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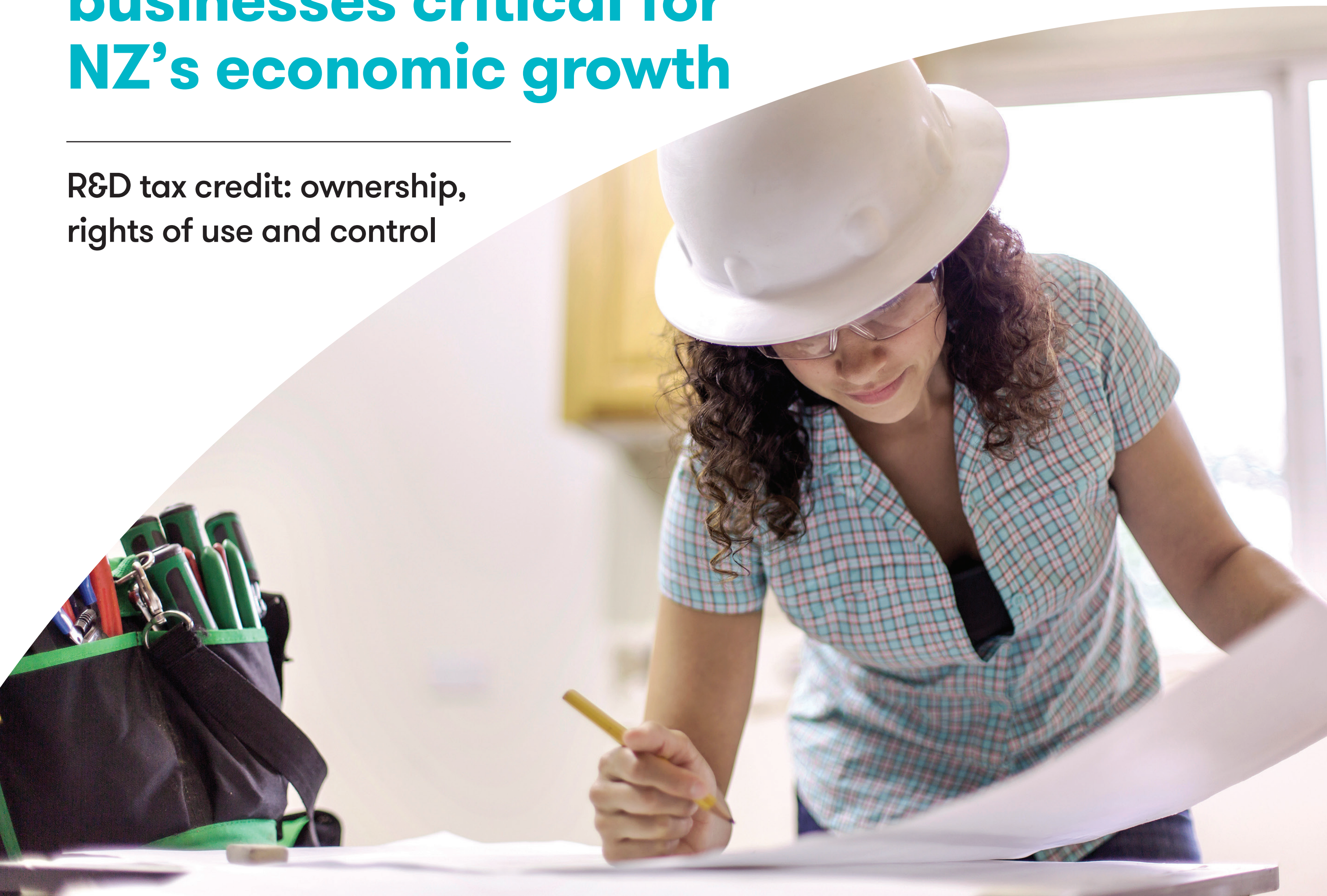
Commentary, opinion and intelligence for the New Zealand business community

More focus on mid-size businesses critical for NZ's economic growth

R&D tax credit: ownership, rights of use and control



PLUS

Time for Kiwi mid-size businesses to leverage increasing overseas investment

Minor Government supplier rule tweaks could majorly reshape our economy

Recession indicators adding up, but no need to panic yet

More focus on mid-size businesses critical for NZ's economic growth

Despite their significant contribution to the economy mid-sized businesses (MSBs) are not performing as well as their counterparts overseas.

Grant Thornton New Zealand recently published, '*The power and potential of the mid-size business*', a research report that focusses solely on New Zealand's mid-market. It found over the past decade, the number of mid-sized businesses has grown at a faster rate than small businesses, have more chance of survival and contributed $35 billion to GDP in 2017. However, it also found, while mid-sized businesses are outperforming both small businesses and large enterprises in employment growth, they fall behind when it comes to productivity and profit growth. Capital investment in mid-sized businesses is also low – they have a similar equity to assets ratio as small businesses.

The mid-market is an important part of our economy, but it's often overlooked as we focus on getting small businesses off the ground and celebrating the success of larger ones.

If mid-sized businesses' view of the world is not articulated in New Zealand's business and economic conversations, their needs won't be met and opportunities for not only those businesses, but a significant portion of the population, will be missed.

Our study found 76% of mid-sized businesses requesting financing in 2018 favoured debt financing while only 9% of all MSBs requested equity financing.

Having put the hard yards in to build their businesses, owners are reluctant to give up a share of ownership to an investor, however, in many cases it's necessary to achieve meaningful growth. It can also open up access to new expertise, networks and markets.

Mid-sized businesses are also falling well behind when it comes to operating internationally. The study found about 27% of mid-sized businesses exported products or services in 2018, and only 1.9% reported having international operations. By comparison, 46% of German, 29% of UK and approximately 33% of Australian mid-sized businesses have international operations.

Our report recommends that mid-sized businesses develop a voice of their own, beginning with the Government determining an official New Zealand-based definition for a mid-sized business. Once a sharper definition is in place, why the best mid-sized businesses succeed can be identified and programmes developed to stimulate or accelerate mid-sized business growth.

For more insights, visit grantthornton.co.nz to download your copy of *The power and potential of the mid-size business.*

Stacey Davies
Partner, Business Advisory Services
T +64 9 922 1291
E stacey.davies@nz.gt.com

New Zealand's mid-market at a glance ...

LARGE	MSBs	SMALL
0.5%	2.2%	97.3%

10,698 MSBs in New Zealand compared to **2,460** large and **471,021** small enterprises

11+ YEARS

65% of MSBs are 11 years or older

376,374 people were employed by MSBs in 2018

The number of MSBs is growing

GROWTH 2014 - 2018

33% MSBs

24% LARGE

11% SMALL

8% Total income growth in 2018

MSBs' contribution to total salaries and wages

40% SMALL

20% MSBs

40% LARGE

$117 billion

MSBs' total income in 2018: $117 billion

$35 billion

MSBs contributed $35 billion to GDP in 2017

SMALL	MSB	LARGE
$225,673	$311,969	$609,459

Productivity (income per employee)

1.9% of New Zealand MSBs have international operations

27% About 27% of MSBs exported in 2018

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Time for Kiwi mid-size businesses to leverage increasing overseas investment

Grant Thornton's latest edition of *Dealtracker* has delivered another deep dive into transactions in the Australian market. The report analyses mergers and acquisitions, and equity markets during the 18-month period to December 2018; and while it provides some good insights into what's happening over the ditch, there are some key takeaways for New Zealand businesses seeking growth opportunities.

Grant Thornton's recent mid-market research reveals that only 9% of New Zealand mid-size businesses (MSBs) sought equity financing in 2018 compared to the 76% that requested debt financing. This finding isn't surprising; owners are often reluctant to dilute the control they have in their companies after spending a significant amount of time and effort to build them. However, bringing in new investors is often an effective way to drive meaningful growth, and the time to do this is now.

The continued upward trend in overseas acquirers is one finding in *Dealtracker* that's particularly pertinent to Kiwi businesses with high growth aspirations; these purchasers comprised 31% of transactions, up from 28% in the previous *Dealtracker* period. Australia, like New Zealand, is regarded as a safe-haven given its relative political and economic stability; this is solidifying its international reputation and is contributing to the strong appetite for Australasian investments, particularly from the US and Canada.

Currently, small and medium sized businesses are the predominant acquisition targets. This composition is reflective of the overall corporate landscape in Australia and New Zealand.

In the future, the level of deal activity in the mid-market sector is expected to accelerate. This means that MSB owners should become increasingly mindful of the need for succession planning, as the baby boomer generation nears retirement. New Zealand's rapidly ageing population will impact Kiwi business owners in much the same way.

There is likely to be a number of MSBs coming onto the market as baby boomers look to exit their businesses. A solid succession plan can make businesses more appealing to overseas acquirers, and more importantly, stand out from the large volume of businesses for sale as their owners start to reach retirement age. Business owners need to be agile enough to contemplate a sale or a smooth exit on the best possible terms any time an opportunity arises.

It's also expected that mid-size businesses that sell products and

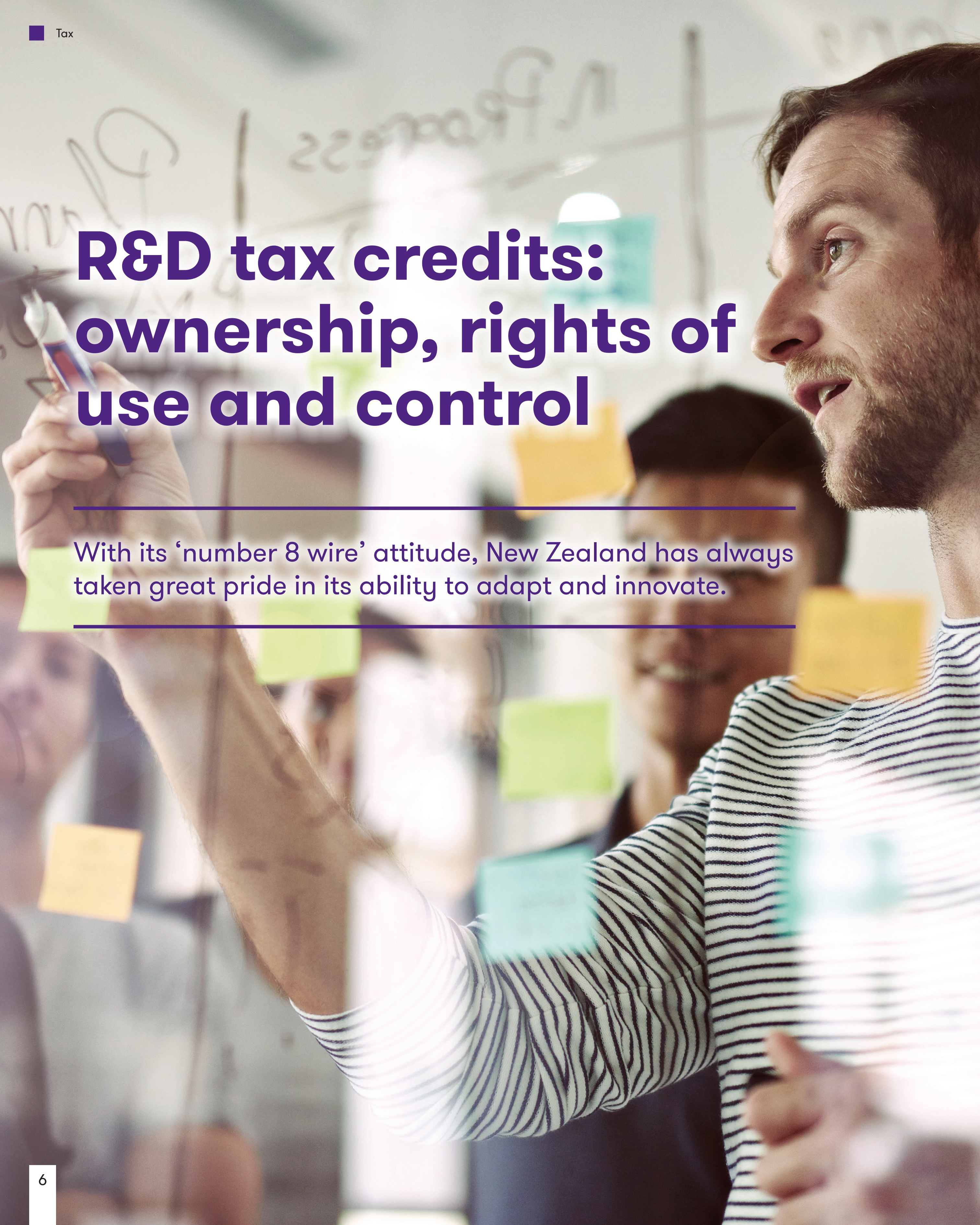
Grant Thornton's recent mid-market research reveals that only 9% of New Zealand mid-size businesses (MSBs) sought equity financing in 2018.

services transferable to buyers' home markets will be particularly attractive prospects for overseas acquirers. Naturally the technology industry has wide appeal, however *Dealtracker* notes that in Australia, transactions in this sector both by domestic or inbound bidders typically have a smaller deal size as the companies acquired are most often in the initial growth phase of the business cycle.

Deal volume is on a positive trajectory compared with previous *Dealtracker* periods. This has been driven by strong M&A activity during 2017 and a surge in IT sector acquisitions by bidders who either want to expand their technological capabilities or have identified growth opportunities.

Visit grantthornton.co.nz to download *Dealtracker* and New Zealand's 2019 mid-market report, *The power and potential of the mid-size business.*

Richard Hughes
Associate Director, Financial Advisory Services
T +64 21 059 3434
E richard.hughes@nz.gt.com



R&D tax credits: ownership, rights of use and control

With its ‘number 8 wire’ attitude, New Zealand has always taken great pride in its ability to adapt and innovate.

With sharp ideas and a keen ability to execute them, even against challenges of size and scale, many New Zealand businesses continue this tradition of innovation.

Acknowledging that R&D activity is a key driver to economic growth from innovation, the Government has stated their aim to increase New Zealand's R&D expenditure to 2% of GDP by 2028. In 2018 New Zealand spent 1.37% of GDP on R&D – considerably less than the OECD average of 2.4%. While producing such an increase is likely to present challenges to business and government alike, increased support and incentives can only stand New Zealand in good stead for enhanced growth through innovation.

How does the R&D tax credit work?

Legislation bringing the R&D tax credit incentive was enacted in April, so many will already be aware that the tax incentive will provide a 15% tax credit on R&D expenditure from the start of the 2019/2020 tax year, provided a business spends a minimum of $50,000 annually on R&D (there's a cap of $120 million). The R&D tax credit will shortly replace the Callaghan Innovation administered Growth Grants, and should be comparatively more readily accessible to a wider range of businesses.

To claim the new tax credit, a business must have a core R&D activity. That means an activity that has a goal of "creating new knowledge, new or improved processes, services or goods". It must also use a systematic approach with a purpose of "resolving scientific or technological uncertainty". The expenditure must also be of a qualifying type: this includes depreciation, buying goods or services to carry out R&D and paying R&D employees. Many businesses will already be undertaking R&D activities without necessarily flagging it as R&D or separating it out as a specific profit and loss item. The challenge will be ensuring that these are identified, recorded and that the qualifying nature of the activity and expenditure is well documented.

Who can claim?

It would of course be of little use to the enhancement of innovation and industry in New Zealand, if the credit was to be provided to businesses who are not spending on R&D in New Zealand, or for which the R&D is unlikely to benefit the country. The legislation therefore includes some very specific requirements about the ownership and control of the outcomes, as well as the types of activities and expenditure that will qualify as R&D.

IRD have fleshed these requirements out in an R&D tax credit guidance document which provides some particularly useful commentary about ownership requirements of intellectual property and matters relating to ownership and control in situations where multiple parties are involved in the R&D activity. It also includes information about the relevance to the 'ownership' requirement where a R&D activity does not successfully conclude and there is no identifiable intangible asset resulting.

Control

Where multiple parties are involved in the R&D activity, only the taxpayer who controls it is entitled to claim a credit. The focus on control is a way to ensure that only the 'principal' in relation to the R&D activity has a claim, and not agents or service providers also involved in the delivery of the R&D. This is to prevent multiple claims for the same activity and expenditure.

The IRD guidelines distinguish between a contractor who manages the day-to-day affairs of the R&D activity (not entitled to claim), and the 'principal' (entitled to claim) who should be entitled to check the work is being carried out in accordance with the terms of the contract, and should retain the right to start, stop or change the direction of the R&D activity. They emphasise that the contract with the R&D contractor should clearly identify the principal's controlling rights.

For businesses interested in making R&D claims, IRD's guidelines may suggest prompt action. Where relationships are not clearly set out in contracts with those conducting R&D activity, a claim may not be available.

Ownership and the right to use

A taxable presence in New Zealand is required of the claimant (a fixed establishment is required), as well as various other conditions relating to the entity that will own the outcomes of the R&D.

A key requirement is that the results of the person's R&D activities must be owned by the claimant or a member of the person's corporate group that is situated in a jurisdiction with which New Zealand has a double tax agreement (DTA). The intention here is to balance the ongoing benefit to the New Zealand tax base in terms of the use of the knowledge, with allowing for New Zealand to become a 'knowledge market' for the provision of R&D to foreign companies.

In recognition of a wider set of rights models to R&D which may fall short of ownership, but from which the benefits of the incentivised R&D activity are likely to accrue to the New Zealand claimant entity – the ownership requirements are also satisfied where the claimant has the right to use the intellectual property resulting from the R&D activity for no further cost.

In terms of R&D development arrangements involving multiple parties – IRD have clarified that the right to use can be shared with others, available in limited ways, or available for limited purposes. This covers the myriad of contractual arrangements that third parties may choose to enter, that may allow for a New Zealand development of intellectual property which is intended for use both by the New Zealand entity and for their overseas partners.

R&D is risky by nature. Many ideas start and finish life as just that, ideas. Even where an idea makes it to the research phase, this phase may be short or long, simple or complex, and may produce new leads and development activities, or in many cases, come to a conclusion with no measurable benefit to the business other than the exclusion of one more possibility.

Sometimes nothing worthy of intellectual property protection will result. In these cases "ownership" of the results means that you must have the right to reuse the knowledge without further payment; failure to produce intellectual property does not mean the claimant will not satisfy the ownership requirement – a claim may still be available for the expenditure incurred.

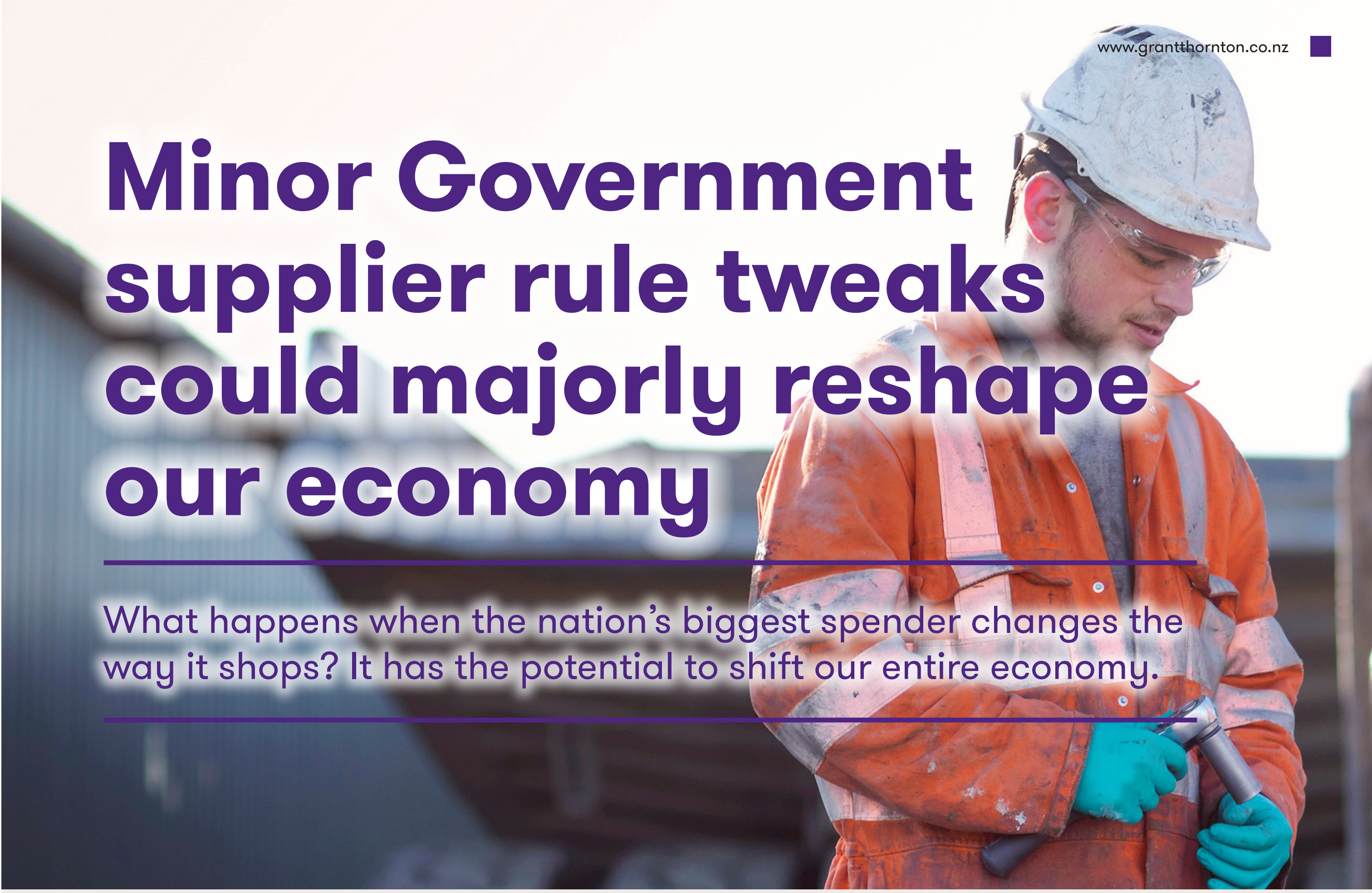
Starting the process of documentation

Record keeping will be a major component of successfully claiming the tax credit. Building your documentation will be a journey that should start as soon as possible to answer the big questions: What R&D are you doing? How much of it is a qualifying activity? What expenditure is eligible? What can we include or exclude? How much of the work is taking place in New Zealand? Once your advisor has those answers, they can start to pull the R&D figures out of the general ledger and work out how to successfully keep records that will satisfy Inland Revenue.

Instead of being the domain of the finance department, claiming the R&D credit will require deeply specialised skills. Businesses from all industries are going to need to work hand-in-hand with accountants and CFOs to document R&D activities and investment.

We are optimistic that the new tax credit will provide a real cash injection into research and development across New Zealand's economy, but an end-of-tax-year scramble to apply for an R&D tax credit simply will not meet the requirements. Contractual arrangements need to be in place, and records kept contemporaneously – businesses need to be recording R&D expenditure as it happens throughout the year.

Oksana Simonoff
Partner, Tax
T +64 9 922 1233
E oksana.simonoff@nz.gt.com



Minor Government supplier rule tweaks could majorly reshape our economy

What happens when the nation's biggest spender changes the way it shops? It has the potential to shift our entire economy.

The Government has just altered its procurement rules, which spell out how every Government agency selects which companies get awarded contracts and projects, and which products and services it buys. The principles remain the same, but there's are a few extra rules, a new Supplier Code of Conduct and 'public value' has been signposted as the new overarching objective. From up close, this looks like a few minor tweaks to some rather dull agency rules. But take a step back and you get some perspective on these changes, and the landscape looks quite different.

Paying more for public value

The biggest change is the focus on public value. This aligns with the Government's general ethos already signalled in the Wellbeing Budget and the Healthy Homes Standards. It also aligns with the mega-trend of ethical consumerism. Shoppers, particularly young shoppers, are voting with their wallets in favour of businesses that espouse positive values. Consumers are prepared to pay more to feel good about where their product comes from, and how it impacts the environment and the people who made it. Many major brands have already experienced consumer backlash and boycotts over unethical business practices.

Now the Government is signalling that it too wants to buy ethical, sustainable, local products and services, and exclude suppliers with bad business practices. How much difference could this make? It's hard to quantify, but there's the potential for significant change. Just look at one simple example: free range eggs. If you wanted to buy them in the 1980s, you had to find a specialist grocery store and pay through the nose. Now all the major supermarket chains are in the process of phasing out the sale of caged eggs entirely. That's how dramatically ethical consumerism can impact the market.

Now the Government is essentially slapping its gigantic wallet down on the table and saying, “I want free range eggs only. Now show me your happy chickens.” It is using its $41 billion annual expenditure to apply a giant lever to our economy – one that makes New Zealand’s economy more ethical, more sustainable, and – hopefully – more productive.

Now the Government is essentially slapping its gigantic wallet down on the table and saying, “I want free range eggs only. Now show me your happy chickens.”

The potential to boost productivity

These changes to the procurement rules should drive growth in local businesses, Māori and Pasifika enterprises, social enterprises and local skills. It may even assist in improving our underperforming productivity. New Zealand has traditionally been less interested in research and technology than we have in basic primary production; we’ve outsourced our unemployment to Australia; and we’ve relied on unskilled workers (both local and imported) to fill the productivity gaps in our economy.

The major suppliers that get the most work from the Government are usually pretty good at systems, innovation and processes. But who is doing the grunt work at the bottom of the food chain? Often it’s subcontractors who are inefficient and unproductive – as well as earning low wages. Similarly, the big companies might be extremely ethical within New Zealand but subcontract to an offshore company that buys its materials from manufacturers that engage in unethical practices.

By asking for long-range workforce planning (including subcontractors) and traceable supply chains, the Government should, in theory, drive demand for local businesses or those that can trace their goods back to the source. Coupled with the workforce planning, the procurement rules should encourage upskilling across our economy.

Raising our standard of living

Implementing changes to the Procurement Rules won’t happen overnight. If they result in positive change it will be incremental; it’s taken decades for free range egg producers to win their market.

However, if these rule changes can increase our productivity, drive local enterprise and deliver public value, they will raise the standard of living for all New Zealanders. That’s what the Government wants to achieve – let’s hope it succeeds.

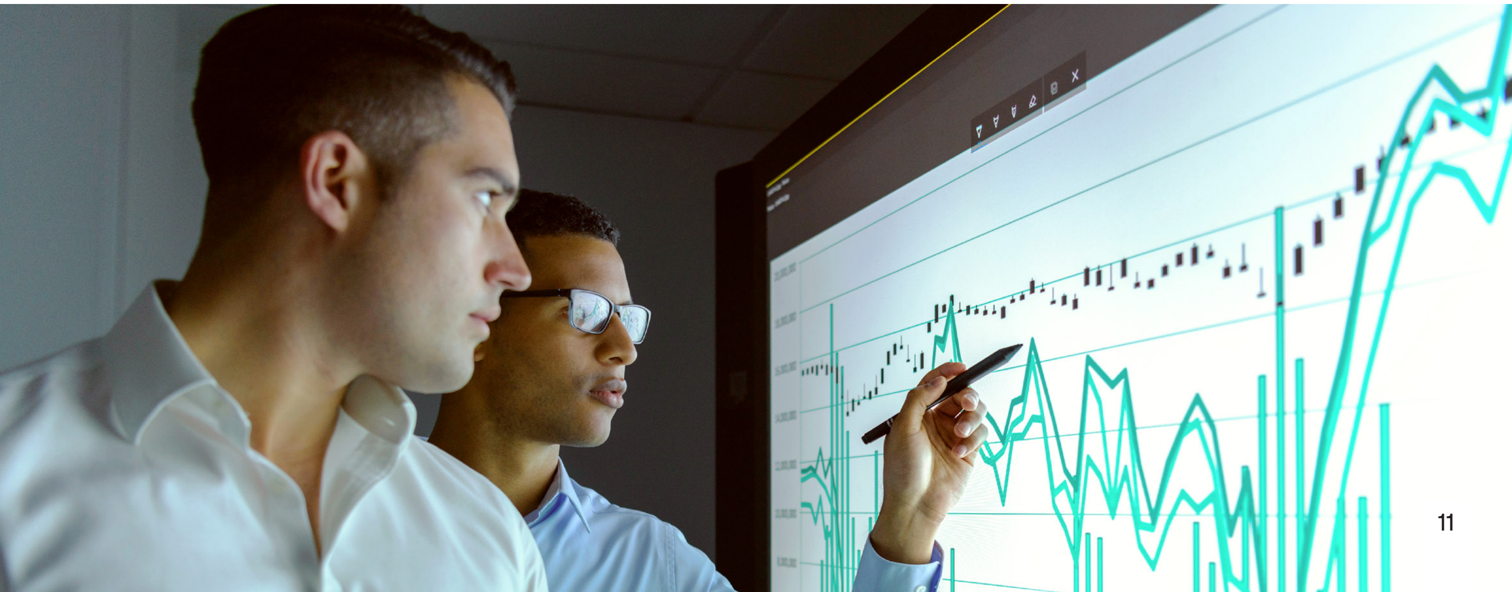
Michael Worth
Partner, Operational Advisory Services
T +64 9 922 1351
E michael.worth@nz.gt.com

Recession indicators adding up, but no need to panic yet

Indicators are currently accumulating that point to a recession. The most alarming warning sign is the US yield curve which plots the yields of Treasury maturities.

The longer you loan Treasury your money, the higher you would expect the yield to be, so the curve looks like an upward slope; it's been flattening out all year and looks more like a yield pancake.

Over the past 50 years, every time a yield curve has inverted, a recession has followed within a year or two; The Bank of America is now predicting a 30% plus chance of a recession in the next year.



The New Zealand Reserve Bank is similarly pessimistic, dropping the official cash rate down to 1%, a move that took almost everyone by surprise.

That suggests the Reserve Bank is predicting tough times ahead; it's pre-emptively doing what it can to stimulate the economy.

Other indicators include high gold prices, low business confidence, and our key trading partners are facing significant uncertainties.

China is staring down the barrel of an ongoing trade war, the UK is grappling with Brexit, and the US has a weakening manufacturing sector and falling industrial commodities.

A US recession would hit New Zealand through trade channels as America buys less, and impact our supply of foreign capital as overseas investors pull their money back home to what they perceive as less risky places.

It could also hit us from the side; if Australia goes into recession we can expect to be dragged along for the ride. On the flipside, if Australia skates through relatively unscathed, we could probably get off lightly as well. It happened during the GFC and it could happen again. That storm caused enormous damage but only brushed by our region.

Storm warning for Kiwi businesses?

Of course, it's important to reiterate that the storm might not hit at all. We're in new territory when it comes to traditional economic indicators; interest rates are incredibly low, inflation has been unresponsive to the usual tools, and low employment hasn't lifted wages.

Whether a recession makes landfall in New Zealand or not, there's no harm in shoring up your financial position, both personally and in your business. Consider what your position would be if sales took a serious dive; if one of your key markets falls over, look to build sales in alternative regions to maintain your profitability; ensure you can comfortably service your debt; know where you could cut back if you need to trim your expenses, and review your systems to see if you can improve cashflow.

The storm warning has been issued; there's no need to panic yet, but you might as well be prepared.

Paul Kane
Partner, Business Advisory Services
T +64 9 922 1276
E paul.kane@nz.gt.com

If you require further information about any of these topics or would like details on other accounting or advisory matters, contact your local Grant Thornton office:

Auckland
L4, Grant Thornton House
152 Fanshawe Street
Auckland 1140
T +64 (0)9 308 2570
F +64 (0)9 309 4892
E info.auckland@nz.gt.com

Wellington
L15, Grant Thornton House
215 Lambton Quay
Wellington 6143
T +64 (0)4 474 8500
F +64 (0)4 474 8509
E info.wellington@nz.gt.com

Christchurch
L3, Grant Thornton House
134 Oxford Terrace
Christchurch 8140
T +64 (0)3 379 9580
F +64 (0)3 366 3720
E info.christchurch@nz.gt.com

www.grantthornton.co.nz

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