ANZ RESEARCH

NEW ZEALAND ECONOMICS
ANZ AGRI FOCUS

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BALTHAZAR

FEATURE ARTICLE: WINE INDUSTRY'S FULL BODIED GROWTH

Will there be further upside for New Zealand wine? The answer appears to be yes. As with many goods, fashion has a role to play and Sauvignon Blanc remains 'in' as a wine preference in established markets and is finding favour with new consumers in developed and developing markets. In order to meet this increasing demand vineyard area is set to expand significantly over the next five years, with the majority of that expansion expected to occur in the Marlborough region. There is scope for more growth from consumers looking for sophisticated foods and beverages, a new generation of younger consumers coming through and a trend towards premiumisation. Health concerns around the amount of alcohol being consumed are having an impact too; however, many consumers appear to have opted for a 'quality over quantity' attitude. All of these trends suits New Zealand's market positioning. Cash rates of return of 5.6% for grape growers and development returns of 120-125% of cost (bareland, development costs and 'time') are currently sufficient to stimulate new investment.

THE MONTH IN REVIEW

Milk, sheepmeat, beef and venison production are all under pressure. In contrast, the main horticulture crops of kiwifruit, pip fruit and grapes are on track to post near-record export volumes.

RURAL PROPERTY MARKET

The key theme moving forward for dairy-aligned land is how long the milk payout stays below breakeven and how this manifests into lending criteria, buyer confidence and 'distressed' property sales. With cashflow pressures set to extend into a second year, property prices will face more pressure from all three dynamics in the spring sales period. Outside of dairy things remain buoyant.

KEY COMMODITIES AND FINANCIAL MARKET VARIABLES

Global and New Zealand soft commodity prices appear to have found a base, though remain well below the prior year. There are generally solid output prospects, and combined with abundant stocks, this should keep supplies and prices fairly stable over the second half of 2016. The wild card could be weather.

BORROWING STRATEGY

The borrowing curve remains 'bowl-shaped', with the 2-year rate the low point. At face value this makes the 2 year term attractive, offering a good mix of cost and certainty, particularly with the curve pricing in one more RBNZ OCR cut. However, with borrowing spreads wider than 6 months ago and competition for deposits looming, we would caution that borrowers may wish to fix for longer irrespective of the outlook for the OCR. Our baseline has the OCR moving lower but there is now a credible scenario where the low has been reached and it need not follow that borrowing rates will follow the OCR down.

ECONOMIC BACKDROP

The economy is showing plenty of vigour across multiple sectors. While the dairy sector is struggling, there is more than enough momentum across construction, migration, housing and non-dairy exports to compensate in aggregate terms. We are forecasting 2½-3% growth over the next three years.

EDUCATION CORNER: NEW HORIZONS: ALTERNATIVE ASIAN MARKETS

This is a summary of our recently released report: *New Horizons: Alternative Asian Markets*. The full report can be accessed here.

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SUMMARY

This month's *Agri Focus* highlights an export sector that has been experiencing strong growth, namely wine. Such sectors (there are many examples we could have chosen) are providing offsets to dairying woes and highlight a broader base across the economy.

Wine sector earnings have doubled over the past 10 years. Yearly growth has averaged 8.4%. Total sales are now around $2 billion per annum.

The New Zealand wine story is mainly driven by Sauvignon Blanc. While other varieties have grown, it's the unique flavour of our 'savi' that stands out. Sauvignon Blanc currently accounts for around 57% of the planted area, 69% of annual production and 86% of annual exports.

Other varieties are also on the rise, with plantings of complementary white styles such as Chardonnay and Pinot Gris set to increase, as well as Pinot Noir and Merlot. Grower survey data undertaken by NZ Winegrowers reveals total vineyard area could expand by as much as 7,000 hectares over the next five years, which equates to a lift of close to 20% on current producing vineyard area.

There is scope for more growth from consumers looking for sophisticated foods and beverages, a new generation of younger consumers coming through, and a trend towards 'premiumisation'. Health concerns around the amount of alcohol being consumed are having an impact too. However, many consumers appear to have opted for a 'quality over quantity' attitude. All of these trends suit New Zealand's market positioning.

Distribution channels are changing. Tasting rooms, wine clubs, online marketing and other direct sales channels that reach consumers through the internet, mobile apps and social media are growing strongly.

Cash rates of return of 5.6% for grape growers and development returns of 120-125% of cost (bareland, development costs and 'time') are currently sufficient to stimulate new investment. However, there is limited suitable land in the likes of the Marlborough region for further development – anecdotally, the range is 7,000 to 10,000 hectares. This implies the possibility of some future scarcity if market demand continues to increase as expected.

Will there be further upside for New Zealand wine? The answer appears to be yes. Like for many goods, fashion has a role to play and Sauvignon Blanc remains 'in' as a wine preference in established markets and is finding favour with new consumers in developed and developing markets.

On a global basis New Zealand is a small player, accounting for just 1% of total global production and 3% of the value of global wine trade. The larger proportion of value is in the premium New Zealand wine currently commands.

NEW GREENSHOOTS

The viticulture sector has grown strongly over the last 10 years. Production area is up nearly 71% to 35,860 hectares and total crush is up 130% to 326,000 tonnes. Our unscientific estimate for production from the 2016 vintage is around 440,000 tonnes, which implies even stronger overall growth (official data will released sometime this month).

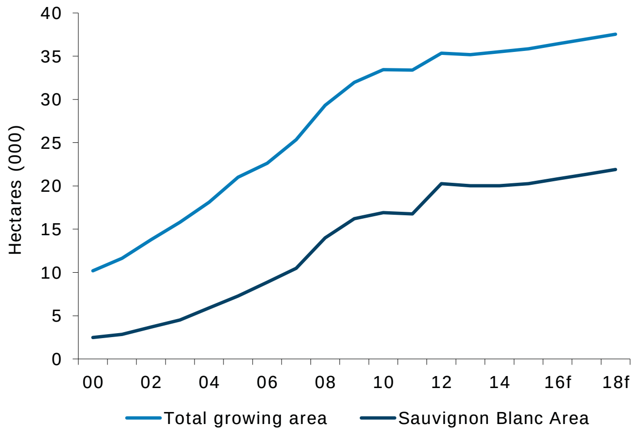
Total sector earnings have soared nearly threefold to $2 billion over the same period, led by strong sales growth to the major markets of Australia, the US and the UK, but also further afield to other niche markets.

GROWTH METRICS FOR NZ WINE INDUSTRY

	2005	2015	% Change
Wine Companies	516	673	30%
Producing Area (hectares)	21,002	35,859	71%
Tonnes Crushed	142,000	326,000	130%
Average yield (per hectare)	6.9	9.1	32%
Total Production (millions of litres)	102	234.7	130%
Domestic sales (millions of litres)	45	61.9	38%
Export sales (millions of litres)	51.4	209.4	307%
Total earnings at export values ($bn)	$0.82	$1.97	141%

Source: ANZ, NZ Winegrowers

FIGURE 1. TOTAL NEW ZEALAND VINEYARD AREA



Source: ANZ, NZ Winegrowers

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Further growth is expected over the coming years with new greenfield investment being led by the larger wine companies. Consolidation and growth continue in earnest.

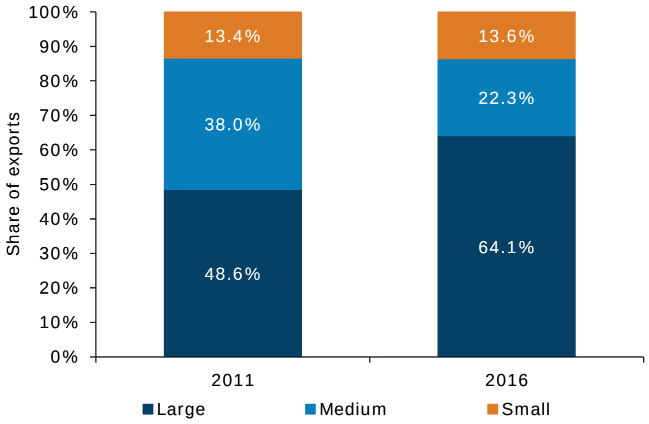
Planting surveys by New Zealand winegrowers suggest the vineyard area is set to expand by as much as 7,000 hectares or 20% by 2020/21. This expansion is currently underway with an estimated 1800ha (or 5%) additional plantings already in the ground and coming into production by Vintage 2018.

The Marlborough region will remain the epicentre of the sector at 65-70% of the growing area). The next-largest growing areas will be Hawke's Bay, Otago and Gisborne.

Sauvignon Blanc is expected to continue to dominate plantings, rising 8% to 21,900 hectares (58% of total growing area) in 2018. The next-largest white wine plantings by 2018 are expected to be Chardonnay (3,303 ha, 9% of growing area) followed by Pinot Gris (2,579 ha, 7% of growing area). Riesling is expected to remain constant, but plantings of Gewurztraminer and Viognier are tipped to fall slightly.

Pinot Noir leads the red wine varietals, with a projected 5,768 hectares of plantings by 2018 (15% of growing area), followed by Merlot (1327 ha), Syrah (450 ha) and Cabernet Sauvignon (280 ha).

FIGURE 2. SHARE OF WINE EXPORTS BY COMPANY SIZE



Source: ANZ, NZ Winegrowers

Wineries are getting larger. It appears to be a case of be big and get scale, or be very, very boutique. While there are no formal statistics on who is funding the new development, the majority is being undertaken by large wine companies that are both foreign and locally owned.

Wineries that have annual sales in excess of 4 million litres now control an estimated 64% of exports versus 49% only five years ago. While a larger proportion was controlled by these companies 15 years ago, this was just two players. Today there are 17 companies with annual sales in excess of 4 million litres. The number of smaller wineries that are locally owned and largely service the domestic and Australian markets peaked in 2012 and is now on the decline (both by number and share of production).

WINE COMPANIES BY CATEGORY

Category	Number	% of number	% total exports
Category 1	587	87%	14%
Category 2	69	10%	22%
Category 3	17	3%	64%
Total	**673**	**100%**	**100%**

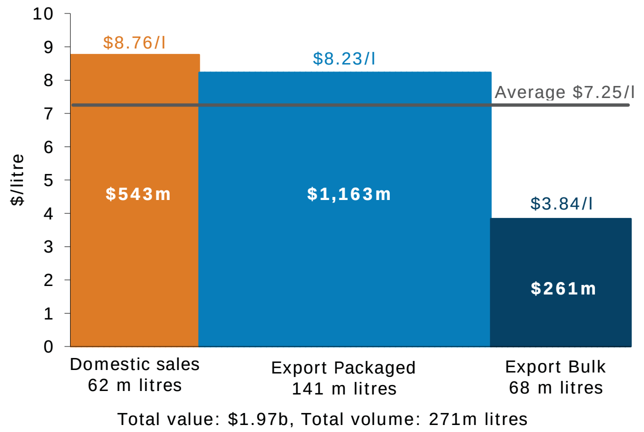
Category 1 = grape wine sales not exceeding 200,000 litres
Category 2 = grape wine sales between 200,000 to 4 million litres
Category 3 = grape wine sales more than 4 million litres

Source: ANZ, NZ Winegrowers

MARKET DRIVERS FOR INVESTMENT IN NEW ZEALAND WINE MAKING

The logical question that precedes any new investment is *"is further expansion financially sustainable?"* To answer this we take a look at New Zealand's major wine markets and the hottest trends within each. We also look at how returns are tracking for grape growers and wineries.

FIGURE 3. NEW ZEALAND WINE SALES FOR 2015



Source: ANZ, New Zealand Winegrowers, Statistics NZ

Total New Zealand wine sales are now around $2 billion per annum. Over the last 10 years total sector earnings have doubled, with annual growth averaging 8.4%. Packaged product destined for export markets accounts for around half

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of total sale volumes. Local packaged sales make up around an additional quarter of total sale volumes, and bulk wine exports account for the remaining quarter. This split has been fairly stable in recent years after bulk wine exports grew from virtually nothing in 2008.

Packaged product makes up a larger proportion of the sector's earnings as it attracts higher returns versus bulk wine exports. Evolving business models and supply chain consolidation has led to the growth in bulk wine exports. Given our distance to export markets and high bottling costs it has made sense for many of the larger multinational wineries to export in bulk to achieve better logistical and packaging efficiencies.

The repackaging of bulk product offshore doesn't necessarily mean lower returns, as long as it ends up in premium packaged wine. The fear for the New Zealand industry has been the risk that spikes in bulk export volumes drive increased supply into lower-value private brands in key export market outlets. This could then permanently erode New Zealand's brand for premium packaged wine and have a negative impact on margins down through the supply chain.

Key offshore markets that have seen increased and volatile levels of private brand sales (i.e. those brands where the retailer's name features on the front or back label) are the UK and Australia. While vintages of above-average productivity do support increased levels of private brand sales, these levels notably reduce in periods of weaker supply. In periods of lower supply, a smaller price differential to move from private brands to premium branded wines is seeing consumers prepared to pay the relatively small extra price for a premium wine with provenance.

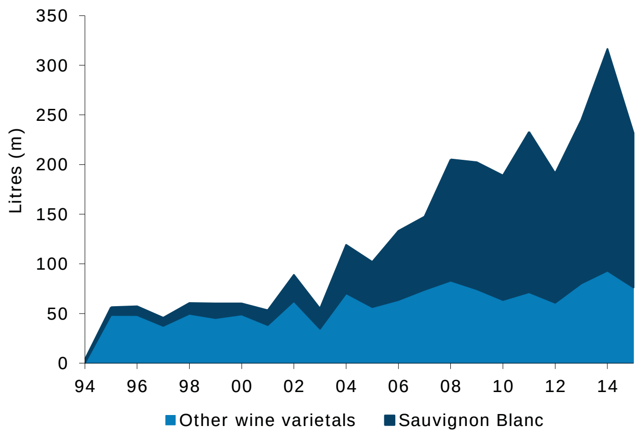
This is highlighted by the latest Nielsen Report, which noted that just 4.8% of sales volumes of New Zealand wines in the UK are in 'private brand' form. This is the lowest percentage in this category of all major wine suppliers to the UK market (Australian wine is 19.2%). Further, private branded sales of New Zealand wine remain at retail price points materially above average, adding significant support to the average retail price per unit of total New Zealand wine sales.

Many other major wine-producing countries have experienced margin compression with the growth in bulk wine exports. For the likes of Australia, bulk wine exports now account for some 60% of total exports, compared with just 10% in the early 2000s. This has significantly impacted on margins and the brand positioning of Australian wine over the last 15 years.

This hasn't happened in New Zealand so far. New Zealand is a higher-cost producer when you look at the 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 to retain New Zealand wineries' bottom lines. The numbers simply do not stack up otherwise.

New Zealand wine is of course dominated by Marlborough Sauvignon Blanc, which has received many international accolades and awards. In total, Sauvignon Blanc accounts for nearly 70% of annual production and 85% of total export sales. It has been the focal point of industry expansion over the last 10 years, accounting for 87% of the increase in growing area over this period. Industry investment surveys suggest this is set to continue over the medium term.

FIGURE 4. NEW ZEALAND WINE PRODUCTION BY VARIETAL



Source: ANZ, New Zealand Winegrowers

The next major varietals are Pinot Noir, Chardonnay, Pinot Gris, Riesling and Merlot. Of these, only Pinot Noir and Pinot Gris have experienced an increase in their growing area over the last 10 years. Smaller varietals experiencing growth include Gewurztraminer and Syrah. Most of the other varietals have seen a decrease in their growing area.

On a global basis New Zealand is a small player. It accounts for just 1% of total global production and 1.8% of total trade by volume. As New Zealand produces higher-value wine it accounts for nearly 3% of the total value of global trade. This places it 8th on the global league table by traded value and 11th by traded volumes. The top five exporters of France, Spain, Italy, Chile and Australia account for 70% of the total volume and value of traded wine.

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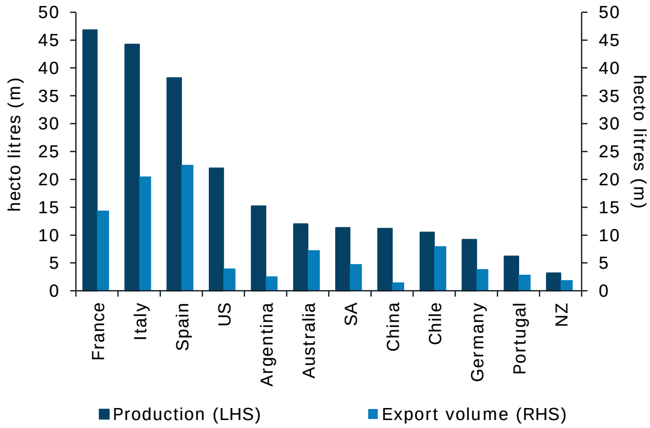
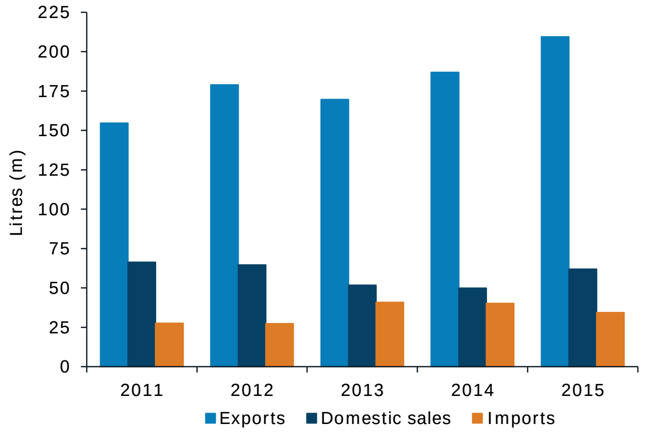
FIGURE 5. NEW ZEALAND'S PLACE IN THE GLOBAL WINE MARKET (2015)



Source: ANZ, OIV

FIGURE 7. NEW ZEALAND WINE PRODUCTION, EXPORTS AND IMPORTS

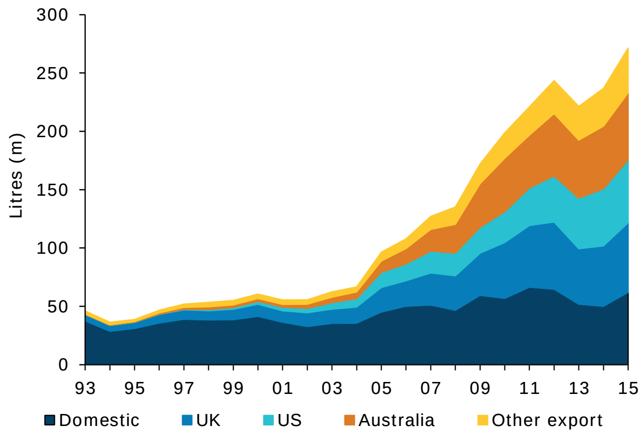


Source: ANZ, NZ Winegrowers

A LOOK AT THE MOST IMPORTANT MARKETS

New Zealand's domestic market and top three export markets of Australia, the US and UK account for 86% of total wine sales and 83% of total sector revenue. While other markets such as Germany, the Netherlands and Canada are slowly increasing their market relevance, the top four markets are expected to continue to dominate overall sales into the 2020s. This is due to supplier/ownership relationships with other parts of the supply chain and strong prospects for Sauvignon Blanc and premium wine within these markets.

FIGURE 6. NEW ZEALAND WINE DESTINATIONS



Source: ANZ, NZ Winegrowers

Around a quarter of New Zealand's wine is consumed domestically, with the rest exported. In total the domestic market consumes 90-95 million litres of wine each year, or 20-21 litres per capita. Imported product can account for anywhere from 35% to 45% of total consumption.

Of the various wine types (table, sparkling, carbonated and fortified) **New Zealand consumers' strong preference is for still and sparkling wines.** White still wine accounts for approximately 60% of total sales. **The favoured varietals are Sauvignon Blanc (52%), Chardonnay (36%) and Riesling (5%). Red still wine accounts for 30% of total sales. The favoured varietals are Pinot Noir (52%), Merlot (29%) and Cabernet Sauvignon (15%).** Sparkling wine accounts for 7.5% of total sales.

Australian wine accounts for 75-80% of total imports, the majority of which is Shiraz and Cabernet Sauvignon. These two varietals, alongside Chardonnay, are the cornerstones of Australian production, accounting for 59% of their total crop. Outside of Chardonnay, New Zealand and Australian supply is generally complementary, with the likes of Sauvignon Blanc and Pinot Noir accounting for only 8% of the Australian crop. Other major sources of imports are France, Italy, South Africa and Chile. French product is targeted at the premium end, whereas all the other importers have an average price of just $2-5/l. The majority of the cheaper imported product is sold via the supermarket/retail channel.

An influential consumer trend is around health and wellness, which is leading to more low-alcohol wines and smaller servings. New legislation lowering the alcohol limit for driving has also supported a similar trend in New Zealand bars and restaurants. **These trends, alongside a more knowledgeable consumer, are driving an increase of domestic product sales at the premium end as consumers 'trade up'.**

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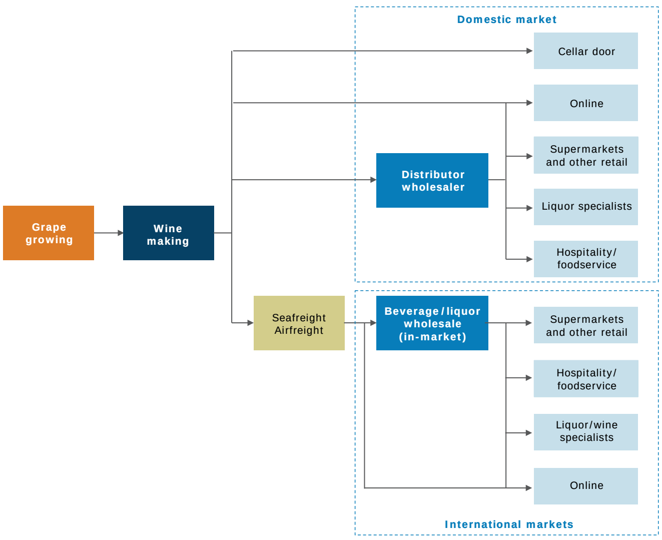
Distribution

In the international market, most of New Zealand's wine is generally still sold through the retail channel, but this is changing. The fastest-growing international sales channel is online – either direct, or through a third party website/distributor.

The domestic distribution channel is more diverse. It has five key distribution channels: supermarkets, liquor stores, hospitality & foodservice, cellar door and online. Of these, off-trade sales (i.e. supermarkets, liquor stores and online) account for around 80% of total sales and on-trade and cellar door sales make up the remaining 20%.

In the off-trade channel, supermarkets are the main players, having increased their share from 30% in the early 2000s to an estimated near-50% today. The New Zealand supermarket industry is concentrated in two entities with centralised buying functions: Foodstuffs and Countdown (Woolworths). Like supermarkets anywhere, they offer the ability to shift volume, but at more competitive margins. Retailer margins usually range from 25-40% of the end retail price.

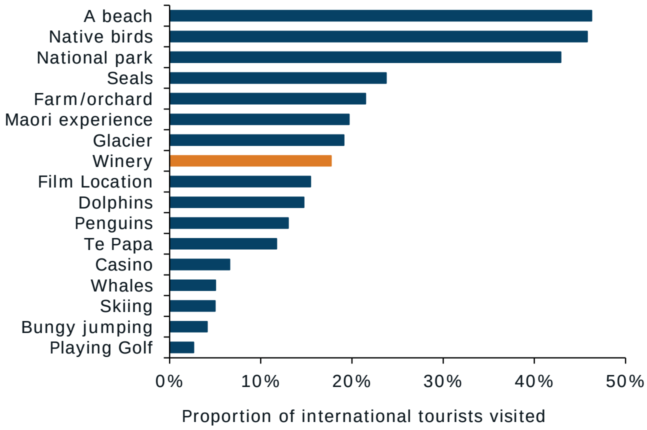
FIGURE 8. DISTRIBUTION CHANNELS FOR NEW ZEALAND WINE



Source: ANZ

Smaller wineries are more reliant on cellar door sales and tourism. This often involves other products/services too, such as a dining experience, special occasion entertainment (eg. weddings) and accommodation in some cases.

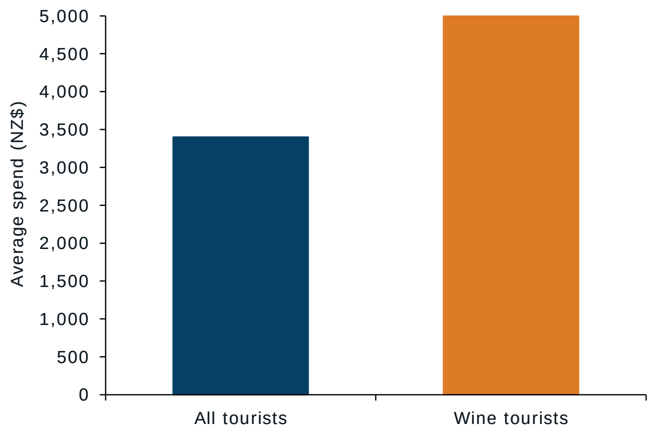
FIGURE 9. SELECTED ACTIVITIES VISITED BY INTERNATIONAL TOURISTS (2015 SEPT YEAR)



Source: ANZ, MBIE

Spending from tourism is significant, with 18% of international tourists visiting a winery. That's the initial connection online distribution mechanisms can then support. Indeed, the number of international wine tourists now totals some 540,000 per annum and they spend some $2.8 billion when they visit. On average they spend $5,000 per visit, significantly higher than the average (about $3,500), primarily because they stay longer.

FIGURE 10. AVERAGE SPEND BY INTERNATIONAL TOURIST (2015 SEPT YEAR)



Source: ANZ, MBIE

This highlights that the wine industry's economic reach goes beyond just the revenue generated from direct product sales. The top five sources of international visitors to wineries are Australia, the US, China, England and Germany.

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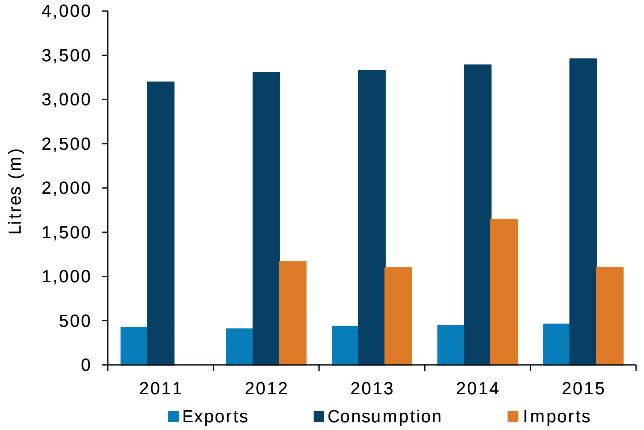
United States

The United States is now New Zealand's largest export market on both a volume and value basis. This follows a 19% surge in sales for the 2015 vintage, with growth in the USD8-15/bottle price category driving sales.

From a purely economic perspective, the US economy (and consumer) **looks on a stronger footing than a host of others around the globe.** Combine that with increasing tourism connectivity (i.e. US airlines resuming direct flights to New Zealand) and a huge market in the first instance, and opportunities abound.

The United States recently surpassed France as the largest wine market in the world (on a volume basis) following a period of sustained growth since the late 1990s. This is the opposite of what has happened in France and Italy, where wine consumption is declining (from a high level).

FIGURE 11. UNITED STATES WINE CONSUMPTION, EXPORTS AND IMPORTS



Source: ANZ, US Wine Institute

On a per capita basis, US consumption has crept up to 11 litres per year. Per capita consumption of wine in the US is likely to continue to grow in the short term, driven by increasing sales to the under-40 cohort and baby boomers maintaining consumption levels. However, consumption growth will moderate as consumers favour premium versus generic/lower-priced wine and as more of the baby boomer cohort begins to retire. Retirement generally coincides with a rapid decline in alcohol and wine consumption.

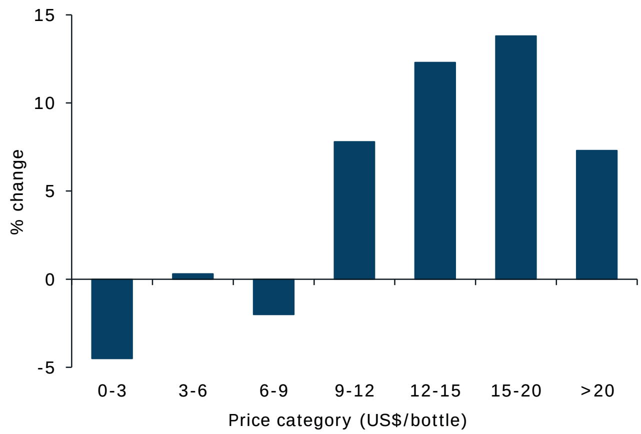
The growth part of the market, especially for Sauvignon Blanc, is the under-40 cohort who are looking for more sophisticated foods and beverages, a trend that naturally favours wine given its wide range of flavours and ability to be paired with different food. The challenge is that this cohort is more discerning, with access to a wider array of market intelligence via information technology. This provides improved opportunities for imported products by breaking down traditional marketing and distribution channels (i.e. more online sales), but also creates fierce competition from direct competitors and other products, such as alcohol blends, cider, craft spirits and beer.

Craft beer and spirits are seeing phenomenal growth in the United States by tapping into different flavours and characteristics that appeal to a specific consumer's palate. This is in direct contrast to mass-produced beer that often has limited or no defining taste characteristics and therefore has wide appeal to most consumers' palates. This has seen the number of craft breweries in the United States increase more than 50% since 2008 and craft production grow at 25% per annum over the last several years. This is in stark contrast to the overall beer category, which is in decline.

Wine consumption faces the same challenge if it is to continue to grow in appeal. Nearly 40% of adults drink wine in the US, with a third consuming wine several times a week and the rest only occasionally. So there is still scope for growth and broader appeal.

Some of the biggest trends in the US market are the movement toward 'premiumisation' and growth in product availability of mid-tier priced wines. Indeed, there is double-digit growth in the USD10 to $20/bottle range at the expense of the under USD10/bottle category, although this still makes up 75% of total sales. The majority of volume growth for Sauvignon Blanc is occurring in the USD8 to 15/bottle price category.

FIGURE 12. GROWTH IN WINE SALES BY PRICE SEGMENT – 2014/15



Source: ANZ, AC Nielsen, Statistica

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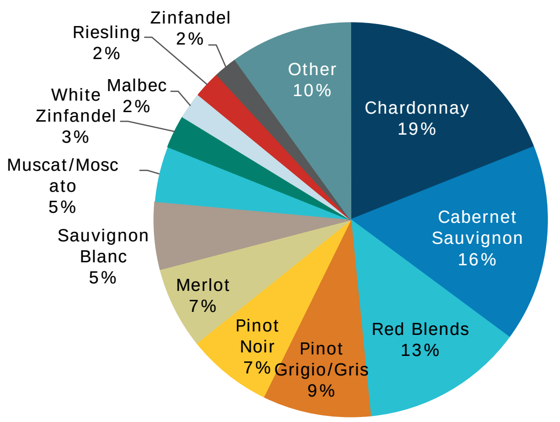
This shift is being fuelled by an improvement in the fortunes of the US consumer due to an improved labour market and the wealth effects of higher equity and house prices. The growth in the availability of mid-tier priced wine is also creating a bridge for the under-40 cohort looking for a more individualised palate offering, but at an affordable price point.

Sauvignon Blanc accounts for around 5% of total US sales, but is one of the fastest growing varietals. Blends are hot items as consumers want to try new, more interesting flavours.

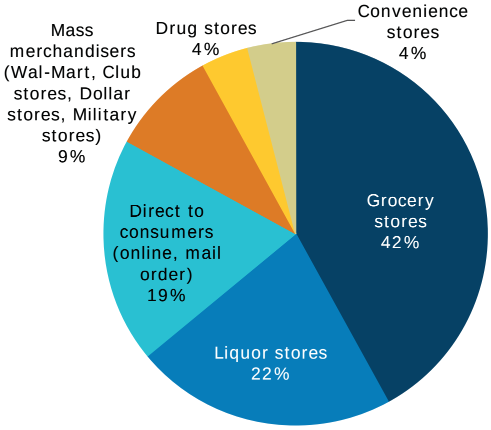
The main US sales channel for wine is off-premise, accounting for more than 80% of wine sold. Within this, the three main distribution channels are grocery stores (42%), liquor stores (22%) and direct-to-consumer (20%). Direct-to-consumer sales are increasing market share at the expense of traditional retail. This channel is experiencing success through tasting rooms, wine clubs, online marketing and other direct sales channels that reach consumers through the internet, mobile apps and social media.

FIGURE 13. OFF-PREMISE WINE SALES IN THE US BY VARIETAL – 2015



Source: ANZ, Wine Institute

FIGURE 14. OFF-PREMISE SALES CHANNELS FOR US WINE



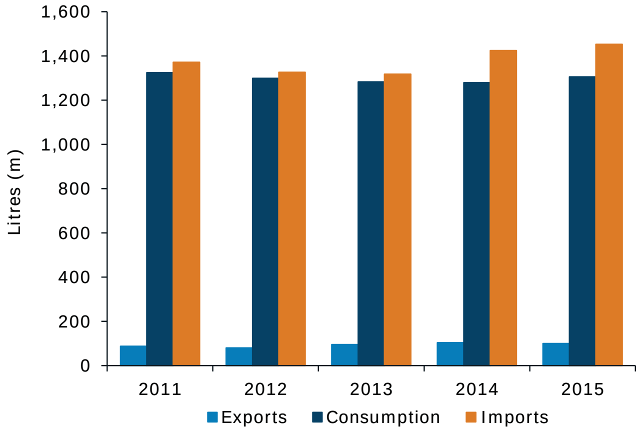
Source: ANZ, Wine Institute

On-premise sales are more sluggish as consumers appear to be buying more wine by the glass instead of the bottle. This appears to be due to a range of factors, such as greater awareness of health impacts, demographics (with younger generations consuming a variety of drinks when dining out), budgetary constraints, more casual dining reducing average eating times, and 'premiumisation' reducing volumes consumed.

United Kingdom

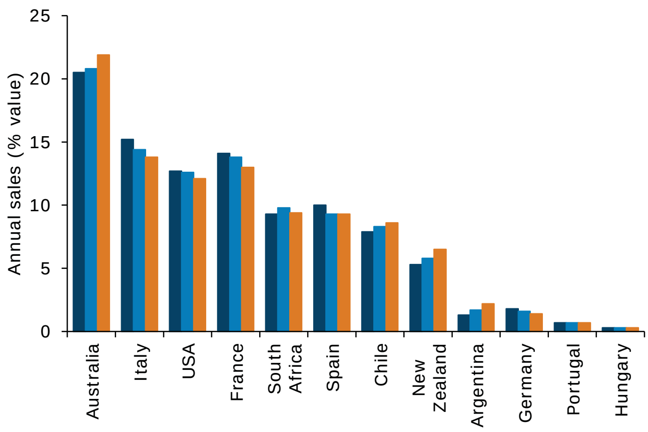
The United Kingdom is New Zealand's second-largest export market on both a volume and value basis. **It is a little different to the Australian and US markets in that the majority of supply is from imports, with very little domestic production.** In fact domestic production accounts for less than 2% of total consumption.

FIGURE 15. UNITED KINGDOM WINE CONSUMPTION, EXPORTS AND IMPORTS



Source: ANZ, Wine & Spirit Trade Association, IWSR

FIGURE 16. UNITED KINGDOM WINE IMPORTS BY COUNTRY OF ORIGIN



Source: ANZ, AC Neilson

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The top import sources are Australia, France, Italy, US, South Africa and Spain. New Zealand ranks 8th, but has been one of the fastest growing in recent years as Sauvignon Blanc has taken market share from other varietals.

Health concerns, along with changing lifestyles and demographics, mean that the volume of wine consumed per capita is in slow decline. There seems to be a split market, with many consumers having traded down to less expensive wines in recent years, but many others choosing to reduce consumption and opt for better-quality wines.

In recent years there has been an increased focus on reducing youth binge drinking and raising 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.

The majority of UK wine sales (around 80%) are through the off-trade channel. The main reason for the dominance of off-trade sales is that the average price is 60% lower than on-trade channels. The majority of off-trade sales are through the major supermarket retailers, such as Tesco, Sainsbury's, Marks & Spencer, Asda, and Morrison. However, there is somewhat of a polarisation, with retail discounters, such as Aldi and Lidl, attracting price-conscious consumers at one end, and independent liquor stores/merchants attracting consumers interested in spending more due to a special occasion, or for better quality.

TOP 10 SUPPLIERS OF UK RETAIL MARKET IN 2015

Country of origin	000s Hectolitres	% chg (y/y)	£ million	% chg (y/y)	£ per 75cl	% chg (y/y)
Australia	1,686	+4	1,172	+3	£5.21	-1
Italy	1,123	-6	745	-5	£4.98	+1
USA	898	-6	651	-5	£5.44	+1
France	805	-10	701	-7	£6.54	+3
South Africa	787	-7	502	-6	£4.79	0
Spain	754	+1	501	-1	£4.98	-2
Chile	650	+2	461	+3	£5.32	0
New Zealand	356	+10	347	+10	£7.33	+1
Argentina	151	+26	116	+25	£5.74	-2
Germany	127	-13	78	-13	£4.62	+1

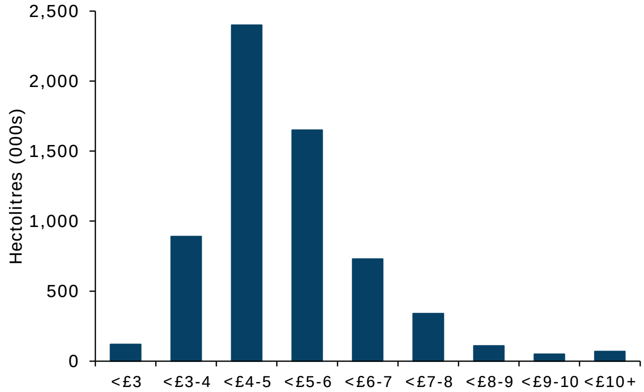
* Hectolitre = 100 litres, approximate exchange rate during 2015 £1 = USD1.50
Source: ANZ, Wine and Spirits Trade Association

The largest suppliers through the UK retail channel are Australia, Italy, US and France. New Zealand ranks 8th, but achieves the highest average price per bottle (GBP7.33/bottle) of the top 10 suppliers. This places New Zealand wine at the premium end of the market with the vast majority of wine sold in the GBP3-6/bottle range.

New Zealand red wine (all varietals) **also has a retail selling price substantially** (approximately 50%) **above the nearest competition.** The average retail price per bottle of wine is typically higher in the UK compared to other EU countries due to higher excise duty and taxes. However, fierce in-market competition reduces actual profit margins for wineries.

UK consumers are generally very price sensitive when shopping for wine in supermarkets and will often only trade up to mid-priced/premium brands when they are heavily discounted. Private labels are important too, accounting for around 15% of sales through the off-trade channel. This is a higher proportion than for other alcoholic drinks. Supermarkets offer a wide selection of private labels, often filling the gap between economy and premium categories.

FIGURE 17. WINE SALES BY PRICE SEGMENT – 2015



* Hectolitre = 100 litres, approximate exchange rate during 2015 £1 = USD1.50

Source: ANZ, Wine & Spirits Trade Association/Nielsen

Still white wine is consumed in slightly greater volumes (45%) overall than still red wine (43%), with rosé accounting for around 10% of the market. **Sauvignon Blanc and Pinot Grigio/Gris continue to take market share from Chardonnay in the white category.** Sauvignon Blanc has around an 8% market share by volume and New Zealand sourced product accounts for around half of this. Aromatic whites such as Albariño, Grüner Veltliner and Riesling are also widening their appeal.

FEATURE ARTICLE: WINE INDUSTRY'S FULL BODIED GROWTH

The top red varietals are Merlot, Shiraz and Cabernet Sauvignon. Pinot Noir is increasing its exposure and understanding in the red category, as is Zinfandel. Red wines from lesser-known grapes and regions in Europe have also gained in popularity.

Promoting a varietal with a regional story that reflects the diversity of wine producers is generally more readily understood. Fruit-flavoured and lower-alcohol wines are new-style products considered to have growth potential too.

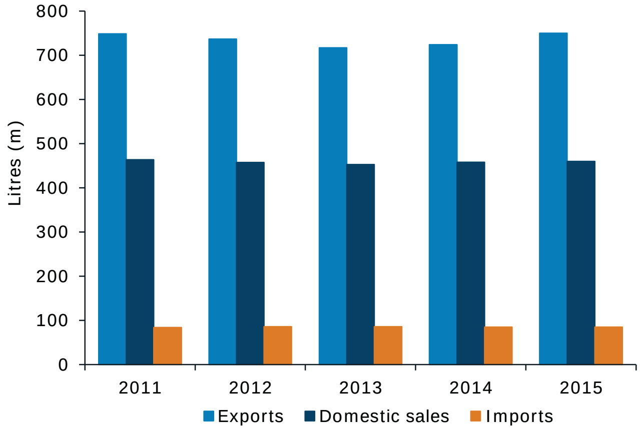
Bars, restaurants, hotels and other foodservice channels account for the remaining 20% of UK sales. The foodservice market is fairly steady in volume terms, but value has increased with some consumers trading up. The foodservice sector is dominated by French and Italian wine, followed by that from Australia, USA, Chile, and Spain.

White wine is a more dominant choice in foodservice than in retail, with a 53% share, compared with 37% for red wine and 10% rosé. The majority of New Zealand wine is sold through the retail channel so there would appear to be opportunities in the less price-conscious foodservice channel.

Australia

The Australian market is New Zealand's third-largest export market on both a volume and value basis.

FIGURE 18. AUSTRALIAN WINE PRODUCTION, EXPORTS AND IMPORTS



Source: ANZ, ABARE

Around one third of Australia's wine production is consumed domestically, with the rest exported. Domestic consumption of wine (table, sparkling, carbonated and fortified) has been relatively stable in recent years, at around 460 million litres, or 20 litres per capita each year. This is in stark contrast to the decline in beer consumption.

Market surveys of Australian consumers show the following factors figure prominently in shaping purchasing behaviour:

- price
- grape variety
- style of the wine
- region of origin
- country of origin
- peer influence
- style of wine; and
- food complementarity.

These features are obviously not unique to the Australian market.

New Zealand product accounts for around 15% by value and 10% by volume of wine sales in Australia. Australian consumers have a strong preference for still white wines (50% of sales), still red wine (34%) and sparkling (10%). **The major white varietals are Sauvignon Blanc (40%), Chardonnay (25%) and other white blends.** The major red varietals are Syrah (25%), Cabernet Sauvignon (15%) and Cabernet Merlot (14%). **New Zealand's largest share is for Sauvignon Blanc (around 70% of volume) followed by Pinot Gris (20-25%) and Pinot Noir (30-35%).** Other more minor varietals are Chardonnay, Riesling and Merlot.

The majority of New Zealand's sales are through the retail and online sale channels, as opposed to foodservice. The two largest supermarket chains, Coles and Woolworths, dominate total sales with an estimated 70% share. The domestic market share of private labels of both major retailers is around 15%, whereas in New Zealand it's less than 2%. Although consumers are able to benefit from lower-priced private label products, this tends to squeeze margins for others in the supply chain and can inhibit innovation for fear a new product won't be accepted by the two dominant retail players.

Premium wine products continue to grow at the expense of cheaper bulk wine, with increased sales through online channels. Online wine retailers have increasingly stocked premium, niche and independent wine labels that are not available from the major retailers. The major growth is in the AUD10-25/bottle price segment. Consumers are also attracted by online wine clubs, offering members better deals and the chance to be a part of wine events, creating an immersive wine experience.

FEATURE ARTICLE: WINE INDUSTRY'S FULL BODIED GROWTH

New Zealand wine dominates Australian sales of imported wines, accounting for around half of total volumes, with France the next-largest supplier at a touch under 15% (but nearly double on a total value basis due to higher returns).

The appreciation in the NZD/AUD, more challenging local economic conditions and higher supply hampered returns for the 2014 vintage, with in-market pricing pushing back to the lows of 2010-2012 (AUD5.86/l). However, a smaller 2015 vintage and better market prospects in the US appear to have relieved the pressure, with prices back to AUD6.84/l this year as exports by volume have dropped by 13%. In comparison, the average French wine price is AUD10-11/l.

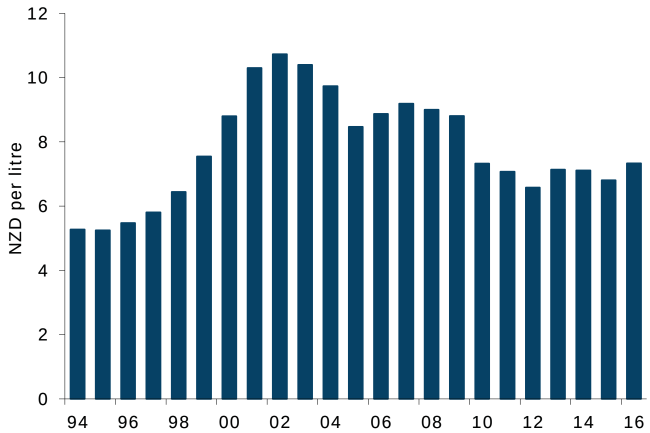
WINE INDUSTRY RETURNS

Currency movements and their impact on returns

While currency movements are a key influence on returns, the impact is difficult to work out due to the sales split between the UK, Australia and US. For individual exporters it will depend on their market split. For the industry we have constructed a trade-weighted index (for wine exports) as a proxy to examine the effect of currency movements.

Average NZD export returns have been remarkably stable since the shift down experienced during the GFC, though returns are well down versus the early 2000s. The average export price has been around NZD7/litre, with a +/- 5% range over the last seven years. Looking back further in time shows much more volatility was experienced during the 1995 to 2009 period.

FIGURE 19. AVERAGE EXPORT PRICE

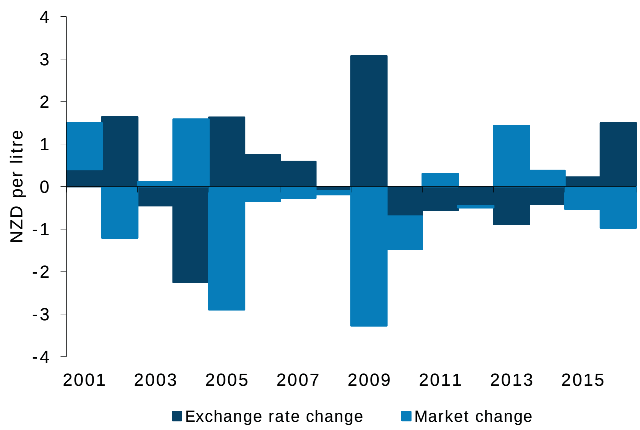


Source: ANZ, NZ Winegrowers

There are several trends that have been influential for NZD returns in the post-GFC period. One was the lift in the NZD over the 2010 to 2014 period. The industry's trade-weighted index increased by 36% over this period. This reduced average export returns by NZD1.82/l, or 27%. **The offset was in-market prices improving by NZD1.29/l**, meaning the average decline was NZD0.52/l, or -7% versus 2010 returns.

However, the improvement in in-market prices over this period perhaps owes a lot to the smaller 2012 vintage. This tightened supply (especially bulk exports) in the 2013-2014 period.

FIGURE 20. MARKET AND EXCHANGE RATE EFFECT ON NZD RETURNS



Source: ANZ, NZ Winegrowers

The last 18 months have been somewhat different to the previous five years. A substantial drop in the NZD/USD and softening in NZD/GBP has delivered currency gains of NZD1.72/l. The flipside is that some of this has been given back to retailers and consumers in the marketplace (–NZD1.50/l), and a stronger NZD/AUD has provided a drag on returns from Australia. Indeed in-market prices have faced pressure in all three major export destinations from a lift in supply following the large 2014 vintage. Pressures have moderated in the UK and Australia this year (2015/16), but average in-market prices in the US have moved lower again.

Part of the movement lower for the US has been more product being diverted from Australia to the US, but there has also been an increased proportion of bulk wine exports (39% as opposed to approximately 30%) lowering the average export price. However, quite a lot of the bulk wine will no doubt be repackaged in the US and then sold for similar prices to already packaged export product.

FEATURE ARTICLE: WINE INDUSTRY'S FULL BODIED GROWTH

Business models

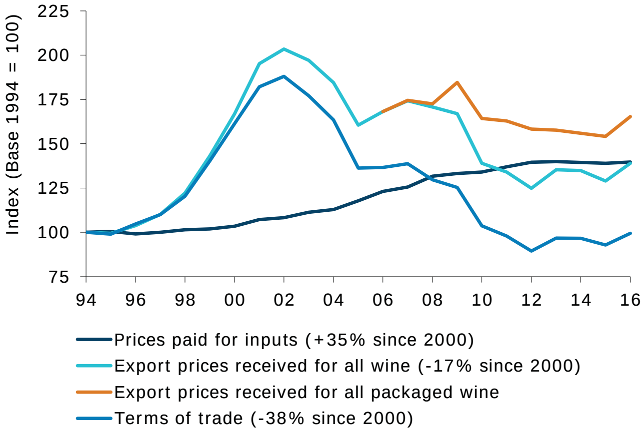
As in every industry there are a wide range of business models. In the wine industry there are grape growers and there are wineries, but there are also businesses that grow grapes and then produce, bottle and distribute their own stable of brands. These businesses vary in size, the types of product they produce and the different markets they participate in. This can make it difficult to analyse returns and benchmark performance across the broader sector.

Wine industry terms of trade

At an industry level the wine industry suffered a very large fall in its terms of trade[1] through the rapid growth period of the early-2000s to 2012 period. The fall was driven equally by lower export prices (currency driven) and an increase in input prices.

Over the last 5-6 years things have stabilised, with export prices flattening out and input prices up only 2% over this period. This, combined with improved economies of scales via both consolidation and individual business growth, as well as a continued focus on productivity and collaboration to drive supply chain efficiencies, has led to more stable economic returns and less volatility in the terms of trade (a flat trend as opposed to a declining one).

FIGURE 21. WINE INDUSTRY'S TERMS OF TRADE



Source: ANZ, NZ Winegrowers, Statistics NZ

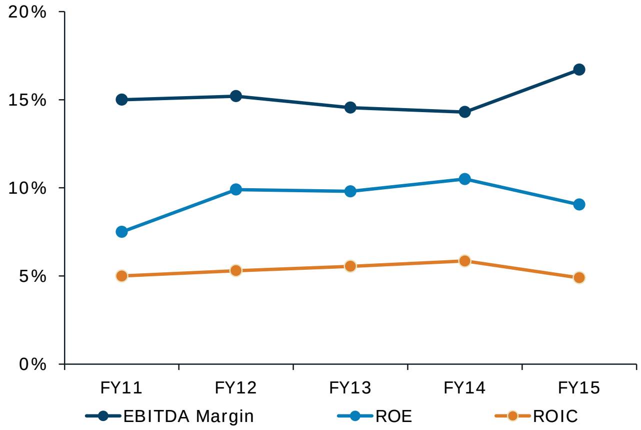
Larger, corporate wineries have driven a more integrated supply chain helping smooth export returns too. New Zealand-sourced wine makes up only a small part of their offering to major retailers. As the industry has matured there has also been more active crop management to ensure steady returns. Many of these trends are typical of what a sector goes through during a consolidation period following rapid growth.

Winery returns

At an individual winery level, returns have remained stable as wine producers have cautiously grown revenues and focused on maintaining margins. Based on our analysis of the financial records of around 50 wine companies over the last 5 years, the average business has typically achieved an EBITDA[2] margin of 15.1%[3].

Stable margins and returns have been supported by steadier export returns, as highlighted earlier. However, cost efficiencies have played an equally important role. Wages have been maintained at around 11% of revenue and marketing expenditure has been carefully targeted. Other cost categories such as bottling, packaging, storage and administration have been kept under control, through improved economies of scale and capital reinvestment to drive processing/supply chain efficiencies.

FIGURE 22. BENCHMARK RETURNS TO NZ WINE PRODUCERS



Source: ANZ, various wine companies

These margins have translated into a Return On Equity (ROE)[4] of 9.2% and a Return on Invested Capital (ROIC)[5] of 5.3%. Not high by any means, but certainly well above benchmark 10-year bond yields around the globe.

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[1] Terms of trade is a ratio of prices received for outputs to prices paid for inputs. The ratio indicates the real purchasing power of each dollar of revenue at the industry level relative to previous years.

[2] EBITDA = Earnings before interest, tax, depreciation and amortisation.

[3] EBITDA margin = EBITDA/revenue

[4] Return on Equity: Net Profit/Equity

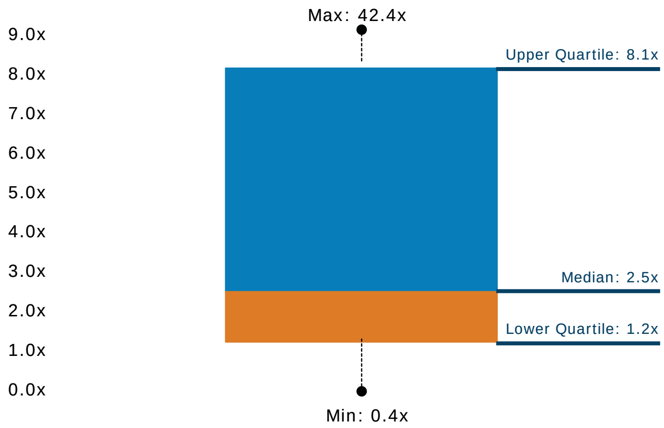
[5] Return On Invested Capital (ROIC): EBIT * (1-Tax Rate) / (Debt + Equity – Cash)

FEATURE ARTICLE: WINE INDUSTRY'S FULL BODIED GROWTH

Market value of wineries

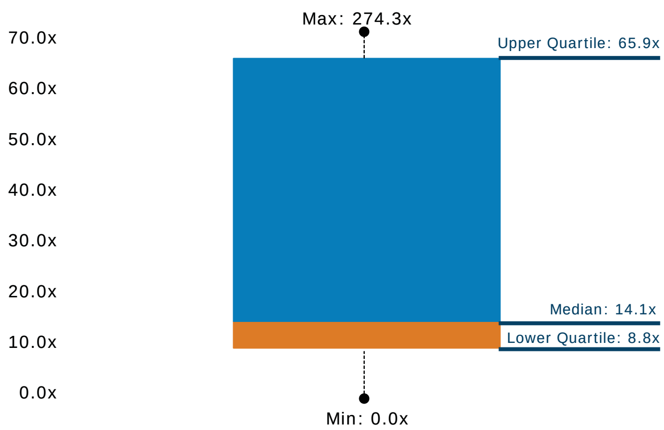
To gauge how returns translate into market value, we analysed the trading multiples of 33 listed wine companies that operate in New Zealand with turnover under $150 million over a five year period. A wide range of value can be observed, reflecting the volatility in returns/dividend, size of company, brand strength, stage in the development cycle and tangible asset base. However, 50% trade within a range of 1.2 to 8.1 times revenue multiple, with a skew toward the median of 2.5. In terms of EBITDA, 50% trade within a multiple of 8.8 to 65.9 times, with a skew toward the median of 14.1.

FIGURE 23. PRICE/REVENUE MULTIPLES FOR WINERIES



Source: ANZ

FIGURE 24. PRICE/EBITDA MULTIPLES FOR WINERIES

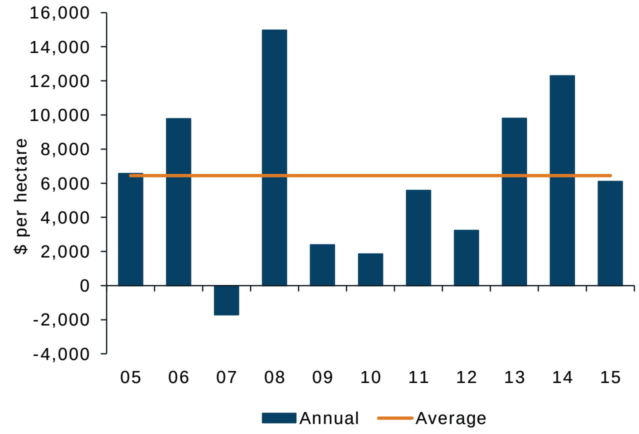


Source: ANZ

Grape grower returns

Over the last 10 years vineyard returns in Marlborough have averaged $6,500 per hectare, but there has been huge variation. The majority of this variation has been driven by the revenue side (yields and grape prices) as opposed to costs. This is not unusual for a primary sector.

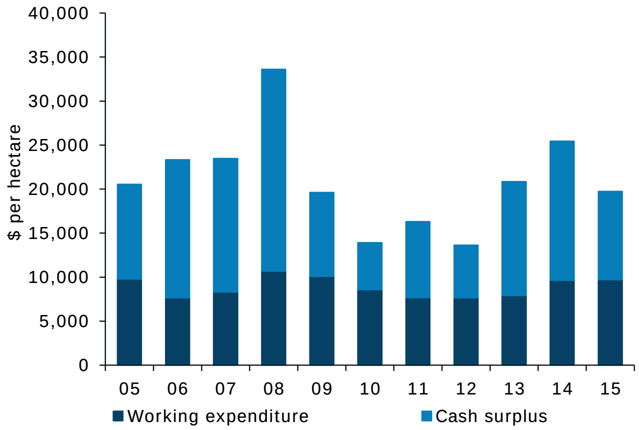
FIGURE 25. VINEYARD PROFIT BEFORE TAX



Source: ANZ, MPI

In recent years tight cost control and improved grape prices have led to three years of back-to-back returns, encouraging new investment. Sauvignon Blanc grape prices have increased to $1,600-$1,700/t over this period – a substantial lift from the 2010-2012 average of $1,200/t. However, there continues to be large variations in yields and cost pressures on labour. Labour accounts for 50-55% of an orchard's cost structure and sourcing quality labour is always a challenge. For this reason, trends towards mechanisation in vineyard tasks such as harvesting and pruning will continue.

FIGURE 26. REVENUE SPLIT FOR VINEYARDS

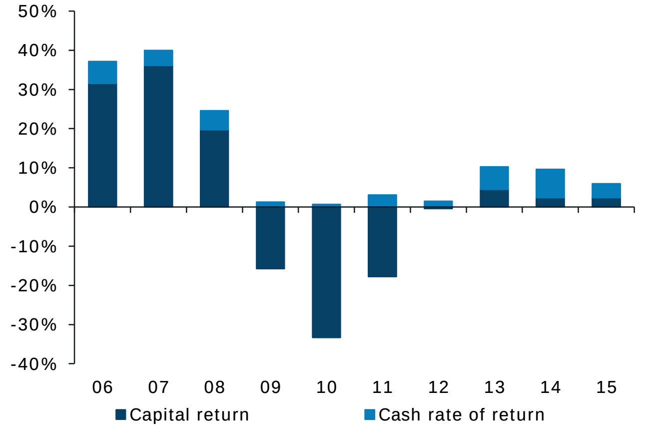


Source: ANZ, MPI

FEATURE ARTICLE: WINE INDUSTRY'S FULL BODIED GROWTH

Total returns have averaged 6.7% over the last 10 years. Of this, 3.8% has been the average cash return and 2.9% the capital return. However, this masks the volatility in capital returns that occurred with the global financial crisis and subsequent adjustment in the sector's terms of trade. The average vineyard's asset footprint more than halved from the peak in 2008 of $336,000/hectare to $154,500/hectare in the trough of 2012. The vast majority of the crunch was a drop in land and building values, which account for approximately 90% of a vineyard's asset base.

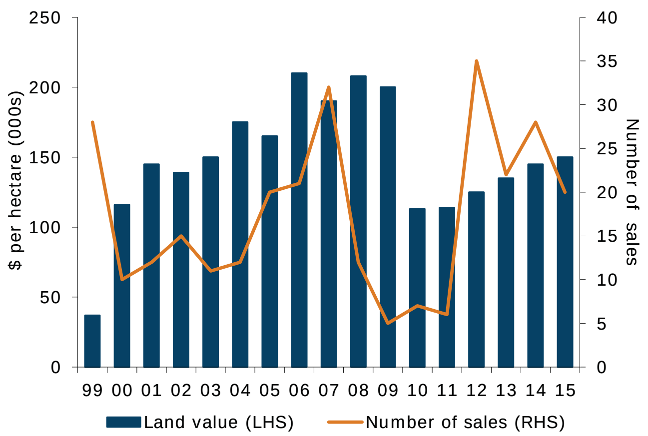
FIGURE 27. TOTAL VINEYARD RETURNS



Source: ANZ, MPI

Indeed, in Marlborough unforced sale values fell by $87,000/hectare through this period (-44%) and the total number of sales fell dramatically. Of course there is large variation even within the growing area of Marlborough. The range depends on factors such as yield history and potential, disease pressures, climatic and soil variations due to locality, irrigation, varietal and clonal mix, age and quality of infrastructure, and reputational attributes of fruit qualities.

FIGURE 28. MARLBOROUGH VINEYARD LAND MARKET



Source: ANZ, Alexander Hayward Ltd Property Advisers.

Over the last three years returns have settled into a more sustainable mix and range given inherent business/sector risks. Cash rates of return have averaged 5.6% and capital returns 3.1%. This makes for a more respectable total return of 8.7% through this period (for land use investments relative to history anyway).

In terms of alternative land uses, the wine sector's critical mass in the Marlborough region and superior returns are the main reasons Marlborough is attracting additional investment. **There is also the capital development aspect, with recent market activity suggesting a mature vineyard value ranging between 120 and 125% of cost (bareland, development costs and 'time').**

CONCLUSION

Is there further upside for New Zealand wine in coming years? The answer appears to be yes. As with many goods, fashion has a role to play and Sauvignon Blanc remains 'in' as a wine preference in established markets and is finding favour with new consumers in developed and developing markets.

On a global basis New Zealand is a small player, but continues to focus on selling a high-quality, high-margin product. Returns are currently sufficient to stimulate new investment. There is limited suitable land for further development in the likes of the Marlborough region – anecdotally, the range is 7,000 to 10,000 hectares. This implies the possibility of some future scarcity of product out of the sought after Marlborough region if market demand continues to increase as expected.

THE MONTH IN REVIEW

SUMMARY

A change in weather patterns brought some much-needed moisture in May. However, pasture cover remains low in many East Coast areas. Milk production finished 2015/16 down 1.7%, and although better than expected, a further fall of 3-5% beckons in 2016/17. The 2016 lamb crop is expected to be an all-time low due to fewer breeding ewes and a lower lambing percentage. While it was a later picking season for the main horticulture crops, they are on track to post near-record export volumes for kiwifruit, pip fruit and grapes.

MOTHER NATURE

A widespread lack of rain in April led to severe soil moisture deficits in many areas and low autumn pasture cover. The worst-affected areas were on the East Coast from Wairoa through to Otago where irrigation wasn't available (i.e. Canterbury).

In May a change in the weather pattern delivered heavy rain from the West to many places. This has led to saturated soils in Southland and the West Coast of both islands. While soil moisture conditions have also improved in many places on the East Coast, lower sunshine hours and cooler soil temperatures mean pasture cover is likely to struggle to recover to adequate levels for the winter period. This is especially the case further south with snow arriving in late May.

DAIRY

Milk production is set to finish the 2015/16 season around 1.86 billion kg MS (-1.7%). The mild autumn, combined with adequate pasture cover in the main dairy regions and solid winter crops allowed many farmers to milk through to the end of the season. This produced more milk than expected, with early autumn flows 7.5% above the three-year average.

Attention is now turning to 2016/17, where we expect a further decline in milk supply of 3-5% y/y. This forecast assumes no weather shock, which could be a big swing variable, given the industry's focus on using less brought-in supplement and more pasture and home-grown feed.

Looking at year-to-date cull cow turn-off suggests the number of cows in milk at peak will be 4% lower in 2016/17. When combined with the decrease in the season just finished, this puts cow numbers 7% below the 2014 peak. Some farming regions have also had large numbers of cows with facial eczema. Sub-clinical cases of facial eczema are not easy to identify but will result in permanent liver damage and reduce milk production. The other risk is more cows being wintered on dairy platforms to reduce grazing costs. This could increase soil damage if it's wet and reduce pasture cover in the early part of the spring. This would reduce early season production, which is difficult to recoup later on.

However, lower stocking rates don't translate one-for-one into lower production. This is due to lower performers (in terms of milk yield and disease susceptibility) being culled and the remaining cows usually being better fed, even with less use of brought-in supplement. This will provide a partial offset.

MEAT AND FIBRE

The 2016 lamb crop is highly likely to be an all-time low. The number of cull ewes continues to track ahead of industry forecasts, suggesting the number of breeding ewes will fall further in 2016/17. However, the biggest drag is likely to come from a lower lambing percentage. The two main challenges are: (1) poor tupping conditions in many of the main breeding areas and less hogget mating (due to lower weights); (2) the facial eczema outbreak in the North Island. This will see lower scanning results and a higher proportion of dry ewes. Lamb survival rates are also likely to be pressured from sub-clinical facial eczema damage rearing its head during lambing, and lighter ewe conditions due to lower pasture cover in many of the main breeding regions.

Elsewhere, beef production is tracking behind industry expectations for steer and bull. Slaughter rates are notably softer in the South Island. This is partially a function of lower on-farm stocking rates due to consecutive years of drought conditions through Northern Canterbury. In the North Island, prime cattle have been more readily available with dry conditions on the East Coast drawing numbers out prior to winter.

HORTICULTURE

The 2016 grape harvest has been deemed by many to have been the smoothest and most 'under control' for many years. This is especially noteworthy in context of most regions harvesting high fruit volumes. **For wine, industry expectations are for a vintage around 440,000 tonnes, which will place it on par with the all-time record from 2014.**

It was a late pipfruit harvest, but exports are well ahead of normal, supported by strong demand from Asia. The export crop is on track to register 351,000 MT (+5% y/y), which, if achieved, will be the second-largest export volume ever (behind 2004).

The 2016 kiwifruit crop will also hit new highs. The picking season started late but the Gold harvest is complete with the final crop expected to be around 45 million trays. The Green harvest is in full swing and will be completed in June. The total green crop (including organic and sweet) is expected to be between 88 to 91 million trays. Some crop management of poorer-tasting fruit is expected to manage in-market pricing and maintain Zespri's brand and reputation for high-quality fruit.

RURAL PROPERTY MARKET

SUMMARY

While the fall in dairy property prices is the main talking point (down approximately 15% since 2014/15), the adjustment needs to be kept in context. The fall has been from an all-time peak and recoil typically follows a boom. That said, turnover has dropped substantially, indicating buyers are wary and vendors still have high expectations. The key theme moving forward is how long the milk payout stays below breakeven and how this manifests into lending criteria, buyer confidence and 'distressed' property sales. With cashflow pressures set to extend into a second year, property prices will face more pressure from all three dynamics in the spring sales period.

Outside of dairy it's a different story. It's telling that the REINZ's all-farm measure of property prices has held steady in 2015/16 versus the year before, despite the dairy farm measure being back 15% y/y. Record-low interest rates, a continued focus on cost efficiencies and productivity initiatives, steady-to-strong earnings (depending on sector) and spillover from the housing/lifestyle market are all supporting rural land prices.

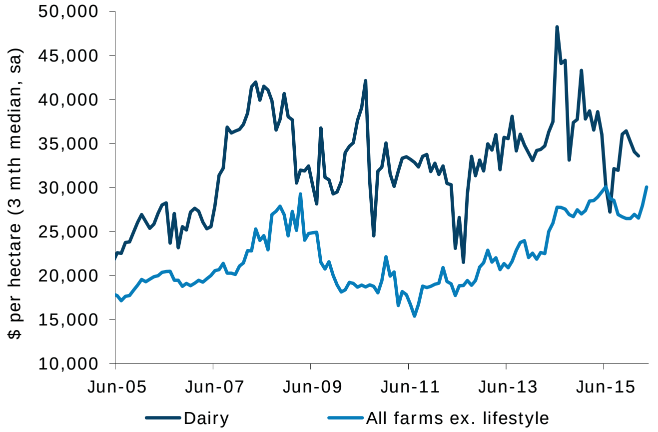
Turnover of rural properties has dropped to a three and a half year low. This indicates a stand-off between buyer and vendor expectations. Sales of dairy-aligned properties have experienced the sharpest fall, but grazing property sales have also declined in recent months. The fall in the number of sales perhaps reflects more challenging climatic conditions in some regions recently and softer sheepmeat and dairy support income. In contrast, horticulture, finishing and arable property turnover has held up. The Bay of Plenty has accounted for the majority of the horticulture sales, indicating most of the sales are kiwifruit orchards. For arable property, the majority of sales have been around Auckland indicating potential future development for commercial buildings or housing is likely to be playing a role.

On the price side, the REINZ all-farm measure increased to $30,100/ha in April. However, the composition of sales can influence the all-farm measure. This seems to be the main reason the last two months has seen a break out of the recent range of $26,000-$27,000/ha.

FARM SALES BY FARM TYPE

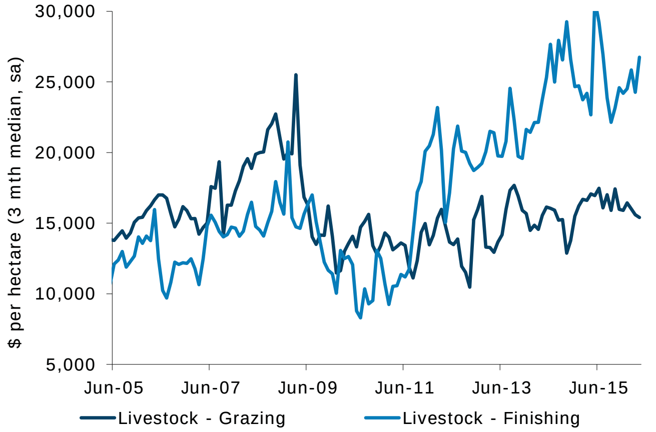
3-Month Seasonally Adjusted		Current Period	Previous Period	Last Year	10-Year Average	Chg. P/P	Chg. Y/Y	Chg. P/10yr
Dairy	Number of Sales	38	37	70	64	↑	↓	↓
	Median Price ($ per ha)	33,600	34,000	38,700	33,100	↓	↓	↑
Livestock – Finishing	Number of Sales	70	68	68	67	↑	↑	↑
	Median Price ($ per ha)	26,700	24,300	22,700	17,400	↑	↑	↑
Livestock – Grazing	Number of Sales	140	175	179	195	↓	↓	↓
	Median Price ($ per ha)	15,400	15,600	17,000	15,700	↓	↓	↓
Horticulture	Number of Sales	70	73	69	43	↓	↑	↑
	Median Price ($ per ha)	218,700	242,800	242,400	158,400	↓	↓	↑
Arable	Number of Sales	35	40	34	21	↓	↑	↑
	Median Price ($ per ha)	66,900	50,100	43,700	31,500	↑	↑	↑
All Farms ex. Lifestyle	Number of Sales	368	394	435	421	↓	↓	↓
	Median Price ($ per ha)	30,100	27,900	28,900	22,200	↑	↑	↑
Lifestyle	Number of Sales	2,244	2,223	1,835	1,540	↑	↑	↑
	Median Price	554,000	545,000	545,000	467,000	↑	↑	↑

FIGURE 1. FARM SALES, MEDIAN PRICE



Source: ANZ, REINZ

FIGURE 2. FARM SALES, MEDIAN PRICE

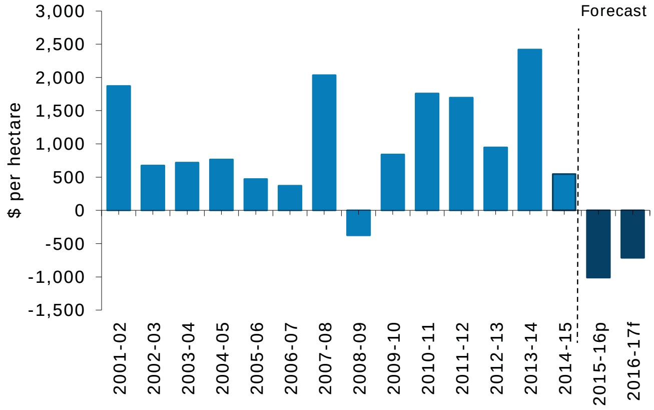


Source: ANZ, REINZ

RURAL PROPERTY MARKET

The key themes going forward are how long the milk payout stays below breakeven and how this manifests itself in tighter lending criteria, buyer confidence and 'distressed' property sales. With cashflow pressures set to extend into a second year, property prices will likely face more pressure from all three dynamics in the spring sales period. Indeed, the current downturn is shaping up as one of the longest and deepest dairy farmers have faced.

FIGURE 3. AVERAGE DAIRY FARM PROFITABILITY BEFORE TAX



Source: ANZ, Dairy NZ

The average-sized dairy farm looks to have lost around $1.00/kg MS in 2015/16. Given where the opening advance schedule from dairy companies has been pitched, **at this point a further loss of $0.60-$0.70/kg MS beckons in 2016/17.** Of course there are many moving parts, and changes in farm systems and farmers digging in on costs could well further close the gap to breakeven.

Accumulated losses and an equity squeeze (from cash losses and lower cow and land values) **are the financial metrics that matter. But it's how these spill over into the 'intangible' factors, such as buyer and lender confidence, that will influence property prices in the spring period.** The decline in the number of dairy farm sales to around half the 10-year average highlights that a gap has emerged in price expectations between buyers and vendors recently. Buyers have obviously become more circumspect on the speed and extent of the recovery in farm-gate prices since the start of the year, whereas sellers are holding on in hope of an upswing. We're in the camp that a recovery is coming, but it'll be glacial, which means continued pressure on cash-flow for a while yet.

Weakened financial performance is spilling over into a tightening of bank lending standards. Indeed, the latest RBNZ survey of credit conditions noted 'both price and non-price lending standards for the rural sector have continued to tighten', adding that banks report they are stringently enforcing current lending standards and fewer policy exemptions are being allowed as a result. The survey also noted that 'many of the banks have now lowered their long-run dairy payout assumption' and concluded that 'this can be viewed as a de facto tightening in lending standards'.

This tightening in lending standards reduces the access to capital to purchase property (especially at high prices), **but will also increase the number of stressed situations and sales down the track.** This is highlighted by the proportion of 'watchlist' lending in the dairy sector increasing to 8% in recent months. This is a key lead variable for 'impaired' lending, especially with cashflow pressures set to extend into 2017.

Looking at the backward-looking indicators shows dairy turnover is now running around 50-60% of the 10-year average. Average prices are back 15% on the same period last year. Anecdotally there is still good demand and prices being paid for quality properties. However, lower-quality properties are often struggling to find buyers. A lot of smaller parcels of land are still being bought by neighbours. For larger/stand-alone operations, buyers include foreign investors, wealthy family businesses, and Māori and other corporate enterprises.

In the month of March, 21 dairy farms were sold at an average sale value of $37,000/ha, or $35/kg MS. The average farm size was 124 hectares and the average production/ha was 912/kg MS. In April, 18 dairy farms were sold with an average sale price of $33,100/ha, or $32.5/kg MS. The average farm size was 128 hectares and production/ha was 834/kg MS.

Year-to-date finishing property prices in 2015/16 are back 3% on the same period last year. Overall turnover has increased due to a strong sales period in late 2015. **Arable property prices have rebounded from late 2015.** However, most of it looks compositional, with higher sales volumes in Auckland recently. Outside of lifestyle and urban areas, prices are expected to be under some pressure given lower domestic grain prices and dairy support revenues.

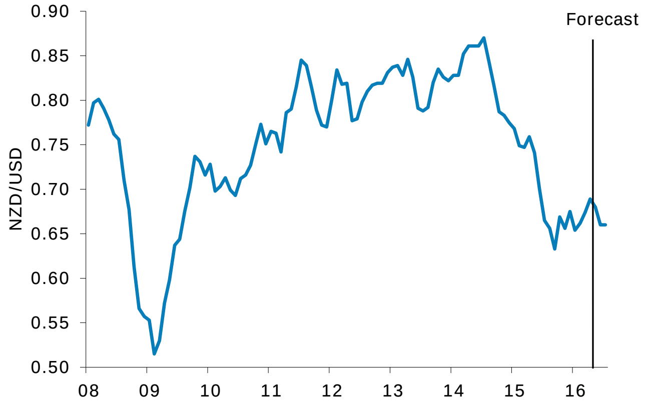
Grazing property prices have dropped back close to the 10-year average of $15,000-$16,000/ha, but year-to-date are up 5%. Monthly turnover has dropped below the 10-year average recently. It is likely that the fall in the number of sales reflects more challenging climatic conditions in some key regions recently and softer sheepmeat and dairy support income.

Turnover of horticultural property businesses has remained near recent highs. Much of the activity has been driven by kiwifruit orchard sales in the Bay of Plenty. Green kiwifruit orchard prices are trading at $400,000/ca ha (with crop) and gold kiwifruit $600,000-$700,000/ca ha with crop and well-located land. Convertible bare land has been selling for between $80,000-$100,000/ca ha.

ECONOMIC INDICATORS

EXCHANGE RATES	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
NZD/USD	0.680	0.675	0.741	↑	↓
NZD/EUR	0.601	0.604	0.663	↓	↓
NZD/GBP	0.468	0.472	0.479	↓	↓
NZD/AUD	0.930	0.909	0.937	↑	↓
NZD/JPY	74.06	75.87	89.28	↓	↓
NZD/TWI	71.31	71.80	75.70	↓	↓

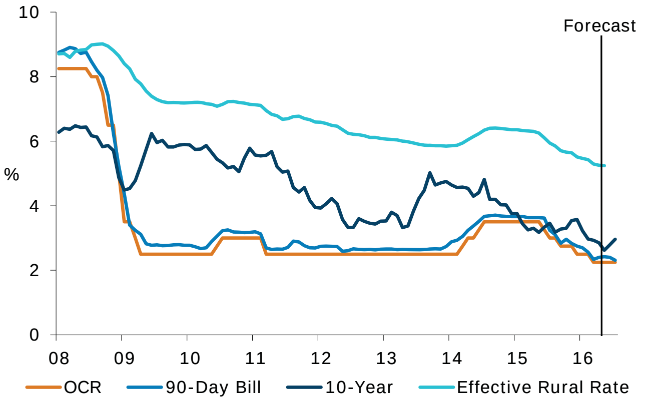
NZD BUYS USD



Source: ANZ, Bloomberg

NZ INTEREST RATES	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
Official Cash Rate	2.25	2.33	3.50	↓	↓
90 Day Bill Rate	2.40	2.43	3.63	↓	↓
2 yr	2.07	2.09	3.26	↓	↓
3 yr	2.12	2.15	3.14	↓	↓
5 yr	2.25	2.33	3.20	↓	↓
10 yr	2.85	2.92	3.30	↓	↓
Effective Rural Rate	5.24	5.33	6.25	↓	↓
Agricultural Debt ($b)	59.42	59.12	55.41	↑	↑

KEY INTEREST RATES



Source: ANZ, RBNZ

The wider NZ economy remains resilient despite stress in the dairy sector. GDP growth is solid and housing is booming, adding impetus to domestic demand. In a world of relatively low growth – and downgraded global growth forecasts – New Zealand's domestic story stands out. When you add favourable yield differentials it is unsurprising that the NZD remains solid.

However, there are risks attached to this solid outlook, and they tend to be skewed to the downside – hence the RBNZ's easing bias. Chief amongst these are the risk of stress in the dairy sector seeping into wider economic activity, and offshore, the potential for lower global growth to derail the Chinese economic story. However, markets will probably not express this risk unless NZ's domestic data were to actually soften, or global growth concerns become a full-blown risk-off event.

Other key currency themes for NZD bilaterals are:

- NZD/USD: Markets appear reticent to lead the Fed, having been disappointed several times in the past. We still see the Fed hiking this year, which should add support to the USD. With that we anticipate another leg lower for NZD/USD in the second half of 2016.
- NZD/AUD: We expect NZD/AUD will remain above historical averages. New Zealand looks firmer in the economic stakes and there is a 50bps yield differential between the two central banks.
- NZD/GBP: Brexit is the defining question for NZD/GBP. Given we believe the June 23 vote will be to stay in the EU, exporters will likely see better levels in the second half of 2016, but it's risky to be unhedged for such a pivotal event – especially one subject to the vagaries of public opinion.

With the economy caught between housing strength and dairy challenges, the outlook for monetary policy (OCR) is not clear cut.

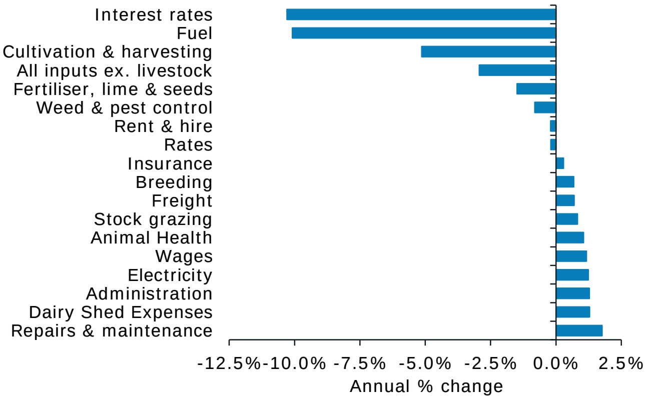
On balance we expect the RBNZ to cut the OCR further in 2016. We expect the combination of a weakening global scene and high NZD to dominate. Some sort of prudential policy response towards housing seems likely, which would give scope for the OCR to fall.

With the US Federal Reserve set to deliver hikes in the coming 12 months, our bias is for yield curves to steepen and NZ/US spreads to narrow as US long-end yields move higher. Of late, however, flattening pressure has been dominant as markets gravitate to the 'lower for longer' Fed view. The interest rate convergence theme remains in play for longer-term rates, having been further underscored by easy global monetary policy settings and NZD divergence from fundamentals.

ECONOMIC INDICATORS

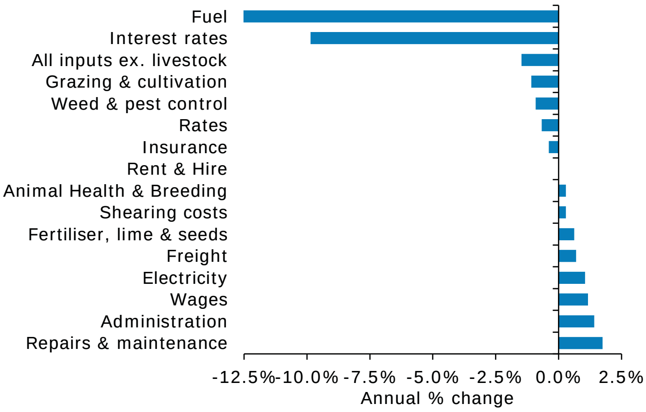
INFLATION GAUGES					
Annual % change	**Current Qtr**	**Last Qtr**	**Last Year**	**Chg. Q/Q**	**Chg. Y/Y**
Consumer Price Index	0.4	0.1	0.3	↑	↑
Farm Input	0.3	-0.7	-0.2	↑	↑
Net Imp. Margins PPI	-3.9	-4.2	-17.1	↑	↑

FARM EXPENSES MOVEMENT 2015/16 – DAIRY



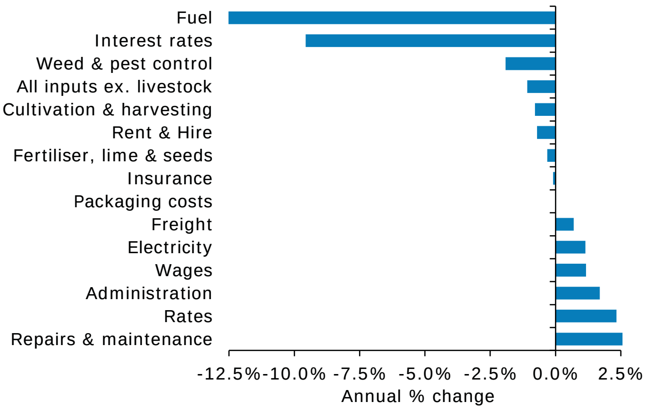
Source: ANZ, Statistics NZ

FARM EXPENSES MOVEMENT 2015/16 – SHEEP & BEEF



Source: ANZ, Statistics NZ

FARM EXPENSES MOVEMENT 2015/16 – HORTICULTURE & FRUIT GROWERS



Source: ANZ, Statistics NZ

The deflationary impacts of lower dairy prices and broad-based weakness in global commodity prices have shown up in the cost of farm inputs in 2015/16.

The cost of inputs for a dairy farm fell 2.9% in 2015/16. This is the largest fall we have on record back to 2000/01. The fall has been led by some of the largest expenditure categories too. Interest rates and fuel led the decline, both back around 10%, but prices were also softer for cultivation, harvest, and purchase of animal feed (-5.1%); fertiliser, lime & seeds (-1.5%); weed & pest control (-0.8%); rent & hire (-0.2%) and rates (-0.2%). In total these cost categories account for around 60% of total farm expenditure on the average dairy farm. Annual wage increases, at 1.2%, were also the second lowest in 16 years. Only 2009/10 was lower (0.9%) following the aftermath of the GFC. **These adjustments (alongside other cuts in expenditure and farm management changes for leaner times) are helping adjust the cost base for both individuals and the broader sector.**

While there will be a rebound for some expense lines (eg. oil prices are in reverse), we suspect there will be more input cost deflation to come in 2016/17. Grazing prices have only been re-rated in recent months, the general feed/grain market remains oversupplied, many service providers are now feeling a more significant pinch and offering 'specials', and fertiliser prices are still under downward pressure. The absence of strong inflationary pressures in the local economy and globally will also lend a hand.

Similar dynamics have spilled over into the other sectors too. The impact hasn't been quite as great, but meat & fibre farmers' input costs fell 1.5%, cropping costs were back 1.4% and horticulture and fruit growers input costs were down 1.1%.

For meat & fibre farmers, this was the first fall in input costs in the last 16 years. The major falls were for fuel (-12.7%) and interest rates (-9.9%), but grazing & cultivation (-1.1%), weed & pest control (-0.9%), rates (-0.7%) and insurance costs (-0.4%) all fell. In total these cost categories account for around 30% of total farm expenditure on an average-sized farm.

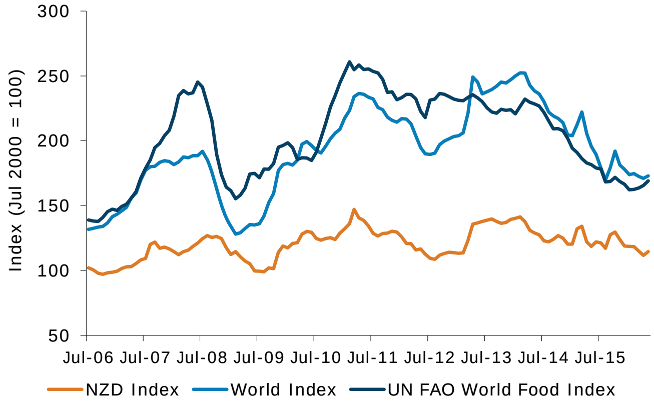
For horticulture and fruit growers it was the largest fall in input costs over the last 16 years. Again the falls were concentrated in similar categories to livestock producers. The main difference was rates, which increased 2.3%. This is likely to reflect increasing land values for most major crops and proximity to lifestyle blocks and urban areas experiencing asset price inflation.

Repairs & maintenance showed the largest cost increase across all the sectors. This likely reflects less capital expenditure, especially from the dairy sector, and more R&M to keep things ticking over.

KEY COMMODITIES: OVERALL INDEX AND DAIRY

SOFT COMMODITY PRICE INDICES	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
ANZ NZD Index	114	115	119	↓	↓
ANZ World Index	173	173	196	↔	↓
FAO World Food Index	169	164	182	↑	↓

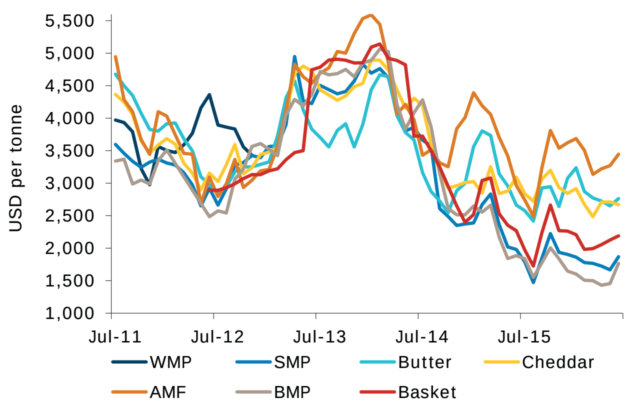
SOFT COMMODITY PRICE INDEXES



Source: ANZ, FAO

OCEANIA DAIRY PRICE INDICATORS USD per tonne	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
Milk Price YTD ($ per MS)	3.90	3.92	4.40	↓	↓
Milk Price Forecast ($ per MS)	4.75-5.00	NA	5.25	NA	↓
Whole Milk Powder	2,205	2,090	2,318	↑	↓
Skim Milk Powder	1,867	1,719	1,980	↑	↓
Butter	2,762	2,715	2,663	↑	↑
Anhydrous Milk Fat	3,444	3,208	2,963	↑	↑
Butter Milk Powder	1,765	1,461	1,885	↑	↓
Cheese	2,669	2,634	3,092	↑	↓

DAIRY PRODUCTS – NZ EXPORT MARKET PRICES



Source: ANZ, GlobalDairyTrade

Global and New Zealand soft commodity prices appear to have found a base, though they remain well below levels prevailing the prior year. There are generally solid output prospects, and combined with abundant stocks, this should keep supplies and prices fairly stable over the second half of 2016.

The potential for upside will depend largely on the weather over the second half of 2016. Markets have started to price in more of a global weather risk premium for grains recently. Notable developments have been a rally in corn, soybean and sugar prices. There is nervousness in the US over what La Niña conditions could mean for US corn-growing conditions during the key summer/autumn period. Drought in Brazil has also taken a toll on the safrina corn crop, forcing Brazil to import corn. Floods in Argentina have reportedly caused significant losses to the soybean crop there, leading analysts to reduce output potential. Sugar prices have increased further on the back of reduced Indian output from dry conditions associated with El Niño. So despite abundant stocks in many cases, growing conditions during the key seasonal periods in the big producing countries provide upside risks for prices over the second half of 2016.

The opening milk price forecasts from dairy companies have ranged from $4.20 to $4.95/kg MS (excluding Tatua). We are more inclined toward the high-$4s/kg MS, but the upcoming July/August period when higher seasonal volumes will be auctioned is critical. If prices can hold steady in the face of higher seasonal supply this will be a good sign that further recovery is more likely later in the season.

Compared with 2015/16, a 5c lower NZD/USD currency assumption adds around $0.50/kg MS and the rest comes from an assumed modest improvement in whole milk powder prices. The latter is based on lower Australasian supply (fewer cows and other farm management changes), lower inventory levels, higher oil prices (further improvement is expected yet) improving the purchasing power of oil-dependent countries, and steady import demand elsewhere. The main areas of nervousness are Chinese demand (with low participation at recent auctions) and suggestions of high onshore inventory levels again.

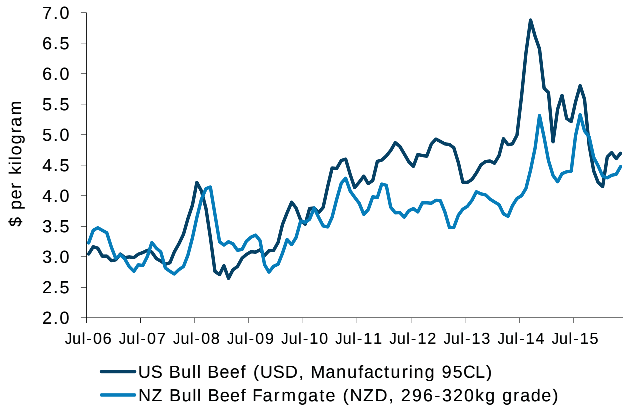
The other area of support is further reductions in farm-gate prices in the Northern Hemisphere. This is starting to squeeze margins and slow milk supply, especially in parts of Europe. In time this will help adjust supply and prices. However, for the likes of skim milk powder there are high inventory levels that need to be cleared first. In Europe, skim milk powder in intervention has hit its already-raised ceiling of 218,000 MT and there are proposals to increase it further to 350,000 MT. This amount of product, if stored, would equate to 85% of New Zealand's annual SMP exports. This is expected to hang over the market for some time and provide a cap on the extent to which WMP prices can improve, due to manufacturing flexibilities and buyer substitution.

KEY COMMODITIES: BEEF AND LAMB

BEEF PRICE INDICATORS					
$ per kg	**Current Month**	**3 Mth Trend**	**Last Year**	**Chg. M / 3M**	**Chg. Y / Y**
NZ Bull Beef[1]	4.48	4.33	4.39	↑	↑
NZ Steer[1]	4.85	4.77	4.61	↑	↑
NZ Heifer[1]	4.28	4.20	4.04	↑	↑
NZ Cow[1]	3.17	3.03	3.06	↑	↑
US Bull Beef[2]	4.70	4.65	5.27	↑	↓
US Manu Cow[3]	4.31	4.25	4.78	↑	↓
Steer Primal Cuts	7.58	7.54	8.30	↑	↓
Hides[4]	60.2	59.4	65.9	↑	↓
By-Products[4]	43.9	44.0	51.6	↓	↓

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

BEEF INDICATOR PRICES

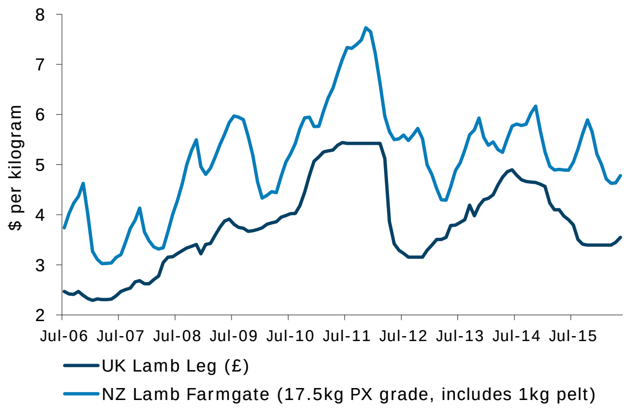


Source: ANZ, Agrifax

LAMB PRICE INDICATORS					
$ per kg	**Current Month**	**3 Mth Trend**	**Last Year**	**Chg. M / 3M**	**Chg. Y / Y**
NZ Lamb[1] (NZD)	4.78	4.66	4.89	↑	↓
UK Lamb Leg (£)	3.55	3.41	3.97	↑	↓
Rack US (USD)	14.5	14.3	15.4	↑	↓
Flaps (USD)	3.54	3.55	4.47	↓	↓
Skins[2]	4.14	3.83	2.55	↑	↑

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

LAMB INDICATOR PRICES



Source: ANZ, Agrifax

The short-term outlook for beef remains solid, but beyond the early summer period things are a little less clear. In the US, many factors, from beef imports through to foodservice sales, the price of competing proteins, US beef production and its mix, and the weather during key sale periods and general economic conditions can all influence prices.

Year-to-date US beef imports are back nearly 13%. The decline has been led by lower Australasian and South American imports, offset by some improvement from Canada and Mexico. This, combined with solid sales, has driven inventories of boneless beef lower (-7% y/y) supporting in-market prices around the 5-year average.

Some of the gap has been filled by higher domestic supply as production has lifted, with more feeder cattle coming through from herd rebuilding in recent years. This is seeing some alternate cuts (rounds and chuck) making their way to the grinder as the supply of US manufacturing beef (cull dairy and beef cows) remains low. Favourable US pasture conditions continue to encourage the retention of beef heifers and cows. A turnaround in these conditions, or high dairy culls due to lower milk prices, need to be watched as future risks.

The other piece of the puzzle is foodservice demand, which is more muddled. This is illustrated by the restaurant performance index oscillating significantly in recent months. On the positive side, real disposable income has picked up over the last six months, which supports dining out and meat consumption. The offset is that consumer sentiment and employment trends have slipped a little. However, overall foodservice demand continues to show expansion and this will be crucial to supporting end-demand and prices in the face of expanding meat supplies (both beef and other protein).

The sheepmeat market is very much focused on tightening New Zealand supply. This is seeing a lift in frozen prices across China, the UK and Europe. Some of the more troublesome cuts, such as flaps and forequarters, have started to show improvement, driven by better Chinese demand. Chinese inventory levels have reportedly moderated, indicating the main winter consumption period was solid. Price tension across the major markets is only expected to continue to increase as supply tightens further. If Britain exits the EU this could weigh on prices due to both weaker consumption and the currency (lower GBP).

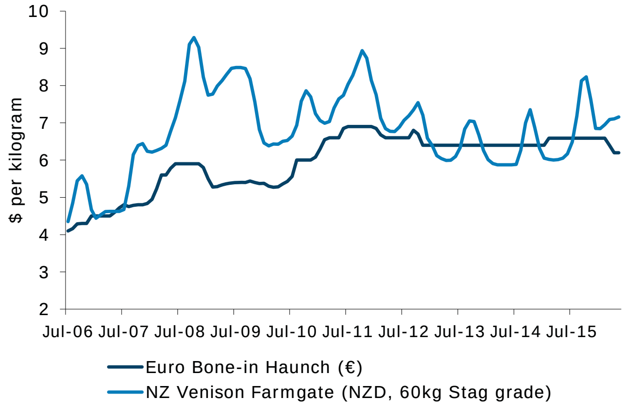
The potential tightening in New Zealand supply to come over the next 12 months suggests there is further upside for schedule prices. Winter contract rates look to be around the high-$5/kg. New season prices seem likely to reach the low-mid $6/kg if this is the case and the 2016 lamb crop is an all-time low as we expect.

KEY COMMODITIES: VENISON AND WOOL

VENISON PRICE INDICATORS					
$ per kg	**Current Month**	**3 Mth Trend**	**Last Year**	**Chg. M/3M**	**Chg. Y/Y**
NZ Stag[1]	7.16	7.05	6.05	↑	↑
NZ Hind[1]	7.06	6.95	5.95	↑	↑
Euro Bone-in Haunch (€)	6.20	6.40	6.59	↓	↓
Boneless Shoulder (€)	4.94	4.93	4.90	↑	↑
Loin (€)	19.0	17.5	16.0	↑	↑

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

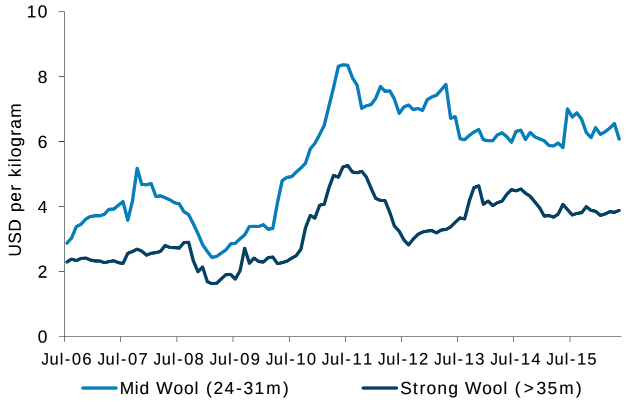
VENISON INDICATOR PRICES



Source: ANZ, Agrifax

CLEAN WOOL INDICATOR PRICES					
$ per kg	**Current Month**	**3 Mth Trend**	**Last Year**	**Chg. M/3M**	**Chg. Y/Y**
NZ Mid Wool (24-31m)	8.94	9.52	7.85	↓	↑
NZ Strong Wool (>32m)	5.71	5.65	5.49	↑	↑
USD Mid Wool (24-31m)	6.08	6.43	5.82	↓	↑
USD Strong Wool (>32m)	3.88	3.81	4.07	↑	↓

WOOL INDICATOR PRICES (CLEAN)



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

A lower NZD/EUR (though up of late) and a fall in production have lifted farm-gate prices by 18-20% y/y. Year-to-date venison production has fallen 20% on the same period last year, driven by lower weaner numbers in recent years and herd rebuilding. Hind turn-off has dropped 25%, with weakness particularly notable in the South Island. Improved velvet and venison returns (and farmers seeking alternatives given the fall in revenue from sheepmeat and dairy support activities) are driving increased retention.

Looking forward, tight supply is expected to underpin prices in the upcoming chilled season. Last year's weaner numbers were back a further 6%, indicating the number of stags available will be lower again. **Combined with the retention of hinds, a lower NZD/EUR (on average over the season), and steady offshore demand in Europe and North America, this could push schedule prices toward the mid-$9/kg level in October.**

The one area of risk is the widening gap between venison and competing meat protein prices. This will require more promotional activity to ensure restaurateurs retain venison on their menus.

Velvet prices finished the season at similar levels ($120/kg) to the year before. There was some in-market price pressure with increased New Zealand supply, a softer Chinese economy and food companies who use it in health products looking to recoup lost margins. However, this was offset by the lower NZD/USD.

Wool supply and Chinese demand are in focus as we enter the seasonal lull for sales. Chinese demand has been softer recently due to high inventories. However, downward price pressure has been limited by lower supply and stronger interest from other destinations such as the UK, Italy and France.

Overall wool auction volumes (-5%) and exports (-9%) are both back on last year, highlighting the decline in sheep numbers. However, recent auction supply has been even weaker than expected, down 16% in May. Combined with the usual seasonal lull in auction supply this creates some potential for upward movement in prices, especially if China were to return to the market as stocks clear.

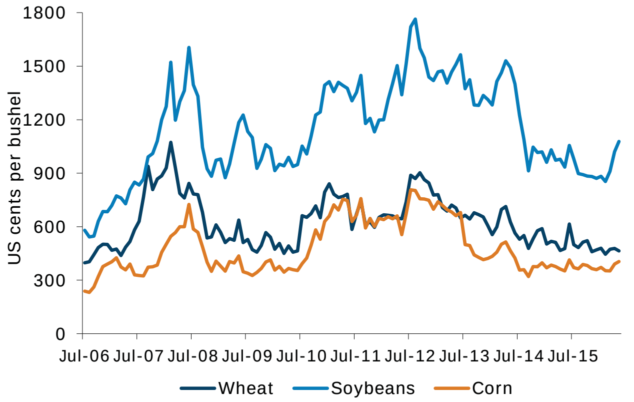
Fine micron wool remains in demand too. This is highlighted by a wider-than-usual price gap between South Island and North Island auction results recently, with the South Island auctions having a higher proportion of finer bred wool.

KEY COMMODITIES: GRAINS

GRAIN & OILSEED PRICE INDICATORS	Current Month	3 Mth Trend	Last Year	Chg. M / 3M	Chg. Y / Y
NZ Milling Wheat[1]	345	348	412	↓	↓
NZ Feed Wheat[1]	287	302	370	↓	↓
NZ Feed Barley[1]	267	288	359	↓	↓
Palm Kernel Expeller[1]	226	218	223	↑	↑
US Wheat[2]	4.65	4.66	4.77	↓	↓
US Soybeans[2]	10.79	9.28	9.34	↑	↑
US Corn[2]	4.05	3.65	3.52	↑	↑
Australian Hard Wheat[1]	319	341	392	↓	↓

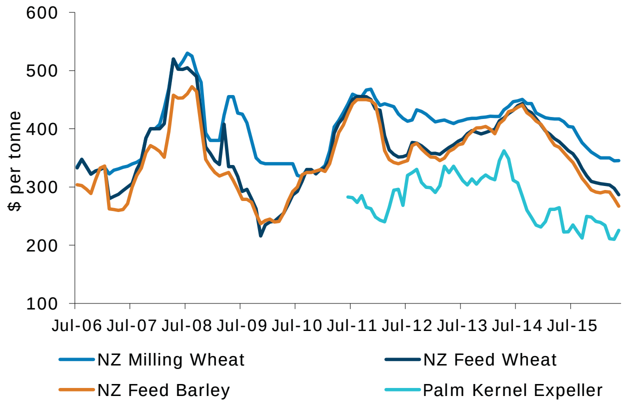
[1] NZD per tonne
[2] USD per bushel

CBOT FUTURE GRAIN & OILSEED INDICATOR PRICES



Source: ANZ, Bloomberg

KEY NZ GRAIN PRICES



Source: ANZ, Agrifax

Trading activity for domestic feed grain remains subdued, with a stand-off between buyers and sellers. Most growers are unwilling to sell at prices that are almost as low as the post-GFC period. They appear to be prepared to wait until either prices rise, or they are forced to sell before the next harvest arrives. Most buyers of feed grain are waiting to see what happens through the winter and into spring before making any commitments. Weather and pasture conditions in the spring/early summer period are therefore likely to dictate where the bottom is. **The other dynamic that could provide price support for domestic grain is higher palm kernel and international feed prices.**

The palm kernel market is perhaps the most interesting at present. Ongoing drought in South-east Asia is impacting on production, which usually starts to seasonally increase at this time of the year. This had prompted importers to get in early, but the latest trade figures for April showed a substantial fall (-85% m/m) with no imports from Malaysia. Overall calendar year-to-date imports are back 15% on the same period last year.

The other development is more offshore competition. Russia has recently increased its palm kernel imports – probably due to the expansion of its domestic livestock industry. This could potentially change long-term dynamics; the only buyers previously have been Europe and New Zealand. So despite limited demand in New Zealand, tighter offshore supply and more competition has seen prices lift somewhat.

The other area of focus is supply conditions for corn and soybeans in North and South America. Price for both have spiked higher recently on weather concerns. Whether these gains can be held on to will depend on US weather developments over coming months. US corn planting has reportedly gone well with an expanded area planted. However, there is nervousness over what La Niña conditions could mean for growing conditions during the key summer/ autumn period.

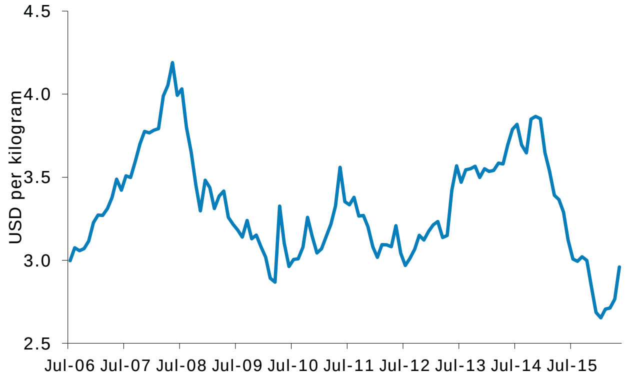
The market's larger focus at present is the impact of drought on Brazilian yields and low beginning stocks from record export sales last year. This is expected to increase export demand for other suppliers, such as the US and Argentina, reducing global stocks. Floods in Argentina have also reportedly caused significant losses to the soybean crop there, leading analysts to reduce estimates of output potential. China's recent import demand has picked up too. So despite abundant global stocks in many cases the run of good growing conditions in some of the big producing and exporting countries looks to be coming to an end, providing potential upside over the second half of 2016.

KEY COMMODITIES: HORTICULTURE

HORTICULTURE PRICE INDICATORS	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
Kiwifruit (USD per kg)	3.0	2.7	3.3	↑	↓
Apples (Weighted Index)	254	244	229	↑	↑
Average Wine Price[1]	5.52	5.00	5.51	↑	↑
Packaged White Wine[1]	5.66	5.53	5.68	↑	↓
Packaged Red Wine[1]	8.87	8.48	9.70	↑	↓
Bulk wine[1]	3.00	3.08	2.99	↓	↑

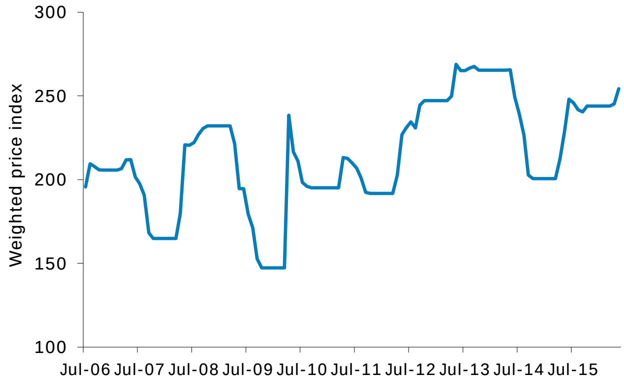
[1] USD per litre

GREEN KIWIFRUIT INDICATOR PRICE



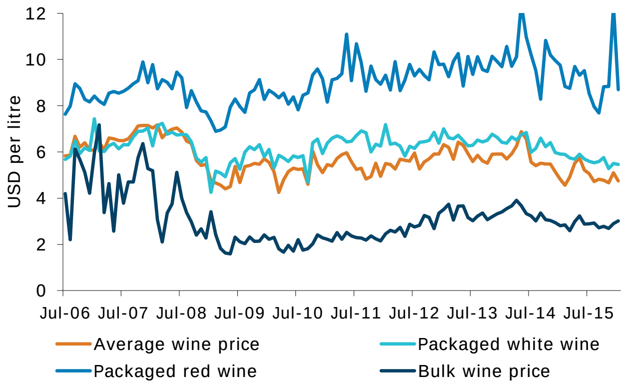
Source: ANZ, Zentrale Markt- und Preisberichtstelle

APPLE INDICATOR PRICE INDEX



Source: ANZ, Zentrale Markt- und Preisberichtstelle

WINE INDICATOR PRICES



Source: ANZ, NZ Winegrowers

The 2016 vintage grape harvest has been deemed by most growers to have been perhaps the smoothest and most 'under control' for many years. This is especially noteworthy in the context of most regions harvesting high fruit volumes. Fruit quality reflects some real effort regards crop load, canopy and disease management – in the main with excellent results.

Industry expectations are for a vintage around 440,000 tonnes, which will place it on par with the all-time record from 2014. This is not expected to pose any supply imbalance issues. While there has been an element of industry chat regards secondary market wine trade pricing (bulk) dropping, there is no firm evidence of that to date.

It was a late pipfruit harvest, but exports are well ahead of normal with strong demand from Asia. At the end of May, 62% of the expected crop had been shipped. This is the highest proportion of sales for this time of year in the last 10 years. Of the product shipped, Asia has taken 41%, Europe 23%, North America 15%, UK 11% and the Middle East 6%.

The average export price achieved so far is up 15% y/y too. As we highlighted in the December 2015 Agri Focus, the industry's focus on producing apples with eating qualities more suited to the Asian palate; an ability to deliver consistently superior quality; exclusivity of 'club' varieties that now make up a third of supply; brand presence; and proximity to Asian markets (freight advantage) are all delivering significant price premiums.

The 2016 kiwifruit crop will also hit new highs. The picking season started late but the Gold harvest is complete with the final crop expected to be around 45 million trays. The Green harvest is in full swing and will be completed in June. The total green crop (including organic and sweet) is expected to be between 88 to 91 million trays. Some crop management of poorer-tasting fruit is expected to manage in-market pricing and maintain Zespri's brand and reputation for high-quality fruit.

Zespri have announced they are looking to maintain green returns at $5.00/tray and gave a forecasted range of $4.20 to $5.20/tray for the 2016/17 season. For Gold, early modelling suggests per tray returns in 2016/17 should be somewhere in the range of $7.70 to $8.80, depending on seasonal factors such as volume, taste and market conditions. Over the long term, they are targeting a per tray return of between $8.00-$9.00. The anticipated doubling of volume this season will provide a good guide for whether or not this is achievable.

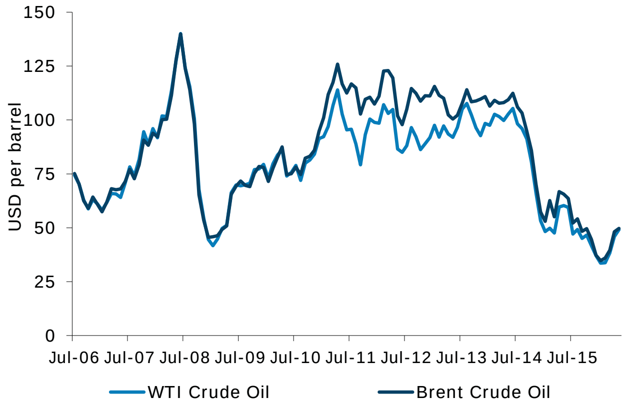
KEY COMMODITIES: OIL, FREIGHT AND FERTILISER

OTHER COST INDICATORS					
	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
WTI Oil[1]	49	39	60	↑	↓
Brent Oil[1]	50	41	66	↑	↓
Ocean Freight[2]	612	487	589	↑	↑

[1] USD per barrel, grade WTI

[2] Baltic Dry Index

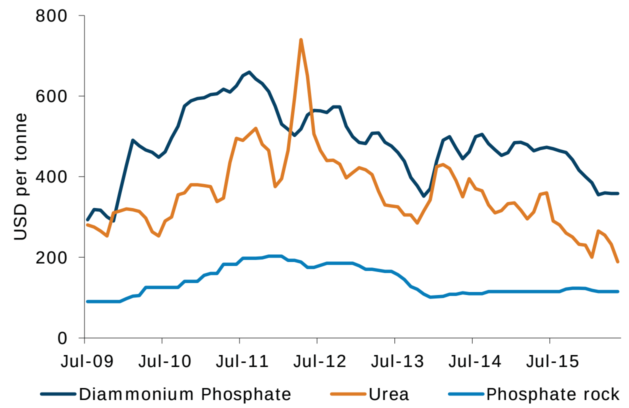
CRUDE OIL INDICATOR PRICES



Source: ANZ, Bloomberg

FERTILISER PRICE INDICATORS					
USD per tonne	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
DAP (USD)	358	358	470	↑	↓
Urea (USD)	189	251	356	↓	↓
Phosphate Rock (USD)	115	115	115	↔	↔
Farm-gate DAP (NZD)	840	840	818	↔	↑
Farm-gate Urea (NZD)	496	502	590	↓	↓
Farm-gate Super phosphate (NZD)	330	330	316	↔	↑

INDICATIVE INTERNATIONAL FERTILISER PRICES



Source: ANZ, Bloomberg

Oil prices have continued to recover, driven by supply-side issues and stronger gasoline demand in the US.

Supply disruptions and financial pressure across multiple suppliers have started to take a toll. We calculate that nearly 2.5mb/d of supply has been shut down or suspended since the start of the year. Most of this has occurred recently and indications are the disruptions are not only likely to remain in place, but intensify in the short term.

Notable recent developments include Shell withdrawing crews from Nigeria after further attacks on its oil pipelines. This has cut Nigeria's output to only 1.3mb/d. Security in Libya is an issue presently too, reducing supply. In Venezuela, both Halliburton and Schlumberger have curbed activity due to lack of payment for services. Venezuela was exporting around 2.4mb/d at the end of 2015. This had fallen to 2.15mb/d in April. However, we suspect the nation's recent issues could see this fall below 2.0mb/d in May. In Canada, wildfires closed oil sand operations in the North of Alberta.

Increasing financial stress on North American producers will likely increase the downward pressure on oil production over the second half of 2016. Signs of this are already emerging. Consensus forecasts for North American Independent exploration and product companies shows oil production should fall by around 500kb/d in 2016, compared with the previous year. This is in stark contrast to consensus forecasts late last year, which suggested production levels would remain relatively unchanged.

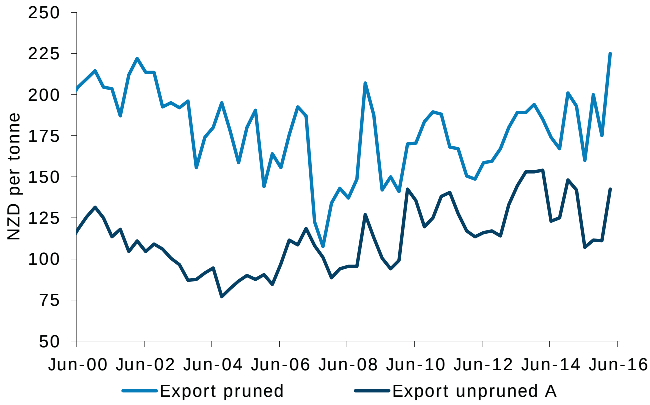
The EIA's latest energy outlook forecasts a decline in US crude oil production to 8.2bbl/d by October 2016 from 9.1 mb/d currently, remaining at that level through 2017. This forecast fall could prove conservative. **We expect the increasing indebtedness to magnify the losses, with US oil production forecast to fall to below 8mb/d in Q3 2016.**

Global fertiliser prices have remained subdued. Ample global supply and soft end-user demand due to low crop prices have kept the pressure on global benchmarks. The offset at the farm-gate for DAP has been a lower NZD/USD versus last year. Nonetheless for urea the 50% fall in international prices has meant lower farm-gate prices.

KEY COMMODITIES: FORESTRY

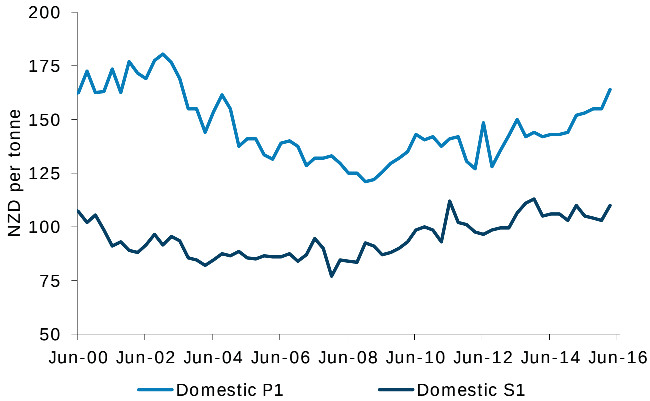
FORESTRY PRICE INDICATORS					
	Current Quarter	3 Period Trend	Last Year	Chg. P/3P	Chg. Y/Y
Export: (NZD per JAS m³ f.o.b.)					
Pruned	225	178	193	↑	↑
Unpruned A Grade	143	110	142	↑	↑
Unpruned K Grade	129	111	134	↑	↓
Pulp	97	90	119	↑	↓
Domestic: (NZD per tonne delivered at mill)					
P1	164	154	152	↑	↑
P2	156	129	126	↑	↑
S1	110	104	110	↑	↔
S2	103	96	103	↑	↔
Pulp	45	43	53	↑	↓

NZ FORESTRY INDICATOR PRICES – EXPORT



Source: ANZ, MPI

NZ FORESTRY INDICATOR PRICES – DOMESTIC



Source: ANZ, MPI

Wharfgate returns for logs remain well above the 5-year average, but have come under a bit of pressure lately from a higher NZD and slightly higher shipping rates. However, in-market prices have remained remarkably stable since the start of the year.

The Chinese log market has maintained its solid recent performance. The market position remains underpinned by moderate inventory levels following a relatively low build-up of stock on ports during the Chinese New Year period. Inventories in China are reportedly near 2.6 million cubic metres at present, which is close to 2013 levels. Usage has also held up at a consistent level, with offtake rates holding near 50,000-55,000 cubic meters per day. This makes log stocks equivalent to about 50 days' supply, a figure lower than the past two-year average of about 65 days. However, it is reported volumes coming into ports are at a greater than the current level of off-take, which implies build-up of inventory levels. The current stability in the China log market is also being reflected in our other main log export markets of South Korea and Japan.

The NZ domestic log market remains positive. Demand for both pruned and structural logs has held at a constant level as mills are continuing to look to secure more logs.

The continuation of the housing boom has supported structural log markets. Housing construction through both Auckland and Christchurch remains the main driver of demand, but interest from other centres has spread with house price escalation. With winter upon us it is expected there will be an easing of demand for structural logs, following the typical seasonal trend.

The roundwood market remains in a much stronger state than many had anticipated previously. New dairy conversions drying up was expected to be felt by sellers of roundwood products, but this has been offset by demand from the horticulture sector (although this is region-specific).

BORROWING STRATEGY

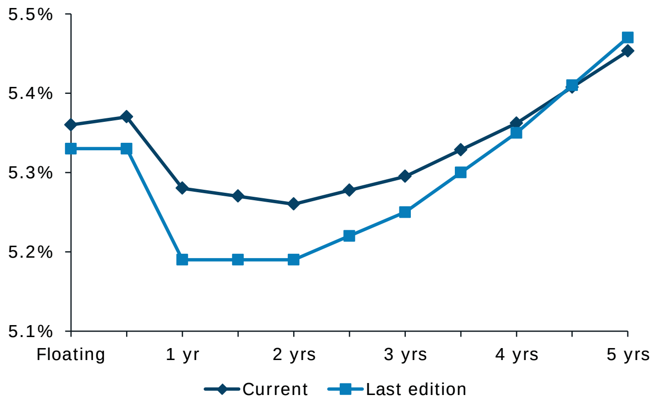
SUMMARY

Indicative rural lending rates are little changed since our last edition, with most rates a shade higher. The borrowing curve remains 'bowl-shaped', with the 2-year rate the low point. At face value this makes the 2 year rate attractive, offering a good mix of cost and certainty, particularly with the curve pricing in one more RBNZ OCR cut. However, with borrowing spreads wider than six months ago and competition for deposits looming, we would caution that borrowers may wish to fix for longer, irrespective of the outlook for the OCR. Our baseline has the OCR moving lower but there is now a credible scenario where the low has been reached and it need not follow that borrowing rates will follow the OCR down.

OUR VIEW

Indicative rural rates have changed very little over the past two months, with small increases seen out to 3 years, and steady to slightly lower rates seen in the 4 and 5 year. The yield curve remains 'bowl-shaped' (figure 1). This reflects an expectation that the OCR will go down in the near term, before mean-reverting higher later on. Mathematically, the 2 year is the lowest point on the curve. With so little separating the shorter tenors, the certainty/cost trade-off is small. Ordinarily, we would be of the view that each tenor has its merits depending on each borrower's degree of risk aversion – particularly with OCR cuts already 'priced in'.

FIGURE 1. INDICATIVE RURAL LENDING RATES

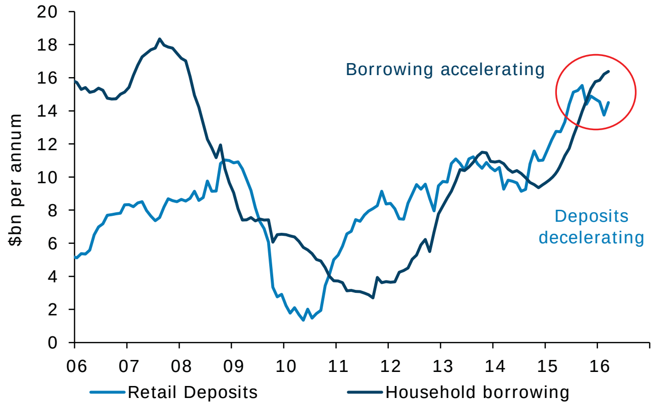


Source: ANZ, Bloomberg

However, as we warned in our last edition, we remain wary of the possibility that wider funding spreads will start to drive borrowing rates up independently of the OCR. Because all-up rates reflect both base rates and spreads, borrowers need to be mindful of where both may be headed. Our sense is that the former (base rates – and the OCR) are biased lower, but that the latter are biased higher. Funding spreads that financial institutions face are still wider than they were a few months ago. So a bank's average funding cost is moving up. The longer this goes on the more pressure there is for this to manifest in higher retail borrowing rates (assuming unchanged wholesale rates). That is a strong reason to expect the OCR to move down and also help the NZD. A complicating factor is that the housing market probably needs higher rates! The RBNZ refers to it as a financial stability risk; that's not normally associated with cutting rates. So there is now a credible scenario that the OCR has troughed.

We are still forecasting a lower OCR. The NZD is one reason. Another is the concerns we have over global conditions. The final reason reflects some domestic realities: credit growth is now outstripping deposit growth (figure 2). Any gap needs to be filled from offshore (where spreads are lower than they were two months ago, but wider than they were a year ago) or through slowing credit growth and/or higher deposits. The end result is likely to be upward pressure on domestic deposit rates, which will have ripple effects through the entire domestic borrowing market in the absence of the OCR falling. But the key message is that a lower OCR need not mean borrowing rates fall as well.

FIGURE 2: BANK FUNDING AND LENDING GROWTH



Source: ANZ, RBNZ

So what should borrowers do? This still depends mostly on individual circumstances. While our breakeven analysis (see table) suggests that rates don't need to rise by much in order for it to be worthwhile fixing, for most borrowers it is likely to be a question of certainty (of both rate and margin) against flexibility (and the possibility that floating rates may fall).

Rural Lending Rates (incl. typical margin)		Breakeven rates			
Term	Current	in 6mths	in 1yr	in 2 yrs	in 3 yrs
Floating	5.36%				
6 months	5.37%	5.19%	5.25%	5.35%	5.53%
1 year	5.28%	5.22%	5.24%	5.37%	5.56%
2 years	5.26%	5.25%	5.30%	5.46%	5.69%
3 years	5.30%	5.32%	5.39%	5.58%	
4 years	5.36%	5.41%	5.50%		
5 years	5.45%				

ECONOMIC BACKDROP

SUMMARY

The economy is showing plenty of vigour across multiple sectors. While the dairy sector is struggling, there is more than enough momentum across construction, migration, housing and non-dairy exports to compensate. We forecast 2½-3% growth over the next three years. Amidst huge uncertainties, businesses are getting on with it, and we're expecting more of the same. The RBNZ looks set for a sabbatical, though the risk remains that it will end up cutting the OCR again – the currency needs it but the housing market doesn't. Global risks skew the outlook lower.

OUR VIEW

The economy continues to grow solidly. Quarterly GDP growth looks to have slowed a tad in early 2016, but indicators still point to a brisk rate of expansion. Our confidence composite, financial conditions and Truckometer are indicating annual GDP growth tracking around 3%. That's above trend and puts more strain on capacity in sectors such as construction. This, in turn, has the potential to exacerbate the supply-demand imbalance within the housing market and in regions such as Auckland.

There is still a host of good news stories out there. Momentum continues to be supported by favourable financial conditions, surging migration, strong activity within the construction and tourism sectors, and housing market strength across both the main city centres (ex-Christchurch) and the regions (notably anything close to Auckland, but more recently across the whole country). While dairying hogs the export limelight, the likes of pipfruit, kiwifruit, wine, other horticulture, and Manuka honey, to name but a few, are going incredibly well. Collectively they have some punch, with export numbers holding up better than expected.

We are expecting modest growth over the years ahead; a half-way house between upside and downside risks.

On the upside we have:

- **Booming migration;** it could strengthen further given NZ's economic credentials, although it does risk a political response. We doubt New Zealand will have any problems filling its migrant target given the political fragmentation globally.
- **Some signs of borrow-and-spend behaviour** filtering into spending trends given housing strength. The wealth effect from rising house prices is a powerful influence on spending. Hamilton house prices are up close to 30% on a year ago. That's an Auckland overflow effect but regional house price lifts are now becoming more wide-spread.

We continue to pay close attention to some key downside risks too. These include:

- **The global scene:** We remain wary over the endgame for asset values, which are being supported by ample liquidity but not backed up by economic fundamentals. Prospects in China remain somewhat of an enigma. The US Fed needs to hike but this risks setting off markets again in a similar fashion to January.
- **Another negative cash-flow year for the dairy sector beckons.**
- **The NZD is doing the economy (exporters) no favours.** Other central banks are keeping rates low, which highlights New Zealand's attractive yields.
- **House prices are extended** and we are now seeing froth across the country. On some levels, it's a sign of a vibrant economy, but valuation metrics need to be borne in mind. The bigger the party, the bigger the hangover. We're on amber alert as opposed to red right now.
- **Borrow-and-spend behaviour is showing up in deteriorating structural metrics.** Household debt (163% of income) is now higher than prior to the GFC, although admittedly debt servicing levels are down due to lower interest rates. Debt brings forward activity; it still needs to be paid back. Some of the recent enthusiasm for debt is healthy; people have a greater belief in NZ's economic future. However, extended house prices, rapid debt accumulation and less saving (households are running down the precautionary savings buffer) are worrying signs.

This combination of upside and downside risks is skewed slightly towards the latter.

An emerging theme we are watching globally is political fragmentation across the globe. This risks driving poor microeconomic policy outcomes, which could undermine economic growth over time. Things like the TPPA deal look likely to become sacrificial pawns to political posturing, with populism trumping leadership. A flipside to this is the potential for NZ's migration numbers to keep surging!

The economy doesn't need another rate cut at present. We suspect the combination of global unease, the high NZD and prospects for increased competition for deposits (which will force up borrowing rates if the OCR does not fall) will bring the RBNZ back to the table at some stage.

EDUCATION CORNER: NEW HORIZONS – ALTERNATIVE ASIAN MARKETS

SUMMARY

Education corner this month is a summary of our recently released *New Horizons: Alternative Asian Markets* research and some select charts. The full report can be accessed here.

The 'Asian Century' is upon us and the opportunities available to New Zealand are, in broad terms, well understood. Asia's economy already accounts for a quarter of global economic output and ANZ expects this will rise to 35% by 2030 and over half the global economy by 2050. The United States and Europe, which currently account for around half of global economic output, could see their share fall to less than a quarter by mid-century. This is a tectonic shift in the economic landscape.

While the Asia opportunities for New Zealand are impressive, we need a framework for moving the conversation beyond opportunity. Regions need to 'connect' and be 'aligned' for opportunities to be unlocked and maximised.

This requires going beyond the often-quoted metrics, such as rising incomes and middle class, into a much broader array of indicators to identify where scarce market-development resources should be directed. After all, incubating export markets takes time, capital and huge effort – better that these efforts and investment be well-directed from the start.

To help with this process we identify six broad categories to assess how different Asian markets rank in terms of connectivity with New Zealand. Three categories relate to identifying demand/opportunity within markets, and three represent constraints or barriers to accessing markets.

Demand/opportunity categories are:

- Food market size and development
- Consumer purchasing power and affluence
- Alignment with New Zealand-oriented trade

Barriers to trade are:

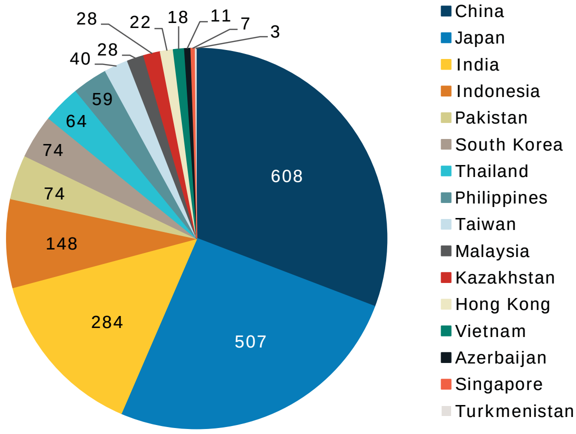
- Market access
- Ease of doing business
- Supply and cool chain development/infrastructure

We gathered a comprehensive dataset of 43 different indicators for 29 Asian countries across these categories.

FOOD MARKET SIZE AND DEVELOPMENT

Here we look at indicators that provide insight into the relative size and growth of a country's food market, but also its state of development. The latter is important due to the perishable nature of much of what New Zealand produces. It is also a useful proxy indicator of westernised consumer preferences, demand for New Zealand's product mix, and the viability of other 'value-add' products.

FIGURE 1. SIZE OF ASIAN FOOD & BEVERAGE MARKETS (US$B)



Source: ANZ, Euromonitor

On this measure the top five countries were Japan, Singapore, Hong Kong, China and South Korea, which was an unsurprising result. However, the different indicators highlight the various features of each market. China versus Japan is a good example. China is a behemoth in terms of its overall size, and apart from Azerbaijan, has been the fastest-growing food and non-alcoholic beverage market in recent years. Conversely, it ranks only middle of the pack on consumer and food market development metrics.

Japan ranked very highly on all the food market and development measures, as well as being a reasonably large market – this is why it took pole position in this category. However, one drawback is its fairly mature food market, with annual growth of only 5% in recent years – much lower than China (+18%), Hong Kong (+9%) or Singapore (+12%). Still, given New Zealand's limitation in terms of the number of people it can realistically feed, the game is about targeting the super-wealthy segments in big markets, such as China, Japan, India and Indonesia, to maximise returns.

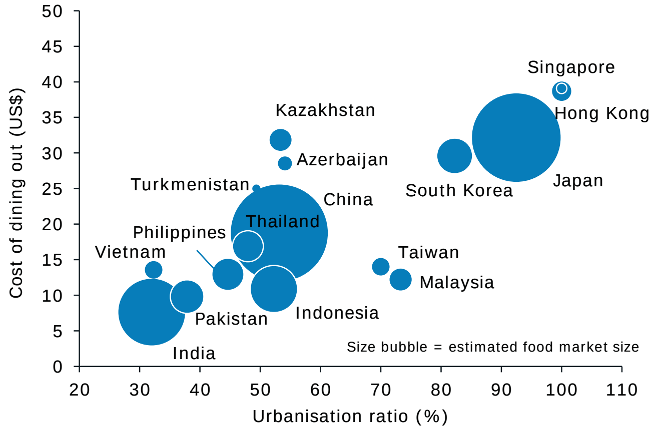
CONSUMER PURCHASING POWER AND AFFLUENCE

This category provides an assessment of where consumers with the highest purchasing power in Asia reside. This is important, as many propositions are endeavouring to target the highest-paying channels and markets, taking into account New Zealand's somewhat limited potential to create scale in these markets. We assume that purchasing

EDUCATION CORNER: NEW HORIZONS – ALTERNATIVE ASIAN MARKETS

power is a function of not just the level of incomes but also recent growth. Looking at the former alone would exclude some of the fast-growing regions and the point of this paper is to look at where new opportunities are being created, and not just focusing on the heavily-westernised countries with high per capita incomes.

FIGURE 2. URBANISATION RATIO RELATIONSHIP WITH COST OF DINING AT MID-RANGE RESTAURANT



Source: ANZ, Euromonitor, World Bank, Numbeo

The familiar names of Singapore, Japan, Hong Kong, China, Thailand and South Korea featured, as well as some less well-known markets, such as Turkmenistan and Mongolia. The former group ranked well on most indicators, but were near dead last for the change metrics for incomes and wealth. This implies fairly mature food consumption metrics compared with the likes of Mongolia and Turkmenistan, who had the strongest growth profiles, but off much lower levels of income and wealth.

ALIGNMENT WITH NEW ZEALAND-ORIENTED TRADE

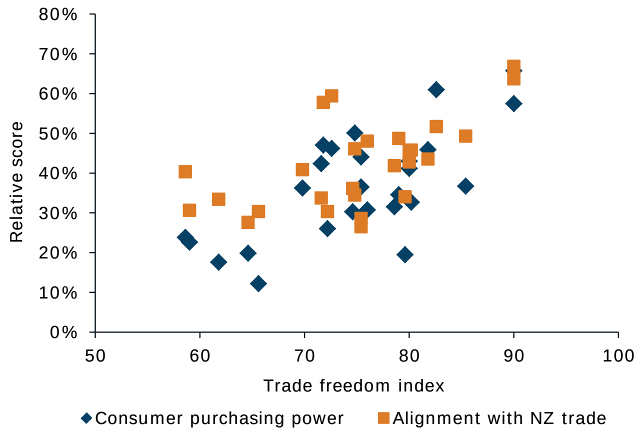
This is about assessing what a marketplace requires, and whether or not we produce it. New Zealand's main competitive advantage is in the production of livestock (specifically dairy, red meat and seafood), horticulture (wine, kiwifruit and pipfruit) and a number of other niche products, usually of livestock or horticulture origin. We therefore want to identify countries where import demand opportunities for these products will be rising in the future.

The top-ranked countries were the familiar names from the other opportunity categories, plus Taiwan. The more interesting results were the middle-ranked countries, which threw up a number of less well-known names, including Armenia, Azerbaijan, Malaysia, Mongolia, Kyrgyzstan, Turkmenistan, Vietnam and Kazakhstan. Each have their own strengths and weaknesses depending on the metric.

MARKET ACCESS

One of the biggest impediments to unlocking primary sector opportunities are tariff and non-tariff barriers. These barriers often significantly inhibit (and distort) trade via pricing imported products out of the market through high tariffs, restricting trade volumes for certain goods, creating investment and policy uncertainty by arbitrarily changing the rules, and/or creating other technical barriers to trade.

FIGURE 3. RELATIONSHIP BETWEEN TRADE LIBERALISATION AND A COUNTRY'S OPPORTUNITY SCORE



Source: ANZ, Heritage Foundation

Singapore, Brunei Darussalam and Hong Kong took out the top three spots for this category, as virtually no tariffs are applied to primary products and New Zealand has free trade agreements with all three countries.

The next most attractive countries were Taiwan, Indonesia, Philippines and Malaysia. What is perhaps more interesting are the markets that ranked well on the opportunity front, but not so well for market accessibility. Countries that rate a mention here are: South Korea, Turkmenistan, Kyrgyzstan, Mongolia, Kazakhstan, Sri Lanka and India. Japan ranked down the pecking order too, but could move up the rankings in this category over coming years if TPPA benefits flow through. It remains to be seen whether global politics will see it fall at the last hurdle.

EASE OF DOING BUSINESS

This is important as it defines the effort required to pursue opportunities. The facets that are important when conducting business within a country are many, but key ones include:

- the regulatory environment;
- the ease of completing appropriate documentation and regulatory requirements (eg. registering a business and its activities, paying taxes etc);

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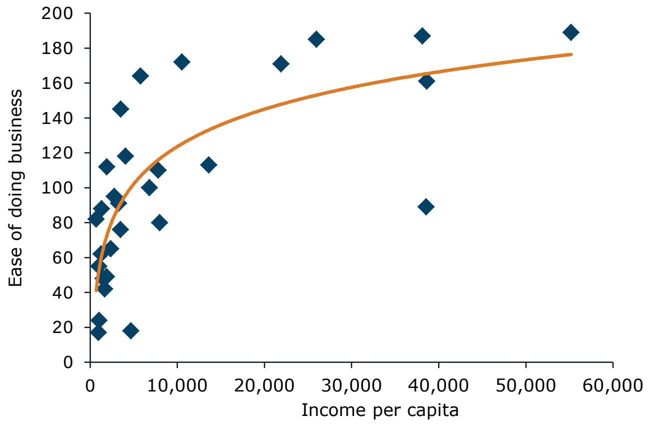
- the political environment;
- the strength of intellectual and property rights;
- the financial framework; and
- the level of corruption.

FIGURE 4. RELATIONSHIP BETWEEN EASE OF DOING BUSINESS AND PURCHASING POWER



Source: ANZ, World Bank

If these facets are not favourable it creates investment uncertainty and limits a business' ability to pursue opportunities. Singapore took out top spot in this category, followed by South Korea and Hong Kong. The next top-ranking markets were Japan, Malaysia, Taiwan, Thailand, Philippines, China, Sri Lanka, Vietnam, India and Armenia.

SUPPLY AND COOL CHAIN DEVELOPMENT / INFRASTRUCTURE

As the majority of New Zealand's primary products are highly perishable they require a robust cool chain to ensure high standards of food safety, adequate shelf life, and a cost-competitive distribution channel, particularly when competing against local producers and other exporters.

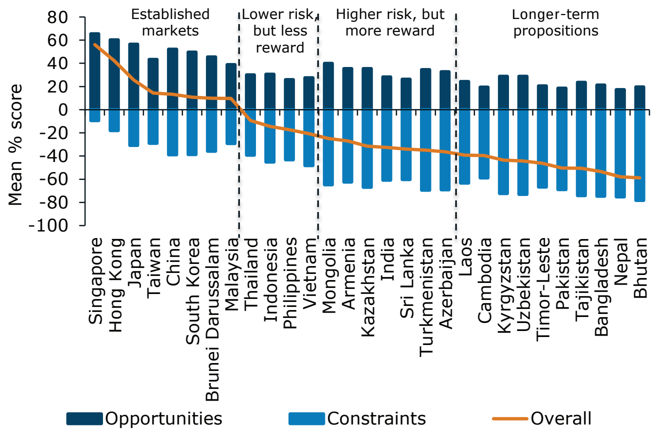
There were few surprises in countries' rankings for this category. The trade hubs of Singapore and Hong Kong took the top spots, with Japan, Malaysia, Taiwan and South Korea rounding out the top six. The next group of countries then includes Brunei Darussalam, China, Thailand, Indonesia, Philippines, Sri Lanka and Vietnam.

OVERALL RESULTS

The overall top-ranked countries are Singapore, Hong Kong, Japan, South Korea, Taiwan, Malaysia and China. Together these countries account for around 80% of New Zealand's bilateral merchandise trade flow and 81% of total goods exports within the Asian region.

The next group of Asian countries on our ranking system – the potential up-and-comers – are less well-known: Brunei Darussalam, Thailand, Indonesia, Mongolia, Armenia, Philippines, Azerbaijan, Kazakhstan and Vietnam. Our ranking system highlights potential opportunity for each, but also helps identify why they are not yet key markets for New Zealand. For various reasons, other key markets stand out more in terms of attractiveness (and most likely returns) at this point in time.

FIGURE 5. RANKED RELATIVE ATTRACTIVENESS OF ASIAN COUNTRIES FOR NEW ZEALAND PRIMARY PRODUCTS
(REGION'S RELATIVE ATTRACTIVENESS SCORE)



Source: ANZ

Our analysis is static. It looks at the attractiveness and connectivity of these markets with New Zealand as we sit here today. But as we know, the Asian region is not sitting still, and some countries within the region are developing and changing at a rapid rate.

The push for further trade openness, faster per-capita income growth, improved cool-store infrastructure and many other factors should see these countries' relative attractiveness for New Zealand exporters continue to grow over time. These 'next-tier' countries could easily shift up our rankings, and it is in this possibility where real opportunity exists. Some factors, such as urbanisation and incomes, evolve relatively slowly. Others, such as trade barriers and supply and cool-chain development, can change relatively quickly. Looking at how quickly key existing barriers have been dismantled (or missing components developed) in other countries suggests that the key markets to watch over the next 5-10 years are Japan, Thailand and Indonesia.

KEY TABLES AND FORECASTS

FX RATES	ACTUAL			FORECAST (END MONTH)						
	Apr-16	May-16	14-Jun	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
NZD/USD	0.698	0.673	0.704	0.66	0.66	0.63	0.61	0.61	0.63	0.66
NZD/AUD	0.918	0.929	0.954	0.89	0.92	0.94	0.92	0.92	0.93	0.94
NZD/EUR	0.609	0.604	0.624	0.60	0.61	0.58	0.54	0.53	0.53	0.55
NZD/JPY	74.31	74.79	74.75	69.3	69.3	66.2	61.0	61.0	63.0	66.0
NZD/GBP	0.477	0.461	0.496	0.46	0.44	0.41	0.39	0.38	0.39	0.40
NZ TWI	72.2	71.3	75.4	69.3	69.8	67.5	64.5	64.0	64.8	67.4

INTEREST RATES	ACTUAL			FORECAST (END MONTH)						
	Apr-16	May-16	14-Jun	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
NZ OCR	2.25	2.25	2.25	2.25	2.00	2.00	1.75	1.75	1.75	1.75
NZ 90 day bill	2.40	2.42	2.37	2.40	2.20	2.10	2.00	2.00	2.00	2.00
NZ 10-yr bond	2.85	2.62	2.50	2.80	2.90	2.90	3.10	3.20	3.40	3.50
US Fed Funds	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50
US 3-mth	0.64	0.67	0.66	0.83	0.83	1.08	1.08	1.33	1.33	1.58
AU Cash Rate	2.00	1.75	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.50
AU 3-mth	2.15	1.99	2.02	2.00	1.80	1.80	1.80	1.80	1.80	1.80

ECONOMIC INDICATORS	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
GDP (% q/q)	0.9	**0.5**	**0.7**	**0.6**	**0.6**	**0.6**	**0.7**	**0.7**	**0.7**	**0.7**
GDP (% y/y)	2.3	**2.6**	**2.9**	**2.6**	**2.3**	**2.4**	**2.4**	**2.5**	**2.6**	**2.7**
CPI (% q/q)	-0.5	0.2	**0.5**	**0.4**	**0.0**	**0.7**	**0.4**	**0.7**	**0.3**	**0.6**
CPI (% y/y)	0.1	0.4	**0.5**	**0.6**	**1.1**	**1.6**	**1.5**	**1.7**	**2.0**	**2.0**
Employment (% q/q)	1.0	1.2	**0.6**	**0.5**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Employment (% y/y)	1.4	2.0	**2.3**	**3.3**	**2.7**	**1.9**	**1.7**	**1.6**	**1.6**	**1.6**
Unemployment Rate (% sa)	5.4	5.7	**5.5**	**5.4**	**5.4**	**5.3**	**5.2**	**5.2**	**5.1**	**5.0**
Current Account (% GDP)	-3.0	**-3.0**	**-3.0**	**-3.4**	**-3.7**	**-4.3**	**-4.4**	**-4.3**	**-4.1**	**-3.8**
Terms of Trade (% q/q)	-2.0	4.4	**-5.8**	**-2.7**	**-0.3**	**0.8**	**1.7**	**2.8**	**1.7**	**0.8**
Terms of Trade (% y/y)	-3.2	-0.1	**-7.3**	**-6.2**	**-4.6**	**-7.9**	**-0.6**	**5.1**	**7.2**	**7.2**

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

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