Westpac Institutional Bank

Fortnightly Agri Update

3 August 2016

Low-hanging fruit

Last week, we published our latest Industry Insights report, covering the horticulture sector.[1] It showed that the horticulture sector in New Zealand is small in terms of direct employment, at around 39,000 FTEs, but is responsible for more than 7% of New Zealand's merchandise exports.

The sector is enjoying a period of exceptional growth across almost all subsectors. Total export revenues reached $3.4 billion in the year to May 2016, and in the four years to May revenues from exports of our three most important horticulture products (by value) grew by 54% (kiwifruit), 105% (apples) and 158% (honey). But growth was not limited to these headliners. Blueberries (116%), onions (81%), and cherries (303%) have also done very well. Huge potential for further growth remains.

A number of factors have driven this recent success. Many product categories have increased yields by up to 50% through new on-farm practices, or growing different varieties. Marketing of individual varieties as brands has opened up new markets internationally, while trade with China and other parts of Asia has benefitted from freer trade, often aided by Free Trade Agreements. At the same time, huge changes are afoot, posing both opportunities and risks:

Increased consolidation and corporatisation is reducing the number of "front doors" in the sector. Scale increases financial viability by allowing uptake of better technology, more skilled management, and by mitigating risk across the business through geographic dispersion of growing capability. We expect to see more corporatisation across sub-sectors, especially in Manuka honey, as the cost to enter the sector rises.

Better technology is emerging, including know-how on planting and pruning; new varieties; digital technology to monitor ripeness, quality, and weather patterns to optimise production; more automation in sorting and packing; and better atmosphere control in refrigerated units. This gives us an advantage over competitors until such time as they catch up on the technology, so changes must remain ongoing. We expect more automation of sorting and packing, and the need to employ technology to further support corporatisation.

Exports are increasingly concentrated in fewer markets, most notably Australia and China, growing risks from a shock in one market. Over the short-term, we expect to see more export concentration in China, but opportunities in emerging markets like India and Indonesia may offer some diversification.

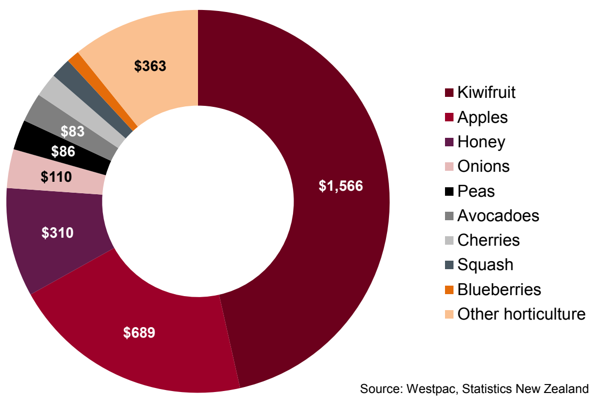
Debt is growing as land values rise on good returns of between 7% and 12% in some products. This could create financial strife for some growers if they have assumed that yields will stay this strong indefinitely. Nevertheless, at current returns, we expect to see further gains in land values, especially in kiwifruit and apples.

There is **potential for more non-tariff barriers**. Some industry sources were concerned that the current political environment globally may be turning away from free trade. Examples of non-tariff barriers already in play include subsidies to local growers, changing relationships in markets where trade is driven by government-to-government negotiations, and the use of biosecurity regulations as a trade barrier.

There is a **risk of labour shortages.** Seasonal workers brought in from offshore are one way of tackling a shortage of workers in the sector. However, there are more structural concerns related to an ageing workforce, and access to skilled scientists and teachers to ensure New Zealand remains competitive. Without planning to attract and keep younger people in the sector, and to boost the number of technical experts in the sector, New Zealand risks falling behind.

David Norman
Industry Economist

Horticulture exports by product ($m), year to May 2016



Source: Westpac, Statistics New Zealand

GlobalDairyTrade Auction Results, 3 August 2016

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	4.7%	$3,797
Butter Milk Power (BMP)	7.7%	$1,661
Butter	6.6%	$2,871
Skim Milk Powder (SMP)	2.1%	$1,965
Whole Milk Powder (WMP)	9.9%	$2,265
Cheddar	-0.8%	$2,889
GDT Price Index	6.6%	

Payout Forecast Table

	2015/16	2016/17	
	Fonterra	Fonterra	Westpac
Milk Price	$3.90	$4.25	$4.60

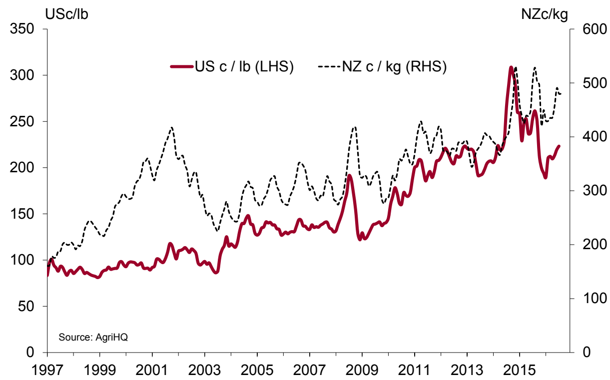
1 http://www.westpac.co.nz/assets/Business/Economic-Updates/2016/Bulletins-2016/Industry-Insights-Horticulture-July-2016.pdf

Beyond the farm gate

Beef

	Current price level compared to 10 year average	Next 6 months
Trend	High	→

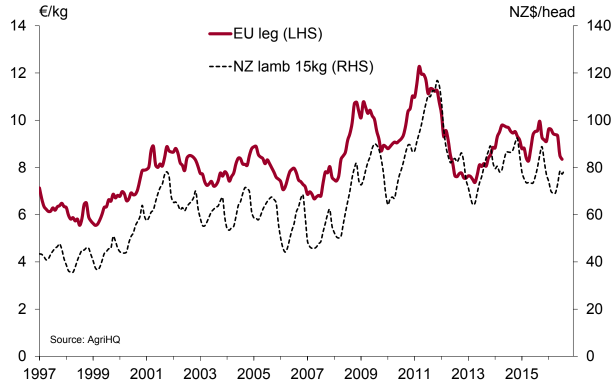
Over the medium term, international beef prices are likely to be underpinned by relatively tight global supply as beef exports from Australia, and to a lesser extent New Zealand, contract. However, this will be balanced against increasing US supply. Changes to market access for Brazil's chilled beef exporters an important wild card that could increase competition for New Zealand's beef exports and weigh on prices.



Lamb

	Current price level compared to 10 year average	Next 6 months
Trend	Average	→

Over the medium term, we continue to expect global lamb supplies to remain relatively tight. There has been a modest improvement in the demand outlook for lamb. The recent improvement in oil prices should help bolster incomes in the Middle East, and although the outlook for the Chinese economy remains soft, there are anecdotal reports of lower inventories supporting demand. However, the sharp fall in the value of the pound following the "Brexit" vote will make NZ lamb more expensive for British consumers, putting pressure on prices.

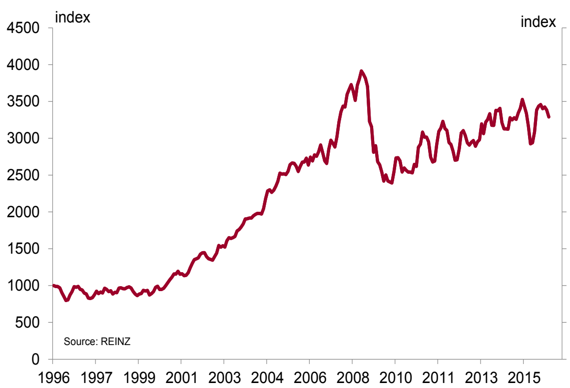


Land prices

	Current price level compared to 10 year average	Next 6 months
Trend	Average	↓

The REINZ farm price index moderated a little further in June, and is 4% lower than a year ago. However, dairy farm prices have been much weaker, falling further in June (albeit on low volumes). The REINZ dairy farm price index is now 18% below a year ago and 33% below its 2014 peaks. On a per hectare basis, prices for horticulture land have moderated over the last couple of months after a very strong run over the last 6 months.

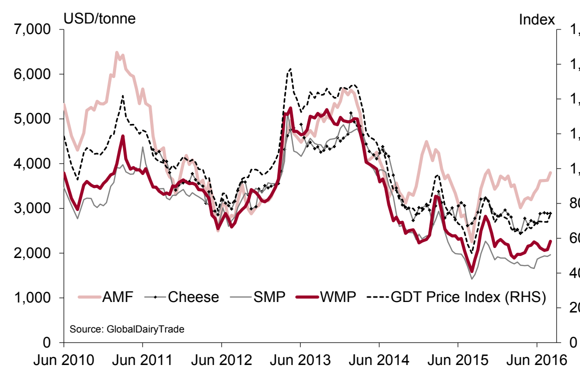
REINZ farm price index



Dairy

	Current price level compared to 10 year average	Next 6 months
Trend	Low	↗

Dairy prices rose 6.6% in last night's GlobalDairyTrade auction, led by a 9.9% lift in whole milk powder prices. Most other products on offer also posted gains. The lift has been well signalled by the futures market over the last week. While the rise will undoubtedly be welcomed by farmers, we would caution against getting too carried away just yet and don't think the conditions are yet in place for a wholesale turnaround in the fortunes of the sector. Dairy prices have been very low for an extended period, giving buyers ample opportunity to stock up. And while there are certainly signs of slower growth in milk supply in major dairy exporters, including the EU, this slowdown is coming off a very high level. We had been cognisant of growing downside risks to our $4.60 milk price forecast for the current season after slightly weaker whole milk powder prices and a much stronger NZ dollar over the last couple of months. However, today's outturn leaves us much more comfortable with our $4.60 forecast for this season's farm gate milk price.



NB: Trend arrows indicate direction of change in world prices.

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist +64 9 336 5670
Satish Ranchhod, Senior Economist +64 9 336 5668
Anne Boniface, Senior Economist +64 9 336 5669
David Norman, Industry Economist +64 9 336 5656
Sarah Drought, Economist +64 9 352 0057
Any questions email: economics@westpac.co.nz

Disclaimer

Disclaimer continued

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation (EU) 596/2014).

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ('WCM'), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ('the Exchange Act') and member of the Financial Industry Regulatory Authority ('FINRA'). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.

Investment Recommendations Disclosure

Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

(i) Chinese Wall/Cell arrangements;

(ii) physical separation of various Business/Support Units;

(iii) Strict and well defined wall/cell crossing procedures;

(iv) a "need to know" policy;

(v) documented and well defined procedures for dealing with conflicts of interest;

(vi) reasonable steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.