

NEW ZEALAND ECONOMICS

ANZ AGRI FOCUS

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BUCKLE UP

FEATURE ARTICLE: AGRICULTURAL PRICE PREVIEW 2015/16

Macro drivers such as geopolitical ructions, sluggish global growth, FX volatility/ shifts and lower energy/feed prices are creating a challenging environment for many primary sectors. But exposure to these forces varies significantly, implying quite diverse outlooks for 2015/16. Key for how things evolve will be local and offshore supply dynamics, as well as NZD direction. Across some soft commodity markets, such as dairy, global prices are below the cost of production, which will help cap production and drive price tension. But this is against a softer demand backdrop.

THE MONTH IN REVIEW

Seasonal conditions have improved with wide spread rain during March. The recovery remains patchy though, and favourable autumn conditions, as well as more follow-up rain, are required.

RURAL PROPERTY MARKET

The rural property market has remained remarkably resilient in the face of lower farm-gate prices and the dry summer conditions. Our seasonally adjusted measures for total turnover continue to hover around the 10-year average and the all-farm price measure is sitting at a very elevated level.

KEY COMMODITIES AND FINANCIAL MARKET VARIABLES

We expect the NZD/USD to gradually decline as the Fed begins to increase interest rates over the back end of 2015. The RBNZ is expected to remain on hold for an extended period. A solid economy flags the next move as being up. Low inflation argues for a rate cut. The outlook is balanced.

BORROWING STRATEGY

Indicative rural lending rates are slightly lower since our last update. Low rates are a welcome development for borrowers; the reasons why they are low (sluggish global growth and low inflation) are not. We remain cautious about fixing in an uncertain environment despite the apparent value on offer.

ECONOMIC BACKDROP

New Zealand is seeing growth and low inflation; a powerful mix. A strong growth pipeline remains in the form of supportive financial conditions, strong migration inflows, rising trends across the construction sector and elevated levels of confidence. Low dairy prices, tight fiscal policy and a high NZD are leaning against momentum, as are natural restraining influences such as skill shortages in some industries. We expect 3% real GDP growth over 2015.

EDUCATION CORNER: GLOBAL LAND PRICE TRENDS

New Zealand farmland values have caught the gold rush fever again. High long-term farmland prices risk undermining many of New Zealand's natural and man-made competitive advantages. We find New Zealand farmland values have appreciated the most of 12 key competing and export markets since 2000, but most of the other countries analysed have experienced impressive gains too. While much of New Zealand's "X-factor" seems to be already priced in, outperformance and total farming returns well outpacing many other asset classes tells you something. So despite near-term challenges, don't be surprised if farmland continues to catch a bid from many quarters for the "touch and feel" aspect, food and other services investment thematics, global scarcity value of quality farmland, development opportunities, and diversification plays.

FEATURE ARTICLE: AGRICULTURAL PRICE PREVIEW 2015/16

AGRICULTURAL PRICE PREVIEW FOR 2015/16					
June Year End	2012/13	2013/14	2014/15p	2015/16f	% change
Finance					
Weighted Rural Interest Rate	5.95	5.85	6.25	6.30	NA
Dairy (\$ per kilogram of milksolid) after retentions					
Fonterra Milk Price	5.84	8.40	4.50-4.70	5.75	+25%
Dividend per share after retentions	0.32	0.10	0.30	NA	NA
Tatua	7.40	8.90	6.75	7.00	+4%
Westland	6.04	7.57	5.00	5.75	+15%
Open Country Dairy	5.90	8.40	4.50-4.70	5.75	+25%
Synlait	5.89	8.31	4.50-4.70	5.75	+25%
Wool (\$ per kilogram greasy, whole of clip net of costs)					
Fine (<24 micron)	11.05	10.35	9.30	9.70	+4%
Medium (25-31 micron)	6.45	5.55	5.60	5.90	+5%
Crossbred (>31 micron)	2.95	3.75	3.85	3.75	-3%
Sheep (\$ per head, weighted averages, GST exclusive and net levies at farm gate)					
Lamb (17.5 kg carcass)	83	94	92	95	+3%
Mutton (24.5 kg carcass)	60	74	65	67.5	+4%
Stores (LW 30-35 kg)	45-80	65-85	60-85	65-85	+3%
Beef (\$ per kilogram of carcass weight, weighted averages, GST exclusive and net levies at farm gate)					
Steer (296-320 kg carcass)	3.80	4.05	4.60	4.85	+5%
Heifer (195-220 kg carcass)	3.70	3.95	4.45	4.70	+6%
Bull (296-320 kg carcass)	3.75	3.90	4.40	4.60	+5%
M Cow (160-195 kg carcass)	2.80	2.75	3.10	3.25	+5%
Deer (\$ per kilogram of carcass weight, weighted averages, GST exclusive and net levies at farm gate)					
Stag (60 kg carcass)	6.70	6.35	6.35	6.05	-5%
Hind (50 kg carcass)	6.60	6.25	6.25	5.95	-5%
Velvet (\$ per kg)	96	100	125	115	-8%
Grains (\$ per tonne, AgriHQ prices grower bids delivered nearest store or mill, net levies and freight to this point)					
Milling Wheat	410 to 430	410 to 450	400 to 450	410 to 440	Unchanged
Feed Wheat	350 to 380	380 to 440	370 to 445	360 to 390	-8%
Feed Barley	340 to 380	370 to 435	360 to 445	350 to 390	-8%
Maize Grain	400 to 440	440 to 500	400 to 460	380 to 420	-7%
Palm Kernel	290 to 350	300 to 370	230 to 310	260 to 280	Unchanged
Kiwifruit (\$ per tray OGR, crop year)					
Zespri™ Green	4.62	5.23	5.96	5.25	-12%
Zespri™ Gold	10.45	12.91	9.78	7.00	-28%
Apples (Weighted FOB returns \$ per TCE, crop year, % change 2014 to 2015 crop)					
Braeburn	18.3	22.4	24.4	21.0	-14%
Royal Gala	26.2	27.4	24.7	25.0	+1%
Fuji	23.5	26.4	32.0	30.5	-5%
Jazz™	21.6	28.5	31.4	31.0	-1%
Pacific Rose	33.5	36.8	38.2	36.0	-6%
Grapes (\$ per tonne, national average, vintage year, % change 2014 to 2015 vintage)					
Sauvignon Blanc	1,151	1,231	1,605	1,675	+4%
Merlot	1,517	1,510	1,768	1,800	+2%
Pinot Noir	2,429	2,754	2,931	3,000	+2%
Chardonnay Mendoza	1,014	1,089	1,692	1,700	Unchanged
Chardonnay Other	1,122	1,177	1,690	1,700	+1%
Pinot Gris	1,306	1,239	1,530	1,550	+1%

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SUMMARY

Macro drivers such as geopolitical ructions, sluggish global growth, FX volatility/shifts and lower energy/feed prices are creating a challenging environment for many primary sectors. But exposure to these forces varies significantly, implying quite diverse outlooks for 2015/16. Across some soft commodity markets, such as dairy, global prices are below the cost of production, which will help cap production and drive price tension over time. Market dynamics look different to oil and iron ore.

In terms of key commodities, we expect:

- A milk price of \$4.50-4.70/kg MS for 2014/15 and \$5.75/kg MS for 2015/16. While not as significant from a cash-flow perspective, the dividend component for 2015/16 will be key as a signal as to how well Fonterra's strategy is going (page 4).
- Better in-market returns are expected for venison, but the strong appreciation in the NZD/EUR is expected to eat up all of these gains plus some (page 14).
- The outlook for sheepmeat is more neutral (page 5). We are cautiously optimistic on demand, but wary of recent weakness in European markets outside of Germany and China. Reduced domestic and Australian supply are expected to help rebalance key markets.
- Beef prices are expected to remain strong, driven by outperformance in the US market and a slow-down in Australian supply (page 8).
- In-market crossbreed wool prices are under pressure from substantially lower synthetic and cotton prices, as well as lacklustre demand growth outside the US (page 12).
- Kiwifruit prices will be lower as NZ supply improves, the elevated NZD/JPY bites and a softer European fruit market (page 19).
- Pipfruit is mixed with lower prices expected in Europe, but Asian prospects look better (page 22).
- A significantly smaller 2015 Sauvignon Blanc vintage is expected to smooth supply between adjoining years, averting the need to reduce prices to shift product (page 24).

THE BIG PICTURE

A number of key macro drivers are providing a challenging environment for many parts of the agriculture sector – though prospects remain far sounder than across a lot of other commodities (i.e. oil and iron ore). We're cautious heading into the 2015/16 season. These drivers include:

- **Sluggish economic and real wage growth in many markets outside the US, dampening demand.** The retail channel's constant conditioning of consumers for "specials" is also proving hard to shake in many markets.
- **Greater uncertainty over the trajectory of some key emerging market economies, including China.**
- **The downstream implications of falls in other commodity prices** such as oil, with oil exporting nations key buyers of the likes of dairy.
- **Geopolitical ructions** disrupting trade flows and import demand in some key import regions (mainly Europe and the Middle East). Russian sanctions and the dramatic fall in the ruble continue to reverberate through many soft commodity sectors and key markets.
- **Conflicting views on what the impact of European quota removal and other policy changes will mean for global dairy supply.**
- **Lower feed costs for the Northern Hemisphere** boosting the competitiveness of key competing exporters and products.
- **Generally lower commodity prices for key inputs**, such as oil and fertiliser, weighing on both the cost curve and sentiment.
- **Competitors opening up market access into China and other emerging markets.**
- **Foreign exchange movements altering competitiveness.** The rise of the USD makes imported food products more expensive in some key emerging import markets. The flipside is a weaker NZD/USD and reduced US export competitiveness. While the USD is up, the euro is down. Euro weakness boosts their exporter competitiveness for the likes of dairying, but reduces local earnings for those products such as venison, sheepmeat, pipfruit and kiwifruit that derive a large proportion of earnings from Europe.

Exposure to these forces varies significantly between the different primary sectors, implying quite diverse outlooks for 2015/16. Some of the effects can take a while to work through due to production lifecycles and various government support programs. **Key for how things evolve will be supply dynamics.** These will be governed by inventory positions, seasonal conditions both domestically and for key competitors, as well as how producers respond to lower margins.

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DAIRY

Our assessment for dairying remains largely unchanged from February. For those who missed it check out theme four of the feature article in the February *Agri Focus*. In February we expected a milk price of \$4.50-\$4.70/kg MS in 2014/15 and \$5.75/kg MS for 2015/16. We still hold this view at present.

We project milk powder prices to trade around the US\$3,000 per tonne mark as new season supply builds and then gradually increase toward US\$3,300 per tonne in early 2016. A key judgement we are making is that with dairy prices sitting below the marginal cost of production, global supply growth will continue to moderate helping rebalance the market after inventories have been utilised. The key risks to our view are Europe's export intentions and China's import demand. We suspect the Russian sanctions and lower euro will support European exports, but how much in the face of lower farm-gate returns remains difficult to determinate. China's import demand remains difficult to read with domestic milk supply critical. Lower farm-gate prices should keep it checked.

The next three GDT auctions are shaping up as critical in determining where the opening milk price and advance will be pitched for 2015/16 come the end of May. This, combined with the wash-up for 2014/15, will have a large influence on farmers' cash-flow over the first half of the 2015/16 season. While we are holding our \$5.75/kg MS milk price forecast for 2015/16, recent auction weakness and NZD strength raises the risk the opening estimate may come in below this.

All of the improvement in auction prices seen in February has now been unwound over the last two auctions. In February there had been fears of an early finish to the New Zealand season as dry conditions spread and milk supply rapidly slowed. Conditions have improved in most areas, easing these concerns, but more follow-up rain is required in many parts. There are still some areas where farmers have had to dry their cows off early and most have shifted to once-a-day, or 16 hourly milking. However, the general improvement in conditions has seen Fonterra add a bit more product to the last few auctions. While the additional amount isn't much in the scheme of things, and the total amount being offered is still well back on the same period last year, market sentiment is still weak and fragile, meaning the price impact has been considerable.

Two additional factors that seem to be weighing on market sentiment are firstly that most buyers appear to have their needs covered for

the second quarter, and secondly, **uncertainty over European milk supply post-quota removal on 1 April** (after 31 years!). There are conflicting views on whether or not milk supply will kick-up in Europe post the removal of the quotas. But what is certainly being reported is that many buyers have disappeared from the market as they have adequate cover for now and can afford to take a wait-and-see approach to European supply.

We still project milk powder prices to trade around the US\$3,000 per tonne mark as new season supply builds, and then gradually increase toward US\$3,300 per tonne in early 2016. More upward momentum for prices is likely to take hold as inventories are run down and lower offshore farm-gate prices bite across the main exporting regions, slowing supply and helping rebalance the market. Lower dairy prices are also being feed through to retail; this should help stimulate demand in many emerging markets.

But as always, volatility in dairy markets remains and the path toward improving prices and getting them back above breakeven is unlikely to be straight forward. The key dynamics we will be watching for direction are:

1. China and its import needs – expected to improve over the back end of 2015 as inventory is run down and lower retail prices for dairy products stimulates demand.
2. Russian sanctions and its economic performance – not expected to improve anytime soon.
3. Oil dependent countries' demand – oil prices are not expected to improve in the near-term, but it isn't all gloomy, with some key importers still active.
4. Cost of production and margins for Northern Hemisphere supply – down due to lower grain and energy prices, but feed prices look to have bottomed. Lower farm-gate prices are now starting to materially bite margins in many regions.
5. European and New Zealand supply is going head-to-head – supply is lower for NZ and fewer cows are expected to be milked in 2015/16. Europe; mixed views, but the Russian situation and euro direction likely to boost export competition and be much more important than headline milk supply.

We are also eyeing the dividend component for Fonterra. Suffice to say that the downgrade to the 2014/15 estimate caught most (including us) by surprise. While a lot of factors influence the dividend, the bottom line is that lower input prices (read:

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international powder prices) should have supported margins and the dividend. We won't go into details on the ins and outs; rather what is clear is that farmer sentiment is testy and a continuation of a low dividend payment would raise question marks over the execution of Fonterra's strategy.

SHEEPMEAT

Tradable sheep meat supply from New Zealand and Australia could tighten by up to 10% (5.5m head) over the coming 18 months. This is conditional on seasonal conditions in both countries continuing to improve. This is should help rebalance key markets, but local supply in the UK and China will also be influential in New Zealand's two largest markets. In 2015/16 we are cautiously optimistic on demand in the UK, Germany and the US, but less so on China, the rest of Europe and the Middle East. Therefore, we expect only a small improvement in farm-gate prices to \$95/head in 2015/16. Lower-than-expected prices during the peak of the processing period, combined with currency strength, is expected to deliver an all-season average price of \$91 per head (for a 17.5kg carcasse) in 2014/15.

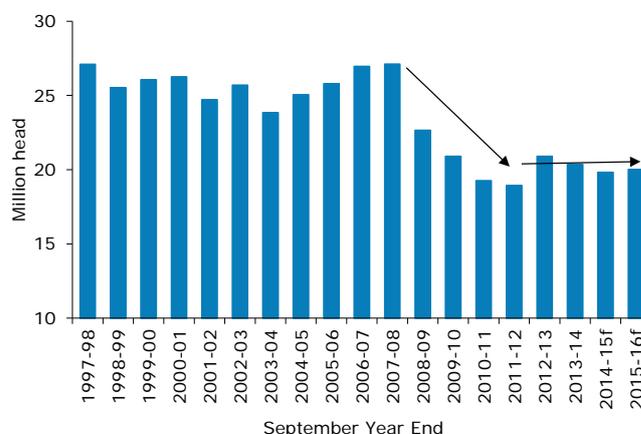
TIGHTER TRADABLE SUPPLY IN 2015/16

In terms of the global supply of tradable lamb New Zealand and Australia are the only ones in the game. That said, domestic production in key export destinations, such as China and Europe also matters for price direction.

In New Zealand, industry forecasts are for a 3% decline in lamb production in 2014/15.

The reduction reflects a decline in breeding ewe numbers in 2013/14, coupled with higher retentions of replacement hoggets this year. These two factors offset gains from a better lambing performance in 2014 after the 2013 drought-affected result. **Dry conditions across the major lamb producing regions brought forward this season's lamb slaughter.** Recent rain has eased the dry conditions in many key regions and lamb turn-off (slaughtering and live exports) has subsequently slowed. Given the large early turn-off it would appear the second half of the season will see substantially softer supply, depending on how seasonal conditions evolve. If conditions do not continue to improve in the key breeding regions then the additional hoggets that are earmarked for retention could be turned off. We estimate this could boost lamb production by 0.3-0.5m head if this does occur, which would leave production relatively unchanged compared with 2013/14.

FIGURE 1. LAMB SLAUGHTER IN NEW ZEALAND



Source: ANZ, Beef + Lamb NZ

It's still quite early to look forward to what 2015/16 might bring. **At present industry forecasts are for little change in the 2015 lamb crop, with both breeding ewe numbers and lambing percentages relatively stable.**

Stable breeding ewe numbers are crucially reliant on lower numbers of ewes being turned-off in 2014/15 after a 7% fall in hogget retentions in 2013/14. Lamb turn-off was prioritised over mutton early on, but a catch-up has started to occur since mid-February. Year-to-date mutton production is currently tracking 5% behind the same period last year, which is roughly 400,000 ewes ahead of industry forecasts. These ewes won't be mated this autumn, suggesting there is downside to the assumption of stable breeding ewe numbers in 2015/16. If this continues over the autumn then the 2015 lamb crop would be up 500,000 head smaller (4%). The continued improvement in seasonal conditions in key breeding regions and an increase in farm-gate schedule prices are both crucial.

With early mating occurring in dry conditions and low pasture residuals there is also a risk to conception rates for the 2015 lamb crop, but an improvement in seasonal conditions during early autumn should help mitigate this.

The drought in 2013 led to a 3-5% drop (against trend) in the lambing percentage. Such a decline this year would decrease the 2015/16 lamb crop by 0.6-1m head. Of course the severity of the dry conditions for different regions is not comparable with the 2013 episode, but what these numbers do highlight is the downside risk of poor seasonal conditions during the main mating period.

All up, while there has been strong supply over the first half of the 2014/15 season, this now appears to have turned around due to an improvement in

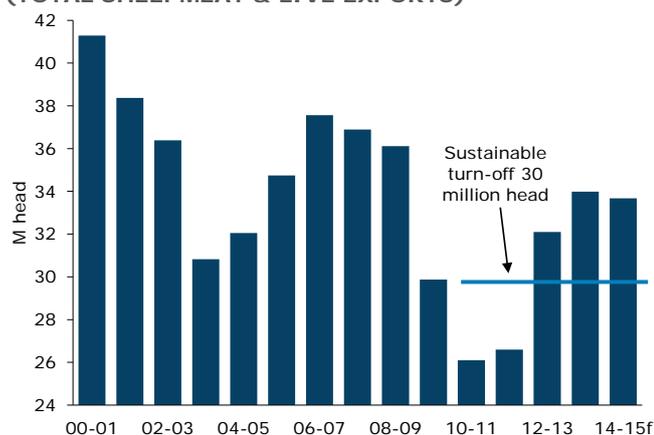
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seasonal conditions in key regions. **While industry production expectations are fairly stable around the 20m head mark for 2015/16, we see some downside risks toward 19m head** via lower breeding ewe numbers and perhaps lambing percentages. As always, how seasonal conditions evolve and lamb survival during the spring will shape the final outcome.

AUSTRALIAN SUPPLY

Australian farmers have once again been liquidating their sheep flock over the last two years. A dry spell in 2014 and sheep production incomes at only average levels versus broad acre cropping has driven the liquidation. For Australia, we estimate a sustainable turn-off to sit around the 30m head mark for sheepmeat. This compares with a turn-off of 34m head in 2013/14. The high turn-off rate has continued over the first half of the 2014/15 season, especially on the east coast, where dry conditions have persisted.

FIGURE 2. AUSTRALIAN SHEEP FLOCK TURN-OFF (TOTAL SHEEPMEAT & LIVE EXPORTS)



Source: ANZ, ABS

Australia processed a record 22.4m head of lamb in 2014, but industry forecasts are for this to slow to 19.8m head in 2015. With the assumption of improving seasonal conditions after recent rain in some key breeding regions, and the intention of farmers to maintain their breeding ewe flock size going forward (MLA/AWI wool and sheepmeat survey), lamb slaughter is expected to decline as farmers retain more ewe hoggets to replace culled ewes in 2014.

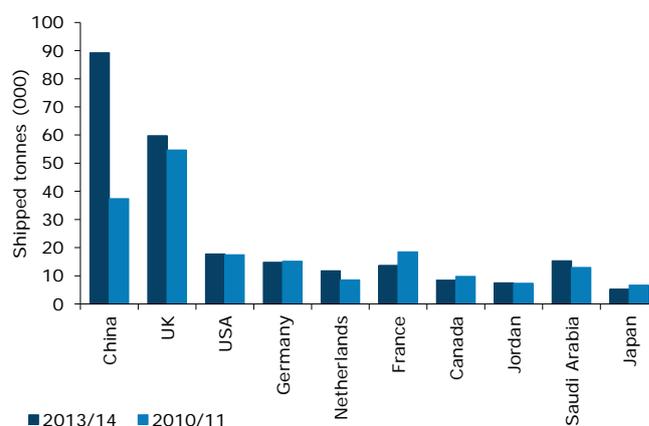
Furthermore, as a result of the breeding ewe flock falling by 3% in 2014, the overall size of the 2015 lamb crop will be constrained, despite an assumption of a higher lambing percentage. This will keep lamb production around 20m head, or lower in 2016.

Mutton production will also have to decline to stabilise sheep flock numbers, which means overall sheepmeat production could be set to decline by 10-15% over the next 18 months. Such a decline will help alleviate current supply pressure in key markets, such as the US, China and Middle East.

IN-MARKET DYNAMICS

Strong local competition in both the UK and China is pressuring prices in New Zealand's two main markets. Consumption has also reportedly softened in both markets over the last six months as retail prices reached unsustainable levels in the first half of 2014. Outside of these markets things are steady as she goes in Germany, but the rest of Europe is reportedly tough going. US foodservice demand is solid as better economic conditions led to more eating out. **The Middle East is softer** as purchasing power has been reduced with the drop in oil prices and extra product has been diverted from China.

FIGURE 3. NZ EXPORT LAMB SUPPLY VOLUMES



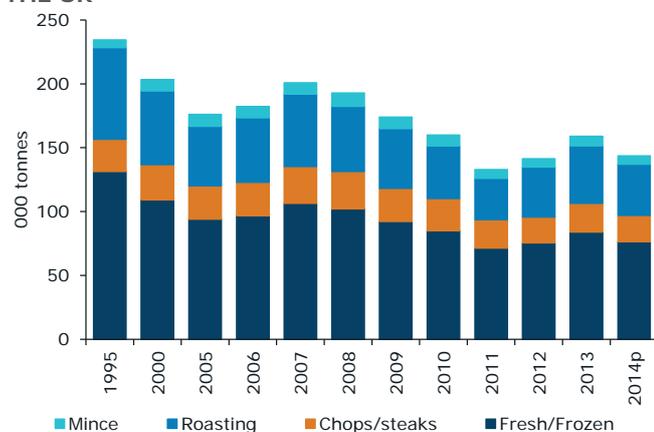
Source: ANZ, Statistics NZ

UNITED KINGDOM

After a steady increase in retail lamb purchases since 2011, total consumption declined in 2014 as retail prices reached unsustainable levels during the first half of the year. Approximately 80% of New Zealand's trade is conducted through the retail channel, so this has seen a slowdown in demand outside the speciality occasion windows of Christmas and Easter where retailers heavily promote (discount) New Zealand product to drive customer foot-traffic. Leg cut demand has been the least affected back 8% in 2014, but other key cuts such as shoulder and chops were back 9-12%.

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FIGURE 4. LAMB PURCHASES THROUGH RETAIL IN THE UK



Source: ANZ, EBLEX

Retail prices declined over the back end of 2014 but have showed tentative signs of stabilisation in early 2015. There is still a lot of uncertainty about how the market will track after Easter. Real wage growth may allow some consumers to treat themselves more often, for many, lamb falls into this category. However, most households are still managing their finances carefully, and as lamb remains the most expensive of the major meats, stabilisation in retail prices and purchases would be a positive outcome.

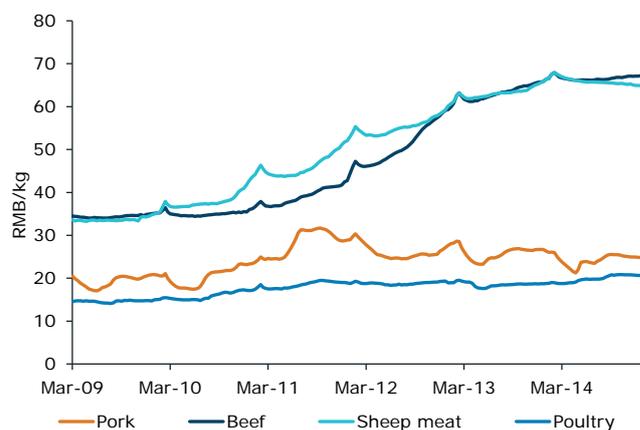
The other area of competition has been from local UK supply, which accounts for approximately 70% of the total market. While New Zealand is counter seasonal to local supply, the largest UK lamb crop in eight years in 2014 saw a material carryover of local supply into 2015. This provided plenty of competition for New Zealand's traditional marketing window. Prospects for the 2015 lamb crop look similar to 2014 with breeding ewe numbers having increased. **This means overall local supply is expected to remain high throughout 2015 with a 4% increase in sheepmeat production forecast.** The sharpest rise is expected to have occurred during the first quarter of 2015, but competition will remain high in 2015 with annual sheepmeat production forecast to hit its highest level since 2008.

CHINA

China's import demand has taken a tumble for the first time since rapid growth in imports started to take place five years ago. It appears that high retail prices over 2014 have finally triggered a local supply response and liquidation of smaller flocks as farmers try to cash in on the high prices. No doubt weather, disease and changing food safety regulation have played a part in their decisions

too. Retail prices for both beef and lamb have also become too disconnected with the other main meat protein groups (pork and poultry) over the last 18 months and we expect this has started to weigh on consumer demand.

FIGURE 5. CHINA RETAIL MEAT PRICES



Source: ANZ, MOA

In the 12 months to January China increased total sheepmeat imports by 4% to 273,570t, but in January and February imports fell substantially. **How long high domestic supply persists – and reported high frozen inventories will take to work through – is difficult to estimate** given the opaque nature of the food supply chain in China. We suspect it might take up to six months, but **the best indicator to watch will be lamb flap and shoulder prices. Both have fallen by 10-20% over recent months.**

OUTSIDE THE BIG TWO

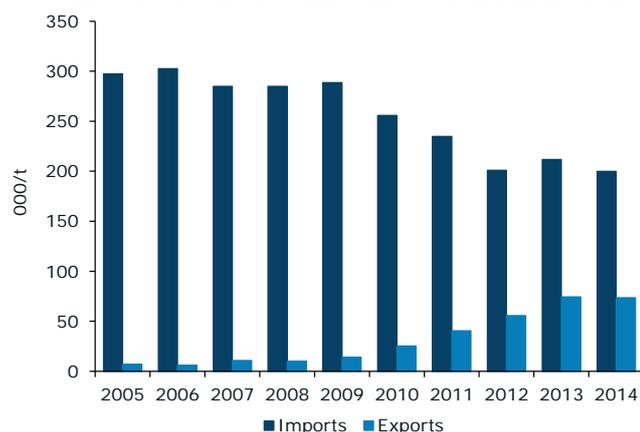
The second-round effects of lower import demand from China is being felt in other markets as exporters try to divert product. Attempts are being made to divert lower value cuts to the Middle East, but many of these markets appear soft due to both political instability and reduced purchasing power from lower oil prices. Luckily the majority of New Zealand's product goes to Saudi Arabia, which has more political stability, a larger/younger population, and government food programmes, and is one of the lowest-cost oil producers. This should provide a degree of stability even in the face of the increased volumes being offered from New Zealand and Australia.

Other more expensive cuts are being diverted to traditional markets, such as the UK, US and Europe. European markets remain the highest-returning markets, but **present economic conditions outside Germany are tough and this is weighing on consumption,** especially

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in countries such as Greece, Spain, Italy, France and Portugal. Heavy promotional activity will be required to shift additional product in these markets, which have been in decline in volumes terms since 2009. **The weak euro is also likely to prove a significant headwind** to NZD returns over the coming 18 months.

FIGURE 6. EUROPEAN SHEEPMET TRADE BALANCE



Source: ANZ, European Commission

The US has a better feel about it with much more robust economic growth prospects at present. Lamb imports in 2014 climbed to their highest level since 2007. Further lifts are anticipated in 2015 as foodservice demand (approximately 50% of New Zealand trade) remains robust and high beef prices push consumers to look at alternative red meat options.

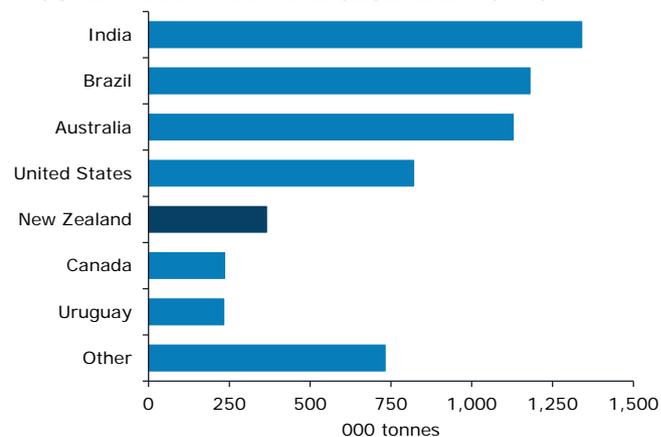
BEEF

Beef prices are expected to be softer until Australian supply tapers off and New Zealand's main cull cow turn-off is complete at the end of May. Beyond this prices are expected to remain very robust, with lower supply expected from Australia and the low supply of domestic lean beef in the US continuing. Demand from the foodservice sector in the US also looks robust, but increased competition from cheaper meat proteins (namely chicken and pork) is expected as the year progresses. Outside of the US things look fairly steady, but the key growth markets of China and Indonesia will be tougher, with changing market access for New Zealand and key competitors. Key for traditional Asian markets, such as Japan and Korea, will be a slow-down in Australian supply over the second half of 2015. We are cautiously optimistic there could be a bit more upside to farm-gate prices in 2015/16, with the sweet spot likely to again be the second half of the year (spring/early summer). Any upside is critically dependent on lower beef supply from both Australia and the US.

TRADABLE SUPPLY TO INCREASE, BUT NOT FROM NZ'S MAIN COMPETITORS

New Zealand is a small player in the global beef export market. However, **preferential market access to key markets** such as the US affords **New Zealand a unique trading position** and shelters it somewhat from direct competition by some key global exporters. How long this remains the case is difficult to gauge, but for now it means that **supply pressures are mainly dictated by domestic production, Australia, who has very similar end markets to New Zealand, and the US**, who takes 50% of New Zealand's total beef exports, but is also a competitor in key Asian markets, such as Japan and South Korea.

FIGURE 7. BEEF AND VEAL GLOBAL EXPORTS



Source: ANZ, Beef + Lamb NZ Economic Service, Global Trade Atlas

Global supply of tradable beef is expected to expand over the coming 18 months, but much of this is driven by the two largest suppliers, Brazil and India.

BRAZIL

Brazil has been added 4.5-5m head of cattle to its herd over the last six years. Combined with improvements in productivity, this is expected to start delivering larger increases in production over coming years. More of this is expected to find its way onto international markets as they gain better market access to key growth markets and a lower currency supports exports over internal consumption.

The other issue for Brazil is the collapse in import demand from its largest export market, Russia. Russia is the largest net importer of beef in the world, but imports are expected to fall to their lowest level in 15 years in 2015. The rapid depreciation of the Russian ruble (RUB) in a shrinking economy severely limits the ability of Russian beef importers to pass on higher prices to consumers.

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For example, wholesale forequarter beef prices in Sao Paulo averaged RUB75,500/t in 2013, but the collapse in the ruble has pushed the equivalent price to RUB108,000/t currently. For Brazilian-sourced product, this represents a 40-50% cost increase to cash-strapped Russian buyers.

This implies a bearish price scenario for grinding beef prices outside of the US and particularly in those geographies where Brazil has market access. Brazil has just regained access to China (New Zealand's second-largest market in 2013/14) after a two-year ban due to an atypical BSE case in Brazil in 2012. With extra product to shift China will no doubt be a target market, which is likely to pressure New Zealand and Australian beef sales. Both are likely to instead focus sales on the higher-value US market, where there is still some headroom in quota fulfilment.

INDIA

India has effectively doubled its beef exports over the last five years to 1.9m tonnes. There are expectations this will continue to climb, as long as regulations don't ban or restrict trade. Further increases in supply are largely based on the projected growth of India's dairy sector (of which carabeef is a by-product), continued demand in international markets, and the abundant supply of water buffalo throughout the Indian sub-continent. Beef consumption is shunned on religious grounds by Hindus, who account for approximately 80% of the Indian population, leaving a substantial surplus for export from the routine culling of unproductive and dry buffalo cows. **The only issue is that there have been numerous reports and suggestions of possible bans and restrictions on beef slaughter on religious grounds.** The most recent restriction is that the sale or possession of beef in the Maharashtra region, which includes Mumbai, has been banned. The good news for New Zealand is that Indian product is not expected to compete in New Zealand's traditional export markets any time soon.

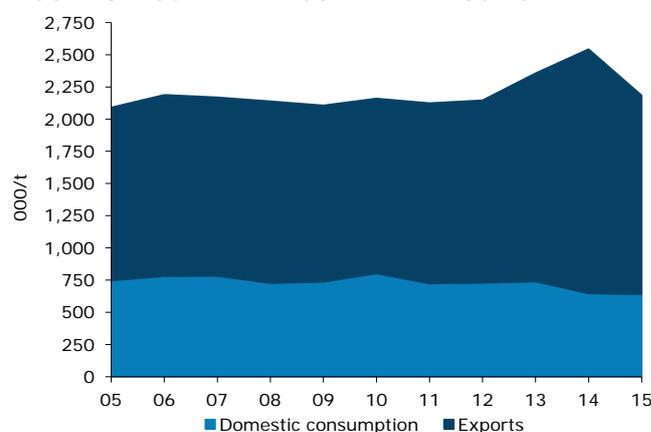
AUSTRALIA AND OTHERS

Outside of India and Brazil other global suppliers which matter are other South American countries and more directly Australia, Canada and Mexico. The last two compete in the US, but have relatively low excess supply at present, especially Mexico. Other South American countries are expected to show modest increases in supply through to 2015/16.

The key remains Australian supply, as they are New Zealand's biggest competitor in all our main markets. Over the last two years production

has surged due to ongoing drought conditions in key cattle-producing regions. This has seen a very high offtake of breeding stock, leading to an estimated 8.5% decline in their national cattle herd to 26.8m head. Seasonal conditions have begun to improve, but reports are mixed from region to region. **If seasonal conditions do continue to improve, supply is expected to decline by 14% in 2015** (a larger slowdown is expected in the second half of the year). This would slow total slaughter to 8.4m head, which is still historically high, but well down on the last two years. **With stable domestic consumption this is expect to see a near 19% decline in Australian exports in 2015.**

FIGURE 8. AUSTRALIAN SUPPLY AND USE OF BEEF



Source: ANZ, ABARES

It remains to be seen what export markets Australia will prioritise with lower exportable supply, but it seems safe to assume it will be the highest-paying ones. This is likely to see competitive pressure remain in the US, but could create opportunities in other traditional Asian markets such as Korea, Japan and Taiwan.

Beyond this season, low breeding cow numbers – with the herd going from a 35-year high to a 20-year low in the space of 24 months – will continue to weigh on Australian supply. **Total annual exports are expected to decline a further 6% from 2015 levels over the following three years.**

IN-MARKET DYNAMICS – UNITED STATES KEY

The US remains a key market given that it accounts for up to 50% of New Zealand's total beef exports.

The demand side is often difficult to gauge, but indicators of both retail and foodservice demand for beef and other meat proteins were strong in 2014. This is expected to continue with the labour market strengthening further and real wage growth ticking

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up. In 2014 “Choice Retail Beef and All Fresh Beef Demand” rose by 7%, which was the strongest gain in 10 years, and there was an acceleration over the second half of the year. The pork demand index also rose 8%, the strongest gain in 16 years.

FIGURE 9. US RESTAURANT PERFORMANCE INDEX



Source: ANZ, National US Restaurant Association

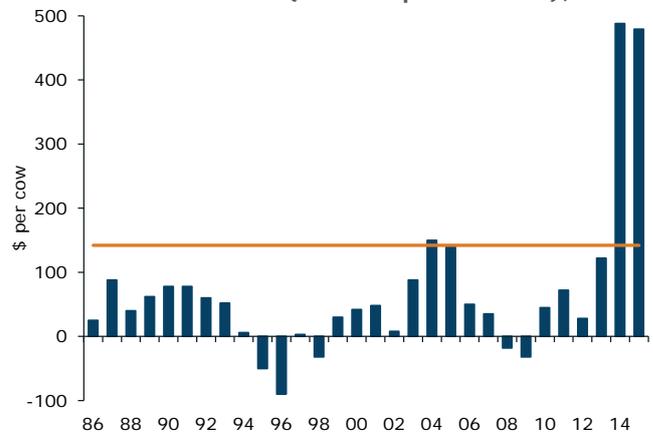
However, this is for the retail channel. The foodservice channel is much more important for manufacturing grade beef. **All indications are that foodservice demand is on an upward trend too.**

The National Restaurant Association index has shown robust growth over the second half of 2014 and into early 2015, with foodservice operators indicating a significant jump in customer traffic numbers and same-store sales trending higher in recent months to a 10-year. It is interesting to note that the overall improvement in foodservice traffic comes at a time when some larger chains have been reporting disappointing sales. But this appears to be a case of losing market share, as there has been a proliferation of new restaurant concepts offering an upgraded eating experience and “gourmet” burger options. Improvements in foodservice demand is particularly positive for beef, as it accounts for nearly a third of overall meat protein sold by foodservice establishments by volume. Chicken has a slightly lower share at 30%, pork is 20% and seafood is 11%. **So higher traffic throughput with consumers who have more money and are buying more expensive burgers (i.e. gourmet) should support robust foodservice demand.**

A robust demand backdrop leaves supply to dictate the pricing cycle over 2015/16. Supply has three dimensions: domestic US supply, imported supplies, and the supply of competing meat proteins (namely pork and chicken).

The biggest gap in supply at present is for domestic manufacturing beef, with US cow slaughter 16% behind the five-year average in 2014. Much of this has been driven by very low turn-off of beef breeding cows over 2014. **This is not expected to change any time soon, with very large profit margins (circa around \$500/cow) forecast to continue in 2015.** The one point of moderation might come from an uptick of dairy cull cows as profit margins fall. Dairy cull cows usually account for approximately 50% of supply and there has been an uptick since the start of 2015.

FIGURE 10. ESTIMATED AVERAGE COW-CALF RETURNS
Returns over cash cost (includes pasture rent), annual



Source: ANZ, USDA-AMS

Domestic US manufacturing beef prices have remained very high, due to a larger shortfall of supply over the second half of 2014. However, import prices took a tumble in late 2014 due to high supply out of Australia and New Zealand, port closures disrupting the flow of product, and softer demand due to cold conditions reducing foodservice demand. The last two issues are temporary and with the port disputes now resolved, its effects have already dissipated.

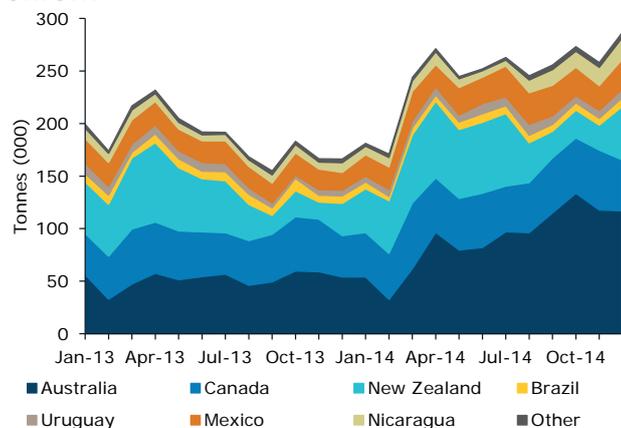
Supply out of New Zealand and Australia is likely to remain high until the middle of 2015 due to the clearance of inventory and dairy cull cows in New Zealand, but the second half of 2015 could be quite a different story.

For Australia, supply is expected to tighten as long as seasonal conditions continue to improve and New Zealand has front-loaded a lot of this year's production due to earlier high prices and dry conditions.

Into next year and beyond prime cattle production in New Zealand is set to tighten with further falls in the number of breeding cows in recent years. Bull beef calf retentions are fairly stable, though, and a slowdown in the growth of the dairy herd could see a few more culls, meaning manufacturing supply is likely to be fairly stable.

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FIGURE 11. US BEEF IMPORTS BY COUNTRY OF ORIGIN



Source: ANZ, USDA

The only dampener on the supply front for 2015/16 looks to be more intense competition from pork and chicken.

Pork production is increasing rapidly with planned expansion enhanced by smaller-than-expected PEDv impacts. The PED virus, while still circulating in the US, has had a smaller impact during the winter than anticipated due to a combination of vaccine effectiveness, natural immunity, and improved biosecurity, which limited the spread of the virus amongst hog farms. Pork production is expected to increase 4-5% in 2015, and with little growth in pork exports expected, the majority of the increase is expected to be consumed within the US. Abundant supplies of European pork are finding their way into many global markets, increasing the competition for US pork. Wholesale pork values are falling and sharply lower hog prices may curtail production at some point, but this is not likely to be before the end of the year or into 2016.

Poultry production is also set to expand in 2015 due to lower feed prices and improved returns. A 4% increase in broiler production is expected in 2015 and, like pork, broiler exports are likely to see only slight growth, leaving most of the increase to be consumed within the US. This means promotional activity by both these competitors is likely to intensify.

OTHER KEY MARKETS IN BRIEF

China

The Chinese beef market continues to offer opportunities, albeit that growth is slowing after three years of rapid rises in imports. Domestic supply appears to have picked up, but much of this seems to be high retail prices over 2014 having triggered a local supply response and

liquidation of smaller herds as farmers try to cash in on the high prices. Cull dairy cow turn-off has also reportedly lifted with the drop in farm-gate milk prices over the second half of 2014. How long these dynamics persist is difficult to gauge, but all up they will eventually lead to a smaller herd and lower production. **There is expected to be an increase in competition from other import destinations** as the Chinese government look to expand the number of countries it sources beef from. **Brazil has recently regained access** after being banned earlier in 2014 over another atypical case of BSE. New Zealand's free-trade agreement – with tariffs becoming zero for beef from 2016, compared with 12-25% for other competitors – provides some buffer against lower-cost alternatives.

Other Asian markets

The forecast drop in Australian beef supply should help relieve price pressure in many traditional Asian markets, such as Japan and Korea, over 2015/16. US supply is also expected to be tight and the higher USD will limit their competitiveness too.

Overall, import demand from Japan and Korea lifted in 2014, but New Zealand shipped less product to both destinations. It seems other markets were prioritised and most of the lift was supplied by Australia and the US. These two competitors seem to be getting a jump on New Zealand for market access with trade agreements in recent years opening up larger tariff differentials as time ticks by. **Sluggish economic growth in both countries isn't expected to deliver robust growth in beef consumption in 2015/16.**

In Japan the fast food sector has been soft and a lot will depend on whether or not ultra-loose monetary conditions and government policy changes can boost the labour market and consumer spending. In Korea beef prices continue to rise as domestic supply tightens after a steady reduction in their cattle herd in recent years, but growth in consumer spending has been sluggish. Grain-fed beef has experienced most of the lift, as there is strong demand for this type of product.

Taiwan has been a more steady market with incremental growth in beef consumption continuing to be driven by growth in the foodservice sector. **Indonesia has very large market potential with a large expanding middle class, but market access remains problematic.** Early in the year the Indonesian government again restricted trade to a very limited number of products/cuts, which means beef exports are likely to plunge again after ranking as New Zealand's sixth largest market in 2013/14.

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WOOL

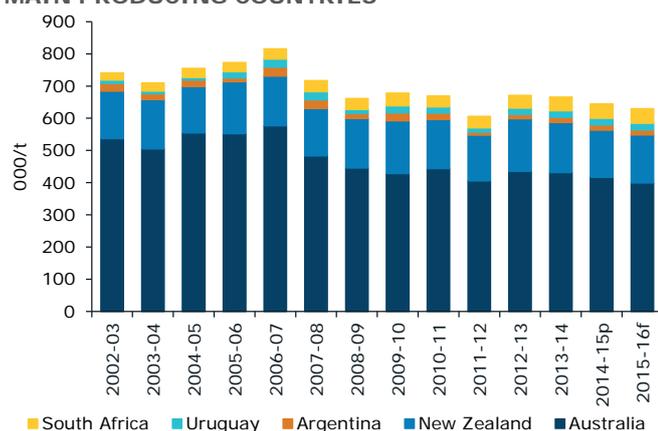
Crossbreed auction wool prices are forecast to be lower in 2015 unless the NZD weakens further. In-market prices will be pressured by substantially lower synthetic and cotton prices, as well as lacklustre demand growth outside the US. An accelerating US housing market and tight supply conditions provide something of an offset, but on balance factors point toward a further softening into 2016. In a tight supply situation auction prices could be volatile depending on buyer sentiment and the need to fill a specific order.

New Zealand fine wool prices tend to follow Australia's. Australian prices have been weaker in recent months as lower synthetic and cotton prices have weighed. Overall fine wool prices are expected to improve slightly due to tighter Australian export supply (-4%) and continued improvement in US import demand. However, slower growth in apparel sales in China and continued sluggishness in Europe mean only a small improvement is expected.

GLOBAL SUPPLY

Lower wool production from both New Zealand and Australia continues to drive a steady decline in overall raw wool production from the main exporting countries. The provisional estimate is that supply from the main exporters has tightened by 3% in 2014/15 and forecasts are for a further 2% decline in 2015/16.

FIGURE 12. VOLUME OF RAW WOOL EXPORTS, BY MAIN PRODUCING COUNTRIES



Source: ANZ, ABARES

Domestically, wool production is estimated to decline by around 5% to 154,600 greasy tonnes in 2014/15. Year-to-date exports to February are largely unchanged on the same period last year, suggesting some inventory liquidation from wool held over from 2013/14 has boosted exportable supply so far.

The majority of the decline this year is driven by lower sheep numbers (-3.9%) with both breeding ewes and hogget numbers significantly lower at the start of the season. The fall largely reflected the continued expansion of dairying in the spring of 2014 (due to the record returns in 2013/14). Adding to the decline is assumed lower yields due to the dry conditions in some of the main sheep regions and lower slipe production. Slipe production is expected to be back due to lower mutton and lamb production.

In 2015/16 a slight improvement (+2%) in production to 157,700 greasy tonnes is expected due to slightly higher sheep numbers (0.7%) and yields (1.5%). Slipe production is expected to remain subdued with industry expectations of fairly stable lamb production. However, as mentioned in the sheepmeat review we see some downside risks to breeding ewe numbers at present, which could weigh on supply. Overall, exports are likely to be fairly stable with lower inventories expected to be carried into 2015/16.

Australia accounts for the lion's share of global wool exports (around 40%) and their production continues to decline. Shorn wool production is forecast to fall by around 4% to 336,000 greasy tonnes in 2014/15, reflecting a decline in the number of sheep shorn and lower average fleece weights as a result of poor pasture conditions across parts of the eastern states. In 2015/16 shorn wool production is forecast to fall by a further 2% to 328,000 greasy tonnes. The volume of wool cut per head is also forecast to decline in 2015/16, reflecting an expected fall in the proportion of wethers in the sheep flock. **Overall, exports are expected to fall by 6% over the two year period, but larger declines are expected in 2015/16 (-4%) with some inventory building expected to take place after a rundown in 2014/15.**

COMPETING FIBRES

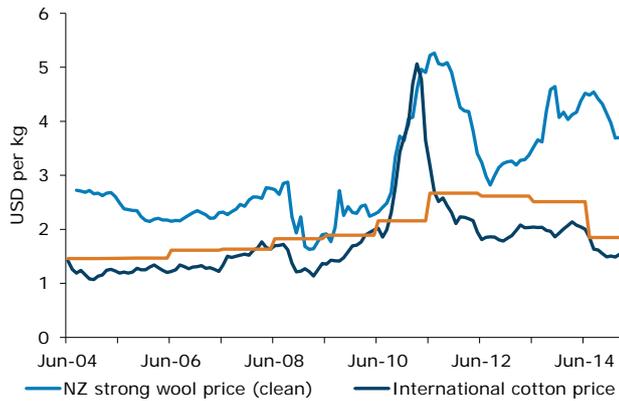
In recent years, wool has increasingly become a niche product in the global textiles manufacturing industry. Synthetic fibres and, to a lesser extent, cotton account for the bulk of fibre consumed. Wool is mainly used in higher-valued textile and clothing products. **Current manufacturing technology supports a degree of substitutability between different fibres, and the degree of substitution is influenced by relative prices.**

One of the reasons for the recent softness in international wool prices has been a fall in the price of both the synthetic fibres and cotton. The price ratio of strong wool to cotton widened over the back end of 2014 to its highest level (2.8) we have

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on record going back to the early 1990s. Ultimately the spread became too much and has snapped back to 2.5 since the start of 2015.

FIGURE 13. STRONG WOOL VS COTTON/POLYESTER PRICES



Source: ANZ, Wool Services International, World Bank

The outlook for 2015/16 is for further weakness in synthetic fibre and cotton prices. This limits any price upside for wool, with relativities already at stretched levels.

Polyester prices have recently declined to their lowest level in five years. The sharp fall in oil prices in recent months has been the main driver of low prices, given synthetic fibres (in particular polyester) are produced from refined petroleum. Low oil prices are expected to persist in 2015/16 due to a supply glut and high stocks.

Cotton prices are expected to remain under pressure in 2015/16, largely due to high global stocks and the termination of China's policy to purchase cotton for stockpiling. World production is expected to decline by 7.5% in 2015/16 as producers in the three main growing areas – India, China and the US – opt to grow better-returning crops. Only a modest increase in consumption is expected, with global growth sluggish. Overall, this is expected to lead to a slight decline in world stocks, but this will be off record highs posted in 2014/15.

Over the medium term prices are projected to recover from 2016/17 onwards, reflecting lower world stocks as reduced plantings lead to smaller crops, which are exceeded by increasing consumption, especially from non-OECD countries.

END DEMAND

At the finer end of the clip demand growth remains fairly lacklustre in both China and Europe, but appears to have turned the corner in the US. Similar dynamics are evident for the stronger end of the clip.

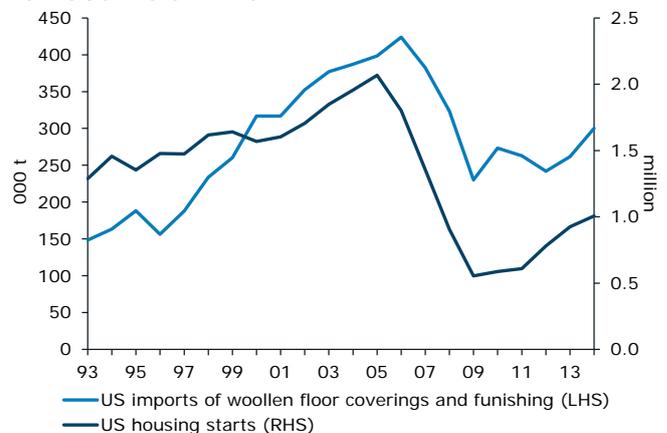
During 2014 tighter access to credit for Chinese textile manufacturers and slower domestic growth for garment sales continued to weigh on demand for fine wool. Although China is a major consumer of apparel these days (and is expected to surpass the US in 2017), growth has slowed in recent years. Retail sales of garments grew by "only" 9% y/y in 2014. This was down from 17% in 2013 and 23% in 2012.

Export demand was steadier with a pick-up in US apparel wool imports over the second half of 2014 helping counter continued softness in Europe. Demand for wool apparel in the US and the EU – two of China's biggest export markets – had been declining since 2010, reflecting slow economic growth and an ongoing shift toward synthetic fibres. The strengthening of economic activity and improvement in the labour market in the US has helped stabilise this, with US wool apparel imports lifting by 11% in 2014.

New Zealand fine wool prices tend to follow Australia's. Australian prices have been weaker in recent months as lower synthetic and cotton prices have weighed. **Overall fine wool prices are expected to improve slightly with tighter Australian export supply (-4%) and continued improvement in US import demand. However, slower growth in apparel sales in China and continued sluggishness in Europe means increases are expected to be small.**

In contrast to fine wool prices, the crossbreed (strong) end of the clip has proved remarkably resilient. Much of it appears to have been driven by an acceleration in US housing activity, with imports of woollen floor coverings and furnishings lifting by 15% in 2014.

FIGURE 14. US WOOLLEN FLOOR COVERING IMPORTS VS HOUSING STARTS

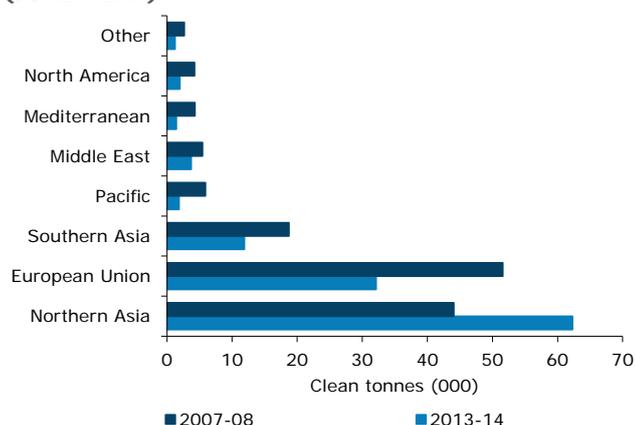


Source: ANZ, USDA, Bloomberg

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The US housing market has been slowly improving since 2009, but only in fits and starts. However, as the recovery has broadened over the last two years, housing activity and new builds have begun to accelerate. The US is the largest importer of wool floor coverings and New Zealand strong wool is estimated to be used in 45% of all wool carpet consumed in the US. Looking forward, low interest rates, low vacancy rates, a buoyant labour market, and valuations metrics such as prices to household incomes or rents are supportive of housing activity returning to more normal levels (i.e. more consistent with long-term household formation rates of around 1.5m annualised) over coming years. This should bode well for end demand.

FIGURE 15. NEW ZEALAND RAW WOOL EXPORTS (JUNE YEAR)



Source: ANZ, Statistics NZ

Outside of the US things are ho-hum. Direct European exports are back significantly over the last two years, with weakness prevalent in both Germany and the United Kingdom (both account for approximately 50% of European import demand). These two countries have been two of the better-performing economies, so weakness here is concerning even though some of the raw wool will be processed and re-exported as finished product within the European Union.

China's housing market is likely to remain weak in 2015/16. The unsold housing inventory in the major cities will take another 12-18 months to offload; thus property investment will drop significantly this year. However, the softer property market is also dampening economic growth and a government policy response is expected to be rolled out. This is likely to include local governments lowering property transaction taxes and the central bank further relaxing mortgages rates. Further monetary policy easing will help improve housing affordability as well.

In the longer term, China's demand for new housing is expected to remain elevated as long as the urbanisation process continues. While property investment growth could slow, total floor space under construction is expected to remain at a high level till 2020. **This supports continued demand growth for household furnishings such as woollen carpets.**

In sum, near-term crossbreed wool prices could remain under pressure from weaker demand outside the US and lower synthetic and cotton prices. A large decline isn't expected though, with tight supply and the US housing market looking more upbeat.

Auction prices are likely to deviate up and down depending on buyer sentiment and the need to fill a specific order. Certain wool types, such as good-quality colour and length wools will have slightly higher demand in a restricted supply environment. This means that pass-in rates and average sale prices will shift between auctions depending on the variety of wool types on offer.

DEER

Exporters have reported better demand for venison at both the fine dining and manufacturing level, which bodes well. However, the 10% plus appreciation in the NZD/EUR is expected to pressure farm-gate venison returns in 2015/16 despite better in-market prospects. Tighter venison supply is expected to start to emerge later in the year with lower weaner (-7%) numbers heading into 2014/15. Lower production is expected to persist over coming years with a 17% decline in breeding hinds over the last four years. Restricted supply, combined with reportedly lower offshore inventories, should be price supportive and ensure limited product is placed in the highest-returning markets, maximising returns.

Velvet prices remain the bright spot for the deer industry, having surged toward \$125/kg in 2014/15, the highest level we have on record. Lower global supplies and solid demand from both Korea and China appear to have been the main catalysts.

IN-MARKET DYNAMICS

Pricing out of Europe remained under pressure in 2014, but early signs suggest some improvement in 2015. Average prices to all major European markets apart from France declined in 2014. But France wasn't all good news, with the higher prices causing a large decline in exports. Some of the softness can be explained by the lower euro, but it also appears that high inventory levels

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and strong competition from other European game producers weighed on prices.

TOP 10 NEW ZEALAND VENISON MARKETS						
	(NZD FOB million)			Volume (tonnes)		
	2013	2014	% chg	2013	2014	% chg
Germany	61.0	53.5	-12%	5,263	5,061	-4%
Netherlands	20.9	22.8	9%	1,297	1,448	12%
United States	18.3	21.6	18%	1,829	2,087	14%
Belgium	21.2	20.8	-2%	1,399	1,471	5%
Switzerland	16.2	16.0	-1%	931	1,021	10%
United Kingdom	7.8	11.9	53%	856	1,389	62%
Finland	6.6	6.5	-3%	951	1,071	13%
Sweden	5.7	3.9	-32%	538	398	-26%
France	4.3	3.3	-23%	325	230	-29%
Canada	3.9	2.8	-29%	301	271	-10%
Other	16.1	14.2	-12%	1,732	1,457	-16%
Total	182.0	177.4	-3%	15,423	15,905	3%

Source: ANZ, DINZ, Statistics NZ

Other game meats have increased both their quality and quantity over the last two seasons, and this has eaten into the premium New Zealand venison can command. **Current supplies of some game products are reported to be low**, especially products such as wild boar, as low prices over the past year helped clear inventories. **However, supplies of European red deer from countries such as Poland and Spain are expected to remain plentiful into 2015/16.**

European inventories of frozen New Zealand venison are reported to be at their lowest level for some time, with solid sales during the fourth quarter (the seasonal high-consumption period) clearing much of the existing stock. Early feedback on sale negotiations for the European autumn have been fairly positive, with lower inventory levels leaving the market better positioned than at the same time last year.

Exporters have reported better demand for venison at both the fine dining and manufacturing level, which bodes well. The high price of beef in many destinations has made venison a more attractive option for chefs of fine-dining restaurants. This supports growth in higher-returning chilled venison sales, which were up 8% in 2013/14. There has also been growth in the "gourmet burger" category, and with high beef prices, this is supporting increased demand for lower-priced venison cuts too. Exports to the UK are also up strongly (+62%) as venison marketers continue to increase sales through the UK retail channel. Increased sales through this channel have helped reduce the industry's reliance on the traditional European game season. Exports to the UK surpassed 1,300 tonnes for the first time in 2014.

There is increasing focus on non-European markets to provide greater diversification too. Key focus areas are the US, China and non-seasonal cuisine in traditional markets (i.e. gourmet burgers).

The US market continues to grow, with both volumes and values increasing in 2014. Higher demand has been simulated by the recovery in economic activity, the increased cost of alternative proteins such as beef, and a refocusing of marketing activities from broad advertising and promotion to targeted support of sales staff in the field (i.e. educational promotion to show how to prepare and use venison). **In China several companies have now exported their first loads of venison** to the mainland following processing plant approvals in 2014. Volumes are small, **with initial shipments primarily designed to test importation procedures and introduce consumers to the product range.**

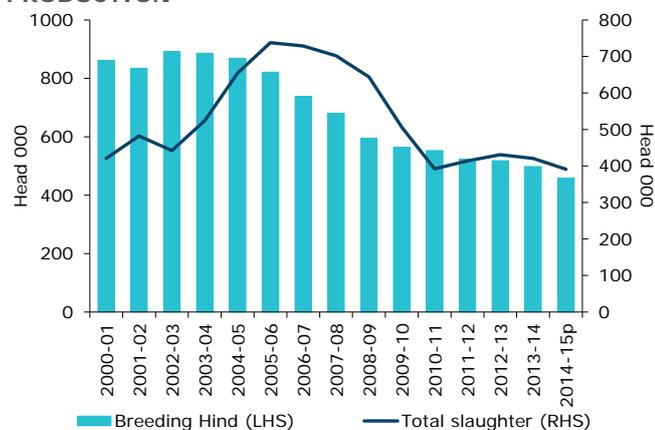
All up, more diversification seems to be starting to occur, but 75% of venison is still sold in euros. This means for 2015/16 the direction of the euro is likely to be the biggest determinant of farm-gate returns. The euro moving to multi-year lows in recent months has wiped out much of the improvement in market prices. The medium-term view for the NZD/EUR remains a story of elevation. Under low and even negative interest rates in some cases, foreign capital inflows to euro area fixed income markets have reversed. In the absence of a monetary anchor, and continued negative interest rates from money printing, the devaluation of the single currency is expected to continue. **Our expectation is that the NZD/EUR will average 10% higher in 2015/16 than the previous year. All else equal this would reduce farm-gate returns by \$1-1.20/kg in 2015/16.**

NEW ZEALAND SUPPLY

The New Zealand breeding herd has continued to decline – sharply over the 2013/14 season according to Statistics New Zealand latest survey of stock numbers. **Breeding hind numbers are estimated to have dropped by 8% in 2013/14.** Combined with declines in the two previous seasons this is going to start to weigh on production potential over the next several seasons. The decline in the past year seems to have been triggered by farmers changing land use and dropping hind numbers to finish a larger proportion of animals instead of selling them store. This is due to reduced finishing capacity due to the continued expansion of dairying, as well as farmers reducing numbers in response to lower farm-gate prices.

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FIGURE 16. NZ BREEDING HIND NUMBERS AND PRODUCTION



Source: ANZ, Statistics NZ, DINZ

Total production has been reasonably stable for the past four years, averaging 414,000 deer, but a proportion of this production has arisen from breeding hind herd reduction. The decline in the breeding herd has been 95,000 head over this period, and combined with lower female weaner retentions we estimate this could have boosted total production by up to 150,000 head (9%) during this period.

Early indications for 2014/15 suggest the decline in the breeding herd is continuing.

Weaner deer numbers on the ground as at 30 June 2014 were 370,000 head, 29,400 (7%) fewer than a year earlier. This indicates venison production should be down by a similar volume in 2014/15. However, year-to-date production (to end of February) is back only 2.7%, and female turn-off continues to make up a large proportion of slaughter for the time of year. Dry conditions in the South Island may have brought forward some of this year's production though too.

All up, venison production looks like it will drop back below 400,000 over coming years, and if farmers start to retain a few more hinds a larger reduction can be expected. Higher velvet prices could also see a few more stags retained.

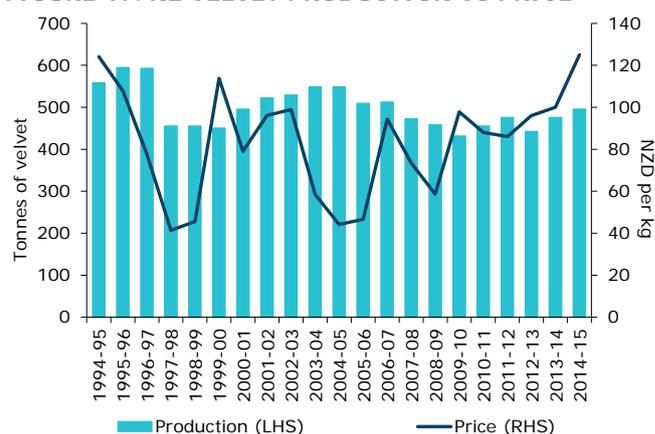
Restricted supply, combined with low offshore inventories, should be price supportive and ensure the limited product is placed in the highest-returning markets, maximising returns.

VELVET

Velvet prices have surged toward \$125/kg in 2014/15, the highest level we have on record. Lower global supplies and solid demand from both Korea and China appear to have been the main catalysts. Chinese velvet demand has reportedly escaped the crackdown on luxury gifts. Middle-income household demand appears to have become more inelastic as income levels have risen.

The Korean market has been pretty steady too. Domestic supply is expected to rise toward 500t in 2014/15 and further increases are expected in 2015/16. Traditionally this has been the catalyst for an adjustment lower in prices, but the rise of China as a large market and lower global supply for now means only a modest reduction toward \$115/kg is expected.

FIGURE 17. NZ VELVET PRODUCTION VS PRICE



Source: ANZ, DINZ

GRAINS

Most buyers of feed grain seem fairly well stocked and contracted through to the early winter. Crop yields on non-irrigated land are back this season due to the dry conditions during the growing season, but irrigated area yields have held up. An increase in the area planted is expected to have provided an offset and delivered a similar-sized feed grain crop (wheat, barley and maize grain) to 2014. Contract prices for 2015 feed wheat and barley seem to have ranged between \$370-\$390/t. Maize grain is around \$400/t at present, but there are some reports of a surplus.

Low inventory levels carried into the 2015 harvest are likely to mean growers won't be in too much of a rush to shift supply that hasn't been contracted, or drop prices. The softening in domestic feed prices over the second half of 2014 and into early 2015 has reduced the attractiveness of imports. However, international prices are not expected to rebound strongly in 2015/16 and this caps any upside for domestic-sourced feed.

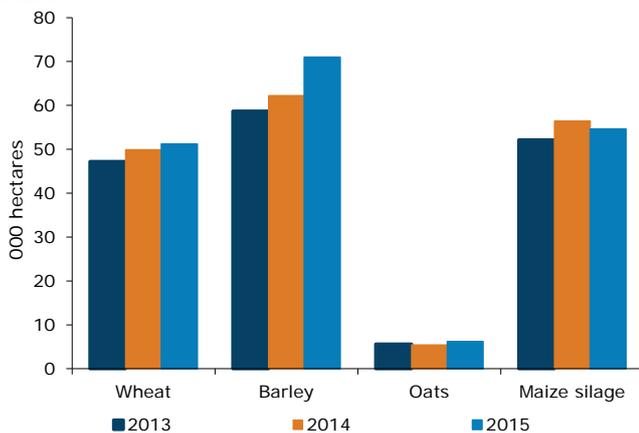
Poultry demand is expected to continue to increase, but dairy will continue to provide the swing in sentiment for domestic grain prices. An improvement in the 2015/16 milk price should help demand prospects, but given our forecast is still below the medium-term average, a large increasing in feeding, or the ability to pay high prices, isn't expected unless seasonal conditions are unfavourable.

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DOMESTIC SUPPLY SITUATION

The Arable Industry Marketing Initiative (AIMI) survey in October revealed farmers planned to plant an increased area of both feed wheat and barley for the 2015 harvest. **There was expected to be an 8% increase in the area of feed wheat and a 15% increase in the area of feed barley.** However, while most (98%) of the area for wheat had been planted when the survey took place, 25% of the intended barley area was yet to be planted. The dry conditions in the South Island during late spring and early summer are expected to have pared this back. Significantly lower on-farm inventory levels for growers and solid winter/early spring prices appear to have been the main drivers of the intention to increase the area planted.

FIGURE 18. NATIONAL CROP HARVEST – ESTIMATED AREA

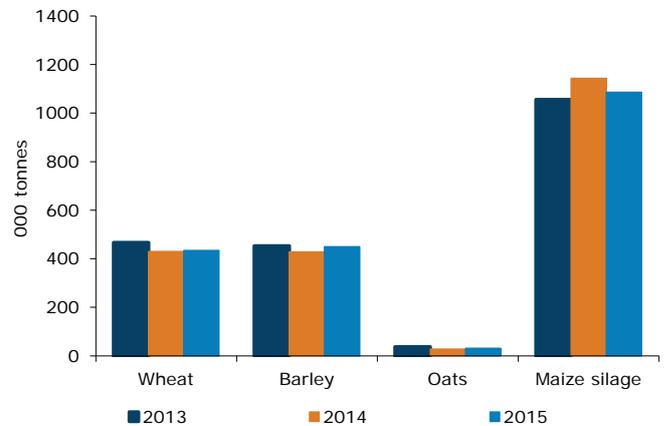


Source: ANZ, Foundation of Arable Research

As always the effects of the dry conditions have been uneven across the different crops and farm systems. **Reports have indicated that winter-sown crops have yielded better than anticipated, and irrigated crops have achieved good yields and quality. Dryland and spring-sown crops that were not irrigated appear to have borne the brunt of the dry conditions, with yields back 10-20% on last year with poor quality.**

On the back of this we estimate **the total New Zealand feed wheat and barley harvest in 2015 could have increased by 3-5% to a touch over 700,000 tonnes.** This assumes average yields are back 5-10%, but it is across a larger planted area. **However, this crucially assumes the extra 25% of area that growers planned to plant in barley after the 1st of October did occur. We doubt this was the case. If we assume only half this was planted then this would leave the total crop 3% lower than the year before.**

FIGURE 19. NATIONAL CROP HARVEST – ESTIMATED PRODUCTION



Source: ANZ, Foundation of Arable Research

The area planted for milling wheat in 2015 declined by 9%. The majority of this is grown under irrigation so yields are not expected to have been adversely affected, but because of the reduced area supply will be back by at least 9%, if not a bit more.

The survey also showed the total area planted in maize grain in 2014 for harvest in 2015 is estimated to be up 9% to 22,400ha. As at October 31 over 18,500 ha of maize grain had been planted with intentions to plant another 3,700 ha. Average maize grain yields across the country have varied by up to 7% in the past four years. This suggests that production of maize grain in 2015 will range between 255,000t and 240,000t of dry matter. Given the dry conditions did bite for a while in most North Island regions, the total harvest is likely to be closer to the bottom of this range. With the increased area this still equates to a decent increase in supply. The volume of maize grain unsold entering the 2015 harvest was very low, indicating growers are likely to be comfortable and will have some ability to store a bigger harvest. However, given the amount of maize that has been imported into the country in recent months, some buyers would appear to already have full storage.

In contrast, slightly less maize silage area is expected to have been planted in 2014 for harvest in 2015. The total area is expected to have declined by 3% to 54,600 ha. Reports on yield prospects have been mixed with later-planted crops the most affected by the dry conditions. All up, slightly lower yields are expected to deliver a 5% smaller crop.

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INTERNATIONAL SUPPLY SITUATION

New Zealand imports of grain posted new highs in 2014 as a large price spread to domestic grain prompted buyers to look at cheaper import alternatives. Palm kernel imports led the way, increasing 26% to 2m tonnes. This was even higher than the 2009 to 2012 period when annual imports were 1.3 m tonnes. Barley and wheat imports also rose by 128,635t (30% combined) compared with the year before. Maize imports ratcheted up to 114,740t due to the dramatic decline in US feed prices after a very good growing season replenished stocks.

FIGURE 20. NZ WHEAT PRICE VS IMPORT ALTERNATIVES



Source: ANZ, Agrifax, USDA

Global grain and oilseed prices are likely to face another relatively tough period in 2015/16.

Feed grain supplies in particular are abundant, courtesy of record US corn and soybean yields in 2014. Russia's grain production was also notably higher, up 15 million tonnes (mt) to 110mt in 2014. For feed grain markets it remains too early to expect a large recovery in prices until stocks stabilise. Stocks also look abundant for soybeans in South America, with renewed weakness in the Brazilian real compounding the selling pressure from Brazilian exporters over the next 6 months. Despite USD soybean prices hovering near a four-year low, soybean futures prices in Brazilian currency terms are 25% higher than just 2 months ago.

In the US there is a real tug-of-war developing between lower export and ethanol production and higher livestock demand. Export demand is being buffeted by the higher USD, reducing the competitiveness of US supply.

While US mandates for renewable energy will remain at similar levels to 2014, lower US gasoline prices have reduced the price of

ethanol, and subsequently the amount that ethanol producers are willing to pay for corn. The price of gasoline in the US has fallen by 35% in the last quarter of 2014, while physical US ethanol prices have tended to firm. Blending margins for refiners to achieve E10 have turned negative, leaving the price of ethanol at unsustainable levels. However, even at the current high ethanol prices, ethanol plant margins have contracted sharply as corn prices have recently risen to 380USc/bu. With ethanol prices likely to fall in 2015 this will only add to the margin compression for ethanol production with corn prices at 380USc/bu.

On the bright side for grain prices, livestock, dairy and egg demand is more robust. Dairy is likely to moderate, with lower margins as farm-gate milk prices continue to adjust lower. However, the offset is that poultry and hog numbers are expected to increase, as evidenced by a larger hatching flock and a jump in hog breeding numbers. Producers are also feeding cattle, hogs and broilers to heavier weights, which imply larger feed utilisation rates.

For wheat prices, one of the few upside risks now stems from Russia. Despite Russia's grain supply being notably higher in 2014, less-than-ideal autumn weather heading into winter dormancy, and the threat of restricted grain trade from Russia, has the market more concerned about future supply rather than immediate grain availability. According to Russia's Meteorological Agency, 16% of Russian winter crops across the country are in poor condition (sparse or failed emergence) and well below average condition versus recent years. However, anecdotal reports from growers in areas such as the Black Earth region suggest crop conditions are much worse than official estimates — with more than 20% of the crops in poor condition.

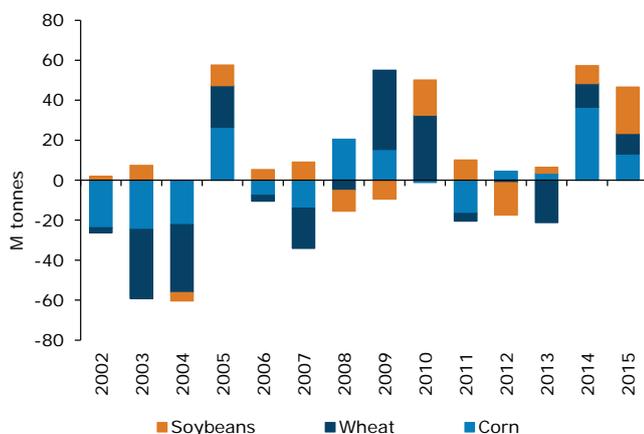
The other concern for the grain market is the increased political uncertainty and financial instability occurring in Russia. With a stagnating economy and rising inflation, food prices and domestic supplies are just one of many issues the government will have on its agenda. While it's unpredictable, risks remain that the government could prolong the export restrictions on Russian wheat exports that are due to end around the middle of the year.

In Australia, lower wheat production in recent years and strong domestic demand from the feed sector (particularly the Australian beef lot feeding sector) has reduced Australia's export availability in the current season. Grain producer cash incomes have also generally been high for several years now, leaving producers with

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some financial flexibility to hold back stocks at current lower price levels. This lack of farmer selling has helped support domestic wheat prices and keep wheat prices higher relative to US markets (after allowing for currency) for much of 2014 and into early 2015. **Australian wheat is likely to remain expensive relative to that of other origins for much of 2015, but the high NZD/AUD has softened the impact for New Zealand importers.** The outlook is for Australian farmers to plant a slightly larger wheat crop in 2015, although final production will remain contingent on spring rainfall.

FIGURE 21. GLOBAL GRAIN STOCKS



Source: ANZ, USDA

New Zealand palm kernel prices appear to have developed some seasonality in prices.

Prices have generally tended to be higher over the late-summer to autumn period and softer over the winter through to early-summer period. This seems to be driven largely by seasonal supply and demand pressures. Dairy demand is highest during the late summer and autumn periods; Malaysia enters its seasonal lull for production in early summer and Indonesia a touch later.

This year appears to be no different, but high domestic stocks and the low forecast dairy milk price appear to have suppressed prices until the dry conditions begun to really bite at the start of 2015. At present spot prices are around \$260-\$270/t in most regions, but some areas are higher – toward \$300/t – due to tighter stocks and lower pasture residuals. We suspect palm kernel prices peaked in March, but are likely to remain high until pasture covers improve and/or herds are dried off in May – basically following the normal seasonal trend lower into next summer.

In 2015 /16 a lot will depend on the direction of dairy prices, seasonal conditions, and the NZD.

We suspect an improvement in the milk price, combined with a slightly weaker NZD, is likely to see prices around the \$260-\$280/t mark if there are normal seasonal conditions.

Overall the softening in domestic feed prices and lower NZD/USD has diminished the attractiveness of imports over the first quarter of 2015. However, international prices are not expected to rebound strongly in 2015/16, capping any upside for domestic-sourced feed.

Historically there have been periods of divergence between local and international grain prices, usually due to local seasonal conditions, but eventually the two converge.

DOMESTIC DEMAND SITUATION

The three main domestic livestock sectors that account for the lion's share of grain demand are pork, poultry and dairy. In the compound feed market poultry (57%) followed by dairy (21%) and pork (14%) are the three largest buyers.

On a long-term basis domestic pork production and feed demand has been fairly stable.

In recent times production has started to trend up slightly with improving domestic consumption, but competition from cheaper imports remain intense. Overall the number of pigs being slaughtered has dropped in recent years with a decline in breeding sow numbers, but heavier weights have help compensate (implying more feeding). **Domestic poultry meat production has been growing around 6% per annum over the last five years.**

An increasing layer flock appears to have lifted feed demand by a similar amount over this period. **Structurally, dairying has provided most of the growth in demand for feed grains over the last five years through intensification and increasing cow numbers.** This demand tends to swing with seasonal conditions and the milk price though. An improvement in the 2015/16 milk price should help demand prospects, but given our forecast is still below the medium-term average, a large increasing in feeding – or the ability to pay high prices – isn't expected unless seasonal conditions are unfavourable.

KIWIFRUIT

Supply of New Zealand kiwifruit will bounce back to pre-Psa levels this year, capping a remarkable recovery. This will influence the marketing mix, especially for Gold returns. The other headwinds for orchard gate returns will be currency (JPY and euro), a difficult European market, and higher promotional costs for Gold.

Green orchard-gate returns for 2015 are expected to drop back toward the low-mid \$5/tray mark after hitting a 12-year high in 2014. There is expected to be increased competition from Chilean supply

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and within Europe on the shoulders of the season due to the Russian food import bans. Combined with exchange rate challenges in some of the main markets, such as Japan and Europe, this is likely to weigh on net NZD returns. Long-term, with smaller volumes of Green to be produced it will be a game of optimising returns. This is expected to see growth in market penetration to China and South-East Asia, and lower volumes sent to Europe.

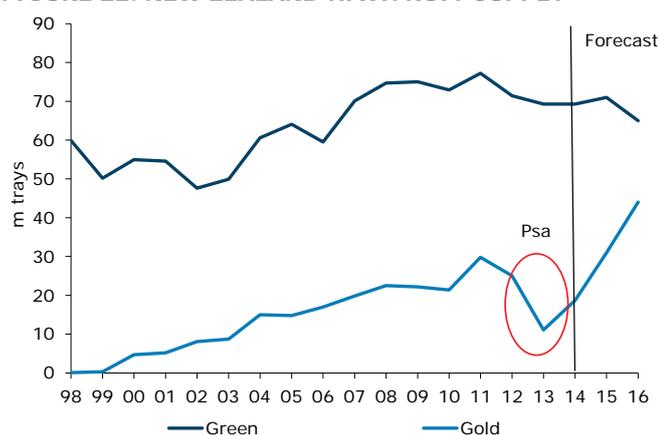
Gold orchard-gate returns for 2015 are expected to drop back toward the low \$7/tray mark. There will be a less favourable marketing mix, with higher volumes, increased promotional cost, and higher fruit loss. Scarce supply in recent years has seen Asia take 70-80% of the crop, but this is expected to decline with Europe's share growing once more.

Overall the industry appears to be on the rebound, but production risk is being replaced with price risk. Growers should budget accordingly – for Gold3 the medium-term sustainable price is probably around the \$6.5/tray mark.

NEW ZEALAND KIWIFRUIT SUPPLY

The 2015 crop is expected to be around 108m trays, a significant increase on the last two years that returns it to pre-Psa levels. This is leading to cool storage capacity challenges, with many new coolstores currently under construction across the various Te Puke-based post-harvest operators.

FIGURE 22. NEW ZEALAND KIWIFRUIT SUPPLY



Source: ANZ, Zespri

Green production is forecast to be a touch higher (2%) than last year, at 71m trays. This is despite some re-grafting of Green vines to Gold in recent years reducing the producing area by 8%. Higher yields are expected to provide an offset, with fruit counts performed by post-harvest operators indicating much higher yields than earlier flower counts did.

The Gold crop is expected to yield around 31m trays, which will be a 66% increase on last year. It will be many growers' first Gold G3 crop after re-grafting from Hort16A. First-year crop yields are reportedly a little patchy with full canopies not yet having developed, but second and third year crops are in good condition.

There had been some fears that a cold, wet and windy spring in the Bay of Plenty would lead to increased flower drop due to Psa, but this doesn't appear to have materialised for the majority. There had also been concerns that the same conditions could reduce dry matter levels, impacting on the taste profile of this year's crop. However, hot and dry conditions since December are expected to have evened things up, with high levels of dry matter and sugars expected, which will be key for repeat purchases and moving a larger crop. Good-sized fruit have also been reported, despite rainfall being below average across the key growing regions. Yields are reported to be the highest on Te Puke and Eastern Bay of Plenty orchards. Katikati orchards received far less rainfall during the summer and as a result yields are lower unless under irrigation.

Beyond the 2015 harvest Green volumes are forecast to fall toward the low 60m tray mark. Volumes of Gold are set to expand to 50-60m trays by 2018, as the re-grafted vines begin to produce more fruit. The pace of increase will depend on a wide range of factors, but management techniques and the optimisation of yield and taste will be important.

Average yields for Gold3 are expected to be controlled by growers to sit around the 12,500-13,000 trays per hectare mark. This produces medium-to-large sized fruit with a dry-matter content that results in good-tasting fruit. While much higher yields (above 20,000/ha), with reasonable dry-matter content, are possible, this is not expected to be the norm as growers will need time to adapt management techniques and knowledge to optimise yield, taste and size. The rapid increase in the supply of Gold3 and its establishment as the #1 global variety will require strong promotion and good-tasting fruit to match. If yields were to overshoot and the taste of Gold3 didn't match it, this could severely undermine long-term returns.

INTERNATIONAL SUPPLY

Chilean kiwifruit supply remains New Zealand's main competition in many export markets. The Chilean industry is aiming for a 70% rise in export volumes to 170,000 metric tonnes in 2015. The significant increase is mainly due to a

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bounce back in yields this season after severe frosts in September 2013 devastated their 2014 crop. The frosts were so bad they have had a lagging effect of lowering fertility in vines, which has added to Psa impacts (discovered in 2011). So while supply has bounced back, yields are still below average.

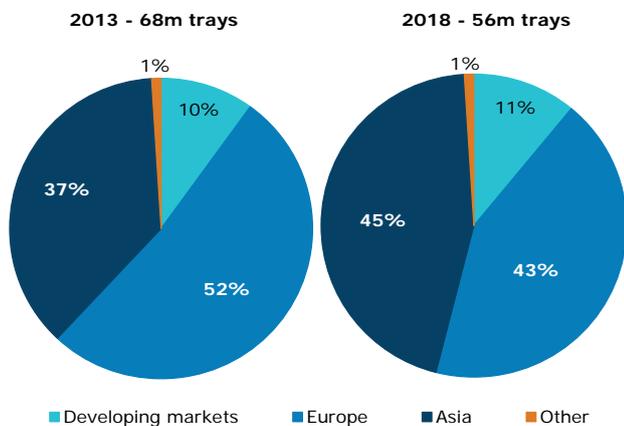
There has also been a reduction in the growing area in 2013/14 due to low returns and the production challenges of recent years. This means medium-term supply is unlikely to grow strongly and be more governed by seasonal conditions and any improvement made in productivity.

China's long-term supply is likely to continue to grow, but it currently suffers from a big perception issue on control mechanisms for pesticide and chemical use. This means New Zealand product currently commands a significant retail premium. Apart from the shoulders of the season, China's supply is also counter-seasonal to New Zealand's production.

IN-MARKET DYNAMICS

The industry continues to play to its strengths of producing high quality and tasty fruit, which helps driver repeat purchases and achieve premium prices across all major markets. More changes are being made to the grading system and the sampling techniques to further strengthen standards as volumes increase post-Psa. The increase in volumes this harvest and over the next two will be a real test of Zespri's marketing structure and the industry's ability to extract price premiums. Growers have received the majority of payments for the 2014 harvest with average Green returns of \$5.96/tray and Gold of \$9.78/tray. The Green result was a 12-year high.

FIGURE 23. GREEN MARKET MIX

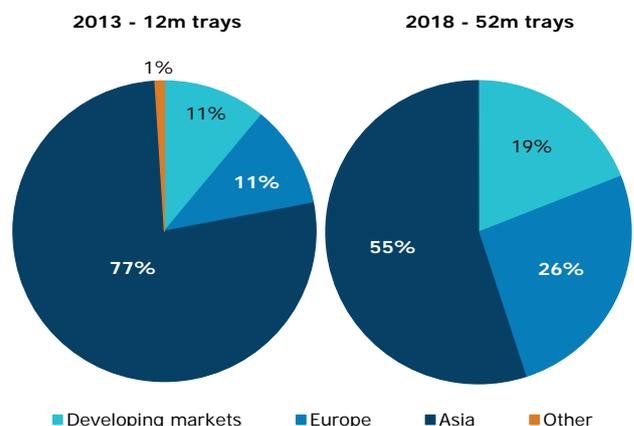


Source: ANZ, Zespri

Green returns for 2015 are expected to drop back toward the low-mid \$5/tray mark. While the crop is expected to be high quality again, supporting taste premiums and repeat purchases, there will be increased competition from a number of quarters to contend with. Increased competition will include more New Zealand Gold, Chilean green and the likelihood of more competition from European growers on the shoulders of the season. Just as in the pipfruit industry, Europe is expected to be more challenging due to the Russian import bans depressing the fresh fruit category, but there is also likely to be more direct competition from European growers on the shoulders of the season with the Russian bans. Russia accounted for nearly 27% of Europe's kiwifruit exports and 9% of total European production prior to the ban. Combined with exchange rate challenges in some of the main markets, such as Japan and Europe, this is likely to weigh on net NZD returns. Fruit loss is also expected to be fractionally higher with a bigger crop, and the cost efficiencies gained in packing and packaging look to have bottomed.

Long term, with smaller volumes of Green to be produced, it will be all about optimising returns. This is expected to see growth in market penetration to China and South-East Asia, and lower volumes to Europe. Japan is still the highest-returning market for Green with orchard-gate returns around the high \$9/tray mark, followed by China/Hong Kong around the \$5/tray mark. Europe is the largest market, but orchard-gate returns are around the low \$4/tray mark. Higher market penetration into China, Japan and South-East Asia will help the marketing mix, as well as provide more price tension for Europe if they want to secure supply. For Green, the taste is an important platform to differentiate New Zealand's offering from competitors, and support a price premium above Chinese and Chilean product, but given its greater commodity nature this can only be pushed so far.

FIGURE 24. GOLD MARKET MIX



Source: ANZ, Zespri

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Gold returns for 2015 are expected to drop back toward the low \$7/tray mark. With increasing Gold supply, a less favourable marketing mix than when supply was scarce, along with higher promotional costs, will be the main driver of reduced returns. **Scarce supply in recent years has seen Asia take 70-80% of the crop. With increasing supply Asia's market share will decline and Europe's will grow again. Some of this is likely to be offset by growth in sales to developing markets.** Fruit loss costs are expected to increase too, with larger crops and more rigorous grading standards being applied to make sure fruit is of a high standard. There could be some exchange rate downside also, but not to the same degree as Green due to comparatively more exposure to Asia (ex-Japan).

The next two years will be critical to the success of the full commercialisation of Gold3. Pricing for the last two years 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 and rapid learning as supply increases. Previously short markets will require increased marketing spend to stimulate demand and provide superior service for retailers. This is expected to see promotion costs increase by approximately \$0.50/tray.

Overall the industry appears to be on the rebound, but production risk is being replaced with price risk. Growers should budget accordingly: for Gold3 the medium-term sustainable price is probably around the \$6.5/tray mark.

PIPFruit

The main European markets are expected to be tougher with high carryover stocks from their growing season and the Russian ban on exports. Added pressure is expected to come from the high NZD/EUR and increased supply from both Chile and South Africa. The UK market might not be quite as tough, with stocks at normal levels. Depending on the variety retail prices are back 5-15% on the same time last year. Exporters seem confident that a window will open up for fresh new season supply, but any spare fruit outside set marketing programs is likely to face stiff price pressure.

A smaller exportable New Zealand crop will help, along with extra fruit likely to be directed into Asia and the Middle East. Early market feedback from Asia remains positive, with New Zealand having developed

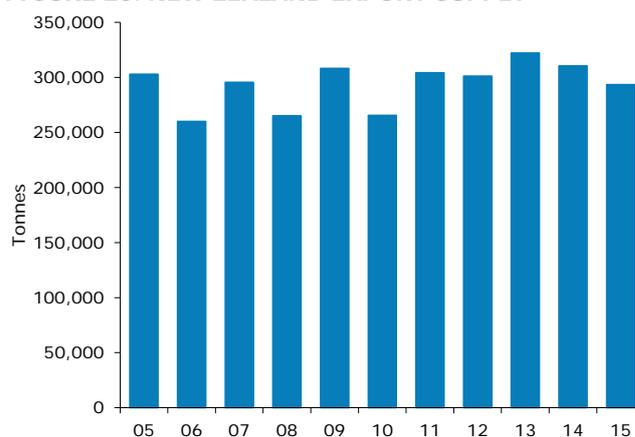
a number of competitive advantages. Taiwan, China, Thailand, Vietnam, Indonesia and UAE look to be offering the best opportunities.

Confidence in the long-term story for pipfruit has returned with two years of profitable returns. New Zealand's relative proximity to Asia and the creation of a "country premium" because of superior quality, an investment in new varieties that are more aligned with tastes in Asia, and better food safety credentials are encouraging a lift in investment in Hawke's Bay.

NEW ZEALAND SUPPLY

Despite it being a biennial bearing "on" year the 2015 national exportable harvest is expected to be down 6% to 293,000 tonnes due to isolated hail events in both Hawke's Bay and Nelson reducing the crop size and pack-out rates. The hail events inflicted varying degrees of damage and while overall supply is not expected to be back by the same degree any damaged fruit will be headed for processing.

FIGURE 25. NEW ZEALAND EXPORT SUPPLY



Source: ANZ, Pipfruit NZ

Despite these challenges the crop is reported to be of good quality and the average size is up on last year. The warm mid-summer temperatures have seen this year's crop develop a well-rounded sweetness, fresh crispness and vibrant colour, which should help marketing programs and price premiums. Growers are also likely to have accentuated management to support fruit size and colour to help maintain competitiveness in what is shaping up as a more challenging market than the past two years.

The sector appears to have a turned a corner after two years of solid returns, with higher rates of plantings than removals. Most growers, packers, and exporters can see a sustainable future now if they can provide the right product into Asia

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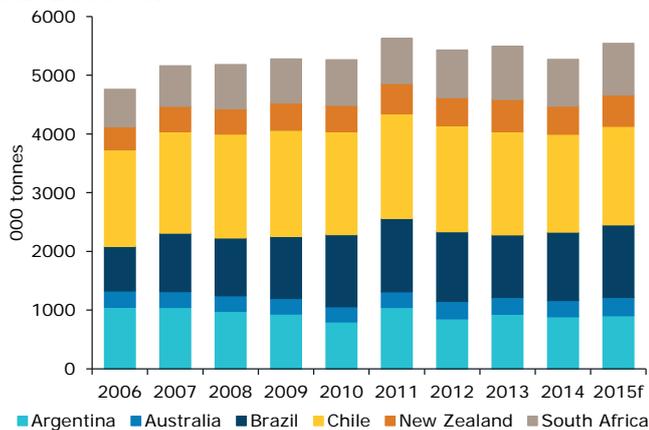
and the Middle East. **This is expected to see significant growth in supply over the next 3-4 years as the planted area expands.** Most of this activity is taking place in Hawke's Bay with an expected 5% increase in the planted area taking place. Existing blocks continue to be reworked too into dwarf/semi-dwarf rootstocks, with higher tree densities and modern varieties targeted at the Asian and Middle East markets.

SOUTHERN HEMISPHERE SITUATION

Southern Hemisphere apple exporters – especially Chile, South Africa, and New Zealand – compete with one another to supply the counter-seasonal window into the Northern Hemisphere. Thus volatility in annual export prices in the Northern Hemisphere is driven by a combination of end-of-season stocks and supply availability from Southern Hemisphere growers.

In February the World Apple and Pear Association (WAPA) were forecasting the Southern Hemisphere crop to increase by 5% to 5.54m tonnes. They expected increases across all countries, but hail in New Zealand and Argentina is expected to see this revised lower. New Zealand's two main competitors, South Africa and Chile, are both expected to harvest larger crops this season.

FIGURE 26. SOUTHERN HEMISPHERE APPLE PRODUCTION



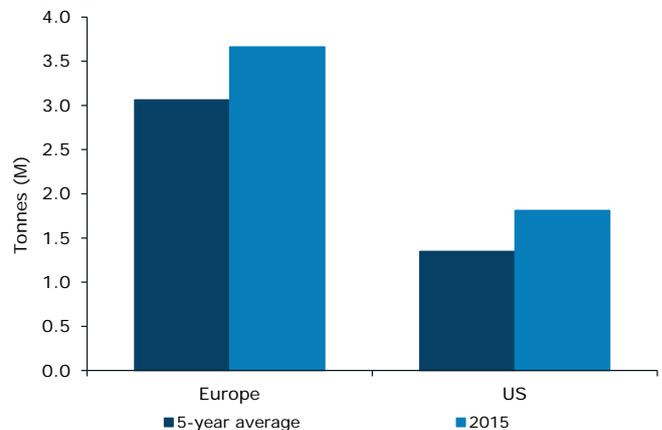
Chile's output was affected by hail and frosts last year, but growing conditions have been much better this season. There are reports of producers diversifying their orchards by planting new and more productive varieties, i.e. Fuji, Gala, Jonathan, Braeburn, Pink Lady and Galaxies in replacement for the traditional varieties such as Red Delicious and its variations, as well as increasing orchard density. This is likely to increase medium-term competition.

The South African harvest is expected to increase on the back of normal growing conditions too, but also a steady increase in the planted area in recent years. While South Africa competes in the EU, they have been diversifying into Africa and Middle East in recent years.

NORTHERN HEMISPHERE SITUATION

The UK and European markets are expected to be tough in 2015, with a large overhang of product from their season and the Russian import ban having depressed retail and wholesale prices for the entire fresh fruit category.

FIGURE 27. CURRENT NORTHERN HEMISPHERE APPLE STOCKS



Source: ANZ, WAPA

Prior to imports of European food products being banned by Russia in August last year, Russia accounted for only 5% of total EU fruit production, but took around one third of total fresh exports. The loss of this major market meant a lot of product had to be shifted on the domestic market, processed or shifted via other export markets. In order to ease the situation caused by the ban, the EU Commission introduced special market support programs for the sector too. These included non-harvest, green harvest and destruction, and donation to charities.

The pipfruit category is one of the most exposed, and particularly European-oriented varieties such as Braeburn. Russia and surrounding ex-Soviet countries accounted for some 70% of Europe's apple exports, or 9% of annual production last year. A 9% variation in production can be the difference between a good or a bad crop (i.e. the usual seasonal variation), but what has made the situation worse is that the 2014 European pipfruit crop was 9% larger than the year before,

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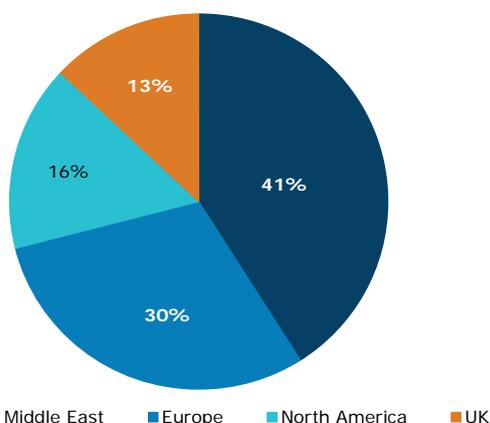
and well up on recent years. **At present European apple stocks are 10% higher than last year and 20% higher than the five year average. Most of the extra stocks are held by Poland, Italy, Germany and Belgium.** All four countries harvested large crops in 2014 and only Italy wasn't overly reliant on the Russian market.

Retail fresh fruit prices fell 20-50% after the ban, but have recovered somewhat since the start of the year. Currently prices are back 5-15% depending on the variety. Exporters seem confident that a window will open up for fresh new season supply, but any spare fruit outside marketing programs, or on the shoulders of the season, is likely to face some price pressure.

ASIAN STORY

The more supportive factor for New Zealand apple returns is continued growth in Asian and Middle Eastern demand, countries that are more discerning on food safety and quality of product. Export earnings from these markets have tripled over the last 10 years, to 40-45% of total.

FIGURE 28. NZ APPLE EXPORTS BY MAJOR REGION



Source: ANZ, Pipfruit NZ

In contrast to Europe, sales into most Asian markets have continued to perform well, with good early season indications too. Many of these markets are located closer to New Zealand, providing a freight advantage versus competitors. New Zealand has also created a "country premium" because of superior quality, an investment in new varieties that are more aligned with tastes in Asia, and a better food safety record. Indeed New Zealand has shown the greatest ability of any country to develop new varieties. Approximately 60% of our producing area is in new varieties, the highest of all countries and well above the global average of 20%.

The top five Asian markets are Taiwan, Thailand, India, Hong Kong/China and Singapore. The Taiwan market has leapt into life with the removal of the 20% tariff in 2013. India is fairly steady with a high tariff barrier of 50% and the potential of methyl bromide treatment being enforced over all apple imports restricting trade. Chinese trade is expected to increase, with a market access issue that last year restricted trade now being resolved. Thailand continues to be the main growth market, increasing by 7% over the last three seasons. Singapore is more stable.

Many of the Asian countries have onerous SPS-based market access conditions which require specialised orchard and pack house management programs during the growing season and post-harvest. The industry believes it is almost unique among apple-producing countries in being able to meet EU requirements for very low chemical residues, as well as the tough quarantine pest conditions for access to many Asian markets with the same fruit.

VITICULTURE

A significantly smaller 2015 vintage is expected following a difficult growing season. This is expected to smooth Sauvignon Blanc supply between adjoining years, averting the need to reduce prices to shift product. However, sluggish export sales for the other varieties are expected to see a surplus of supply develop for these categories, even with smaller crops.

Offshore the UK and US remain the best-performing of the big three markets. The Australian market is proving tougher, with a slowdown in economic growth and high NZD/AUD. Premium wine sales are expected to continue to grow to both the UK and US over the coming 18 months. Competition from Chilean Sauvignon Blanc is likely to increase in both these markets following a better growing season. US domestic supply of Sauvignon Blanc has also increased in recent years. Outside the big three markets, Southern Europe also looks tough, but some of the wealthier Northern European countries seem to be picking up the slack with solid growth in sales to the Netherlands, Denmark, Finland and Sweden. China and Canada have also taken larger volumes.

The average Sauvignon Blanc grape price is expected to rise toward \$1675/t (+4%) for the 2015 vintage. Spot market pricing is reportedly slightly stronger with the smaller vintage, but prices are not at significant premiums to contracted supply with buyers preferring to offer other incentives to attract and

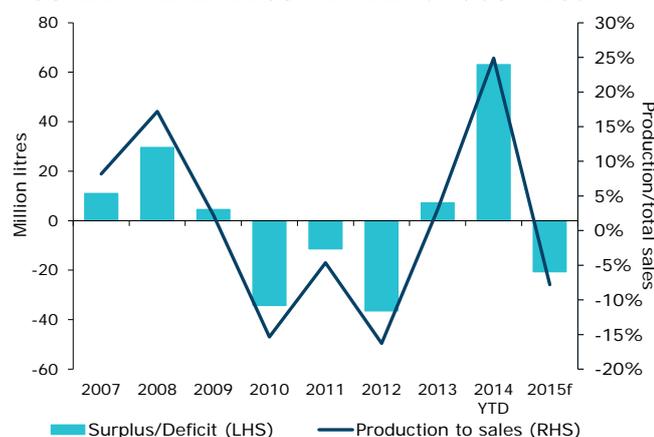
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retain supply. Grape prices for the other varieties are expected to be largely unchanged due to increased competition from other Southern Hemisphere producers and increasing stocks.

NEW ZEALAND SUPPLY

There have been fears that a slower than desirable run rate for sales of the 2014 vintage could have required wineries to offload product at discounted prices before the 2015 vintage arrived. It now appears this won't necessarily be the case (especially for Sauvignon Blanc) with a significantly smaller 2015 vintage expected following a challenging growing season. This will help smooth supply between adjoining years.

FIGURE 29. NZ WINE SUPPLY DEFICIT/SURPLUS



Source: ANZ, NZ Winegrowers

The 2015 wine vintage proved challenging for Sauvignon Blanc, with the combination of cooler weather and late frosts during spring and in the flowering period, together with the lingering impacts of very high crop yields in 2014, giving rise to a poor fruit set across Marlborough. Further, especially dry conditions during the critical fruit development period and widespread disease pressure (powdery mildew) across Marlborough and Hawke's Bay combined to depress yields and added to production costs.

Year-to-date shipments of the 2014 Sauvignon Blanc vintage since its release are up 9% to 124m litres, or 52% of estimated production. This is a much lower share than at the same time after the last four previous vintages (2010-2013) were released when approximately 65% of estimated production had been sold. If this pace of sales is maintained for the rest of the season then a surplus of nearly 30m litres of Sauvignon Blanc is expected to be carried into the 2015/16 season. However, this follows five years of deficits where there had been a significant run-down in inventories.

The other factor is that average yields for the 2015 vintage are expected to be anywhere from 5-15% below the four year average due to the challenging growing season. With only a small increase in the planted area this is expected to deliver a crop that is 70,000-100,000 tonnes lighter than the large 2014 vintage. Assuming average yields are back 10% and export growth continues around the 5% mark this creates a deficit of 41m litres for the 2015 vintage. Given the wide margin of error in some of these estimates it seems fair that between the two vintages supply is more or less adequately matched with demand for Sauvignon Blanc.

Performance of the other styles looks a little less balanced, with higher surpluses expected over the two vintages. Export sales of the 2014 vintage for other styles have been more sluggish so far. Of the other majors only Pinot Gris (11%) and Chardonnay (3%) have increased their exports, whereas Pinot Noir (-5%), Merlot (-4%), Sparkling (-19%), Riesling (-19%) and Cabernet (-36%) have all declined. Year-to-date sales indicate a surplus of 33m litres heading into 2015/16. As a proportion of the 2014 vintage this equates to nearly 35%, which is substantially more than Sauvignon Blanc at 13%. So even factoring in a decline in the 2015 vintage of the other styles, the sluggish export market seems likely to lead to a second consecutive accumulation of stock in 2015.

Depending on a style's maturity profile this could cause some price pressure if product isn't contracted, or part of a wider range of products being marketed.

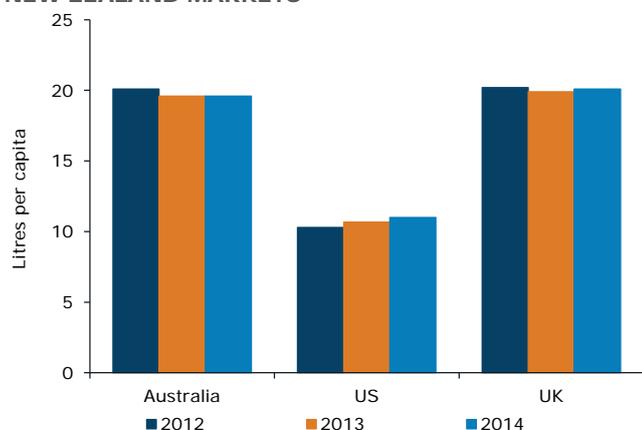
EXPORT MARKETS

The big three export markets of Australia, UK and US continue to dominate, accounting for 83% of export volumes and 77% of total earnings. So far the best performers out of these three have been the UK and US. This reflects the relative economic performance of these countries, as well as a stronger USD. Volumes are up 11% to the UK and 14% to the US, while average NZD returns are largely unchanged. Australia has been tougher as economic growth has slowed and labour market conditions deteriorate. Exports volumes are up 6% with a surge in February, but average returns are back 10%, highlighting the impact the high NZD/AUD is having on returns.

Outside the big three, Southern Europe also looks tough, but some of the wealthier Northern European countries look to be picking up the slack with solid growth to the Netherlands, Denmark, Finland and Sweden. China and Canada have also taken larger volumes.

FEATURE ARTICLE: AGRICULTURAL PRICE PREVIEW 2015/16

FIGURE 30. PER CAPITA CONSUMPTION IN MAJOR NEW ZEALAND MARKETS



Source: ANZ, ABRAE, California Wine Institute

Australia

Annual wine consumption in Australia remains relatively stable at 20 litres per capita. Premium wine products continue to grow at the expense of cheaper bulk wine, with increased sales through online channels. The two largest supermarket chains, Coles and Woolworths, dominate sales with an estimated 70% share. The domestic market share of private labels of both major retailers is around 15%. Online wine retailers have increasingly stocked premium, niche and independent wine labels that are not available from the major retailers.

New Zealand dominates import sales, accounting for around half, with France the next largest importer at a touch under 15% (but nearly double on a revenue basis). Australia remains New Zealand's largest market, but currency challenges have hampered returns for the 2014 vintage. Better economic conditions and tighter supply seemed to allow wineries to increase in-market prices, matching the appreciation in the NZD for the 2012 and 2013 vintages. However, more sluggish economic conditions in Australia and higher New Zealand supply have seen in-market prices drop to 2009-2011 vintage levels this season. Combined with the NZD/AUD remaining at post-float highs this has seen average returns decline by 10%, putting them on track to register their lowest season average since the late 1990s.

The other potential challenge for some smaller wineries is that there has been some chatter that the Wine Equalisation Tax rebate on New Zealand product may be dropped by the Australian Government. The rebate is equivalent to 29% of the wholesale price, but only some generally smaller New Zealand wineries receive the

rebate. Total rebates were around the A\$23m mark in 2013/14, which amounts to nearly 7% of New Zealand total exports to Australia.

US

The US remains the fastest-growing market of the big three and is likely to become New Zealand's largest market in the near future. Premium wine segments continue to grow at the expense of value wine. Total bulk wine imports fell by 16% in 2014, reflecting increased availability from California after three large crops in a row. However, while bottled wine imports were also slightly lower (1%) total value increased due to better prices.

Craft beer, spirits and cider segments continue to achieve superior growth, especially amongst the younger demographics. This has slowly reduced wine's market share of the alcohol category. New label entries and innovative packages have proliferated within all categories. These have reportedly helped sales, but sometimes at the expense of traditional brands.

The largest four importers (Italy, France, Spain and Australia) saw reduced imports in 2014.

New Zealand out-performed, with year-to-date exports up 14%, as heavy promotional activity in recent years and New Zealand's unique Sauvignon Blanc style drive growth. That said, domestic supply of Sauvignon Blanc from California has increased by 50% to 120,000 tonnes in recent years providing competition. A lower NZD/USD and continued improvement in the US labour market is expected to see a continuation of recent trends.

UK

Annual wine consumption in the UK remains relatively stable at 20 litres per capita. There seems to be a split market, with many consumers having traded down to less expensive wines in recent years, but many others have also chosen to reduce consumption and opt for better-quality wines. In recent years there has been an increased focus on reducing binge drinking by youths and awareness of the health implications of daily recreational wine drinking by the middle aged. This has prompted government policy changes such as increased excise duty and minimum pricing policies (i.e. no loss-leading by retailers, similar to some of the changes in the domestic market). Preferences for more sophisticated and unique styles of wine have also been driven by educational promotion on the different types of wine and their combination with food.

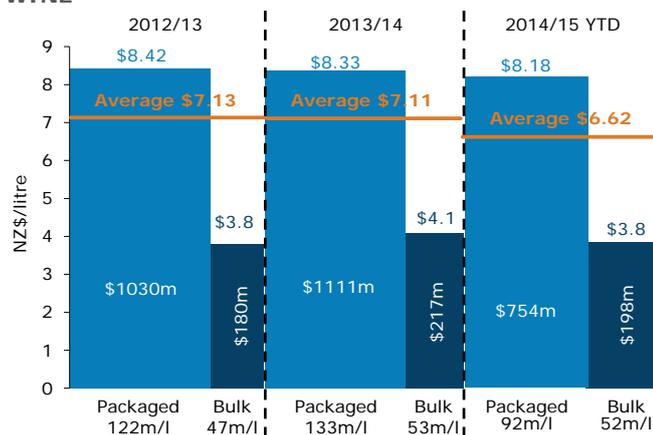
FEATURE ARTICLE: AGRICULTURAL PRICE PREVIEW 2015/16

Continued improvement in economic conditions and the labour market is expected to see these trends extend and perhaps see a pick-up in foodservice demand. However, the retail channel remains the main distribution channel and there has been a conditioning of consumers for “specials” in recent years that will be hard to shake.

PACKAGED VS BULK WINE EXPORTS

New Zealand wine exports in the 8 months to February have increased by 10% compared with the same period a year before. The average price has slipped by 5% with much of the weakness driven out of Australia and parts of Europe. Part of this appears to be currency strength, but also weaker economic conditions for both export destinations.

FIGURE 31. NZ SPLIT BETWEEN BULK VS. PACKAGED WINE



Source: ANZ, NZ Winegrowers

A higher proportion of bulk wine exports (36% vs 31% over the same period) have also played a part. Bulk wine prices are back 4%, whereas packaged prices are back only 2%. All the major exporters have seen dramatic growth in bulk wine exports since the mid-2000s, and in 2013 bulk wine made up more than half of all New World wine exports for the first time.

For New Zealand, while bulk exports have stabilised (around the 30-35% mark), they are expected to remain part of the landscape. Evolving business models and consolidation has led to the growth in bulk wine. Given our distance to markets and high bottling costs it has made sense for many larger wineries to export in bulk to get better logistics and bottling efficiencies.

The risk for New Zealand with larger vintages, such as in 2014, is that bulk exports spike and more product finds its way into lower-value home brands, eroding New Zealand's brand for

premium packaged wine. This pushes margins down throughout the supply chain and pressures returns for packaged wine. The smaller 2015 vintage appears to have averted this.

New Zealand is accepted as a higher-cost producer when you look at our cost of production against a range of other competitors. Therefore, high quality, proprietary-branded packaged wine with a high margin/price focus is an imperative for New Zealand's competitiveness and bottom lines long term.

INTERNATIONAL SUPPLY

World wine production is estimated to have declined by 6% in 2014, led by smaller crops in both Italy and Spain. It is too early to tell what the 2015 Northern Hemisphere vintage will bring, but the Southern Hemisphere crop looks like it is a bumper one, with improved yields in Chile, Argentina and Australia.

WINE PRODUCTION OF TOP EXPORTERS (MILLION LITRES)				
	2012/13	2013/14	2014/15	2015/16
France	4,155	4,200	4,615	NA
Italy	4,562	5,243	4,442	NA
Spain	3,112	4,565	3,700	NA
Germany	901	841	973	NA
Portugal	633	629	589	NA
Australia	1,226	1,231	1,256	1,380
Chile	1,255	1,285	1,003	1,180
USA	2,174	2,350	2,250	NA
New Zealand	194	248	320	246
Argentina	1,178	1,498	1,124	1,348
South Africa	1,057	1,098	1,142	1,119
Rest of the world	5,175	5,572	5,277	NA
World Total	25,622	28,760	27,086	NA

Source: ANZ, OIV

Chile

The 2015 Chilean grape harvest is set to bounce back from low yields in 2014. Total production fell substantially in 2014 due to abnormal seasonal conditions, with frost and ongoing drought issues across most regions reducing yields. The total planted area has continued to climb, but this is expected to plateau or even decline in coming years as many growers are struggling with profitability. Overall

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supply is not expected to decline though, as many growers are changing management practices to try to boost yields. Nearly 15% of Chile's grape area is planted in Sauvignon Blanc making it one of the larger Southern Hemisphere suppliers. Average prices are only a third to a half of those achieved for New Zealand product showing the additional premium that New Zealand's Sauvignon Blanc achieves. Chile's main export destinations are the US (18%), UK (13%) and China (11%).

Australia

In Australia better quality and slightly higher yields are expected to be achieved due to better growing conditions across the main regions.

The harvest reportedly began earlier than usual in many regions due to hot conditions in February causing fruit to ripen quickly. **Domestic supply of Sauvignon Blanc and other niche white varieties continues to grow, increasing competition at the margin.** Smaller Australian wineries continue to struggle with low margins and profitability. One survey suggested only one fifth of producers have been profitable in recent years. In 2014, the largest twenty winemakers in Australia produced over 80% of total wine production by volume. Australian producers have gradually been increasing their stocks of wine relative to sales with this ratio estimated to be 1.5 at present (slightly more than New Zealand).

Argentina

The 2015 Argentina grape harvest appears to have bounced back from its 2014 low, but government policies mean not all of it will be made into wine. The Government has estimated an initial crush forecast of 2.6m tonnes, but they have also announced that 35% of the harvest will be made into grape juice concentrate. Huge stocks of cheap white wine remain, with export sales struggling over the past 18 months (despite the depreciation in the peso), and domestic sales stagnating due to high retail prices reflecting domestic inflationary pressures. It is hoped that by making 35% of the harvest into juice concentrate this will remove 200m litres of generic white wine and help stable producer prices. Producers are expected to continue to struggle with high inflation increasing production costs, though, as well as an array of trade restriction adversely affecting imports of key inputs. Sauvignon Blanc makes up only a small proportion of overall supply, with Malbec and Torrontes varieties Argentina's signature wines. Argentina's main export destinations are the US (40%), Canada (8%) and the UK (6%).

South Africa

The 2015 South Africa vintage is expected to be similar to the last several years, but back slightly on the record achieved in 2014. The harvest has started two weeks earlier than normal, and according to some wineries, while fruit size is smaller, quality is expected to be higher following a long, dry and windy summer. Despite the South African industry's best efforts to reduce bulk wine exports they continue to grow, and are expected to account for 70% of total exports in 2015. In 2014 their top wine export markets by volume were the United Kingdom (23%), Germany (16%) and Russia (6%). Notably, exports to the US decreased by 25%, as unpackaged wine sales underperformed.

THE MONTH IN REVIEW

SUMMARY

Seasonal conditions have improved with widespread rain during March. The recovery remains patchy though, and favourable autumn conditions, as well as more follow-up rain, are required. Final quarter milk supply is expected to be weak, and annual supply slightly below last year. Turn-off of prime stock has slowed, but mutton production remains high implying another decline in breeding ewe numbers. The 2015 kiwifruit harvest is expected to bounce back to pre-Psa levels. A smaller vintage and pip fruit crop is expected.

Widespread rain during March has helped ease dry conditions in many regions. As always, however, the recovery from a dry event remains patchy. More follow-up rain is required in many regions and warm temperatures need to hang around for the remainder of the autumn to ensure an adequate recovery in pasture covers. The rain has been beneficial for winter crops, but some of the earlier damage won't be undone and conditions will need to continue to be favourable to ensure adequate yields. If pasture covers and winter crops don't improve further a tough winter could beckon.

DAIRY

Widespread rain in March has seen pasture covers start to recover. However, in some regions it has been too little, too late. This has seen some herds already dried off earlier than normal. Many others have shifted to once-a-day or 16-hourly milking. Combined with the low milk price reducing the incentive to feed supplement, a very soft finish to this season's milk supply is expected. Fonterra's latest forecast implies production will be down nearly 14% over the final quarter. All up this is likely to leave annual milk volumes slightly below the record 2013/14 season after good early season production.

Attention will start to turn to what's in store for 2015/16. As always the evolution of seasonal conditions will be important, but tight cash-flow matters too: if cows are in lighter condition heading into winter a softer start could be expected. **The other dynamic to watch closely is the final cull cow turn-off.** Weekly cow slaughter is continuing to track 50% above last year (currently up 148,000 head). Some of this is early turn-off due to the low milk price and dry conditions, but if it continues into May then the number of cows available to milk next season could be 2.5-3.0% lower. This would be a significant drag on milk supply in 2015/16 even if favourable seasonal conditions support per head production.

MEAT AND FIBRE

Turn-off of prime stock has slowed with an improvement in seasonal conditions. Lamb slaughter in the South Island has slowed more sharply than the North Island. Overall lamb production is still tracking 2% ahead of the same time last year, but further declines are anticipated. **This has freed up space for breeding ewes, and production is now only 5% behind the same time last year.** With 83% of this season's forecast mutton production already having been processed, **this is pointing to yet another decline in breeding ewe numbers. Combined with a lack of grass for tupping in some key regions, it also implies a smaller 2015 lamb crop.**

Total beef production could be headed for a new record if cull cow turn-off remains high. Total beef production is tracking 19% ahead of last year and cull cows have contributed to over 70% of the lift.

HORTICULTURE AND VITICULTURE

It was a challenging growing season for the 2015 vintage and average yields are expected to be anywhere from 5-15% below the four year average. With only a small increase in the planted area this **is expected to deliver a national crop that is 70,000-100,000 tonnes lighter than the large 2014 vintage.**

Despite it being a biennial bearing "on" year, the 2015 national exportable pip fruit harvest is expected to be down 6% to 293,000 tonnes due to isolated hail events in both Hawke's Bay and Nelson that reduced the crop size and pack-out rates. The hail events inflicted varying degrees of damage – while overall supply is not expected to be back by the same degree, any damaged fruit will be headed for processing.

The 2015 kiwifruit crop is expected to be around 108m trays, a significant increase on the last two years that sees a return to pre-Psa levels. Green production is forecast to be a touch higher (2%) than last year, at 71m trays. This is despite some re-grafting of Green vines to Gold in recent years that reduced the producing area by 8%. Higher yields are expected to provide an offset, with fruit counts performed by post-harvest operators indicating much higher yields than earlier flower counts did. **The Gold crop is expected to yield around 31m trays, which will be a 66% increase on last year.** It will be many growers' first Gold G3 crop after re-grafting from Hort16A. First-year crop yields are reportedly a little patchy, with full canopies having not yet developed, but second and third year crops are in good condition.

RURAL PROPERTY MARKET

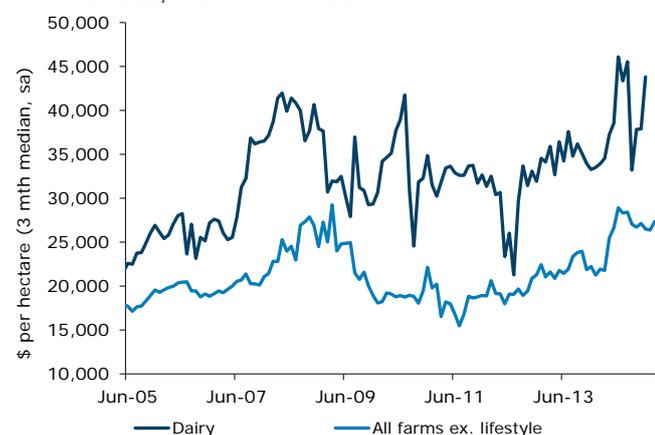
SUMMARY

The rural property market has remained remarkably resilient in the face of lower farm-gate prices and dry summer conditions. Our seasonally adjusted measure for total turnover continues to hover around the 10-year average, and the all-farm price measure is sitting at a very elevated level. Arable and finishing property prices have softened, reflecting a bit of a pull-back from dairy sector interests and a shortage of suitable properties. Existing quality dairy farms remain sought after, however. Grazing and horticultural property prices have improved. A lot of the buoyancy in horticultural property prices is coming from the kiwifruit sector. Some recent Green kiwifruit orchard sales have been comfortably above the \$300k per canopy hectare mark, while Gold sales are comfortably over \$400k per canopy hectare (note these have included the 2015 crop). Orchard sale volumes in western Bay of Plenty have been strong. Prices for both pipfruit and viticulture property have also been reported to be solid.

The all-farm price measure for February rose to **\$27,300/ha. That's up 54% in the past decade.** Total turnover has remained remarkably stable over the last six months around the 450/month mark, which is similar to the 10-year average. **Within this, existing quality dairy farms have remained sought after**, with the average price kicking up in February. The majority of sales in recent months have been centred in the traditionally more expensive dairying regions of Taranaki and Waikato. **Finishing and arable property prices have pulled back since the end of last year.** This seems to be due to a lack of listings, with vendors focusing on their existing business in a tougher operating environment. **Grazing property prices bucked the trend** with turnover remaining solid and average prices picking up. **Horticultural property prices remain the bright spot, led by kiwifruit.** Looking forward, cash-flow constraints could put the brakes on dairy-aligned property in the spring. Outside this, while farm-gate prices are under pressure, it's likely to be more "steady as she goes".

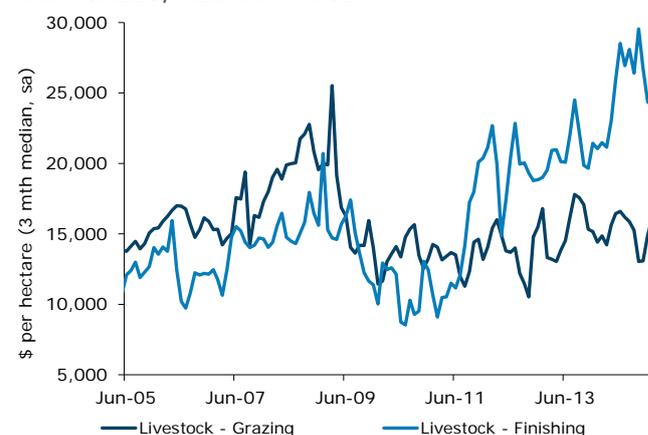
FARM SALES BY FARM TYPE								
3-Month Seasonally Adjusted		Current Period	Previous Period	Last Year	10-Year Average	Chg. P/P	Chg. Y/Y	Chg. P/10yr
Dairy	Number of Sales	69	70	88	69	↓	↓	↓
	Median Price (\$ per ha)	43,800	37,900	33,300	31,900	↑	↑	↑
Livestock – Finishing	Number of Sales	60	59	113	66	↑	↓	↓
	Median Price (\$ per ha)	23,000	24,100	21,500	15,900	↓	↑	↑
Livestock – Grazing	Number of Sales	204	194	218	211	↑	↓	↓
	Median Price (\$ per ha)	16,700	16,200	15,000	15,500	↑	↑	↑
Horticulture	Number of Sales	70	56	44	44	↑	↑	↑
	Median Price (\$ per ha)	250,000	227,400	126,800	151,100	↑	↑	↑
Arable	Number of Sales	27	25	26	20	↑	↑	↑
	Median Price (\$ per ha)	43,700	52,500	24,600	28,900	↓	↑	↑
All Farms ex. Lifestyle	Number of Sales	448	426	521	443	↑	↓	↑
	Median Price (\$ per ha)	27,300	26,400	21,900	21,100	↑	↑	↑
Lifestyle	Number of Sales	1,776	1,722	1,656	1,527	↑	↑	↑
	Median Price	524,000	517,000	511,000	445,000	↑	↑	↑

FARM SALES, MEDIAN PRICE



Source: ANZ, REINZ

FARM SALES, MEDIAN PRICE

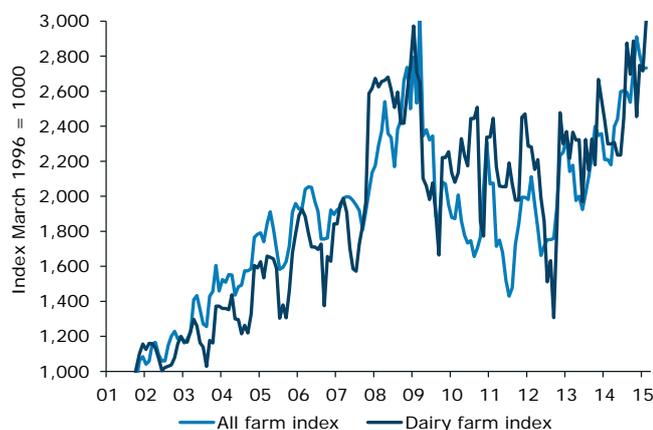


Source: ANZ, REINZ

RURAL PROPERTY MARKET

According to the REINZ's all farm index, which adjusts for compositional differences, prices are now back to pre-GFC levels. Much of this activity has been dairy-centric, so the major challenge farm prices now face is the extent of the recovery we might see in farm-gate returns, and constrained cash-flow over the coming 12 months. In the current environment buyers will no doubt start to sharpen their pencils even more on any deals, and apply more conservative assumptions in budgets. After the 36% increase in dairy property prices over the last two years vendor expectations have risen, so it will be interesting to see how vendors respond. If there is a reduction in listings, as opposed to a "list and see" approach, this could have a material effect on activity levels and how prices respond.

RURAL LAND PRICE INDEX (BASED ON \$/HA)



Source: ANZ, REINZ

However, as we note in this month's *Education Corner*, while much of New Zealand's "X factor" seems to be already priced in, outperformance and the fact that total farming returns have outpaced many other asset classes tells you something about New Zealand's farmland, our expertise, industry structures and processing/marketing expertise – many facets are world class. So despite near-term challenges don't be surprised if farmland continues to catch a bid from some quarters for the touch and feel aspect, food and other services investment thematic, global scarcity value of quality farmland, development opportunities and diversification plays.

As we noted late last year, the run-up in land values over the last two years hasn't been reflected in the same growth in rural credit as was seen during the pre-GFC era. This suggests the majority of purchases, or at least a large proportion of them, have been funded by other capital sources over the last two years. Intuitively this would seem to be the case, given a different mix of buyers, including more foreign and equity investors. Another part of the story could be a

rebalancing of debt within the sector. These things are difficult to assess, but are important for the sustainability or otherwise of the price increases that have taken place.

Examining the backward-looking indicators for the rural property market shows that in the month of January, 15 dairy farms were sold at an average sale value of \$32,500/ha, or \$30 per kg MS. The average farm size was 139 hectares and the average production/ha was 1,097 kg MS. In the month of February, 33 dairy farms were sold with an average sale price of \$51,400/ha, or \$51 per kg MS. The average farm size was 100 hectares and production/ha was 1,010 kg MS.

Turnover of finishing properties has softened a touch since the end of last year and has been below the 10-year average. Average prices have softened \$2,000-\$3,000/ha versus the highs seen over the second half of 2014. However, they remain very elevated. Arable property prices have followed a similar trend to finishing, but have backed-off by a bigger margin of \$15,000-\$20,000/ha compared with the record highs posted in late 2014. Part of this is likely to have been compositional. Grazing property prices have bucked the trend, lifting \$1,000-2,000/ha. The new range over the past year seems to be \$14,000-\$16,000/ha for grazing properties, which is a lift of \$2,000/ha over the 2009 to mid-2013 period.

In the horticultural sector, total turnover and prices have continued to increase since the start of the year. Monthly turnover has average nearly 50% above the 10-year average since the start of the year. Average prices hit \$250,000/ha in February.

Kiwifruit orchards are in hot demand. Confidence has been boosted by solid orchard-gate returns, new investors entering the sector, Psa being less prevalent in many of the main growing regions, and confidence continuing to build in the financial performance of the new Gold variety G3. Properties have reportedly sold quickly and prices appear to be up \$50,000-\$100,000/ha on the same time last year. Some recent Green kiwifruit orchard sales have been comfortably above the \$300k per canopy hectare mark, while Gold sales are comfortably over \$400k per canopy hectare (note these have included the 2015 crop). Orchard sale volumes in western Bay of Plenty have been strong. In the viticulture space, wine companies continue to drive most of the investment activity in terms of both acquisition and new developments. Land sales have transacted between \$150,000-\$200,000/ha in Marlborough over the last two years. This is approximately \$50,000/ha, up on the post-GFC range of \$100,000-\$150,000/ha.

ECONOMIC INDICATORS

EXCHANGE RATES

	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
NZD/USD	0.748	0.765	0.852	↓	↓
NZD/EUR	0.696	0.650	0.616	↑	↑
NZD/GBP	0.505	0.497	0.512	↑	↓
NZD/AUD	0.982	0.952	0.940	↑	↑
NZD/JPY	89.68	91.19	87.08	↓	↑
NZD/TWI	80.01	79.00	80.47	↑	↓

NZD BUYS USD

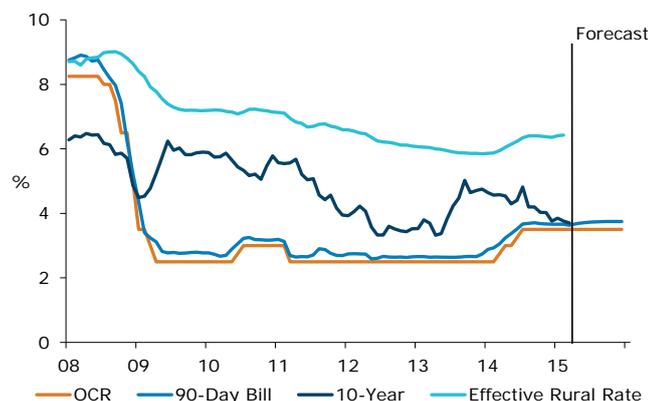


Source: ANZ, Bloomberg

NZ INTEREST RATES

	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
Official Cash Rate	3.50	3.50	2.75	↔	↑
90 Day Bill Rate	3.63	3.67	3.05	↓	↑
1 yr	3.56	3.58	3.53	↓	↑
2 yr	3.57	3.60	3.98	↓	↓
3 yr	3.56	3.62	4.24	↓	↓
5 yr	3.61	3.68	4.12	↓	↓
10 yr	3.70	3.79	4.58	↓	↓
Effective Rural Rate	6.43	6.38	5.87	↑	↑
Agricultural Debt (\$b)	54.43	54.15	51.78	↑	↑

KEY INTEREST RATES



Source: ANZ, RBNZ

The NZD remains elevated and stretched according to traditional valuation metrics, but nonetheless underpinned by a large interest rate differential versus the rest of the world. The first quarter of 2015 saw 27 central banks ease policy in 35 actions. Most G10 policy rates are sub-1% (NZD, AUD, and NOK the exceptions), and half of G10 currencies have engaged in QE (USD, EUR, GBP, SEK, JPY). **The reality of yield-related support, the still-elevated (albeit declining) goods terms of trade, and respectable growth for the NZ economy should support the NZD.** It is only when paired against an economy growing equally as strong, such as the USD – and currencies pegged to the USD – that we expect declines.

To get the NZD down materially on a TWI basis requires either countries with low interest rates to record strong growth, such that interest rates then need to be normalised (outside of the US this is unlikely), or a massive turn in NZ's economic fortunes. The obvious candidate here is China's growth story unravelling, resulting in material declines in commodity prices. That's a risk, but not more than that, and if it does eventuate we won't like the reasons for the currency fall.

We expect the NZD/USD to recede in a gradual fashion. The US labour market continues to strengthen and the unemployment rate has dropped below the Fed target. Core inflation at 1.7% y/y remains close to the Fed target, even if the transitory impacts of weak commodity prices are suppressing the headline result. ANZ expects the Fed to begin hiking rates in the second half of 2015 and the NZD/USD to decline to 0.70 by the end of 2015 as the US Fed begins the long process of policy normalisation. While higher US rates will support a lower NZD/USD, a large NZ-US yield gap will keep the NZD/USD still elevated relative to history.

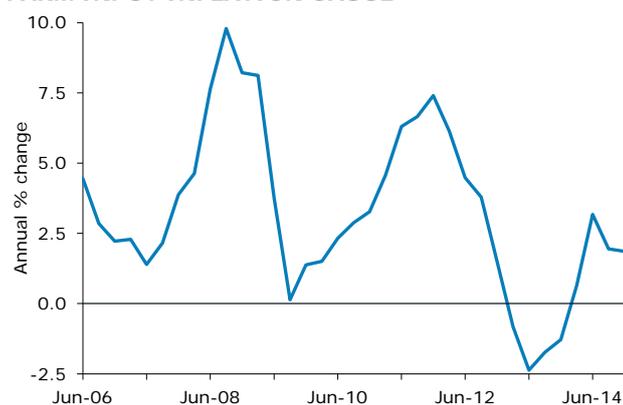
The NZD/AUD is likely to remain elevated. While the solid New Zealand / sub-trend Australia story is mature and well understood, interest rate differentials strongly favour the NZD. This will not change materially until the Australian economy starts to turn the corner. That's looking like a late 2016 story.

We expect the RBNZ to remain on hold for an extended period. A solid economy flags the next move as being up, but low inflation argues for a rate cut. The outlook is balanced. **Longer-term interest rates in NZ are expected to remain low.** While there is some pressure for long-term interest rates to move up (i.e. the US Fed lifting rates), this is countered by what is likely to be a gradual rising profile and abundance of global liquidity seeking out nations and bond curves that offer even the slightest semblance of real yield.

ECONOMIC INDICATORS

INFLATION GAUGES					
Annual % change	Current Qtr	Last Qtr	Last Year	Chg. Q/Q	Chg. Y/Y
Consumer Price Index	0.8	1.0	1.6	↓	↓
Farm Input	1.9	1.9	-1.3	↓	↑
Net Imp. Margins PPI	-12.9	-12.7	20.8	↓	↓

FARM INPUT INFLATION GAUGE



Source: ANZ, Statistics NZ

ANNUAL NET IMPLIED MARGINS PPI AG/FORESTRY/FISHING (OUTPUTS – INPUTS)



Source: ANZ, Statistics NZ

Substantial downward pressure on dairying costs is already starting to build as a cash-flow deficit over the first half of the 2015/16 season fast approaches.

The two biggest focal points for reduced spending have been capital items and discretionary expenditure. However, with downside risk to both the 2014/15 and 2015/16 milk price, the heat is now being turned up on core operating costs. As we highlighted in the December *Agri Focus* a scenario of a \$4.50/kg MS milk price in 2014/15 and opening forecast of \$5.50/kg MS for 2015/16 would see cash-flow tighten by up to \$0.85/kg MS during next season. This was a downside scenario then, but its probability has increased substantially now. On the average farm if this were to materialise then a 10-15% trimming (\$0.77/kg MS) of core operating costs (including finance, tax & drawings) will be required to avoid an increase in debt.

This tough environment, combined with the continuation of a generally low inflationary environment in the New Zealand economy, is expected to see plenty of hard bargaining and downward pressure on costs. Key core operating areas that are likely to come under more pressure will be feed, stock grazing, fuel, freight, repairs, maintenance and fertiliser. The challenge for every farmer is to maintain productive capacity while reducing operating costs not showing a marginal return. This requires complex farm management decisions and will vary by region and farm system.

These dynamics will have broader impacts beyond the dairy sector. Cost categories that are similar or the same for other sectors are likely to benefit from lower prices. Those farmers providing services such as dairy grazing or feed are likely to face pricing pressure.

The headline PPI margin for agriculture, forestry and fishing was largely unchanged in the final quarter of 2014, though down on a year ago. Dairying PPI margins were down a further 9% as international powder prices remained under pressure into December. Meat and forestry were up 4-6%, driven by better output prices. All these sectors benefited from a fall in the NZD during this period and stable to higher in-market prices. Some of this is expected to have reversed in the first quarter of 2015. Horticulture, fruit growing and seafood were little changed.

During 2014 the red meat and fibre sector were the winners, with margins increasing by 12%. They were followed by other livestock and seafood sectors. Dairying experienced the largest annual decline (-42%) courtesy of the fall in international dairy prices. Forestry also declined by 3% in 2014.

KEY COMMODITIES: OIL, FREIGHT AND FERTILISER

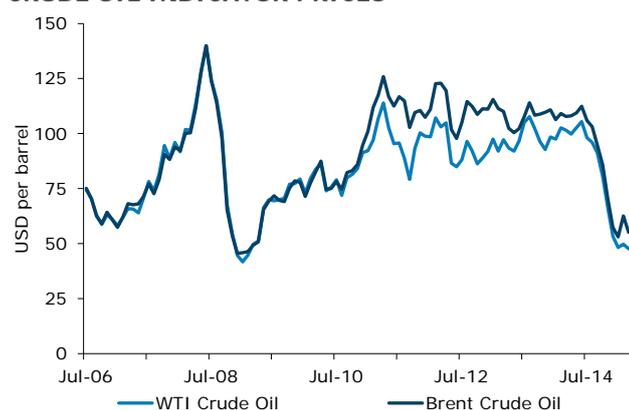
OTHER COST INDICATORS

	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
WTI Oil ¹	48	50	102	↓	↓
Brent Oil ¹	55	58	108	↓	↓
Ocean Freight ²	602	643	1,362	↓	↓

¹ USD per barrel, grade WTI

² Baltic Dry Index

CRUDE OIL INDICATOR PRICES

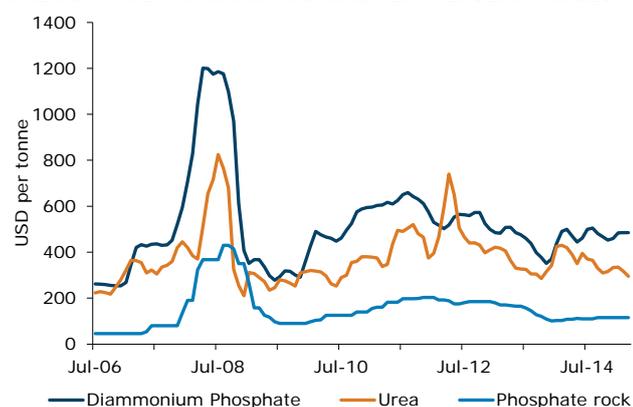


Source: ANZ, Bloomberg

FERTILISER PRICE INDICATORS

USD per tonne	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
DAP (USD)	485	476	499	↑	↓
Urea (USD)	295	328	420	↓	↓
Phosphate Rock (USD)	115	115	108	↔	↑
Farm-gate DAP (NZD)	815	815	836	↔	↓
Farm-gate Urea (NZD)	590	590	694	↔	↓
Farm-gate Super phosphate (NZD)	316	316	326	↔	↓

INDICATIVE INTERNATIONAL FERTILISER PRICES



Source: ANZ, Bloomberg

Oil prices could improve slightly as a pick-up in seasonal demand slows the rising oil market surplus. Market participants appear eager for a price recovery, but will likely remain disappointed with an oversupplied market capping any potential upside. US shale oil production and drilling activity will continue to be a key focus, which has contributed significantly to the record high US oil supplies of 9.4mmbbls/day. As US oil production closes in quickly on the more capped Russian (conventional) and Saudi Arabia (OPEC) oil output it will likely exert greater influence on benchmark US and international prices going forward.

So far there has been a lack of a US supply response despite ongoing declines in rig activity, which flags tighter supply. The lead time between the current fall in rig counts and lower shale oil production is being delayed by 3-6 months, as improved technologies and profitable hedging strategies are being implemented. Production is expected to continue to rise over the second quarter, contributing to US oil inventories rising to their highest levels on record (1982 when records begun). This oversupply will likely offset any price support from a stronger-than-expected pick-up in seasonal refinery demand ahead of the US driving season.

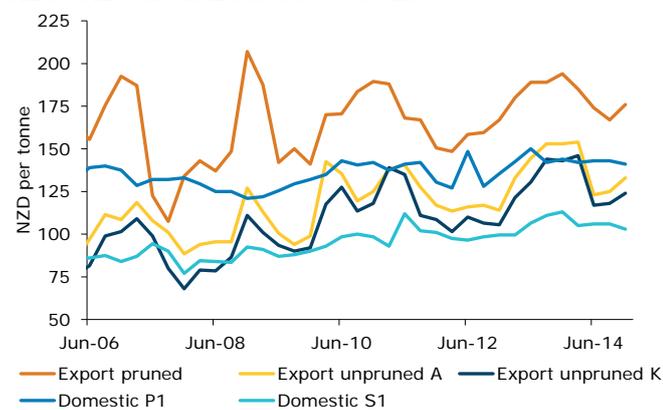
The Brent/WTI spread has narrowed to about USD5/bbl recently and could narrow further as OPEC production continues to slowly rise above the 30mmbbls/day production quota. OPEC production gained in March, supported by increased output from Iraq and Libya as weather constraints and geopolitical tensions eased. **Going forward, output should tick higher primarily driven by increased Saudi Arabian production** to record high levels of 10mmbbls/day and barring any wider MENA disruptions from unpredictable (but short-lived) geopolitical flare-ups. **Rising Iranian exports following a preliminary nuclear deal could weigh on prices near-term,** but may have a marginal impact medium-term should sanctions be lifted gradually. Iranian sanctions since 2011 have prompted a number of cancellations or delays in upstream projects, resulting in declining oil production capacity.

Global fertiliser prices have remained relatively stable, but the lower NZD/USD has put some upward pressure on landed prices in recent months. Urea prices have remained under pressure with new capacity coming on-stream. Spring planting in the Northern Hemisphere is expected to see reduced demand due to weaker crop economics, which is expected to continue to hold down prices. Chinese export supply is also expected to remain high in 2015. Global phosphate markets have lifted recently with seasonal demand from both Brazil and India increasing. However, weaker crop economics is expected to limit any upside.

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	176	175	194	↑	↓
Unpruned A Grade	133	134	153	↓	↓
Unpruned K Grade	124	127	143	↓	↓
Pulp	112	116	137	↓	↓
Domestic: (NZ\$ per tonne delivered at mill)					
P1	141	143	144	↓	↓
P2	122	126	124	↓	↓
S1	103	106	113	↓	↓
S2	100	106	102	↓	↓
Pulp	50	50	50	↔	↔

NZ FORESTRY INDICATOR PRICES



In-market export log prices have weakened with increased stocks in China and more competition from Russian supply. The decline in freight rates and the NZD/USD have helped offset lower in-market prices in recent months, but with these stabilising, more pressure is now expected to come on NZD returns.

In March Chinese log stocks rebounded to over 4 million m³. Many sawmills in China closed early for the Chinese New Year holiday period due to poor sales and restricted credit lines. This saw reduced sales from ports and increased inventories. **Lacklustre demand is expected to persist for some time as the unsold housing inventory in the major cities will take another 12-18 months to offload; thus property investment is expected to drop significantly in 2015.** The other concern has been increased Russian supply of logs, which generally command a premium to New Zealand logs. The near halving in the value of the Russian ruble has increased their competitiveness significantly. The volumes shipped so far have not been substantial in the scheme of things, but enough to add to the current negative market sentiment. Additional policy support for the housing market is expected at some point, but with already-announced measures yet to gain traction, near-term price pressure is expected to continue.

In the domestic market, there are very high prices being paid for pruned logs (\$155-\$165/t). This has been driven by relatively high demand for exports of finished pruned products in Australia and the US. In the Central North Island, there is also a physical lack of pruned logs available, which has meant very high competition for logs and increasing prices. Harvesting of some larger-scaled pruned forests has finished recently, and while there are reports of pruned wood becoming available from smaller lots quality is reportedly variable.

BORROWING STRATEGY

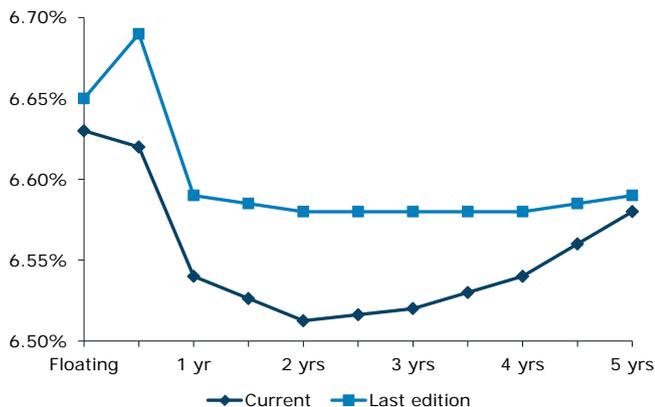
SUMMARY

Indicative rural lending rates have changed very little over the two months since our last edition. The small changes that have occurred have produced a “bowl” shaped curve, with 2-3 year rates marking the low point. Echoing comments made in earlier editions, while low rates are a welcome development for borrowers, the reasons why they are low (sluggish global growth and low inflation) are not. It is also too soon to rule out a shift in direction by the Reserve Bank, with the New Zealand dollar trade weighted index at elevated levels, inflation way below target, and dairy prices softening. As such, we remain cautious about fixing despite the apparent value.

OUR VIEW

Indicative rural lending rates are slightly lower since our last edition. Upon closer inspection, the rural yield curve has developed a very slight “bowl” shape. But with all interest rates sitting in a 15bps range, the curve is basically flat. Consequently, borrowers can pick whatever term they like and pay roughly the same rate.

FIGURE 1. INDICATIVE RURAL LENDING RATES

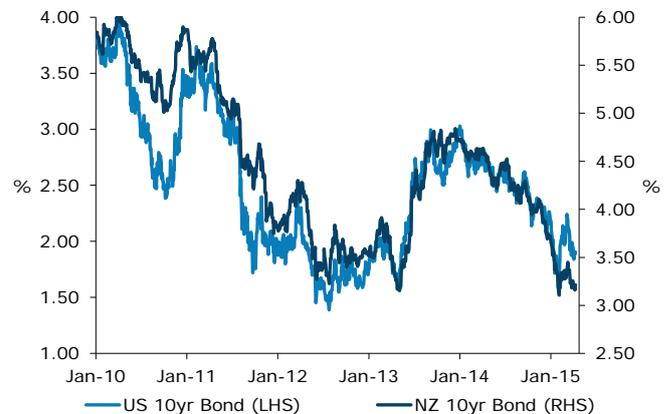


Source: ANZ, Bloomberg

Echoing comments made in our last two editions, as welcome as low interest rates are for borrowers, what worries us is the root cause of them moving lower – which resides overseas. With global growth sluggish, inflation low across the globe, and central bank interest rate cuts the norm rather than the exception, global interest rates have declined sharply.

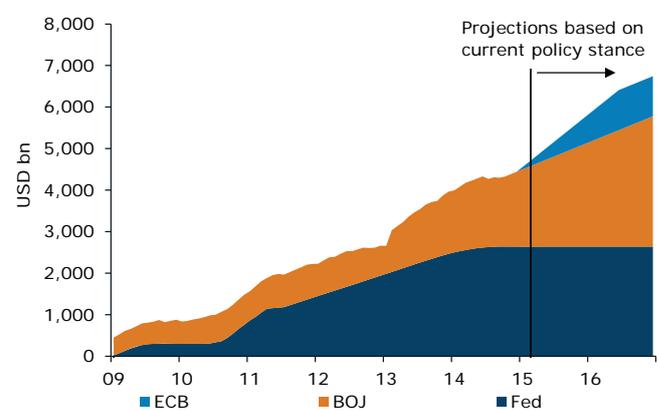
New Zealand’s long-term interest rates have always followed global interest rates, especially the US and Australia. Given US rates have stabilised in the wake of the Fed’s more relaxed stance, and Australian rates have fallen on the expectation that the RBA will ease a second time, we expect New Zealand long-end rates to remain subdued for some time. We are also mindful that German interest rates continue to plumb new lows. Germany has not traditionally been a market to watch, but with ECB QE the latest major disruptor in markets, all eyes are on Europe.

FIGURE 2. US AND NZ 10 YEAR BOND YIELDS



Source: ANZ, Bloomberg

FIGURE 3. G3 SOVEREIGN BOND PURCHASES



Source: ANZ, Bloomberg

We are also mindful of the domestic policy outlook. With the OCR steadfastly on hold, but the near-term risk profile lower courtesy of the sharp fall in inflation, the elevated trade weighted index (TWI), and sluggish dairy prices, it will be a long time before the OCR needs to go higher (and it may well go lower first). Against such a backdrop, until we can rule out cuts, we see no hurry to lock in despite rates being low. **With the yield curve this flat, breakeven analysis tells us very little.** As the table below shows, if you think rates will go up, fix for longer, and vice versa. We’re cautious, and thus see no need to hurry to fix.

Rural Lending Rates (incl. typical margin)		Breakeven rates			
Term	Current	in 6mths	in 1yr	in 2 yrs	in 3 yrs
Floating	6.63%				
6 months	6.62%	6.46%	6.50%	6.53%	6.59%
1 year	6.54%	6.48%	6.49%	6.54%	6.60%
2 years	6.51%	6.49%	6.51%	6.57%	6.67%
3 years	6.52%	6.52%	6.54%	6.63%	
4 years	6.54%	6.55%	6.59%		
5 years	6.58%				

ECONOMIC BACKDROP

SUMMARY

New Zealand is seeing growth and low inflation; a powerful mix. A strong growth pipeline remains in the form of supportive financial conditions, strong migration inflows, rising trends across the construction sector and strong confidence. Low dairy prices, tight fiscal policy and a high NZD are leaning against momentum, as are natural restraining influences such as skill shortages in some industries. We expect 3% real GDP growth over 2015.

STRONG MOMENTUM

The New Zealand economy remains in a strong growth and low inflation sweet spot. Growth is running above 3%, and supportive financial conditions, solid levels of confidence, the construction sector pipeline, strong net immigration and the historically high terms of trade suggest that a robust pace of underlying momentum should be sustained for a while.

There are some obvious tailwinds to growth:

- Financial conditions are supportive despite the NZD being elevated.
- Migration flows are strong.
- Asset prices continue to rise, which typically boosts spending.
- A broad-based uplift in construction sector activity continues.
- Confidence is high. Firms continue to invest and hire.
- Strong productivity growth in the likes of agriculture is boosting production.
- New Zealand's terms of trade are still elevated despite dairy prices being low. Falls in oil prices, if sustained over the year, will deliver a de-facto tax cut equivalent to more than \$1 billion.

However, headwinds, challenges and risks remain:

- The NZD is well over-valued.
- Dairy prices are low and cash-flow is tightening across the rural sector. Other major export sectors have also recently started to see lower prices too.
- Mother Nature continues to deliver challenges.
- Fiscal policy is restrictive.
- The RBNZ is becoming so concerned with the property market that a non-OCR response looks to be pending, targeting the investor market.
- As the economic expansion matures and broadens firms are finding it more difficult to attract staff.

For a lot of businesses, the real constraint is not sales, but the capacity to keep up. That's a natural braking influence apparent in some areas.

- The global scene is fraught with tensions. Europe is a mess. Japan is stagnant. Australia is wobbly, with the likes of iron ore prices collapsing, and China is slowing rapidly. The US economy is firm but there is a reason global bond rates are low; there are genuine concerns over the prospects for global growth and arresting disinflation trends in some nations. Of course equities continue to turn a blind eye, hooked to the lower-for-longer interest rate mantra.

We're forecasting a solid performance across the economy over the year ahead. Momentum will be a tad slower than 2015, but don't be fooled by that. We're still picking 3% real GDP growth, with the moderation akin to the economy slowing from a gallop to a canter. That said, this solid rate of growth will still mask frictions. The high NZD is problematic. Retailing is not firing despite house prices moving up, as households remain cautious (indeed, a good thing when thinking about the longer-term story). Every day of surging house prices ups the risks of a calamity in the future, in a bust-follows-boom fashion. Slow and steady supports the "long game".

Despite a solid activity backdrop and above-trend growth, inflation is low. Through a combination of supply-side flexibility, an elevated NZD, and global disinflationary forces, local inflation pressures have remained well contained.

The OCR looks to be on hold for an extended period. We can fathom scenarios where the OCR moves up (strong economy filters into inflation) or down (weak global scene, high NZD, no inflation). Uncertainty is higher than normal so we're picking an extended period of stability. In the near-term it is looking like the RBNZ will turn to their prudential tool-kit to slow the Auckland property market down. Naysayers will point to that as doing nothing to fix the shortage of stock. That's too clever by half; the rental market in Auckland (rents are up only 2.2% over 2014) tells us the supply-shortage thesis is not the only game in town. The investor and offshore buyer have been incredibly influential. The RBNZ looks to have the former in its sights.

While we envisage solid growth over the year, the mix is becoming less sustainable. The current account (the national chequebook) is slipping more into the red, the trade balance is weakening, and net international liabilities are on the ascent. Eventually this will necessitate a currency adjustment. That's looking a 2016, or 2017 story though.

EDUCATION CORNER: GLOBAL LAND PRICE TRENDS

SUMMARY

New Zealand farmland values have caught gold rush fever again, increasing by 24% in the past year. Rural land prices are not the only asset class to have surged in price; when the risk free rate is low, cash is put to work and surges have been notable across multiple asset classes.

Higher prices are welcome; they should reflect the industry's long-term assessment of future cash-flow. However, the decline in farm-gate returns this season has many farmers and investors questioning affordability, and whether the market has gotten ahead of itself.

The RBNZ will be eyeing rural land prices as a financial stability risk (the potential for a boom to be followed by a bust). Quite apart from that, high long-term farmland prices risk undermining many of New Zealand's natural and man-made competitive advantages. They can affect competitiveness in a number of ways, including too-high barriers for new entrants/succession, starving other key areas of the business of investment (i.e. pastoral renewal etc), and increasing financing costs via the greater use of debt. The latter is of course not a problem providing the maths still stacks up.

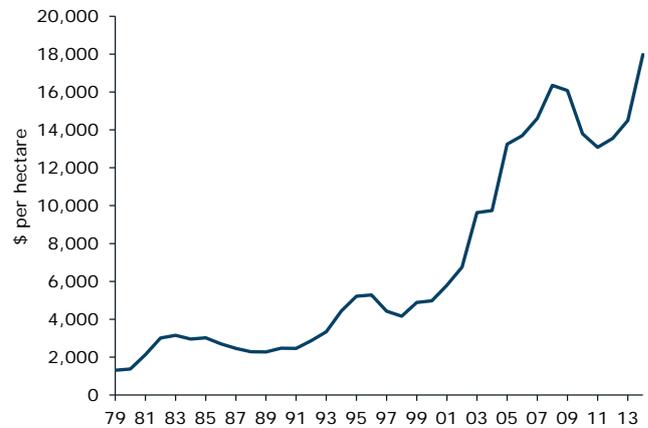
We find New Zealand farmland values have appreciated the most of 12 key competing and export markets since 2000, but most countries analysed have experienced impressive gains too.

While much of New Zealand's "X-factor" seems to be already priced in, outperformance and total farming returns well outpacing many other asset classes tells you something about New Zealand's farmland, our expertise, industry structures and processing/marketing expertise – many facets are world class. So despite near-term challenges, don't be surprised if farmland continues to catch a bid from many quarters for the "touch and feel" aspect, food and other services investment thematics, global scarcity value of quality farmland, development opportunities, and diversification plays.

INTRODUCTION

Over the last 30 years average New Zealand farmland values have increased by 6-8% per annum depending on property type, making it a fantastic investment for many. Adjusted for inflation, prices have averaged a 2.4-4.4% lift per year; still stellar stuff. In the famous words of Mark Twain: "Buy land, they're not making it any more" seems to have held true over this period. Over the past year, buyers seem to have caught gold rush fever again, with average farmland values up 24% y/y (according to REINZ's monthly index, which adjusts for compositional issues) to above pre-GFC levels.

FIGURE 1. AVERAGE FARMLAND VALUES



Source: ANZ, QVNZ, REINZ

The appreciation in land values can't solely be attributed to a scarcity of supply. Better returns (both actual and expected), productivity improvements, a different mix of buyers (foreign and equity investor interests), succession, record-low interest rates, a competitive lending environment, land use change to the likes of dairying and viticulture, irrigation developments, offshore interest in rural land as an asset class, and a restricted supply of quality properties have all had a hand in driving prices higher. Nevertheless, with the recent downturn in farm-gate prices (especially dairy-aligned property) and rising uncertainty over some emerging market economies, the eye-watering gains seen in the past year has farmers and outside investors questioning affordability.

Like all investments, land can be valued and viewed many different ways. Usually it all boils down to rate of return and associated volatility of returns. Dairy land values in New Zealand have increased by 8.6% per annum since Fonterra's formation in the early 2000s, and during this time annual cash returns have averaged 4.9%. All up this has given a total annual return of around 13.5% for the average owner-operator over this period. While this looks very respectable, it does mask some big ups and downs over this period.

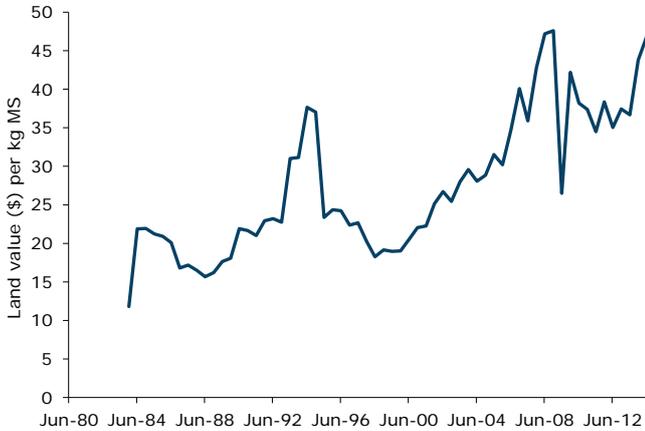
The questions now being asked, given the present downturn, is whether farmland values are once again overvalued, and whether there will be a correction. There are a number of valuation metrics one can use to get a feel for this.

On a land price paid per kilogram of milksolid basis, the monthly trend over the past 18 months has generally been above \$40. Historically the \$40 level has been a key psychological barrier. In the latest QVNZ data (to the middle of 2014) prices had spiked back to pre-GFC levels of \$47, which was 17% above the trend increase over the last 30 years (comparing

EDUCATION CORNER: GLOBAL LAND PRICE TRENDS

with the trend adjusts for productivity gains during this period).

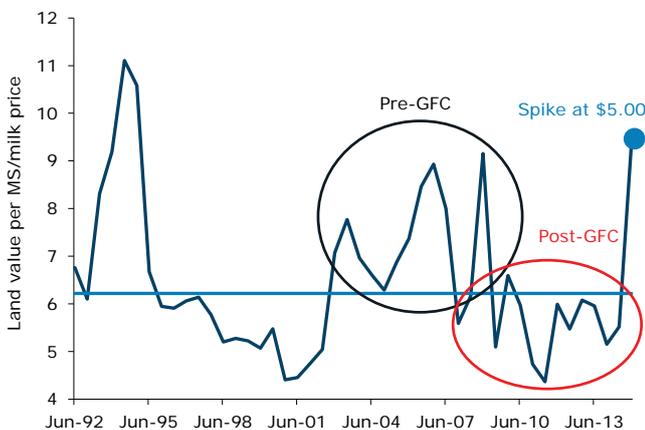
FIGURE 2. DAIRY LAND PRICE



Source: ANZ, QVNZ

While this measure implies overvaluation, it only captures outputs and not earning potential. **A better measure on this front is the land valuation to milk payout multiple, which over the second half of 2013/14 remained at 5.5 (below the historical average of 6.2) courtesy of the record payout in 2013/14.** But this wasn't a one-off, with this metric being below its historical average since the GFC.

FIGURE 3. LAND VALUE MULTIPLE TO MILK PRICE



Source: ANZ, QVNZ

Of course the danger now is the extent of recovery in the milk price. If dairy land prices were to stay at \$47 per kg MS and the milk payout was to stay around \$5.00 (fully shared-up Fonterra farmer) the multiple would spike to 9.4 – pre-GFC levels again. While a short-term spike is no doubt manageable, a return to the 8-year trend milk payout would only see this metric increase to 6.8 (slightly above the historical average of 6.2). Add in record-

low interest rates, a levelling off in cost pressures, and efficiency gains during this period, and you could certainly argue that things are not too out of whack relative to history. But a lot depends on the future direction of milk prices.

Long-term, land prices – and how they affect New Zealand's international competitiveness – remains key for all sectors, not just dairying.

High land prices can affect competitiveness in a number of ways: creating too-high barriers for new entrants/succession, starving other key areas of the business of investment (i.e. pastoral renewal etc), and increasing financing costs via the greater use of debt. Indeed, as we noted on our trip to Wisconsin – the heartland of US dairying – land values were a quarter of those in New Zealand, and when we did breakeven analysis on the cost of production for milk between the two (incorporating a capital charge) it suggested much of our dairy industry's natural and man-made competitive advantages (technology, genetics, scale, know-how etc) have already been priced into land values here. Pushing them too much higher in this case highlights the risk of undermining long-term competitiveness.

This raises the question of whether New Zealand has been unique in experiencing rising land values. Have other key competitors and local producers in important export markets experienced similar land market dynamics?

Assessing New Zealand land prices within a local framework is inadequate given we live in a globalised world. Consider the options facing bond portfolio managers at present around the globe: a 10 year German bund at 0.2%, or a New Zealand Government bond equivalent at 3.3%. In a globalised and "coupled" world, capital flows quickly to the best deals.

Massive declines in the risk-free rate have also had a massive impact on asset valuations globally. When the risk-free rate (proxied by US 10 year Treasuries) goes down in yield (up in price), all asset classes, which are all substitutes to a greater or lesser degree, move up in price. Witness the bull-run in equities. It's been an across-the-board phenomenon across all asset classes. New Zealand longer-term interest rates are more strongly correlated with global long-term rates and the international risk free rate than they are to local specifics such as the OCR. So, local asset prices (equities, rural land prices, commercial property) have performed well, following global trends.

EDUCATION CORNER: GLOBAL LAND PRICE TRENDS

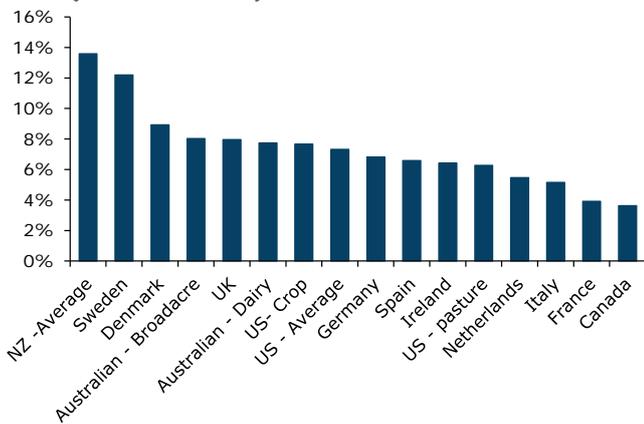
INTERNATIONAL FARMLAND TRENDS

Comparing farmland values between countries is fraught with difficulty. This is due to a lack of consistency in how the data is collected; often poor quality of collected data, especially in emerging markets; the vastly different production systems utilised by various countries; and wide variations regarding the sectors that are more or less important for different countries or even regions within a country.

What we have done is collect data from a range of countries where the statistics are broadly comparable and who are either key competitors, or export destinations. Obviously the majority of New Zealand's pastoral area is utilised for livestock, so we have tended to focus on cropping (a default proxy for feed costs for housed livestock systems) and grazing land. The same principles apply for other sectors such as kiwifruit, pipfruit and viticulture, but gathering comparable data on South American competitors proved too difficult.

We found reasonable data for the US, Canada, UK, Europe and Australia. Data for South America provided difficult to source and is probably the biggest gap. We looked into China, but because of the collective ownership structure for farmland comparisons cannot be made.

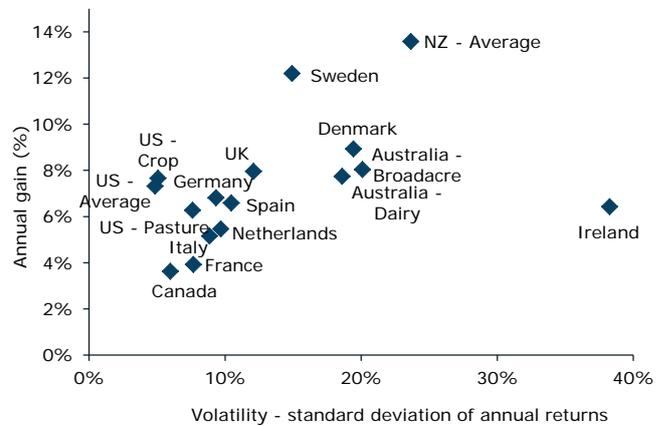
FIGURE 4. ANNUAL FARMLAND PRICE TRENDS SINCE 2000 (IN USD TERMS)



Source: ANZ and various other sources

Of the 12 countries we analysed, New Zealand's annual gain of 13.6% since 2000 was the highest. The catch was New Zealand's land prices were the second most volatile after Ireland over this period.

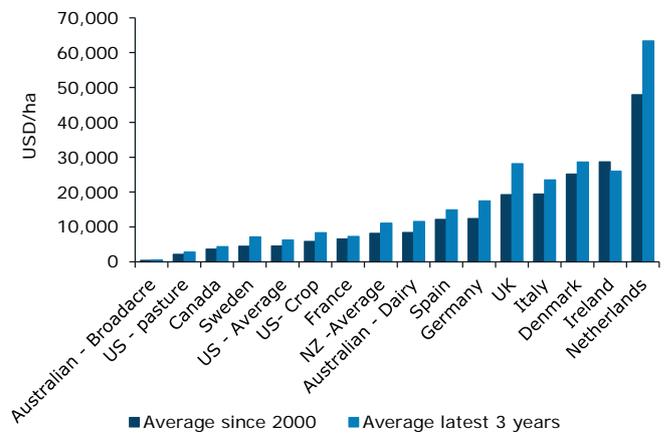
FIGURE 5. RISK/REWARD FOR FARMLAND (IN USD TERMS)



Source: ANZ and various other sources

Ireland aside, which experienced one of the biggest property bubbles during the 2000s, our analysis showed a reasonable relationship between annual returns and volatility. **This relationship showed that the higher returns from capital appreciation in farmland were also associated with greater volatility in these returns, and vice versa.**

FIGURE 6. AVERAGE FARMLAND VALUES



Source: ANZ and various other sources

While New Zealand has seen the largest gains in farmland prices of the 12 countries we analysed since 2000, on an outright basis they were middle of the pack. This could imply some catch-up, but is probably more likely to reflect larger exposure to growth markets such as China lifting actual and expected earnings. This is difficult to prove without more in-depth research into earnings between the different countries.

The Netherlands was the most expensive place to buy farmland, with prices averaging US\$48,000/ha since 2000. Ireland was next (US\$28,600/ha), then Denmark (US\$25,200/ha),

EDUCATION CORNER: GLOBAL LAND PRICE TRENDS

Italy (US\$19,400/ha), the UK (US\$19,200/ha), Germany (US\$12,400/ha) and Spain (US\$12,100/ha). The average for New Zealand over this period was US\$8,150/ha.

The picture changes a bit when we focus on the past three years (the average for New Zealand was US\$11,100/ha) and changes still more when we eye current prices, which have been close to US\$15,000/ha. This implies we may have well passed Germany and Spain in recent times.

While these numbers highlight broad trends in global land prices across some competitors and key export destinations, they do miss the wider variations associated with different land uses and the specific qualities (soil type, climatic variable etc) of various regions within a country. We know these dynamics cause wide variations even within New Zealand.

Anecdotally, in every country it seems quality properties have seen much higher rates of appreciation compared with averages since the 2000s (and over the long term). In a lot of the countries we examined, premiums for quality and well-located properties seemed to range anywhere from 20-50% above the average. Generally key attributes of quality farmland included water access, excellent soil types, low pest/disease issues, favourable climatic conditions, and good access to services and infrastructure. Within any country, government policies, access to capital, currency volatility, market access, industry structures and general infrastructure (i.e. ports & roading etc) were also important.

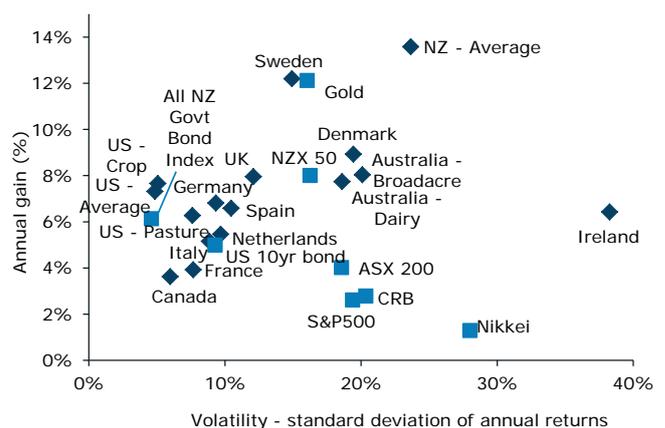
Without the associated earning potential from farmland for each country, analysis of whether or not competitiveness is being eroded is impossible to assess. **But what the above analysis does highlight is that New Zealand farmland prices have had a fair old run since 2000. Getting too far out of whack with earning potential places long-term competitiveness at risk.**

The situation is not unique to New Zealand though, with many other countries also experiencing rapid increases in farmland values. While the owner-operator model still dominates in agriculture, in all countries a much wider array of investors has arrived on the scene since the mid-2000s. These investors originate increasingly from emerging countries, especially China, India, Brazil and Malaysia. Globally, the investors are both private actors – especially from America and Europe – and public or state-owned companies – especially from the Gulf States and China. This has provided added competition on the buy-side for the traditional owner-operator looking to expand.

The motivations of these “newish” investors vary, but do include some unique angles that the farmland market hasn’t traditionally factored in. Buying into the food story and the “buy more land; they’re not making it any more” message ring true for many, but other motivations include:

- Potential returns from carbon sequestration, or other environmental services** (biodiversity, water availability and quality, etc.) could further increase the future income streams and earning potential for land in many countries.
- Diversification of investment portfolios.** Farmland generally has a low correlation with the returns of many other traditional asset classes like equities, other major sectors (i.e. healthcare, manufacturing etc), and bonds, providing a good diversification avenue for many investors. This is due to the peculiar risks and complexities associated with farmland and different agricultural sectors. Of course, for some investors these risks put them off also.
- Hedge against inflation.** The literature is divided on this issue, but the returns from agricultural land are mostly uncorrelated with – and higher than – the inflation rate in developed economies.
- Wide variation in performance and opportunity for improvement.** The performance gap in many agricultural sectors is often a lot wider than other sectors. This offers the opportunity for larger-scale investment and/or land use change to lift performance and returns.

FIGURE 7. RISK/REWARD OF FARMLAND VS OTHER ALTERNATIVES



Source: ANZ and various other sources

When you compare rates of return on farmland with equity and bonds from the 12 countries, it shows that since 2000 the rates of return have generally been higher, while the annual volatility has often been less. Of course this

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doesn't include the cash returns from the chosen farm enterprise. This would probably add volatility in most cases, but is also likely to provide anywhere from 2-8% in cash returns depending on performance.

While past performance isn't an indicator of the future, one can see the attraction and motivations for new money to continue to filter into farmland investments – not just in New Zealand, but right around the globe.

New Zealand farmland has been top-of-the-pops for returns since 2000, but there is a feeling many of New Zealand's natural (climatic conditions etc) and man-made (market access, expertise, services etc) advantages are now either fully or more than fully priced. This may temper near-term gains, but the extent of outperformance over this period tells you something about New Zealand farmland, our expertise, industry structures and processing/marketing know-how – many facets are world class.

Despite near-term challenges, and while much of New Zealand's "X-factor" seems to be already priced in with total farming returns well outpacing many other asset classes, don't be surprised if land continues to catch a bid from many quarters for the "touch and feel" aspect, food and other services investment thematics, global scarcity value of quality farmland, development opportunities, and diversification plays.

KEY TABLES AND FORECASTS

FX RATES	ACTUAL			FORECAST (END MONTH)						
	Feb-15	Mar-15	10-Apr	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
NZD/USD	0.756	0.748	0.759	0.72	0.70	0.70	0.69	0.69	0.68	0.68
NZD/AUD	0.969	0.982	0.983	0.97	0.96	0.97	0.97	0.97	0.97	0.97
NZD/EUR	0.676	0.696	0.711	0.71	0.71	0.74	0.69	0.66	0.62	0.62
NZD/JPY	90.49	89.68	91.37	88.6	86.8	87.5	86.9	87.6	87.4	88.4
NZD/GBP	0.490	0.505	0.515	0.49	0.47	0.45	0.45	0.45	0.44	0.44
NZ TWI	79.3	80.0	79.5	79.1	77.8	78.7	76.7	75.8	74.0	74.2

INTEREST RATES	ACTUAL			FORECAST (END MONTH)						
	Feb-15	Mar-15	10-Apr	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
NZ OCR	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.75
NZ 90 day bill	3.63	3.63	3.63	3.70	3.80	3.80	3.80	3.80	3.80	4.20
NZ 10-yr bond	3.29	3.23	3.20	3.00	2.80	2.80	2.90	3.10	3.20	3.30
US Fed Funds	0.25	0.25	0.25	0.50	0.50	0.75	1.00	1.25	1.50	1.75
US 3-mth	0.26	0.28	0.27	0.70	0.70	0.95	1.20	1.45	1.70	1.80
AU Cash Rate	2.25	2.25	2.25	2.00	2.00	2.00	2.00	2.00	2.00	2.00
AU 3-mth	2.33	2.23	2.26	2.20	2.30	2.30	2.30	2.30	2.30	2.30

ECONOMIC INDICATORS	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
GDP (% q/q)	0.8	0.5	0.7	0.9	0.8	0.7	0.6	0.6	0.6	0.6
GDP (% y/y)	3.5	3.0	3.0	3.0	3.0	3.2	3.1	2.8	2.6	2.6
CPI (% q/q)	-0.2	-0.3	0.4	0.5	0.0	0.4	0.5	0.6	0.2	0.2
CPI (% y/y)	0.8	0.2	0.3	0.4	0.6	1.3	1.4	1.6	1.8	1.8
Employment (% q/q)	1.2	0.6	0.5	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Employment (% y/y)	3.5	3.1	3.3	2.9	2.1	1.8	1.5	1.4	1.2	1.2
Unemployment Rate (% sa)	5.7	5.5	5.4	5.4	5.3	5.2	5.1	5.1	5.1	5.1
Current Account (% GDP)	-3.3	-4.1	-4.4	-4.6	-4.8	-4.8	-4.9	-4.9	-5.0	-5.0
Terms of Trade (% q/q)	-1.9	-0.5	0.5	0.6	0.3	-0.1	-0.3	-0.4	-0.5	-0.5
Terms of Trade (% y/y)	-4.6	-6.7	-6.3	-1.3	1.0	1.4	0.5	-0.4	-1.2	-1.2

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

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