Thursday, May 19, 2016 Section D

Capital Markets

The New Zealand Herald

NZ stock market in tip-top shape

NZX boss Tim Bennett doesn't believe the sharemarket is over-valued; he says it is poised for further growth, as **Jamie Gray** reports

As the benchmark S&P/NZX50 share index heads towards yet another record high, NZX chief executive Tim Bennett says the market is in great shape.

The index built on an already strong 2014 to end last year with a 13 per cent gain.

Concerns about an economic slowdown in China led to convulsions in domestic and world markets in February, but investors seem to have put their worries behind them for now.

"The sharemarket is in great shape," Bennett says. "We have seen, over a number of years, a very strong performance in the index. We are also seeing a lot more interest in the initial public offer (IPO) pipeline this year than last year."

Globally, 2015 was a slow year for IPOs. In the United States it was the slowest year since 2009 and New Zealand felt the impact of that.

Bennett and investment bankers pointed to the successful listing of Tegel as an important milestone for the market. "In a lot of ways, it (Tegel) was a bellwether and we hope that it will open the IPO window over the next couple of quarters," he says.

The NZX has seen an increase of debt issuance on the local market. "Trading activity in the debt market is up 60 per cent, year on year, so there is obvious investor demand there as well," says Bennett.

He says the NZX launched more exchange traded funds (ETFs) last year and the NZX now has 23. Interest in those products continued to be strong.

Bennett says demand for initial public offers from investors is clearly evident and we are starting to see the pipeline develop. "While we don't think that we will have a spectacular year like we did in 2013/14 — when the mixed ownership models listed — clearly there are a lot of investors who are seeking IPOs and so from a sellers' side they are wanting to raise capital to grow their businesses, which is good for the economy.

"We are also seeing foreign investors looking to divest their New Zealand assets and of course we are seeing some private equity investors looking to realise their investments."

"The caveat to all that is that we still live in a volatile world, with two IPOs pulled last year because of market volatility.

Tim Bennett says we have a strong economy and an attractive market. Picture / Michael Craig

"In the next year or two, we expect to see a good mix of New Zealand businesses come to the market in the mid-sized businesses — in the range of $300 million to $700 million," Bennett says.

As the sharemarket enters another year of very strong gains, analysts fear it is looking overvalued from a price-earnings perspective but Bennett is dismissive.

"It's all relative," Bennett says. "New Zealand is an attractive market. We have got a very strong economy. We have got businesses that are paying relatively high yields and with a good mix of companies to invest in."

The common complaint from fund managers is that not enough IPOs have come to the market to meet investor demand. Bennett does not expect to see the number of new share issues racing away anytime soon.

"By and large, we have seen some quality companies list in New Zealand, and investors who have had a diversified portfolio have done very well out of that, so we are very pleased with what has happened in the market over the last few years," he says.

After the partial privatisations of the big power generators — Meridian, Mighty River Power and Genesis — Bennett says big listings in the years ahead would be few and far between.

But in terms of future trends, he expects to see some of the foreign-owned local businesses start to come back to the market.

And Bennett expects to see more of the medium-sized privately held companies — in the $300 million to $500 million bracket — coming to the

continued on D4

Turning distance into an advantage

Leading investment banker Scott St John is upbeat about the prospects for the New Zealand economy and markets saying the "tyranny of distance" has turned into an advantage.

"New Zealand continues to be a wonderful place to be and live," says St John who is managing director of NZ First Capital. "I think the rest of the world continues to wish it had our problems. I think immigration and tourism opportunities will continue to grow faster than most people think, for longer than most people think.

"The tyranny of distance has now turned into an advantage and in an infrastructural sense I hope we are bold enough and aspirational enough to capture that opportunity."

He supports the Government's announcement that it intends to invest in tourism infrastructure to underpin projections of three million tourists coming to New Zealand each year. "You don't need to travel too far to see what those numbers could mean."

> You have got a few champions who are growing their businesses from New Zealand.
> Scott St John

Italy has close to 50 million visitors each year, with Venice attracting more than 30 million tourists alone.

"We have a lot to offer . . . peace and lack of crowds being two relatively attractive elements."

St John underscores his upbeat outlook with some caution: "In that last six months there has been a lift of activity, but at a time when the world is staring down the barrel with demographic changes and ageing populations, we are striding into a very low interest rates environment . . . that is going to create challenges.

"Add to that the interesting prospect of disruption in its various forms, I think it argues for active management — not so much in the sense of trying to pick winners — but more importantly in terms of avoiding potholes. The returns one has derived in the past will, in my view, not necessarily be a predictor of the returns one will receive in the future from various assets or asset classes."

St John says meaningful transactions are proposed or executed — pointing to the proposed NZME/Fairfax NZ merger and Sky City's capital-raising "in the last week or so alone".

"You have got a few champions who are growing their businesses from New Zealand," he adds. "The obvious listed examples are Xero and Fisher and Paykel Healthcare.

"Auckland Airport and Air New Zealand are also seeing the benefit of the investment they have made in route development."

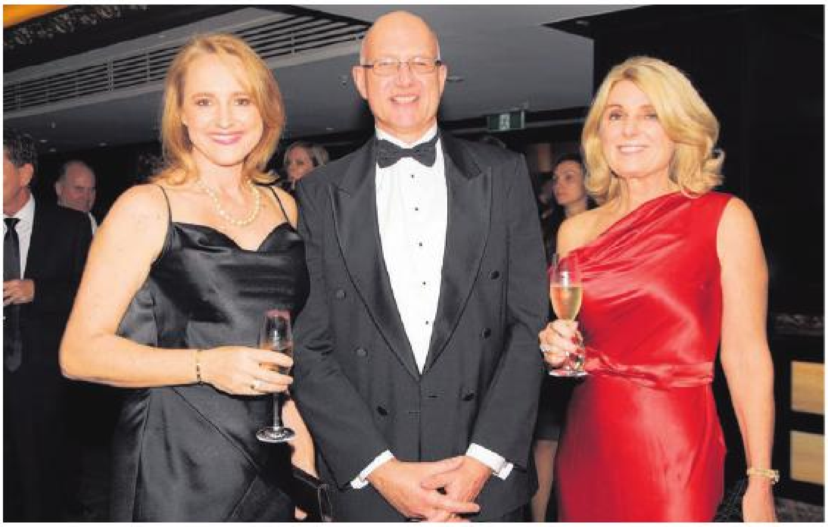
St John says the continued restructuring by global investment banks is also creating more opportunities for homegrown talent.

"We are continuing to hire talent . . . this is a big advertisement for locally based deep-rooted resource on the ground," he laughs.

Though there continues to be some "fly in fly out activity" from service providers, he says, locally based support will provide a stronger resourcing model. — *Fran O'Sullivan*

Doing the right thing by the customer

After the finance company debacle, New Zealand securities regulation has concentrated on enlivening the capital markets and building renewed customer confidence, writes **Jim McElwain**



Infinz executive director Jim McElwain with Maree Webster (left) and Lady Deborah Chambers at the 2015 Infinz Awards.

The International Monetary Fund (IMF) is making two visits to New Zealand this year — the first in August to assess the banking and insurance sectors and the second in November to check out our securities regulation.

The visits are part of the IMF's Financial Sector Assessment Programme.

This process was last undertaken in 2003, well before the Global Financial Crisis transformed the world's regulatory landscape.

The IMF will be looking at international best practice. New Zealand was offered a "two paths" moment when we sat down to write the Financial Markets Conduct Act (FMCA), hard on the heels of our own version of the GFC — the finance company debacle.

We could have gone the way of the North, writing thousands (or, in the case of America, literally millions) of pages of heavily prescriptive regulatory code, overseen by an alphabet soup of regulatory agencies.

INFINZ Fellow and Chair of our Advocacy Committee, Ross Pennington, notes that we have opted for a new approach, based on enlivening the capital markets and attracting confident participation in them. This new law is principles-based and the guiding principle is conduct (translated basically as doing the right thing, especially by your customers).

The sort of novelty adopted in our approach to securities regulation isn't particularly new in New Zealand. We have lent against the tide in establishing central bank independence; Crown fiscal transparency; the world's only traded interbank benchmark; listed debt and equity issues off terms sheets; Open Bank Resolution; the New Zealand Debt Management Office and New Zealand Local Government Funding Agency; and macro-prudential restrictions to quieten asset bubbles while keeping policy rates low. This is all part of an approach which is focused on preventing harm, rather than pursuing miscreants after the event.

So what does good conduct and culture look like?

Liam Mason, Director of Regulation with the Financial Markets Authority told last year's INFINZ Conference: "For financial services firms, embedding a strong culture that puts customer interests at the heart of the business is crucial to ensuring conduct that benefits both the business and consumers."

> It's about doing the right thing.
> Sir John Anderson

And leadership is crucial. Liam added: "We expect boards and directors of financial service providers, both big and small, to set a strong tone-at-the-top — to ensure that customer outcomes are central to organisational strategy, culture and conduct."

This probably starts with product design, then disclosure, and is the customer fully informed? Then marketing, including considering who the product or service is not suitable for. Service providers will need to consider how sales incentives are balanced with customer outcomes, and how does this balance bear out in sales and advice practices?

In a submission prepared by INFINZ Fellow Sue Brown, INFINZ has advocated in the context of the review of the Financial Advisers Act that there should be a clear separation between those providing personalised financial advice versus those who are in a sales function. This approach would provide greater clarity and therefore confidence to the consumer.

INFINZ is focused on raising standards in the industry, with finalists in tonight's INFINZ Awards judged against the extent to which they have assisted in achieving the client's objectives and contributed to development of the capital markets and the wider economy.

To assist the market in establishing better practice in conduct and culture, INFINZ has partnered with the Financial Markets Authority and the CFA Society (an association of investment professionals) to hold an afternoon seminar on June 28 — see www.infinz.com.

Even greater focus on improving customer outcomes should improve confidence in the markets and mean a better performing economy all round. As INFINZ Fellow Sir John Anderson would say: "It's about doing the right thing."

● *Jim McElwain is Executive Director of the Institute of Finance Professionals NZ Inc (INFINZ).*

● *Financial Markets Authority chief executive Rob Everett is the keynote speaker at tonight's INFINZ Awards in Auckland.* **See D8**

Inside

No longer Wild

The benefits of a more robust regulatory regime have become clearer, says Rob Everett — **D8**

Soaring angels

Angel investment is playing an important role in growing the economy — **D10**

The futures of dairy

New contracts a way to lessen the volatility in milk prices — **D14**

Room at the inn?

Tourism growth means BZ is filling up fast, writes Anne Gibson — **D18-20**

Capital Markets 2016

Executive Editor: Fran O'Sullivan
Writers: Liam Dann (Herald Business Editor-at-large), Bill Bennett, Anne Gibson, Jamie Gray, Tim McCready, Tina Morrison, Graham Skellern and Jonathan Underhill.
Subeditor: Isobel Marriner
Graphics: Isobel Marriner
Advertising: Neil Cording, Nathan Laing and Nancy Dudley.
nzherald.co.nz

A bull run to be proud of

The market is in good shape after years of hard work by those running, regulating and operating in it. **Liam Dann** reports

What kind of amazing investment could outperform the property market in this country? The NZX-50 as it turns out.

Both the sharemarket and the property market have been on a stellar bull run since the Global Financial Crisis-inspired lows in 2009.

There are no prizes for guessing which one has dominated the media headlines and public debate. But on a gross index basis the NZX-50 has outperformed even Auckland's super hot property market since 2009.

Both markets bottomed out after the crash at the start of March 2009.

Since then Auckland median house prices have soared 92 per cent according to REINZ figures. Meanwhile the NZX-50 is up 185 per cent (as at last Friday's close).

That's an incredible result by any measure but particularly when you consider the tax advantage that property investment has enjoyed for most of this period.

It would be nice to lay the credit for that run firmly on the performance of local corporates. There have been some excellent performances — F&P Healthcare, Air New Zealand, the rise of Xero and the Spark turnaround spring to mind.

But clearly there are big economic forces at work as well.

The GFC ushered in a period of ultra-low interest rates and somehow the emergency settings have become the new normal.

As Warren Buffett emphasised at his Berkshire Hathaway annual meeting last month: "The low interest environment makes businesses more expensive and cash less valuable."

Then there are the demographics of the baby boom in the West and China's growth story in the East which mean we have a historically unprecedented mountain of savings looking for a home at a time of historically unprecedented low interest rates.

It is hardly surprising that assets like stocks and property are running red hot all over the world.

Of course that begs the question: are we due for a crash?

After an ominous and potential bearish start to the year it looked like the correction might be upon us.

There are no shortage of pessimists in the United States ready to predict the next crash. They'll be right eventually. Wall Street stocks may well be overvalued versus real earnings and the imminent rise of US interest rates could bring them back down to earth.

Hopefully the seemingly endless signals from the Federal Reserve and a slow pace of rate rises should ensure an orderly correction when it comes. But history suggests it probably won't be and when the you throw in the wild card of the Chinese economy it seems highly plausible that we will at least see a repeat of January's turmoil in the next 12 months.

Auckland median house prices have soared 92 per cent according to REINZ figures. Meanwhile the NZX-50 is up 185 per cent (as at last Friday's close). That's an incredible result by any measure but particularly when you consider the tax advantage that property investment has enjoyed for most of this period.

Investors in the New Zealand market will be relying on some strong underlying value in New Zealand companies. That will underpin our market if and when Wall Street decides its time to take a tumble.

The good news is that the market is still dominated by companies with solid operating earnings and good dividend returns.

During the financial crisis the NZX-50 fell 44 per cent from the peak to the trough. The S&P-500 dropped 57 per cent.

There are few hot stocks which are soaring on strong growth stories.

There's Xero of course, and Orion Health (up 48 per cent since January one) and Comvita (up nearly 200 per cent in 12 months) also fits that bill.

That's not such a bad thing for a market that otherwise risks looking a little boring. But when volatility returns we can be sure the power companies will keep generating and the planes will keep landing. Unlike 1987, the local market is not loaded with speculative stocks. It is well-balanced and weighted towards solid sustainable businesses.

That it is in good shape is no accident after years of hard work by those involved in running, regulating and operating in it. For all the fair winds of the global economy, the local bull run of the past seven years is something the industry should be proud of.

Performing well

Fran O'Sullivan sat down at UBS New Zealand for a roundtable with **Nicholas Ross**, **Andrew Fredericks** and **David Lane**.

Herald: How are you seeing the New Zealand economic environment and the international factors which are affecting the market outlook?
Nicholas Ross: The New Zealand environment is very strong and we are still seeing good growth. We have all been surprised by the near-term impact of the downturn in the dairy sector. That has been counter-balanced by very strong growth in services and tourism. We have this very strong Government and fiscal position which can underwrite strong growth, in Auckland in particular, as the Christchurch rebuild tapers off. When you look at what is out there, it is astonishing how the NZ economy is performing so well when we have a mixed picture in Australia, which is very heavily dependent on resources and the financial services sector.

Herald: The IMF has warned about the potential for the Brexit vote to negatively impact on capital markets. That's well known. But what about other international factors like the impact of a Trump presidency?
Nicholas Ross: It is really interesting. We put out a piece of research recently which said the presidential election has no significant impact on capital markets. It went back 50 years.
Andrew Fredericks: Same with the Australian election. But elections do affect the timetables for capital market activity. Given the number of political events this year, it makes the timetable challenging.
David Lane: My view is if we get through the UK Brexit, we could have a second half of the year that is extremely active. On China — While everyone has a theory on why it was going to fall apart, the facts are this year it has massively out-performed expectations.

Herald: Staying with China, it has been a concern but you are optimistic. Why?
Nicholas Ross: We are still extremely well placed for growth in the region despite the concerns in China. The Five Year Plan has just come out and the Government has targeted 6.5 per cent growth for the next five years. There is still a phenomenal pool of demand for New Zealand product and they will continue to be large exporters of capital.
Herald: But there are some wrinkles aren't there when it comes to foreign investment In New Zealand — particularly with the Overseas Investment Office?
Andrew Fredericks: The OIO has been an impediment to investment. It is slow and it is uncertain, if you contrast it to the Foreign Investment Review Board (FIRB) where there is a defined timeframe for making decisions. It is actually very difficult for firms making investments into NZ to get equity and bank financing for an uncertain period.

> You don't need to be a rocket scientist to see that we screen very well
> Nicholas Ross

Herald: The underlying demand for good assets and well-run companies is still very evident when you talk to investors. Why is NZ attractive?
Nicholas Ross: I think New Zealand clearly has emerged as a separate asset class from Australia and a very good place to invest. Certainly some of the infrastructure opportunities here keep a lens very much on us. If we look at some of the M&A activity there is certainly a lot of interest from international investors. You don't need to be a rocket scientist to see that we screen very well.
Andrew Fredericks: Additionally, private equity firms have gone through a period of divestment and are now raising funds and starting to look for investments. We've had the Diligent takeover and the Nuplex scheme of arrangement. With a lower exchange rate, USD investors are also looking more favourably at Australia and and NZ.

Herald: There has been a lot of volatility however on markets — what is driving that?
David Lane: The general view was the NZ market got quite over-valued (for institutional investors) and they found it hard and reduced their weightings. But then in came another wave of overseas buying, whether it was indexed-based buying or thematically buying on yield and the relative attractiveness of New Zealand as a place to invest. There was a huge rally in March and a lot of institutions were underweight. So, a very difficult year for them so far. But if the market is doing its job properly new opportunities will arise be it Tegel or listed media situations. Confidence is coming back in — we've seen a range of block trades and the deal pipeline open up a little bit in the last four weeks.
Nicholas Ross: We have been in a period of unprecedented volatility and a lot of market participants are not used to that environment. Same with clients having their fund managers say we are down 10 per cent or up 5 per cent. The volatility drives the more conservative end of town to companies with good governance and track records. They don't want that volatility but good multiples.

Herald: Just summing up, New Zealand capital markets are clearly in a good space. But what has surprised you?
David Lane: Housing consents at a sustained peak of over 30,000 per year. If you had asked me if that was a reasonable assumption by Fletcher Building five years ago — I would have said "no".
Andrew Fredericks: If you go back two years ago there was a massive concern that the fall from the peak of the Christchurch rebuild would impact on the NZ economy. But that that has been filled by infrastructure, tourism and net migration.
Nicholas Ross: You don't have to be an investment banker to make this comment — just walk around Auckland City. You can't drive anywhere in Auckland because it is blocked. The Convention Centre build. Scott Pritchard's Precinct build at the Downtown Centre — there is so much going on in Auckland and that is before some of the major projects.

Herald: Concerns for the future?
Nicholas Ross: Negative interest rates are drawing investors to invest in positive yield countries. But the low rates will start biting into the "man in the street" and the fiscal position of Governments. When your retired mum and dad can't generate enough from their savings then that will need to be subsidised somehow.
● *Fran O'Sullivan is Head of Business for NZME*


Nicholas Ross
Country Head, New Zealand


Andrew Fredericks
Executive Director, Investment Banking


David Lane
Executive Director, Head of Equities New Zealand

NZ stock market in tip-top shape

continued from D1

market as a way of raising money in order to grow their businesses.

Some market commentators have criticised the NZX for the slow start of its new NXT market but Bennett says he is happy with progress so far.

"The market was designed for smaller high growth corporations and we are pleased with the way that it has developed.

"In the next quarter or two we will see a much closer relationship between NXT and the crowd funded companies, but all that takes time to develop."

Bennett says new markets always take time to evolve.

As an example, the exchange's dairy derivatives operation started six years ago and only started to gain traction in the fourth and fifth years.

> New Zealand is an attractive market. We have got a very strong economy. We have businesses that are paying relatively high yields and with a good mix of companies to invest in.

"Talk to us in six to 12 months time and we will start to see some real progress there (in the NXT)," he says.

The derivatives side of NZX's operation is relatively small — representing about $1 million in revenue — but Bennett says it forms an important part of the overall equation for capital markets.

"All of these systems are part of an ecosystem that we need to build, so you need to add pieces to that ecosystem to really make the capital markets work."

He credits the Government's partial asset sales programme for rekindling investor interest in the sharemarket, which for many had been a no go zone since the travails of the 1987 sharemarket crash.

"Clearly it brought back a lot of investor participation," he says.

"It put the sharemarket back on the map for a lot of investors who had been reluctant to invest since 1987, and at a good yield," Bennett says.

In addition, it put New Zealand back on the map for global investors and raised the country's profile.

Company alliances the way of the future

More companies are planning to form alliances to create value from under-utilised assets and to speed up growth.

The latest EY Global Capital Confidence Barometer found that 40 per cent of executives surveyed planned to enter alliances with other companies, even competitors, to take advantage of the expertise and reach of others.

These alliances join mergers and acquisitions as engines of growth.

The alliances are usually more informal and less permanent than joint ventures — each company maintains its autonomy with a view to creating a shared opportunity, such as entering a new market or developing a more effective process.

The EY report says relationships between companies are becoming more fluid and complex as business models are reinvented. These unprecedented collaboration and relationship opportunities involve customers, suppliers — and competitors.

Executives are also increasingly looking to alliances to help respond to digital transformation.

Companies are often outsourcing innovation and traditional services to more nimble and agile service providers to stay ahead of this digital revolution.

Pip McCrostie, EY's global vice chair of Transaction Advisory Services, says executives now find themselves planning for multiple possible futures.

Mergers and acquisitions remains a strong option to accelerate strategic plans. At the same time, alliances are becoming more attractive as companies seek new sources of revenue and earnings while looking to manage costs and risk. Increasingly, companies are taking this option to bolster their research and development processes.

Key mergers and acquisitions findings from the barometer

50%
of respondents expect to actively pursue acquisitions in the next 12 months

74%
are considering cross-border investments

37%
expect distressed asset sales to become more prominent in deal making

and the appetite for
US$1-5b
deals has increased five times

The sectors with the highest appetite to acquire were: oil and gas, and consumer products and retail 59 per cent; power and utilities 58 per cent; diversified industrial products 55 per cent and life sciences 51 per cent.

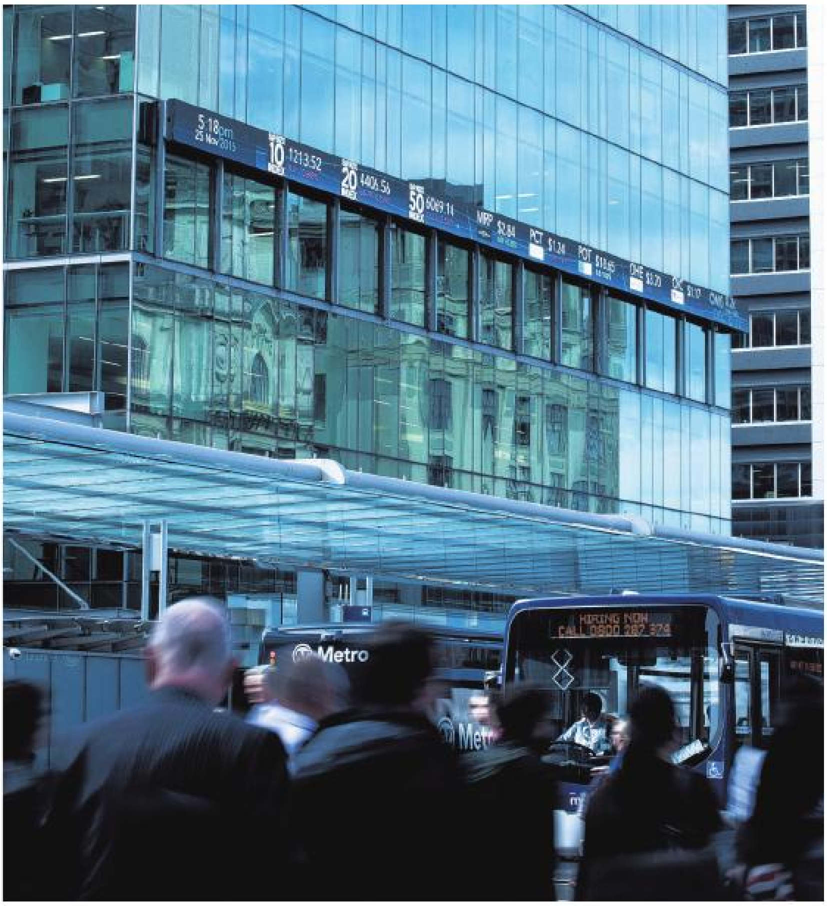
The top investment destinations were the United States, United Kingdom, India, China and Germany.

The report found that in spite of tough market conditions in global equities, commodities and currencies, there were no signs yet of systemic shocks in capital markets or impending asset bubbles.

The volatility in the commodity and currency markets and political instability in the Middle East, Korean Peninsula and South China Sea were considered very serious but have not altered medium- to long-term capital allocation strategies.

Keeping the score on the capital markets front

Do we have the foundations in place to ensure New Zealand's capital market can perform, asks **Tim Bennett**



A new regulatory environment and a wave of new listings, kick-started by the Government's share offer programme and growing KiwiSaver funds, were heralded as the catalyst for the revitalisation of New Zealand's sharemarket.

Three years after Mighty River Power's NZX listing, and five years since the Financial Markets Authority was established, it's a fitting time to assess how effective this programme of change has been and what challenges lie ahead.

The headline statistics are impressive: over the past three years the S&P/NZX 50 Index is up 48 per cent, and equity market capitalisation to Gross Domestic Product ratio, a key indicator of market health, has risen from 35 per cent to 47 per cent.

However, these numbers, especially viewed against the backdrop of New Zealand's strong economic performance, don't necessarily give a clear picture of the underlying health of the capital market ecosystem.

Is the sharemarket considered a viable source of capital for businesses? Is there a broad base of investors and intermediaries willing to support them? Are we getting regulation right?

In other words, do we have the foundations in place to ensure, regardless of economic and market cycles, that New Zealand's capital market can perform its core function of supplying growth capital to businesses and connecting everyday New Zealand investors to those investment options?

The demand for capital — Issuers

Since the beginning of 2013, prior to Mighty River Power's listing, 34 companies have listed on NZX, raising almost $7 billion in capital. Excluding the gentailers, almost a third of capital raised has been used to grow those businesses.

In the past year, we have seen a resurgence in debt listings and issuances on NZX, with 27 new debt listings representing more than $9.27 billion.

Some terrific businesses have graduated to the S&P/NZX 50 Index including the a2 Milk Company, Comvita, Heartland Bank, Precinct Properties and Xero — all of which have taken advantage of being listed to cost-effectively raise capital to grow their businesses through secondary offerings.

More private companies and their shareholders are now considering NZX as a viable option for raising capital or selling a stake in their business, which was less common three years ago.

Crowdfunding is also becoming a viable option for capital raising, with 35 smaller businesses so far using that market to raise $25 million.

For businesses at the next stage of development, NZX's NXT market offers a platform for future capital growth, along with a pipeline of companies that will grow to NZX Main Board size.

And there are promising signs that stronger linkages will develop in the next few years between crowdfunding and NXT.

Supply side — Investors

Growth in KiwiSaver funds under management (FuM) is up 102 per cent to $33.4 billion in the three years to 31 March 2016. There are now 19 (up from 14 three years ago) fund managers in New Zealand with more than $1 billion in FuM and four (up from three) with between $500 million and $1 billion.

It is these kinds of smaller, boutique fund managers that are particularly important to support smaller companies coming to the public markets.

Yet despite this growth, the full benefit of the KiwiSaver funds inflow is yet to be seen in our equity market.

New Zealand Treasury analysis published last year found that across the market, KiwiSaver portfolios were overly conservative, reducing potential future retirement incomes. It found only a small portion of KiwiSaver funds are invested in the New Zealand equity market.

Part of this is a Catch-22 problem: managers see a market that has a limited supply of attractive investment options. On the other hand, some potential listed companies see managers as overly cautious.

Experience offshore suggests that this will change over time as the number and diversity of fund managers grows, and as KiwiSaver balances grow, investors will seek a broader range of investment options.

The past three years has seen a resurgence of global interest in our market, with offshore ownership now at 46.3 per cent.

This is in part due to the relative attractiveness of the New Zealand sharemarket.

But it is also clear that New Zealand is now firmly back on the global investment map, which recognises the growing depth of our listed companies, and the quality of our market infrastructure and regulation.

Tens of thousands of New Zealanders became share owners for the first time through the listings of Mighty River Power, Meridian Energy and Genesis Energy, and we continue to see 1000 or more new brokerage accounts being opened each month.

But there are still practical barriers to direct retail investment in the equity market, including the relatively high cost of providing advice and research, which limits access by smaller investors to the equity market.

Changes to the Financial Advisor regime, currently under review, will be important to ensure that all types of New Zealand investors have access to appropriate financial advice, and ultimately a broader range of investment options.

Infrastructure and Regulation

The much-needed overhaul of New Zealand's legislative and regulatory framework, following the global financial crisis, has helped to restore trust in New Zealand's public markets.

As the frontline regulator of the public market, NZX has made a substantial investment in our regulatory and operational infrastructure, including a robust technology platform and appropriate governance structures, to ensure we operate fair, orderly and transparent markets.

As investing becomes increasingly global, we need to be conscious that financial failures offshore have as much potential to erode this hard-earned investor trust, as do events in New Zealand.

Keep the focus

The resurgence of appetite for raising capital through public listings, a growing domestic investor base, and an effective regulatory environment, all point to the New Zealand market ecosystem being in good health.

Last night's INFINZ Awards celebrated the achievements of the people and firms at the heart of that ecosystem: businesses, bankers, brokers, researchers and advisors.

It is a fantastic industry we work in. But although the overall ecosystem is in good health, we need to be very conscious of the importance of maintaining a vibrant local industry. The biggest challenge for our future is how NZX and the New Zealand market differentiates itself in a much broader and deeper Trans-Tasman capital market.

NZX has an obvious leadership role to play here, to continue to develop and protect our capital market ecosystem.

This includes ensuring private companies see the public market as a option for raising capital; supporting advisors and smaller fund managers who bring those companies to market; and ensuring that distribution and advisory networks are in place to allow all New Zealanders to invest in great New Zealand businesses.

We can't lose focus — we need to continue to work together to maintain this hard-earned momentum and preserve our capital market on behalf of all New Zealanders.

● *Tim Bennett is the chief executive officer of the NZX*

Market statistics

	Apr-13	Apr-16	% Change
S&P/NZX 50	4614	6821	48%
Equity Value Traded ($m)	2,900	3,900	34%
Equity Market Cap / GDP	34.6%	47.4%	37%
Debt Market Cap / GDP	6.6%	8.5%	29%
S&P/NZX 50 Div 12-Month Yield	4.7%	4.6%	-0.4%

New issues

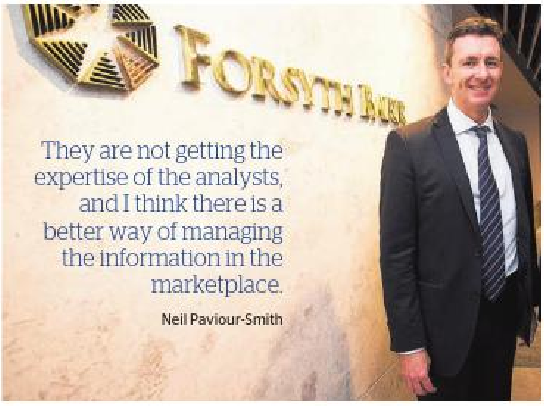
	Last 3 Years
New Listings	34
Capital Raised ($m)	6,973

Investors

	Mar-13	Mar-16	% Change
KiwiSaver FuM ($B)	16.56	33.42	102%
Fund Managers > $1B	14	19	36%
$0.5B - $1B	3	4	33%
Offshore Ownership	35%	46.3%	32%

Mum and dad investors missing out

Blacking out analysts' research at the time of an IPO is a sore point for a leading share broker, writes **Graham Skellern**



Investors would be better served if they had access to published research reports at the time of an initial public offer (IPO).

In nearly all of the IPOs coming onto the New Zealand sharemarket, analysts' research reports of the participating broking firms are blacked out for 30 to 40 days up to and after the time of listing.

The lead managers of the IPOs have set this rule in accordance with the global practice of their parent investment banks — a protocol that grew out of the United States.

The blackout is a sore point for Neil Paviour-Smith, managing director of Forsyth Barr and a director of NZX.

"The role of an advisor is important and the blackout is not helpful or an ideal development in the market to assist investors confronted by a lot of information at the time of offer.

"Companies looking to complete IPOs do produce comprehensive information for investors but it's also important that they receive clear and concise messages," he says.

"They are not getting the expertise of the analysts, and I think there is a better way of managing the information in the marketplace. We want more listings in New Zealand and blackouts are a poor development.

"Research blackouts are something we've seen in offshore jurisdictions and they have evolved here as the banks have followed the policy of their overseas owners."

Paviour-Smith says any potential conflict of interest for the analyst can be managed and "I would hope that the blackout practice gradually disappears from our landscape".

He says analysts are not involved in organising the IPO, and their viewpoint can be of help to the vendors, advisers, fund managers and investors all at the same time.

"If you manage your processes and put in strong conflict procedures around Chinese walls, and the analyst's research is transparent, then I don't know why it needs to be blacked out."

It's almost a Catch-22.

Broking firms such as Forsyth Barr invariably get involved in the syndicate arranging the IPO and by doing this need to agree to the manager's protocol on research.

"We have debated the point strongly," says Paviour-Smith, "and if we don't get involved then our clients will have less access to the IPO. It is a difficult decision to make.

"(On some occasions) we have been able to get a softening to the hard edge of the rule where we have come up with a two page summary facts sheet — and that's got us to a place where, on balance, it's okay to be involved with the IPO.

"But there have been times when we have turned down being involved in an IPO — for a variety of reasons, not just the blackout."

The Financial Markets Authority (FMA) had earlier put out a note saying: "While New Zealand firms often follow global practices and impose black-out periods restricting research publication immediately before and after an IPO, there are no requirements under the FMA Act (or NZX rules or other New Zealand law) to restrict the publication of research of a company making an IPO.

"In fact, research may be published by participants at any stage during an IPO. Research reports may also be shared with retail investors, as well as institutional investors."

The Financial Markets Conduct Act 2013 (FMC Act) put in place a new framework for those offering securities in New Zealand, including new, more flexible rules for advertisements and other promotional activities.

The Authority said the broad FMC Act obligations on fair dealing and new advertising regime encouraged fair, efficient and transparent promotion of financial products.

This gives those in the industry an opportunity to re-examine how and when they share information such as research reports.

"We strongly encourage participants to make research reports available to retail investors and/or their advisers, although we recognise that this is a decision for each business to make.

"When multiple joint lead managers are involved in an offer, participants should not unnecessarily restrict other joint lead managers from making their research available to retail investors and/or their adviser," the authority said in its note.

The authority is aware that the current market practice for promoting an IPO has led to an imbalance in the information available to institutions and retail investors.

Though certain institutional clients of joint lead managers have access to valuable research, retail investors and their advisers often have limited access to quality contextual information to help with investment and trading decisions.

So how do retail investors get around the blackouts and become more confident about investing?

Paviour-Smith says: "They need to speak to an Authorised Financial Adviser; they should try and not listen to the 'noise' and follow the herd mentality; they need to form their own view and feel comfortable with the investment; they need to understand the risks and rewards such as investing in a company for a while rather than selling it for a gain on the first day; and if something is too good to be true then maybe it is and if there's any nagging doubt, then come to terms with that."

Paviour-Smith says the book builds for an IPO have been good for the sharemarket.

"You no longer see the price extortions of extraordinary bargains and massive premiums on day one. The book build finds the (market) level for the IPO and if the share price sustains that level, then investors have a good experience and hopefully stay invested in that business."

Increased productivity is the name of the game

Dairy farmers, facing volatile prices, must take advantage of advances in genetics, forages and labour-saving technologies, writes **Mark Hiddleston**

Winter is traditionally a time for dairy farmers to make sure their farms are in good order and can meet the demands that will be put upon them in spring.

This year, they'll need to look not just at their assets but also their whole business, and this is more urgent and challenging than it has been for many years.

The world has changed. The global supply of dairy products — much of it from competitors who have upped their game — is growing faster than demand.

It seems likely that low prices will be around for some time, and producers that succeed in this environment will be those with the lowest cost of production.

This is not just about cost-cutting, although this has its place. It's a race where the winners will be those with the most efficient businesses.

On the farm, this means clear direction and disciplined management, building on New Zealand's strengths in pasture management, and taking full advantage of advances in genetics, forages and labour-saving technologies.

This may require cash. At a time when many farms are already running operating losses and reducing high marginal cost production, farmers face the prospect of debt-servicing and costs being spread over less production.

In New Zealand farmers are far from markets and sell down the value chain. As a result they are more exposed to market volatility, and often rely on banks to fund them through cyclical lows, confident in speedy recovery.

A more volatile environment requires better risk management. While the best strategy is a low cost structure and an ability to respond to varying market conditions, derivatives can increase the predictability of product prices, and moving debt from the predominant floating rates to fixed reduces that variable.

Another alternative is seeking new equity investment.

Investing in dairy farming at the bottom of the price cycle has its own challenges and opportunities. Foremost, it requires investors to look past the headlines to a sector with great long-term prospects and — in some cases — adequate short and medium-term returns too.

It's generally accepted that investments in dairy business return about 3 to 7 per cent but top-performing operations have achieved returns in the high single figures and even low double figures. To generate a similar return in the current environment, investors are considering three key issues:

The expectations of investors to our top-performing farms should be no different to the top performing companies on the NZX — companies operating in mature markets attract investment by demonstrating an ability to outperform their competitors.

Mark Hiddleston

- The expectation of an increase in dairy pay-out over time
- The ability of a farm to adapt to a lower cost structure and still perform
- An opportunity to buy quality land in good locations and with quality improvements in this more constrained environment.

Attracting investment is seldom a means of restructuring balance sheets. In fact, highly indebted farmers often question why they would consider taking in new equity when their own equity has been eroded by losses, asset values are down and interest rates are low.

Others see selling assets and leasing them back as a low-risk way to strengthen the balance sheet while still retaining control of the business.

Currently, investors are looking at the implications of a milk price of about $3.90, and $4.50-$4.75 in 2016-17 with no certainty about when prices may improve in an environment where many farms need a milk price over $5 to just break even. But the capital is out there, and investors are aware demand for dairy products from the growing middle-classes of Asia will underpin the profitability of dairy for decades to come.

For investors, venturing off the beaten path and buying in at the low point of the price cycle has its advantages. The entry price can be lower, they will buy better, and income statements will show which businesses are worth investing in at current income levels.

Investment in dairy is nothing new, but until recently investors were often invited to "participate" in dairy, to "share the commodity story" with the promise of attractive returns from growing primary commodity demand and consequent capital growth.

Today, the expectations of investors to our top-performing farms should be no different to the top performing companies on the NZX — companies operating in mature markets attract investment by demonstrating an ability to outperform their competitors.

To see the leading edge, the annual Dairy Business of the Year competition — of which ANZ is a supporter — features farmers who combine all the attributes of high performance, which is on-farm management, pasture productivity and new technology to drive down the cost of production.

In the 2014-15 season, the top businesses achieved $3.13/KgMs cost of production, including depreciation and owner's labour.

Many farmers are reducing costs, often faster than predicted. ANZ customer forecasts indicate 10 per cent of farmers have a plan to operate at this cost level.

As more join them, this will restore New Zealand dairy's ability to compete on cost and provide an opportunity for investor returns around the desired level, provided investors can be confident management is in place to perform at this level.

For farmers, counter-cyclical investment in dairy not only brings in working capital at a time when they need it most, but it also helps stabilise the sector as a whole by running counter to the peaks and troughs.

Equity partnerships, in which investment funds — sometimes pooled, sometimes from single entities or investors are brought into the business — have proven to be among the most resilient when prices are low or the business faces other adverse conditions.

The change from "participation" to "performance" in agri-investment is a fundamental shift towards making more agri-businesses attractive and accessible to capital.

At ANZ a major focus for our agri-business team is creating "investable businesses." That means helping owners address and improve areas such as productivity, governance and management of these businesses.

Through our networks and sponsorships such as Dairy Business of the Year, we have identified top performing dairy businesses and — through our partnership with Ministry for Primary Industries and our own research — have showcased them and their strategies for success to the industry.

The overall goal is to enhance returns through consistent improvements in productivity driven by research, innovation and good management.

- *Mark Hiddleston is Managing Director Commercial & Agri for ANZ*

No longer the Wild West

NZ has joined the international game in funds management and licensing financial services firms, says **Rob Everett**

We are often asked whether the regulations we are implementing will make a difference. Are we regulating for its own sake, and imposing process and cost with no benefit?

At a system level, the benefits of having a more robust regulatory regime have become clearer. A recent example is that New Zealand was able to sign the Asia Region Funds Passport because our securities regulation regime is increasingly seen as being on an equal footing with global standards.

I had the privilege of signing that document and took pride in the recognition it represented for how far New Zealand has come. Just as I take pride in New Zealand being a valued contributor at the International Organisation of Securities Commissions (IOSCO).

The work we've done has given us a ticket to the international game in terms of funds management; and in terms of contributing as equals to improving global standards for licensing, supervision, monitoring — and taking enforcement action against — financial services firms.

That we no longer look like the securities wild west to the rest of the world is critical if we wish — as the government's business growth agenda makes clear that we do — to be a destination for international capital.

That doesn't come if there is no confidence in our markets.

And we have clear signs that confidence is there, and building.

But what about signals from New Zealanders that there are benefits to the new Financial Markets Conduct world?

The Financial Markets Authority's investor confidence survey forms part of our annual performance measures. This year's survey produced interesting results as people were asked for the first time whether they had confidence in the effectiveness of the regulation.

Overall, across the 1000 people surveyed, this new score was reasonable at 60 per cent, but the scores among investors were higher. For people with managed funds and shares, 80 per cent and 75 per cent respectively were confident in the effectiveness of regulation.

Confidence in the markets themselves fell for the first time since the survey started — from 60 per cent to 56 per cent, reflecting the turmoil in global markets over the last year.

However, these levels of confidence in regulation are early signs that even when the markets are unsettled, it's possible to differentiate between the systems and controls within the regulatory framework and sentiment reacting to market volatility.

There is still a way to go to broaden that confidence across a wider demographic and build deeper, more sustainable market growth where more of the population would be willing to put their money.

KiwiSaver is introducing people to saving for retirement and managed funds but this has yet to translate into more engaged attitudes towards investment.

> We will not be a destination for international capital if there is no confidence in our markets

The full benefits of the FMC Act will not be truly felt by either the industry or consumers for a few more years, and that simply reflects the fact we are completing the build phase of this new conduct regime. But the benefits seen already show that the FMC regime is not regulation for its own sake.

The purpose of the regulation is to build better markets and services for people to invest their hard-earned money. Longer term success depends on us being an effective conduct regulator. Conduct is literally what the Financial Markets Conduct Act says on the tin.

If firms are, and crucially can show they are, putting customers' interests at the centre of their business, then they have already grasped what good conduct means to us. And what the risks of poor conduct are: Bad customer outcomes and lots of attention from the regulator.

It's impossible to implement conduct regulation without focusing on culture and we highlighted that in our first *Strategic Risk Outlook* late in 2014. Governance and culture were signalled as primary contributors to help deliver better outcomes for customers. When poorly constructed, they are primary drivers of risk to our markets.

Globally, there is much discussion about whether it's practical or possible to turn culture into a specific obligation, or duty, rather than allowing firms to organically foster their own culture.

To us the reality is simple. Culture drives what actually happens at the businesses and individuals we regulate, which is why it's important. But a regulator has no role in prescribing culture — that's the job of leadership.

We don't look at, or judge, your values statements or your wellness programmes. We look at things like who gets promoted, who gets paid and for what, and what happens to complaints and incident reports. We judge and respond to you on the basis of how all that translates into outcomes for your customers.

Achieving fair, efficient and transparent financial markets is not a one-off challenge. We see signs of progress, but we certainly haven't cracked it and we're very conscious we won't if we don't work with the financial services industry.

A big part of that is encouraging the industry's more effective and efficient participation in our markets through innovative forms of capital raising; shorter and clearer disclosure documents; and a pragmatic approach to using tools such as exemptions from the rules to avoid unnecessary cost and burden.

I believe the mandate we have been given, and the way we implement it, is starting to make a positive difference to the way New Zealand financial services are considered globally and locally.

It's important for all of us that our markets are recognised abroad as a place worth doing business; and by New Zealanders as a place they are confident can help them to get ahead financially and in which they will be fairly and honestly treated.

● *Rob Everett is Chief Executive, Financial Markets Authority*

IPOs in short supply despite boost

New Zealand is an attractive place for capital, which is fuelling the market, but there are few initial public offers on the horizon, reports **Jamie Gray**

Equity markets here and around the world have been strong, driven in no small part by interest rates that in many countries are close to zero.

That has meant investors have been piling into sharemarkets in search of yield and New Zealand, with its high proportion of dividend-paying stocks, has been singled out by investors for special attention.

The surprising thing has been the length of time central banks have clung on to their highly accommodative monetary policies, which has meant sharemarkets have tended to carry on stronger for longer, says David Gibson, co-head of Deutsche Craig's. "We get the jitters every now and then, as we did in February over worries about China," he says.

"Since then, we have had a very strong rally and global markets have remained strong."

Gibson concedes the market, from a price earnings (p/e) perspective, looks pricey. He says that on the face of it, the market looks expensive at an average p/e multiple of 20 times — which is 35 per cent above the 20-year average of 14.8 times.

However, the premium to historical price earnings has recently been skewed due to the emergence of high p/e tech companies and the high concentration of the so called "gentailers" — Meridian, Genesis and Mighty River Power.

"We are not expecting a major New Zealand-specific market correction, especially given where interest rates are," Gibson says.

"New Zealand companies' earnings performance has been solid. We are one of the strongest-performing markets and our price-earnings ratios and multiples look high. However, you need to back out of that equation the unique characteristic of the New Zealand market — the fact that such a high proportion of our market is in the (high dividend-paying) power generator/retailers, with some technology as well," Gibson says. "If you back those out, we still look strong."

New Zealand is an attractive place for capital at the moment because of the stable political backdrop.

Companies are performing well and the official cash rate — at 2.25 per cent — still has room to move on the downside; many other countries do not have the same luxury.

Gibson says there has been strong support for New Zealand stories. Those companies involved in high-value agriculture with exposure to China — such as Comvita and A2 Milk — have enjoyed a sweet spot in the market.

Food remains a strong theme for investors, as evidenced by the success of the Tegel float. "Hopefully in the next five years a lot of other companies — food stories with an Asian focus — will emerge," Gibson says. "To our minds there is a shortage of supply emerging for these quality businesses.

"We expect IPO levels to remain relatively light — not through a lack of demand — but we just can't see a lot of companies lining up with a lot of scale," he says.

"I don't think that we will see many more IPOs this year, but I do think we will see a surprising number of mergers and acquisitions," Gibson says.

"We are going through a slight merger and acquisition wave at the moment, which I think will continue through into the end of this year."

Gibson says dairy prices were the potential overhang, especially given the impact they might have on the banking sector if conditions remain depressed.

Corporate activity levels continue to rise with the recent Z Energy/Caltex deal being a case in point.

Gibson says private equity firms have been very active and are flush with cash, supported by cheap funding from the debt markets.

In the "hot" sectors — health supplements and honey — high multiples are being paid.

The media sector is attracting a lot of interest given the big changes taking place at NZME, Fairfax and MediaWorks.

Gibson says the collapse of electronics retailer Dick Smith — which was brought to the market by private equity — has made investors cautious about private equity funds seeking to exit retail businesses.

In the domestic credit markets for the year-to-date, aggregate maturities of bonds have been less than total new offers, creating the first significant positive new issuance in about four years.

Gibson says there is a "reasonable pipeline" of new debt issues ahead.

Honey producer Comvita has found a "sweet spot" in the market.

> I don't think that we will see many more IPOs this year, but I do think that we will see a surprising number of mergers and acquisitions.
>
> David Gibson

Angel investments soar

The angel investment market in New Zealand is maturing and playing an important role in growing the economy, reports **Tim McCready**

The latest Young Company Finance Index, compiled by the New Zealand Venture Investment Fund, shows that angel networks and funds last year invested a record $61.2 million into 94 New Zealand companies across 132 deals.

Software and services received 39 per cent of the amount invested, followed by pharmaceuticals/life sciences (15 per cent), technology hardware and equipment (11 per cent), and food and beverage (8 per cent).

More than two-thirds of the investment last year were follow-on investment, indicating a maturing of the market and demonstrating that angel investment has become an important component in the patchwork of the New Zealand capital markets.

Angel investment often fills the gap in early-stage company development before venture capital kicks in. In addition to funds, angel investors can provide advice, introductions and access to networks and markets that would otherwise be unavailable.

Angel investors typically invest from a desire to help the country, the industry or an innovation they are passionate about — and hope that at least one will turn out to be the blockbuster that makes good on their investments.

"After I arrived in New Zealand I wanted to do something that would help the country grow long-term," says Chris Sattler, lead investor with the ICE Angels and now active with the Flying Kiwi Angels.

"Property is one asset class but I strongly believe in investing in 'more productive' assets to provide interesting and high-value jobs for the future," he says.

"Angel investment is a driven environment and it's energising to work with the founders.

"Plus, it's a great way to build a network of interesting, like-minded people."

New Zealand can now point to global success stories — most notably Xero, TradeMe, and Orion Health, which provides confidence that world-leading companies can be developed from New Zealand.

Chris Twiss, Investment Director at the New Zealand Venture Investment Fund, says New Zealand is increasingly on the radar for international investors looking for opportunities.

"We are now seeing angel-backed companies successfully raising capital from overseas investors — including venture capital firms, angel groups and equity crowdfunding," he says.

"Offshore investment brings capital and access to networks and markets, and widens the shareholder base."

There are now eight crowdfunding operators licensed by the Financial Markets Authority in New Zealand. Alongside angel fund investment, four of those crowd funders - Snowball Effect, PledgeMe, Equitise and CrowdCube — raised $14.9 million of retail investment for 27 companies.

"Crowdfunding platforms demonstrate the efficiencies that technology can bring to what has historically been a clunky and time consuming business, corralling multiple individuals into a single early-stage company investment," says Twiss.

"In addition, the crowdfunding platforms in their own right have opened up this form of investment to entirely new audiences."

Since the Young Company Finance Index began measuring activity in 2006, $414.7 million has been invested into young companies by angel groups.

Although the average deal size last year was $464,000 — down slightly on 2014 — the total amount of angel investment captured by the index in 2015 represents a 9 per cent increase on the previous record in 2014, and is certainly a jump from the $21.4 million invested back in 2006.

Although the index demonstrates that angel investment is growing, it is important to note that it only measures investment made through angel networks and funds.

The index reports that 76 per cent

Index
YOUNG COMPANY FINANCE INDEX

CAPITAL INVESTED - FULL YEAR

Year	Amount invested	Number of deals
2006	$21,366,964	30
2007	$29,518,348	55
2008	$32,569,403	41
2009	$43,238,580	75
2010	$53,109,861	112
2011	$34,798,049	103
2012	$29,896,789	101
2013	$53,086,526	114
2014	$56,407,433	119
2015	$61,206,681	132
TOTAL	$414, 698,634	882

We are now seeing angel-backed companies successfully raising capital from overseas investors.

Chris Twiss, New Zealand Venture Investment Fund

Giving start-ups an early boost

The Icehouse and ICE Angels have recently launched a $10 million fund which they plan to invest in 25 start-ups over the next three years.

The Tuhua fund was established last November, with cornerstone investors being former local Microsoft executive Ross Peat, Japan's internet pioneer Tim Williams, former PwC partner Richard Burns, software entrepreneur Dennis Row, The Icehouse CEO Andy Hamilton and ICE Angels chief Robbie Paul. The Warehouse founder Stephen Tindall has since joined and is now the biggest investor with $250,000.

Although The Icehouse and ICE Angels have an active platform for start-ups and angel investment, they identified a couple of issues in the market. The first was how hard it is for start-ups to raise their initial funding, and the second was the challenge that comes with raising a large funding round.

"Both of these areas we thought could do with some energising through an investment from the fund," says Hamilton. "We are also able to be opportunistic on great deals out there that require quicker decisions when others are leading the investment. We wanted the fund to power up our angels to do more deals, do more investment and influence more growth."

The fund plans to invest up to $1 million per start-up, and has so far made three investments — Avertana, which extracts high value chemicals from industrial waste; Nyriad, which develops software to rapidly compresses and stream data; and a co-investment with Sequoia Singapore and Sky TV in 90 Seconds, a cloud video production platform. The fund is expected to announce their fourth investment soon.

"In addition to active board members and advisors, investees will have access to board observers who are charged with unloading administrative tasks off the founders, mining our networks for talent, and enabling data-based decision making by leveraging insights from our 97 investments," says Robbie Paul. "The start-ups will also have access to The Icehouse space in Parnell and its team".

"The Fund will really speed up the path to market for these start-ups and it will unleash the network of investors that have come on board with the Fund," adds Hamilton.

Graphics / NZ Venture Investment Fund

to record levels

of deals last year were syndicated across angel groups.

These networks help shortcut the investment process, by linking start-ups with investors and providing access to deals, shared research and pooled investment capital.

Rowan Simpson, who was the third employee at Trade Me and is now a seasoned advisor and investor through his family Hoku Group, says the flipside of these groups is that they can dilute the impact an angel can have in a company.

"If you have invested in 50 early-stage companies, then the money, and much more importantly, the attention you can give to each one is unlikely to make any material difference," he says.

"Risk is essentially broken down into smaller and smaller chunks, with no significant individual investors, and therefore no one with any real skin in the game.

"As activity by individuals and those outside formal networks isn't recorded, an important question is: What portion of the market does the index capture?

"In our experience the best ventures choose their investors carefully — because they can," says Simpson. "By just including those ventures Hoku Group are invested in directly that raised further capital last year, the numbers would increase significantly."

Regardless of the number, it would be fair to say that significantly more capital is needed to create the number of globally-competitive businesses New Zealand so desperately needs. Investment figures have doubled in the eight years since 2007, but New Zealand only invests around $13 per capita through angel investment. Compare this to the United States, where some estimates of angel investment are north of US$70 per capita.

There is a lot more to do to develop and broaden the investor base in New Zealand, particularly outside the main centres.

"New Zealand needs to be one unified market for both starting and funding young technology and innovation companies," says Twiss.

"The relatively recent formation of new angel investment networks in Canterbury, Taranaki and Southland is a step in the right direction."

But the most important driver to take angel investing to the next gear will come from the demonstration of investment success.

"Active angel portfolio management and the development of tools and expertise to improve investment returns — both the number of exits and the quantum returned — for angel backed companies is definitely top of mind now for the industry," says Twiss.

While angels understand that their investments are particularly high risk, it is without doubt essential to see financial returns for the ongoing health and development of the angel market — and ultimately of course, the New Zealand start-up sector.

In our experience the best ventures choose their investors carefully — because they can.

Rowan Simpson, Hoku

Aussie silence on tax credits worrying

Despite a cut to the Australian company tax rate, New Zealand is still in a sound competitive space, writes **Alex Malley**

For New Zealanders, two things would have stood out in the Australian Government's Budget, handed down earlier in the month by first time Treasurer Scott Morrison.

With the Kiwi company tax rate at 28 per cent, a cut to the rate in Australia from 30 per cent to 25 per cent might, at first blush, appear to be something of a threat to New Zealand competitiveness in terms of attracting investment and talent.

However, when you consider Treasurer Morrison is proposing phasing this in over 10 years, the initiative becomes somewhat less concerning.

New Zealand is set to retain its competitive edge for the foreseeable future. Finance Minister Bill English has been upfront in ruling out tax cuts in his Budget later this month, citing "continuing tight fiscal conditions" and an emphasis on additional debt repayments.

When he does move, which he has flagged he will do when the fiscal situation improves, it's a safe wager that it won't just be a promise to implement cuts some time over the next decade, not least because in 10 years' time other sovereign nations' tax rates will also have moved.

Though Morrison's plan for cuts in Australia might underwhelm, it sends a further signal to markets that the long-term trend in company tax rates is down. This is important as we are all engaged in a global competition for investment and the jobs that accompany that investment.

Another element of tax competitiveness concerns multi-nationals and the issue of Base Erosion and Profit Sharing (BEPS). Morrison's Budget outlined a number of "integrity" measures to ensure compliance with Australian tax laws.

Initiatives to improve public trust in the tax system are welcome but it's important to acknowledge that competitiveness — including tax competitiveness — is the name of the game for many jurisdictions.

Bolting new sets of regulation on to an existing body of laws can obscure the need to address more fundamental assumptions, and Australia and Morrison need to address the underlying problem, not just the symptom.

English and Prime Minister John Key have rightly hitched their wagon to the multi-lateral efforts led by the OECD and G20 to tackle BEPS at a global level, and incremental progress is being achieved. This process needs to be supported by all nations.

Australian Treasurer Scott Morrison arrives at Parliament in Canberra to read the Budget. Picture / Getty

Disappointingly from a New Zealand perspective, there is nothing in the Australian Budget indicating that New Zealand's proposal for the mutual recognition of imputation credits has gained any traction.

As Key pointed out in his submission to the Australian Government's now abandoned white paper tax reform process, the mutual recognition of imputation credits would be the "next leap forward in Trans-Tasman integration."

Mutual recognition — the ability for a New Zealand investor to claim an imputation credit on an investment in an Australian company and vice versa — is one of the most significant barriers to a seamless Trans-Tasman capital market. It discourages the free flow of capital between both markets and limits investment opportunities in both markets.

However, it is not surprising that the Australian Government has not moved to progress the issue. It has previously been reviewed by both countries' Productivity Commissions, which concluded that, though it would be beneficial for the freer flow of capital between the two

> There is nothing in the Australian Budget indicating that NZ's proposal for the mutual recognition of imputation credits has gained traction.

nations, Australian Government revenues would be the net loser.

In a time when the Australian Government is clearly focused on budget repair, it is unlikely this issue will gain favour in the short to medium term. Key has been pragmatic about Australia's capacity to afford such a move, noting: "If Australia is not able to move now to mutual recognition, we seek at least an in-principle decision to implement mutual recognition when fiscal circumstances permit."

With Australia now in election campaign mode counting down to a July 2 poll, the issue will need to be pursued with whoever forms the next Australian government.

● *Alex Malley is Chief Executive of CPA Australia*

Bonds now in a sweet spot

New Zealand's debt market is experiencing the perfect storm in terms of interest rates, investor appetite and issuers' preference, writes **Jonathan Underhill**

New Zealand's listed debt market tells a good story at the moment — the average bond yield is more than 200 basis points below the bond's coupon rate, according to NZX data.

There's just one problem: most Mum and Dad savers have no idea what that means.

In plain language, NZDX bonds on average are becoming more valuable. For an investment that started life as a fixed interest opportunity paying better than the bank, that makes them particularly attractive. Six years ago, the average yield and coupon (the fixed interest rate on a bond) were just 30 basis points apart.

Bonds are currently in a sweet spot. Investors are hungry for yield and willing to look at fixed-income securities that offer more than bank deposits with less risk than stocks.

On the sell side, things are sweet too. The new Financial Markets Conduct Act makes it easier for corporates to issue bonds, allowing them to make offers on the strength of a two-page term sheet rather than a full prospectus, provided they've sold bonds previously or are already listed with the NZX.

Telecommunications network operator Chorus raised $400 million this month selling May 2021 bonds that pay 4.12 per cent annual interest. It used the funds to repay most of the $450 million it had drawn against a bank facility that matures in July, reducing its interest costs in the process.

For Chorus chief financial officer Andrew Carroll there are other attractions — the bonds offer ease of execution, more flexibility than bank facilities with their covenant requirements, lower costs and the ability to issue longer-dated debt that matches Chorus's long-term assets.

"When we speak to the brokers they say retail investors are getting such terrible returns from the banks at the moment. They're looking for these types of investments," Carroll says. The 2021 bond issue was "well oversubscribed".

It's "scratch me, I'm dreaming" time for well-rated issuers, given the prolonged period of low interest rates. In March, Auckland Council raised $250 million selling four-year bonds at a coupon of 3.04 per cent, a record low for the city, and below the 4.41 per cent rate on its existing December 2018 bonds.

However, the latest sale by the council, whose credit rating is only one notch behind the country's, is unlikely to woo Mums and Dads who can get a better 3.53 per cent on term deposit. They are more likely to appeal to institutional fund managers who need investments across a wide spectrum of risk. But retail investors may have been tempted by Wellington International Airport's $75 million of May 2023 bonds sold this month at an interest rate of 4.25 per cent and with an investment grade BBB+ rating.

"Retail bonds are quite cost-competitive at the moment," says the airport company's chief financial officer Martin Harrington. "Recently they've been the most price-competitive option for corporates."

Investors are hungry for yield and willing to look at fixed-income securities that offer more than bank deposits with less risk than stocks.

He says there is "a strong appetite from retail investors — the facts of retail bonds is they are tradable and you get a coupon for the term. In a portfolio of risks you might have some of them."

Record low borrowing costs have lured many corporates to the listed bond market this year, including Genesis Energy, Meridian Energy, Spark New Zealand, Auckland International Airport and Fonterra Co-operative Group.

They join a market whose value has climbed about 66 per cent in the past year to stand at $20.9 billion at the end of April.

The debt market went through one of its biggest ever growth spurts last November, when the Local Government Funding Agency (LGFA) listed six bonds, or about $5.56 billion of debt that it had sold on behalf of local authorities.

There were 3218 trades in total on the NZDX market last month, up 34 per cent from April 2015.

The value of trading jumped 61 per cent to $174 million, which is still a miniscule 0.8 per cent of the debt market's value. For comparison, NZX sharemarket trading last month was $3.9 billion, or 3.3 per cent of the $117 billion market capitalisation for listed companies.

That partly reflects the tendency of debt investors to hold to maturity — the so-called "bottom drawer" investment strategy — because they're typically looking for income rather than speculative capital gains.

But NZX head of markets Mark Peterson says trading and liquidity are increasing as the market broadens and issuers take advantage of ease with which they can tap programmes again and again, with only a short-form term sheet.

The Financial Markets Conduct Act is "a wonderful piece of legislation that's been welcomed incredibly by the market and seen as a real improvement to efficiency," Peterson says.

"It sets us apart from other markets — Australia, in particular, where you need a full prospectus.

"Conditions right now are a perfect storm - the right point in the interest rate cycle, strong investor appetite and the preference of issuers looking for diversity in their debt," he says.

Added to that, issuers say execution risk has risen in offshore markets such as Europe, where talk of the Brexit, or British exit from the European Union, is ratting bond investors.

"The pipeline still looks strong — we'll probably see more listed instruments coming through," he said.

Corporate bonds are typically priced at a margin over the comparable swap rate. Five-year swaps are currently around 2.35 per cent, near record lows and down from 4.75 per cent in early 2014.

Both Chorus and Wellington Airport say they'd tap the NZDX market again, assuming conditions were broadly the same. The airport's Harrington says it has debt maturing next year and "may look to prefund some of that."

Chorus was saddled with bank debt when it was split off from Telecom (now Spark) in 2011. Its debt diversification plans were thwarted by "regulatory surprises" when the regulator began looking at prices it could charge for access to its copper network. That created too much uncertainty to successfully promote a bond sale, Carroll says.

At December 31 last year it had senior debt of about $1.8 billion, of which $1.08 billion was in bank facilities and $667 million in European medium-term notes. By then, though, it also had the certainty of a final pricing determination for its network from the Commerce Commission. Hello bond market.

"Our preference ultimately is to not have much bank debt at all," he said, although a second issue of NZDX-listed bonds was unlikely to be as large as the initial $400 million sale.

Retail investors should talk to a financial adviser before diving into the market unless they have a good level of sophistication and understanding, Peterson says.

Insurance Australia Group (IAG) this month launched the most complex debt offer so far in 2016, with an offer of up to $350 million of unsecured subordinated convertible notes, notionally maturing in June 2043 — 27 years away.

They will pay a fixed interest rate for their first six years then switch to a floating rate tied to the three-month bank bill rate.

IAG has the option to repay them early and investors can elect to have them converted to ordinary shares after nine years, if the notes are still outstanding.

IAG even warns amateur investors off, saying the notes "are complex financial products and are not suitable for many investors.

"If you do not fully understand how they work or the risks associated with them, you should not invest in them."

New investor groups spice up private equity market

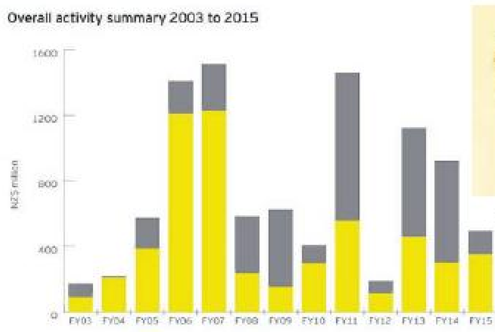
The emergence of new investor groups such as iwi and community trusts will introduce additional liquidity into the private equity sector, says the latest EY survey.

But there is some concern about limited interest in additional venture capital fund raising from both domestic and international investors.

Overall, the New Zealand Private Equity and Venture Capital Monitor 2016 says the market remains positive — with some caution. "As for the invested companies, the current low interest rate environment will support companies seeking leverage to grow, while low dairy prices and shortage of skilled and experienced staff will continue to hinder some players."

The monitor says crowdfunding gained huge momentum in 2015, raising over NZ$12 million for 20 companies in the 12 months after the Financial Markets Authority's authorisation in 2014.

Venture capital funds, initially thought to be rivals to crowdfunding, raised capital on the funding platforms themselves (Punakaiki Fund and Powerhouse Ventures) and



"it will be interesting to see how the trend develops in 2016".

Colin McKinnon, executive director of the New Zealand Venture Capital Association (which commissioned the 13th annual survey) says the mid-market investment activity increased 17 per cent to record the highest level since the monitor began.

"Concurrently, the continued strong return of cash to investors provides positive stimulus to future fund raising," he says.

Mid-market investment activity increased to $284.1 million in 2015 from $243.5 million in 2014. The rise

Colin McKinnon

was driven by higher average investment value — $16.7 million in 2015 to $12.8 million the year before — despite a lower number of transactions. There were 17 transactions last year compared with 19 in 2014.

The total investment value last year was $346.6 million, with the number of deals increasing from 81 to 86 — the highest since 2006 — and the average deal value rising from $3.7 million to $4 million.

The venture capital investment increased from $55.8 million to $62.5 million, driven by the increase in the number of deals — 69 last year compared with 62 in 2014.

The total divestment value in 2015 fell sharply to $147.8m from $620.3 million in 2014.

The divestment activity last year was dominated by mid-market transactions, while 2014 featured a small number of of high value buy-out and mid-market divestments, primarily Pacific Equity Partner's sell-down of Griffins Food to URC (Philippines).

Notable deals last year included the purchase of Manuka Health by Pacific Equity Partners; Tembusu Partners' investment in CricHQ; Pencarrow's investment in Icebreaker; Allegro Private Equity's acquisition of Carpet Court; and Archer Capital's acquisition of the Aspire2 Group. In September Pacific Equity Partners agreed terms to acquire Academic College Group, but will settle in 2016.

Archer Capital completed its purchase of NZ Pharmaceuticals from Direct Capital and others in early 2016. The monitor says this reinforces the theme of strong activity level from overseas funds in 2015, but delayed completions through the Overseas Investment Office process into 2016.

On the short term outlook (next six months) for the private equity and venture capital market, respondents in the survey were relatively optimistic, reflecting the New Zealand economy's resilience despite the struggles in the dairy sector.

Farmers can look into the future

The NZX is a launching new dairy futures and options contracts as a way to lessen the volatility in milk prices, writes **Tina Morrison**

In Midwest America, the Chicago Mercantile Exchange has become the hub for global wheat trading, while Malaysia's claim to fame in the commodities market is palm oil.

For New Zealand, widespread conversion to dairy farming from sheep has seen milk overtake meat and wool as the largest commodity export and set the country on the path to becoming a global hub for the dairy market.

Though New Zealand isn't the largest producer of milk in the world, our small domestic market means the country exports about 95 per cent of its production, making Fonterra Co-operative Group the world's biggest exporter of dairy products.

The country's step-up in milk production has coincided with unprecedented volatility in prices as governments rein in interventionist policies and allow dairy products to trade more freely.

Global whole milk powder commodity prices didn't change by more than 10 per cent in any month in the two decades prior to 2007. But since then, it's changed by more than 10 per cent a month on 22 occasions.

The emergence of New Zealand as a base for a physical market for dairy products, increased volatility in pricing and an uptick in global trade led by emerging market demand for protein has all helped lay the foundations for a dairy derivatives market in New Zealand.

"The dairy market globally is undergoing a transition that many other commodities including agricultural commodities have gone through," says Kathryn Jaggard, head of derivatives at financial markets operator NZX. "Dairy is slightly late in this evolution."

Jaggard joined NZX in 2008 and has almost two decades' experience in global derivatives.

She describes "an explosion in exports and global trade where you have emerging economies who are now wealthier and they are seeking in this case reliable and quality sources of protein and food, your levels of government intervention are coming down and the management of risk is moving from the responsibility of government to markets."

Volatility and uncertainty drives demand for risk management tools which, for dairy, is spurring the development of a derivatives market offering futures and options.

NZX launched its Global Dairy Derivatives Market in October 2010, following the establishment of Fonterra's online auction platform GlobalDairyTrade in July 2008, which trades in physical dairy products.

The derivatives market started with whole milk powder futures and has since added skim milk powder, anhydrous milk fat and butter futures, and whole milk powder options.

The NZX is trading about 1000 dairy derivative contracts across its platform a day, and on track to reaching the 3000 to 5000 lots a day, which would see it hit a global liquidity benchmark.

Jaggard says volume traded on the Kiwi bourse is ahead of its dairy rivals overseas and growing at a faster pace than other commodity markets for milling wheat and palm oil were at the same period of their evolution.

However, it's difficult to predict when it will reach the point of being considered the global benchmark for dairy derivatives, given the catalyst for higher volumes could be unpredictable events such as a drought or a political event.

In recent times, analysts have been caught out when the fortnightly GlobalDairyTrade (GDT) hasn't followed the futures market, although Jaggard says the gap hasn't been that large and current dairy market conditions are unusual.

"You have a futures market which is reflecting the underlying, and in the underlying right now there's not a huge consensus around where price is going," she says.

During the global financial crisis, between October 2008 and October 2009, the GDT average winning whole milk powder price was below the average US$3050 for 371 days. In comparison, in recent times, the price has been below US$3050 for about 420 days.

"No market can accurately predict exactly what's going to happen. The futures are just reflecting that the market is struggling to find consensus."

Jaggard notes that the NZX futures market is unusual globally in that there is a transparent underlying physical market every two weeks, which isn't the case for other commodity futures such as cocoa, coffee, sugar, grain or oil where the futures is the only indicator of price sentiment.

Criticism of the futures market has also come from outside financial markets, with New Zealand First leader Winston Peters likening the GDT auction system to "a glorified TAB", saying he believes New Zealand needs to establish a physical commodities exchange rather than a derivatives market.

"We are allowing others to skim the cream, locking our farmers into being price takers rather than price makers," Peters said in his usual catchy turn of phrase.

While Jaggard says she's glad that Peters is talking about risk management because it's an important topic for dairy farmers to discuss, she says we need to have "informed and sensible conversations" about tools to manage risk.

"These markets have existed for hundreds of years in other areas around the world. Without being critical, it's really an uninformed comment and you need to really have more information about how these markets grow and develop, and we need to support their development rather than making comments such as that," she says.

Education on risk management for dairy farmers is a hot topic for the NZX at the moment as it prepares to launch a new futures and options market for milk this month which it plans to promote at the upcoming Fieldays.

NZX sees it as offering the country's farmers a way to lessen the volatility of milk prices, putting them on a more even footing with farmers in other countries who benefit from similar schemes.

The market could also be used by milk processors to enable them to offer a fixed-price contract to farmers, or by banks to launch a swaps contract.

"High levels of volatility are unsustainable when you managing a business, whether you are a buyer or a seller, so you need some way of managing that volatility to create certainty," Jaggard says.

The push by NZX has been encouraged by the Government, which wants to see the development of new financial products as part of its reforms of financial markets.

"Price volatility in the dairy sector has obviously been a key issue for the dairy industry and the broader economy in recent times," says Commerce Minister Paul Goldsmith.

"Managing volatility assists farmers and others in the industry with their business plans. The Government welcomes NZX responding to this issue by developing the dairy futures product, and expects product innovation to continue in this sector."

This could see the development of a centre of expertise in New Zealand for a wider range of agriculture commodities that the country is dominant in, such as forestry, meat or wool.

"The ambition is to meet the demand where it sits," Jaggard says.

"At the moment, what we are focused on is really building these dairy tools but absolutely there is the opportunity to expand beyond those into other commodities."

Milk price contracts to launch this month

The milk price futures contracts will be launched on May 27, the NZX announced late last week.

An announcement of the related milk price options contracts will be made in June.

These contracts are designed to address growing demand from producers and purchasers of milk products wishing to manage risk relating to price fluctuations, said NZX. For example, both contracts can help New Zealand dairy farmers mitigate the financial risks associated with a variable milk price.

NZX Head of Markets Mark Peterson said: "We are committed to building markets for the long term, and the launch of milk price futures and options contracts is no exception. We will continue to focus our efforts on growing market participation and trading activity, and educating interested parties on the benefits of commodity risk management tools.

"As expected with new derivatives products, we expect that liquidity in the market will build slowly at first," he said.

"With 95 per cent of their product sold overseas, New Zealand dairy farmers are highly exposed to the global dairy market.

"The new futures and options contracts will help to level the playing field with their overseas counterparts in the US or Europe, who have access to a wide range of risk management tools."

Once the futures and options contracts are available for trading on NZX's dairy derivatives market, all users of these contracts will be required to trade through an NZX Derivatives Participant (a broker).

Derivatives contracts carry risk and operate differently to fixed price schemes offered by milk processors. NZX encouraged parties wanting to enter into these contracts to seek advice from an authorised financial adviser as to whether derivatives contracts are appropriate for their individual circumstances.

Aussies prefer NZ investment

After a stellar 2015, the acquisitions and mergers market here remains confident even though the deal flow has been slow so far this year, reports **Bill Bennett**

Though merger and acquisition activity this year might not reach the highs seen in 2015, Simpson Grierson partner Michael Pollard remains positive about the market.

"We are starting to see a steady deal flow. Last year was a standout, yet this year's deal flow is still reasonable. Unless there's some kind of adverse event, I'd expect to see a solid, busy year in 2016," he says.

The year got off to a slow start, but then so did 2015. That's not unusual in New Zealand where there is a pronounced break in deal activity during the summer months.

Pollard says: "A lot of the deal value came on during the middle and towards the end of last year. There was not much activity in the first quarter of 2016. Most of the deals talked about have been hanging around for a while — like Paymark and Tegel.

"There has been a shift in the market. There were 12 initial public offers in 2014, only three last year and just one so far this year, although some are still in the market — they are getting away slowly and we are seeing the same pattern across the Tasman in Australia."

Deals nudged the $9 billion mark in New Zealand in 2015, and mergers and acquisitions around the world, with global volumes up 37 per cent, had a flow-through effect into the New Zealand market.

Pollard says the global capitalisation market is coming off last year's high. With national regulators still trying to inject life into their economies, there was a huge wave of activity and that had a knock-on effect in New Zealand.

He says overseas business confidence remains strong, but is less so than last year.

Another Simpson Grierson partner, James Hawes, says the mood is reminiscent of the period immediately after the global financial crisis.

He says "while the deal flow is slow, the market confidence is high. There is lots of money still around of the equity side, both private and public."

Australian funds have New Zealand in their sights. Hawes says "to some extent we are insulated from the negative sentiment in Australia.

Michael Pollard

James Hawes

In fact, Australian funds find New Zealand a good place for their money when things are not going too well at home.

"We're aware that towards the end of last year Australian funds were more active in New Zealand than they were in Australia. They like to be able to buy into a mature business in New Zealand.

"They find it easier and less expensive to buy a top company with a strong competitive position here. They are still a strong source of our deal flow," Hawes says.

> While the deal flow is slow, the market confidence is high. There is lots of money still around of the equity side, both private and public.
>
> James Hawes

It's not only Australian money making its way to New Zealand. It's long been true that a significant proportion of local merger and acquisition transactions involve a foreign buyer, but Pollard says almost all of last year's deals were to overseas investors.

He says Japanese investors remain interested in New Zealand. They are still active here. Many, maybe most, of the tech-heavy New Zealand companies go to American buyers.

"There is a lot of United States capital floating around and while the news tends to focus on other countries, United States are heavy investors in New Zealand farmland and agriculture."

Pollard says last year United States-based Accel Partners invested $133 million in Xero. Equifax acquired Veda, the credit reporting company. Winona Capital, a Chicago-based private equity firm invested in Rodd and Gunn. In comparison there was only one sizeable Chinese deal and one with a Japanese investor.

While United States investors are strong in the technology field, they have a broad interest in New Zealand business. That's not the case with Chinese investors.

Hawes says they are focused on the primary sector and in many cases it is narrower still with dairy being the main interest.

Another niche market of interest to Chinese investors are honey-related assets, especially those in manuka honey.

Hawes says "despite the talk of a slowdown in China, we are not seeing any let up in Chinese interest in New Zealand assets. Chinese investors are becoming more Western in their outlook.

"In the past most of the money involved an element of Chinese state backing, and those investors would look at local businesses from a different perspective to others.

"Now they are more used to dealing in our part of the world and there's less complexity in the deals."

One barrier to deals in the past has been the time taken by the Overseas Investment Office) to deal with applications to acquire sensitive land or assets.

Pollard says even non-strategic land applications could take months to get approval.

"There isn't the capacity to handle the big deals. It tends to slow things down and it makes it harder to get overseas investment in New Zealand. However, we hear the agency is recruiting people which could help."

New tech streamlines transactions

The use of FinTech software to improve the operations of financial services is the talk of the town, writes **Geoff Ward-Marshall**

Technology is redefining the provision of financial services — it is cutting out the middle man and providing customers with quicker, direct and more convenient financial services at lower costs.

FinTech is the use of software to increase efficiency in the provision of financial services, and is a hot topic at the moment. FinTech is where finance and technology collide to disrupt the traditional banking and financial services model.

The Financial Markets Conduct Act 2013 has the purposes of promoting innovation and flexibility in financial markets and promoting and facilitating the development of fair and efficient markets.

So far, the FinTech innovation in New Zealand has been focused at the front end. Crowdfunding platforms and peer-to-peer lending services as well as the looming robo-advice revolution in the financial advisory sector are examples of FinTech innovation focused on front-end inefficiencies.

The major FinTech disruption to capital markets, however, won't be at the front-end.

We expect that disruption will come through the use of distributed ledger technology to remove inefficiencies in back office functions that currently facilitate transactions on the markets.

The use of distributed ledger technology (blockchain) is currently front of mind for major banking institutions and investment exchanges around the world. Venture capital and institutional funding for blockchain innovation is flooding in.

Originally developed as the technology that underpins Bitcoin, it has the potential to streamline capital markets transactions and reduce counterparty risk associated with the monitoring or enforcing contractual obligations.

> FinTech is where finance and technology collide to disrupt the traditional banking and financial services model.

It can be described as a digitally distributed, decentralised, unchangeable ledger for verifying and recording transactions.

Using this technology, parties can securely send, receive and record value or information through a peer-to-peer network of computers without the need for a third party intermediary.

It is a means of transferring value and holding records with each transaction being recorded as a "block" that is added to a continuously growing chain.

It is a permanent record and its security comes through the continual replication of the chain in the network and its decentralised nature.

It can also be used to develop a "smart contract". The terms of a traditional contract are coded and uploaded to the blockchain, resulting in a decentralised smart contract that is not reliant on third parties for record keeping or enforcement.

Contractual clauses automatically execute when pre-programmed conditions are satisfied, resulting in the removal of ambiguity as to the agreed terms and any disagreement regarding external dependencies.

The opportunities for our capital markets to leverage an immediate, secure, permanent and unchangeable record of transactions and transfers of value without the need for intermediaries are vast.

These include:

● **Clearing and settlement**

The incumbent settlement and registration systems can take several days to settle trades. Both NZX and ASX currently operate on a recently reduced T+2 settlement cycle for cash trades.

Blockchain allows real time settlement without the need for an intermediary and has the real potential to automate the clearing and settlement process.

It could remove inefficiencies that result from the current need for counterparties and systems to undertake clearing, settlement and reconciliation processes.

Clearing and settlement disruption is already happening. At the end of last year, Nasdaq announced that it was using its Nasdaq Linq technology to successfully complete blockchain-based share sales.

This was described as the beginning of a process that could revolutionise the core of capital markets infrastructure systems and that would have profound implications for settlement and outdated administration functions. Closer to home, ASX recently paid A$14.9 million for a 5 per cent stake in a start-up focused on developing distributed ledgers.

● **Smart contracts**

Financial transactions are an obvious use of a smart contract. A smart derivatives contract could be pre-programmed with all contractual terms except for price, which could be determined algorithmically from market data fed into the contract.

Margin could be automatically transferred on a margin call and the blockchain would perform the record keeping, auditing and custodial functions, resulting in efficiencies and cost savings for the contracting parties.

Technology and regulation will need to evolve at the same pace to make it easier for both small and large firms to launch new ideas and innovate in financial services.

The Uber approach of acting first and dealing with regulation as an afterthought won't work in the capital markets. FinTech innovators will need to consider regulatory impacts at a very early stage.

Foreign regulators are facilitating innovation through a regulatory "sandbox". This is a safe space for testing innovative products and business models without immediately incurring all the normal regulatory consequences.

The UK's Financial Conduct Authority has recently opened its sandbox and Australian Securities Investments Commission will be consulting on its proposed sandbox later this year.

The UK regulator has also recently signed co-operation agreements with both Singapore and Australia to facilitate referrals of FinTech businesses between those jurisdictions.

The Financial Markets Conduct Act is already hard-coded to encourage innovation and efficiency in our financial markets. FinTech innovators should take heart that New Zealand's regulatory approach to FinTech will have to be one of encouragement and facilitation.

● *Geoff Ward-Marshall is a Senior Associate at DLA Piper*

Mike Taylor says the key to success is to pick up growth companies when they are trading at a discount.

Taking a piece of the pie

Mike Taylor finds untapped gold in small and medium companies, as **Bill Bennett** reports

Imagine you are at a house auction. If the room is full, it's likely the bids will realise all the value in the property. On the other hand, if there are only one or two bidders, the owner will be more ready to accept a deal.

That is the principle behind Pie Funds founder Mike Taylor's approach to investment. He seeks overlooked small and medium companies with growth potential, then unlocks the value.

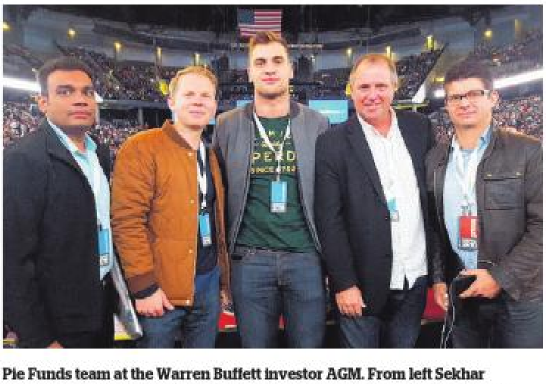
Taylor says; "There are about 2500 listed companies in Australia and New Zealand. Fund managers typically focus on the top 200 in Australia and, maybe, the top 50 in New Zealand. The others are not followed as closely. It means many of the small and medium listed companies are not efficiently priced.

Stockbrokers are not producing research on these companies and analysts are not watching them.

"There's no point in finding small firms that will stay small for ever. We're looking for companies that will grow. Then when one becomes large, the market takes notice and it becomes efficiently priced."

This investment philosophy has worked well for Taylor and Pie Funds. It's a boutique fund with an impressive record. Morningstar ranks Pie's Australasian Growth Fund in the top 10 globally for equity performance between 2007 to 2016. It has returned 20.2 per cent per year since it began.

Taylor says he started Pie Funds in 2007 after realising most fund managers under-performed. He says: "If you left money with one for five to 10 years you might come out with a couple of per cent more than you'd earn from a term deposit. I knew from watching overseas investors such as Warren Buffet that it is possible to achieve returns of 20 per cent a year."



Pie Funds team at the Warren Buffett investor AGM. From left Sekhar Paruchuri, Mike Taylor, Chris Wright, Brenden Hall and Herald Business Editor-at-large Liam Dann

He says the problem with funds is they are often set up with the aim of earning fees. Managers are told not to lose any investor funds. Yet, to generate high returns you need to take on greater risk.

The other characteristic of most funds is that they are widely diversified. It's not unusual for them to include dozens of companies, maybe as many as 100.

Pie Funds uses the concentrated portfolio approach. They include up to 15 individual stocks. He says the number means you get all the benefits of diversification. The stocks are diversified across industries and across both Australia and New Zealand. Diversification benefits diminish with higher numbers. Apart from anything else, he says it's hard for fund managers to keep a close eye on that many investments: "You can be too diversified."

Dealing with a manageable number of otherwise unwatched smaller companies means spending time doing research and due diligence. Taylor says he pays special attention to company financials and to meeting and learning about management teams. This is as much about knowing which managers to avoid as to finding the star performers to follow.

The goal is to find a business that is either growing rapidly or is about to start growing. Taylor says: "Often that means finding one in an industry with plenty of tail wind. We also look for blue sky opportunities, that is, a business that's scalable. It needs to have ambition to roll out fast expansion.

"We want to see a clean balance sheet. We don't like to see a lot of debt. Ideally a small business has no debt, we don't want to invest in something that could end up being owned by a bank."

Over the years Taylor has met 1000 company management teams. Often this means focusing on the founder or CEO. He says you need someone who has the charisma and energy needed to drive the growth. They need to be good at sales without being a spruiker. Communication skills are vital. He says eventually you're going to need someone who can sell the company's story to the wider investment community. "If the CEO is a bad presenter then no-one is going to buy the stock," he says.

Leadership skills are also important. Taylor says just because someone is a CEO, it doesn't mean people will follow them. He looks carefully to watch how staff respond to the CEO.

He says a concentrated portfolio of small cap stocks is more likely to generate a higher return than one made up of large cap stocks. This is partly down to mathematics. If 10 per cent of the fund is invested in a single company that doubles in size during a year, the fund is up 10 per cent. In every year there is always one stock in any market showing stellar growth. Searching for small cap stocks with potential means there's a higher chance of capturing that winner.

At the same time, there are companies that grow quickly from $100 million to $1 billion. It's much harder to go from $1 billion to $10 billion.

Taylor says his approach gives Pie Funds access to high-growth companies: "It's a matter of experience. We look for the right kind of companies where there's future growth that has not yet been recognised by the market.".

Buying at the right time helps boost returns. Taylor says the key is to pick up growth companies when they are trading at a discount. Early this year fears of a US recession saw stock prices fall to a low, small caps fell further than most, they tend to be volatile. This was an ideal time to buy.

Small cap stocks are riskier than large cap stocks. Taylor says Pie Funds guards against the volatility of the sector by carrying a lot of cash. "You never know when the next opportunity will turn up, having money means you can seize it."

Ideally a fund would have a 100 per cent success rate. Taylor says in reality about seven out of 10 work out. Of these a few usually do well and one or two will make five times the money invested. The trouble is "When you buy the stocks, they all look the same."

Estate of play for housing

Land development is a long and capital-intensive process and in some cases this is holding back the rate of building new houses, reports **Anne Gibson**

Interest rates have never been lower and demand has never been higher — so why aren't vast new housing estates springing up all over Auckland?

Is it the price of land, price of construction materials, labour and trades shortage, or could it be issues with developers getting access to money to finance such big schemes?

Evan Davies, chief executive of Todd Property, arguably New Zealand's largest residential developer, says funding challenges are indeed one of the problems as development becomes more intense and far more costly to build in Auckland.

"I've never subscribed to the theory that it's raw land prices," Davies says, when asked about reasons for lack of new housing development.

"It's not so much the availability of funding, but capacity in a broad financial sense is the issue," he says, referring to the ability of many developers to get access to money for the more complex, long-term, large-scale housing projects.

"Much land development is a very long, capital-intensive process," he says, referring this time to the need for those developers to secure lines of credit over a long-term time frame.

"The period of time between commencement [of a project] and realisation can be quite a number of years."

Todd has had experience of that. The 160ha Long Bay project, where it is building thousands of new residences as well as a new town centre, has been running for years.

"Part of that was getting the planning in process but more time-consuming was creating the infrastructure before it could begin selling land, mainly to group builders, for the residences.

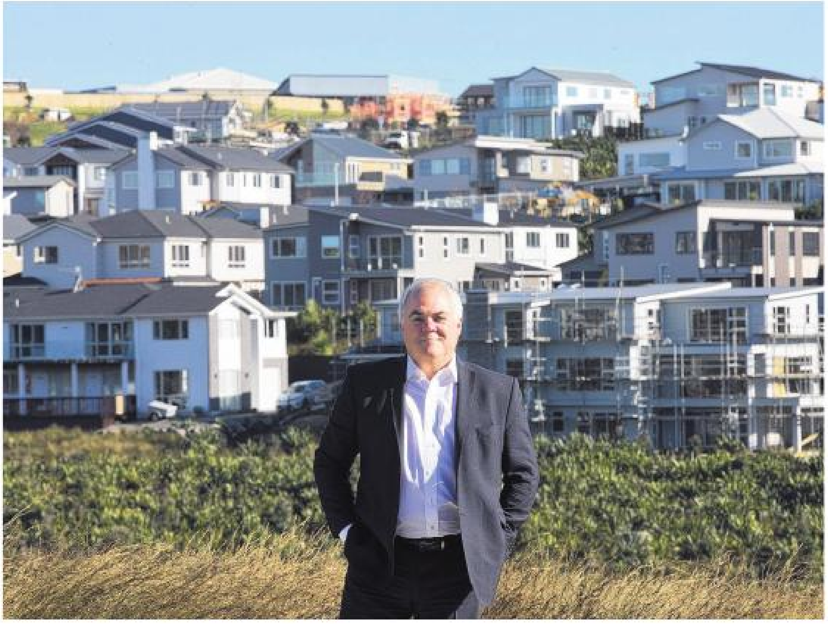
To date, more than 300 residences are up there — a mixture mainly of terrace-style and stand-alone larger houses on Auckland's northern outskirts.

"Estimated project completion date: 2022," Todd says, on its website, of Long Bay. Yet plans were first launched for housing there way back in 2001 by former landowner Greg Olliver and his Landco.

That is a 24-year timeframe between the initial conception and completion. The project has changed along the way, including Todd agreeing to develop only 60ha of its 160ha site above the precious coastal Long Bay Regional Park.

Davies says the rise of more multi-unit housing schemes, more terraced-style housing and more apartment blocks brings more expense and more complexity to large-scale housing projects.

"As we focus more and more on intensity in residential development, that brings capital availability more into focus because you need more and it takes longer to build apartments than single homes — it simply requires more capital," Davies said.



Todd Property's Evan Davies at the Long Bay development. Picture / Brett Phibbs

Todd and NZX-listed Fletcher Building are New Zealand's largest businesses funding and developing Auckland's mammoth new housing estates, responding to the critical shortage of housing.

But these businesses are not just financing the creation of the projects. They are building them as well, taking all the steps in the process: buying bare greenfields and brownfields sites, and developing a master plan for what will sometimes be entirely new town centres within the surrounding housing estates. They must then secure planning consent to allow for housing, create the legal titles for each residence, register those titles, build the infrastructure needed such as roads, bridges, footpaths and street lighting. Then there's landscaping the parks and streets.

Fletcher and Todd worked together, and are almost finished, at Stonefields in Mt Wellington.

General Finance, based at Ellerslie, loans up to 70 per cent to buy standard residential sections.

"In smaller centres or out in country areas we will reduce our loan to value ratio accordingly. We do not lend on commercial subdivisions. If a borrower wishes to purchase a piece of land to cut up into a couple of sections, we are happy to consider this," they said in a fortnightly commentary.

General Finance has noticed a big increase in house building.

"Nationally, the number of building consents being issued for new dwellings was 28,000 to the end of the March year. The last time this figure was matched was in 2004, before the global financial crisis.

"Only four years ago, the national figure was around 15,000. The issue is that the level is still not high enough. Residential construction is a big employer, but a number of developers are saying it is getting harder to find skilled tradespeople.

"One of the most effective ways to stabilise house prices is simply to build more. This is more effective than enacting a number of new laws such as land taxes, that do not make much sense," General Finance says.

Williams Cairns of General Finance said his business funded small-scale housing developments. "Once you get outside the banks, there's very few second-tier lenders in the market and that's because a lot of the financial regulations have resulted in big compliance and banks have the ability to comply with all the rules. Some of the smaller people are saying this is too hard and they're just got out of it.

"The regulation in the marketplace has pushed the indigenous Kiwi institutions out of the second-tier lending market. I'm all in favour of the capital adequacy regulations on finance companies, and people should have a greater level of protection when investing.

"It's all about the Government interference with our lending, such as setting of fees rather than letting the market decide. If a lender charges high fees and high interest rates, no one is going to go to them. The market should be left to sort it out. We now have fewer alternative terms of finance.

"If it's not the banks, where do you go? Years ago there was more diversity of funding, well before the global financial meltdown, and they had wider mandates. We don't want to go back to where people put money in and lost it. Laws that have strengthened the financial stability are good laws," Cairns says.

When it comes to residential development, retirement village businesses are bigger than Todd and Fletcher combined, and they are powerful financial forces when it comes to funding.

Their money comes from traditional trading bank sources and their shares are widely held by a combination of institutional and retail investors.

Ryman, Metlifecare and Summerset are NZX listed businesses, and have Auckland central in their growth plans, although Ryman has spread to Melbourne where it says it will soon be building more residences than throughout all of New Zealand.

The village operators argue that existing housing stock is freed up for purchase when older people buy a licence to occupy in a village.

Reesby & Company describes itself as "the largest commercial property finance brokers in New Zealand. The majority of our transactions are in the $1 million to $20 million range, however the company has also financed a number of New Zealand's largest property projects.

"... We also have our own private lending vehicle for property finance that does not meet bank criteria."

The Auckland-headquartered business, headed by Martin Reesby, offers merchant banking, commercial and retail finance, and development and investment finance, and is behind some of New Zealand's largest projects.

Many of these are towering new apartment blocks and include the $100 million Queens Residences apartments on Queen S, $200m Lighter Quay development in the Viaduct Basin, $60m Chaffers Dock Apartment building in Wellington, Vincent Apartments in Auckland CBD, and Hopetoun and Urba Apartments in Freemans Bay.

Rebound creates more interest from banks

About 80 per cent of residential subdivisions get some or all of their funding from one of the four main banks, one sector chief says.

Ashley Church, Property Institute chief executive, said the remaining 20 per cent comes from a variety of second-tier lenders. "These are businesses such as NZ Mortgage & Security (James Kellow, backed by Mansons TCLM), Newgate Capital (Jared Lynch, backed by Tournament) and Reesby (Martin Reesby).

"Usually one of these will be the main funder — but sometimes they will provide mezzanine finance, sometimes equity funding, or some times they act as a broker/arranger for one of the main banks," Church says.

Some of the larger land subdivision developers, such as Fulton Hogan, Todds and Fletchers, may not fund on a project-by-project basis but may, instead, have a large debt facility to develop with, he says. That means they don't need formal bank approval to buy, build or sell. "Large iwi are also land developers but debt levels — whether they fund the project or gear up on investment assets — are harder to gauge," Church says.

With the recent rebound in prices I think it's likely that confidence will return, but some of the banks may now be a bit more concerned about the longer term projects.

Ashley Church

"Occasionally there are offshore funders involved with projects. For example, I'm aware that one of the major banks and an offshore bank are involved with the Sugartree apartment development (in central Auckland), and the Rose Garden apartments in Albany also have one of the Chinese banks involved.

"It would be difficult for the offshore banks to have significant involvement outside a joint venture because scale projects require an experienced team, on the ground, to attend site meetings, cost meetings, and progress updates throughout the build process, and that can't be achieved remotely, Church says.

New greenfields subdivisions have slowed down a bit over the past 12 months, mostly as a response to the loan to value ratio restrictions.

Church says this is compounded by some of the conditions (builders terms) accompanying subdivision projects (for example, where settlement is aligned with completion/on sale of a finished house), which add to the risk profile and make the banks less keen to be involved. "With the recent rebound in prices I think it's likely that confidence will return, but some of the banks may now be a bit more concerned about the longer term projects," he says.

Geographic concentration is also considered a risk. One of the major banks pulled out of a significant Flat Bush land purchase by one of its customers due to having five to six other projects under way in the area.

Funding of apartment developments has also slowed, generally, on the back of weak sales data earlier this year — "and this may not recover quickly due to the extent to which the activities of the big four banks are influenced by their Australian parent companies, which are about to go through some pain with an oversupply of apartment projects completing in Sydney, Melbourne," Church says.

— Anne Gibson

Helping to build the industry

James Kellow, director of NZ Mortgages & Securities, runs and half-owns one of this country's largest residential development funding businesses. He talks to New Zealand Herald property editor **Anne Gibson**

How hard is it for developers to build big housing projects?
Planning, creating and delivering a large-scale housing project is all-consuming for the developer/project principal and often the project financier.
It is difficult, but probably not different to any other business transaction of $100 million or more. There is a lot of money involved and with housing you have the added responsibility that you are creating people's homes, or for investors, their retirement income.
So you think a lot about the built environment and try to get that right. The key message is that with any $50 million-$100 million project it will be hard and you need more than a good finance partner. You also need to employ specialist planners, quantity surveyors, engineers, architects and project managers. People with experience who are not scared of working to a larger scale. Once you have successfully completed a number of large projects it becomes a little more cookie-cutter – but there are always little surprises to watch out for.
New Zealand Mortgages & Securities (NZMS) have never backed an unsuccessful project. We like to think this is the result of experience and expertise – not luck.

What are the impediments in terms of funding?
I always think that if a developer can create a project in a reasonable location, of good design that will be desirable to purchasers and tenants and with a sound profit margin (to cover unforeseen cost increases and risk), then the funding part is easy.
I have never been involved in a good project with sound level of presales and margin that has not been able to find the funding.
The biggest impediment to funding is that the project is simply not good enough. Buyers are very smart, and simply won't pay up for substandard development product.

How much would you loan to this sector annually?
Many developments take longer than 12 months so this is a hard question to answer accurately. In a normal year we would like to lend well over $100 million split between first and second mortgages.
A $20 million second mortgage normally has $80 million of bank debt as first charge holder, so $50 million of second mortgage mezzanine is roughly $250 million of total project funding.
This year we have projects completing with gross realisation of well over $300 million but it will be a larger than normal year. NZMS has no real funding constraints. When there are sound property deals to invest in, we will take as much as is available. When the opportunities slow down, the funds are invested in other areas. We have a preference for backing winners, projects with good momentum – so we don't do every deal, just the ones we know will work out well.

James Kellow

Why do they come to you when banks fund a lot?
We work in with a bank. A bank will typically fund between 70 and 80 per cent of a project's cost. On a $100 million development there is more than $20 million of hard equity required.
Most Auckland developers do not have this much cash readily available so we can provide this equity with a second mortgage called mezzanine finance, often up to 100 per cent of the projects cost. On our first mortgage deals we are often able to provide property development finance with no presale requirements. When an experienced developer is able to lock in a sufficient percentage of the project sub trade, we are able to fund without a fixed-price head contractor.
NZMS can approve a finance facility within hours if all of our directors are available.
It is this speed, that adds to a project's momentum, that many borrowers prefer. They may pay a bit higher total interest but get the development started (and finished) sometimes months earlier.

What interest rates and terms do you loan on?
Interest rates for first mortgages normally range from 7 per cent to 11 per cent depending on loan size, term and level of risk.
On a development loan the funds are drawn monthly as the building progresses, so the facility is only fully drawn for the last few months of the project before the presales settle. So higher interest rates are not necessarily a large part of a project's costs.
On our second mortgage mezzanine funding the rates or fees are higher, but with 80 per cent of the loan provided by bank funding at (say) 6 per cent the average interest cost is similar to our first mortgage loans.

Name some of the big projects you are funding now?
I like to talk about projects that are well advanced and you can actually see them rather than being in the planning stages. NZMS funded projects completing this year are:

- Urba Apartments – 143 apartments at 5 Howe St, Freemans Bay. Completed value is $70 million. Purchasers start moving into their new homes this month (May).
- Queens Residences – 281 apartments and retail just behind Queen St between Wakefield and Airedale Streets. Completed value is $130 million. Purchasers start moving around June.
- Belmont Residential Estate, Pukekohe. Approximately 350 residential sections within a new Special Housing Area (SHA) with 10 per cent of the lots covenanted as affordable housing. The first 70 sections are complete now with house building to start next month and we are anticipating to have a total of 300 sections finished by Christmas. Total gross realisation of sections funded by NZMS will be $105 million.

Many of the larger deals are for borrowers that NZMS or the company's principals have known for many years.
We are always happy to help with small transactions from $3 million as we have learned that with our support and expertise, borrowers can grow to undertake larger projects in the future.

More room at the inn?

New Zealand is filling up fast, as annual tourism growth has risen from 3-4 per cent to 10 per cent, reports **Anne Gibson**

New hotels worth hundreds of millions of dollars are desperately needed throughout New Zealand to solve our critical accommodation shortage.

Dean Humphries, Colliers International's national director of New Zealand and South Pacific hotels, said international and local investors would build that new stock.

"In the past 18 months the investment split has been close to 50/50," he says.

Just how many new hotels are needed will be revealed in the New Zealand Trade and Enterprise initiative, codenamed Project Palace.

NZTE is trying to sell hotel projects to investors in Asia, the Middle East, pockets of the United States and Europe,

Humphries says Auckland and Queenstown have critical supply shortages.

"Based on forecast unconstrained tourism demand, we will need a large number of new hotels in most of our main centres, most particularly Auckland and Queenstown.

"Government forecasts suggest increasing tourist numbers will continue as New Zealand is growing fast in popularity due to its safe environment, attractive exchange rate and many attractions.

In 2017 alone, we have the World Masters Games, Lions (rugby) tour and Rugby League World Cup.

"This means we are now on the global radar as one of the most attractive places for hotel investment in the Asia-Pacific region," says Humphries.

Construction is soon to start on the $200 million Park Hyatt on Auckland's waterfront.

Further excitement was generated last month when it was announced 10,000 Chinese Amway agents would come in groups of about 500 to Queenstown in the shoulder seasons of around 2017/18.

Humphries says the big tourism upswing has taken operators by surprise.

"We have gone from annual growth of 3 to 4 per cent to in excess of 10 per cent. Conversely, over the same period we have had virtually no new hotel rooms built, so New Zealand is filling up fast. In the past 12 months we have seen an additional 320,000 international visitors come to New Zealand. This is nearly the size of the city of Christchurch. In 2012, we had 2.5 million international tourists and in the year ending March 2016, we had 3.216 million.

"This is an increase of more than 700,000 new visitors in the past three years," Humphries says. "I believe it caught everyone in the industry by surprise."

"There is no silver bullet. However, Project Palace is a key initiative by a number of Government departments to assist with the critical shortfall in hotel rooms.

"We also need a wide range of other initiatives from the public and private sectors," he says.

Humphries' latest report on the sector found the surge in visitors has translated into record occupancy levels with the majority of key markets operating at or near full capacity during the peak summer period.

"Record occupancy levels have created highly favourable conditions for hoteliers to aggressively drive room rates, which has resulted in double digit or close to double digit average daily rate growth in the majority of our centres led by Queenstown, up 19.5 per cent in the March 2016 year, Auckland up 9.6 per cent and Rotorua up 13.1 per cent," his report showed.

"Buoyant trading conditions have contributed to increased property values with strong level of investment activities recorded in 2015 — 11 sales totalling over $300 million.

"In the March 2016 year, five hotels had been sold for $114 million.

"Despite positive trading conditions, new supply anticipated to come online in main centres in the short term remains low," Humphries says.