

AGRICULTURE

KPMG Agribusiness Agenda

The big opportunities and challenges facing
New Zealand agriculture

Reflections on the views of industry leaders

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The photos featured in this publication have been predominately taken by KPMG staff from our offices around New Zealand. The photographs were submitted by staff to our Spring Agribusiness photo competition held in September/October 2009.

Foreword



Jan Dawson
Chief Executive
KPMG New Zealand

Expectations of protein shortages on a global scale, concerns about climate change and evolving customer requirements over to the sustainability and efficacy of food products present significant opportunities and challenges to the New Zealand agribusiness sector. The sector underpins and supports not only the rural community but many other sectors of the New Zealand economy, including financial services, freight and logistics, engineering, science and education. The penetration of the agribusiness sector across the New Zealand economy makes understanding the opportunities and challenges facing the sector particularly relevant to most New Zealand businesses, as these issues drive, to a large extent, the growth and success of our economy.

KPMG has been a proud advisor to many successful agribusinesses for over a century. Last year, we created the KPMG Agribusiness Network to recognise the importance of the sector to the New Zealand economy and the future of our business. The network includes partners and professional staff from all our offices across the country and all our service disciplines and is focused on co-ordinating our service delivery, thought leadership and sponsorship activities in relation to the agribusiness sector.

Despite our history working in the sector, we challenged ourselves on establishing the network to obtain a real insight on the most significant opportunities and challenges facing the sector over the next five years to ensure that we are able to provide the services and advice that agribusinesses really require. This was originally intended to be an internal project, however as we have met and talked with our clients and other influential leaders in the industry, it became apparent that the insights we were developing would be relevant to a wider audience and help fill a perceived void in analysis of the wider agribusiness sector.

We are very pleased to introduce the inaugural edition of the **KPMG Agribusiness Agenda** in which we provide analysis and commentary on 12 key opportunities and critical challenges that the industry faces at the start of the new decade. The report considers a range of issues that we consider the industry needs to resolve to truly become a customer led, science driven, high productivity sector that can assist in driving the long term growth in profitability and success of the New Zealand economy.

Having completed the **KPMG Agribusiness Agenda** we are excited about the prospects for the sector and consequently the wider economy. KPMG is committed to investing in delivering insights that are relevant and challenging to the industry and others with an interest in the long term success of New Zealand. We are committed to playing our part in the long term growth and success of the agribusiness sector.

We look forward to receiving your feedback on this report and the discussions we expect it to generate.



Ross Buckley
Chairman – Agribusiness
KPMG New Zealand



Ian Proudfoot
Partner and Report Author
KPMG New Zealand

Background



Photo by Esti Garfield KPMG Auckland

As advisors to a large number of New Zealand's leading agribusinesses, KPMG took the opportunity to meet with a wide cross section and number of CEOs, Chairmen and leaders in the sector during the last quarter of 2009 and early part of 2010. We are concerned that there are critical issues in the sector that remain either unsatisfactorily addressed or need attention if this vital sector is going to remain healthy and at the forefront of the New Zealand economy.

As a result, this report has been prepared to reflect the common themes and concerns raised in those conversations and to present our analysis of the most critical issues facing the sector in the short to medium term.

We have distilled our sector research and our conversations with these leaders down to a series of common topical areas that we believe forms an agenda of major issues for the industry over the next year and beyond. These are the issues that must be addressed by all of us participating in the sector to enable New Zealand agribusiness to grasp the opportunities available to it and maximise the industry's value to all its stakeholders.

Executive summary

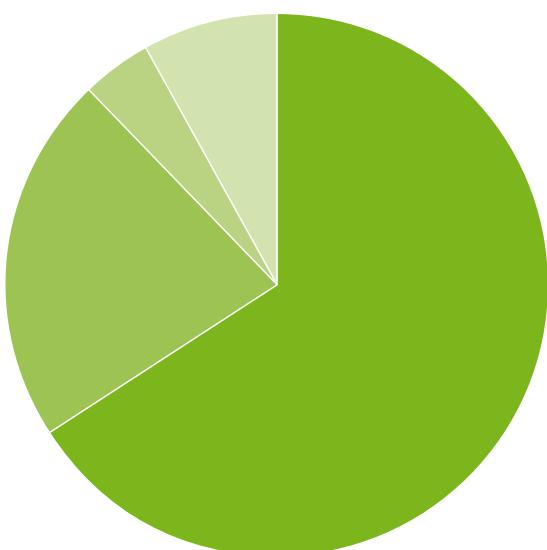
When the primary sector sneezes, the New Zealand economy catches a cold

The full impact of the global financial crisis will only become apparent when the global economy returns to more normal growth patterns. In our view, the crisis has seen the balance of global economic influence swing towards Asia and caused structural changes in many western economies. While the strength of the Australian banks has substantially protected the New Zealand economy from the worst of the fallout of the crisis, many analysts have spent time over the last year considering the role that our country has to play in the post crisis global economy. The ability New Zealand has to produce safe, sustainable food has been ignored in the past in favour of other wealth creation strategies. However many have concluded that the agribusiness sector will be a core contributor to the prosperity of the economy as we move into the post crisis world.

Prime Minister John Key summarised the National-led government's position towards agriculture, saying that the government "views agriculture as a key driver of New Zealand's economic engine. When things are going well on our farms, this flows through into small towns, the provincial cities, and into our big cities. Conversely, when the primary sector sneezes, the New Zealand economy catches a cold."¹ John Key's comments are supported by recent export data, which show 66% of New Zealand's merchandise exports come from agribusiness and food related products.

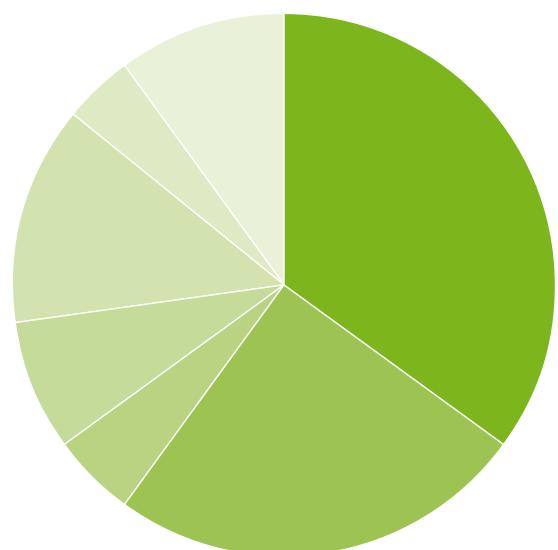
¹ John Key; Speech to Federated Farmers National Conference; 2 July 2009; www.beehive.govt.nz

Exports of main commodities
- Year to October 2009



- 66% Food and agribusiness related exports
- 22% Manufactured products
- 4% Petroleum related products including oil
- 8% Undisclosed other commodities/ confidential data

Food and agribusiness related exports
- Year to October 2009



- 35% Dairy products
- 25% Livestock, meat and associated products
- 5% Fish and seafood
- 8% Horticultural products
- 13% Forestry products
- 4% Viticultural products
- 10% Other food related products

Source: Statistics New Zealand; Overseas Merchandise Trade Statistics October 2009; www.stats.govt.nz



Photo by Roger Nuttall KPMG Christchurch

Global food production needs to increase by 40% by 2030 and 70% by 2050 compared to average 2005 to 2007 levels to meet expected demand

The diversity of the agribusiness sector in New Zealand and its focus on export markets positions the sector well to meet the growing global demand for high quality, safe and sustainable food expected to eventuate over the next 50 years. The Food and Agriculture Organisation of the United Nations, using long term population and income projections, has estimated that global food production needs to increase by 40% by 2030 and 70% by 2050 compared to average 2005 to 2007 levels to meet expected demand.² They predict that much of the increase will come from converting additional land to agricultural production, particularly in Africa and Latin America, however they note there remains significant potential for further increases in the productivity of crop and livestock production over the next 10 to 20 years even in the most productive areas through development and adoption of new technologies.

It has been challenging for industry participants in many sectors to consistently generate sufficient operating profits to maintain a viable business in recent years, with some relying on the capital appreciation of land to support their balance sheets. The profitability of the industry is significantly influenced by many uncontrollable variables – the climatic conditions, exchange rates, commodity prices and market access arrangements to name a few. We have been consistently told in our conversations that there is a lack of understanding amongst non industry people of the complexity and challenge of running a successful agribusiness. However there is universal belief that the global environment creates significant opportunities for the industry if there is a collective will to do some things differently.

This view was put succinctly in the Horticulture Industry Strategy document, which noted “the horticulture industry cannot keep on doing what it has always done and expect to continue to grow...In fact, the evidence suggests, that continuing with no change will lead to an eventual decline in revenue for the industry...The second issue that became clear is that significant growth is achievable, but that requires change – change in behaviour and change in attitude.”³ A view that is not only relevant to the horticulture sector but many other agribusiness sectors.

As a protein rich country with secure and reliable sources of fresh water and a history of agricultural innovation New Zealand has strategic advantages that, if managed appropriately, will assist the economy to grow, both directly and indirectly, and enhance the wealth of all New Zealanders. This will require each of the sectors encompassed within New Zealand agribusiness to grapple with, and develop responses to, a range of challenges including competition from new production regions, meeting the needs of new customers, delivering sustainably produced food and investing in infrastructure to deliver productivity improvements across the industry.

² Organisation for Economic Co-operation and Development/Food and Agricultural Organisation of the United Nations; OECD-FAO Agricultural Outlook 2009 – 2018: Highlights; 2009; www.agri-outlook.org

³ Horticulture New Zealand; An Overview: Horticulture Industry Strategy 'Growing a New Future; July 2009; www.hortnz.co.nz

Efficient, best practice production methods rather than lower cost

For many years, the New Zealand agribusiness sector has traded on a belief that our commercial advantages were cheap land, abundant grass and plenty of water making this country the lowest cost place to grow food in the world. This is no longer true. Farm prices have risen significantly over the last twenty years making land in New Zealand among the most expensive in the world. Dairying has moved to more marginal regions increasing the need for supplemental feeds, while agricultural intensification and environmental restrictions have put pressure on water resources increasing the demand for irrigation schemes around the country. European farmers ignored the challenges to their traditional markets that new world producers presented after the Second World War and many have had to rely on subsidies since. New Zealand must learn from the European experience and respond to the new competitive environment; there is no Common Agricultural Policy to support the industry in New Zealand.

Average price per hectare of dairy farm land (\$)



Source: Livestock Improvement Corporation/ DairyNZ; New Zealand Dairy Statistics 2008-09; 2009; www.dairynz.co.nz

Against this background, the global demand for food has seen increasing investment in countries in South America, Africa, Asia and Eastern Europe where land, labour and compliance costs are significantly lower than those in New Zealand creating a new tier of low cost producers. A common theme from our conversations is that New Zealand agriculture needs to discard the low cost production position once and for all and adopt a universal focus on efficient and sustainable production models which are resilient to market volatility and shocks ('the most efficient producer').

This suggests that the industry needs to be prepared to make investments in researching and developing best practice products and production techniques, training and developing future industry leaders, exploiting the natural resources available in an optimal manner and utilising tools that smooth the peaks and troughs of increasingly volatile business cycles. In some circumstances this is likely to require industry participants to reconsider the most appropriate structure for their sector to adopt to secure future growth and success.

The generally low operating returns from agribusinesses have meant many investors have steered clear of the sector in favour of higher yielding investment options. In New Zealand's shallow capital markets this has presented many

New Zealand agriculture needs to discard the low cost production position once and for all and adopt a universal focus on efficient and sustainable production models which are resilient to market volatility and shocks



Photo by Roger Nuttall KPMG Christchurch

We do not believe the co-operative model is an impediment to the industry securing the capital it needs

organisations with challenges to raise sufficient capital to exploit the opportunities available to them. Transitioning from the traditional industry model to a more efficient and sustainable production model will require companies and co-operatives to raise new capital. Recent experiences with proposed share issues being withdrawn and low uptakes on co-operative share offers suggest sourcing the required capital will be challenging, particularly from a rural investor base which is currently more highly geared than ever given the significant land price inflation that has occurred. While we do not believe the co-operative model is an impediment to the industry securing the capital it needs, we consider co-operatives will need to be flexible in how and where they source capital, with the potential that non-supplier investment structures may need to become a more common part of the capital structure moving forward.

The challenges of the current regulatory and compliance frameworks have been highlighted as a potential constraint on achieving the structural changes required within the industry. There has been a perception that regulations have been imposed for regulations sake without full consideration being given to the costs and associated benefits of regulations. While the government is taking steps to reform some of the most challenging areas, such as the Resource Management Act, new regimes, such as the Emissions Trading Scheme, add further complexity to the regulatory and compliance environment.

There needs to be a mature conversation around some of the more controversial areas of regulation, such as the commercial release of genetically modified organisms, to ensure that the opportunities they offer to increase productivity are balanced with the risks to the environment and New Zealand's market reputation. The government acknowledges the need to wind back some of the regulation imposed on the economy over the last decade. We believe that rapidly removing regulation and compliance requirements that add little or no value has the potential to unleash the growth potential in the sector.

Meeting the challenges of new markets

Success depends on how intimately our exporters are able to understand their new customers and that will only come from doing the hard work to build the personal relationships that are so central to business in Asia

The markets our exported products go to have changed markedly in the last ten years, as Asian countries have become increasingly more important to our exporters over our traditional markets in the Northern Hemisphere. We believe that this is a trend that will continue as the government continues to deliver free trade and market access agreements with countries in the Asia Pacific region. The trade agreements unlock the doors to the new markets; however that is where the hard work starts for our exporters. They need to understand the preferences of these new potential customers in order to develop product offerings that are able to deliver to meet these expectations. Success will be dependent on how intimately our exporters are able to understand their new customers and that will only come from doing the hard work to build the personal relationships that are so central to business in Asia. The work the government has done has created a unique market opportunity for the New Zealand agribusiness sector. The onus is now on the industry to grasp the opportunity and maximise its benefits for themselves and for the wider economy.

The food price spikes experienced globally in 2008 after many years of relatively stable food prices reflect a trend towards volatility that we expect to see continue in future years. The challenge of feeding a rapidly growing global population will make food prices more susceptible to supply shocks. Consequently we believe innovative ways need to be identified to smooth volatile market prices to provide a sufficiently stable earnings stream that will enable investment decisions to be taken on long term developments. Strategies such as the partnership programmes being developed by the meat companies, are intended to link the customer to growers, removing the growers from the fluctuations of the spot market and providing certainty to the supplier and processor over profitability. Volatility creates opportunity if understood and managed correctly.

A strong theme from our discussions has been that the government must support the industry in delivering to new customers through partnering with agribusinesses in research and development activities. Much of the intellectual property currently being used in the sector is now dated as the uncertain funding environment for the Crown Research Institutes and a general lack of investment by New Zealand Inc in R&D has seen the speed of science advancement in New Zealand slow in comparison to many competing countries. Despite the talk from the new government about the importance of science in driving productivity improvement, its actions to date have given mixed signals about whether it is prepared to back its words with tangible actions. We consider that co-ordinated science strategies with the public and private sectors collectively pooling their resources and investing in innovative, commercially focused research will be a critical factor in New Zealand's agribusinesses successfully exploiting the opportunities available to them in new markets.

Brand New Zealand – customers will decide

The most valuable asset of New Zealand Inc is the intangible association that has developed over the years between New Zealand and clean, green, pure experiences and products. Some of this can be attributed to the 100% Pure campaign that has been run by Tourism New Zealand since 1999, but there are many other activities that have contributed to the association, from marketing campaigns run by the New Zealand Dairy Board promoting dairy products made from grass fed cows milk, to the nuclear free policy implemented in 1987 and the promotion associated with the Lord of the Rings films. Regardless of how the brand has been created, New Zealand's intangible positioning as "100% Pure" has real tangible value; an Interbrand valuation in 2005 of the Pure New Zealand brand valued it as being worth around US\$13.6 billion.⁴

⁴ Tourism New Zealand; 100% Pure New Zealand Facts and Figures; 2009; www.10yearsyoung.tourismnewzealand.com

The New Zealand brand is one which conveys values such as quality, sustainability, safety and purity to consumers and can carry a price premium for New Zealand product over produce from competitor countries. The actions of growers and producers must be consistent with the values of the brand if the market positioning and the premium it carries are to be preserved on a long term basis. A recent article in the UK Guardian newspaper by a prominent environmental journalist, Fred Pearce,⁵ that claimed that New Zealand's green credentials were little more than "a commercial greenwash" has been widely reported in the media. Further reporting of this kind could have a significant detrimental impact on our agribusiness sector if day to day practices fail to meet global best practice standards for sustainability, animal welfare and traceability for example.



Photo by Murray Sarelius KPMG Auckland

An overriding objective for the agribusiness sector must be ensuring that actions and behaviours are consistent with New Zealand's golden goose, our clean, green, pure image in the global market place

Much debate has taken place over the need for a compulsory national animal traceability scheme in recent years. Arguments against the scheme have revolved around the cost of such a scheme and lack of commercial demand from customers for a national scheme. Traceability schemes have increasingly been introduced around the world in response to consumer demands for certainty around the safety of their food and on this basis we consider a traceability scheme secures New Zealand long term market access. It also provides a mechanism that the authorities can use to contain biosecurity incursions to protect the wider industry against the crippling impact of an event such as a foot and mouth outbreak. We consider that a traceability scheme, such as the National Animal Identification and Tracing project, is a must do rather than a nice to have if we want a long term ticket to play in the high value markets.

Animal welfare issues do not play well in the media and unfortunately there have been a number of high profile stories in the last year. The obligation to ensure the humane and ethical treatment of all animals is a given on all farmers, however the debate over the extent to which animal welfare should be regulated continues, particularly in the pork industry at the current time. We consider that establishing animal welfare standards below global best practices levels may assist in generating short term economic gain, but any benefits will be short lived as consumers increasingly demand the highest standards and will vote with their feet from buying New Zealand product if they do not consider the methods adopted in its production are to best practice standards.

An overriding objective for the agribusiness sector must be ensuring that actions and behaviours are consistent with New Zealand's golden goose, our clean, green, pure image in the global market place. In our view, the discussion around the environment has changed in the last year from being focused on the climate change issue to recognising a sustainable business model can represent a competitive advantage to a company. We consider that there are opportunities available to companies adopting sustainable practices to achieve first mover advantage and command price premiums for their products. However, in our view the future for producers that fail to adopt sustainable practices will increasingly be focused on low value commodity markets where they are competing with increasingly efficient, lower cost producers from new production regions.

⁵ UK Guardian; "New Zealand was a friend to Middle Earth, but it's no friend of the earth" Fred Pearce; 12 November 2009; www.guardian.co.uk

Infrastructure investment is needed to harness our potential

Like many areas of the New Zealand economy, there has been under investment in the social infrastructure of the agribusiness sector in recent decades. In addition to the investment in research and development, three areas we have identified that in our view need additional investment are water, education and communications.

There has been under investment in the social infrastructure of the agribusiness sector in recent decades... areas in need of additional investment are water, education and communications

The resolution of a fresh water policy that protects water quality and ensures optimal economic allocation of the water available in New Zealand is of significant importance to New Zealand agribusiness. We consider that irrigation schemes in water constrained areas present opportunities for the government to work with private investors to accelerate the implementation of the schemes given the economic benefits that can be generated. We would hope any fresh water policy makes allowance for government investment in irrigation through public private partnerships. The importance and value of water to New Zealand cannot be undervalued in a world that is increasingly fresh water constrained, and resolution of water policy on a national basis is important if the industry is to have the confidence to make investments that will maximise the value of the resource to the economy.

We believe complexity is only likely to increase in future years placing a greater onus on industry leaders to understand the issues their industry sector faces before identifying solutions to respond to these challenges at the earliest opportunity. It also places an onus on New Zealand Inc and the government funded tertiary education sector to develop and provide the training programmes and mentoring that current and future industry leaders will need to meet these challenges. Investment in training and development to build the talent pool available to the industry is a key investment that needs to be made in New Zealand's intellectual capital infrastructure.

It has also been regularly highlighted to us that general governance standards in the industry need to be raised to reflect the complexity of the issues that industry leaders are now required to deal with. Enhancing the range of skill sets available to boards will better enable organisations to engage with stakeholders and provide greater insight on issues, as the clarity of understanding of an issue and its possible solutions will be significantly enhanced. This will only be achieved by investing in the development and mentoring of industry leaders.

The Government needs to ensure that broadband investment is focused where it will maximise the productive return to economy. This should see rural communities receiving at the least the same levels of investment as urban regions. The broadband initiatives should not be about being able to download movies faster or having fibre past a higher percentage of front doors than any other country in the OECD but must be about creating wealth for the country. The Government should ensure a communications infrastructure is built that will help our economy grow and enable rural business to maximise the use of technology to drive productivity growth and improved profitability.

Section 1



Efficient,
best practice
production
methods



New Zealand agriculture needs to discard the low cost production position once and for all, and focus on developing efficient and sustainable production models, resilient to market volatility...

Most efficient producer

The sector needs to refocus on becoming the most efficient, integrated and sustainable producer of high quality food solutions in the world

The New Zealand agribusiness sector has historically claimed its competitive advantage to be an ability to produce food for export at a lower cost than other countries around the world. However, the expectations that a global food shortage is looming as the world's population continues to expand is opening up historically marginal agricultural regions, such as South America, areas within the former Soviet Union, Mongolia and Western China and large tracts of Africa to large scale intensive farming. These regions have the benefits of lower cost land and labour and normally have less complex regulatory regimes. In addition they are located geographically closer to key markets, enabling them to deliver food to the customer at a significantly lower cost than a competing New Zealand farmer or grower could achieve. With the erosion of New Zealand's historic low cost advantage, our conversations have indicated a wide consensus that the sector needs to refocus on becoming the most efficient, integrated and sustainable producer of high quality food solutions in the world.

There is likely to be a development lag in some of these new production regions before they are able to produce and export bulk product in an optimal, low cost manner. This gives New Zealand companies a short buffer (maybe as little time as five years) before low cost regions are producing bulk commodity products in significant volumes and undercutting New Zealand's pricing in our traditional commodity markets. This buffer provides our agribusiness industry with a transitional period to move from the traditional low cost model to a most efficient producer model; consequently the time to start revisiting industry structures, practices and products is now so that the industry is well established on a journey up the value chain in advance of base commodity products from new suppliers coming into international markets in large volumes.

So what will an agribusiness sector that has adopted a most efficient producer model look like? In our opinion it will invest heavily in science, technology and infrastructure to gain a competitive advantage in producing the quality functional food products our customers in premium markets are demanding. The sector will have the ability to deliver these food solutions all year round through adoption of advanced global sourcing and logistics methodologies. The companies will be constantly talking with customers to understand their future needs and requirements around product presentation, sustainability and traceability to deliver to these in advance of competitors and lock in price premiums.

Understanding value in the supply chain

Adoption of the most efficient producer model requires focus on all aspects of an industry's supply chain, including 'on farm' activities, processor structure, manufacturing techniques, logistics partners, in-market distribution models and customer management. For this model to be successfully adopted, global best practice methodologies need to be utilised at each stage of the supply chain, to minimise cost and ensure that as much of the value available in the supply chain is recognised by the New Zealand farmer/ grower and processor. A common



Photo by Christine Hopson KPMG Tauranga

frustration has been expressed by many of the industry leaders we have had conversations with, relating to the current lack of understanding in the industry of where profits fall in the supply chain and a consequent lack of understanding of where the value is being eroded.

The issue can be simply illustrated using the current market prices for lamb; a kilogram of chilled New Zealand lamb is currently selling in Waitrose in the UK for an average of around £8 a kilogram,⁶ which in New Zealand dollar terms converts to sales revenues of between \$250 and \$300 for an average lamb. However the farm gate price for this lamb is currently estimated by Meat and Wool New Zealand to be \$72,⁷ around 25 to 30% of the retail price of animal. While retail return from the meat on each animal will vary, it is the lack of a clear explanation of why the farm gate price is around 30% of the retail value of the product that frustrates farmers and growers. They struggle to understand how international market prices correlate with the farm gate payments that they receive and could potentially be a significant barrier to transforming on farm practices.

Achieving a step change in on-farm practices represents a challenge to the industry. A step change will require the average farmer to make a significant investment in developing more sustainable pastoral and production technologies, better management and use of water resources, access to high speed communications and technology solutions and consistently high standards of animal welfare. These topics are considered in more detail later in this paper. Issues that are currently distracting the industry, such as the management of a national dairy database and development of a governing body for the wool sector, need to be resolved quickly to ensure that industry sectors can move forward in a co-ordinated and cohesive manner.

A mature conversation on genetic engineering is required

Utilisation of genetically modified crops has the ability to be a significant contributor to improved on farm efficiency, however this is a politically charged and divisive issue in New Zealand. The current policy on the development and use of genetically modified organisms (GMOs) was established following the report of the Royal Commission on Genetic Modification issued in July 2001 which recommended that New Zealand adopt a precautionary approach to GMOs that preserved our options for the future. Current legislation requires that the Environmental Risk Management Authority must review any new organism before it is imported, developed, field tested or released in New Zealand, with each case being considered on its own merits as each organism presents different potential risks and benefits. Currently, there are no fresh meats, fruit or vegetable products sold in New Zealand that have been genetically modified.⁸

⁶ Waitrose Deliver; New Zealand fresh lamb pricing for home shopping; March 2010; www.waitrosedeliver.com

⁷ Meat and Wool New Zealand; Sheep and beef mid season update 2009/10; February 2010; www.meatnz.co.nz

⁸ The Ministry of Environment; Genetic Modification – The New Zealand approach; June 2004; www.mfe.govt.nz

We have a moral obligation to utilise science to feed the world's population including genetic modification technologies

Many argue that consumers both here and overseas do not want genetically modified products under any circumstances due to the unknown long term health and environmental impacts. There is a growing body of opinion that believes the market is ready to accept genetically modified products and in reality has little choice if we are to feed the growing population if the climate warms as many expect. A joint meeting of leading food and agricultural scientists from the US and New Zealand in January this year, was told by Dr Andrew West (CEO of AgResearch) and Dr Nina Fedoroff (Chief Science Advisor to US Secretary of State, Hillary Clinton) that in a food constrained world we have a moral obligation to utilise science to feed the world's population including genetic modification technologies.⁹ The utilisation of science, and particularly genetically modified products, needs to be managed carefully to protect New Zealand's clean, green brand but a mature conversation needs to happen on this issue if our producers are to become world best, efficient producers.

With the European Union recently approving four new genetically modified species for limited release in Europe¹⁰ and a number of applications expected later this year for the release of genetically modified grass seeds in New Zealand, now is an appropriate time for this debate. It may be that the protection of the clean, green brand is considered to be more important and valuable to the industry than the release of genetically modified species, which could then trigger a second discussion as to whether wide scale adoption of organic farming is an alternative, but equally high value path for the New Zealand industry to follow.

A viable grassroots sector will invest in the future

Farm businesses must be viable and profitable if farmers and growers are to continue to invest in developing their land and utilising the infrastructure and technology available to improve their productivity. This is more critical at the tail end of the global financial crisis as restricted credit availability is slowing the level of land sales and reversing historic price increases, suggesting that the capital gains on land that have supported business returns and borrowing levels in the sector in recent years are unlikely to reoccur in the foreseeable future. Adoption of the efficient producer model will remain a pipe dream if we lack a viable farmer/ grower sector in New Zealand.

Profitability of an average sheep and beef farm (\$000)	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09	09/10
Total gross revenue	333	322	292	330	301	299	290	347	318
Fertiliser, lime and seeds	37	38	35	41	38	38	42	44	41
Other working expenses	116	123	120	134	134	135	134	139	137
Interest	25	30	30	35	41	48	55	56	52
Standing charges/ depreciation	35	41	41	46	47	48	50	49	50
Total expenditure	214	232	225	256	259	270	281	289	280
Farm profit before tax	119	90	67	73	42	29	9	59	37
Farm profit before tax (%)	36%	28%	23%	22%	14%	10%	3%	17%	12%

Source: Meat and Wool New Zealand – Economic Service; Sheep and Beef Farm Survey – Per Farm Analysis, Class 9 All Classes – New Zealand; 2 February 2010; www.meatnz.co.nz Note data for 2008/09 season is provisional and 2009/10 is forecast

Farm costs are driven by many factors, including global prices for base fertiliser commodities, the climatic conditions which impact on the need for supplemental feed, fuel prices, bank lending rates and the mix between operator performed and outsourced activities. Profitability for an average sheep and beef farm over

⁹ Waikato Times; Scientists 'morally obliged' to use GE to solve food crisis; 27 January 2010; www.stuff.co.nz

¹⁰ New Zealand Farmers Weekly; Europe finally gets nod to grow GM spuds; 15 March 2010; www.farmersweekly.co.nz

the last decade has varied significantly as farm gate prices and input costs have varied. DairyNZ analysis on returns for dairy farms shows similar volatility, with the operating return from an average dairy farm varying between breakeven and a high of around 10% over a similar period.¹¹ Against a background of land prices which have risen significantly over this period, the operating return on investment of the average farm has been poor in the last ten years, particularly given the risks that farmers take on.

The owner operator farmer has been able to adopt a farm for survival mode during challenging financial times. Our business advisory team has seen this in the dairy industry over the last two seasons as the payout fell and was initially expected to remain low in the 2009/10 season. Costs are cut through minimising external inputs, reducing the use of external labour and contractors and minimising drawings out of the business. This approach has historically served the sector well in coping with challenging financial times, however the trend towards consolidated ownership of farms in corporate structures adds more fixed cost and overhead to the farming model, making it harder to strip costs back during challenging financial periods. Cost management and control assists in maintaining short term financial solvency of a business, however does not drive long term productivity growth and efficiency improvement.

The challenge for many farmers will be committing to the investment to change their on farm processes when in many cases they are already financially strained and the industry structures beyond the farm gate are in flux

Transition from the low cost model to the most efficient producer model is likely to increase on farm costs, through investment in irrigation and farm infrastructure, new grass varieties, enhanced nutrient strategies for the land, on farm monitoring and tracing technologies and genetic improvements of the herd. However the improved quality of output and increased productivity will enhance the farm profitability. The challenge for many farmers will be committing to the investment to change their on farm processes when in many cases they are already financially strained and the industry structures beyond the farm gate are in flux and not assured to secure them the financial benefits from delivering a larger, higher quality supply of product.

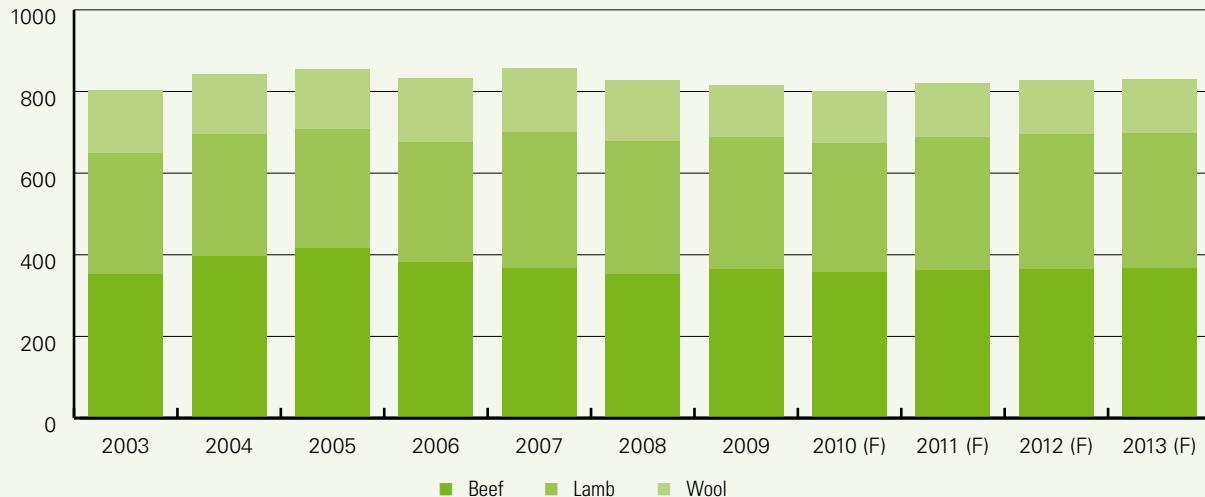
Current industry structures for processing and marketing may not be optimal

During our conversations we have received comments on the perceived need to reform industry structures in many of sectors of the New Zealand agribusiness industry, however there is also a general assessment that there has been little will within the industry or government to make the required changes in many sectors. It is our belief that without reform in some sectors, notably meat, wool and pipfruit, it will be a significant challenge for the industries to maximise their potential throughout the supply chain and they would be unlikely to achieve most efficient producer status.

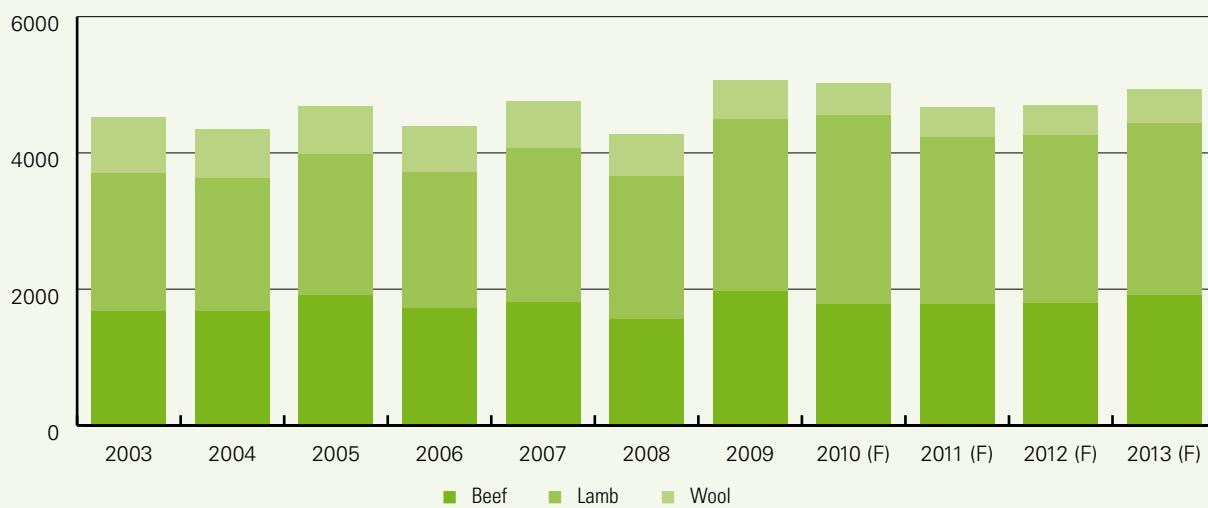
Much has been written and spoken in recent years about the performance of the meat and wool sectors and we have had an almost universal view expressed in our conversations that both of these sectors need urgent consideration to be given to the appropriate processor/ marketing structure to enable the industries to improve their overall profitability. Export volumes from the sheep and beef sector have shown no growth in recent years and Ministry of Agriculture and Forestry (MAF) projections for the next four seasons indicate little expectation for this situation to change in the short to medium term. As a consequence the fluctuations in export earnings from the sector arise from movements in prices and exchange rates rather than any real volume growth.

¹¹ DairyNZ; DairyNZ Economic Survey 2007-08; June 2009; www.dairynz.co.nz

Export volumes in the sheep and beef farming sector (000 of Tonnes)



Export revenues in the sheep and beef farming sector (\$m)



Source: Ministry of Agriculture and Forestry; Situation and Outlook for New Zealand Agricultural and Forestry; July 2005 and July 2009; www.maf.govt.nz

A report on the future of the meat sector prepared by MAF in June 2009 highlighted some of the key constraints on the sector, including a heavy reliance on a small number of traditional markets (where participants face a variety of international competitors and alternative protein choices), capital constraints that limit the ability to invest in innovation and a structural overcapacity in the sector which results in sub-normal profits for the processing companies. The poor financial performance of the industry has consequently made alternative land uses more attractive and has led to high conversions of sheep and beef farms to dairy operations in recent years. The remaining farmers left in the industry have often taken short term survival decisions to maximise the profitability of their businesses.¹²

MAF highlighted four potential future scenarios for the industry including slippery slope (a continuing decline in size and profitability), a new market orientation (increase market exposure, secure year round supply and successful processor consolidation), shrink-to-fit (sector right sizes for lower supply and achieves competitive advantages in traditional markets) and the knowledge industry (a step change in innovation generates true customer partnerships leading to greater internationalisation of the industry). Our conversations suggest the meat industry

¹² Ministry of Agriculture and Forestry; Meat: The Future – Opportunities and Challenges for the New Zealand Sheep Meat and Beef sector over the next 10 to 15 years; 24 June 2009; www.maf.govt.nz

Our conversations suggest the meat industry is currently at the top of the slippery slope with little collective will to change its long term course, despite there being widespread understanding of the need for change

is currently at the top of the slippery slope with little collective will to change its long term course, despite there being widespread understanding of the need for change. The industry appears to lack a catalyst for change despite the stagnant financial performance, and it was widely suggested to us that the major processing companies are digging in to be the last one standing at the bottom of the slope.

Compare briefly our meat industry to Brazil's, where government figures suggest that the livestock and cattle raising sector in that country grew by 5.8% in 2008.¹³ JBS, now one of the largest meat companies in the world, has grown out of the Brazilian meat industry over the last 10 years with significant acquisitions in Argentina, the USA, Australia and Italy and has further global growth aspirations.

Our meat industry should have ambitions to become a most efficient producer (or a knowledge company) to utilise an integrated, technologically innovative supply chain to meet the requirements of customers around the world with year round supply. There is no reason why a restructured New Zealand meat industry could not emulate the success that JBS has achieved in the global meat industry or Fonterra has achieved in the export dairy sector. We believe the lack of growth in the industry is the catalyst for change and support the view that the time is now right for the industry to develop a structure that will secure its future long term. A realistic alternative if this is not done is for JBS or a similar company to enter the New Zealand market through acquisition of one or more of the processors and change the industry landscape forever.

Even industry bodies delivering to producers face challenges

There are agribusiness industry sectors where the structure adopted appears to be working for the good of all participants in the market. Two examples that have been highlighted during our conversations are the wine and kiwifruit industries. Both have become major export industries over the last 10 years but have achieved this using very different industry structures.

New Zealand Winegrowers works in partnership with wineries, providing support by investing levy receipts in industry good research and development and marketing activities, but leaves the day to day interaction with customers to the individual wineries. The wine model has leveraged New Zealand's global brand and made it specific to wine, creating an environment where the wineries are able to open conversations with customers that already understand the product's background story and quality proposition. The recent double headed challenge of oversupply of grapes and falloff in international demand as a result of the recession have, however, had a significant impact of the profitability of the industry and raised concerns as to whether much of the work done over the last decade in international branding wines, particularly Marlborough Sauvignon Blanc, to achieve premium prices has been devalued. These are challenges that have decimated the value of the Australian wine industry in recent years and have the potential to do long term damage to the New Zealand industry.

The wine industry has demonstrated many of the aspects of a most efficient producer in recent years, consistently integrating new innovation into production processes while focusing on the requirements of the customer for a sustainable, quality product to command a price premium over the mainstream market. The industry is already collectively working to restrict the supply of grapes (with a target set to reduce the harvest by around 7% this season), introduce new varieties to the international market and develop product to suit the tastes of new customers, particularly in China. The response of the industry to its current challenges will demonstrate whether it has already become New Zealand's first most efficient producer sector.

¹³ Brazilian Government; Economy sectors – Farming and cattle raising, 2009; www.brazil.gov.br

Widely adopting a most efficient producer model will require significant change in mindset and behaviour at many levels across the New Zealand agribusiness industry. We do not believe that the sector has an alternative choice if it is to be anything more than a producer of expensive commodity products competing against production from new low cost regions



Photo by Petr Hadrava KPMG Auckland

We also consider the kiwifruit industry demonstrates many of the traits of a most efficient producer industry although the current single desk structure is not accepted as optimal by all industry participants. The single desk export model to markets outside of Australia, through Zespri, has created a very different export structure to the wine industry but a structure that has also introduced innovative products to the market and created significant brand awareness for New Zealand kiwifruit around the world. Zespri has been able to utilise the single desk approach to invest heavily in research and development (the most tangible sign of this being the gold kiwifruit which generates a grower premium of around 38% over the traditional green fruit) and offshore production facilities to ensure an ability to provide customers with year round supply. This together with a significant investment in consumer focused marketing in key countries has grown exports from \$321 million in 1995 to \$871 million in 2008.¹⁴

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¹⁴ Plant and Food Research; Fresh Facts – New Zealand Horticulture 2008; 2009; www.plantandfood.co.nz

Capitalising the industry for growth

The low operating returns that have been generated from the agribusiness sector have led many investors to question why they should invest in agriculture when there are investment options available to them that have better returns and lower risk. A common theme in many of the conversations we have had with agribusiness leaders is that investor perception of returns available in the sector has led to the industry being capital constrained on a number of levels. The lack of "on farm" equity is considered to be an issue at the farmer/ grower level where high gearing is placing a constraint on the effective operation of farms and investment in land improvements. It is also highlighted as an issue with the producers and processors who are struggling to access the capital they need to invest in their businesses to position them to compete more effectively in global markets.

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The recent report by the Capital Markets Development Taskforce has highlighted New Zealand has a fundamental issue with the depth of its capital markets, describing New Zealand as 'capital shallow'. In the Taskforce view this has resulted in under investment in the physical capital stock of the country and consequently limited our ability to increase productivity to maintain incomes at comparable levels to other OECD countries.¹⁵ Conventional wisdom is that the lack of depth in the capital markets is compounded in the agricultural sector where co-operative structures have traditionally been used and have relied on supplying shareholders to provide the funding for growth. As land prices have inflated in recent years this has constrained the ability of many suppliers to provide additional capital to the co-operatives at a time when they need it to take advantage of the growth available in a protein constrained world.

New Zealand agribusiness is under represented in a shallow capital market

The representation of Agribusiness companies on the main board of the New Zealand Stock Exchange is significantly underweight to the contribution that the sector makes to the wealth of the economy. There are 11 predominately agricultural focused companies listed on the NZX with a market capitalisation of \$1.8 billion, representing around 3.4% of the total capitalisation of the market (\$53 billion) and significantly lower than the individual market capitalisation of Fletcher Building, the current market leader at \$4.9 billion.¹⁶ The argument has regularly been run that this is a reflection of the fact that farmers are unwilling to cede control of the large producer co-operatives. However non industry investors have not necessarily looked on agribusiness investments favourably in recent times, with two proposed initial public offerings (Synlait Dairy Company and BioVittoria) being withdrawn prior to listing in the last six months. The extent of upfront investment in capital assets, the low cash returns and the high susceptibility to uncontrollable variables such as weather, commodity prices and exchange rates have all been identified as reasons the market has not looked favourably at investment in the sector.

¹⁵ Capital Markets Development Taskforce; Capital Markets Matter – Summary report of the Capital Market Development Taskforce; December 2009; www.medi.govt.nz

¹⁶ National Business Review; New Zealand Capital Markets; 4 March 2010; www.nbr.co.nz

The implication of this assessment is that the growth of the New Zealand agribusiness sector has been constrained due to the lack of availability of equity and has had to rely on debt funding to invest in any growth initiatives undertaken. The following table provides a summary of an analysis we performed on the funding arrangements of three groups of companies; the largest industrial companies listed on the NZX, the largest agricultural co-operatives and the listed agribusiness companies, to assess whether there is a material difference in the funding structures of the companies.

	NZX Listed Industrials	Agricultural Co-operatives	NZX Listed Agriculturals
Interest cover ratio (Net interest expense cover by operating earnings before tax, interest, non-operating items, depreciation and amortisation)	5.00	3.00	3.47
Operating return on total assets employed	11.9%	9.8%	6.9%
Operating return on equity employed	27.5%	25.8%	15.3%
Equity funding ratio (Equity over total debt and equity)	55.8%	49.7%	50.6%
Proportion of debt classified as a current liability	14.9%	31.7%	67.1%
Ratio of total debt over total assets employed	34.4%	38.6%	44.0%

Source: KPMG analysis of most recent annual report issued by companies included in the sample. Grouping for NZX listed includes 15 largest NZX listed industrial companies by market capitalisation. Group for Agricultural Co-operatives includes 15 largest agricultural co-operatives that are members of NZ Co-operative Society. Group for NZX Listed Agriculturals includes listed agricultural stocks.

Our analysis indicates that agribusiness companies do use more debt in their funding structures than the large listed industrials however the noticeable difference between the groups of companies is in respect of the level of reliance on short term debt. Our analysis indicates that the listed industrials reported around 15% of their year-end debt as current (ie repayable within 12 months) while for the agricultural co-operatives current debt amounted to 32% and the listed agricultural sector companies reported current debt at 67%. The reliance on short term debt is reflected in the lower interest cover levels reported by the agricultural companies (due to the higher costs often associated with short term debt) and would also suggest that funding is being used to cover immediate working capital requirements rather than longer term strategic investments.

The agribusiness industry may be capital constrained as a result of land price inflation

Our research does not suggest that there is a material difference between co-operatives and listed companies in respect of the equity employed in the businesses, but there is a concern as to whether the co-operatives are able to call on more capital to fund investment. Fonterra recently offered shareholders the opportunity to increase their investment in the co-operative through purchasing 'dry shares' or shares that are not linked to production. A total of 3,461 shareholders (around 33% of total shareholders) subscribed for shares, investing \$271 million, although Fonterra has yet to announce how many dry shares have been issued as opposed to normal season adjustments for increased supply.¹⁷ Had all shareholders subscribed for their full entitlement of dry shares the co-operative would have raised approximately \$1.1 billion; the actual subscription level consequently represents a take up of around 24%. The uptake of the Fonterra offer is consistent with the experience that Silver Fern Farms had when they offered investment shares to their co-operative shareholders, the company raised \$22 million noting that the capital investment was at the lower end of expectations,¹⁸ with the subscription level for new shares at around 18% of available shares. Compare these situations to some of the listed companies

¹⁷ Fonterra Co-operative Group Limited; Media Release – Fonterra raises \$271 million from farmers; 25 January 2010; Annual Report 2009 – Annual Report; September 2009; www.fonterra.com

¹⁸ Silver Fern Farms; Stock Exchange announcement – Results of Silver Fern Farms' Exchange Offer; 9 October 2009; www.nzx.com

The old adage that farmers do not trust the capital markets and prefer to be invested in tangible assets, such as land, still holds true

that have made fully subscribed equity raisings in the last year, Nuplex, Sky City, Fletcher Building and PGG Wrightsons for example, and it would appear that there remain real challenges for co-operatives raising equity. Our business advisory team suggest the old adage that farmers do not trust the capital markets and prefer to be invested in tangible assets, such as land, still holds true and is in part responsible for the low take up of these recent co-operative share offers.

The explanation for the low uptake of recent co-operative equity offers may be found in the Financial Stability Report issued by the Reserve Bank of New Zealand.¹⁹ The report highlights that on farm debt levels have doubled in the period between 2004 and 2009, with the dairy sector leading the debt accumulation due to increasing land prices and heavy conversion of pastoral and forest land to dairy farms on the back of expectations of long term increased payout levels. The Reserve Bank notes "that a number of farms are experiencing significant financial distress and are working hard to cut costs and reduce debt levels" and they state that "rural land prices rose beyond sustainable levels until around the middle of 2008, with buyers and sellers taking an overly exuberant view of the prospects for the sector."

The Reserve Bank has responded to concerns about the level of debt accumulation in the sector by imposing new minimum capital ratios on the banks. The capital the banks are required to hold to back their loan books is to be calculated using the risk weighted methodology included within the Basel II framework. The conversations that we have had with banks have indicated that these requirements have a significant impact on the cost of funding for rural lending and that price increases will need to be passed through to farmers as their facilities come up for renewal or repricing. The knowledge that debt price increases are not too far over the horizon together with the level of debt stress in the sector means that for many farmers their primary focus is on retiring debt rather than increasing the capital they have invested in their processing co-operative.

The co-operative model needs to evolve if farmers are to retain long term control

Despite the financial stress that many farmers are currently facing and the challenge this creates to provide the capital that co-operatives require for growth, there is still a strong desire amongst farmers to retain control of their processing co-operative. The Fonterra board has received this message clearly over the last two rounds of capital structure discussions. Fonterra farmers have demonstrated no desire to give up control of the stainless steel assets through which their milk is processed, however this limits the options for the co-operative in sourcing capital to deliver on its international food ingredient strategies.

The challenge to source sufficient equity to fund growth put the long term value add strategies of the co-operative at risk thus the Fonterra board have developed a number of alternative strategies to work around the farmer imposed restriction on an initial public offering, including the sale of 'dry shares' and the implementation of a profit retention policy, reversing the historic practice of paying out 100% of profits each season. Other co-operative boards have moved away from the pure co-operative model and adopted one of a variety of hybrid capital structures to increase capital resources, in some circumstances these facilitate external investment into the co-operative while others enable farmers to trade in co-operative shares. The co-operatives that have adopted hybrid structures have had mixed experiences; the benefit of being able to source external investment capital has, in our view, been balanced by challenges in defining how members returns are distinguished from the trading profits of the business.

¹⁹ Reserve Bank of New Zealand; Financial Stability Report; November 2009; www.rbnz.govt.nz

We consider that the co-operative structure does have the ability to deliver the future for New Zealand agriculture. However the co-operatives may need to be flexible in how and where they source capital and non-supplier investment structures may need to become a more common part of the capital structure

Some of the world's most successful companies are co-operatives so there is no reason why New Zealand co-operative's cannot achieve great success for their members, their investors and the wider economy. In normal economic conditions, companies with well developed strategies and a compelling vision of how success will be achieved should always be able to convince investors that the expected returns justify making an investment in the vision.

The key challenge for New Zealand's processing co-operatives is to ensure that farmers understand the compelling reasons to invest in the future growth of the organisation. This requires the directors and management of co-operatives to engage with the shareholders at many levels to ensure that they understand and are committed to the long term vision. Fonterra, having been faced down by its shareholders over the IPO proposal in 2007, has invested significant time communicating its strategy with shareholders, (directly on farm, at shareholder meetings and at factory open days), through regular email correspondence and newsletters and through the media, having organised a number of sponsored media trips to key parts of its operation. This meant that by the time the directors presented a revised capital structure proposal, the shareholders understood how it linked to the long term plans of the co-operative and the directors understood what changes would be acceptable to shareholders. This level of shareholder engagement must become the norm rather than exception if New Zealand co-operatives are going to be able to secure the capital to take advantage of all the opportunities that are available to them in the new, sustainable markets facing the industry in the future.



Photo by Jennifer King KPMG Auckland

We consider that the co-operative structure does have the ability to deliver the future for New Zealand agriculture. However the co-operatives may need to be flexible in how and where they source capital and non-supplier investment structures may need to become a more common part of the capital structure. Co-operatives need to do a better job at selling their compelling vision of the future, so farmers view their investments in co-operatives as more than a bolt on to their farm, but as an integral part of maximising the value of their business. If co-operatives can achieve this then farmers will be prepared to increase their investment as they will understand the value proposition associated with putting more capital into their business.

Unwinding hindering regulation should be a priority

We see little evidence in our day to day business lives of any substantive reversal in the trend towards increased regulation and compliance

The world we live in today is undoubtedly more regulated than it was 20, or even 10, years ago. Think about the security checks we now face around air travel, the challenges of building a house that complies with the latest building code or the complexity of exiting a non performing employee. Regardless of the messages from the government and regulators about reducing the time and cost associated with compliance and minimising the amount of red tape around processes, we see little evidence in our day to day business lives of any substantive reversal in the trend towards increased regulation and compliance. The challenge for any business, in the agribusiness segment or elsewhere, is consequently to manage the compliance burden in the smartest, most efficient way possible to prevent it becoming a deterrent to running a successful business.

Our discussions with industry leaders have highlighted a number of significant regulatory and compliance issues facing the agribusiness sector. These include issues such as the management of water rights, the roll out of a national traceability scheme, the implementation of the detailed provisions around free trade agreements to access new markets and the increasing regulation of bank lending, all of which are addressed elsewhere in this report. However, this is not a complete list of the regulatory challenges facing the sector, with other challenges including the time taken to obtain consents under the Resource Management Act ('RMA'), the ability to access skilled seasonal workers under the Recognised Seasonal Employers scheme and the implementation of the emissions trading regime.

Further reform of the RMA is required to facilitate growth

The National led government has acted quickly since its election to try and address the frustrations associated with the implementation of the RMA. In September 2009, an amendment bill was passed with the intention of "improving the act by removing costs, uncertainties and delays that have frustrated New Zealand homeowners, small businesses and farmers for years."²⁰ The government acknowledges however that the harder changes to the structure of the act still need to be addressed including critical areas for the agribusiness sector such as aquaculture consenting and fresh water management.

Having recognised the stagnation of the New Zealand aquaculture industry with no new marine farm facilities having been approved since 2004, the government established a technical advisory group to investigate a range of issues and make recommendations on the development of sustainable aquaculture industry in New Zealand.²¹ The group have made many recommendations to government including proposals for changes to RMA as it relates to the planning

²⁰ New Zealand Government; Nick Smith (Environment Minister) – Streamlined resource management law passed; 9 September 2009; www.beehive.govt.nz

²¹ Aquaculture Technical Advisory Group; Re-starting Aquaculture; 15 October 2009; www.fish.govt.nz

The aquaculture industry has a goal of becoming a \$1 billion export industry by 2025, however this target will most likely be unachievable without significant changes to the Resource Management Act

and consenting of marine farms. The group concluded that the RMA treats aquaculture more restrictively than other coastal activities by prohibiting it outside of defined aquaculture management areas, meaning that a plan change needs to be obtained before resource consents can be applied for; having the impact of increasing the cost and uncertainty associated with marine farm development. The aquaculture industry has a goal of becoming a \$1 billion export industry by 2025, however this target will most likely be unachievable without the significant changes proposed by the advisory group being implemented to restart industry growth and address the last 10 years of stagnation under the restrictive provisions of the RMA.



Photo by Ulli Rose KPMG Tauranga

The current limitations of the RMA have also been highlighted in recent months as a result of the consent applications made by three companies for water take, land use and effluent discharge consents for intensive cubicle farms in the Mackenzie Basin. While the prevailing view amongst the industry participants we have had discussions with is that the project should not progress because of the impact that intensive, indoor dairying farming could have on the New Zealand dairy brand globally, all believe the case has highlighted clearly the compliance costs and process failings inherent within the act as currently drafted. Each of the applicants has made three separate consent applications, however the government has been able to call in the effluent discharge consent for consideration by a ministerial board of enquiry, on the grounds of national significance, while leaving the water consent applications to work through a separate and unrelated process with Environment Canterbury,²² while the land use consents have already been granted by the Waitaki District Council.

Whatever perspective you have on the cubicle farm proposal, the ability under the act to create three separate processes, which could ultimately give different decisions on the consent requests is clearly unacceptable if we want to create an environment where agribusinesses are prepared to commit to major capital investments to enhance the productivity of the New Zealand economy. We encourage the government to fast track further structural reform of the Resource Management Act.

²² New Zealand Government; Nick Smith (Environment Minister) – Minister calls in Mackenzie Basin dairy discharge consents; 27 January 2010; www.beehive.govt.nz

Flexibility in employment programmes is required to ensure economic outcomes

The Recognised Seasonal Employer scheme has been a major success since it was introduced by the last Labour government. The scheme enables recognised employers in agricultural industries, such as horticulture and viticulture, to recruit seasonal workers from the Pacific region to cover shortfalls in available labour in New Zealand. The scheme has enabled growers and contractors to source reliable, hard working labour from the Pacific Islands and has been widely used in the industry.²³ However with the onset of the recession and the resulting increase in unemployment, the Department of Labour has taken steps to restrict the availability of RSE workers this year and encouraged companies to source New Zealand workers.

Unemployed people (000's)	Dec 2007	Dec 2008	Dec 2009
Northland	2.0	5.3	6.9
Auckland	25.7	37.5	57.2
Waikato	7.6	9.8	12.4
Bay of Plenty	4.4	5.7	9.5
Gisborne/ Hawkes Bay	5.1	6.9	9.3
Wellington	7.0	10.5	18.7
Tasman/ Nelson/ Marlborough/ West Coast	2.6	3.4	4.3
Canterbury	9.0	12.4	20.0
Otago	2.9	3.2	4.4
National unemployment total	80.0	109.0	168.0

Source: Statistics New Zealand; Household Labour Force Survey – December 2009 Quarter; 4 February 2010; www.stats.govt.nz

However, the location, work expectations and physical abilities of unemployed New Zealanders does not necessarily correlate with the location or requirements of RSE employers, meaning restrictions on the RSE could potentially create employment shortages for the agribusiness sector. Schemes such as RSE provide the industry with certainty and have consequently been very successful in achieving their objectives. It is important that the long term view is taken in relation to this and similar schemes to ensure that the employee requirements of the industry are met and not subject to continual changes in qualification requirements or short term policy shifts.

The reality of day to day business is that compliance requirements continue to increase regardless of the best intentions of the government and regulators. Tax changes, be that the implementation of the emissions trading scheme or the proposed changes to property taxes and GST, all have the impact of increasing the complexity of doing business. Link this with some of the challenges that are faced by agribusinesses wanting to obtain consents to develop their businesses or employ appropriately skilled people it becomes easier to do nothing than to do the right things to grow the business, improve productivity and create more wealth for themselves and New Zealand economy. We acknowledge that the government faces a significant challenge unwinding the regulation imposed on the economy over the last decade, however unwinding regulation that adds little or no value and contributes cost should be an urgent priority if we are to unleash the growth potential inherent within many New Zealand agribusiness sectors.

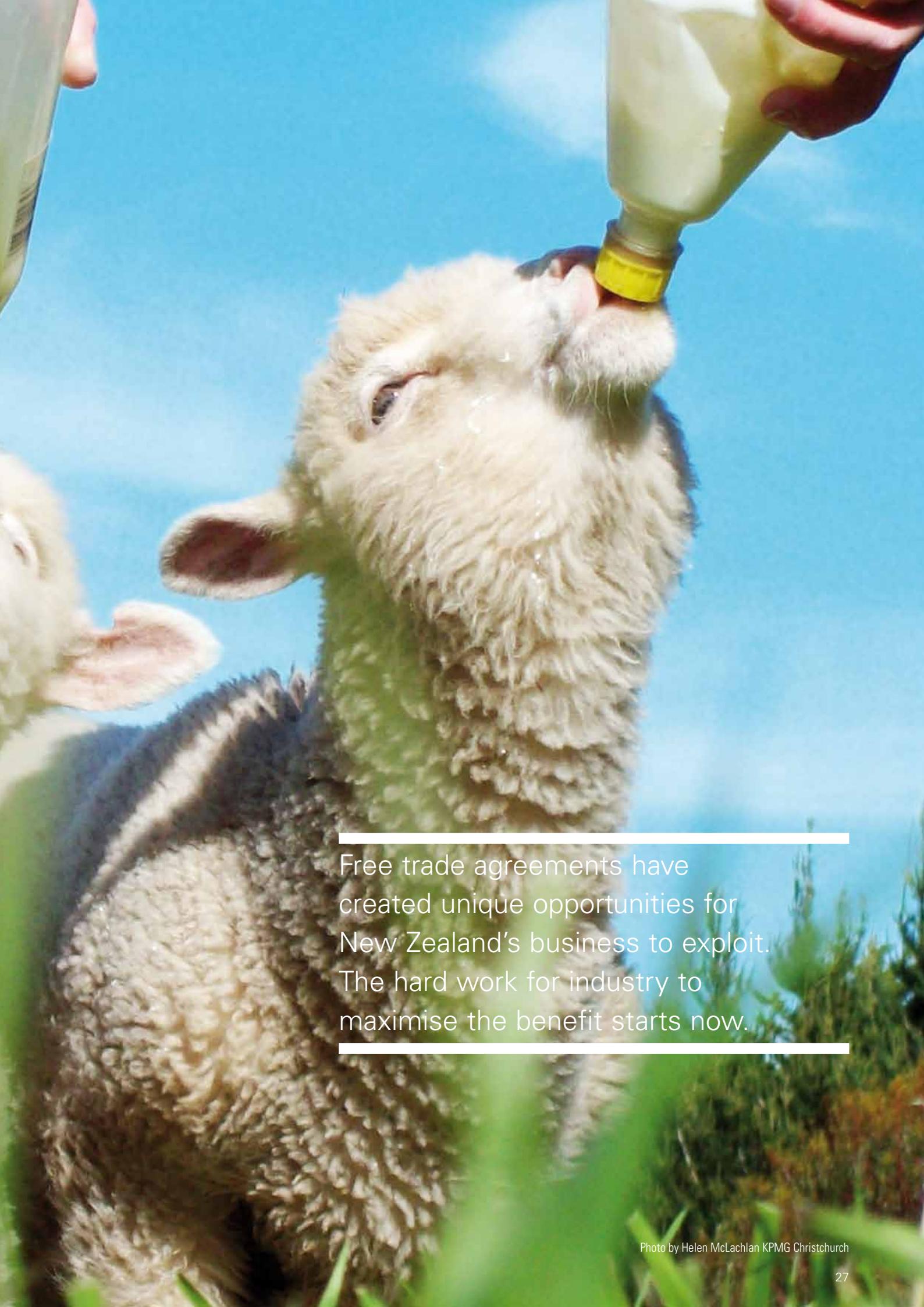
The government faces a significant challenge unwinding the regulation imposed on the economy over the last decade

²³ New Zealand Government; Nick Smith (Environment Minister) – Minister calls in Mackenzie Basin dairy discharge consents; 27 January 2010; www.beehive.govt.nz

Section 2



Addressing future market realities



Free trade agreements have created unique opportunities for New Zealand's business to exploit. The hard work for industry to maximise the benefit starts now.

Meeting the opportunities of new markets

2009 has seen tangible rewards flow for years of behind the scenes work on securing new free trade agreements. Coming on the back of the historic agreement with China signed in 2008, agreements have been signed with the Association of South East Asian Nations (ASEAN) and Malaysia with a number of further agreements awaiting signature or currently in negotiation. In addition to this, President Obama indicated at APEC his support for negotiations for the USA to join the Trans-Pacific Strategic Economic Partnership agreement to which New Zealand is a signatory.

New Zealand's Trade Agreements in Force		New Zealand's Agreements under negotiation	
Date		Status	
Australia/ NZ Closer Economic Relations	1983	NZ/ Malaysia Free Trade Agreement	Signed 2009 not in force
NZ/ Singapore Closer Economic Partnership	2001	NZ/ Gulf Co-operation Council Free Trade Agreement	Concluded not signed
NZ/ Thailand Closer Economic Partnership	2005	NZ/ Hong Kong Closer Economic Partnership	Concluded not signed
Trans-Pacific Strategic Economic Partnership (NZ/ Chile/ Brunei/ Singapore)	2005	Expansion of the Trans-Pacific Strategic Economic Partnership	Negotiations started
NZ/ China Free Trade Agreement	2008	NZ/ South Korea Free Trade Agreement	Negotiations started
ASEAN/ Australia/ NZ Free Trade Agreement	2009	NZ/ India Free Trade Agreement	Negotiations started

Source: Ministry of Foreign Affairs and Trade; Trade Agreements; February 2010; www.mfat.govt.nz

With the exception of the Australian CER agreement, New Zealand's current trade agreements have a common feature – they are not with our traditional trading partners in Europe and North America. These traditional trading relations continue to be governed by complex tariff and quota rules which are designed to skew the markets in favour of local farmers and producers. The European Union is taking some steps to reform some aspects of the Common Agricultural Policy (with major reforms being made in 2003 to move away from a supply subsidy model to an assistance model that is not linked directly to production)²⁴ which has been further refined with recent changes to dairy price subsidies. Little progress is being made through the Doha Round of the World Trade Organisation to establish a level playing field for exporters into the developed markets of the Northern Hemisphere.

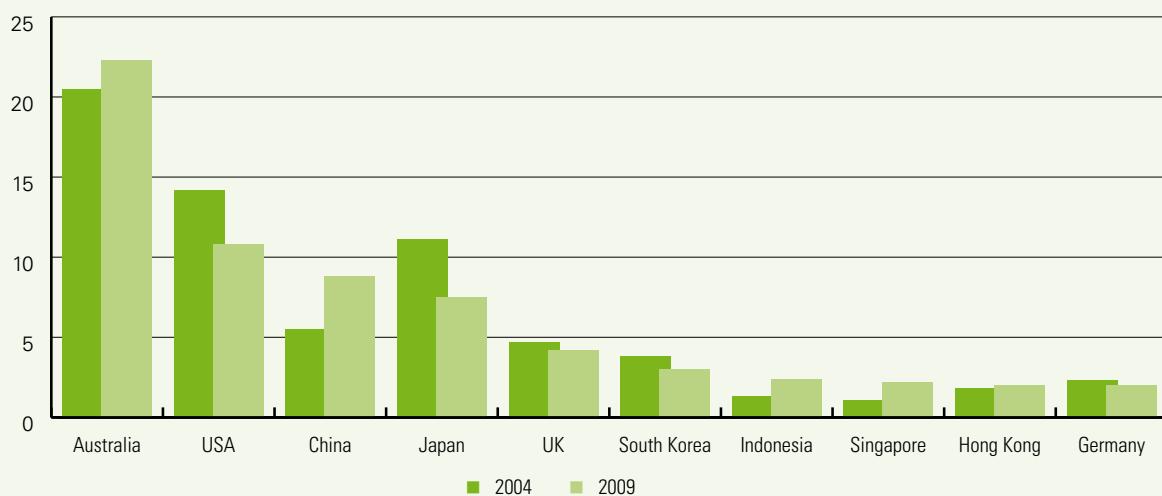
In response to the glacial speed of international trade reform, the New Zealand government has taken an apolitical approach to developing a trade policy that is in the best interests of our country's exporters. That has yielded a portfolio of bi-lateral trade agreements that have opened up a range of new markets to primary producers and had a material impact on the profile of our key export markets in the last five years.

²⁴ European Commission Agriculture and Rural Development; The Common Agriculture Policy Explained; 2008; <http://ec.europa.eu/agriculture/>

Trade agreements are changing the traditional mix of our export destinations

The traditional markets for our products (such as the United States, Japan, the United Kingdom and Germany) were collectively the destination for around 32% of exported product in 2004, however they only accounted for 24% of exports in the year to October 2009. Over the same period growing Asian countries, including China, Indonesia, Singapore and Hong Kong, saw their share of total exports increase from just under 10% to over 15%. Our trade agreements have created huge opportunities, however these opportunities are in markets with different dynamics, business practices and language to our historic markets and consequently present our exporters with a range of new challenges.

Percentage of New Zealand's total export sales - 2004 vs 2009



Source: Statistics New Zealand; Overseas Merchandise Trade Statistics October 2009 and October 2004; www.stats.govt.nz

The trade agreements have placed the onus on our exporters, in the agribusiness sector and beyond, to understand the demands of these customers and do the hard yards to deliver to them

The customers in these new markets have markedly different requirements for our products – they have different taste expectations, they require different levels of product certification and have different supply chains for getting product to consumers. The trade agreements have placed the onus on our exporters, in the agribusiness sector and beyond, to understand the demands of these customers and do the hard yards to deliver to them. The agreements do not guarantee New Zealand exporters one extra dollar of sales revenue but they do ensure that we have a level playing field to sell our products if we understand the needs of our potential customers and deliver to them.

It is no longer acceptable to assume we understand what our customers need; this understanding must be gained through talking and partnering directly with customers to deliver the product solutions they need to be successful in their markets. This demands a much higher level of customer intimacy than we have ever had with our real customers; not the intermediaries and distributors that have historically owned the customer relationships, but with the final retailers and consumers of our products. Customer intimacy enables us to understand the needs of the consumer and to develop solutions that are tailored to meet these needs exactly. It is a move away from the commodity approach that has been dominant in the agribusiness sector for the last hundred years, to supplying a product tailored to a niche market that creates value for the customer and delivers new export revenues for New Zealand.

Innovative strategies are required to deliver solutions to customers

There are many opportunities for New Zealand agribusiness to generate value through utilising the provisions of the trade agreements, both through building on existing marketing strategies and for greenfield market developments. During our conversations we have been told about the successes that the meat industry has had in carving out niche markets for New Zealand grass fed beef in Northern Asia (in competition against grain fed beef imported from Australia and the USA) and the opportunities for New Zealand wine in the growing exports to China. However the product mix presented to customers has to be different to our traditionally successful export products, such as Sauvignon Blanc, in favour of the red wines preferred by Chinese consumers.

The industry needs to give careful consideration to its go to market strategy to ensure it is offering potential customers the solution they need rather than the solution that we believe the world needs

The industry needs to give careful consideration to its go to market strategy to ensure it is offering potential customers the solution they need rather than the solution that we believe the world needs. A good example of innovative thinking is the Dairy SolutioNZ consortium that has been assembled by the Waikato Innovation Park. The consortium is made up of leading New Zealand agribusinesses, including companies specialising in farm management, animal genetics, on farm technology, rural supplies and education providers, and is focused on developing and delivering to clients a large scale farm solution that utilises the best available experience, technology and delivery capabilities available within New Zealand.²⁵ The consortium approach enables a single entity to present to a client a turnkey solution designed to meet their specific business requirements. The consortium announced in January a joint venture project with the Emirates Investment Group to develop large scale farms in the Middle East and Pakistan, a project that management of Dairy SolutioNZ suggest could generate hundreds of millions of dollars of export receipts in future years.²⁶

The opportunities afforded by the trade agreements need to be balanced with the costs and risks associated with commercialising new products in international markets. Decisions on the products which are taken to full commercialisation need to be made carefully as the history of New Zealand agribusiness is littered with examples where the wrong product has been commercialised through a lack of understanding of the needs of the end consumer. The New Zealand Dairy Research Institute spent 15 years and a significant sums of money developing a process to remove fatty acids from butter to create a spreadable butter product in the 1970's, however a quick look at the supermarket shelves today shows that spreadable butters are now made from a blend of butter and oil, a lower cost product which has left New Zealand's spreadable product without a market. Development of spreadable butter was driven by an industry wanting to preserve butter sales volumes rather than understanding what the taste and cost preferences of the consumer were. While there will always be successes and failures in commercialising products, understanding in detail the needs of the end consumer in advance of a commercialisation decision being taken is critically important.

What our new customers demand may not be what our traditional customers have demanded, however the trade agreements that are in force, are ready for signing or are in the pipeline have created a unique market opportunity for New Zealand business to exploit. The onus is on the agribusiness sector's to take this opportunity with both hands and maximise the benefit of the hard work done by the government for producers and the wider NZ economy.

²⁵ Waikato Innovation Park; Dairy SolutioNZ (NZ) Limited – Global, large scale dairy developments; 2010; www.innovationwaikato.co.nz

²⁶ The Dominion Post; Dairy expertise exported in Middle East venture; 28 January 2010; www.stuff.co.nz

Responding to volatility in global markets

Global food and resource shortages during 2007 and 2008 initially appeared to have brought an end to the relative long term stability of international food prices. Increasing concerns over the ability to feed a global population that is expected to increase by 70% over the next 40 years, together with uncertainty around the impact that global warming will have on the long term supply of food and the changing food requirements of consumers in fast growing economies, such as China, India and Brazil, resulted in a severe food price spike which the United Nations Food and Agriculture Organisation data suggests peaked in June 2008.²⁷ With the 2008 food price spike now passed and on the back of the global financial crisis, the obvious question to ask is whether the trends that were seen in 2007/08 were an overreaction to a set of circumstances or whether we have seen a fundamental shift in global markets which makes volatility an increasing part of the day to day reality for New Zealand farmers.

Volatility will be a fact of life for the industry in the future

The amount of land available for food cultivation is relatively fixed thus with the rapid growth in population the amount of land available to feed each person is declining

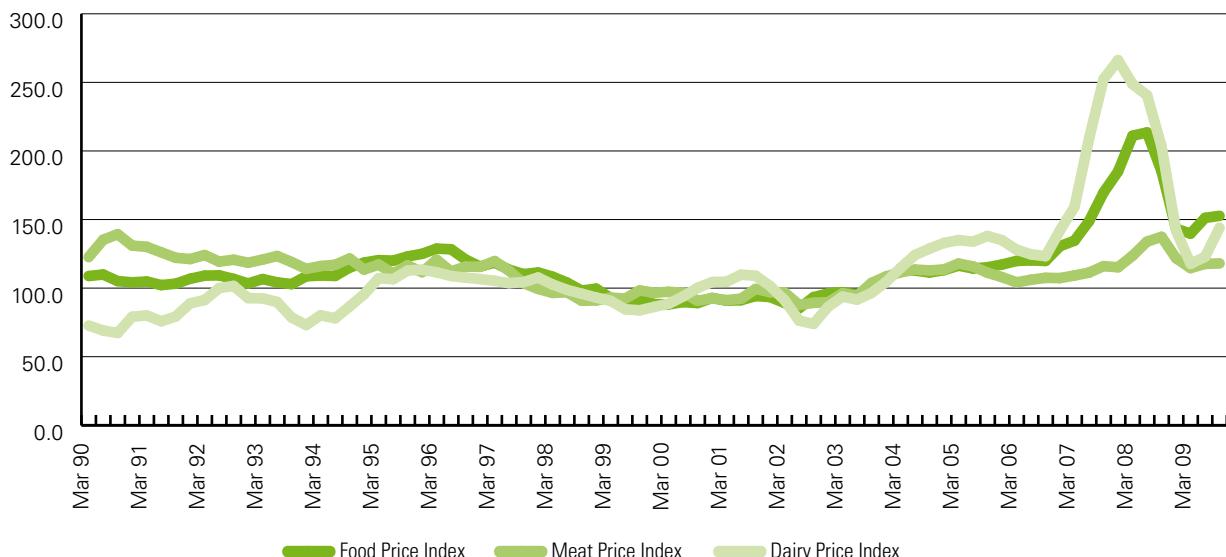
The conversations that we have had with industry leaders suggest a general belief that the global food market is changing as the world starts to face up to the challenge of feeding a rapidly growing population. There is a common view that the amount of land available for food cultivation is relatively fixed thus with the rapid growth in population the amount of land available to feed each person is declining. This increases the susceptibility of food prices to supply shocks, be that an extreme weather event or a unilateral change in trade policy being implemented by a government. At the same time the cultivatable land available is coming under increasing pressure from other uses, including increased demand for plants that can be used to produce renewable bio-fuels and investors looking to cultivate forests as carbon sinks to offset carbon emission charges under Emissions Trading Schemes.

The impact of the 2007/08 food price spike was seen in many developing countries where governments took steps to secure food supply, predominately with the intention of minimising social unrest. The price spike was also felt in developed countries where retail food prices increased significantly. Statistics New Zealand data shows the food price index for the year to December 2008 increased 9.1% compared with an increase of 2.7% in 2006 and 5.4% in 2007.²⁸ Food price movements in New Zealand are further compounded by the volatility of the New Zealand dollar and as a consequence managing an agribusiness in such a volatile environment presents a real challenge to the industry.

²⁷ Food and Agricultural Organisation of the United Nations: World Food Situation – Food Price Indices; January 2010; www.fao.org/worldfoodsituation

²⁸ Statistics New Zealand; Food Price Index; November 2009; www.stats.govt.nz

UN FAO quarterly global food price indices - 1990 to 2009



Source: Food and Agricultural Organisation of the United Nations; World Food Situation – Food Price Indices; January 2010; www.fao.org/worldfoodsituation

During the first half of 2009 much was made of the impact that the Fonterra Global Dairy Trade online auction system was having on the market price for whole milk powder (WMP). The auction mechanism was launched in July 2008 when the achieved price for WMP was US\$4,395 per tonne but this had fallen to US\$1,829 per tonne by July 2009, a 58% price reduction.²⁹ Hindsight suggests that the online auction price was merely reflecting the global drop in commodity prices, the overall FAO dairy commodity index recorded a 47% reduction over the same period. The online auction mechanism provided faster, more accurate information on global market trends than had previously been experienced by New Zealand farmers. It was unfortunate that the system launch coincided with the downside of the largest food price spike in living memory, but it did highlight that the availability of relevant timely information provides the industry with the best opportunity to respond to and manage through volatility.

Innovative ways to address volatility are required to provide a reliable platform for investment

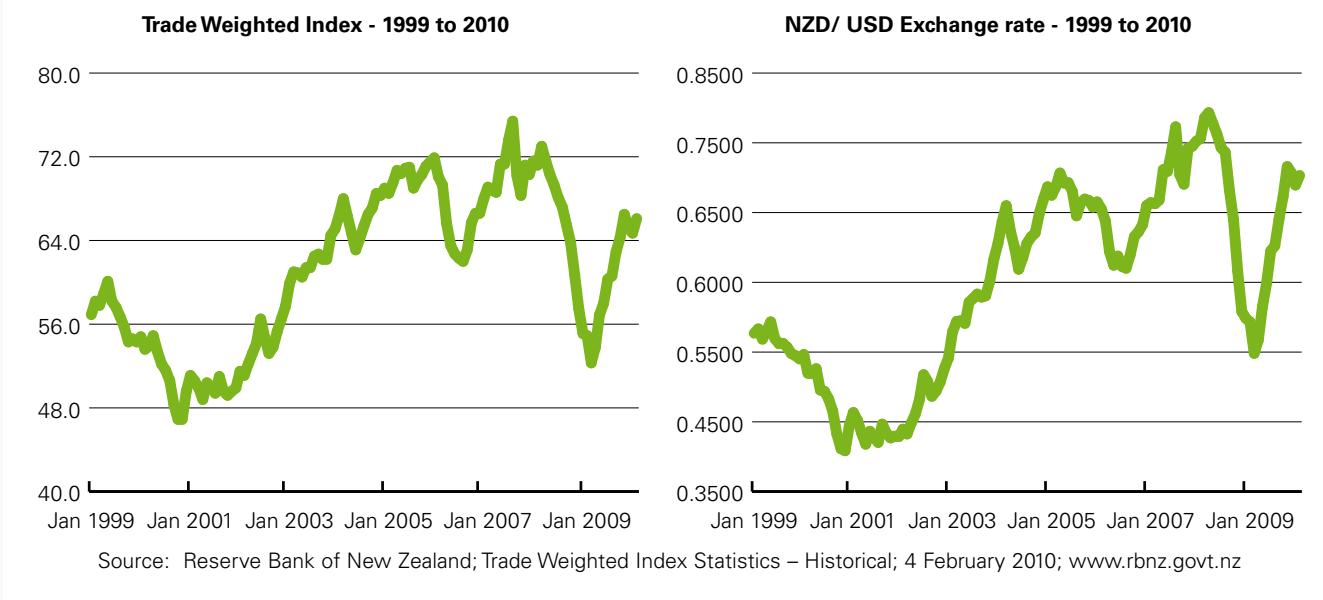
Export payments to farmers for a lamb have averaged \$57.33 over the last 11 years however the average prices have ranged from \$39 to \$71

The sheep and beef sector has experienced significant volatility to returns at the farm gate over recent years. Farmers have consistently expressed frustration over the sector's inability to manage through the volatility and provide some certainty over earnings to enable long term investments decisions to be made for their businesses. Industry statistics show that the export payments to farmers for a lamb have averaged \$57.33 over the last 11 years however the average prices have ranged from \$39 to \$71 during this period. The statistics show a similar trend for beef cattle, with the price of beef animals killed averaging \$763.63 but with a range on average prices over the period of more than \$400 from \$517 to \$966.³⁰ The volatility in farm gate returns in the meat industry is a combination of the prices that are able to be achieved in export markets, the competition for stock between the processing companies in the local market with the exchange rate overlaying the final return achieved. The impact of the exchange rate has been clearly highlighted in the current season where market prices for lamb have been sustained but the impact of the strengthening of the NZ dollar is expected to reduce returns to farmers by around 19%.³¹

²⁹ Fonterra Global Dairy Trade; Historical data on previous trading events; February 2010; www.globaldairystrade.info

³⁰ Meat and Wool New Zealand; Compendium of New Zealand Farm Facts; March 2009; www.meatnz.co.nz

³¹ Meat and Wool New Zealand; Sheep and Beef Mid Season Update 2009/10; February 2010; www.meatnz.co.nz



To address the volatility inherent within the meat industry, the processing companies have placed significant focus on developing partnership programmes with major international customers, such as Tesco, Marks and Spencer, InterMarche, McDonalds and others. These programmes have focused on providing the customer with a high quality, guaranteed supply from identified farmers for which the overseas buyer pays a price premium. The programmes enable the meat processors to approach suppliers to secure supply in accordance with an agreed schedule to supply their customer, enabling them to take a more proactive approach to hedging the currency exposure and providing certainty over returns to the farmer. These programmes reduce the exposure of the industry to the volatility of the spot market and are intended to improve the returns made by the supplier and the profitability of the processing company.

Such programmes also enable meat companies to invest in product innovation to meet the needs of their customers, a recent example of this being the use of processing beef from pure bred Angus beef cattle to produce premium Angus burgers for McDonalds. The Angus burger programme is estimated to increase McDonald's purchases of certified New Zealand Angus Beef by 500,000 kg annually and provides a consistent year round demand for the product which pays a premium to farmers.³² Initiatives such as customer partnership programmes and product innovation provide the New Zealand meat industry with the tools to manage the volatility it has always faced while targeting product at high price, high profit niche markets which provide improved returns to our producers and the economy.

Volatility creates opportunities for those prepared to think outside of the box

Volatility presents the industry with significant challenges but also creates opportunities. One such example is the launch of a dairy futures market by the NZX which will enable farmers to buy derivative contracts to fix the price on a component of their supply. Similar markets have been established in Australia for grain and the US for a range of agricultural commodities and are actively used by farmers as a way of managing the volatility they are exposed to in global commodity markets. Given that instruments have been available to farmers for years to hedge their exposure to currency fluctuations and are not widely used it will be interesting to see the uptake on dairy futures.

³² New Zealand Angus Pure; McDonald's new premium beef range serves up boost to NZ beef industry; August 2009; www.anguspure.co.nz

With the announcement of the final implementation of the Emissions Trading Scheme a further potentially volatile factor is about to be introduced into the equation for businesses operating in the agribusiness sector. It is not yet clear how the global carbon market will develop over the next five to ten years and many commentators have different views. The one certainty would appear to be that carbon credits are becoming a tradable commodity. A potential impact of carbon credits becoming tradable is that over time the market price for carbon offset will vary with investors and speculators being able to distort the price. Managing the volatility associated with carbon markets will potentially present a challenge to the industry and is an area that needs to be kept under observation as ETS style schemes are rolled out around the world over the next few years.

Volatility has been a fact of life for the Agribusiness sector and we expect that as the headroom in global food supplies reduces further that price shocks will become an increasingly common phenomena

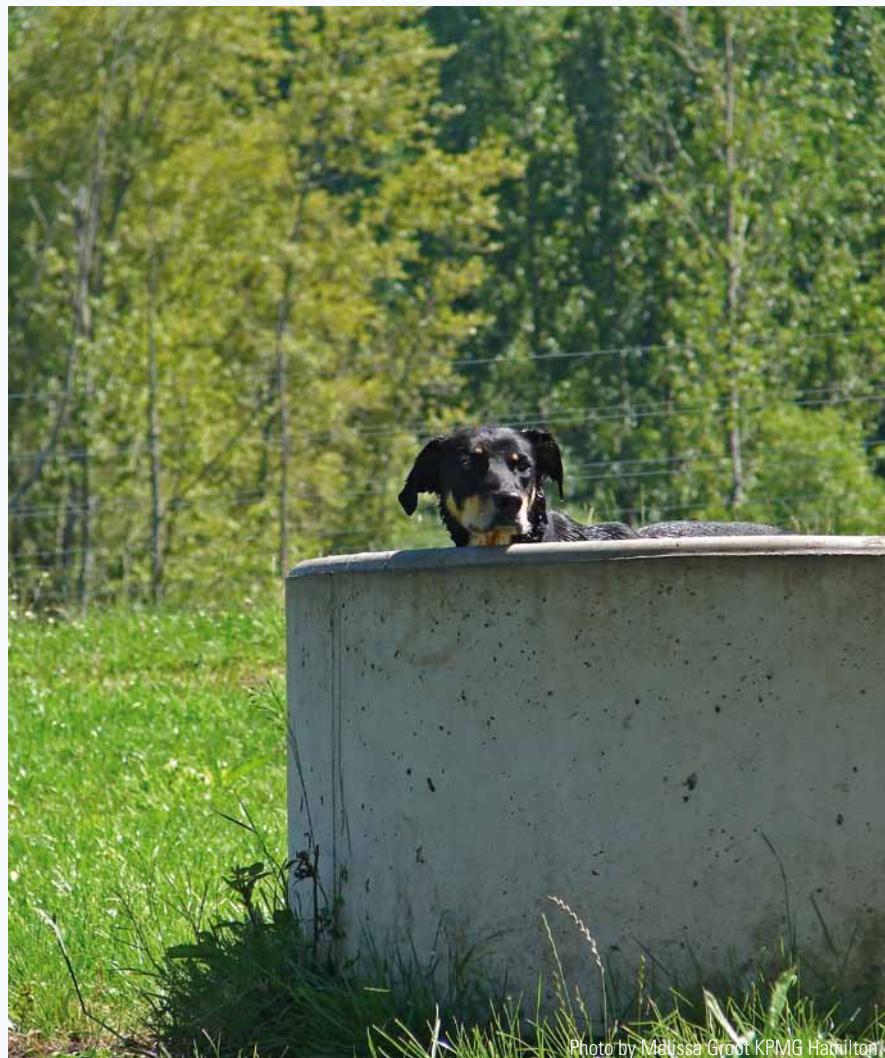


Photo by Melissa Groot KPMG Hamilton

Volatility has been a fact of life for the agribusiness sector and we expect that as the headroom in global food supplies reduces further that price shocks will become an increasingly common phenomena. The challenge is consequently on the industry to develop strategies and tools to better enable the impact of these shocks to be managed and to ensure the viability of producers during the inevitable down cycles.

An over reliance on dated science must change

Our agricultural sector has been predominately relying on old science, much of which was developed in the 1960's and 70's

Improvement in the productivity of New Zealand's primary sectors will be achieved through focusing resource and funds on some key priority areas; investment in productive assets, leadership development, maximising the use of our natural assets and research and development. With customer requirements changing rapidly and New Zealand's primary products being offered into new markets with different consumer demands and expectations, the conversations that we have been having suggest that the need for investment in leading edge science in the agribusiness sector has never been greater. Some of the industry leaders we have talked to have expressed the view that our agricultural sector has been predominately relying on old science, much of which was developed in the 1960's and 70's, for far too long and without significant investment to make the leap forward, the speed at which we are caught and passed by competitor countries will increase.

Despite much talk about the importance of improving the productivity of the New Zealand economy, the track record to date of the National-led government has suggested that they are not fully committed to a view that science is a high priority driver of productivity improvement. Measures the government have taken include the abolition of the Research and Development tax credit, the closing of the New Zealand Fast Forward Fund, to which the labour government had committed \$700 million over a 10 to 15 year period (replacing it with the Primary Growth Partnership which carries a commitment of \$190m for the four year period to 2012/13) and the imposition of a minimum return expectation on Crown Research Institutes.

The Prime Minister in his opening speech to parliament, however, did highlight a desire to increase the connections between the science community and business through making science a high priority area for new spending in the forthcoming budget. The government also committed at the Copenhagen Conference on Climate Change to contribute \$45 million over four years to the Global Research Alliance on Agricultural Greenhouse Gases, an initiative that it has driven to pool the research resources and capabilities from 20 countries to reduce farm emissions while delivering the growth in the food supply that an expanding population demands.³³

Alignment of commercial and research activities can deliver value to an industry

There is evidence within the industry that when a sector aligns its commercial and research activities it can achieve dramatic growth in productivity and export earnings. We consider that one of the significant contributors to the success of the New Zealand wine industry has been the alignment of the levy funded industry good research activities with the commercial requirements of grape growers and wine makers.

³³ New Zealand Government; Media Release - \$45 million for Global Research Alliance, 17 December 2009; www.beehive.govt.nz



Source: Statistics New Zealand Info Base; Value of Exports and Re-exports HS2204 Wine from Q1 1988 to Q4 2009; 26 February 2010; www.stats.govt.nz

New Zealand Winegrowers acknowledges in its annual report that its research programme is focused to provide practical information to the industry to assist with decision making processes. The programme mixes pure scientific work on the fundamental elements of viticulture with initiatives that bridge the gap between scientific discovery and commercial application by the industry. It has also focused on communicating the knowledge gained from research to the industry users on a timely basis. The success of the programmes has meant that for every dollar of levy funding invested in projects there is approximately \$6 of research investment by other stakeholders including government funding.³⁴ The investment in science has been a contributing factor to the dramatic growth the industry has experienced in export sales over the last 10 years in particular.

Contrast this with the New Zealand Wool industry which has experienced a 66% decline in export revenues over the last 20 years as market prices and wool supply has fallen. Growers within the industry voted last year to end Meat and Wool New Zealand's collection of a wool levy which will reduce the funding available for industry good activities including research and development, by around \$11m a year in direct and matched government funding.³⁵

The wool industry has lacked a clear vision for its long term direction for many years, a challenging environment for an industry good body to make targeted, strategic investments in research and development. Consequently, it has also been difficult to demonstrate the value generated from the levy investment. The result of the vote against the levy has been the establishment of a ministerial taskforce to develop a turnaround strategy which will hopefully provide the opportunity to integrate science into a new market strategy for the industry.

The taskforce reported in February 2010, noting that there was no silver bullet to restore profitability after four decades of decline, however concluded that there was a future for the strong wool sector in New Zealand based on building new markets and repositioning wool to highlight the strengths of the product not shared by other fibres. Achievement of this strategy is dependent on many factors, but the report highlighted the "importance of research and innovation in contributing to a vibrant and sustainable future for wool, both on and off-farm". The taskforce further stated a belief that research and development should be entirely focused on new products, processes, customers and markets, however noted that the nature of the activities and how they are funded was outside the scope of the report.³⁶ If the strong wool industry is to reverse the trend it has experienced over many decades, then we consider that the debate on funding research activities must be taken up by the industry as a priority and solutions found to enable industry good investment to recommence in an targeted and strategic manner.

If the strong wool industry is to reverse the trend it has experienced over many decades, then we consider that the debate on funding research activities must be taken up by the industry as a priority

³⁴ New Zealand Winegrowers Inc; 2009 Annual Report – Research Report; 2009; www.nzwine.com

³⁵ Meat and Wool New Zealand; Media Release – Sheepmeat and beef levies to continue – defeat for wool and goatmeat; 31 August 2009; www.mawnz.co.nz

³⁶ Wool Taskforce; Restoring Profitability to the Strong Wool Sector; February 2010; www.maf.govt.nz

CRIs can provide agriculture with the science to gain competitive advantage

The Crown Research Institutes (CRIs) have been a key source of research capacity for the agribusiness sector since their establishment out of government departments in 1992. In recent years the cost and complexity of delivering world class science has lead to a number of the CRIs exploring restructuring initiatives to build scale and capability to better meet the needs of their commercial partners. HortResearch and Crop and Food completed a merger to form Plant and Food, and while discussions on a merger between AgResearch and Lincoln University were not consummated, closer working relationships have been built between those organisations. The National government provided clear guidance to the leadership of the CRIs on its expectations of a 9% return on funds employed on coming into power, which received a mixed response from the sector. The Minister of Research, Science and Technology has subsequently convened a taskforce to examine how the CRIs can best deliver on national priorities and respond to the needs of research users, particularly industry and business.

The Crown Research Institute Taskforce reported in February 2010 with conclusions that the contribution of the CRIs to New Zealand would be improved by addressing factors that impede their performance including funding, ownership and governance arrangements. Specifically the taskforce recommended that a statement of core purpose should be established for each institute to clarify the exact role that entity should play in delivering benefits to New Zealand, addressing the perceived conflict about whether CRIs exist to create value for themselves, as entities, or the economy. The taskforce also recommended that CRIs should be funded on a long term basis to achieve their core purposes and to address the business uncertainty and strategic impediment that the current contestable funding arrangements create. The balance to providing long term funding of strategically important projects to New Zealand is an increase in the governance surrounding each CRI, through greater public accountability and monitoring of achievement against a comprehensive range of performance indicators, with the entities being accountable to a single government owner. The Taskforce concludes that adoption of the changes will make better use of the funds available, provide greater clarity and mandate to boards and improve the confidence and attractiveness of the sector for increased investment.³⁷

CRI sector needs to be given the ability to pursue opportunities which may not be linked to immediate commercial returns

Access to world class science is important to New Zealand agribusiness achieving long term productivity improvements. To achieve this, the CRI sector needs to be given the ability to pursue opportunities which may not be linked to immediate commercial returns. We support the wide ranging proposals included in the taskforce report as a basis to ensure that long term projects required to maintain New Zealand's leading position in the premium food production sector are properly funded and given the focus they deserve. We believe the long term benefits of world class science to the New Zealand economy are not best served by the current return constraints placed on the primary sector CRIs and encourage the government to adopt the proposals made by the taskforce as a high priority.

New Zealand agribusiness will be best served by the full alignment of innovative science institutes, with the commercial and market requirements of the farmers, growers and processes in the sector. The successes of, for example the wine industry or the Zespri gold kiwifruit demonstrate this is a strategy that adds value to the industry and the New Zealand economy. Reports issued recently providing growth strategies for the Horticulture and Aquaculture industries indicate that those sectors are committing to a future based on commercial science. We consider that co-ordinated strategies where the public and private sectors pool their resources and collectively invest in innovative science and commercially focused research will be a critical to the future success of our agribusiness sector.

³⁷ Crown Research Institute Taskforce: How to enhance the value of New Zealand's investment in Crown Research Institutes; February 2010; www.morst.govt.nz

Section 3



Sustainability
is an imperative
– like it or not



...customers in premium markets demand a sustainable supply chain designed from 'pasture to plate'.

Brand New Zealand needs to be backed by substantive actions

Whether you believe that man made greenhouse gases are catalyst for climate change or not, the discussion internationally has changed in a subtle but significant way during 2009. Customers in the premium markets that New Zealand's primary production is targeted towards are now demanding that the supply chain is designed from "pasture to plate" in a sustainable manner to enable them to meet the demands of end consumers for high quality products that are produced and distributed with consideration given to the environmental impacts. The trend is a response to the demands of an increasingly large group of consumers that are making personal lifestyle changes to reduce the impact that they have on the environment as well as seeking to achieve a healthier, balanced lifestyle.

Industry leaders must be prepared to put their personal views on climate change to one side and think about sustainability as a business opportunity rather than purely a cost

As a consequence, industry leaders must be prepared to put their personal views on climate change to one side and think about sustainability as a business opportunity rather than purely a cost. The implementation of the Emissions Trading Scheme will increase costs to agribusinesses, although the direct costs of carbon will not impact the agriculture sector until January 2015.³⁸ The indirect costs of not creating a more sustainable business model could be substantial. It is our view that the ability to demonstrate adoption of a sustainable business model to a verifiable standard will increasingly become a minimum requirement to get an invitation to the negotiating table with the leading retailers and food processors. As an example, Walmart Stores, the world's largest retailer, has a stated public policy to "purchase products that are grown and produced by people who use sustainable practices in their businesses"³⁹

Developing business cases for sustainable opportunities remains a challenge to many

Numerous surveys have been completed to gauge the opinions of executives on the impact that sustainability will have on their business model, operations and reporting. A survey conducted in 2009 by the MIT Sloan Management Review and Boston Consulting Group found strong consensus amongst executives that sustainability is having and will continue to have a material impact on how companies think and act, with 92% of respondents saying their company was addressing sustainability. However, a majority of the same group of executives felt that their companies were not acting decisively to fully exploit the opportunities, with almost 70% of respondents believing that their company has not yet developed a clear business case for sustainability.⁴⁰

³⁸ New Zealand Government; "Nick Smith (Minister for Climate Change Issues): Revised ETS balances NZ's environment & economy"; 14 September 2009; www.beehive.govt.nz

³⁹ Walmart Stores; Walmart is bringing more sustainably sourced food to customers; 14 July 2009; www.walmartstores.com

⁴⁰ MIT Sloan Management Review; Sustainability and Competitive Advantage – Special Report; Fall 2009; www.sloanreview.mit.edu

The MIT Sloan/ Boston Consulting Group researchers sought to explain why respondents recognised the importance of sustainability but failed to develop clear strategies to maximise the opportunity and identified three root causes; a lack of information on which to base decisions, difficulties in defining a business case for value creation and flawed execution. Our conversations have suggested that the results documented by the researchers would be broadly reflective of current thinking within the New Zealand agribusiness sector, although we believe a higher percentage of companies have started to develop business cases to implement sustainable initiatives.

Failure to ingrain sustainable practices creates risk to the public image of New Zealand

Much of the global marketing of New Zealand has been focused around the “100% Pure,” clean, green nature of our environment and it is a story that has been used to support sales of our primary products for decades. However, telling the story is no longer adequate, it is critically important that farmers, growers, processors and distributors deliver on the talk and ensure their practices are consistent with the public image of New Zealand we have spent so much time and money to develop.

While arguments over the carbon footprint of New Zealand product delivered to European and North American customers ('Food Miles') have largely been rebutted, external scrutiny of New Zealand's environmental record is unlikely to subside. Apart from the claims of 'greenwash' made by an environmental journalist in Britain, 2009 has seen a number of challenges to the sustainability of New Zealand agricultural production. Widely reported issues surrounding the breeding practices in the pork industry and the treatment of bobby calves on the Crafar family farms have raised concerns in the minds of the public as to the sustainability of animal management practices. The recent report from The Dairying and Clean Streams Accord also highlighted an increase in the level of significant non-compliance with resource consent and regional plan requirements surrounding the discharge of dairy effluent into streams and waterways together with a near doubling in the number of infringement notices issued in the last two years.⁴¹ The compounding of these issues does cause the urban population and our export customers to question whether our agricultural sector does adopt best practices in respect of environmental management and sustainability.

The New Zealand wild harvest fishing industry consistently has to respond to challenges surrounding the sustainability of its operations

The debate surrounding the consent applications for the cubicle dairy farming proposal in the Mackenzie country has initiated a national debate on what constitutes acceptable farming practice in New Zealand. While Greenpeace has actively highlighted areas where they perceive Fonterra has failed to meet appropriate sustainable production practices, including the importation and use of non sustainably produced palm kernel feeds and the use of coal to power a number of dairy factories around the country. Fonterra contests all of Greenpeace's claims however it is the publicity stunts by activists (such as the boarding of a ship importing palm kernel product) that grabs the media headlines and gets reported around the world, giving attention to the claims of greenwash throughout the New Zealand agribusiness sector.

The New Zealand wild harvest fishing industry consistently has to respond to challenges surrounding the sustainability of its operations. Despite the New Zealand fisheries being rated amongst the most sustainable in the world by an international panel of marine scientists in August 2009,⁴² media reports have challenged the sustainability of the fisheries, including a highly critical article in

⁴¹ The Dairying and Clean Streams Accord; Snapshot of progress 2008/2009, March 2010; www.maf.govt.nz

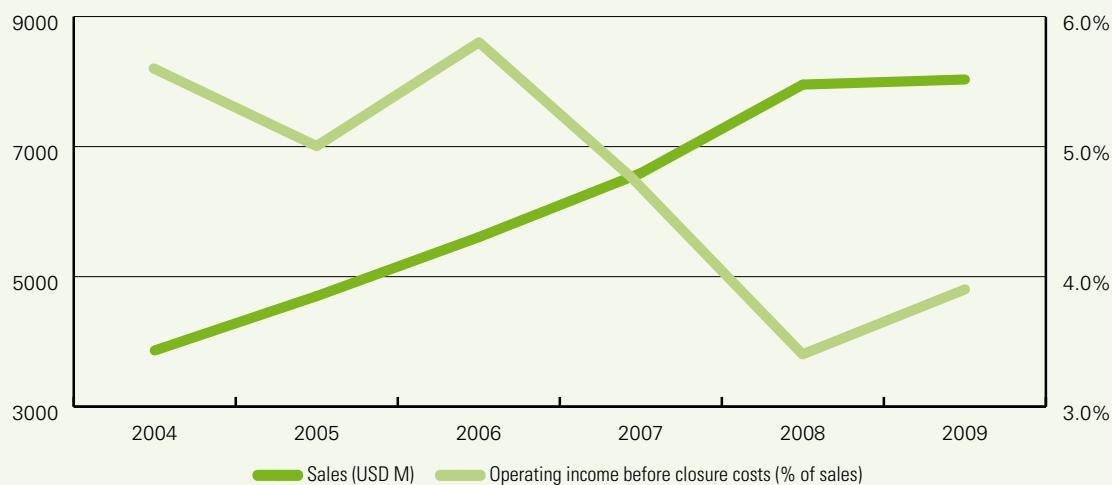
⁴² The Press; Kiwi fisheries get top marks; 3 August 2009; www.stuff.co.nz

the New York Times alleging over fishing of the Hoki fishery. A separate report alleged that UK supermarket chain, Waitrose, is refusing to stock New Zealand caught Hoki because they claim that bottom trawling is used in the industry.⁴³ While both these reports have been able to be substantially discredited the perception of the industry has been impacted. Presenting to a strategy workshop of Te Ohu Kaimoana in November 2009, Sealord management used the Orange Roughy fishery to illustrate the risks to the industry if a fishery is not managed in a sustainable manner.⁴⁴ They noted that the history of management of the species has been poor and that a number of factors, including the use of bottom trawling make it an easy target for environmental groups and consequently the fish has become untouchable in the UK in particular. A clear message was given that the premium Orange Roughy fishery is under threat unless the industry adopts a joint approach to manage the fishery, achieve a sustainable reputation and secure Marine Stewardship Council certification.

There is a growing market for sustainably produced products

Historically concerns have been raised as to whether there is a market for sustainably produced products. Our conversations have suggested that industry leaders consider that the markets exist and although they are often niche at the current time, they are growing rapidly. Whole Food Markets is a US public company that operates stores focused on selling sustainably produced products and consequently provides a barometer of growth in the sustainable food segment in North America. The company has experienced rapid growth over the last five years as consumer demand has grown for sustainably produced food products.

Whole Food Market Inc - Selected Financial Information for years ending 30 September 2004 to 2009



	2004	2005	2006	2007	2008	2009
Stores	163	175	186	276	275	284
Same store sales growth	14.9%	12.8%	11.0%	7.1%	4.9%	-3.1%

Source: Whole Foods Markets Inc; 10K for the 52 week period ended 28 September 2008 and Fourth Quarter Earnings report for the 52 week period ended 27 September 2009; www.wholefoodsmarket.com

⁴³ New Zealand Herald; UK stores reject NZ hoki; 21 July 2009; www.nzherald.co.nz

⁴⁴ Sealord Group; Sealord update - Presentation to Te Ohu Kaimoana; November 2009; www.teohu.maori.nz

Whole Food Markets has increased same store sales in five of its last six financial years with a decline being experienced in 2009 reflecting the impact that the global financial crisis has had on retail sales in the USA. Over the period the company's total sales have more than doubled from US\$3.9 billion to over US\$8.0 billion giving an indication in the growth in consumer demand for sustainable products. The company's annual report highlights that during 2009, Whole Foods Market was one of the top 20 performing stocks in the S&P500 index and was ranked as the 324 largest US public company. John Mackey, the CEO and co-founder, says that with fewer than 300 stores he is incredibly excited about the future as the company is well positioned to take advantage of changing demographic trends, particularly as a greater emphasis is placed on healthy eating.⁴⁵ Whole Foods Market demonstrates that a company that has "selling the highest quality natural and organic products available" as a core value can achieve significant growth and financial success in the modern business environment. Sustainable is no longer niche, it can be the basis of a successful mainstream business and it can be highly profitable.

There are many New Zealand companies in the primary sector using sustainable production practices and highlighting these in their marketing efforts to command a premium price point. The strategies proposed by Elders Primary Wool and Wool Partners International to increase the return that sheep farmers receive on their wool clip are both focused on promoting the sustainable nature of the fibre.



Photo by Archie Simmons KPMG Wellington

Failure to adapt to sustainable business practices will in our view leave the industry facing a future competing in low price, commodity markets

Taking the Just Shorn wool brand as an example, Elders have explained the strategy as responding to increasing calls by consumers for products that are verifiable as environmentally sustainable and made from the highest quality products.⁴⁶ Just Shorn will use new tracking technologies to link the wool in the carpet to its New Zealand origins, guaranteeing to manufacturers, retailers and customers that they are getting the quality product that they have paid for. By providing the verification to customers that the product is sustainably sourced it is expected that it will command a premium price and in turn will deliver improved returns to growers. For Just Shorn or other similar initiatives to work, there is a need to align the grower, manufacturer and retailer with the customer's requirement for a demonstrably sustainable product; while this may add some cost delivering, such a product will add value to all points in the supply chain and deliver better outcomes for all involved.

We believe that ensuring robust, sustainable business processes must be a priority for New Zealand agribusinesses. The adoption of global best practices creates a significant business opportunity for the industry; one where the global first mover advantage is still there for the taking in many premium, niche product sectors. Failure to adapt to sustainable business practices will in our view leave the industry facing a future competing in low price, commodity markets with producers from countries that have increasingly got a significant low cost advantage over our producers.

⁴⁵ Whole Foods Market Inc; 2009 Annual Report; November 2009; www.wholefoodsmarket.com

⁴⁶ Elders Primary Wool; Luxurious new carpet brand making its way to America; 1 February 2010; www.justshorn.com

Traceability is a must do quickly



Photo by Archie Simmons KPMG Wellington

The government established the National Animal Identification and Tracing (NAIT) project in April 2006 with the purpose of developing a universal livestock identification system, supported by a core registry of data that links people, property and animals. The government confirmed in January 2010 that NAIT will be implemented from October 2011 for cattle farmers, with taxpayer funding being provided to build and operate the new system.⁴⁷

The NAIT scheme will develop a single national farm and core animal data system that handles all traceability requirements for cattle and deer (in the first instance). The proposal has been controversial, with Federated Farmers, in particular, expressing concerns about the costs and benefits associated with the scheme for farmers. Federated Farmers in their General Election manifesto published in 2008 expressed concerns that no comprehensive and robust needs analysis for NAIT had been performed together with a cost benefit analysis comparing the "additional costs and benefits of the NAIT bureaucracy with existing systems."⁴⁸ Federated Farmers have argued that NAIT should be deferred until customer requirements are more thoroughly understood to ensure that any system secures trade access and meets biosecurity and food safety obligations. Other commentators have questioned the appropriateness of the technology that has been selected for the initial implementation of the scheme, suggesting that there are newer and better technologies available.

⁴⁷ New Zealand Government; David Carter (Agriculture Minister) – Government gives green light to NAIT scheme; 27 January 2010; www.beehive.govt.nz

⁴⁸ Federated Farmers of New Zealand; 2008 General Election Manifesto – New Zealand's Economic Backbone; 2008; www.fedfarm.org.nz

Many of our key export markets for meat have already implemented identification schemes or are in the process of implementing such schemes

The global trend is towards integrated, national traceability schemes

International developments around animal traceability suggest that New Zealand will be out on a limb if a national animal identification scheme is not implemented in the short to medium term. As the table sets out, many of our key export markets for meat have already implemented identification schemes or are in the process of implementing such schemes. The European Union has mandated animal registration in member states since 2000. It is apparent that the implementation of traceability schemes in Japan, South Korea and the European Union has been driven from consumer demands for safe food which has overridden any concerns about the compliance cost requirements associated with such schemes.

Country	Nature of scheme	Implemented
Great Britain	Individual cattle passports required for each animal supported by a computerised cattle tracing scheme with all bovine animals being identified with an ear tag.	1996
Australia	All cattle, sheep and goats are registered on the National Livestock Identification System, with requirements for recording animal movements varying between states.	2000
USA	National Animal Identification System, a federal-state-industry partnership is currently in an initial implementation period with voluntary participation. Timing on the phase in of mandatory registration is not yet clear.	-
Japan	Each cattle beast has a bar coded ear tag that links the animal to final product with consumers being able to search details of the animal on line.	2003
South Korea	A mandatory beef traceability scheme is being implemented with all cattle required to be tagged to be able to be slaughtered with information being made available on the internet to be matched to product labelling.	2009

Source: MAF Biosecurity New Zealand; Review of Selected Cattle Identification and Tracing Systems Worldwide – Lessons for the New Zealand NAIT Project; February 2009; www.nait.org.nz

The experiences of the Argentine and Brazilian beef industries provide cautionary tales about the risks of not having an integrated tracking system. The European Union imposed import restrictions on Brazilian beef as a result of deficiencies in the national cattle identification and tracing system. The USA has imposed restrictions on the import of Argentine beef following an outbreak of foot and mouth disease in 2006 which highlighted the deficiencies in the tracking systems in that country. These weaknesses have also prevented Argentine beef making any headway in Asian markets and have driven the introduction of a new mandatory tagging system that was implemented in 2007.⁴⁹

NAIT provides an insurance policy for the agribusiness sector

During our conversations, it has become apparent that one of the most significant areas of concerns that industry leaders hold is around biosecurity risks such as an infectious disease epidemic, a significant pest incursion or counterfeit or contaminated products being supplied under a New Zealand brand. The potential catastrophic impact of a foot and mouth outbreak in New Zealand was highlighted around the time of a hoax outbreak on Waiheke Island in May 2005, when it was suggested a full scale outbreak could wipe \$10 billion from GDP and cost the economy 20,000 jobs in a two year period. The reputational risk to New Zealand of counterfeit or contaminated products was highlighted clearly in 2008 with Fonterra being implicated in the Chinese melamine laced milk scare that broke out around the Sanlu dairy company, a business that Fonterra held a substantial minority investment in.

⁴⁹ MAF Biosecurity New Zealand; Review of Selected Cattle Identification and Tracing Systems Worldwide – Lessons for the New Zealand NAIT Project; February 2009; www.nait.org.nz

While NAIT will not necessarily prevent biosecurity incidents occurring, it will provide authorities with the ability to contain those scares in a rapid manner and provide assurance to export markets over the quality and safety of New Zealand food. The processes that Fonterra has in place to track the product the co-operative produces in New Zealand enabled it to quickly demonstrate to Chinese customers the safety of New Zealand products over locally produced products, resulting in a relatively minor and short lived impact on export sales into China compared to what could have been experienced.

Concerns have been expressed to us as to whether the Ministry of Agriculture and Forestry has the incursion response systems in place to ensure that the benefits of NAIT can be captured, with examples being given of the varoa mite infestation in the honey industry or the recent psyllid outbreak in the potato sector, as situations where the incursion response was not quick enough to avoid significant financial damage to impacted sectors. The onus will fall on the Ministry to ensure that its incursion responses are adequate to utilise the data available within NAIT to restrict the impact of any particularly outbreak to the maximum extent possible, given the level of investment being made in the technology.



While we acknowledge that implementation of NAIT may impose additional compliance costs on farmers and processors, we consider international market trends suggest that access to key export markets will increasingly be conditional on the existence of a robust national traceability scheme. The scheme should be designed and implemented to meet both the biosecurity needs of the country but also to align with the commercial expectations of customers, to minimise the risk of duplication of compliance requirements to the maximum extent possible. If New Zealand producers continue to want to have a ticket to play in key, high value export markets we consider implementation of a national traceability scheme is a must do rather than a nice to have. If the scheme is implemented in an optimal way it could create a strategic advantage which would enable New Zealand farmers to command premium prices in export markets, similar to the results that Icebreaker has achieved through the inclusion of "Baa codes" on their merino clothing product packaging, enabling the consumer to use the internet to link their product back to the high country station on which the wool was grown.

Animal welfare is an obligation on all farmers

It is arguable that the two most widely reported agribusiness stories in general media in New Zealand during 2009 both related to animal welfare issues. The pork industry faced a media storm after Mike King fronted a media campaign over the welfare of pigs and pig farming practices. Later in the year, the Crafar family came to national attention following the release of video footage of showing bobby calves that had dehydrated to death on their Benneydale dairy farm. Both of these stories dominated the headlines for a number of days and were picked up and reported across the world. The commercial farming of animals and their subsequent slaughter for food is an element of the industry, that while accepted by consumers, is challenging to many and only accepted on an assumption that farmers are doing all they can to treat animals in a humane and ethical manner during their lives. A real or perceived failure to meet the standards expected by the consumer will, as we saw during 2009, generate a passionate reaction which has the potential to damage the industry both locally and internationally.

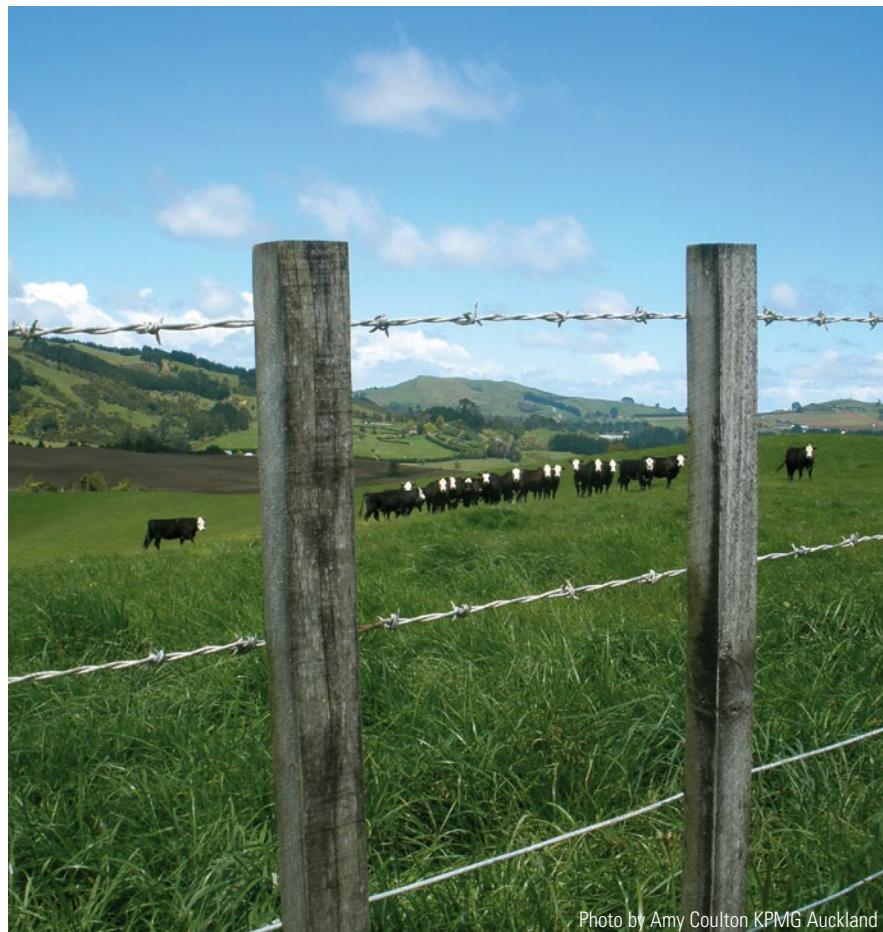


Photo by Amy Coulton KPMG Auckland

"Good farmers...do not take animals for granted. It doesn't matter if an animal is alive for a few days or for longer, we farmers have an absolute duty of care to ensure that they are treated humanely and ethically"

Animal welfare issues do not play well in the media for the industry

During our conversations there has been complete unanimity of views expressed on the obligations on farmers in respect of animal welfare. There is a clear view that there is a moral and ethical obligation on each farmer to uphold the highest standards of animal welfare. In the days following the Crafar farms story breaking, Lachlan McKenzie, the chairman of the Dairy section of Federated Farmers effectively summarised the obligation on farmers, writing "Good farmers...do not take animals for granted. It doesn't matter if an animal is alive for a few days or for longer, we farmers have an absolute duty of care to ensure that they are treated humanely and ethically"⁵⁰

While there is broad agreement that animal welfare is a critical issue, it has been apparent in recent months that there remains significant tension over the costs and benefits associated with implementing improved animal welfare standards. Recent proposals by the National Animal Welfare Advisory Committee (NAWAC) in respect of welfare standards for dairy cattle and animal transport have not met universal approval from the industry, while public consultation on a review of the Pig Welfare Code was deferred late last year amidst threats of legal action from the New Zealand Pork Industry Board. The draft Pig Welfare Code has been released for discussion in early March 2010.



Photo by Gina Barlow KPMG Wellington

NAWAC noted in a press release at the time of the deferral that they were proposing in the code the banning of the use of sow stalls at a date to be agreed with the industry, a proposal the industry has so far indicated that it is strongly opposed to.⁵¹ In its annual report, the New Zealand Pork Industry Board, notes that use of sow stalls during the critical early pregnancy stage reflects international best practice.⁵² Sow Stalls are used to confine an animal during pregnancy (for periods ranging from four weeks to the entire pregnancy) to reduce the risk of miscarriage, in theory increasing the size of a litter and consequently improving the economics of pig rearing for a farmer. Sow stalls have been banned in the UK since 1991 with alternative systems required to be in place by 1999, however data from BPEX (the British Pork levy payers organisation) suggests the UK breeding herd performance is significantly poorer than close European neighbours (where sow stalls are not yet banned) resulting in a higher, less competitive cost of production.⁵³

⁵⁰ New Zealand Herald; "Fed Farmers dairy boss responds to mistreatment reports"; 1 October 2009; www.nzherald.co.nz

⁵¹ Biosecurity New Zealand – National Animal Welfare Advisory Committee; NAWAC Review of the Pigs Code of Welfare; 16 December 2009; www.biosecurity.govt.nz

⁵² New Zealand Pork Industry Board; Annual Report 2009; December 2009; www.pork.co.nz

⁵³ BPEX; Breeding – Improving reproductive performance; January 2006; www.bpex.org.uk

The debate over sow stalls is a clear example of where public expectations of best practice animal welfare and industry economics clash. Another very relevant example is the discussion around bobby calves, which were historically sold by dairy farmers to the Dairy Meats Co-operative for the production of veal. Around 2002, the meat processing companies came into the market and dairy farmers deserted the co-operative for a few extra dollars to the extent that it was eventually taken over in 2004. When Dairy Meats was operating on a co-operative basis, dairy farmers were receiving around \$50 a calf, those prices have now fallen to a point where farmers receive less for a calf than the cost of the milk that they are fed for four days before they are sent for processing. This has created a welfare issue as the calves have become a cost to the industry and consequently farmers facing cash flow constraints look for ways to reduce the cost associated with calves and bring milk supplies into production earlier. Our conversations have suggested that the humane management of bobby calves is becoming an increasingly significant issue for the industry, which if not handled appropriately could have an adverse impact on the profile of the New Zealand dairy industry.

At the end of the day, the consumer has the ultimate ability to determine the course of action that the industry in New Zealand must take

As we have concluded in respect of sustainability and traceability, the requirements of the customer will ultimately govern the animal welfare standards adopted. Increasingly customers want to understand where their food has come from and have certainty that it has been produced using best practice animal welfare standards. While New Zealand farmers may see short term economic benefits from establishing animal welfare standards below global best practice, in respect of the sow stalls for example, these benefits are likely to be short lived as the major supermarket chains increasingly adopt strategies to target sourcing towards products that meet the highest standards. As UK supermarket group, Tesco, notes they require all farms supplying their product ranges (from the Value range through to the Finest range) to meet their livestock standards and codes of practice.⁵⁴ At the end of the day, the consumer has the ultimate ability to determine the course of action that the industry in New Zealand must take.

⁵⁴ Tesco plc; Corporate Responsibility – Animal welfare; 2009; www.escoplc.com

Section 4

Investing in rural infrastructure



In addition to the investment in R&D, three areas that need additional investment are: water, education and communications.

Abundant fresh water is one of New Zealand's greatest economic resources

The scarcity of water around the globe is becoming an increasingly pressing issue in many countries. After a run of droughts in Australia, water policy is one of the most significant agenda items for the Australian Federal government and it has announced an investment of A\$12.9 billion in Water for the Future, a 10 year initiative to prepare Australia for a future with less water. The scheme is focused on securing water supplies for Australian households, businesses and farmers. A\$5.8 billion of the fund is being directed towards sustainable rural water use through enhancing the efficiency and productivity of on farm irrigation and upgrading infrastructure through public and private initiatives.⁵⁵

Water is a globally constrained resource with an increasing value

The 2030 Water Resources Group, which includes the World Bank Group and many global food and agribusiness companies, noted that on a global basis "constraints on a valuable resource should draw new investment and prompt policies to increase productivity of demand and augment supply. However, for water, arguably one of the most constrained and valuable resources we have, this does not appear to be happening [and] there is little indication that, left to its own devices, the water sector will come to a sustainable, cost-effective solution to meet the growing water requirements implied by economic and population growth."⁵⁶

The 2030 Water Resources Group estimate that global water usage could grow from 4,500 billion m³ today to 6,900 billion m³ by 2030 under an average economic growth scenario with no efficiency gains assumed. Agriculture currently accounts for around 71% of global water withdrawal (around 3,100 billion m³) and it is estimated that this will increase to 4,500 billion m³ in 2030. A key driver of delivering the food that it is estimated that the global population will require by 2030 and beyond is the availability of water and the implication is that water will become an increasingly scarce and valuable resource, providing New Zealand agribusiness with a huge strategic advantage if we take action to better manage our water resources.

A consistent message that we get from our conversations with clients and contacts is that water is one of New Zealand's greatest natural resources and one which we currently significantly undervalue. The global water situation means that this has to change and as a country we need to recognise the immense value of our water resources to ensure that they are being managed in

⁵⁵ Australian Government; Water for the Future; December 2009; www.environment.gov.au/water

⁵⁶ 2030 Water Resources Group; Charting Our Water Futures – Economic frameworks to inform decision making – Executive Summary; 2009; www.mckinsey.com

Our water resources must be used in such a way as to contribute to New Zealand's economic growth without adversely impacting the overall environment of the country

a cohesive and integrated manner. To the extent possible, our water resources must be used in such a way as to contribute to New Zealand's economic growth without adversely impacting the overall environment of the country.

The productivity gains that arise when water is used in a strategic manner are significant. Figures from Irrigation New Zealand, suggest that around 4% of New Zealand's farmland is irrigated yet this land accounts for around 12% of agricultural GDP, suggesting irrigated land generates around three times the production of an equivalent area farmed under dry-land systems. Irrigation New Zealand believe that there is around 750,000 hectares of irrigated land in New Zealand and estimate this could be increased sustainably given current water resources, topography and demand to over 1 million hectares, providing significant economic and social benefits to the New Zealand economy.⁵⁷

Government policy needs to prioritise investment in better management and use of water resources

The National led government announced its new strategy "New Start for Fresh Water" in June 2009 which acknowledged that "sound water management is essential to provide for New Zealand's economic development and growth" in response to concerns that in some parts of New Zealand, water resource limits are being approached, which is impacting water quality and resulting in economic opportunities being missed. The government has charged the Land and Water Forum, a non governmental body, with reporting back on water policy options by the middle of this year.⁵⁸

The resolution of a fresh water policy that protects water quality and ensures optimal economic allocation from the water available in New Zealand is of significant importance to New Zealand agribusiness. We consider that irrigation schemes in water constrained areas such as Canterbury, the Wairarapa and Hawkes Bay present opportunities for the government to work with private investors to accelerate the implementation of irrigation schemes given the economic benefits that can be generated and would hope any fresh water policy makes allowance for government investment in irrigation through public private partnerships. We were encouraged by the Prime Minister's comments in his opening speech to parliament, relating to government plans to seek to accelerate the development of irrigation schemes in Canterbury during 2010.

Water is New Zealand's liquid gold. Development of a policy framework that provides certainty over the access, quality and cost of water to agribusiness is important if the industry is to have the confidence to make long term investments in improving productivity and increasing its contribution to the New Zealand economy. We believe that there is a need for national co-ordination of water management strategy to ensure its value as a key contributor to New Zealand's economic future is handled in a consistent manner and in the best interests of the New Zealand economy and not delayed or blocked by local political issues, while ensuring that the risk of unintended environmental issues is appropriately managed.

⁵⁷ Irrigation New Zealand; A few facts about irrigation in NZ; 2009; www.irrigationnz.co.nz

⁵⁸ Ministry for the Environment; Backgrounder on "New Start for Fresh Water" cabinet paper; 24 September 2009; www.mfe.govt.nz

Identifying and developing leadership potential

Running a modern agribusiness, be it a farm, vineyard or processing company requires a leader with a broad range of skills to understand and respond to the complex environment that the businesses now operate in. The long term success of New Zealand agribusiness, like any other business, will be dependent on the industry's ability to grow future leaders both from within rural communities and through the introduction of external talent.

Historically, the agribusiness sector has been one where family succession has dominated the ownership of farms and industry leadership has come from those farmers with the time and inclination to take on a directorship in their co-operative. Land prices have made family succession of farm ownership less likely and it is no longer a matter of the kid that has not left home taking over ownership of the farm which has resulted in an ageing of the farming population. The increases in land prices in recent years have created a barrier for entry for younger farmers looking to buy land and has also placed pressure on 50:50 share milking agreements (as land now represents a greater proportion of the total assets of the venture) significantly curtailing the new entrants ability to enter the industry.

From our conversations, we have identified two recurring leadership issues that it is perceived the agribusiness industry faces – attracting, training and retaining the top talent and implementing processes to ensure that New Zealand's largest business sector has best practice governance. The industry needs to develop strategies to attract the best and brightest on to the land and into the processing and support companies to equip itself with the skill sets to compete effectively in international markets.

Attracting and developing the best talent is a challenge for the industry

The challenge of making a career in agribusiness an attractive option to prospective employees from the school level is perceived as a significant challenge to the industry by many of the industry leaders we have talked to. There is a general perception that careers in the professions (law, accountancy, medicine) or education are promoted in favour of agricultural or science based careers. The complexity and range of dimensions associated with an agricultural career have not historically been promoted to students and it is our belief that industry bodies should be placing more focus on promoting the merits of their industry to prospective employees. A quick review of the websites of a number of major industry bodies highlights that most have career resources available to students, however the quality and relevance of the content varied significantly. We consider that the industry has an obligation to engage with the New Zealand education system at all levels to create a compelling case for young people to



Photo by Helen McLachlan KPMG Christchurch

Attracting the talent is only one component of the issue. There is then also a need to foster and develop that talent with relevant tertiary and post graduate programmes

consider careers in agribusiness and the government should be ensuring that giving students an understanding our rural economy forms a key part of the school curriculum, given its importance to the wealth of our economy.

Attracting the talent is only one component of the issue. There is then also a need to foster and develop that talent with relevant tertiary and post graduate programmes. In Massey and Lincoln universities, New Zealand had two of the world's leading agricultural academic institutions, however a perception has been expressed to us that the pressure to deliver research papers to secure funding has resulted in those institutions reducing their focus on their historic agricultural roots in favour of academic pursuits that attract higher funding levels. Neither Massey or Lincoln feature in the Top 50 world universities listing for natural sciences produced by the Times Higher Education Supplement⁵⁹ which raises the question as to whether New Zealand as a country can afford to not have a recognised world leading institution focusing on the sector that drives a significant proportion of the value creation in the economy.

Organisations such as the Agricultural and Marketing Research and Development Trust (AGMARDT) are involved in funding a range of projects focused at growing intellectual and leadership capability in the agricultural sector. AGMARDT is a not for profit organisation that makes grants to develop the capabilities in the agribusiness sector in leadership, research and innovation, as well as supporting knowledge sharing through funding the attendance of international speakers at New Zealand conferences. The grants and scholarships that AGMARDT and similar philanthropic bodies distribute, together with commercial sponsors and supporters, is valuable. However the funding is limited compared to the total value of the agribusiness sector to the New Zealand economy. AGMARDT's annual report shows that it was able to make 47 grants worth a total of \$2.9 million in the year to June 2009, with many of these being part of longer term committed projects.⁶⁰ We consider that continued investment in some of the innovative programmes throughout the country focused on developing leadership talent needs to be a key focus to increase their accessibility and grow the pipeline of future leaders in the sector and raise the question of whether additional private and public investment is required in tertiary agricultural education.

⁵⁹ Times Higher Education Supplement; Times Higher Education – QS World University Rankings 2009; 8 October 2009; www.timeshighereducation.co.uk

⁶⁰ The Agricultural and Marketing Research and Development Trust; 2008/2009 Annual Report; December 2009; www.agmardt.org.nz

Leaders with governance skills need to be identified and nurtured

The development of talented individuals to work in and eventually lead the industry will to some extent help to address a widely perceived weakness around governance across the agribusiness sector from farmers and growers through to some of the larger processing companies. Our conversations have suggested that many businesses in the sector operate on a here and now basis, focused on ensuring adequate cash flow to survive from day to day rather than taking the time to critically assess the risks and opportunities associated with their businesses and developing strategies to minimise the risks and maximise the ability to benefit from the opportunities. A common explanation for the lack of governance in the sector is that at the request of the participants, key advisors (such as banks, accounting and law firms) have focused on compliance rather than strategic advice and as a consequence independent advice on best practice business governance has not been provided to a key sector in the economy. Some of the major processors have taken steps to strengthen governance within their organisations; good examples being the candidate assessment process that Fonterra has in place for prospective directors and Alliance Group's long term involvement of an independent advisor to the board.



Photo by Sam Caulton KPMG Auckland

We consider that industry participants should be looking to get more out of their advisors than purely compliance services

With the challenges of the last global financial crisis and the food price spike over the last 18 months more agribusinesses are turning to key advisors for advice on governance and particularly understanding and managing risk. We believe that firms such as ours, together with the banks and law firms have an important role to play in providing relevant training and guidance on governance issues to companies throughout the sector. We also consider that industry participants should be looking to get more out of their advisors than purely compliance services and should consider involving an independent director or mentor in their business if they do not believe their current advisers are able to fulfil this role. Industry bodies, banks and other advisors should all be focused on improving the level of governance in the sector as this will better enable the sector to understand and respond to many of the other challenges discussed in this paper.

The land ownership model is changing

The trend away from the one farm, one farmer owner operated model towards a more concentrated ownership structure has been commented on in a number of our conversations. The availability of credit, progress in settling Waitangi Treaty claims and expectations of continued strong dairy payouts has increased the consolidation of land ownership, particularly in the dairy sector, in the years leading up to 2008. The increase in corporate farming groups, many of which have grown out of family farms, together with greater ownership of land by Maori Incorporations and a trend towards farm syndication has increased the separation between land owners and farm operators and created new governance challenges for the sector. Investment decisions that a farmer owner has historically made based on an intimate knowledge of the land are not made so easily from a remote office location and as a consequence there has been some high profile failures in the corporate farming model in the last year.

There is consequently a need for corporate farming groups to ensure that they build governance processes and internal controls to maintain oversight across their operations while providing the flexibility required to enable farm managers to make the instinctive responses needed to achieve the best returns from the land while complying with legislation. We agree with a view that the driver for involving an independent director or adviser to assist in developing robust governance frameworks should not be the level of turnover or profitability but the existence of debt in an organisation, as debt exposes a business to bankruptcy and the way this risk is best managed is through strong internal controls backed by good governance.⁶¹

The agribusiness leader of the future requires a set of skills geared towards operating a business in an international market environment. These include relevant language and cultural skills and the ability to build relationships with customers of sufficient intimacy to identify and understand their most pressing business needs, all the while engaging fully with investors, suppliers and stakeholders on the strategic plans for the long term growth of the business. The leadership and governance model that has been portrayed as having been adopted by the Crafar family to run New Zealand's largest family corporate farming business is not the model for the industry moving forward. Agribusiness leaders are closer to the pulse of the New Zealand economy than they are often given credit for and there is a growing group of dynamic, savvy professionals who have the skills to lead the New Zealand economy into its next major growth phase, however they need the support of effective governance structures, appropriate to the size and complexity of the entities they are leading, to assist and mentor them and the industry to their maximum potential.

Investing in connected rural communities

The productive capacity of the New Zealand economy is increasingly focused in rural communities, yet only 1.6% of the new money the government initially proposed to put into broadband and fibre networks was targeted towards the 13.8% of the population that live in rural communities

A core plank of the National government's manifesto at the last election was the roll out of Ultra Fast Broadband to businesses and homes across New Zealand. They committed to an investment of \$1.5 billion to deliver a future proofed fibre network to 75% of the population over a six year period. In addition to this commitment was a promise to double the Broadband Challenge Fund to \$48 million to accelerate the roll-out of broadband to rural and remote areas of the country. In their pre-election material, National argued that "fibre will deliver big economic benefits for New Zealand – enhanced productivity, improved global connectivity and enhanced capacity for innovation"⁶² The immediate question for many was how would running fibre down the streets of residential suburbs in Auckland, Wellington and Christchurch improve the productivity capacity of the New Zealand economy, a question that the now National government is still to satisfactorily answer.

The productive capacity of the New Zealand economy is increasingly focused in rural communities, yet only 1.6% of the new money the government initially proposed to put into broadband and fibre networks was targeted towards the 13.8% of the population that live in rural communities (approximately 585,000 people)⁶³ that between them grow, process and export 66% of New Zealand's merchandise exports. As a result of lobbying from Federated Farmers and other rural organisations, the government revisited its plans for the rollout of rural broadband and announced the details of the Rural Broadband Initiative in September 2009. This initiative increases the proposed spend on improving the coverage and speed of broadband services in rural regions to \$300 million over the next 10 years, however this does not represent new money but money that has been freed up from a reform of the local residential Telecommunications Service Obligations.

Broadband enables investment in technologies that improve productivity

A common theme throughout this document has been the increasing complexity of agribusinesses and like other sectors of the economy managing the complexity requires rapid access to relevant data and the ability to use technology solutions to analyse the data and communicate the resulting actions efficiently. A regular theme during our conversations has been the slow up take in the agribusiness sector of technology solutions that have the ability to transform productivity and reduce the cost of doing business. While it is undoubtedly the case that the slow take up of technology is in part the result of an ageing population, our conversations have suggested the major deterrent to investing in technology is the unreliable and slow communications platforms that currently exist in rural areas, meaning the productivity benefits expected

⁶² NZ National Party; Broadband plan to get NZ up to speed; 15 September 2008; www.national.org.nz

⁶³ Ministry of Economic Development; Rural Broadband Initiative; September 2009; www.med.govt.nz

are not available to be realised with the current infrastructure. In addition, our conversations have highlighted that the challenge of getting talented young people into the rural sector is compounded by the current communications networks; for a generation that is growing up using social networking sites and online gaming the lack of high speed broadband can be a major impediment to taking employment in a rural area.

Fast and reliable broadband access is necessary if agriculture businesses are to reach their productive potential and realise their opportunities in the global market place

In their response to the Rural Broadband Initiative proposal, Federated Farmers state that "there are significant productivity gains to be had from increasing the quantity and quality of broadband internet provision in agriculture. In fact, in the modern environment, fast and reliable broadband access is necessary if agriculture businesses are to reach their productive potential and realise their opportunities in the global market place. There can be little doubt that businesses and communities that do not have appropriate access to these technologies will suffer"⁶⁴ The view expressed by Federated Farmers and other submitters with similar opinions on the initiative should be carefully considered by government to ensure that the complete broadband package delivers their stated goal, increasing the productivity of the New Zealand economy.



Photo by Anne Edgar KPMG Christchurch

The Government needs to ensure that broadband investment is focused where it will maximise the productive return to economy. This should see rural communities receiving at the least the same levels of investment as urban regions and you could easily build a case based on the generation of export earnings to argue that a greater percentage of the total spend should be directed towards rural communities. The Telecommunications Users Association of New Zealand highlighted this issue in their submission on the initiative, stating "TUANZ applauds the government's re-think which led to an increase in the funding for rural areas, but believes the balance is still skewed too strongly to the benefit of urban areas and the detriment of rural New Zealand...The government should concentrate much more of its funding in areas where it is clear that commercial forces are unlikely to deliver." The broadband initiatives should not be about being able to download movies faster or having fibre past a higher percentage of front doors than any other country in the OECD but must be about creating wealth for the country. The government should ensure a communications infrastructure is built that will help our economy grow rather than one which satisfies political ambitions.

⁶⁴ Federated Farmers of New Zealand; Submission to the Ministry of Economic Development on the Rural Broadband Initiative; 2 November 2009; www.fedfarm.org.nz

KPMG Agribusiness

The leading advisory firm to New Zealand Agriculture

KPMG has worked with agricultural businesses for more than 100 years providing services ranging from assisting farmers and growers with accounting compliance and tax returns to provision of audit, tax and advisory services to many of New Zealand's leading agribusinesses.

In addition to our traditional accounting, audit and taxation services, some of the services we provide to clients in the agribusiness sector include:

- **Sustainability Advisory Services** (including advice on the emissions trading regime, assurance over sustainability reports and advice on adoption of sustainable business strategies)
- **Financial Risk Management** (strategic advice on the design and implementation of treasury and hedging strategies together with accounting advice on treatment of transactions in financial statements)
- **Family Business Advisory Services** (tailored advisory services to family business including investment structuring, succession planning and business mentoring)
- **Trade and Customs Services** (specialist advice around understanding regulations and structuring transactions to maximise the benefits available to New Zealand companies within trade agreements and custom arrangements)
- **Corporate Finance** (a wide range of transaction advisory services on both the buy side and sell side of transactions together with valuation services, modelling support, due diligence, PPP advisory and financial restructuring)
- **Business Performance Services** (advice and implementation services around the design and optimisation of key business process including planning, procurement, logistics and delivery as well as measurement and reporting)

The current recession has resulted in New Zealand Inc rediscovering the importance of the primary sector to the economic well being of the country. Our long history of working closely with many of the leading players in agricultural sector positions us well to understand the issues that the sector is facing, facilitate discussion around these issues and provide targeted, value adding solutions to businesses operating at all levels within the sector.

KPMG Agribusiness has been established to deliver value to the agribusiness sector. Having the agribusiness sector as a strategic focus industry for our firm ensures that our investment decisions on new product development, research, thought leadership, sponsorship and community support are made with thought as to how we can use any initiative to contribute in a positive way towards New Zealand's rural and agricultural communities.



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