been a shuffling of processing capacity. Nevertheless, with industry forecasts for a 6 percent decline in mutton production in 2013/14, many in the industry will be nervous of the continuous creep of dairying and its effects on long-run production potential.

HORTICULTURE AND VITICULTURE

Hail and a biennial bearing habit in Hawke's Bay pipfruit trees has meant the total pipfruit crop is estimated to be back 6 percent on last year to 17.1m cartons. **The 2014 kiwifruit harvest is expected to be slightly larger.** Gold production is expected to increase to 17.5m trays and Green is forecast to decrease slightly to 66.5m trays.

RURAL PROPERTY MARKET

SUMMARY

The rural property market seems to have eased its foot off the gas pedal a touch since the New Year. Overall activity levels are still strong, with total turnover hovering around pre-GFC levels, nearly 20 percent above the 10-year average. However, prices have eased slightly and have been mixed across sectors. While the dairy payout has been revised up, attention has turned to what is in store for next year. A lower milk price, lifting interest rates, and plenty of robust discussion on political and environmental regulatory risks seem to have returned a touch of realism. That said, the dairy sector continues to dominate activity and pricing in many regions. Elsewhere kiwifruit orchards are reportedly moving quickly and at prices not seen since Psa was discovered in 2010. In the sheep and beef sector, apart from the odd marquee property selling for good money, things remain fairly subdued.

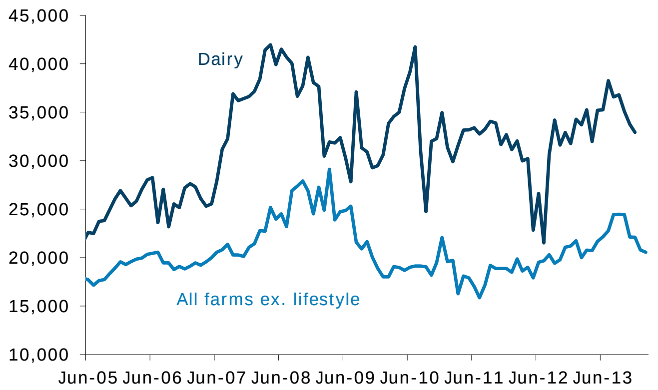
Total turnover in recent months has continued to hover 20 percent above the 10-year average. This means annual 2013/14 sale volumes are likely to return to pre-GFC levels for the first time. Sale volumes of finishing properties have led the charge, followed closely by dairying. But the buoyancy in sales volumes has generally been broad-based with all property types exceeding or on par with their turnover average from the last 10 years. **The average all-farm price has dropped $1,500/ha since the end of 2013 to $20,600/ha.** However, this can be influenced by the mix of sales (both region and type) from one period to the next. The softening seems to have come through on dairying and grazing properties. Many of the normal drivers for better activity and price levels remain the same. But taking the shine off would seem to be a moderation in the farm-gate price for dairying in 2014/15, higher interest rates, and perhaps some conservative budgets for production, with the dry.

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	93	95	58	72	↓	↑	↑
	Median Price ($ per ha)	32,900	33,800	31,800	30,300	↓	↑	↑
Livestock – Finishing	Number of Sales	119	122	73	66	↓	↑	↑
	Median Price ($ per ha)	20,300	20,200	18,800	14,400	↑	↑	↑
Livestock – Grazing	Number of Sales	240	245	195	222	↓	↑	↑
	Median Price ($ per ha)	14,400	14,500	13,000	15,200	↓	↑	↓
Horticulture	Number of Sales	44	38	37	47	↑	↑	↓
	Median Price ($ per ha)	128,100	140,900	112,400	146,300	↓	↑	↓
Arable	Number of Sales	27	27	14	19	↓	↑	↑
	Median Price ($ per ha)	22,900	22,200	27,600	26,300	↑	↓	↓
All Farms ex. Lifestyle	Number of Sales	559	553	403	458	↑	↑	↑
	Median Price ($ per ha)	20,600	20,800	20,000	20,200	↓	↑	↑
Lifestyle	Number of Sales	1,690	1,653	1,590	1,567	↑	↑	↑
	Median Price	515,000	522,000	495,000	425,000	↓	↑	↑

Farm Sales, Median Price

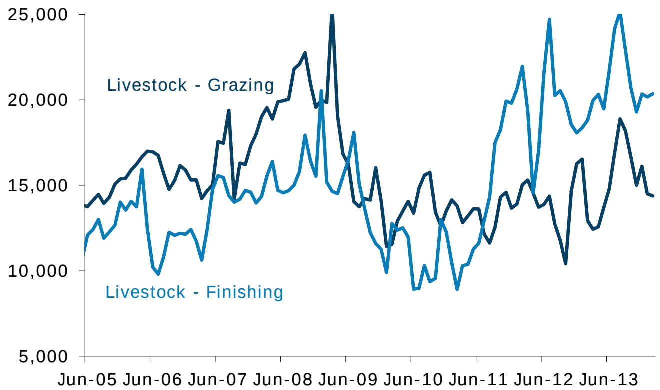
$ per hectare (3 mth median, sa)



Sources: ANZ, REINZ

Farm Sales, Median Price

$ per hectare (3 mth median, sa)



Sources: ANZ, REINZ

RURAL PROPERTY MARKET

In the property price cycle productivity is an oft-overlooked variable. We did some in-depth analysis on livestock productivity trends back in the October 2012 edition of the *Agri Focus*: “The great growth frontier for livestock”. What it showed amongst other things is most of New Zealand’s livestock sectors have made great strides in outputs per animal and per hectare since 1990/91. Agricultural productivity gains were particularly strong after deregulation in the mid-1980s, averaging 4.0 percent per annum over a 17-year stretch. However, with a lot of the easy wins taken, a renewed focus on genetics, nutrition, and best-practice feed budgeting and farm management was required to arrest a slowdown in the mid-2000s.

The first signs of productivity reinvigoration seem to be coming through. Examples include the prospect of average milksolids production per cow breaking through the 370 kg MS barrier for the first time ever in 2013/14. This represents a remarkable recovery from the drought last year and reinforces some of the positive developments in farm systems, skillsets and behaviours in recent times. As Fonterra’s half-year results showed, the growth in milk supply has caught even them by surprise –so much so they have decided to increase capital expenditure in new processing capacity by $400-$500 million (+16 percent) over the next three to four years. Another productivity highlight is the roll-out of the red meat sector’s PGP. This is the first substantial increase in funding and activity specifically targeted at on-farm activity in a long time. A host of new innovations in the horticulture sector are boosting long-run yields and also improving other attributes at the same time (i.e. taste, colour etc). There is also a number of new irrigation schemes moving closer to the investment ready stage and construction.

Of course there are challenges on the productivity front too, and none bigger than regional water plans and proposed caps on nutrient limits. The Canterbury region is the current focus, with nitrate loss caps recently being set at 20-25 kg N/ha/annum across the whole of the region and higher standards are to be set in sensitive areas. The benchmark level is an average of the losses from 2009-2013, above which (it is assumed) restrictions on land use will apply. Limits apply to individual properties where they have their own water takes. Irrigation schemes have been given bulk nitrate loss caps, which they will then allocate across their individual users. Given current understanding, farming practices and technology, this will have a large impact on productivity and land use trends.

So while there are many signs productivity growth is being reinvigorated, there are also some large challenges. The success or not in this facet of farm management will have a large flow-on through to the property market, as productivity is a crucial part of the assessment purchasers must make when evaluating a property and its potential.

As a side note, one key area to watch going forward is the unwind of policy stimulus from central banks. Courtesy of Quantitative Easing (QE) and record-low interest rates, asset values have lifted across all classes around the globe, supported by an abundance of liquidity. NZ was not immune from this dynamic. Interest rates are now moving up and QE is being unwound. In such an instance asset valuations need to morph away from liquidity-driven support towards the economic fundamentals, and in effect the underlying returns. With underlying returns across farming still low and implicitly capitalised into the asset value, productivity remains critical.

Examining the backward-looking indicators for the rural property market on page 12 shows the turnover of dairy properties has been solid. Since the start of 2013 it has run 30 percent above the 10-year average, although this is slightly behind the activity levels seen in the last quarter of 2013. **In the month of January, 25 dairy farms were sold, at an average sale value of $22,600/ha, or $35 per kg MS.** The average farm size was 138 hectares and the average production/ha was 639 kgs of MS. **In the month of February, 36 dairy farms were sold with an average sale price of $34,800/ha, or $35 per kg MS.** The average farm size was 121 hectares and production/ha was 986 kgs of MS.

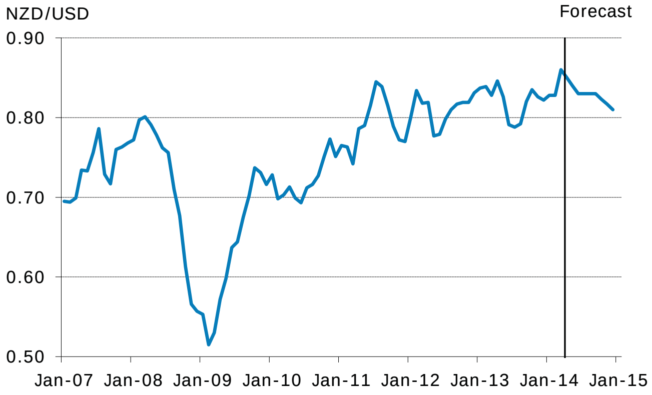
Turnover and prices for finishing property have continued to show strength. Turnover continues at levels nearly twice the 10-year average and prices are oscillating around the $20,000/ha mark. The strong activity has been driven by dairy support, irrigation developments, and/or possible future dairy conversion. **Turnover activity for grazing and arable properties has picked up since the end of 2013, but prices have softened over the same period.** Turnover for grazing properties has held above the 10-year average for three months in a row, the first time since the GFC. Average prices have moved back to $14,500/ha after reaching close to the $19,000/ha mark in the spring period.

In the horticultural sector kiwifruit orchards are in hot demand. Confidence has risen from solid 2013 orchard-gate returns, new investors entering the sector, and Psa being less prevalent in many of the main growing regions. **Properties are reportedly selling quickly and some at prices double the year before.** For a well-situated quality gold kiwifruit orchard the going rate is $350,000 per canopy hectare. Green kiwifruit orchards are more difficult to come by, but recent sales at the premium end have ranged from $200,000-$250,000 per canopy hectare. The viticulture market has been slower so far this year as buyers wait to assess the impact of a large 2014 vintage on returns.

ECONOMIC INDICATORS

EXCHANGE RATES	Current Month	Last Month	Last Year	Chg. M / M	Chg. Y / Y
NZD/USD	0.860	0.839	0.828	↑	↑
NZD/EUR	0.624	0.613	0.639	↑	↓
NZD/GBP	0.519	0.507	0.549	↑	↓
NZD/AUD	0.933	0.930	0.802	↑	↑
NZD/JPY	87.81	86.13	78.49	↑	↑
NZD/TWI	79.95	78.28	76.91	↑	↑

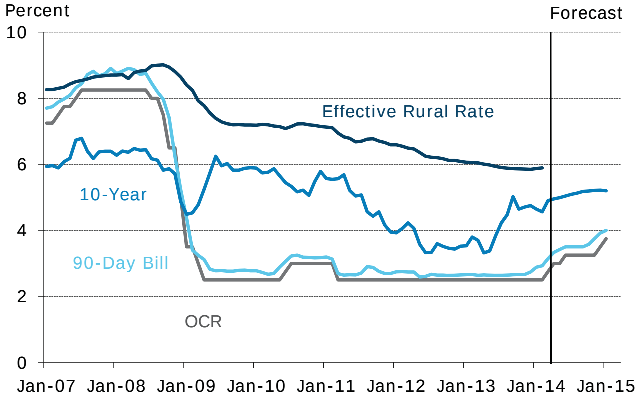
NZD Buys USD



Sources: ANZ, Bloomberg

NZ INTEREST RATES	Current Month	Last Month	Last Year	Chg. M / M	Chg. Y / Y
Official Cash Rate	2.75	2.58	2.50	↑	↑
90 Day Bill Rate	3.14	2.98	2.64	↑	↑
1 yr	3.53	3.33	2.53	↑	↑
2 yr	3.98	3.61	2.57	↑	↑
3 yr	4.24	3.87	2.71	↑	↑
5 yr	4.37	4.18	2.66	↑	↑
10 yr	4.90	4.70	3.70	↑	↑
Effective Rural Rate	5.89	5.86	6.05	↑	↓
Agricultural Debt ($b)	51.80	51.88	50.18	↓	↑

Key NZ Interest Rates



Sources: ANZ, RBNZ

New Zealand's economic prospects remain bright, as does the outlook for commodity prices (though weaker dairy prices of late are acknowledged), employment, and construction. This combination will keep attention on prospects for interest rates moving up. **As a consequence, we expect the NZD to remain elevated**, holding broadly steady in a 0.82-0.87 range through till at least the end of Q3. During that time, we would not discount the possibility of spikes higher towards historic highs around 0.884, **but our central scenario for the next 2 quarters is one of *strength*, rather than *strengthening*.** Beyond that, we see NZD falling gradually. But to be sure, while our long-term forecast has NZD/USD falling back below 0.80 (and NZD/AUD back below 0.90) this expectation is largely based on the USD adjusting to recovering growth there, as opposed to any negative judgements on NZ.

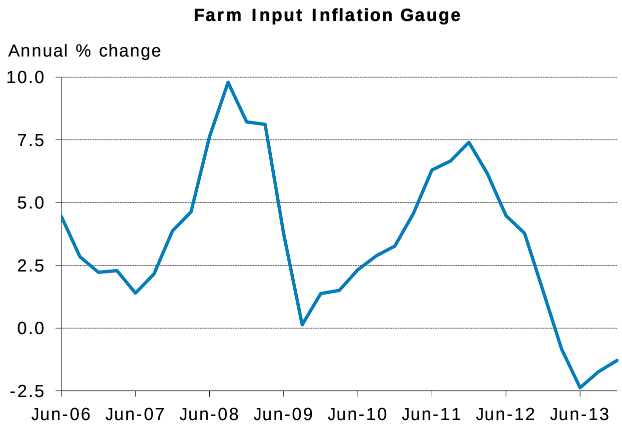
Recent upside surprises to domestic data have tended to push the NZD higher, as did the RBNZ's OCR increase, despite the latter being well-flagged. While at face value this points to the possibility of future upside surprises putting fresh upward pressure on the NZD (which could happen), it is worth noting that monetary policy expectations have stabilised, and that USD weakness has played a role. Upcoming OCR increases are now largely priced in and dairy prices are retreating. Consequently, we are more neutral than bullish on the NZD.

Interest rates have moved sharply higher, and will continue to do so as the RBNZ lifts the OCR, and as the US Federal Reserve normalises US monetary policy and US bond yields move up. But while this move is in prospect, it is now largely built into current market pricing. In other words, forward interest rates are close to our own forecasts, offering few obvious opportunities for hedgers.

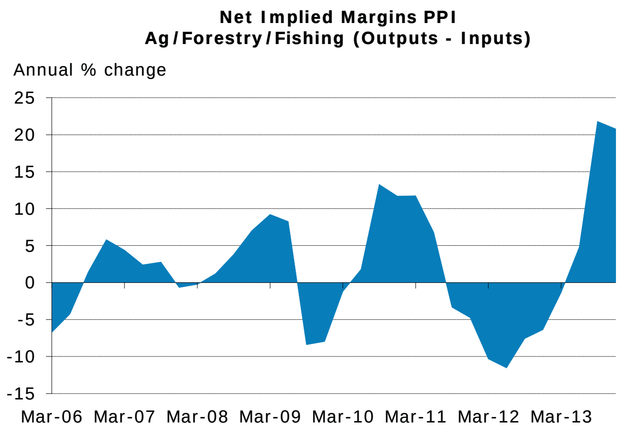
At this stage of the cycle, we see the risk profile as balanced. Indeed, the front end (which is influenced primarily by domestic monetary policy) could go higher if the NZD moves lower, inflation surprises to the upside, or the economy is able to withstand OCR increases. But equally, higher leverage and the low duration profile of mortgage debt mean the economy is more sensitive to rising interest rates than it has been in the past, and it is possible the RBNZ may not need to lift the OCR by as much as projected. Similarly, long-end interest rates (which are influenced primarily by the US) may rise more rapidly if the Fed brings forward its tightening profile and/or US recovery gathers more momentum. But equally, if we see a sharp slowing of Chinese growth, or the US recovery fizzles, we may well see US interest rates consolidate or move lower.

ECONOMIC INDICATORS

INFLATION GAUGES					
Annual % change	Current Qtr	Last Qtr	Last Year	Chg. Q/Q	Chg. Y/Y
Consumer Price Index	1.6	1.4	0.9	↑	↑
Farm Input	-1.3	-1.7	1.5	↑	↓
Net Imp. Margins PPI	20.8	21.8	-6.4	↓	↑



Sources: ANZ, Statistics NZ



Sources: ANZ, Statistics NZ

Cost pressures are expected to continue to build over 2014. This will whittle away some of the year's better farm-gate prices, but more importantly, is likely to set a higher cost structure in place for 2014/15. **A higher cost base in 2014/15 of course carries risks if farm-gate prices undergo a dramatic readjustment.** This is not our central scenario. We would just note volatility in soft commodity prices has doubled since 2006, and none of the drivers for the increase in volatility have changed.

The two drivers of the expected acceleration in on-farm cost pressures are a lift in general economy-wide inflation, and spill-over effects from this year's record milk price into service providers' pricing intentions, and eventually, prices. With the NZ economy hitting expansion mode, the economy's spare capacity will continue to be soaked up over coming quarters, and as this happens inflation pressures will rise. **We expect to see headline inflation increase toward 2.4 percent y/y by the end of the 2014/15 season (up from 1.6 percent at present).** This will spill over into general cost pressures for all farm types. A spend-up by the dairy sector has potential to add fuel to the fire. This would affect all farmers/growers as there are many inputs that are used by all.

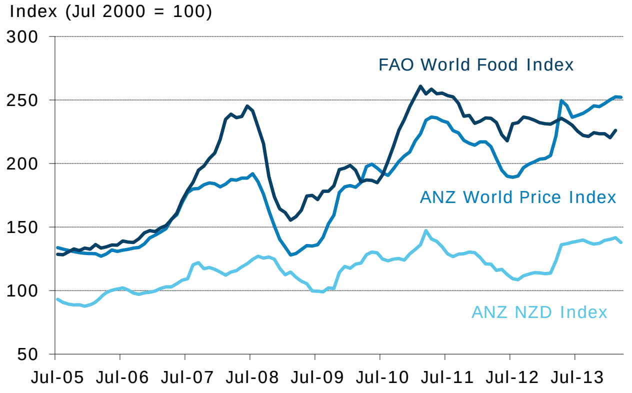
Increases in the OCR will come into focus with 65 percent of rural loans on shorter-date terms. In total we expect 125bps of hikes over the next 18 months. This means the effective rural interest rate is likely to be 75-100bps higher in 2014/15. For the average dairy farmer with debt of $21/MS, this could translate into an extra cost of $0.16-0.21/MS.

The increase in PPI margins slowed in the December quarter to +0.4 percent q/q. On an annual basis margins were 21 percent higher than the year before, primarily due to a 49 percent y/y lift for dairying. Encouragingly, all the other main primary sectors experienced a y/y lift also. In the December quarter there were softer margins for the horticulture and fruit-growing sectors (-2.4 percent), due to softer output prices (-2.4 percent). Forestry (+1.9 percent), seafood (+1.6 percent) and meat and fibre (+1.1 percent) experienced the largest quarterly lifts. The lifts for forestry and meat and fibre were driven primarily by better output prices. In the seafood sector lower input costs (-1.6 percent q/q) were the main driver of improved margins. **Lower input costs have been an unusual feature over the past year, with five quarters in a row of declines. This is the longest stretch of quarterly declines since 2002.** On an annual basis, input costs in the December quarter were back 1.3 percent. The largest declines over 2013 were for meat and fibre (-4.2 percent) and cropping (-3.7 percent).

KEY COMMODITIES: OVERALL INDEX AND DAIRY

SOFT COMMODITY PRICE INDICES	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
ANZ NZ Index	138	141	124	↓	↑
ANZ World Index	252	250	222	↑	↑
FAO World Food Index	226	222	231	↑	↓

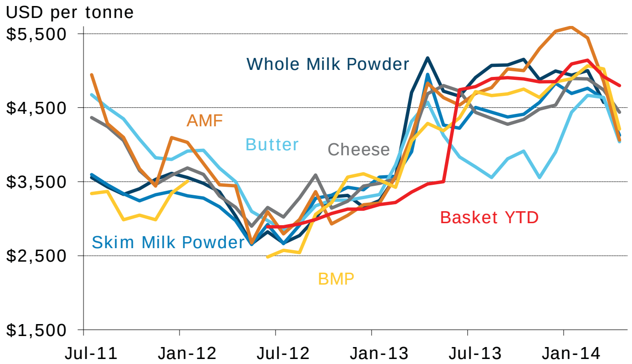
Soft Commodity Price Indices



Sources: ANZ, FAO

OCEANIA DAIRY PRICE INDICATORS USD per tonne	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
Milk Price YTD ($ per MS)	8.40	8.52	5.60	↓	↑
Milk Price Forecast ($ per MS)	8.40	8.42	5.50	↑	↑
Whole Milk Powder	4,033	4,979	5,172	↓	↓
Skim Milk Powder	4,126	4,762	4,949	↓	↓
Butter	4,040	4,335	4,573	↓	↓
Anhydrous Milk Fat	4,062	5,521	4,829	↓	↓
Butter Milk Powder	4,211	4,936	4,289	↓	↓
Cheese	4,438	4,773	4,688	↓	↓
Basket YTD	4,920	5,028	3,470	↓	↑

Dairy Products - NZ Export Market Prices



Sources: ANZ, GlobalDairyTrade, USDA

Global food prices bounced (+2.6 percent) in February following nearly a year of declines. The gains were broad-based across the main sectors, which bodes well for NZ's soft commodity basket. For future direction, geopolitical concerns in Europe and any escalation of trade sanctions with Russia are a must-watch. This could have a number of implications for dairy, meat and grain markets. The upcoming winter wheat harvests and spring planting season for the key Northern Hemisphere producers will also be important for the direction of grain prices and the cost of production for intensive livestock production. **Closer to home, continued NZD strength is likely to keep the pressure on farm-gate prices in the near term**, but as the 2014/15 season progresses we expect a softening, which should provide some relief.

Dairy prices look to be in for a softer period after starting to adjust lower in March. The catalysts seem to have been a broadening in the supply response out of the US and Australia, seasonably high volumes of wholemilk powder from NZ, and a slowdown in Chinese import demand. W**hile the near-term outlook is bearish, some of the factors causing lower prices are likely to prove temporary.**

One temporary factor is the seasonally high volumes of NZ supply, which will tail off over the next two months. While a solid finish to the 2013/14 season is expected, the recent broadening in dry conditions in the North Island will make it highly dependent on Mother Nature. While cow condition is reportedly good and supplementary feed is available farmers will continue to milk their herds. But many are now down to once-a-day milking and if cow condition slips too much then cows are likely to be dried-off early to maintain condition for next year.

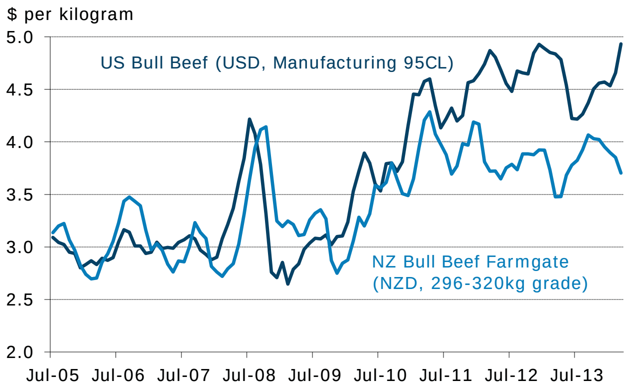
The other temporary impact is a slowdown in China's import demand. This is typical at this time of the year due to high stock levels and the seasonal lift in domestic milk supply. During the months of January and February, China imported 221,000 tonnes of WMP, 77 percent more than in the same period in 2013. Chinese imports are usually strong in the first quarter of the year to take advantage of the preferential tariff rates with NZ, meaning inventory levels tend to build up. **Additionally, as in all countries, China's milk production picks up during their spring period.** This allows dairy processors to utilise more domestic product in the manufacture of certain consumer goods. This appears to be happening at present, but we do not expect China to be able to rapidly expand their overall domestic production through the full course of the year after culling an estimated 15 percent of their herd in 2013. **Overall we expect there might be a bit of downward pressure on the 2013/14 milk price, but are still anticipating a milk price in the low-to-mid $7/kg MS range in 2014/15.** At this stage we would be closer to the bottom end of this range, especially given the elevated level of the NZD.

KEY COMMODITIES: BEEF AND LAMB

BEEF PRICE INDICATORS					
$ per kg	**Current Month**	**3 Mth Trend**	**Last Year**	**Chg. M/3M**	**Chg. Y/Y**
NZ Bull Beef[1]	3.70	3.90	3.48	↓	↑
NZ Steer[1]	3.90	4.09	3.55	↓	↑
NZ Heifer[1]	3.32	3.51	2.95	↓	↑
NZ Cow[1]	2.44	2.80	2.42	↓	↑
US Bull Beef[2]	4.93	4.59	4.84	↑	↑
US Manu Cow[3]	4.69	4.41	4.39	↑	↑
Steer Primal Cuts	7.33	7.27	6.55	↑	↑
Hides[4]	73.2	72.6	58.3	↑	↑
By-Products[4]	55.0	52.3	45.5	↑	↑

[1] (NZD, 296-320kg Grade Bull & Steer), (NZD, 195-220kg Grade Heifer) (NZD, 160-195kg Grade Cow)
[2] USD, Manufacturing 95 CL [3] USD Manufacturing 90 CL [4] USD$ per Hide

Beef Indicator Prices

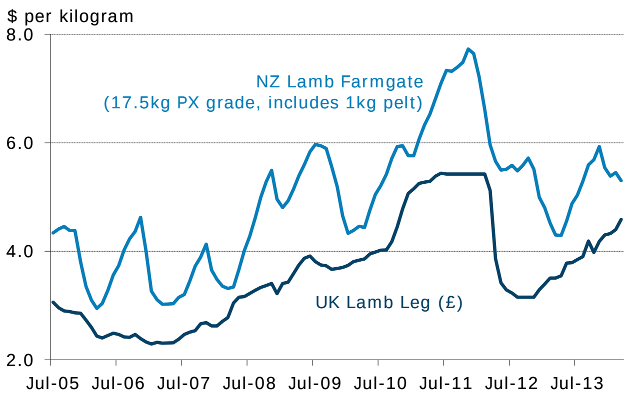


Sources: ANZ, Agrifax

LAMB PRICE INDICATORS					
$ per kg	**Current Month**	**3 Mth Trend**	**Last Year**	**Chg. M/3M**	**Chg. Y/Y**
NZ Lamb[1] (NZD)	5.30	5.46	4.30	↓	↑
UK Lamb Leg (£)	4.59	4.34	3.51	↑	↑
Rack US (USD)	16.8	16.5	15.9	↑	↑
Flaps (USD)	5.86	5.53	4.79	↑	↑
Skins[2]	7.83	7.83	7.89	↔	↓

[1] 17.5kg PX grade, including 1kg pelt [2] USD per skin

Lamb Indicator Prices



Sources: ANZ, Agrifax

The in-market fundamentals for beef still look very solid despite a decline in farm-gate prices. Near-term pressure is expected to remain from the seasonal uplift in the NZ cull cow slaughter, high Australia supplies, and the high NZD. However, beyond the middle of the year things look set to improve.

US import manufacturing prices have hit new records as domestic supplies have tightened and retail demand has remained strong. USDA data shows an 8 percent decline in the number of cows processed in the US during the first two months of the year. Domestic supplies are expected to remain tight as beef cow numbers are rebuilt and dairy farmers look to expand. US retail demand is reported as solid, despite high prices. In part this has been due to the extreme cold weather, which led to more eating at home. However, foodservice demand was lower (the main channel for imported product), one factor that has led to a split in domestic and imported product prices.

The other factor is that there has been no let-up in the dry conditions in Australia. This has seen an extra 300,000 cattle (+18 percent y/y) processed in the eastern states so far this year. The extra supply out of Australia has kept a lid on import prices in the US and all other major markets. Luckily China is managing to soak up much of the additional production that other markets can't take. In other markets, pricing and demand in Indonesia, South Korea and China has been slightly weaker due to holidays, but this is expected to improve due to tight domestic supplies, high retail prices, increased food safety standards, and NZ having better market access than most competitors.

It has been steady as she goes in lamb markets, with most of the main cuts continuing to show stability or steady improvement. Solid Easter demand from retailers and a softer NZD against the EUR and GBP (compared with last year) has seen a pick-up in exports to Europe. With Easter being 20 days later than last year processors also had the opportunity to make the most of the extended lead-up period to secure stock. This lifted processing through-put during February (+4.5 percent y/y).

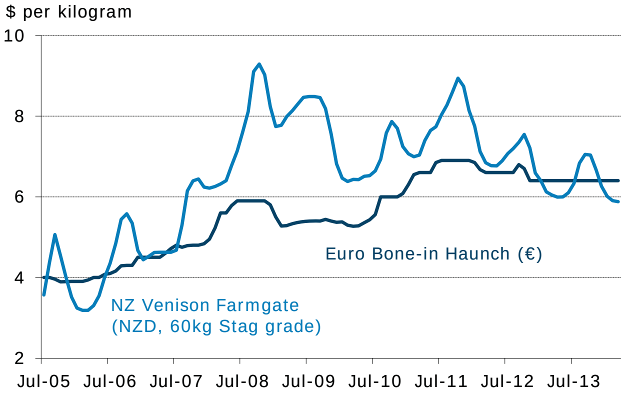
As we head into the autumn/winter period a schedule price around the early $6/kg mark looks to be the target. Most of the main items of the carcass remain in demand from China and Europe. This is evidenced by the price of UK legs being up 30 percent y/y and flaps +22 percent y/y. Bone-in middle cuts remain difficult to sell though. Lamb supply is also expected to contract. Year-to-date lamb slaughter is tracking slightly (-3 percent) behind last year. But the decline isn't yet as large as current industry forecasts (-8 percent). This implies slaughter through-put could slow more dramatically in the autumn period, especially if the dry conditions in the NI dissipate.

KEY COMMODITIES: VENISON AND WOOL

VENISON PRICE INDICATORS					
$ per kg	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
NZ Stag[1]	5.88	6.06	6.04	↓	↓
NZ Hind[1]	5.77	5.96	5.93	↓	↓
Euro Bone-in Haunch (€)	6.40	6.40	6.40	↔	↔
Boneless Shoulder (€)	4.53	4.62	4.69	↓	↓
Loin (€)	13.1	13.6	13.9	↓	↓

[1] (60kg Stag AP grade), (50kg Hind AP grade)

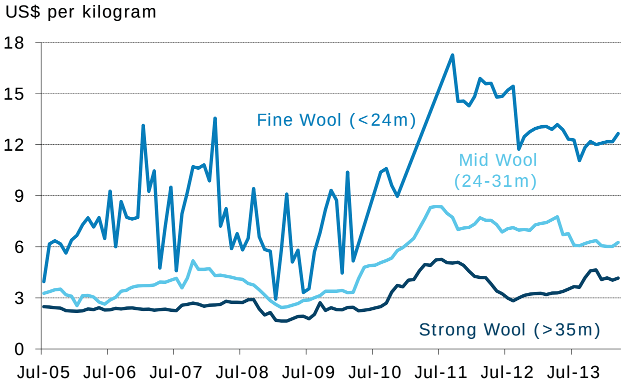
Venison Indicator Prices



Sources: ANZ, Agrifax

CLEAN WOOL INDICATOR PRICES					
$ per kg	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
NZ Fine Wool (>24m)	14.71	14.71	15.58	↔	↓
NZ Mid Wool (24-31m)	7.28	7.31	9.17	↓	↓
NZ Strong Wool (>32m)	4.84	4.95	3.96	↓	↑
USD Fine Wool (>24m)	12.65	12.15	12.90	↑	↓
USD Mid Wool (24-31m)	6.26	6.04	7.59	↑	↓
USD Strong Wool (>32m)	4.16	4.09	3.28	↑	↑

Wool Indicator Prices (Clean)



Sources: ANZ, Beef + Lamb NZ, Wool Services International

The venison market has been one of the biggest underperformers in recent times. In March farm-gate prices reached their lowest level in seven years. In Europe there are indications that sales of frozen venison have based as lower prices start to move product. There has also been more interest in chilled venison lately. This is a good signal for current demand levels, as it means almost immediate consumption, rather than frozen product that could be consumed at any point this year. Elsewhere offal and by-product sales are good, and there has also been more chilled venison exported to the US.

However, there is still hesitancy from European importers with respect to forward purchasing big volumes of frozen product. Importers who have bought early have been burnt in recent years as prices have eased instead of the usual seasonal uplift that occurs into the Northern Hemisphere autumn. **There are also reasonably high stocks of legs in the European market**, which combined with stiff competition from wild hunted meat in Germany is capping demand for these cuts.

Wool prices have flattened out over the past several months as the seasonal lift in supply has helped balance the market out. This has resulted in strong wool prices stabilising around the $4.90/kg clean mark, which is 12 percent below the peak in October and November.

Inventories of NZ wool are reportedly low throughout the supply chain, but end demand has been sluggish, leaving higher inventory levels of finished product. This is now keeping a cap on importer and manufacturer demand. Total bales offered at auction are down 9% year-to-date, but total sales are down just 3%, reflecting better clearance rates. However, the better clearance rates mainly reflect the buying pressure experienced in October and November. Average pass-in rates at auction have been 17% since the start of the year, higher than the 11% passed in for the same period the year before.

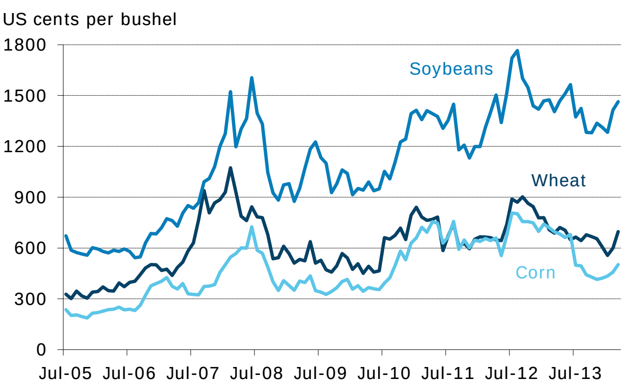
Wool prices are expected to remain reasonably flat for the time being, though they may deviate up and down at each auction depending on buyer sentiment and need to fill a specific order. Certain wool types, such as the good quality colour wools, have slightly higher demand. This means that pass-in rates and average sale prices will shift between auctions depending on the variety of wool types on offer.

KEY COMMODITIES: GRAINS

GRAIN & OILSEED PRICE INDICATORS	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
NZ Milling Wheat[1]	421	421	415	↔	↑
NZ Feed Wheat[1]	414	397	362	↑	↑
NZ Feed Barley[1]	409	398	350	↑	↑
Palm Kernel Expeller[1]	345	316	336	↑	↑
US Wheat[2]	7.0	5.9	6.9	↑	↑
US Soybeans[2]	14.6	13.4	14.0	↑	↑
US Corn[2]	5.0	4.4	7.0	↑	↓
Australian Hard Wheat[1]	423	388	428	↑	↓

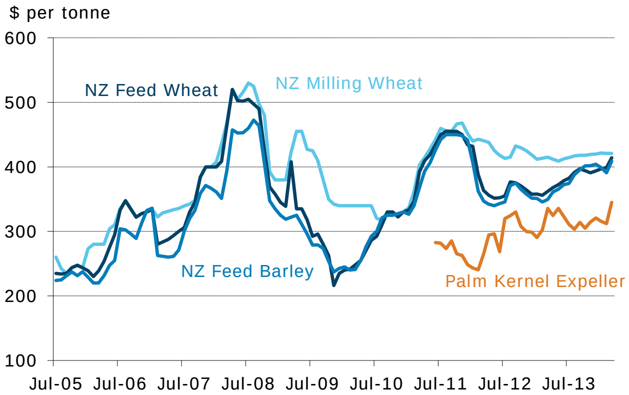
[1] NZD per tonne
[2] USD per bushel

CBOT Future Grain & Oilseed Indicator Prices



Sources: ANZ, Bloomberg

Key NZ Grain Prices



Sources: ANZ, Agrifax

Both domestic and international grain prices have leapt into life in the past month. On the domestic scene broadening dry conditions and the record dairy payout are driving up demand for local grain for feeding. The 2014 grain harvest is also finished and anecdotally it seems yields are back on last year. The current strong demand, combined with a smaller harvest, has placed considerable price pressure on current spot sales for feed grains, as well as contract prices for spring delivery. In some of the drier areas, silage plantings are being cut as greenfeed in order to meet the high demand. **Maize supply has been tight despite a 12 percent y/y increase in the area harvested in 2014. The dry conditions have resulted in a large variation in yields. But most of the 2014 crop was contracted before harvest, meaning the availability of uncontracted crop for spot sales has been fairly tight.** This means buyers who want to contract more are bidding up the spot price to draw out contracts for grain that growers will have left aside for the spot market.

Palm Kernel prices have moved rapidly higher since late February. As demand in the North Island has lifted most of the arriving imports are now sold before it arrives. Unlike last year, however, there seems to be a steady rate of arriving boats with no big supply gaps emerging as yet. There is a lot of supply on its way for delivery during April that will relieve the pressure somewhat. But most of it is reportedly already sold up until May. The other driver of higher prices has been a drought in Malaysia causing production concerns and European competition.

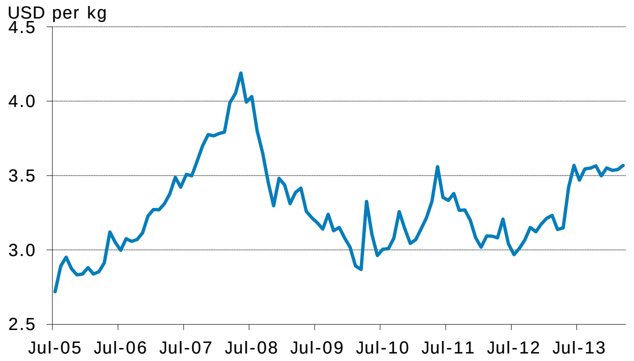
Internationally, Australian feed grain prices have been pushed up by the dry conditions in Northern NSW and Queensland. **This has led to a large increase in demand from the cattle industry** as more animals are finished on feedlots. Demand from China is also reportedly high due to both tight domestic supplies, and some US corn shipments being rejected because they don't meet their GMO standards. **In the US, prices have moved up.** This has been on Black Sea tensions, yield concerns in Brazil and Argentina, speculation of lower US winter wheat yields, and stronger than expected feed and export demand. The Ukraine typically contributes about 3-5% of global trade in wheat and corn so any disruptions to this could reduce tradable supply. There has also been stronger than expected feed demand for US corn lately, which has caused further cuts from the USDA to season-ending stock estimates. In the coming months the price action could be bumpier, but further increases in global wheat prices are likely due to the poor current outlook for many winter wheat crops in the US.

KEY COMMODITIES: HORTICULTURE

HORTICULTURE PRICE INDICATORS	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
Kiwifruit (USD per kg)	3.6	3.5	3.1	↑	↑
Apples (Weighted Index)	265	265	247	↔	↑
Average Wine Price[1]	5.7	5.8	6.2	↓	↓
Packaged White Wine[1]	6.4	6.6	6.6	↓	↓
Packaged Red Wine[1]	10.6	9.8	9.3	↑	↑
Bulk wine[1]	3.55	3.20	3.74	↑	↓

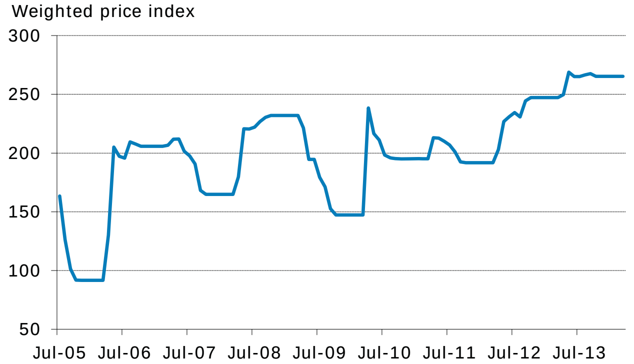
[1] USD per litre

Kiwifruit Indicator Price



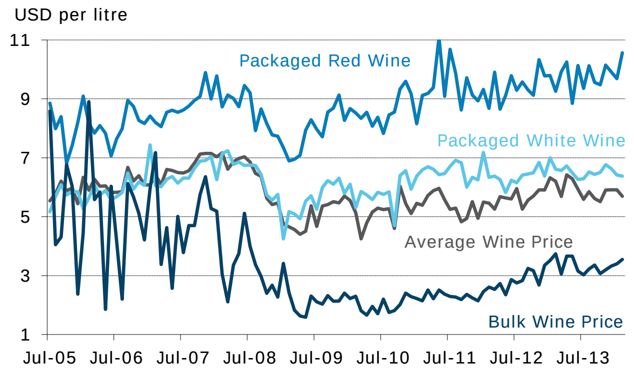
Sources: ANZ, Zentrale Markt- und Preisberichtstelle

Apple Indicator Price Index



Sources: ANZ, Zentrale Markt- und Preisberichtstelle

Wine Indicator Prices



Sources: ANZ, NZ Winegrowers

The 2014 kiwifruit harvest is expected to be slightly larger than the year before. Gold production is expected to increase to 17.5 million trays, due to better yields and some earlier grafted Gold3 beginning to produce fruit. Psa was reported to be less prevalent in the past year and better management techniques of Psa should help those vines that are able to produce fruit in 2014. Green production is forecast to decrease slightly to 66.5 million trays. This is largely due to some re-grafting of Green vines to Gold reducing the producing area to 8,550 hectares (-0.7 percent y/y).

On the pricing front, the 2014 Chilean kiwifruit crop has been affected by severe frost. Reports on the size of the loss vary, but it could be 30+ percent of total production. This is expected to reduce Green competition, and combined with lower NZ supply, should provide a decent boost for in-market Green prices. There isn't expected to be such a large impact on Gold, with the market already well short. Long-term Chilean production will continue to be NZ's main direct competition in many markets. For Gold the next two years are critical to the success of the full commercialisation of Gold3. Pricing for the 2013 harvest suggests customers have been satisfied with the eating experience (taste and firmness). Continued marketing support and consistent service and quality over the next two years will be critical to firmly establishing it as the leading global Gold variety. This will involve more investment, marketing and rapid learning as supply increases, which equals more costs.

In the pipfruit sector the 2014 harvest is expected to be down by 6 percent to 500,300 tonnes. The main reason for the drop is that it's a biennial bearing "off" year for the Hawke's Bay region. There were also some localised hail events in parts of Hawke's Bay. Nelson production is expected to be only slightly back on last year. Countering the biennial bearing "off" year decline in yields to some extent were generally good growing conditions throughout (apart from the localised hail events). This has helped fruit size and colour. Growers are likely to have accentuated management to support fruit size and colour to help maintain the price premiums they have achieved in export markets.

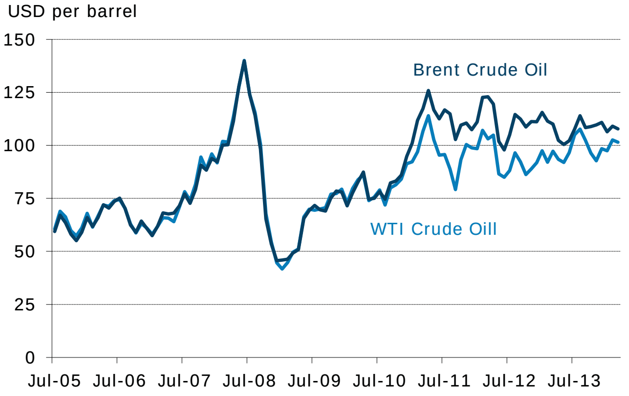
Overall the current expectations are that returns for the 2014 pipfruit crop will be similar to or slightly up on 2013. In addition to NZ production being down, Chilean output is expected to be down by as much as 10 percent because of hail, while South African producers have also been affected by hail and frost. However, it remains to be seen if European markets will be as favourable and this could reduce inter-market competition with Asia.

KEY COMMODITIES: OIL, FREIGHT AND FERTILISER

OTHER COST INDICATORS	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
WTI Oil[1]	102	100	97	↑	↑
Brent Oil[1]	108	109	110	↓	↓
Ocean Freight[2]	1,373	1,548	910	↓	↑

[1] USD per barrel, grade WTI
[2] Baltic Dry Index

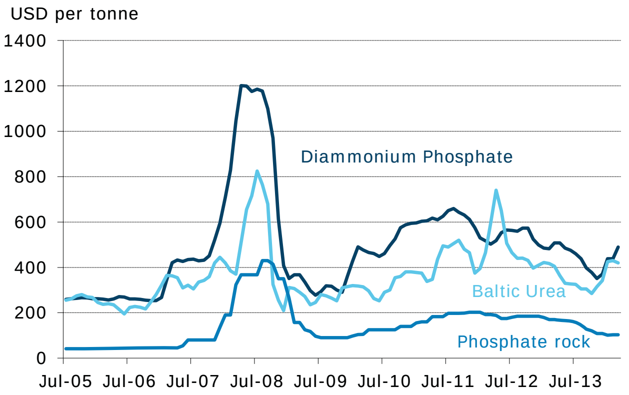
Crude Oil Indicator Prices



Sources: ANZ, Bloomberg

FERTILISER PRICE INDICATORS USD per tonne	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
DAP (USD)	490	415	508	↑	↓
Urea (USD)	420	399	405	↑	↑
Phosphate Rock (USD)	103	104	170	↓	↓
Farm-gate DAP (NZD)	836	829	NA	↑	NA
Farm-gate Urea (NZD)	694	641	NA	↑	NA
Farm-gate Super phosphate (NZD)	326	326	NA	↓	NA

Indicative International Fertiliser Prices



Sources: ANZ, Bloomberg

Market conditions for US oil have been particularly strong through the early part of the year, with WTI outperforming Brent by almost 6 percent year-to-date. Aside from the recent geopolitical support from the events in the Ukraine, an abnormally cold US winter has supported the West Texas benchmark, whilst Brent's relative underperformance has been driven by renewed concerns about the robustness of Chinese growth. With the West Texas benchmark coming off a two-year high, the US winter passing, and leveraged money (funds) heavily long WTI, risks are skewed towards further falls in WTI. Brent should fare comparatively better, with China's construction activity picking up this coming quarter.

On the supply front, OPEC output fell under 30 million b/d in January for the first time since October 2010 and further disruptions in Libya since then have kept supply tight. Iranian nuclear disarmament discussions are progressing steadily, but significant Iranian output is unlikely to be a factor in the near term, though it may be something to look out for later in the year.

Latent concerns about Russian oil supply are also likely to support oil markets, but the general consensus is that Russia can't afford to turn off the tap and Europe can't afford a break in Russian supply.

Global fertiliser prices have moved higher since the New Year after basing in the last quarter of 2013. The lower prices encouraged some key importing countries to increase purchases. This has led to farm-gate price increases for DAP and Urea.

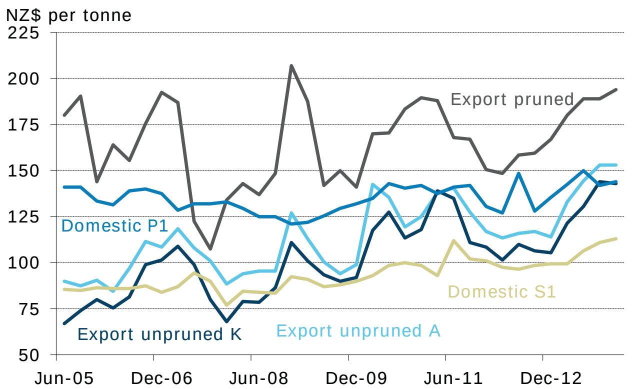
Global Urea prices look to have done their dash with global supply from low-cost production regions in the Middle East and North African region continuing to increase. Additionally the opening up of the Chinese low tax window from July 1 will add further supply pressure from the middle of the year.

In phosphate markets things got overly bearish in the second half of 2013. Indian demand was particularly weak due to changes in the subsidy program and the weak Rupee. **A rise in export capacity is expected to ensure prices don't move too much higher, but a return of Indian demand means prices are unlikely to return to those seen in the second half of 2013.**

KEY COMMODITIES: FORESTRY

FORESTRY PRICE INDICATORS	Current Quarter	3 Period Trend	Last Year	Chg. P/3P	Chg. Y/Y
Export: (NZ$ per JAS m³ f.o.b.)					
Pruned	194	186	167	↑	↑
Unpruned A Grade	153	144	114	↑	↑
Unpruned K Grade	143	132	106	↑	↑
Pulp	137	118	91	↑	↑
Domestic: (NZ$ per tonne delivered at mill)					
P1	144	145	136	↓	↑
P2	124	123	117	↑	↑
S1	113	106	100	↑	↑
S2	102	100	94	↑	↑
Pulp	50	49	51	↑	↓

NZ Forestry Indicator Prices



Sources: ANZ, MPI

Export log prices have increased further in recent months, but are likely to be in for a period of consolidation.

In China high port inventories have created some concerns for exporters. Due to record high prices, China is drawing supply at record rates from its main suppliers, but also greater supply from supplementary sources. This led to a greater than expected build-up of inventories during the Chinese New Year period when consumption slowed down. **Since the holiday period demand has picked up, but Chinese government efforts to constrain construction growth through a range of policies and buyers becoming less prepared to lock-in prices is providing some grounds for caution.**

Prices have continued to rise though, but with higher seasonal supply about to come online from Russia, this could well prove to be the tipping point and it is likely some of the recent upward pressure on prices may ease. The near-term outlook for exports continues to look mostly positive, however. In addition to Chinese demand, housing starts in the US are expected to pick up during the coming months.

Despite the further increase in export prices, returns back at the wharf in NZ have been clipped by the rise of the NZD/USD and shipping companies lifting freight costs by US$2-4 per cubic metre.

Domestic log demand is reported to be at its highest since 2007. Though there are fewer logs going into this market than in 2007, processing capacity is reduced too. Sawn timber exports are much higher than in 2007, but domestic consumption is lower. However this is changing, with domestic sawn timber use up 8 percent in 2013, and building consents continuing to rise.

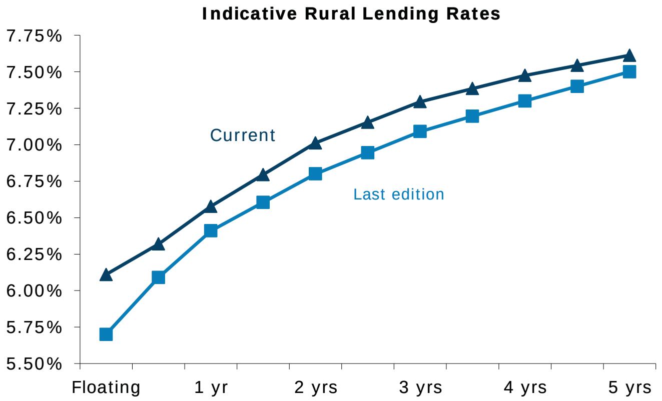
BORROWING STRATEGY

SUMMARY

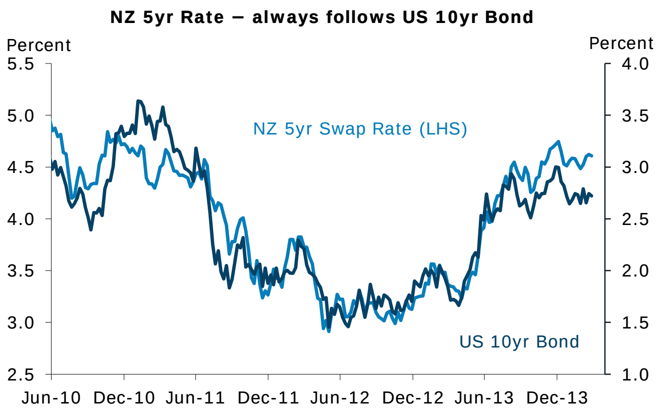
Indicative rural lending rates are up across the board, led by higher front-end rates. Longer-term rates have moved up by less, "flattening" the borrowing curve. As a result, even though the outright cost of fixing has risen, the relative cost of fixing for longer terms (versus floating) has declined. The decision to fix for longer terms has become more of a line call, with expectations for additional OCR hikes now built into the term structure. The proverbial horse has bolted for those looking to save by fixing early, as we noted in our last edition. However, the greater certainty that fixing provides has its benefits. Thus, we prefer to hedge our bets, maintaining a portion of exposure to floating rates while splitting the remainder across several fixed-rate terms.

OUR VIEW

Lending rates are up by between 0.1 and 0.4 percent in the two months since our last edition, with the front end responding to the RBNZ's 25 basis point lift in the OCR, alongside projections for further interest rates increases over the next 2 years. By contrast, **long-term fixed rates have moved up by less,** reflecting a period of consolidation in global interest rate markets, which tend to be the bigger driver of NZ long-term interest rates, as the second chart shows.



Sources: ANZ, Bloomberg



Sources: ANZ, Bloomberg

If the OCR is projected to rise, why then do we not favour fixing, and why do we assert that **the horse has bolted**, so to speak? These are questions we are commonly asked. Broadly speaking, the answer lies in two places. First, markets tend to be very forward looking (and in fact tend to be extremely good predictors of the business cycle). And when you combine that thought with the second part of the answer – that the RBNZ flagged the need to lift interest rates a long time ago – you end up with a market that **has now largely priced in what lies ahead in terms of changes in the floating rate.**

We use breakeven analysis to gauge what's priced in. As the table below shows, 1yr, 2yr and 3yr rates are expected to lift by 1.28 percent, 0.94 percent and 0.71 percent respectively over the next two years. Against our expectation that US rates will move higher and the RBNZ will lift the OCR by a further 1.5 percent over the next two years, those breakevens look reasonable. They are certainly not way off line. Consequently, **we do not see immense value in fixing, but nor do we see any harm in doing so.** Against our forecasts right now, market pricing seems about right.

Rural Lending Rates (incl. typical margin)		Breakeven rates			
Term	**Current**	**in 6mths**	**in 1yr**	**in 2 yrs**	**in 3 yrs**
Floating	6.11%				
6 months	6.32%	6.84%	7.23%	7.72%	7.93%
1 year	6.58%	7.03%	7.45%	7.86%	8.02%
2 years	7.01%	7.36%	7.65%	7.94%	8.09%
3 years	7.30%	7.56%	7.77%	8.01%	
4 years	7.48%	7.70%	7.87%		
5 years	7.61%				

For borrowers, then, **the only real way one will "win" by fixing is if the RBNZ ends up needing to lift the OCR by more than this, or if US interest rates rise by more.** Beating the market in this regard will be difficult with so much now priced in. That said, fixing is not just about the maths of paying the lowest price. It is also about certainty, budgeting and affordability, and in that regard fixing still has a role to play, and as our breakevens show, what's priced in looks reasonable. The point we are making is simply that **the "get in early" opportunity has passed, and decisions to fix from here need to be taken with more caution.**

With little in the way of obvious "get in early" opportunities, and the market reasonably fairly priced against our expectations, **our preference is to maintain a mix of floating and fixed** – while spreading your exposures across a number of terms. At this stage of the cycle **it's less about the maths and more about risk management.**

ECONOMIC BACKDROP

SUMMARY

The economy is firmly into a broad-based expansion and we're picking 3 percent plus growth over the coming two years. Despite a robust outlook, risks and vulnerabilities remain. The global expansion remains finely balanced. Our national balance sheet is still weak and there is limited scope for a borrow-and-spend upswing. Prospects for strong growth mask friction and tensions, a fact that means attention must be paid to the microeconomic picture which is, in effect, getting the small stuff right. One of the economy's biggest challenges over coming years will be expanding its supply-side capacity to meet demand and ensuring the inflation genie does not get let out of the bottle courtesy of a building boom. Productivity growth needs to lift for growth to be solid and inflation contained: we're positive on this front.

OVERVIEW

The economy is firmly into a broad-based expansion. Indicators are in agreement that NZ's economic momentum is lifting. There are obvious drivers in the form of accommodative financial conditions, the $40bn Canterbury rebuild, our increased purchasing power as a nation provided by a goods terms of trade at a 40-year high, and record commodity export prices. A net immigration-assisted pick-up in population is also providing a boost.

Business confidence is at a 20-year high and consumers are also in a positive frame of mind. **What is particularly striking is the sheer number of positives out there.** The economy finished 2013 on a strong note and we're picking 3 percent plus growth over the coming two years, with business and consumer confidence indicating more top-side to this. Nevertheless, prospects for strong growth mask friction and tensions, a fact that means attention must be paid to the microeconomic picture. The national balance sheet is still weak, the NZD high, and fiscal policy contractionary; these are major headwinds. Nonetheless, the economy is moving forward strongly, such that one of the biggest challenges over coming years will be expanding its supply-side capacity to meet the demand and ensuring a building boom does not let the inflation genie out of the bottle.

The global economy is expanding solidly but this masks disparate performances. We've pencilled in respectable growth in aggregate. Emerging market economies with weak fundamentals will remain under the spotlight as liquidity-driven support from QE is removed. There will be wobbles.

The outlook for farm-gate prices remains solid for most primary sectors. Just about all the main sectors are set to record a decent lift in farm-gate prices in 2013/14. Dairy prices in 2014/15 are expected to moderate somewhat from this year's record, but most other sectors are expected to experience further incremental lifts.

The labour market improvement is broadening through the economy, though the construction sector is likely to continue to lead the charge for quite some time yet. We expect the unemployment rate to gradually trend lower over the next year or so, with a mismatch of skills the primary roadblock to a more marked fall. Modest employment and wage growth will underpin moderate rates of consumer spending.

New Zealand's Crown accounts remain on track to return to an Obegal surplus by 2014/15, with solid revenue growth and ongoing spending restraint helping to contain net debt, now projected to peak below 27 percent of GDP. We expect the fiscal stance to remain tight for years to come, though some election sweeteners (funded via reprioritised spending) are likely.

Inflation is expected to drift higher over the next couple of years. The strengthening domestic expansion remains the dominant driver of the rising inflation trajectory, with a productivity uplift and proactive central bank capping the magnitude. However, risks look skewed to the upside.

We expect the New Zealand dollar to remain elevated on domestic support factors (high yields), but the domestic crutch to be progressively usurped by a re-assertive USD over the projection period. The highs in NZD/AUD are in, but we expect the cross to remain elevated until solid evidence of the Australian economy turning the corner emerges.

As expected, the Reserve Bank raised the OCR by 25bps this month. **We expect a further two OCR hikes by mid-year**, a stop-start tightening profile thereafter, and a relatively low OCR endpoint by historical standards. That's a reflection of the punch monetary policy will achieve, and also recognition of imbalances across the wider economy. Local bond yields are expected to rise gradually in coming years, albeit outperform the anticipated normalisation in global bond yields, as major central banks begin lifting official interest rates from 2015.

EDUCATION CORNER: THE CHINESE INFANT FORMULA MARKET AND THE WAVE OF REGULATORY REFORM

SUMMARY

Infant formula can be characterised as a value-add product rather than a commodity, due to its defensible characteristics. Markets tend to be highly consolidated for such products. While NZ dairy companies have historically stayed away from the direct marketing and selling of infant formula, this has changed in recent years and the industry has a long history of integration through the provision of dairy ingredients to infant formula manufacturers.

Much of NZ's recent investment has been based around the Chinese market, which is more fragmented than others due to rapid growth and less regulation. But repeated food safety incidents have triggered a wave of regulatory reform. While the direct impact of the reforms remains highly uncertain and dependent on their official interpretation by Chinese authorities, they are likely to have wider implications beyond the infant formula category.

Some of these implications will most likely include:

- Consolidation and more vertical integration of domestic and multinational infant formula participants. Chinese officials and institutions need a more concentrated marketplace if they are to have any hope of monitoring and enforcing compliance of the new regulations;
- Longer-term NZ and other multinational companies face more formidable competition from Chinese manufacturers as regulatory reform forces them to consolidate and they are supported with additional subsidies;
- Consolidation of the participants in the infant formula category leads to different business relationships being formed, which then creates different discussions and eventually new ventures which leads to a reshaping of supply chains outside the infant formula category;
- Increased food safety standards lead to a quickening in the move to large-scale and intensive dairy farm systems in China, which incrementally improves the competitiveness of their domestic supplies over time; and
- Category growth for infant formula will slow rather than accelerate as breast-feeding rates increase for a range of reasons.

For NZ businesses, the combination highlights the need for agility and staying informed: China is not a market where opportunities simply fall into one's hand. China's projected rise in per capita income will be matched by an evolutionary shift in the regulatory and policy environment over time. While the direct impact of the individual reforms remain highly uncertain they are already rapidly reshaping investment, supply chain partnerships, and the infant formula category.

INTRODUCTION

The infant formula segment of the dairy sector receives out-sized attention in the catch cry for NZ to undertake more 'value-add'. This catch cry has become increasing loud in recent years as it is seen a way to generate additional margin and help reduce the cyclical nature of earnings that comes with the cycles inherent in commodity prices (dairy is one of the most volatile). Of course this is all easier said than done, and margin creation or 'value-add' can come in many forms – be it service proposition, functional attributes of a product, or the coolness factor of a brand.

Infant formula is one of the more complex foods as it is designed to mimic human breast milk. It sits on the dividing line between food and pharmaceuticals. The turning of food ingredients into pharmaceuticals and other health products has been an area of huge growth and focus in recent times, and not just in the dairy sector. In part this is due to a push in Western society toward healthier lifestyles, but the biggest driver seems to be the emergence of the Asian middle class, where food is viewed for health first and nutrition second. This cultural difference is driving substantial category growth in health and pharmaceuticals products derived from different food ingredients.

A recent report by the Pacific Economic Cooperation Council conducted by Coriolis showed **infant formula fits into the 'value-add' rather than commodity category as it is highly defensible. This defensibility derives from:**

1. **Product complexity;**
2. **Economies of scale and integration required between the different supply chain partners**
3. **Patents and other intellectual property involved;**
4. **The importance of doctors and other health professionals / institutions in the sales process;**
5. **Global regulations (e.g. bans on advertising for product used for up to six months of age)**
6. **Required brand trust with consumers, and**
7. **Widespread government market intervention.**

This defensibility has led to a highly consolidated global market dominated by a handful of multinational companies. Consolidation is even more pronounced at the national or regional level, with almost all markets structured as three

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or four key companies, typically some subset of the multinationals, and perhaps some regional or niche brands, such as goat or organic.

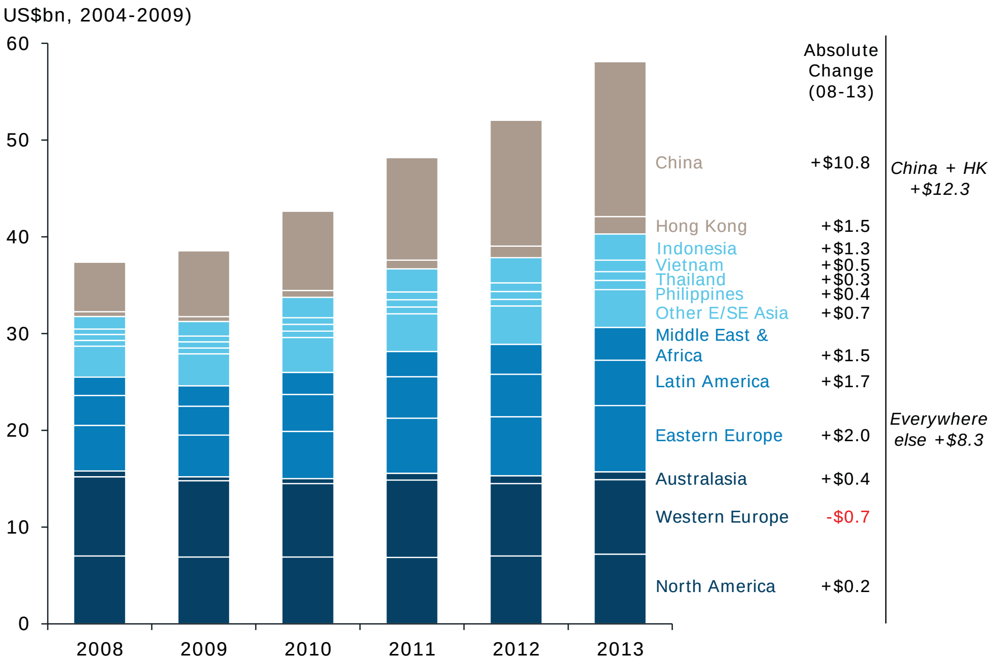
The main exception to this is the Chinese market, which the report describes as the 'Wild West' in comparison to other markets.

However, the food safety events in 2008 in China and repeated incidents since have triggered a wave of regulatory reform that is looking to clean up and bring order. This is affecting both multinational and domestic participants right along the entire dairy supply chain. There have been many signs of these reforms filtering through to the New Zealand dairy industry, including Fonterra being fined for price fixing and anti-competitive behaviour, and the first ever visit from Chinese authorities to audit New Zealand's dairy supply chain. These reforms and other changes have sent jitters through the industry with a debate on who will benefit and who will fall. We take a look at some of these changes and what they might mean for the infant formula supply chain and wider New Zealand dairy industry.

GLOBAL INFANT FORMULA CATEGORY

Globally the baby food / infant nutrition category is valued at a tad over US$58 billion according to Euromonitor data. Since 2004 it has had a compound growth rate of 6.6 percent, making it one of the fastest-growing packaged food categories. The vast majority of this growth has come from the Chinese market, which has accounted for nearly 60 percent of total global growth since 2008. Other developing countries have experienced strong growth as well, but growth across developed countries has been virtually non-existent.

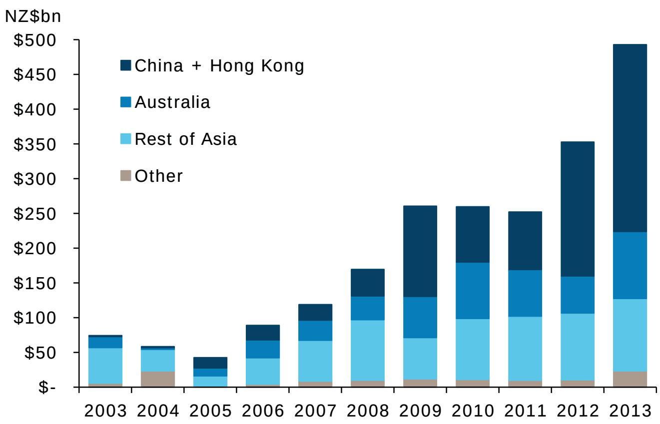
Growth in baby food / infant nutrition sales by global region



Sources: ANZ, Euromonitor, Coriolis analysis

NEW ZEALAND'S SLICE OF THE PIE

NZ infant formula exports



Source: ANZ, Statistics NZ

New Zealand's exports of infant formula totalled nearly 44,000 metric tonnes and $500 million of earnings in 2013. The vast majority of this went to China (55 percent by value and 49 percent by volume). Compound annual growth in total exports over the last 10 years has been 23 percent, with a significant step-up in sales over the last two years as a number of dairy companies and other players have moved into retailing their own brands. The domestic market is worth an additional $25-30 million, although it is difficult to know how much makes its way overseas to be consumed.

Given that total infant formula sales accounted for only 3.3 percent of total dairy export earnings and 1.8 percent of total volumes in 2013 it may well be asked why the regulatory changes in the Chinese infant formula market matter.

Well, while New Zealand dairy companies have historically stayed away from the direct marketing and selling of infant formula, the

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industry has a long history of integration. This includes being the primary global supplier of many dairy ingredients, but especially the milk powders that are used by other companies to manufacture infant formula. Additionally, as the Coriolis report notes, over the last 10 years the New Zealand industry has rapidly moved up the supply chain into bulk base infant formula powder for others, contract packing retail product for other companies, and more recently into the retailing of specific brands (much of which has been based around the Chinese market).

Different supply chain models operating in New Zealand

Sources: ANZ, Euromonitor, Coriolis analysis

NEW ZEALAND'S BROADER LINK INTO CHINA

As most know, China matters hugely for the NZ dairy industry, but more so than ever before with exports accelerating rapidly in 2013. In fact they accounted for 32.4 percent of total dairy exports in 2013. This is a dramatic increase from the 21.5 percent of dairy exports that China bought only a year before. Put another way, China will contribute $2.80 of the $8.75/kg MS payout in 2013/14.

CHINESE DAIRY IMPORTS (tonnes)

Product Category	2012	2013	% change	NZ share
WMP	405,557	619,397	53%	90.83
SMP	167,553	235,019	40%	52.73
Infant Formula	91,502	122,793	34%	17.00
Whey	378,380	434,070	15%	47.69
Cheese	38,811	47,316	22%	42.30
Butter	24,356	33,205	36%	84.87
Fluid Milk	93,154	183,321	97%	18.00
Total	**1,260,601**	**1,718,446**	**36%**	**57.87**

In total China imported 1.72 million tonnes of dairy products in 2013, which was a 36 percent year-on-year increase. New Zealand supplied an estimated 58 percent of this by dominating wholemilk powder imports, with a 90 percent share. However, the lift in Chinese import demand was driven more by limited domestic supply than a rapid increase in demand. This is reflected in a large increase in their milk powder, fluid milk and UHT milk imports to substitute and/or reconstitute with domestic fluid milk to make up for lower domestic supplies.

The official estimate is that domestic milk production declined to 35.31 million tonnes, which equates to a drop of 5.7 percent from 2012. However, other industry sources put the reduction in production at more than double the official level. The cause of low supply was the reported culling of nearly two million cows (15 percent of herd) driven by a combination of weather factors, disease outbreaks (foot & mouth), food safety policy changes, and poor profitability. Both the large-scale culling of cows, structurally high production costs, and regulatory reforms suggest at least a three-year window has opened up for higher quantities of dairy imports.

CHINA'S INFANT FORMULA MARKET

In the infant formula space, Chinese imports totalled 122,800 tonnes in 2013. NZ had around a 17 percent share of this, selling 21,300 tonnes at a value of NZ$268 million. Estimates on the total size of the Chinese infant formula market vary, but according to Euromonitor data at retail baby food/infant nutrition sales topped $15 billion in 2013. Infant formula sales were estimated to be about 85 percent of this, or $12.75 billion.

GROWTH DRIVERS OF INFANT FORMULA DEMAND IN CHINA

A number of factors have supported accelerated consumption of infant formula in China in recent years. According to UNICEF, China has one of the lowest breast-feeding rates globally, with only 28 percent of children below six months of age being exclusively breast fed. This compares with the global average of 40 percent. Follow-on formula is also used earlier and for longer periods with the introduction of solids, semi-solids or soft foods after six months of age.. The low rate of breast-feeding and high consumption levels of infant and follow-on formula seem to be due to a range of factors:

1. **Society frowning upon breast-feeding in public places and other cultural factors.**
2. **Aggressive marketing of infant formula.** This has led to a belief amongst parents and some health institutions and practitioners that it is a better and more nutritional option than breast feeding.

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3. **The historical one-child policy meaning families want to do the absolute best for their children.** Coupled with the above belief and rising income levels, this has led to high levels of infant formula consumption and prolonged use of follow-on formula.
4. **Urban mothers usually getting no more than four months of maternity leave and children being left with grandparents while mothers work.** In fact, urban breast-feeding rates are reportedly around 20 percent, whereas in rural areas they are nearly 40 percent. Part of this is due to the income gap.

There are a range of forecasts on future growth. Most predict it to continue, but not quite at the pace of the last few years. There are a number of positive and negative influences occurring at present. While it seems breast-feeding rates may have fallen further since UNICEF's last survey in 2008, it seems difficult to imagine them falling too much further.

The Government is now taking a more active role and has announced a goal to raise breast-feeding rates to at least 50 percent by 2020. Initiatives so far have included more education on the benefits of breast-feeding, changing hospital practices and advice, restricting sales channels to registered retailer outlets, and the installation of breast-feeding booths in cities and workplaces.

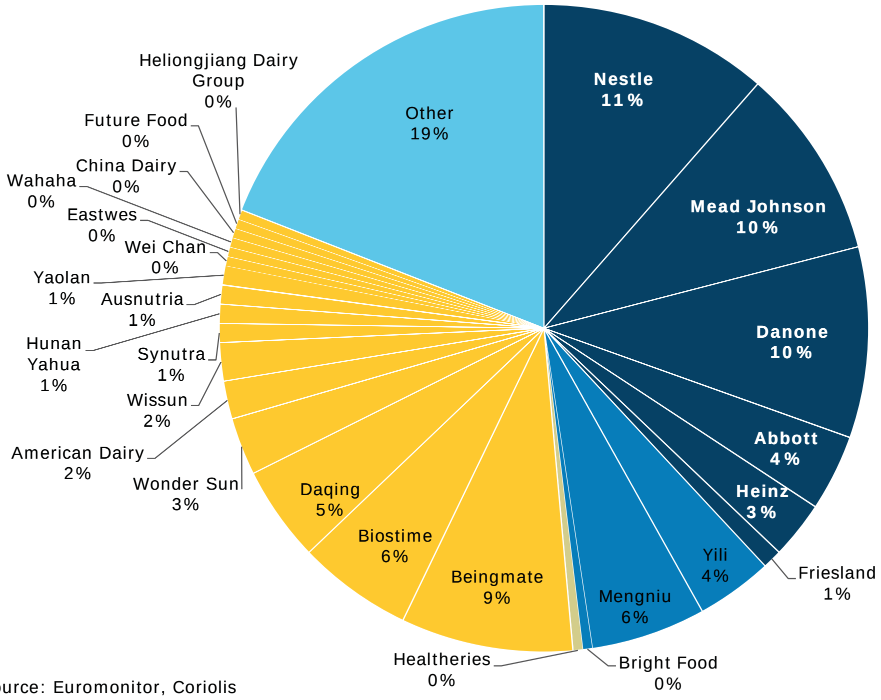
But while the infant formula category may have reached the point on the adoption curve where growth will slow, there are other positive drivers. These include the relaxing of the one-child policy, continued urbanisation, and ongoing income increases.

In fact our Chinese economic team believe over a 14-year period an additional 9-10 million extra babies could be born from couples now being allowed to have two children if either parent was an only child. This would provide organic sales growth in infant formula of 0.6 percent per annum over this period. Add in urbanisation continuing at the same rate since the turn of century, and the growth rate increases to 1.0 percent per annum. Another scenario is China gradually shifting to allowing two or more children, which would equate to 55-60 million extra babies and a much higher growth rate of 2.6 percent. **However, if the initiatives to boost breast-feeding are successful then under the current situation of an extra 9-10 million babies, category growth would be negative 2.0 percent per annum.**

How these influences evolve will have important implications for many New Zealand dairy manufacturers' investments into infant formula and own brands in recent times. But probably the biggest immediate issue is the wave of regulatory reform in the Chinese dairy industry, much of which is targeted at the infant formula market as authorities look to restore order to the 'Wild West'.

According to the Chinese dairy industry there are 127 infant formula manufacturers with a total annual output of 600,000 tonnes. The 127 manufacturers include both domestic and multinational companies who process product in China. With imports totalling only 122,800 tonnes, these numbers imply imports of infant formula make up only a small proportion of total sales. Multinationals are also estimated to have a much larger retail market share, around 45-50 percent. **These figures suggest a lot of infant formula is being processed by multinational companies within China, and it would seem highly likely that a lot of New Zealand's other exports – especially milk powders – are being used by these multinationals and domestic Chinese manufacturers to produce infant formula products.**

Market share of Chinese infant formula



Source: Euromonitor, Coriolis

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So while the direct sales of infant formula might be small as a proportion of overall export earnings at the moment, indirect sales, while difficult to estimate, are likely to be much larger. Moreover, while the catalyst for recent reforms has been a desire to improve the safety of infant formula, it is also influential in reshaping investment and the relationships between the various participants within the supply chain. The reshaping of the supply chain can be seen in recent merger and acquisition activity and outward foreign direct investment by Chinese dairy manufacturers who produce more than infant formula. **So while the direct impact of the reforms remain highly uncertain and dependent on their official interpretation by Chinese authorities, the reforms are already having a number of implications for the New Zealand dairy industry's structure, business relationships, sales channels, ability to conduct more 'value-add' and future earnings potential.**

THE WAVE OF REGULATORY REFORM

Since the widely publicised melamine adulteration scandal that occurred in 2008, Chinese authorities have increased their efforts to ensure food is safe. However, this is easier said than done and the melamine problem is not an isolated incident, with China topping the list for the most food safety violations. Food safety scares happen regularly in China across all sectors, and the accumulation of these incidents have led to very low consumer confidence in Chinese product. This confidence is not easily restored where the cultural view of food is focused on health and not solely nutrition. Food safety isn't just solely a Chinese issue though, with other recent high-profile incidents of E. Coli in the US beef supply chain and horse meat in Europe.

The problems with China's food safety controls are numerous. Firstly there are insufficient regulatory laws, and existing laws are not cohesive. The enforcement of regulations is spasmodic and inconsistent across the country. Food safety monitoring is shared between national, provincial and local authorities. Local authorities do not necessarily have the resources, both human and technical, to enforce laws. The control of food safety is spread across multiple institutions and information is often not shared between them. Fragmentation of China's food safety regulatory system is one of the major factors limiting their ability to manage issues with responsibility shared across numerous institutions.

The main agencies and their key responsibilities include:

Administration of Quality Supervision, Inspection and Quarantine (AQSIQ)

Oversees food import/export and quarantines at the national and local levels. Main functions include issuing production permits for food processors and producers; supervision of licensed food enterprises for compliance with regulations concerning food manufacture, packaging and labelling; and enforcing control of unlicensed food processing and production.

Ministry of Agriculture

Handles farm-level food safety regulations and policies. From a food safety perspective its most important responsibilities are to regulate and enforce the use of chemicals, pollutants and pesticides on farms.

National Development and Reform Commission (NDRC)

Formulates policies for economic and social development and investigates and enforces anti-monopoly practices, such as price-fixing in pharmaceuticals and infant formula.

China's Food and Drug Administration (CFDA)

Founded in 2003 to be an umbrella regulatory body to other food safety institutions. Its main responsibilities are to set and enforce health laws, regulations and policies and coordinate regional and nationwide health resources.

Ministry of Industry & Information Technology (MIIT)

MIIT will play an important role in the consolidation of the Chinese dairy supply chain. It has responsibility for industry planning, consolidation, formulating industry regulations and standards, monitoring industry operations, promoting major technological development and innovation, and various other functions.

Ministry of Science & Technology (MST)

Investigates technological innovation to improve food production, manufacturing and processing. It regulates the quality of market products, oversees the inspection of market products, and punishes sellers who violate product quality standards. It also regulates product packaging and can confiscate or destroy illegal products or product ingredients.

Ministry of Health

From a food safety perspective the Ministry of Health provides experts to investigate poisoning cases, enforce food safety and hygiene inspections, and can order local health departments to conduct investigations into food quality violations.

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Ministry of Commerce

Enacts and amends standards and rules regarding the procedures for food processing, packaging, storage, transportation and sales.

National Institute of Nutrition & Food Safety (NINFS)

A research agency for nutrition and food hygiene with the objectives of studying health-related nutrition and food hygiene problems and to train nutrition and food hygiene specialists.

In the dairy sector there have been a number of regulatory and other developments from these institutions since 2008 that are reshaping the dairy supply chain and market power between the different supply chain partners. Most of the changes have revolved around the infant formula market, but many are having broader knock-on effects on milk supply, vertical integration, and the cost of production. Below is a timeline of the main announcements and events since 2008.

KEY REGULATORY REFORMS AND OTHER EVENTS IN THE CHINESE DAIRY INDUSTRY	
Mid-08	Media reports begin to surface on sick infants who have been fed infant formula contaminated with melamine.
Sep-08	Chinese inspectors find chemical melamine in 69 batches of infant powder produced by 22 companies, including brands such as Sanlu, Mengniu, Yili and Yashili.
Oct-08	Ministry of Agriculture announces an emergency rescue plan with the Ministry of Finance to give special subsidies to dairy farmers seriously affected by the fallout for demand following the contamination scandal. 150,000 officials are sent to overhaul the entire supply chains from cattle feed to milk collection. Milk collection stations are rationalised, with a third shut down, and the proportion of those with milking machines installed increased.
Nov-08	The Chinese government reports an estimated 300,000 victims of melamine-contaminated infant formula, with six infants dying and 54,000 babies hospitalised.
Feb-09	National People's Congress passes new Food Safety regulations. The new regulations ban any unsafe additives being added to food products and require traceability of imported food products.
Mar-10	China's Ministry of Health passes new National Standards for Dairy Safety. The new standards are aimed at providing standards unification, as well as improving the overall safety and quality of dairy products.
Jun-10	China's Ministry of Agriculture issues its five-year plan. Part of this includes a National Dairy Development Plan requiring all raw milk collection stations to be registered by 2013, which in part contributed to herd liquidation in 2013. Additionally there was new technical guidance for dairy farmers and processors to improve quality and safety.
Jun-10	The Deputy Chief of CFDA is arrested on corruption charges. The head of the CFDA was executed in 2007 after being found guilty of serious corruption. Both cases highlight ongoing corruption issues.
Nov-10	MIIT, NDRC, and AQSIQ issues notice to assess and clean up dairy manufacturing facilities across China. Dairy manufacturing facilities are required to renew licenses by March 2011. Those that do not meet quality, safety, energy efficiency, and other requirements will be ordered to improve or shut down.
Mar-11	In March 2011 after audits have been conducted, 643 out of the 1,176 dairy manufacturers (including 114 infant formula manufacturers) in China were deemed to have passed inspections. 107 were ordered to suspend operations until identified problems were remedied. 426 failed and were closed down.
Sep-11	Synlait commissions second dryer that is capable of producing full-formulated infant formula base products.
Mar-12	Chinese State Council issues the Modern Agriculture Development Plan (2011-2015). This aims to increase total dairy production and target the expansion of scaled dairy farming.
Apr-12	Nestle buy Pfizer's baby food business for US$11.85 billion, beating out Danone. The Pfizer unit is a high-growth business built on its top SMA Gold brand, which ranks number five globally in the infant milk formula market with high exposure to the Asian and Chinese markets.
Jun-12	Four people are imprisoned for producing and selling melamine adulterated milk in 2009. Also melamine-tainted products that were supposedly destroyed in 2008 have reportedly reappeared, disguised in new packaging.
Jan-13	AQSIQ issues new Dairy Import/Export Inspection and Quarantine Regulations requiring all imported dairy products to meet higher standards and go through more thorough inspections when being registered.
Feb-13	Hong Kong authorities place restrictions on the number of infant formula cans (not more than two) that can be taken to mainland China following acute shortages.
Mar-13	Yili is granted permission to build a $214 million infant formula processing plant in South Canterbury.
Apr-13	AQSIQ issues further draft details on the dairy products to be included under the new Dairy Import/Export Inspection and Quarantine Regulations. Just about all the main products are included, making the regulations much wider than infant formula businesses.
May-13	Mengniu increases its shareholding in China Modern Dairy holdings to 28% to secure quality and quantity of raw milk.
May-13	Premier Li Keqiang ordered the relevant Chinese government agencies to regain consumer trust by strengthening government oversight for domestic and imported dairy/infant formula products.

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Jun-13	The State Council (which includes nine institutions) issue a working paper called 'Further Strengthen Quality and Safety of Formula Milk Powders for Infants/Young Children'. It includes options for more vertical integration of the domestic dairy supply chain (raw milk dairy manufacturers are required to have self-owned sources; manufacturers need to have self-controlled sources), new labelling requirements for imports, prohibition of base powder imports, and stricter penalties for substandard milk, illegal additives, illegal importation.
Jun-13	MIIT holds discussions with 127 infant manufacturers over possible vertical integration. It reportedly calls on the top 10 brands including Yili, Wandashan, and Firmus, to merge with competitors.
Jun-13	Mengniu launches general offer to acquire outstanding Yashili shares consolidating the infant formula supply chain.
Jul-13	NDRC announces a probe into anti-competitive pricing practices in Chinese infant formula. Several companies all announce proactive price reductions on specific products.
Aug-13	NDRC completes its investigation into infant formula pricing practices. Danone, Mead Johnson, Fonterra, Abbott, FrieslandCampina and Biostime are fined a collective US$110 million for price-fixing and anti-competitive behaviour. Three other companies (Nestle, Beingmate and Meiji) were granted full immunity for cooperating with NDRC, providing information to the investigators and proactively implementing measures to rectify any breaches.
Aug-13	Fonterra reports contaminated whey protein concentrate with botulism and a product recall is issued. The whey had been sold to third-party manufacturers who used it to produce infant formula, protein drinks, sports drinks, and other beverages. Subsequent testing shows the affected batches of whey were not Clostridium botulinum, but Clostridium sporogenese – a non-toxic strain.
Aug-13	There are reports MIIT plans to consolidate the infant formula industry to improve quality control and ability to monitor. According to the reports MIIT hopes the top 10 companies will account for 80% of the market by 2015 (presently 60%). Plans to reduce the number of participants from 127 to 50 and hopes to consolidate some domestic manufacturers into 3-5 large-scale companies by 2018 with over RMB$5bn in annual sales.
Aug-13	China Association of International Trade under the Ministry of Commerce announce that domestic and foreign baby formula will be sold in 20 pharmacies in Beijing and Jiangsu province as of October 2013, in a pilot program that will be extended to 20,000 pharmacies in 500 cities by 2015. This limits the number of retail outlets able to sell baby formula.
Aug-13	Yashili is granted permission to build a $220 million infant formula plant in South Auckland.
Sep-13	Fonterra launches its Anmum baby milk brand in Guangzhou and Chengdu and plans to roll it out to 70 other cities over the following three years.
Sep-13	Yili invests US$50m in Hong Kong dairy firm China Huishan Dairy Holdings Co. as part of its drive to secure milk supply. China Huishan Dairy Holdings Co. is reportedly looking to raise up to $1.3bn through an IPO in Hong Kong. Yili said the move would strengthen its partnership with Liaoning Huishan and secure a "long-term" and "stable" raw milk supply in northeast China.
Sep-13	Danone investigates allegations by Chinese TV that it paid medical practitioners to promote its infant formula products. Chinese TV claimed that companies have found a way around a ban on directly marketing milk powder in hospitals. A former Dumex employee supplied a list of names of doctors and nurses who had illegally received money from Dumex (Danone subsidiary) under the guise of "sponsorship".
Sep-13	China Business Journal reported the possible formation of a "national champion league" of six dairy companies with government subsidies of up to RMB30 billion (nearly NZ$6bn). The subsidies are to be provided to: Yili Group, China Mengniu, Heilongjiang Wondersun, Wissun International Group, Feihe International Inc, and Treasure of Plateau Yak Dairy Co.
Oct-13	Meiji, Japan's leading infant milk formula (IMF) producer, has walked away from the Chinese market citing falling sales, rising costs of raw materials and increasingly "fierce" competition in the US$1 billion imported sector. But the company acknowledges that consumer distrust is a factor, with the brand suffering a number of setbacks.
Oct-13	Ministry of Health issues rules to tighten the labelling guidelines on infant formula makers and to promote the use of breastfeeding.
Nov-13	Certification and Accreditation Administration of China (CNCA) notifies all embassies that all foreign dairy processing plants exporting to China must be registered by May 2014. Additionally, alongside the CFDA, there are announcements affecting imports of infant formula into China from all countries: must be in consumer-ready packaging upon import (effective immediately – this requirement does not apply to exports of bulk infant formula 'base' powder and ingredients for further processing); are required to have at least three months shelf life when presented for import clearance in China (effective immediately); and must be labelled for the Chinese market prior to export (i.e. overstickering in-market is no longer permitted) from 1 April 2014. It is noted that in some instances this is already being enforced domestically within China.
Nov-Dec-13	CFDA publishes a series of detailed regulatory changes that require the re-licensing of infant formula manufacturers to meet higher traceability and food safety measures. They include the re-evaluation of existing licensed infant formula manufacturers by 31st May 2014. This re-evaluation requires domestic manufacturers to have self-built or self-controlled raw milk sources and the implementation of Good Manufacturing Practice (GMP) and HACCP usually required for pharmaceutical companies. Additionally domestic manufacturers can no longer engage in OEM, re-packaging activities, use the same infant formula to produce different branded products, or use any other milk other than cow or goat's milk. Companies that fail to meet the requirements will not be registered.
Nov-13	Yili forms quality partnership with Italy's Sterilgarda Alimenti – to help improve the quality of its liquid milk.
Jan-14	Danone issues legal proceedings against Fonterra for loss of earnings and reputational damage following the whey protein concentrate recall.
Feb-14	Danone increases it shareholding in Mengniu to 9.9%. The proceeds of the shares are to be used to repay a loan after the acquisition of Yashili.
Mar-14	Chinese inspectors from CNCA visit New Zealand dairy companies to audit them to ensure they are aligned with new regulations.

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While the direct impacts of some of the reforms remain uncertain and dependent on their official interpretation by Chinese authorities, some observations can be made.

Consolidation and more vertical integration of domestic infant formula participants seem inevitable. It has happened before, with the number of dairy processors being reduced from 1,176 to just 643 in 2011. It doesn't look like it will be any different for the 127 infant formula manufacturers, with pressure coming from a number of sources. As the Coriolis report showed, most other markets are highly concentrated with the top 3-4 players having 80+ percent market share due to product complexity, government intervention/policies, required brand trust and the intellectual property/patents involved.

Chinese officials and institutions need a more concentrated marketplace if they are to have any hope of monitoring and enforcing compliance of the new regulations. Some of the most prominent policies that will push consolidation are the banning of the traditional sub-contract or "Original Equipment Manufacturer" manufacturing arrangements for domestic companies; banning of the importation of base infant powder (defined as 95-98 percent pre-mixed); the rumoured RMB$30 billion in subsidies for six favoured companies; the requirement that manufacturers who use raw milk as a primary input have their own self-built dairy farm and manufacturers that use milk powders have self-controlled milk sources.

Consolidation is likely to benefit the stronger and larger domestic and multinational companies through the exiting of smaller participants, or companies specifically focused on one process (such as sole canning businesses). But while there might be less competition for larger companies, the recent crackdown on pricing and fines for multinational companies suggests there are other levers authorities can use to ensure affordability and avoid anti-competitive behaviour.

If there is consolidation and more vertical integration of domestic infant formula participants, the same is likely to apply for imports and multinational companies. The recent audit of New Zealand's dairy industry by Chinese authorities was actually targeted much more widely than commonly reported. This audit was planned before the announcements around the new requirements for infant formula imports and the need to be registered by May 2014. The tight timelines for registrations meant it became a bigger focus during the auditing process. The general audit was similar to what has occurred in the meat and seafood industries in recent years. On the general audit it is unlikely there will be too many major issues, but there could be some transitional issues that might need to be dealt with, especially if we look at the experiences in the meat industry.

However, in the infant formula space it could be a bit more of a lottery for small companies and single-focused entities, given the authorities desire to reduce the number of entities they need to monitor. Reportedly some of the 100+ New Zealand registered sales and marketing companies have already exited. There have been clear indications that infant formula brand owners should have control of the quality of manufacturing and associated milk supply, be able to demonstrate full traceability to the consumer, and have a mechanism for providing full accountability within China for servicing consumers. Expectations are likely to include the ability for brand owners to undertake and control recalls in-market, trace issues back to any problem that may be associated with initial manufacture, and then be able to provide credible assurances and relevant evidence that any required corrective and preventative actions have been implemented.

This is likely to prove too much for many. It is also highly unlikely blending ingredients at one site and then canning at another will achieve import certification, nor will there be an ability to have multiple brands for the same formulation of infant formula, both of which occurs in some cases. While most believe it will be about demonstrating traceability, some current practices clearly involve too many participants for Chinese authorities to keep track of, leading to consolidation or shutdown. **Many of the same drivers above will also lead to a realignment of the larger multinational companies supply chains into China.**

In the longer term, New Zealand and other multinational companies will face more formidable competition from domestic players, who are supported with subsidies. The degree of competition that will be posed by domestic players will depend on how successful the consolidation and vertical integration of these domestic players is. But additional scale should enhance some of their natural advantages such as better distribution networks and knowledge of the marketplace. While it will take time to fully restore consumer confidence in domestic brands, the recent price-fixing prosecutions directed at multinational companies, quality issues, especially Fonterra's whey protein concentrate recall and the recent bribery allegations against Danone, who has a 10 percent market share, shows multinational companies are not squeaky clean either. With both domestic and multinational companies faced with having to register and meet the same traceability, quality standards and labelling requirements, the

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additional area of support for domestic players seems to be more direct subsidies and tax breaks as well.

Consolidation and vertical integration leads to a reshaping of supply chains outside the infant formula category. Through the process of meeting the new regulations for the infant formula market, changes such as the requirement to have self-built and/or self-controlled raw milk supplies is likely to lead to different investment patterns and business relationships developing. This could have implications for other product categories. Take Yili and Mengniu, who plan to build infant formula plants in New Zealand, Bright Foods' investment in Synlait, or Fonterra building its own domestic supply in China as examples. Would these changes be happening if the regulatory framework for the infant formula category wasn't being reshaped? These investments create different business relationships, which then create different discussions and eventually new ventures.

Long term the changes will lead to more large scaled and intensive dairy farm systems in China. This is already occurring with 35 percent of farms having over 100 cows in 2012, compared with just 4 percent 10 years before. But the reforms are likely to speed up the process. To meet the new food safety and traceability requirements larger-scale and more intensive dairy farm systems are being favoured through higher farm-gate prices. These farms often sit very high on the cost curve (meaning a higher farm-gate price is required) due to a lack of natural advantages and expertise (genetics, feed management etc). How these operations are perfected and productivity improved over time will determine the competitiveness of domestic milk versus imported product. We suspect they could slowly become more competitive with other imported sources.

Category growth for infant formula will slow rather than accelerate. There seem to be some overly optimistic views on how much further the Chinese infant formula category will grow. While there are some positive drivers, such as the relaxing of the one child policy and continued urbanisation, it won't be one-way traffic. The push to boost breast-feeding, restrictions on who can sell it, the crackdown on direct marketing through health professionals and hospitals, and continued safety scares suggest much more modest category growth going forward.

KEY TABLES AND FORECASTS

FX RATES	ACTUAL			FORECAST (END MONTH)						
	Feb-14	Mar-14	3-Apr	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
NZD/USD	0.839	0.865	0.856	0.83	0.83	0.81	0.79	0.78	0.77	0.76
NZD/AUD	0.940	0.937	0.927	0.94	0.95	0.95	0.94	0.93	0.92	0.90
NZD/EUR	0.608	0.627	0.622	0.60	0.59	0.57	0.56	0.55	0.53	0.51
NZD/JPY	85.40	89.28	88.89	87.2	88.8	89.1	86.9	85.8	84.7	83.6
NZD/GBP	0.501	0.520	0.514	0.49	0.48	0.47	0.45	0.45	0.44	0.43
NZ TWI	78.4	80.5	80.0	78.0	78.1	76.6	74.8	73.7	72.5	71.1

INTEREST RATES	ACTUAL			FORECAST (END MONTH)						
	Feb-14	Mar-14	3-Apr	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
NZ OCR	2.50	2.50	2.75	3.25	3.25	3.50	3.75	3.75	4.00	4.25
NZ 90 day bill	2.84	2.90	3.18	3.50	3.50	3.90	4.00	4.00	4.40	4.50
NZ 10-yr bond	4.72	4.55	4.63	5.00	5.20	5.20	5.10	5.20	5.30	5.50
US Fed Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00
US 3-mth	0.25	0.24	0.23	0.40	0.40	0.50	0.60	0.80	1.10	1.40
AU Cash Rate	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.00	3.25	3.50
AU 3-mth	2.64	2.63	2.67	2.70	2.70	2.70	2.90	3.20	3.40	3.70

ECONOMIC INDICATORS	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
GDP (% q/q)	0.9	**0.9**	**0.8**	**0.8**	**0.8**	**0.8**	**0.7**	**0.7**	**0.7**	**0.6**
GDP (% y/y)	3.1	**3.5**	**3.9**	**3.6**	**3.5**	**3.3**	**3.2**	**3.1**	**3.0**	**2.8**
CPI (% q/q)	0.1	**0.5**	**0.5**	**0.7**	**0.3**	**0.7**	**0.7**	**0.8**	**0.3**	**0.7**
CPI (% y/y)	1.6	**1.7**	**2.0**	**1.8**	**2.0**	**2.2**	**2.4**	**2.5**	**2.5**	**2.5**
Employment (% q/q)	1.1	**0.6**	**0.4**	**0.4**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.2**
Employment (% y/y)	3.0	**3.4**	**3.4**	**2.5**	**1.8**	**1.5**	**1.4**	**1.3**	**1.2**	**1.1**
Unemployment Rate (% sa)	6.0	**5.7**	**5.6**	**5.6**	**5.6**	**5.5**	**5.5**	**5.4**	**5.4**	**5.4**
Current Account (% GDP)	-3.4	**-3.4**	**-3.5**	**-3.6**	**-4.4**	**-4.8**	**-5.1**	**-5.3**	**-5.4**	**-5.5**
Terms of Trade (% q/q)	2.4	**0.2**	**-0.6**	**-1.0**	**-1.2**	**-1.4**	**-1.4**	**-1.2**	**-1.0**	**-0.9**
Terms of Trade (% y/y)	20.0	**15.4**	**9.5**	**0.9**	**-2.7**	**-4.2**	**-5.0**	**-5.2**	**-5.0**	**-4.5**

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

NEW ZEALAND'S 20 LARGEST EXPORT MARKETS

NZ'S TOP EXPORT MARKETS FOR THE 12 MONTHS ENDED FEBRUARY 2014 (NZ$M)

	Global Total	China	Australia	USA	Japan	Korea	UK	Singapore	Germany	Malaysia	Indonesia	Taiwan	Philippines	Hong Kong	Thailand	UAE	India	Nether-lands	Saudi Arabia	Canada	Algeria
Sheepmeat	2,837	745	5	218	51	3	527	12	236	38		33	1	32	4	9		147	80	81	9
Beef	2,127	200	12	900	180	114	31	34	10	33	66	135	24	33	13	23		32	30	70	
Other Meat	456	22	44	26	35	25	28	5	64	5	8	4	3	30	2	1		22	7	5	3
Milk Powder	9,500	4,769	69	3	39	12		292		407	300	233	278	96	280	458		1	212	7	135
Butter	2,409	339	91	64	14	14	4	40		59	80	62	86	22	41	61		10	77	6	88
Cheese	1,426	133	199	6	329	97	36	10		36	53	37	53	18	17	17	1	17	58		18
Whey/Casein	1,935	221	49	663	233	46	2	75	179	22	55	11	24	1	21	1	6	14	24	30	
Kiwifruit	845	83	58	20	225	36		10	179	12	9	58	2	23	7	4	4			3	
Apples	516	21		72	6		56	16	53	13	7	21	1	22	46	28	21	53		13	
Other Fruit/Vege	891	17	405	34	162	21	11	13	8	36	12	19	2	9	13	3	1	16	1	3	3
Wine	1,287	22	385	311	14	2	297	21	12	2	1	1	1	18	2	6		34		79	
Wool	732	366	38	15	16	1	46		40	5	1	5		6	7	1	35	1		4	
Skins/Hides	605	193	23	3	6	28	5		1		6	4		32	9		18				
Logs	2,561	1,844			153	332						12		1	4		209				
Sawn Timber	1,129	168	323	172	71	58	2	5	3	15	20	44	38	1	30	9	3	18	16	1	
Fibreboard/Plywood	334	22	40	14	197	1				4	21	4	9		1		5			1	
Wood Pulp	646	158	72		59	83				18	126	23	5		16		12				
Fish/Seafood	1,421	406	263	149	105	30	14	28	25	8	2	7	15	58	31	12		8	2	12	
Crude Oil	1,649		1,431			1		159						16	18						
Aluminium	1,009	25	77	31	510	134	41	2	1	2	6	3		7	2		13	47		3	
Remainder	15,117	1,181	5,452	1,349	506	589	353	319	187	250	153	205	229	340	195	82	357	185	57	210	2
TOTAL	**49,430**	**10,934**	**9,037**	**4,050**	**2,911**	**1,626**	**1,451**	**1,042**	**997**	**966**	**926**	**919**	**770**	**766**	**760**	**714**	**687**	**607**	**563**	**528**	**256**

NZ'S MERCHANDISE EXPORTS ANNUAL CHANGE BETWEEN THE 12 MONTHS ENDED FEBRUARY 2014 AND A 12 MONTH SPAN A YEAR EARLIER (NZ$M)

	Global Total	China	Australia	USA	Japan	Korea	UK	Singapore	Germany	Malaysia	Indonesia	Taiwan	Philippines	Hong Kong	Thailand	UAE	India	Nether-lands	Saudi Arabia	Canada	Algeria
Sheepmeat	217	335	-2	-9	7	-1			-9	-10		-18		4	1			3	-19	-9	-4
Beef	1	115	-3	-57	-17	-7	2	-10	-8	8	30	-2	-16	-6	1	-1			21	-12	
Other Meat	14	5	3	5	-7	-5		-2	10	-4	4	2		3	1			3	-5	1	3
Milk Powder	2,552	2,572	19	-12	12	4		102		111	21	83	68	-42	78	53	-1	-5	-56	7	-242
Butter	493	152	14	-56	-4		4	5		10	33	10	19	5	11	22			-23	-13	47
Cheese	-41	30	-32	-46	22	-37	12	1		8	-9	8	-7	2	3	1	1	-11	-24		-8
Whey/Casein	-52	-44	-6	-118	23	-3	-1	12	24	-6	13	-1	-1		19		-1	6	-6	-2	-1
Kiwifruit	-232	-34	-9	-6	-93	-28			-16	-2	1	-37		-7	1	1	1			-1	
Apples	143	18		26			7	4	13	1	1	2	1	-1	14	9	-2	19		7	
Other Fruit/Vege	91	3	66	1	-8	-3	-1	2		14	5	2		2	-3	1		3		1	
Wine	88	-9	15	41			20	5	2					-2				8		1	
Wool	-52	-23	-13	-7	-4	-1			-4	-2	1	-6		-1	-2	1	2	1		1	
Skins/Hides	52	-5	3		-3	6	1		-1		-4	-1					7				
Logs	843	725			-16	74						2		1			57				
Sawn Timber	26	5	-6	14	-7	3		-1	2		-1	7	-14			2		8	-10		
Fibreboard/Plywood	-43	-5	-16	4	-17					-5		1					2				
Wood Pulp	58	-15	10		-25	17		-5			38		1		-8						
Fish/Seafood	-46	45	-13	17	-26	-15	3		4		-2		12	-32	9	7		2		-1	
Crude Oil	-353		-365		-33	1		36			-24			16	17						
Aluminium	-24	-11	-5	-22	36	17	-19	1	-1		2	1		-12			-3	-33		1	
Remainder	-264	-59	-363	-1	-115	10	52	25	37	1	-28	32	40	-12	4	15	-93	28	-17	-4	
TOTAL	**3,471**	**3,800**	**-705**	**-225**	**-277**	**30**	**80**	**174**	**55**	**122**	**82**	**84**	**103**	**-84**	**146**	**109**	**-30**	**32**	**-140**	**-21**	**-206**

NZ'S MERCHANDISE EXPORTS ANNUAL CHANGE BETWEEN THE 3 MONTHS ENDED FEBRUARY 2014 AND A 3 MONTH SPAN A YEAR EARLIER (NZ$M)

	Global Total	China	Australia	USA	Japan	Korea	UK	Singapore	Germany	Malaysia	Indonesia	Taiwan	Philippines	Hong Kong	Thailand	UAE	India	Nether-lands	Saudi Arabia	Canada	Algeria
Sheepmeat	127	100	1		3	-1	-1		4	-1		-2		1				6	1	-4	3
Beef	27	9	1	-14	-5	5	5	-1		3	23	9	-7	-2	2	-1		1	6	-1	
Other Meat	2	-1	-1	1	-1	-1			3		5	1		-1					-2		2
Milk Powder	1,316	1,222	5	-4	2	1		27		39	8	33	12	-28	57	62			12		-131
Butter	281	105	8	-23			2	5		5	3	6	8	2	3	10		-5	-6	-2	22
Cheese	5	23	-14	-3	10	-22	20			4	-6	1	-2	1	3			-6	-2		-6
Whey/Casein	74	-20	-2	-16	17			11	41	2	4		1		9			5	-4	1	-1
Kiwifruit	1		-1	1																	
Apples	12							1				7		1							
Other Fruit/Vege	49	2	38	1	1	-1	-3	1	-1	2	3	1			1			-1			
Wine	53	1	7	16			20	3	1					-1		1		4			
Wool	-36	-37	-2				1		-1			-2		-2		1	4				
Skins/Hides	6	-9				3	1							3	1		1				
Logs	217	184			9	4						1					19				
Sawn Timber	24	-3	4	5	6	-1			1		1	-2	4			1		1	-1		
Fibreboard/Plywood		-2	1	1	1					-1			-1								
Wood Pulp	29	-6	5		-3	12				1	9	2	1								
Fish/Seafood	-7	-1	-8	10	-3		1	1			-1		1	-1	4	1		1			
Crude Oil	-100		-114					-18						16	16						
Aluminium	20	-7	-3	-4	41	-1	-6			1				-4			-1	-6		1	
Remainder	-66	-52	-85	-8	-3	48	16	9	1	-5	-7	4	15	-3		3	-38		-1	-9	
TOTAL	**2,034**	**1,509**	**-159**	**-37**	**74**	**47**	**56**	**40**	**50**	**50**	**43**	**59**	**33**	**-16**	**97**	**78**	**-16**	**1**	**1**	**-12**	**-112**

IMPORTANT INFORMATION

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