more give, less take

nab

Sector Insights:

# Corporate Finance Insights

February 2014

# Welcome

**Peter Stephens**
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**Welcome to the February 2014 edition of NAB's Corporate Finance Insights. With MORE to talk about and MORE to think about, our Corporate Finance Insights publication focuses on themes that are topical and relevant to our clients. As with all publications, we include interviews and opinions from key market participants to provide you with insights that can help with your strategic business decisions.**

In this edition we are pleased to present a compilation of articles with an underlying theme around the Australian opportunity in the growing Asian region. We are very pleased to be able to share with you direct commercial experience from David Foote, CEO of Australian Country Choice, one of the largest vertically integrated supply chain organisations in the world, as he discusses the challenges and opportunities of expansion of supply of high quality meat into Asia. Adding to this discussion we have the benefit of an interview with Samuel Wibisono, General Manager Beef Division at Japfa Comfeed Indonesia that has recently made acquisitions of two top end cattle stations to supply Australian beef exports into a growing Indonesian market.

In addition to our client perspectives, some of our specialists have provided their insight into the major trends and opportunities in the Asian food bowl theory and raised discussions on a number of key challenges and opportunities. Including, in supplying our Australian grown produce into Asian markets we have examined the standard and availability of existing infrastructure.

Industry participants unanimously agreed that the quality of existing road and rail infrastructure and competition at ports is a major constraint on the movement of agri-food products within and out of the country. The quality of road and rail systems is critical when delivering perishable goods and linking into 'just in time' logistics timetables. Additionally, ensuring that competition at ports from non-food related products does not result in slower loading times leading to rising shipping, quality issues or storage costs.

Finally, there's a commentary on the recent Third Plenary Session of China's Communist Party's Central Committee. This four-day meeting provides an indication of how the country will be led for the next decade. The ensuing Communiqué – and more detailed Resolution – is the framework by which China's leadership presents the long-term vision for the country's development path and to this how Australia and our business banking customers can prosper.

We trust that you enjoy the latest instalment of our Corporate Finance Insights series.

**Yours sincerely**

**Peter Stephens**
**Head of Capital & Ratings Advisory**
**NAB Advisory**

## In this issue

# A fresh look at Australia in the Asian Century

**Dr Ken Henry**

Non-Executive Director - FASSA, BCom, PhD, DB h.c

**Australia's role in securing the food, water and supply chains of Asia will be dependent on our ability to embrace change and innovation, says Dr. Ken Henry.**

There are some key parallels between the issues my colleagues and I were grappling with when I was leading the development of the former government's White Paper on Australia in the Asian Century and those The Economist team, headed by Laurel West, Asia Director Industry & Management Research, encountered when writing the recent NAB sponsored White Paper – Improving Food Quality in Asia.

As we consider those common issues, we need to start by stepping back and putting them into a broader context.

### Outlook – population and consumption

Over the last 50 years, the world's population has grown about 120 per cent. At the same time the world's production of food grew by about 180 per cent. So food production has outstripped population growth by some margin. Today Asia consumes more than 50 per cent of the world's total food production.

Globally 1 billion people suffer from chronic hunger – 600 million of them live in the Asia Pacific region. A further 1 billion people in the world live on less than US$2 per day in income – those people too should be regarded as being food insecure.

Paradoxically, at the same time we have an alarmingly accelerating incidence of obesity – so we should not only be thinking about food quantity but also about food quality.

By 2050 the world's population will grow by about one-third, which means there will be about 9.5 billion people living on the planet. Global food demand will increase by 70 per cent over that time period: in Asia, food demand will double and in non-Asian countries food demand will go up by about 40 per cent.

*"There is a role for Australian businesses in securing niches in global supply chains and indeed in regional supply chains closer to home, through partnerships that are built on trust, mutual respect, and focussed on quality, reliability and safe product."*

As consumer numbers rise, they are are also becoming wealthier – in terms of incomes and real wealth. Today there are about 500 million people throughout Asia, including South Asia, who are regarded as middle class. By 2030, that number is expected to be 3.2 billion people.

There are some products – meat, milk and eggs, vegetable oil and sugar – that are subject to increasing demand at a more than proportionate rate with income. In Australia today average meat consumption is between 100 and 110kg/person. In South Asia it's 5.5kg/person. But by 2050 it will probably be 18kg/person. In East Asia more meat is consumed already – 40kg/person increasing to 75kg/person/year.

### Water and food security in focus

On the supply side there are some obvious challenges. Firstly fish stocks have been severely depleted around the world, including Asia. Secondly the supply of arable land is shrinking due to continuing urbanisation and population growth. Between now and 2050, Asia's population will grow by more than 1 billion people – 400 million of those will be in India. In China the rate of population growth is already quite slow. Even so, China's population will grow by another 60 million people out into the 2030s before it starts to decline.

The spectacular growth in global food production in the last 50 years was made possible by more intensive irrigation. Today 80 per cent of Asia's fresh water is devoted to irrigation agriculture. And there are significant water quality problems already being encountered, particularly in China and India.

Sixty per cent of China's ground water is regarded as 'bad' or 'worse than bad'. Fifty per cent of the water in the Hai River basin and in the Yellow River is considered unusable for any purpose including agriculture. China creates desert at the rate of 2,500sqkm/year.

Although a major increase in food production has occurred with the introduction of new crop varieties, fertilisers and irrigation, crop yield growth has stagnated recently. In addition, agricultural input costs have been increasing strongly and trade policies throughout the region remain poor.

There are some big issues at stake here. Regional security is a key concern. Food security, water security and energy security are front of mind for the Chinese political leadership. That means that China has an intense interest in both the sources of water, food and energy and in the quality of their supply chains.

It's worth asking whether China can satisfy its legitimate aspirations for security in food, energy and water without disturbing the peace and stability of the region. Those security considerations are among the factors that are driving interest in vertical integration in all three areas but especially in food and energy.

## Opportunities for the future

Yet one should not be pessimistic in all of this. There are opportunities – in particular for Australia. We probably grow enough today to feed 40 to 60 million people. It's possible that Australia could double or even triple food production – and I've heard higher estimates than that.

But even if we were to triple our food production, we would be feeding only a very small proportion of the world's population – and only a very small proportion of the Asian population. We couldn't even aspire to feed more than one-twentieth of Asia's middle class, no matter what we were to do with our agricultural production.

But with Asian food demand doubling over the next 40 years as predicted, and with a premium being placed on high quality, safety and reliability, there is an extraordinary opportunity for premium Australian produce.

The Asian century White Paper points to the following factors that should assist Australia in carving out a future as a safe, reliable and high quality food supplier in the Asian century:

- Proximity to Asian markets;
- A relatively open foreign investment system;
- Expertise in environmental management and environmental sustainability;
- Robust bio-security systems;
- A record of innovation;
- A reputation for high-quality safe product;
- A skilled workforce;
- A strong financial system; and
- Demonstrated expertise in logistics and supply chain management.

These factors give Australia an impressive brand, but there are some things we need to do and need to do better.

The first is to develop better links between scientists and businesses both here in Australia and across the region; these linkages are going to be needed to underpin the development of best practice in food production and value adding in food.

We also need a better understanding of work places and of cultures in the region. If Australian businesses are going to do well in the region, Australian business people need to become much more Asia capable. We need businesses that are capable of securing partnerships in the region and as part of regional and global value chains.

## Competition and the cost base

A key question is around how Australian businesses can hope to compete given a high local cost-base, relative to the region.

When commodity prices took off in late 2003, it was the biggest external demand shock the Australian economy had ever experienced.

Something had to give in order to re-equilibrate aggregate demand and aggregate supply. And the thing that gave was the relative price between Australia and its trading partners. That relative price is captured in two things – the nominal exchange rate (the average of Australia's exchange rate with all of its trading partners) and the relative cost of production. You can think of the latter as relative nominal unit labour costs.

From the end of 2003 through to when the global financial crisis (GFC) hit, both the nominal exchange rate and nominal unit labour costs accelerated. Since the GFC, things have been a little different. The AUD is still pretty high: the nominal trade weighted exchange rate is still elevated relative to its average of the 1990s. But Australia's costs of production, while still growing, have not been growing at the pace of our trading partners. That effect is starting to wear off. Nevertheless, Australia has become a much more expensive place for doing business.

**Ingredients for the future**

There is a role for Australian businesses in securing niches in global supply chains and indeed in regional supply chains closer to home, through partnerships that are built on trust, mutual respect, and focussed on quality, reliability and safe product.

The Asian agricultural and food production sectors produce mass product at low cost. That is not our future. Our future is in high quality product. But we're only going to secure that future if we have a good understanding of Asian culture, of the way business is done in the region, and if we have businesses that are capable of securing partnerships in regional and global value chains.

Trade liberalisation in the region is also required – and that's why every Australian government that I've been associated with has banged the drum about the need for further trade liberalisation and especially in the Asia Pacific region. It's good to see that the new government has emphasised that it is determined to secure further regional trade liberalisation.

Greater knowledge and more sophisticated regulation in Australia that supports sustainable agricultural development in this country are also critical ingredients. We have our own ecosystem and water sustainability challenges but we have demonstrated the capacity to introduce innovative regulatory regimes for enhancing environmental sustainability of agricultural practices. Even so, more work needs to be done.

Massive infrastructure investment is required in Australia if we're going to secure our future in the Asian century, and that includes our future in agri and food businesses throughout Australia. Not all of Australia's future agricultural product is going to come from the north, but there is certainly an infrastructure deficit in the north of Australia, particularly road and rail infrastructure that connect places in an east-west direction rather than a north-south direction. This country has a strong infrastructure backbone, but it's lacking ribs.

We also need to do whatever we can to further develop an Australian national brand. And that brand is going to be a clean, safe, secure brand. That's the area in which we're going to be able to secure a future.

Attending to all of the factors that affect two-way investment flows should be a key priority going forward. By that, I mean Australian investments in the region. But I'm also talking about regional investment – whether it be Chinese, Japanese, Indian or Korean – investments in Australia.

Finally, we need to ensure that Australian business ventures can access capital in the right form, at the right price, for the right tenor. National Australia Bank has declared a strong interest in ensuring that Australian businesses are able to access capital appropriately.

Since the Australia in the Asian Century White Paper was released, we've had a change of government. While it's too early to speculate about the implementation in light of that change, we should be very optimistic.

This government has indicated already that it has a deep commitment to ensuring that Australia has a much more intensive and extensive focus on infrastructure. It has also indicated that it's going to conduct a broad review of the Australian financial system, which will provide an opportunity for the development of some of these issues, particularly access to capital. And the government has also indicated that it's going to undertake a review of the Australian taxation system.

There is enormous opportunity for change that will benefit agricultural food production in Australia and improve the prospect of Australian food producers making the most of the Asian century.

# **Reading the tea leaves –** China's reforms and the implication for Australian agribusiness

**Patrick Vizzone**

Regional Head of Food and Agribusiness, Asia, Institutional Banking

**Patrick Vizzone, Regional Head of Food & Agribusiness, Asia, Institutional Banking reflects on how the outcomes of the recent Third Plenary Session of China's Communist Party's Central Committee may shape the Australian agriculture sector.**

There's been much ado about November's Third Plenary Session of China's Communist Party's Central Committee. The salient pronouncements from this four-day meeting are embodied in a communiqué entitled "The Decision on Major Issues Concerning Comprehensively Depending Reforms" (or "The Decision"). This provides the framework by which China's leadership presents the long-term vision for the country's development path. It's a solid indication as to how the country will be led for the remainder of this decade.

The reform measures are wide-ranging. Sixty targets in 15 areas have been established as part of the reform roadmap. Several measures are likely to have a marked impact on the domestic economy – and how China will feed itself. With Australian agrifood exports to China at A$3 billion and growing at 26 per cent per annum, these changes are likely to have a significant impact.

## Demand and supply dynamics

The world's population is expected to grow to 9 billion by 2050. By then, Asian agrifood demand should double to US$3.1 trillion. Asia's incremental demand growth is forecast to be 2.5 times the rest of the world combined. China is expected to comprise a whopping two-thirds of this.

There is no other industry where the basic laws of economics – particularly demand and supply – work better than in agribusiness. So while demand looks bright the supply of arable land, water and other scare resources are finite. In some cases available natural resources are shrinking.

A Food and Agricultural Organisation of the United Nations (FAO) Agricultural Outlook report released in June 2013[1] made a number of important points in this regard. Namely that China's consumption growth will outpace production by 0.3 per cent per annum. This is similar to the historical trend. Secondly, China's entry into global agricultural markets has started to drive mergers and acquisitions in the agribusiness arena. Underscoring this, from 2010 to September 2013, the value of major outbound agrifood M&A deals was in excess of US$9 billion. This is a trend that is feeding into aggregate global M&A activity. In 2012, activity in the food and beverage sector was up 117 per cent on the previous year. Continuing the trend, food & beverage was the most targeted sector globally for financial sponsors in 1H 2013 with $40.2bn in M&A volume via 25 deals. Finally, expansion of agricultural production is likely to slow due to resource constraints and declining productivity gains. This will increase the predominance of global trade. Currently, about 16 per cent of the world's calories cross international borders.

Countries like Australia, with plentiful and safe supply and strong bio-security, are well placed to satisfy such demand. Australia has four times more arable land per capita than its nearest competitor – the US. It also has a major geographical advantage to the most densely populated region in the world.

That said, elevated exchange rates – which have moderated in past months – high labour costs, and the need for better infrastructure are known challenges that need to be addressed.

## Positive developments for Australian agriculture

Concerning the recent Plenum, there were numerous key pronouncements that should have a significant, ongoing and generally positive impact for Australian agribusiness. This includes a continued commitment to urbanisation, the spotlight on sustainability and the environment, and changes to China's one child policy to name a few.

Over the last three decades rapid urbanisation in China has created the largest mass-migration is history. Since the mid-90s China's urban population has expanded by 21 million people per annum – about the population of Australia. This has been one of the main contributors to China's steep growth path.

The decision underscored the leadership's commitment to urbanisation. Going forward, the growth of small and middle-level cities will be an important channel to ease population and environmental pressures in China's largest cities.

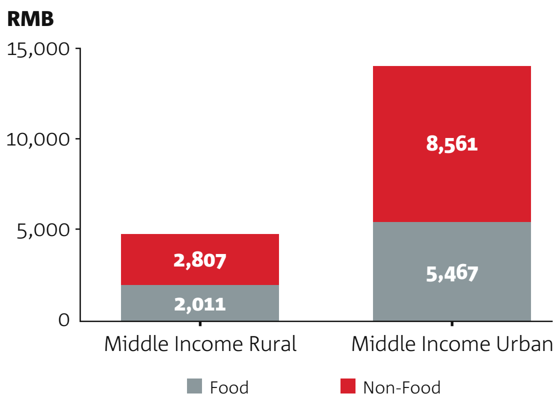
*"Small shifts towards greater reliance on food imports will have sizable implications for global food markets. Put another way, ripples emanating from China can appear like a tsumani overseas. That's because China's total demand is vast relative to the size of some globally traded markets."*

1. Food and Agriculture Organization of the United Nations, OECD-FAO Agricultural Outlook 2013-2022.

As depicted in Charts 1 and 2, continued urbanisation and generally higher income levels will continue to propel food consumption. Urbanites on average consume 2.9 times more than rural dwellers. The uplift in food consumption is nearly as great – RMB2,010 vs. RMB5,467 per annum. Contrasting the consumption patterns between low and high income earners provides the crystal ball in terms of growth in specific categories. High income urbanites consume 44-78 per cent more animal protein, 106 per cent more fruit, 151 per cent more milk and 716 per cent more wine (albeit from a very low base).

The opportunity for Australian producers is clear. Such demand increases underpin large expected increases in export volumes. In the first eight months of 2013 horticulture and animal protein exports from Australia to Greater China increased 61 per cent and 182 per cent respectively. Underscoring the growth prospect, Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) estimates that in 2050 China's imported beef market will increase to US$10 billion.[2]

**Chart 1: China Urban vs Rural Consumption – 2012**

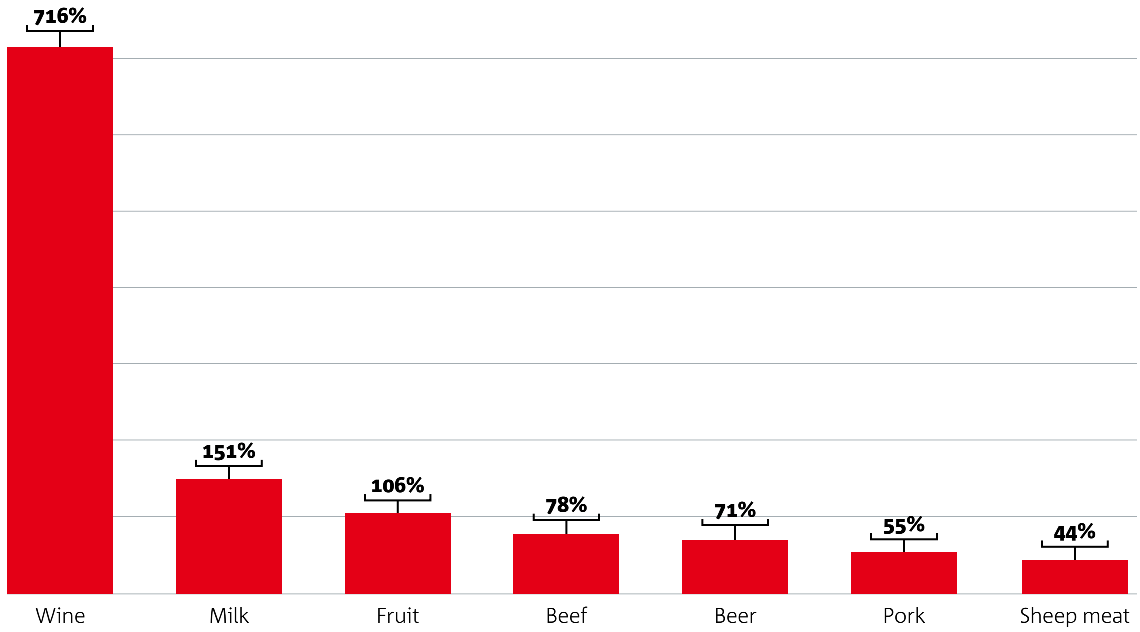



Protection and rehabilitation of the environment is clearly top of mind for China's leadership. China's central government has generally assessed the performance of local government through economic metrics. Gross Domestic Product (GDP) growth has reigned supreme. However, the pursuit of higher growth has come with other costs – particularly environmental degradation. Unsustainable agribusiness practises have also taken a toll. The decision clearly articulates that the Central government is more committed than ever to protecting the environment through direct and indirect means.

## Focus on self-sufficiency

China's ability to satisfy increased food demand depends mostly upon its domestic productive capacity. Output – which is still mostly produced by smallholders – is struggling to keep pace with the country's increasingly urbanised population. Until the turn of the millennium China was generally self-sufficient in overall food terms. In 2001, China became a significant net importer of agricultural products, particularly soybeans.

**Chart 2: Impact of higher incomes in urban households. Increase in consumption volumes**




2. What Asia wants: Long-term food consumption trends in Asia, 10 Oct 2013.

Twelve years on and China now purchases 65 per cent of all internationally seaborne traded beans. More recently China's grain self-sufficiency dropped below 90 per cent. This is also a result of weather events and high domestic prices – compared to international benchmarks – which make imports more competitive.

Together with increased environmental protection, this signals that China's leadership is fine-tuning the concept of self-sufficiency, which has historically focused on grain independence. The result is a more pragmatic and sustainable view of self-sufficiency that leverages the benefits from trade.

Small shifts towards greater reliance on food imports will have sizable implications for global food markets. Put another way, ripples emanating from China can appear like a tsumani overseas. That's because China's total demand is vast relative to the size of some globally traded markets. Wheat provides a relevant example. According to the United States Department of Agriculture (USDA), China consumes 126 million metric tonne of wheat. With 2013 production forecast at 118 million MT, the gap represents one-third of Australia's total production. Moreover, China produces 17 times more course grain, 142 times more pork and 314 more vegetables than Australia.[3] The numbers are quite staggering.

While merchandise trade will benefit, so too will service and investment flows. Fast and more sustainable growth will emanate from urban areas, leaving rural areas to produce more food. This should happen on a broader scale than in the past. Premier Li Keqiang recently stated that China should "actively explore" ways to build large-scale farms and develop a better land management system.[4]

With deep experience and a best-in-class reputation for efficient large-scale agribusiness, Australia could play a significant role in helping China manage the "red-line" of 120 million hectares of arable land that underpins overall food security. Increasingly, we are seeing Australians – in addition to players from other nations – forming on-shore partnerships or Wholly Foreign-Owned Enterprises (WFOEs) in upstream production. China's dairy industry provides a great example of where foreign know-how combined with local knowledge has propelled the industry. Similar opportunities are also apparent in animal protein (particularly beef), horticulture (China grows half of the world's vegetables) and branded foods.

## Demographic change ahead

Another significant revelation is that China has loosened its decades-long one-child policy. This allows couples to have two children if one is an only child. Previously, both parents were required to be. This is an important and necessary step to address demographic issues regarding ageing population and gender skew given the cultural preference for boys (in 2010 there were 118 male newborns to every 100 females).

Demographers expect that an additional two million babies – give or take – will be born annually. Just the incremental growth represents 6.5 times Australia's total annual birth rate. Companies producing infant formula are already benefitting on the expectation of demand increases. One leading international player registered a 7 per cent gain in share price in the days preceding the Plenum. This will also continue to underpin China's insatiable demand for dairy products – spurred on by buoyant consumption growth and significant supply-side issues. The challenge for producers in Australia (and New Zealand) is that global milk production costs among dairy exporters continue to converge on the back of cost increases amongst low-cost producers. Going forward, efficiency gains are critical for Antipodean producers to retain their international supply curve advantage.

Over the last decade Australia and China have been inextricably linked – with demand for natural resources at the forefront. As we move from the mining boom to the "dining boom" the future continues to look bright – especially for agribusiness.

3. World Agricultural Supply and Demand Estimates Report (WASDE).
4. Forbes Magazine, "China's Rural Land Reform Drives Agribusiness Stocks", December 2013.

# Developing a meaty supply chain across Asia

**David Foote**

Chief Executive Officer, Australian Country Choice

**One of the largest vertically integrated supply chain organisations in the world, Australian Country Choice (ACC) is looking to expand its supply of high quality meat into Asia. CEO David Foote discusses the challenges and opportunities ahead.**

**Why is ACC interested in exposure to Asia and particularly China?**

We have a relatively mature domestic business that creates a surplus of product, so we have capacity that can take advantage of overseas customer opportunities for highest value and best use.

Being on the doorstep of Asia and having had an existing business into Asia through the sale of product, we wanted to capitalise on our experience by exploring new growth opportunities in building our supply chain relationships within Asia and with a principal focus on China.

**ACC's Australian model has been based on a stable customer base – the major supermarket sector. How different is the business risk model in Asia, where supermarkets are not as concentrated?**

Our current model allows us to have a risk averse approach, so our priority is to look for a customer or customers that will most closely match our business today – for example, a supermarket or large restaurant chain that sees both the intrinsic and extrinsic value in an integrated supply chain that can provide continuity of supply, quality, food safety, provenance and value.

We've learned that no single country or company can service China. We have to really look at China in terms of its provincial areas and identify tier 1 or 2 cities with key operators in food service or retail in those markets and then pitch the supply chain model to them.

**What risks does ACC face using this model?**

Outside the commercial trading risks you face in any other country, and outside selling the supply chain model as a customer/consumer benefit, nothing stands out. If there is a risk in China, it is around rushing to do a deal out of excitement rather than following your strategic plan, which will take time.

We are learning that China has a history of taking 100-year horizons with subsequent activation time frames on major projects. Australia is very different, so it can be challenging to adapt. We rush to do a deal in six months to last three to ten years. The Chinese are looking for deals that last much longer, so six months has never been on the horizon.

You also have to recognise the extent to which many Chinese businesses or business managers have been influenced by their previous status as state-owned enterprises. This makes this sector more cautious in their approach and generally less entrepreneurial.

**In supplying Asia, how does ACC plan to manage counterparty risks?**

At the moment we always start with money up front before anything happens. One significant advantage of exporting by ship is that the product can be en route but the documents to clear it and transfer ownership are not exchanged until payment is made.

There's some risk in having the goods and documents in port, but you can always reload the boat and send it home or to another customer or destination if something goes awry. This will cost you, but you won't lose the goods. Choosing the right partner will limit this risk.

**What due diligence does ACC apply to potential partners?**

We see greater sovereign risk than company trading risks. But generally we call on 35 years of international trade experience in doing business around the world when it comes to selecting partners.

We are unlikely to do business with any company that does not have assets, a strong corporate or business profile or a traceable and verifiable history in any country. In the case of China I can also ring my NAB bankers to ask for their view on any proposed partner.

**How will the beef sector meet the aspiration of being the 'food bowl' of Asia?**

Australia will never be Asia's food bowl – our production systems are simply not big enough. But we can be one of the grains of rice or cubes of beef in the food bowl. As a high cost nation, Australian product will not be affordable to a majority of the Chinese population for some time to come. Our productivity cannot meet the protein demands, but we do have capacity to supply as much as we see fit.

However, trade and technical access issues in Asian markets will continue to be a challenge for

Australian meat exporters, based on a combination of lack of understanding of our inspection and accreditation systems and an unbalanced trade environment. The world wants to supply China, but China doesn't need the world. Over 70 countries count China as their No.1 trading partner. And we can't have open slather into China when we don't allow free access for Chinese suppliers into Australia.

Our free trade expectation is quite one sided, especially when it comes to agricultural products. If there is open access between food products, it may threaten our bio security status and our bio security status remains a significant and highly valuable point of difference. So we will most likely have to deal with a free trade situation that is unlikely to change for agricultural products.

**To what extent does weather volatility create challenges in ensuring long-term supply?**

For agricultural products weather is a key to determining annual productivity. Given our small population base, Australia remains reliant on export markets for all of our commodities. Dry or wet years simply determine the amount of product surplus to domestic demand. Apart from increasing costs of production, I see no cap to Australia raising its productivity levels or not being able to sell its products. Weather isn't the biggest issue – cost is. It all comes down to whether the market can afford the cost of production to create a sustainable business.

That won't be the case in all circumstances. As the Chinese middle class grows the capacity to pay more grows. But the reality is, if the average weekly wage is the equivalent to the cost of a kilo of Aussie beef, consumers won't see value for money, and we won't to be able to sell below the cost of production.

**Where do you identify global competitive threats to the Australian beef and sheep meat sector?**

Australia is now a dominant sheep meat producer and exporter thanks to the significant change in the New Zealand production system from lamb to dairy. This has created significant opportunities for Australia's sheep meat industry across South Asia, China, the UK, Europe and the Middle East. After goat, people of the Muslim faith prefer sheep meat, so that is an important and opportune growth market for us, with few competitors.

The cross global flow of beef seems to be focused on Asia, which is importing over 3.4 million tonnes per year, with Africa importing 600,000 thousand and Europe 900,000 metric tonnes (mtn) from the major exporters such as India (1.5 mtn), South America (1.9 mtn) and Australia-New Zealand (1.8 mtn). South American beef exports are restricted due to continuing foot and mouth disease, so countries with bio security concerns won't buy. North America can be an aggressive competitor but it is a net importer of beef, with its Bovine Spongiform Encephalopathy (BSE) history limiting open access to all markets

The European Union (EU) has a long history of being protective and restrictive, with stringent quotas that are easing as EU production declines.

# Agriculture infrastructure development in Australia

**Frank Drum**
Senior Associate, Government, Education & Community, Institutional Banking

**Ben Matigian**
Director, NAB Advisory

**Frank Drum and Ben Matigian examine the infrastructure gap in Australian agriculture and the potential for strategic infrastructure investment in the sector.**

**The food bowl of Asia – fact or furphy?**

Recent research and political debate within Australia has focused on Australian agriculture's potential to be "the food bowl of Asia"—statistically possible, but commercially unlikely.

A recent study by the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) projected that the real value (in 2007 US dollars) of Australian production of agri-food products to be 77 per cent higher in 2050 than in 2007, with the value of agri-food exports projected to increase by 140 per cent over the corresponding period.[1] ABARES highlights that realisation of these projections is highly reliant on sustained productivity growth and the development of underutilised land and resources in areas such as Northern Australia.

Research such as this has generated considerable debate within the industry, with agri-food producers questioning whether the necessary productivity gains can be achieved. Industry participants identify variable seasonal conditions, scarce water resources, reduced research and development funding and finite land resources as key factors that will inhibit the necessary productivity gains required.

In addition, processors and exporters further down the supply chain highlight strong competition at ports from non-food related products, ageing road and rail infrastructure and regulatory burdens as key challenges to growth in Australian agri-food exports.

In 2013 NAB Advisory spent time engaging with industry stakeholders to better understand the infrastructure gap in Australian agriculture. Industry associations, businesses, consultancies and government bodies across a broad range of subsectors were consulted to ensure that commercial, political and social view points were integrated into NAB's analysis. Some organisations involved in meetings included; Dairy Australia, LiveCorp, Landmark, AACO, Sunrice, Cargill, Warrnambool Cheese and Butter, Harvest Moon, Burra Foods, Australian Country Choice and the Australian Horticulture Exporter's Association. We focused on identifying what strategies and structures existing industry participants were using to enhance their supply chains and what role the banking sector and private investment community can play in supporting the sector.

## Critical infrastructure issues

The discussions highlighted three key issues

**1. Standard and availability of existing infrastructure:** Industry participants unanimously agreed that the quality of existing road and rail infrastructure and competition at ports is a major constraint on the movement of agri-food products within and out of the country.

Poor road and rail quality is resulting in increasing transport, compliance and health and safety costs, and slowing the speed to market of some products — critically important when delivering perishable goods and linking into 'just in time' logistics timetables. Additionally, competition at ports from non-food related products was resulting in slower loading times leading to rising shipping and storage costs.

Given that the level of throughput remains one of the key drivers of profitability in road, rail and port infrastructure, any efficiency gain that can support higher sustained throughput could present a significant financial reward to investors.

For example, NAB analysis indicates that within the grains industry average port capacity utilisation on a state by state basis is at best 76 per cent and at worst as low as 46 per cent, analysis that is supported by a quote recently made by Alison Watkins (CEO GrainCorp) that stated that average capacity utilisation at port in NSW was as low as 30 per cent.[2]

Much of the inefficiency in port utilisation relates to bottle necks in the rail network, with many lines operating with significant speed restrictions (some as low as 20km/h) causing higher operating costs, and many operating with substantial weight restrictions as they are unable to safely carry heavier loads.

The poor quality of rail infrastructure is extremely significant when you consider that the average train can carry over 2,000 tonnes of grain, while the average truck hauls between 40-45 tonnes. This means the average export vessel takes 18 trains to load. But the same vessel needs almost 900 truck trips – a massive difference in efficiency and a considerable increase in cost to both the industry and the broader community. Despite the clear efficiency advantages, statistics provided by GrainCorp suggest that the proportion of grain arriving at their ports by road has been steadily



1.'Food demand to 2050 - Opportunities for Australian Agriculture', Australian Bureau of Agricultural and Resource Economics and Sciences - <http://adl.brs.gov.au/data/warehouse/Outlook2012/fdi50d9abat001201203/Outlook2012FoodDemand2050.pdf
2. CEDA CEO Vision: Capturing the Global Food Boom - 23 May 2013.

increasing from around 15 per cent to over 30 per cent.

NAB analysis suggests that to replace and expand the Australian grain industry storage/handling and port network $3.9 billion in funding would be required, with 83 per cent of funding requirements relating to the replacement of existing infrastructure. Both important points in considering the attractiveness of the size of the investment required and the type of investors that may be attracted to Brownfield developments and the potential investment returns associated with that.

**2. Privatisation of large scale infrastructure:** The ongoing adoption of 'just in time' delivery and use of take or pay contracts in service delivery contracts with third party logistics providers means stakeholders need greater certainty in the quality, reliability and delivery of infrastructure.

The privatisation and regional-based management of infrastructure such as rural and regional rail networks presents significant challenges to achieving the aforementioned outcomes. This is particularly the case for those industry participants moving product through sections of the supply chain managed by multiple operators with differing maintenance and management timetables.

For example, in Victoria the state's railway assets are maintained by Metro Trains, V/Line and the Australian Rail Track Corporation (ARTC), with one food processor commenting that "High rail traffic, ad hoc rail maintenance and ongoing line closures is increasing the need for collective rail management, with high rail traffic and line closures resulting in delays in load times and paying out of take or pay contracts at considerable cost to the business."

**3. Variability in regulations and regulatory burden:** A bugbear of many industry participants surveyed was the inconsistency in the type and application of regulations across states. In early November 2013, ABARES released a report on the issue titled "Review of Selected Regulatory Burdens on Agriculture and Forestry Business" highlighting that "rural businesses are governed by around 90 Acts administered by the Australian Department of Agriculture, as well as those common to all businesses. This represents roughly 8 per cent of the total stock of Commonwealth Acts for an industry that contributes around 2 per cent to Australia's gross domestic product."

The sheer geographical size of the Australian agriculture sector often means that the production, processing and exporting of agricultural products can occur across multiple states. Variable weight restrictions for trucks and trains can result in higher traffic on transport networks, degrading the quality of infrastructure further and significantly impacting the speed to market.

The collective approach of government and industry around this issue presents considerable opportunity – certainty and consistency around regulation and niche concessions could provide both a benefit to business and the broader community.

For example, in 2010 SunRice (Australia's sole processor and marketer of rice) in partnership with Deniliquin Freighters, was granted a special permit by the New South Wales Government's Roads and Maritime Services. This concession enabled the construction and running of two purpose-built, 36.5m A-Double road-trains which were 10m longer than a regular B-Double road-train. This enabled the trucks to carry two Twenty Foot Equivalent Units (TEU) shipping containers of up to 30 tonne gross weights on specific routes from the mill to rail terminals in the region.

This resulted in a 13 per cent increase in milled rice per load than trucks were previously permitted. This substantially lowers the overall cost of transport and provides SunRice (who pay on a per container basis) with significant productivity gains. It also benefits the local community and the state with larger trucks funnelled onto specified routes and an overall reduction in truck volumes.

### Infrastructure investor financial requirements

It is also extremely important to recognise the divergent requirements of investors when considering infrastructure development.

Infrastructure investors seek to achieve a total return that comprises both income and capital appreciation that would outperform inflation by a certain margin. In a nutshell, the basic principles for investors in the space would include:

- long duration of the assets;
- inflation-linked 'predictable' returns; and
- low risk of capital loss.

The challenge facing the agricultural sector is to consider how its infrastructure fits into above categories. Review the historical profitability within the sector and you find significant volatility in returns, so predictability will be a major roadblock.

Generally infrastructure projects that are supported by the private sector have the backing

*"The quality of existing road and rail infrastructure and competition at ports is a major constraint on the movement of agri-food products within and out of the country."*

of long-term off-take agreements that are underpinned by a quantifiable level of resources or a clearer indication of usage in terms on traffic. Investors and financiers will look to these agreements to understand the long-term cash flows available to services debt and equity.

When we look at agricultural production, there are many variables that come into play that are outside the controls of the operators such as weather patterns, disease and domestic and international trade regulations. The uncertainty of production volumes over the long term is a key impediment on the ability of the producers to sign up to long-term off-take agreements.

### Where to from here? Key challenges and opportunities.

This debate highlights a number of challenges and opportunities facing the agricultural sector:

**How do we close the gap between the needs of the industry and the requirements of the investment community from a risk and return perspective? Are appropriate mechanisms in place to alleviate the risk aversion of investors to the inherent volatility in agriculture?**

Many of these challenges are discussed in another article in this publication titled "Large scale greenfield agri-business development: parallels between agri and resources."

**How can industry and government work more closely to develop appropriate valuation models?**

To date, government agencies, industry associations and lobby groups have spent considerable time and expense identifying the scale of the infrastructure gap i.e. location, reliability and quality of the existing infrastructure footprint.

This information, while significant, fails to provide both federal/state governments and private investors with the relevant financial metrics to support a decision to invest in regional specific or supply chain level infrastructure projects.

Are federal and state governments appropriately communicating with the industry and the finance sector the statistics available on industry so they can make more informed decisions on industry and project development? I.e. are regional production data, state and port-based trade flows, pricing information and modelling techniques appropriately available to those in the best position to make a commercial decision?

**In the current fiscal environment, federal and state governments are becoming increasingly cautious around broad-based sector funding, unless large-scale sustainable socioeconomic benefits can be illustrated. Support appears to be shifting to regionally-focused or business-specific assistance in conjunction with co-funding from stakeholders and private third party investors, where tangible economic benefits within a clearly defined commercial framework can be identified.**

For example, Tasmanian Irrigation Pty Ltd (TI) was established on 1 July 2011 as single state-owned company responsible for the development and operation of publicly subsidised irrigation schemes. TI develops schemes as public-private partnerships. This means that TI works closely with private landholders to work out how much water is wanted and shares the cost of building a scheme between the public and the private sector. A total of $220 million has been set aside by the Commonwealth and Tasmanian governments to progress the irrigation development.

To date, through the funding, combined with private capital raised via the sale of water entitlements, the development program has realised a tranche of nine highly reliable irrigation schemes either built or in construction phase. TI's new and inherited irrigation schemes will have the capacity to deliver a minimum of 100,000 megalitres annually. This kind of development improves the carry capacity of the land in the area, lifting productivity, attracting new or existing industry and potentially further investment to support the associated growth in agricultural production.

**What role will federal and state governments play in ongoing funding? Given the current fiscal environment and recent trends in funding, how does industry most appropriately negotiate with government on future infrastructure funding requirements?**

**Is there necessary funding currently available for the research and development to alleviate the drag on productivity from variable seasonal conditions, scarce water resources and finite land resources?**

**What private investment sources and funding structures are available or can be developed to attract the necessary funds required?**

This is in part discussed in another article in this publication titled "Capturing the boom with patient partners."

# **Large scale greenfield agri-business development:** parallels and differences between agri and resources

**Michael Clarke**
Director, NAB Advisory

**Michael Clarke – Director, NAB Advisory looks at how mining/resource project financing may be a helpful paradigm for financing large-scale greenfield agri developments.**

Financing greenfield development projects is never easy, and financing large scale projects in the $1 billion+ range tends to complicate the risks exponentially. Add in the fact that Australian financing markets have not seen projects of this scale in the agri commodity space and you end up with a lot of questions about the right approach.

The overall Australian project finance market has deep experience and expertise when it comes to assessing and structuring the financing of greenfield development risk of this scale – and our local project finance market is widely considered a world leader in this aspect of risk assessment. However, this expertise has only rarely been applied to the agri sector.

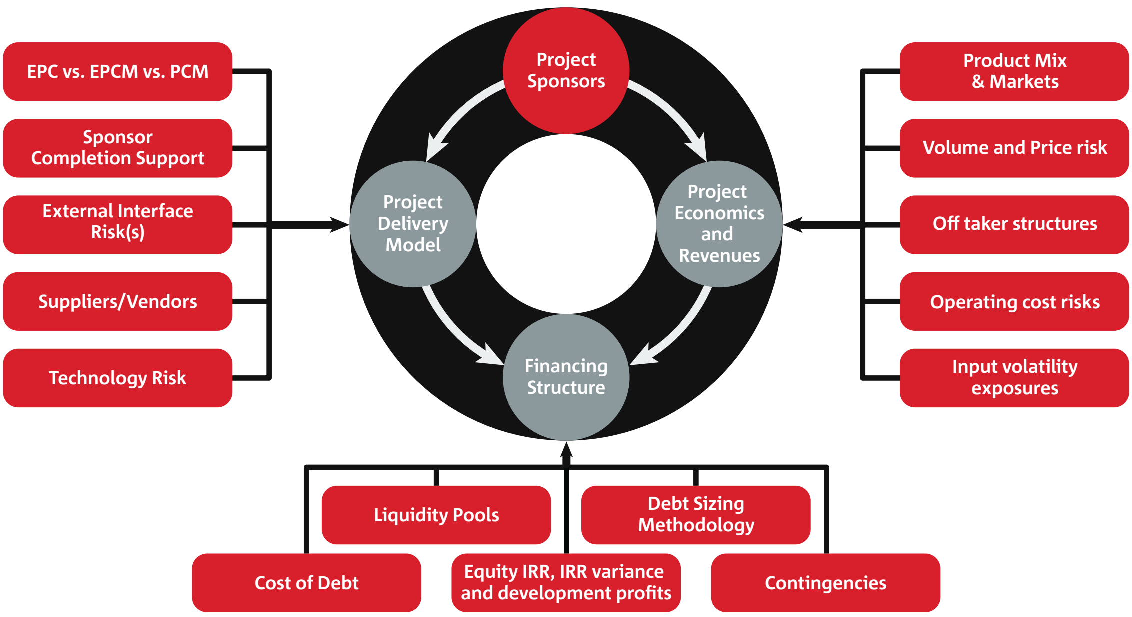
In this article, we provide an overview of the key risk allocation factors that project debt financiers consider in large-scale greenfield development projects and discuss the ways these factors could match agri greenfield development needs. We also draw some parallels between resource-related financings and lessons that can be applied to agri sector – in particular implications of exposure to price and quantity risks and how the debt market often assesses those sources of risk.

It's important to note that every major project is different, and the ultimate optimal package of risk allocation will be situation and project dependant – as such, please consider this only a preliminary discussion paper.

The most important thing to note from Figure 1 is that the financing structure is directly a function of the commercial structure of the project. All else equal, reducing the project's exposure to commercial risks and sources of cash flow volatility will increase the leverage potential and decrease the weighted average cost of capital of the project. Importantly, the flip side is also true – retaining exposure to risk typically results in a requirement for additional equity funding. A well-worn phrase in project financing is 'risk should be allocated to those best able to bear it', and debt financiers, who do not participate in economic upside, typically have limited appetite to bear much risk.

The importance of the commercial structure to the financing structure also highlights the need for early engagement with financiers, to ensure that commercial agreements and technical studies will ultimately meet bankability standards. In general, we think engagement should begin after 'pre-feasibility' studies have passed initial stage viability filters and as the so-called 'bankable feasibility' process begins – with your financial advisor assisting in shaping the technical, market and commercial work-streams within the 'bankable' feasibility to meet the ultimate requirements of the debt investors in a timely fashion.

**Figure 1: A basic framework for greenfield development financing**



## Project delivery model

Delivery or completion risk remains a key focus of project assessment. Completion risk is the level of certainty that the project will be built/delivered on time and therefore produce the outputs and revenue required to service the debt. The last position debt investors want to be in is an almost-finished project which can't produce the cash flows to service the principal and interest. The bank market therefore generally views completion risk as a risk that equity sponsors should bear in one form or another. For bearing the completion risk, equity does typically participate in upside upon completion in the form of 'development profits', reflected via reduced cost of capital in secondary or refinance markets, whereas debt does not share in that upside.

The project delivery model has a lot of trade-offs. For example, appointing an overall fixed-time, fixed-price wrap contractor over the entire project can create a high degree of completion certainty, reducing requirements for contingency funding and potentially influencing the nature of equity completion guarantee required. However, this comes at the direct cost of paying additional contractor wrap margins on top of sub-contractor costs. The trade-offs in balancing and optimising this factor is often one of the most difficult and contentious issues that project sponsors face; the 'optimal' solution is a function of both the cycle for external market risk appetite in contractor and finance markets) and sponsor appetite and capacity for risk.

For large-scale greenfield agri projects, we see direct parallels in the completion risk structuring that banks require for mining (and infrastructure) greenfield project financing.

**Figure 2: Resources vs Agriculture: project delivery model considerations**

| Risk factor | Mining/Resources (generalised) | Agriculture (generalised) |
|---|---|---|
| **Packaging, contracting and procurement** | Major projects often have definable packages (e.g. rail line, port, mine site etc), as well as critical path implications. All packages need to be delivered on time or else the revenue cannot be generated. Allocating and wrapping the interface risks between the packages is a core focus of bank concern, with strong preference for a single point of responsibility/accountability.<br>It is rare for single 'head contractors' that wrap projects to have the specific expertise in every element/package of the project, which is where sub-contractors come in. A key role of the head contractor is to absorb the risk of the interfaces between specialists/sub-contractors, which of course does come with economic cost implications.<br>We also emphasise that the risk requirements and therefore the 'optimal' approach to execution when the project requires limited resource debt financing are much different than when a project is funded 'internally' by large corporate entities. | Large-scale agriculture projects are expected to have multiple logical packages – such as water supply, logistics, on-farm infrastructure, value-add processing. Similar to mining projects, the whole is dependant on each part, with allocation of interface risk expected to be a major focus of bank requirements and due diligence.<br>Similarly to resources, we expect that major contractors involved at the head level are unlikely to have all the specialist skills for every individual package, and therefore we would expect to see sub-contractors performing various tasks. Even with head contracts that wrap interfaces, banks' due diligence will still be looking carefully at the proposed sub-contractors and the risks between the packages, including the capability of sub-contractors to deliver. |
| **External interfaces** | Where key elements of the value chain are broken out of the project envelope (e.g. separating port and rail to the mine), this creates a major external co-dependency, which adds challenges to successful financing. | If the proposed agri project is co-dependant on say, the build/delivery of major new water infrastructure, then the price-and-time risks that this dependency creates need to be carefully assessed and a bank acceptable mitigation strategy developed. |
| **Technology** | Debt financiers will not take risk on meaningful technology/innovation risk. The potential capital structure solution (i.e. level of contractor protections and sponsor/equity protections) for any technology risk will be dependent on the criticality and relative size of the technology in terms of the projects capacity to generate operating cash flows. | Expected to be the same as for resources.<br>An important potential 'technology-like' factor is understanding the risks of producing new product (e.g. crops of a certain type) in the region that may not have had that type of crop before. |
| **Pre-completion cash flows** | In some projects, revenues can begin to be generated while the project is still in construction, e.g. ramp-up production. The funding envelope may take these cash flows into account, but will also have to consider the potential variability of those cash flows. | Uncertain applicability to agri-related projects, probably project specific. |

Disclaimer: The above is a high level snapshot of risk only and not intended as a comprehensive guide to the risks considered by the debt market.

## Project economic model/revenue model

The proposed economic/revenue model is of at least equal importance to the delivery model, with the cash flow structure (including tenor and volatility risks) ultimately driving the debt sizing and the debt sizing methodology adopted (e.g. sculptured debt service cover ratio (DSCR). In addition, sources of operating volatility may mean requirements of greater or lesser reserve funding accounts to ensure the project retains sufficient liquidity.

There are important risk similarities in the economic model of large-scale agri projects compared with mining/resource projects – most importantly, commodity volume and price risk. Consequently, the lessons and structures generally adopted for resources projects may apply to greenfield agri projects.

**Figure 3: Resources vs Agriculture: economic model considerations**

| Risk factor | Mining/Resources (generalised) | Agriculture (generalised) |
|---|---|---|
| **Product mix** | Not all mining commodities are pure "commodities" per se. While most commodities have transparent benchmarks (some with greater relevance, reliability and liquidity than others), key differences in product output (e.g. trace elements, purity relative to benchmarks) are all highly important.<br>The detailed assessment of the product mix and its comparison back to benchmarks (as well as view on the liquidity of the benchmark market) drives important differences in allocating risk in formal off-take agreements. Lenders prefer to see commodity product with low variation to benchmark, as these products are expected to appeal to a wider range of consumers (and therefore reduce risk of reliance on more limited customer sets or source of demand). | Similar to mining – agriculture commodities face a variety of variance-to-benchmark risks, and certain commodities have more liquid/transparent market pricing than others.<br>We anticipate that risk allocation methods used in resources may be highly applicable here. |
| **Volume risks** | Mining production volumes are inherently risky, with multiple potential sources of volume variability through time. However, banks ultimately gain comfort via due diligence from the combination of using proven processing methods against "proven reserves" in the ground. In addition, assuming that extraction and processing ultimately works to plan (as covered often as an element of completion risk), the residual sources of volatility may only be relatively short term (e.g. production disruption due to natural events, known variations in geology, accidents or scheduled/planned events).<br>Technical due diligence to get to the point of bank comfort on volume risk is often highly extensive.<br>Mining projects produce volumes only over a limited life, with volumes ultimately declining to zero as reserves as depleted. This has major implications for the structure of debt in terms of shaping the principal repayment/amortisation to ensure debt is fully repaid (usually with a buffer period, referred to as the 'tail') before the end of useful life of the asset. | The parallel for greenfield agri projects would be crop productivity and any processing risks – both of which are expected to be assessed and allocated using similar risk review techniques as for resources (i.e. extensive due diligence).<br>In addition, agri projects face volume risk in the form of weather, pest and water risks. These sources of volume risk may be longer term in nature than some volume risks within mining, which may require different (and more conservative) strategies to mitigate in the capital structure. The level of upfront insurability of these risks will also be important.<br>A key positive difference to mining projects is that agri has no or minimal natural decline – in theory, well-managed farmland will produce output into 'perpetuity' (though individual assets like processing plants may have a more limited life). This changes the shape of the debt amortisation profile, and thus the optimal capital structure of the project. |
| **Price risks** | Mining commodities face volatile price risks, which the project (and financiers) usually retain some residual exposure to. General means of managing this risk may include:<br>1. Off-take contracts incorporating specified prices, reference prices or price cap/floor mechanisms.<br>2. Financial hedging (applicable for certain commodities only)<br>3. Profit margin/cost curve protection (see more below).<br>Attempting to allocate price risk outside the project vehicle may actually lead to creation of new risks – for example, 'delivery risk' on certain types of financial hedges or off-take agreements. This highlights the requirement to always view the overall risk structure as a 'package' of risks due to their interrelated and cross-referenced nature. | This factor is a direct parallel between resources and agri – both face similar levels of price volatility and similar considerations in allocating that risk. Point 3 in the opposite column is particularly important, as is the flow-on discussion in cost risk. |

Continued...

| Risk factor | Mining/Resources (generalised) | Agriculture (generalised) |
|---|---|---|
| Operating Cost Risks | Debt financiers devote a lot of attention to assessment of the project's position in the cost curve for its particular commodity. Debt financiers have a strong preference for projects with cost structures that are in the lower half* of the overall cost curve – achieving financing of a project in the upper half* will be more challenging and will likely require significant extra risk protections for the bank.<br>Position in the cost curve is viewed as a form of protection against commodity price volatility, with low cost curve projects considered more likely to survive and continue to service capital over the price cycle.<br>Extensive due diligence is conducted both on the overall market and peer projects, as well as to gain comfort that estimated operating costs are accurate.<br>*Views about each commodity are different and change over time. The 50th percentile/ "lower half' reference used here is a highly generalised example. | We expect that for large-scale agri greenfield development, the operating cost assessment and position in the cost curve will form an important component of the financing due diligence package.<br>The risk package between cost curve position, cost risk, volume risks and price risks are all inter-related and the optimal structure is likely to depend on project specific factors.<br>We would like to emphasis this point as a key consideration in assessing the risk of any proposed large scale agri project. |

Disclaimer: The above is a high level snapshot of risk only and not intended as a comprehensive guide to the risks considered by the debt market.

With the projected growth in demand for agricultural commodities, Australia will be challenged to bring on new supply at meaningful scale – and this may ultimately involve larger projects than have historically been contemplated by the agricultural sector, and therefore require different financing models. It's a useful exercise to consider the potential parallels in risk and funding structuring lessons for financing these projects from the greenfind mining/resources space where there is significant precedents for successfully financed large scale development.

# Indonesia takes on Top End cattle

Samuel Wibisono

Japfa's GM Beef Division

**In the wake of Japfa Comfeed Indonesia's acquisition of two Top End cattle stations Samuel Wibisono, Japfa's GM Beef Division, explains the opportunities and challenges for Australian beef exporters into a growing Indonesian market.**

**Japfa recently acquired two cattle stations in Australia's Top End. Could you provide some background on the acquisitions?**

There has been a lot of talk with regard to Indonesian state-owned enterprises' initiatives to own cattle stations of up to a million hectares in recent times, but Indonesians have owned cattle stations in Australia for a while now, dating back to the Tipperary station, so it's not a new concept.

The Japfa group believes in the strength of vertical integration. We have been looking to vertically integrate our cattle business for a long time, but we started to look at it again seriously in 2012. We did due diligence on two other stations but were not able to close the deal.

The biggest issue for us has been that in terms of return on investment (ROI), the numbers have not been that exciting when compared with other opportunities in South East Asia. That's why we did not invest earlier. But I think the timing is right now in terms of where property valuations are at, so we hope it will be a good investment as a long-term play.

**To what extent have property valuations shifted?**

Valuations have come back quite a bit since the peak in 2009. We think that with the relaxation of the 350 kilogram weight limit and the import quota system by the Indonesian government, land valuations will improve in the Top End.

**JAPFA has a sizable feedlot operation in Indonesia. Why not just continue to purchase feeder cattle from Australia? What is the advantage of investing upstream in Australia?**

We would like to be an instrument in the way genetics are being developed in the Northern Territory. By being fully integrated we have our own processing plant and slaughter house. We do not believe the more popular Brahman cattle offer the best yield there.

For a number of years we have been promoting the possibility of Euro-type crossbreed cattle across the Top End but the producers have been quite slow to switch. I can understand: they have issues with market access for some Euro-type live stock. The Brahman is preferred in most of the feedlots in Asia. But being an integrated operator we are trying to maximise yields and the Euro-type do a better job for us in the feedlots and the slaughterhouse.

So one of the initiatives we would like to pursue with our two properties is to accelerate Euro-type cattle into the herd. There are already some Charbray genetics in Inverway. We will also be keeping all the male progeny as bulls. Hopefully that will improve the productivity and yields at the station level but will also have that follow-on effect at the feedlots as well as in the slaughterhouse.

The acquisition will have great benefit in terms of productivity and yields across the supply chain. There are not many producers that have caught on to that idea. One or two of the more progressive producers have been putting on some high yield-type cattle but the others have been very slow. So I think this integration means we will be able to provide a captive market for our own station and our own supply chain.

**How do you see demand for beef growing in Indonesia?**

Traditionally Indonesians mainly eat fish and chicken. But with an expanding middle-class and better purchasing incomes there is a growing preference for beef as a better source of protein. The beef sector is likely to see a 5 to 7 per cent growth in demand. When you look geographically, that will be closer to the double digits in places like Jakarta. Growth will be much higher there compared with the smaller cities and outside regions.

*"Traditionally Indonesians mainly eat fish and chicken. But with an expanding middle-class and better purchasing incomes there is a growing preference for beef as a better source of protein. The beef sector is likely to see a 5 to 7 per cent growth in demand."*

**This is the Due Dilligence team from Japfa group for cattle station acquisitions. Names from left are: Renaldo Santosa (Project Development); Kevin Monteiro (Corporate Finance); Charles Mok (Procurement); Patrick Underwood (Inverway Station); Bruce Warren (Head of VAM & Australia); Christina Ng (Corporate Legal); Samuel Wibisono (GM Beef Division); Michael Underwood (Riveren Station).**

**How does this growing middle-class in Indonesia perceive Australian products? Is Australia's 'clean and green' image a plus or do consumers generally look for a value proposition?**

I think the image of imported products still has that value add. A good example would be our affiliated company that produces fresh milk under the Greenfields brand. All the milk is produced in a dairy farm in East Java and is processed on site. It has been branded and positioned as an imported product but people have been pleasantly surprised to find it was actually a domestic product.

So I think there is some value in terms of imported products but more and more Indonesians will want to see products that are produced locally, in line with growing nationalism. I think that will be a good position for our operation where we are producing the product domestically to some extent.

As domestic companies improve their issues with facilities and improve food safety through better traceability systems and are able to communicate it to consumers the nationalistic movement will grow a lot faster. That is especially the case for beef, because Halal is a very big issue. Locally processed beef is perceived to be guaranteed Halal when compared to imported beef.

**Do you foresee a return to the previous levels of livestock exports from Australia to Indonesia?**

The high point was 2009/2010, when Indonesia was importing 750,000 head of cattle from Australia annually. The Indonesian government has relaxed the 350 kilogram weight rule but whether those 2009 numbers are achieved again will depend on whether the agricultural industry will continue to import slaughter cattle.

But I think it really comes down to the supply capabilities more than anything else. Certainly the demand for live cattle from Indonesian feedlots is always there. There is over one million head capacity in Indonesia's feedlots.

Of course, then there is growing competition from other importing markets in South East Asia. Everyone is very excited about China. We are expecting growing competition from other importing countries for the cattle.

**Why did you decide to partner with NAB to finance your recent acquisitions?**

Traditionally, our main relationship is with a European bank, so it is a credit to NAB's team in Darwin that we decided to partner with them. They were able to deliver the product in a short period of time and were also very competitive in terms of the pricing. We were quite pleasantly surprised. They really pulled out all the stops. I hope from here we can continue to do business. We are looking at other opportunities in Australia and China.

# Capturing the boom with patient partners

**Ben Matigian, Director, NAB Advisory discusses the best approach to dealing with offshore investors in Australian agricultural businesses.**

Over recent years it has been widely publicised that the evolving middle class in Asia is going to drive the growth of the Australian agricultural sector. As the mining boom tempers off, word is spreading of the so-called ‘dining boom’ that is going to drive our country for the next 20 years. The large majority of people buy into this story, however finding the domestic capital to support this belief will have its challenges.

Historically, domestic institutional investors have not been comfortable with the risk profile inherent in the agricultural sector. Analyse the shareholder registers of the few listed agricultural companies and you will find the majority of the institutional investors that hold the shares are either foreign strategic investors or offshore pension funds. Prior to Archer Daniel Midlands takeover offer of GrainCorp, foreign institutions held around 30 per cent of the company’s shareholder register.

Figure 1 clearly shows the “food bowl” rhetoric has brought many investors to Australia looking to place their capital to capture the predicted growth.

More recently, interest from Asian investors has dominated the headlines, with the ongoing search to secure supply stimulating their participating in Australian agriculture investments. Our agribusiness clients will attest to the number of enquiries from large-scale Asia-based state-owned enterprises (SOE) and privately-owned enterprises (POE). Many of our clients have welcomed these investors and dedicated significant amounts of time and resources to hosting them as they conduct their due diligence. There are varying degrees of understanding of the local agricultural sectors, so considerable time has been spent on educating the investors about the vast differences in the regions throughout Australia.

A key consideration for our clients is understanding the drivers of each investor and how progressed they are in terms of their growth strategy. However, before we consider the investors’ objectives, first our clients need to consider their own objectives in wanting to engage with an investor.

There is a unique opportunity available for our clients to position themselves and their business in the driver’s seat of the boom. Early movers could see businesses scale up to capture market share, long term offtakes and secure the family business for generations to come.

Businesses need to determine if they are ready to engage with these investors.

## Defining your objectives

Clearly articulating your own objectives will be critical for selecting appropriate investors and will help shape the optimal investment strategy and structure. Some key questions to consider include:

**Ben Matigian**
Director, NAB Advisory

**Table 1 Foreign ownership of Australian large-scale corporates**

| Grain | Dairy | Sugar |
|---|---|---|
| Glencore (Swiss) / Viterra (& ABB) | Lion (Japan) / Dairy Farmers | Finasucre (Belgium) / Bundaberg Sugar |
| Agruim (Canada) / Landmark | Fonterra (NZ) | Wilmar (Malaysia) / Sucrogen |
| Cargill (US) / AWB | Lactalis (French) / Parmalat | Mitr Phol (Thailand) / MFS Sugar |
| | Saputo (Canada) / Warnambool Cheese and Butter (takeover offer) | COFCO (China) / Tully |
| CBH (Aust) | Bega (Aust) | Mackey Sugar (Aust) |
| Graincorp (Aust) | Murray Goulburn (Aust) / Warnambool Cheese and Butter (takeover offer) | |

- What are you trying to achieve by bringing in external capital to the business?
- Why are you expanding the business?
- How long do you plan to operate the business?
- Do you have a succession strategy?
- Do you want to completely exit the business and what options are available?
- Do you want an active or passive investor?
- How would a new stakeholder in the businesses impact your strategy?
- Are you looking to take some cash off the table for an earlier superannuation cheque?
- What level of risk are you willing to take on?

The answers to these questions can be used as a guide to what investment structures would be relevant for the business.

**Understanding your alternatives**

The inclusion of new stakeholders will corporatise the business – if that has not already occurred. The most common investment structures we see in the market are:

- outright or partial sale
- joint ventures
- establishment of a fund by rolling in assets or acquiring new assets
- long-term supply agreements

The main driver for any of these options will be a delicate balance between the level of risk and reward that the owners want to maintain following a transaction. This would have been identified when the objectives were established.

Depending on the investor, an outright sale may require the vendors to stay on the property to manage the operations of the business. This gives the vendor the ability to cash out early, but will limit the upside potential should the anticipated growth materialise. Asian SOEs have not been as receptive to full exits – the question always arises as to why the vendor is selling out given the growth potential of the sector.

If the vendor seeks an exit, our advice would be to maintain a material level of equity in the business to maximise interest and therefore value. A partial sale will provide the vendors with an avenue to benefit in the growth, however vendors will maintain a significant level of risk in the business.

An opportunity to share in the upside while protecting the value of the existing enterprise that has been created could be in the formation of a joint venture. Under this approach, the two parties can contribute the level of assets that they are willing to place ‘at risk’ and share in

the upside potential (and risks) of the newly-created enterprise. The most common avenues our clients have taken have been the formation of a joint venture in pursuit of an acquisition of a new business, or to roll in some of the existing properties/assets and expand or vertically integrate the operations.

There is also the potential of maintaining the existing structure of the business and just entering into the core long-term supply contract with the investor. This can provide the business with long-term certainty of off-take and will provide the basis for investment decision around expansion. However, the structural features within the contract will need to clearly articulate accountability for any shortfall in supply.

### Understanding the investors requirements

Selecting the right investor for the business is crucial in ensuring a stable operating framework that will work for all stakeholders over the long term. Our experience from working closely with major SOEs in Asia is that their investment philosophy is focused on finding long-term partners. As such, these investors are seeking to place their capital alongside that of the existing owners, which leads them down the partial sale or joint venture approach.

Although a clear focus of their investment is based around securing supply, they are very selective in the investments and a strong track record of profitability, even during the tougher times, is essential.

These Asian investors understand their own limitations and capabilities when it comes to operating assets in foreign countries and a key requirement will be for the existing management to stay on to run the operations following any transaction.

This investor class will take a long-term view of their investments; you may have even heard the term 'patient capital' be used to describe their approach.

For the last few years many SOEs have been in Australia 'kicking the tyres'; although a limited number of investments from SOEs have actually been executed. Asian businesses that already have a presence in Australia, albeit a non-agricultural presence, have joined the queue of parties interested in Australian beef assets and trying to get an early mover advantage.

*"Analyse the shareholder registers of the few listed agricultural companies and you will find the majority of the institutional investors that hold the shares are either foreign strategic investors or offshore pension funds."*

Some changes in the regulatory environment within China have made the executives of these SOEs personally accountable for their investment decisions. We are finding a significant level of caution when investment decisions are being considered or executed.

### Assessing the options

The solution will come down to the balance between risk and reward; the final investment structure needs to align to the original objectives. To assess the options fully, we need to consider the finer details in terms of available funding, taxation implications, legal obligations and foreign ownership regulations. Businesses need professional assistance to understand these key considerations as many of the perceived risks or roadblocks can be navigated around through appropriate structuring.

### Financing implications

The appropriate capital structure will be determined on a case-by-case basis and will largely be driven by the type of investment structure that was established. The optimal debt and equity position could look vastly different to the business as it stands today.

Unlike financial investors, who would look to leverage the balance sheet as high as possible, these strategic investors will take a more conservative approach to mitigate external influences wanting to take control of the assets in a downside scenario.

### How to progress

Our clients have already invested significant time in educating some of these investors – that has an associated level of costs, so clients want to know early in the piece how serious the specific investors are. Engaging the services of professional advisors can be useful as they can be used to filter out the 'tyre kickers' from the real investors who have a clear and approved mandate to invest in the sector.

# **Funding your international growth –** plain sailing or troubled waters?

**Michael Hogan**
Head of Trade, Asia, Specialised Sales

**Michael Hogan, Head of Trade, Asia, Specialised Sales, explains the best options for finding expansion capital – particularly for trade with China.**

Cash is king. It's an old but simple rule. It's especially important when markets are tough. Having access to enough of it and at the right price is essential for any company to survive.

Most Australian based companies have well established methods of ensuring funding is at hand to support day to day operations. But as companies are increasingly trading overseas, and especially into Asia, can they be sure that funding will continue to be available and from the same sources? And if so, are these likely to be on the same terms and conditions as at home? If not, what other options are there to support their business growth?

In the years following the global financial crisis, record low market interest rates for record long periods of time would seem to be a perfect backdrop for plentiful sources of cheap funding. But while this might be the case for the largest, most well-known groups, it definitely isn't so simple for the many more Australian small and medium-sized players venturing into the region.

Many companies naturally start with small overseas operations, so a large to mid-sized corporate in Sydney looks more like a foreign start-up in Singapore. Without a proven track record, minimum three years in some markets, and increasingly strict compliance hurdles, opening a bank account, let alone asking for a credit facility, can be an uphill battle.

While dark clouds may lurk on the horizon, it need not be all doom and gloom. NAB's growing footprint in Asia sees it working successfully with a wide range of Australia related clients to navigate these choppy waters. Often leveraging its wider relationship with a group's parent, NAB can provide credit and working capital facilities in the region's main centres to help bridge the gaps in a company's working capital cycle. A strong network of good local partners allows NAB to ensure these services can also be provided in locations where NAB doesn't have a physical presence.

*"Companies can trade directly from AUD to RMB (without the cost and lag of going via USD). Second, Chinese buyers no longer need to go through a long and arduous process of gaining exchange control approval to settle invoices overseas."*

As well as helping secure credit and banking services facilities in far away places, NAB is working closely with many clients to prevent, or at least reduce, the need for some of these funding requirements in the first place.

Working closely with major clients in the Natural Resources and Agri sectors, NAB works with a number of large companies to map out their physical and financial supply chains to understand where liquidity gets trapped or bottlenecks occur. The net effect of any blockage is to slow down the 'order to cash' cycle, delaying the cash flow, or in some cases stopping it.

By identifying and helping resolve these issues, and by advising on how to prevent them in the future, we have been able to help clients make significant improvements in their 'Days Sales Outstanding', or 'DSOs', which ensure clients receive their money more quickly, and often more cheaply. As well as needing to borrow less, the fact that a company often gets its product to market more quickly as part is an added bonus.

### 'To RMB or not to RMB...'

Another recent development is also making life easier for Australia companies doing business with and in Asia – the easing of regulatory restrictions on trading in Chinese Renminbi (RMB). Companies at both ends of a trade flow can now hold, pay, receive and hedge and invest in RMB.

The opportunity to speed up cash flows and reduce borrowing needs can be seen in two ways: first companies can trade directly from AUD to RMB (without the cost and lag of going via USD). Second, Chinese buyers no longer need to go through a long and arduous process of gaining exchange control approval to settle invoices overseas. A quick conversation with their bank is all that's needed. Many companies are winning more orders, getting paid more quickly and reducing borrowings by invoicing in RMB.

These are just a few ways in which companies are learning to fund their businesses differently in new markets. As Australia's trade with Asia continues apace, the opportunities are exciting and the prize is significant. While new challenges will present themselves, having good advice and service from someone you can trust is key. With the right guide, that journey into the Asian century might not be such a rough ride after all.

# Water reform and irrigation in New Zealand

**New Zealand is in the process of key reforms to fresh water management, while encouraging more private investment in irrigation. Duncan Southwell, Head of BNZ Advisory, outlines the state of play in the New Zealand water market.**

Compared to many countries, New Zealand has a plentiful supply of fresh water. Despite this, the country faces a number of challenges in relation to fresh water management, including:

- Deteriorating water quality (e.g. rising phosphorous and nitrogen levels)
- Over-allocation of water rights
- Inefficient water allocation (e.g. first in first served, rather than best economic and/or environmental use)
- Litigious and uncertain decision processes
- A lack of robust water management information
- Inadequate attention to cultural issues and values

## Reform process

Over the last four years the Government has undertaken substantial engagement with stakeholders on the issue of fresh water management. This included seeking advice from the Land and Water Forum (LAWF), a stakeholder group of 58 organisations, which included a range of industries, environmental organisations, recreational groups and Maori interests. The reports produced by the LAWF provided a strong consensus platform for proceeding with fresh water reform.

Following the first report of LAWF, the Government delivered an initial range of initiatives in 2011:

- Produced a National Policy Statement for Freshwater Management (NPS). This set a nationwide regulatory framework. It directs local government to set freshwater objectives, and to establish corresponding quality and quantity limits.
- Established the Irrigation Acceleration Fund to support the development of irrigation infrastructure; and announced the intention to set up a Crown vehicle for investing equity in regional scale irrigation schemes.
- Established the Fresh Start to Fresh Water Clean Up Fund to assist councils with historic pollution problems.

In March last year the Government released its planned freshwater reform package, which is based on the LAWF's recommendations. The comprehensive reforms include a more collaborative approach to the planning and decision-making process, and greater central government direction around the approach to be used under the NPS.

The reform process continues to develop and seek public feedback, and will take time to fully implement.

## Focus on agriculture: crown facilitation of irrigation projects

A number of small-scale irrigation and water storage projects have been completed in New Zealand in recent decades. Commonly they have been financed using cooperative structures, owned by the project's water users.

**Duncan Southwell**
Head of BNZ Advisory

Before

After

**Ruataniwha Water Storage Project – before and after**

**Planned Completion October 2017**

Many of the easy wins have been achieved, but there remain large areas of land that could be a lot more productive if they had reliable water. In achieving this, the country now faces a need for larger storage schemes.

These larger projects bring with them a new set of challenges. One of these challenges is significantly higher capital needs, which can stretch traditional co-operative funding models and require alternative ownership structures and a wider group of investors. Attracting those investors is complicated by the lack of precedent of similar (non-cooperative) water investments in New Zealand.

However, with a further 1.9 million hectares capable of being irrigated, the Government is keen to encourage private investment. It recognises that there is significant economic upside to New Zealand from improved water storage and irrigation infrastructure and is committed to acting as an enabler in this area. Two targeted funding programmes have been established towards this end:

**Irrigation Acceleration Fund** – $35 million in funding spread over five years, to support the staged development of irrigation infrastructure proposals through to the "investment ready" prospectus stage. The fund will contribute up to 50 per cent of qualifying expenditure.

**Crown Irrigation Equity Fund** – The Crown's vehicle for making investments in regional water storage and off-farm irrigation infrastructure. The 2013 Budget has allocated $80m, with another $320m expected in future years as additional projects develop through to the investment ready stage. Potential investments need to meet good industry practice standards, and be financially viable over the long term. As a bridging investor, the Crown will take minority stakes and needs to be provided with a clear exit strategy.

### Case study: Ruataniwha Water Storage Project

Agriculture is a key part of the Hawkes Bay regional economy. However, the area is very prone to drought – with four consecutive years of drought over 2006-2009 – and current water allocation exceeds limits.

The proposed long-term sustainable water supply solution is to build a 90 million cubic metres storage reservoir, at an estimated construction cost of $265m. The scheme will provide direct irrigation for 20,000 to 30,000 hectares, with productivity increased for 42,000 hectares overall. The increased agricultural and horticultural activity will have follow-on economic benefits for the wider region. The storage facility will also improve the resilience and stability of the regional economy, and provide environmental benefits through, for example, the ability to maintain minimum river flow rates.

Although farmers are the main direct beneficiaries, the enhancement to their returns from improved water storage is not sufficient to fully fund a scheme of this magnitude. Full privatisation would require public subsidies to be feasible. However, the Hawkes Bay Regional Council (HBRC) favours investing alongside the private sector, rather than acting just as an arms-length subsidiser.

The scheme is adopting a Build, Operate, Own and Transfer (BOOT) financing structure. Investors buy into the scheme and receive returns for a 70-year period, after which the asset ownership is transferred to the regional council and potentially other community stakeholders. The initial investor mix and their expected returns are expected to be along the following lines:

| Investor | Returns |
|---|---|
| **Hawkes Bay Regional Council** | ▪ Direct returns below commercial levels<br>▪ Positive externalities – regional economic, social and environmental benefits<br>▪ Ownership of the asset after a 70-year period |
| **Central Government** (as an enabler) | ▪ Direct returns below commercial levels<br>▪ Positive externalities (such as higher NZ economic growth) |
| **Private investors** (e.g. farmers using the scheme and outside private investors) | ▪ Commercial returns directly from their investment |

The scheme's financial structure marries the discipline of private sector investment along with government enablement, importantly involving the Crown as an investor rather than a grant provider. This style of model has the ability to accelerate growth for the sector and make agricultural fresh water an investable asset class in New Zealand.

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