DIVERSIFYING SOURCES OF CAPITAL FOR THE PRIMARY SECTORS

The primary sectors are in need of finding more innovative ways to attract capital with both bank credit and foreign investment having tightened. There are a range of possible domestic sources for both debt and equity. To attract some of this capital the sectors need to adopt a different approach and be investment ready.

Access to capital funding

Having access to capital funding is very important in determining the long-run health of a business. Cash flow is often described as the lifeblood of any business - in the case of capital it provides the structure or foundation. Having access to capital funding provides the critical ability to make a step shift when required (or desired) and allows reinvestment to occur to remain relevant in a fast-paced world.

While the New Zealand primary sectors have historically been well served with access to foreign capital, domestic bank capital and internal equity, things have notably tightened in recent years. The two key catalysts were first the dairy downturn tightening bank credit availability and lowering internal equity or retained earnings that were available to reinvest. The other was the Labour-led coalition placing new restrictions on foreign investors when purchasing land-based assets and requiring investment proposals to demonstrate greater economic benefit to New Zealand.

An additional pressure pre-COVID-19 was the Reserve Bank of New Zealand changing the capital requirements for domestic banks (i.e. types of and how much capital is needed to be held against loans) when lending to the primary sectors. This potentially makes it less profitable for banks to lend to the primary sectors versus other areas of the economy.

Post-COVID-19 some of these new measures and the timing of implementation are in a state of flux. However, a post-COVID-19 economic environment is naturally going to make accessing capital more difficult, with bank profitability under pressure, lower internal equity available to reinvest, and general economic uncertainty leading to business cautiousness.

Table 1: Potential pools of domestic capital that could provide more capital to the primary sectors – mid-2019 assessment

	TOTAL ASSETS ($)	NZ ASSET ALLOCATION %	NZ ASSETS ($M)
Crown Investment Entities			
NZ Super Fund	$44,000	40%	$17,600
ACC	$45,000	40%	$18,000
Savings Industry			
Government Super/NPF schemes	$10,000	40%	$4,000
Kiwisaver Funds	$55,000	60%	$33,000
Other Super funds	$25,000	50%	$12,500
Broker Wealth FuA	$25,000	50%	$12,500
Bank Wealth FuA	$30,000	60%	$18,000
Independent Adviser Wealth FuA	$6,000	40%	$2,400
Private Investments			
Non advised wealth	$15,000	90%	$13,500
Family offices	$15,000	25%	$3,750
Iwi funds	$9,200	80%	$7,360
TOTAL	$279,200	51.1%	$142,610

The main point is that with two of the largest sources of capital funding 'restricted' compared with yesteryear, where could additional capital be sourced to fund the future needs of the primary sectors?

The size of the capital gap

The future size of the capital gap for the primary sectors is not well known. There has been limited research conducted on it and it is a dynamic measure that changes with economic conditions. The historic easy availability of bank funding has perhaps limited the need for it and also reduced potential innovation for how the primary sectors attract capital.

An ANZ report from 2012 (*ANZ Insight: Greener Pastures – The Global Soft Commodity Opportunity for Australia and NZ*) provided a base case for the New Zealand primary sectors. It showed that to achieve real value growth of 2.1% p.a. until 2050, $210 billion of capital would be required to grow production/value and $130 billion for intergenerational succession/farm turnover – a total of $304 billion. Some of this was expected to be funded via bank debt and retained earnings, but a capital gap of $110 billion (or $2.8 billion p.a) was identified.

While the analysis is dated, real export value growth has been running at around the mid-2% p.a. mark since. Capital has been found to fund growth through this period, but we suspect general productivity and market conditions (through the record terms of trade) have done more of the heavy lifting to achieve the higher growth rate.

The reality is that a substantial capital gap is still apparent and a lot of capital is still required to fund the following:

- Intergenerational transfer
- High-growth areas such as horticulture and forestry land use change
- Recapitalisation of dairy balance sheets
- Investment to meet environmental/social standards
- Productivity improvements, infrastructure needs (i.e. irrigation)
- Investment needs beyond the farm-gate (i.e. coolstores and fruit packhouses).

In a post-COVID-19 world you might add that the urgency and need to address the capital gap question is even greater if the primary sectors can provide new employment opportunities and help maintain every New Zealander's long-term standard of living.

Some ideas

In New Zealand there are a number of different pools of capital that could potentially be tapped more vigorously to provide funding options either in the form of equity and/or debt. Altogether the government investment arms, the New Zealand savings industry and private equity outside the residential property market are estimated to have total assets of around $280 billion, of which about 50% is estimated to be allocated to New Zealand ***(see Table 1)***.

For context, the total on-farm asset base of the primary sector is estimated to be around $225 billion and total bank debt stands at $63 billion, the lion's share of which is associated with dairying at $40 billion. Outside the private equity space both the government investment arms and the savings industry have very low overall exposure (thought to be in the low single digits) to the primary sectors or land-based investments. So only

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a small proportion of the total capital available would need to be allocated to such enterprises to help fill the capital gap in the primary sectors.

There are range of reasons often given about why the primary sectors have failed to attract funding from some of these pools of capital including:

- Investment structures not being suited to the investors' need and/or regulatory requirements
- Private owners being reluctant to accept 'external' capital and easy access to bank capital as an alternative
- The long-term nature of ownership and often uncertain exit strategies
- Primary sector businesses often not presenting a professional 'investment ready' case (i.e. the financial reporting and record-keeping has not been to the required standard)
- Liquidity concerns if investor funds are required back quickly, or the business under-performs
- Perceived historical under-performance of the asset classes with low rates of cash returns versus risks, which has also led to difficulty in agreeing on valuations
- General lack of sector understanding and experience, with more education required.

Addressing these concerns is not insurmountable, but requires good professional input and more formal business arrangements and procedures. Examples include the primary sector-focused companies that are listed on the NZX. However, these are the minority and their operations/asset base tends to be focused on mid-supply/value chain activities, with generally limited ownership of production end assets. So there appears to be room for new financing innovations to occur at greater scale, especially at the production or farm/orchard end of the supply chain.

Indeed, looking at the Australian market a number of listed and private agri-funds have been created in recent years to buy different portfolios of assets. We are seeing the emergence of some in New Zealand, but the field is fairly limited at present. On the debt funding front there would appear more room for mezzanine debt. This could be used to fund riskier development activities through to recapitalisation of dairy businesses that are currently too financially stretched. Redeemable preference shares could do similar things to mezzanine debt, but in its more traditional form could also be suited to help facilitate succession. Then there is the more traditional form of equity partnerships which exist but have largely been between private investors.

The primary sectors and professionals who provide investment and strategic business advice all need to be looking at more innovative ways of attracting capital.

Being investment ready

While all these funding options can be adapted to different situations in the primary sectors the first thing a business needs to do is to become investment ready. When introducing outside equity or debt there is a need for more formal business arrangements, financial controls and procedures.

The first aspect of being investment ready is to define partner goals, motivations and timeframes. Central to the success is alignment of the partners' goals. During the formation period, and regularly throughout the lifetime of a relationship, it is healthy for all partners to test their alignment with the business strategy. The key considerations should include:

- What are the objectives of the venture?
- What is the investment scope and timeframe for the venture?
- Are each of the partners' investment objectives aligned?
- Will partners be locked in for an initial term for the protection of the business goals?
- How will the venture be funded?

After common goals and timeframes are established a more thorough understanding of a business and what makes it tick is required. This means undertaking all the normal due diligence on a proposition, including:

- What are the inputs, processes and outputs of the business?
- For each of these, what are the key elements for value creation?
- What must the business get right (critical success factors) and what might go wrong (the key risks)?
- How will the business get the critical success factors right, and how will it mitigate the risks?

The formal part of this involves the construction of a business plan showing the returns and assumptions used, a capital expenditure budget and other future development plans, financial projections and so on. Also, directors/managers should be researched, independent legal and financial advice needs to be sought on all structural, ownership and financial decisions, and there should be common objectives among all the partners.

Following this if everything aligns binding business agreements should be entered into. Collectively, these agreements set out the joint venture's goals and how it will operate. They should anticipate the possible points of future disagreement and contain 'ground rules' for the procedures to be followed if partners cannot agree. Common features that a Shareholders' Agreement might contain include:

- Objectives and purpose of the venture
- Authority to make commitments on behalf of the venture
- An indicative investment period (i.e. 'sunset' clause) and a clear process to allow partners to exit, or transfer shares from the partnership
- A share valuation process for changes of ownership
- Financing arrangements
- Meetings and reporting standards. Reporting systems should be regular and timely, and provide all the information to which partners are entitled, which keeps all parties well informed and ensures there are no surprises. Full transparency is an important aspect of successful partnerships
- Voting procedure on major decisions (e.g. capital expenditure, leases, debt funding, investment in other enterprises)
- Disputes processes and how they are to be addressed
- Appointment of directors and an outline of the decision-making process and responsibilities between governance and management
- Other clauses aimed at protecting individuals' property rights
- Employment contract terms for key people, which includes a detailed contract and job description.

In the case of a debt instrument the requirements are usually not the same, but as part of being investment ready it should still be required.

Innovative ways of attracting capital

To conclude, these are just a few ideas of the different options and what could help diversify the sources of capital in the primary sectors. Loosening restrictions on both bank credit and foreign investment could also be thrown in the mix, depending on how much growth needs to be ignited in a post-COVID-19 world. But like most things it is good to have choice. In order to foster this, the primary sectors and professionals who provide investment and strategic business advice all need to be looking at more innovative ways of attracting capital.

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