Westpac

Agribiz

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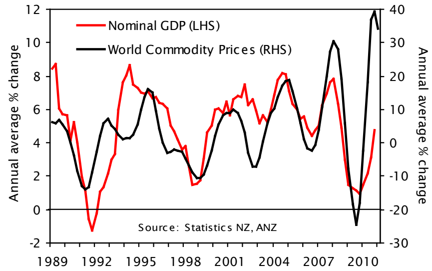
A balancing act

- Prices for NZ commodity exports have reached all-time highs.
- Higher prices for key exports is a clear positive for the NZ economy.
- However the magnitude of the boost to the domestic economy is more uncertain than usual. High debt levels and falls in land prices have, and may continue to, delay the full pass-through from higher farmer incomes to broader economic activity.

Both world and NZ dollar prices of New Zealand's key commodity exports were at record highs in February which will provide a boost to not only the rural sector, but also the wider New Zealand economy. Yet for a variety of good reasons the flow through from sky-high commodity prices to wider economic activity has, to date, been relatively muted. Debt levels for some in the sector remain high, and the impact of significant falls in land prices is still being digested by many. But this situation won't last forever. In the near-term rising revenues should outpace costs – improving cash-flows and confidence. In addition, the bulk of the downward adjustment in rural property prices has probably occurred, meaning greater stability in rural property prices over the next couple of years than we've seen since 2008. Finally, while aggregate debt levels still appear high on some measures, debt is not spread evenly within the sector, leaving many operators well placed to take advantage of investment opportunities.

This means that while we're not picking anything like the 10% nominal GDP growth the historic relationship between commodity prices and growth might suggest, the scale of the aggregate income boost means at least a portion of this will find its way into the wider economy. If high commodity prices are sustained, we can expect to see the benefits feed through to broader economic activity this year.[1]

Figure 1: Commodity prices and GDP



There are any number of factors which can affect farmers' investment, spending and debt repayment decisions –far too many to list comprehensively. However, common key themes include:

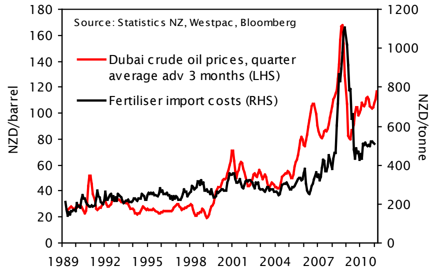
- Operating costs
- Income
- Land prices
- Debt

Cost pressures moderate

Farm input costs are on the way up. However, they are not yet under the same intense pressure we saw during 2007/08. An extended period of below trend growth in NZ means there is spare capacity in many parts of the economy (especially labour market) which could be transferred into the rural sector.

Debt servicing costs have also fallen from recent peaks – although this relief is likely to be temporary. Short-term interest rates in particular are expected to rise, eventually, from their current stimulatory levels as the local and global recovery gains momentum. Recent increases in oil prices are set to add to cost pressures in the near-term, especially if Middle East geopolitical tensions keep oil prices elevated.

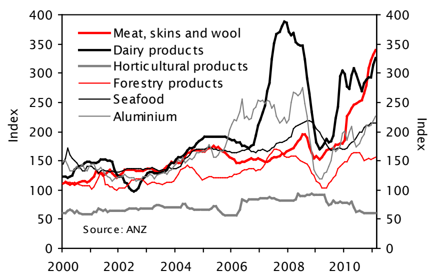
Figure 2: Fertilizer and oil prices



So far, commodity price rises have outrun cost increases

World prices for New Zealand commodity exports increased strongly in both world price and New Zealand dollar terms during the second half of 2010/early 2011. And although prices have since retraced from their peaks as markets responded to uncertainty about the unfolding situation in Japan, they remain well up on levels of a year ago. Notably, the latest step-up in prices has been much more broadly based than the 2007/08 boom which was dominated by advancing dairy prices.

Figure 3: World commodity price index



Yet even if growing demand (underpinned by income growth, urbanisation and changing diets in emerging economies) supports a rising trend in aggregate commodity prices, changes in supply will inevitably cause volatility. High prices offered encourage existing producers to ramp up production and allow new (possibly higher cost) producers to enter the market, increasing supply and putting downward pressure on prices. In addition, as has been demonstrated over the last 12 months, poor harvests, drought, and floods can all quickly swing the balance between demand and supply for agricultural commodities.

Volatility aside, higher global commodity prices are already being reflected at the farm gate in many sectors. For example, March should see $640 million more flowing into dairy farmer pockets than in February. Wool export earnings were up $94.5 million, or almost 18% for the 2010 calendar year while beef export revenues were up $138.5 million – close to 8% higher.

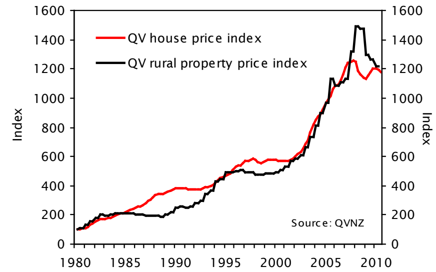
So while volatility in prices is inevitable, recent experience has probably left some farmers gun-shy – sceptical of the sustainability of current price levels. This in turn leaves them more reluctant than in the recent past to invest and spend as quickly in response to higher incomes, instead preferring to take a more cautious approach.

Dairy farmers, for example, glimpsed the prospect of their annual payout falling by over 40% over just a couple of years – from $7.90 in 2007/08 season, to an early prediction of $4.55 for the 2009/10 season. While this didn't eventuate (final payout was $6.60 for 2009/10 season and will be close to $8.00 for 2010/11), the scale and speed of this change in fortunes no doubt remains fresh in the mind of lenders and borrowers alike. Of course, we must bear in mind that the full impact of volatility in global commodity prices is buffered by the floating exchange rate for many sectors – dairy in particular (the NZD tends to be high when commodity prices are high and vice versa).[2]

Depressed land prices a drag on spending

Until 2008, rural property prices had been accelerating strongly – averaging 10% growth per annum between 1981 and 2008 on QV's rural property price index measure. But since peaking in mid-2008, prices have fallen at least 18%. There has been anecdotal reports of even bigger falls. Turnover is also well down – there were 15% fewer farm sales in the year to February than 12 months earlier – a whopping 73% below the 2008 heydays.

Figure 4: Rural and residential property prices

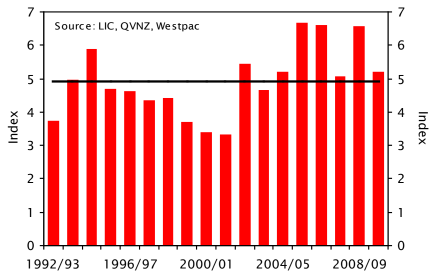


Falling land prices have acted as a drag on rural sector spending. But with the outlook for net income growth positive, liquidity improving and interest rates still low, it is likely that the bulk of the downward adjustment in rural property prices has now occurred. If instead of posting another double digit decline this year rural property prices stabilise and head sideways, then this will provide an improved backdrop against which farmers may feel more confident to increase spending as incomes rise.

The outlook for land prices is integral to the outlook for the agricultural sector for two reasons. Firstly, selling land provides a means of equity release for exiting farmers, and secondly, with no capital gains tax, rising land values offer a tax efficient method of bolstering total returns to farming, which has traditionally offered low operating returns. Of course this method of generating returns works well when prices are backpedalling cash-flows come to the fore.

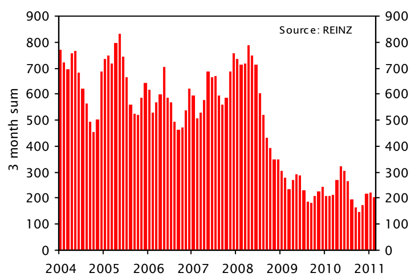
The coincidence of a steep correction in land prices and improving commodity prices means the current price to income ratio for all important dairy land no longer appears especially out of whack compared to historic averages *(Figure 5)*. (Dairy land prices are a key bellwether for other land prices as they often provide the benchmark for the most highly valued use).

Figure 5: Dairy land price to income ratio



Of course these measures of land value have two main failings. Firstly, they are based on actual land sales completed, which risks misrepresenting market values when sales volumes are very low (like now). Secondly, by utilising LIC average production data, they assume average earnings productivity. In reality, the difference between the top and the bottom producers can be stark. MAF analysis[3] suggests a breakeven point for the top 10% of dairy farmers of $4.26 Kg milk solids – almost 40% lower than for the bottom 10%, who are estimated to require a breakeven payout of $7.11 Kgms in 2009/10. And it is the top producers who decide the land's price – as the most productive user, they will be willing to pay the highest price.

Figure 6: Number of farm sales

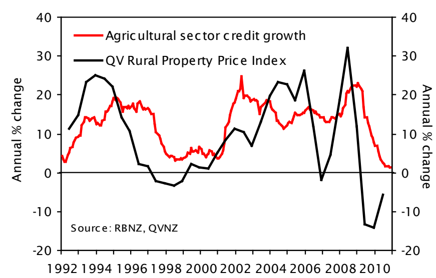


High debt levels could slow the "normal" transmission

The run-up in rural property prices was fuelled by a combination of rising incomes, increasing productivity and easy liquidity. It went hand in hand with increasing debt in the agriculture sector. Indeed, growth in debt has outpaced growth in land values, particularly in late 2008-2010 when farmers were forced to draw down on overdraft facilities to compensate for the sharp deterioration in revenues. Most recently, agricultural credit growth has slowed as higher cash-flows have been directed toward debt repayment.

Agricultural debt levels are high relative to earnings – but the distribution of this debt is far from even. Debt is concentrated among relatively few highly indebted farms while the remainder (the bulk of farmers) carry more modest debt levels. This means looking at aggregates can overstate the extent to which farmers need to repay debt in order to reach an optimal debt level.

Figure 7: Credit growth and rural property prices

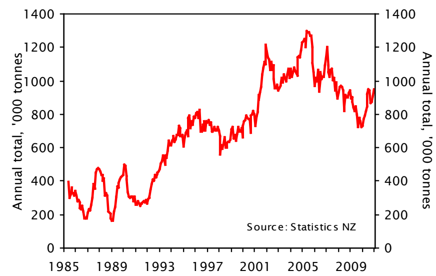


Starting to see signs of high farm gate prices translating to investment

Given strong global commodity prices have been an important feature of New Zealand's economic story over the last 12 months, have we seen any evidence of a pickup in rural investment activity?

There have certainly been some green shoots. Surveyed confidence in the sector has improved markedly (albeit interrupted by adverse weather events) and the anecdotal evidence is favourable for production-related investment. We've seen new tractor registrations pick up notably in recent months, and fertiliser imports over the last year are over 30% above imports for the 12 months prior.

Figure 8: Volume fertiliser imports



Yet even with these encouraging signs, the flow-through from elevated commodity prices to wider economic activity has been somewhat muted to date. High existing debt levels, falling land values and heightened caution within the sector have all played a part. So even if we are right, and commodity prices remain elevated for a time, it may still take a while for higher incomes to be built into wider farmer expectations, confidence and eventually income and investment decisions. Nonetheless, improved export receipts will provide an important leg-up to New zealand's faltering economic recovery, eventually helping provide a boost to investment, employment and on-farm spending in the rural sector and the broader New Zealand economy.

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[1] Of course the catastrophic events in Christchurch and enormous rebuilding task will dominate New Zealand's economic landscape over the medium term, making it difficult to disentangle the impact of high commodity prices. Nonetheless, they remain a key pillar of New Zealand's improving economic outlook.

[2] "*Buffet or Buffer*", Westpac Economics Bulletin, September 2009

[3] Source: MAF Farm Monitoring Overview 2010, October 2010

Japan – what does it mean?

New Zealanders, still coming to terms with their own tragic earthquake, have watched the evolving situation in Japan with heightened concern. While the facts surrounding the devastating earthquake, tsunami, and now nuclear crisis in Japan are still unfolding, and it is too soon to speak with any degree of certainty about the economic effects, it is worth considering some of the mechanisms via which the disaster could impact on New Zealand's agriculture sector.

Despite the strong growth of China and other developing Asian economies, Japan remains one of New Zealand's major trading partners. It accounts for about 8% of New Zealand's merchandise exports by value – most of this commodity exports including aluminium, meat, fruit and wood products. For some of these exports, Japan is a key customer. 53% of New Zealand's aluminium exports are Japan-bound, as are 29% of vegetable exports and 21% of fruit. About 4% of New Zealand's tourists (and 6% of tourist spend) come from Japan, and in the order of 3% of student migrants. Less than 2% of New Zealand merchandise imports come from Japan with the bulk being imports of motor vehicles.

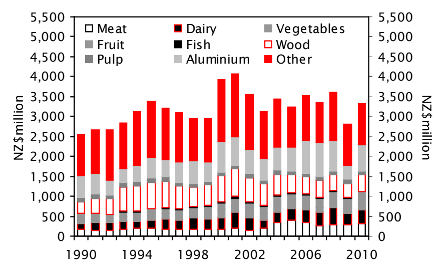
Assuming a major nuclear meltdown is avoided and the impact of the disaster is largely confined to Japan, the events are likely to disrupt but not cripple the regional economy. However in the near-term, New Zealand exports to Japan may be dented as Japanese growth slows and consumer and business confidence is hit. Early estimates are that disruption to activity will be worth around 0.6% of GDP (20% of a capital loss estimated to be in the order of 3% of GDP). In addition, damage to some ports, roading and rail infrastructure may create delivery and distribution difficulties for imported and local products alike. Indeed there were early concerns about the Japanese agriculture producers' ability to access sufficient and timely supplies of feed for stock.

However, as the rebuilding phase gets underway, demand for some commodity exports is likely to pick up. Traditional Japanese housing is wooden framed, while many commercial and industrial buildings use timber. The rebuilding of both should benefit log and lumber exports in particular – especially as Japan's strict earthquake safety codes prefer wooden framed housing. After Kobe, Japanese wooden building starts spiked in 1996, and New Zealand and Chile both increased log exports to Japan during 1995-1997.

Yet while Japan is sadly familiar with rebuilding in the aftermath of earthquakes, there are fewer precedents for the unfolding nuclear crisis. In particular how consumers and Governments alike will respond to elevated radiation detected in food. Authorities have already banned shipments of spinach and milk from areas around the crippled Fukushima Daiichi nuclear power station, after levels of radiation found in samples exceeded legal limit. Although it is a net food importer, Japan does export some relatively small quantities of foodstuffs, mainly fruits, vegetables, dairy products and seafood with exports valued at around $3.4 billion p.a. Authorities in a number of countries including China, the US, and Korea have all increased monitoring of Japanese food exports while radiation levels are assessed.

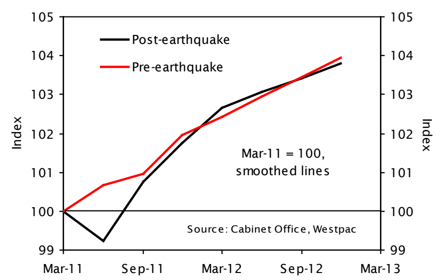
As a global food exporter, NZ may provide a temporary fill-up to meet global needs. Over a longer horizon, exporters into the Japanese market may promote New Zealand's clean green and nuclear free image to a radiation-aware Japanese consumer. Should there be a marked change in Japanese preferences over a longer horizon, meat and dairy in particular may receive a boost.

NZ merchandise exports to Japan

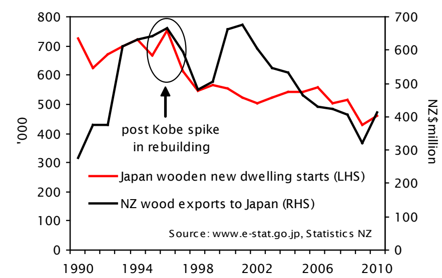


Source: Statistics NZ

Japanese activity profiles



Wood exports to Japan & housing starts



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