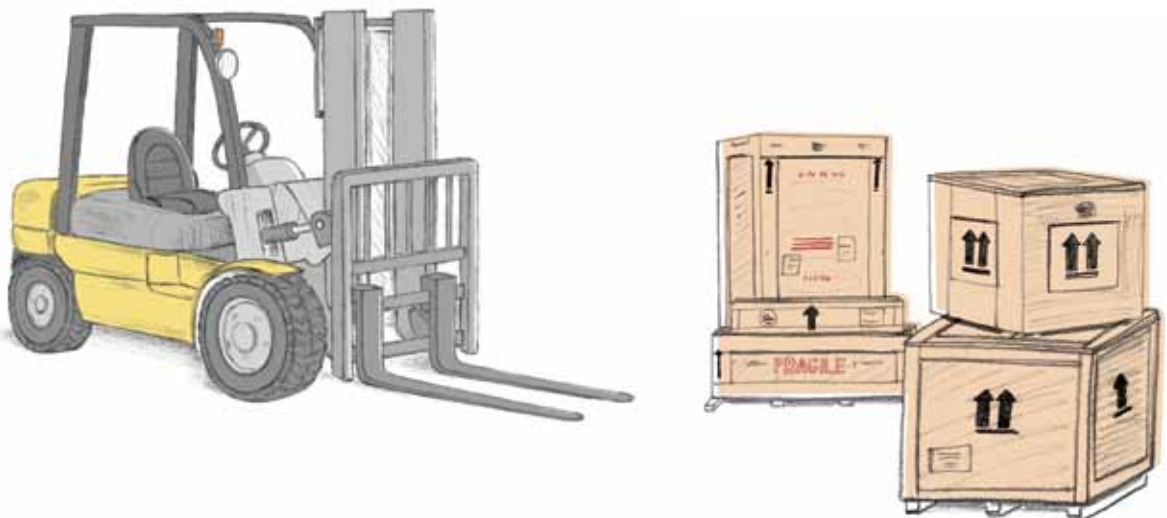


The impact of PSA: challenges facing the kiwifruit industry and solutions to secure its future

December 2011



In its most virulent form, PSA destroys kiwifruit vines. Its impact on the horticultural sector should not be underestimated, as kiwifruit accounts for 46% of all New Zealand horticultural exports.

A major threat to our most important horticultural industry

The \$1 billion (by export value) New Zealand kiwifruit industry faces immense harm, if not potential destruction, from the PSA outbreak discovered in November 2010.

This paper sets out Grant Thornton's views on the potential impacts of PSA on the New Zealand kiwifruit industry and its stakeholders. It considers possible reactions (and their impacts) that those in the industry may take in response to the crisis and suggests the most important actions growers, post-harvest operators and other stakeholders should consider in order to best protect their long term interests.

Industry background

The New Zealand kiwifruit industry produces over 100 million trays of fruit a year, 75% of it green kiwifruit and 25% gold.

77% of the crop is grown in the Bay of Plenty. All New Zealand-grown kiwifruit sold overseas is marketed

and sold through the grower-owned corporate, Zespri, whose sole marketing rights are enshrined in the Kiwifruit Industry Restructuring Act 1999, passed at the request of growers.

Zespri's effective monopoly has recently been challenged by Turners & Growers which is attempting to grow and sell its own varieties.

Although it is not technically a cooperative, Zespri shares have voting restrictions that are tied to supply volumes making it a cooperative in almost all but name.

Zespri sells directly and indirectly through various collaborative marketing agreements. Growers typically do not contract directly to Zespri, but to a post-harvest operator, which packs and delivers the fruit to Zespri markets on the grower's behalf.

Each post-harvest operator runs a pool system for grower payments received from Zespri, from which they deduct packing and cool storage fees. Zespri makes monthly payments in the 12 months after the crop has been packed.



The threat of PSA

Two PSA strains have been identified in New Zealand: PSA LV (less virulent) and PSA V (virulent). PSA LV has probably been here for some time and seems to be relatively benign. PSA V, however, results in the death of the vine. Its primary stage is leaf spotting, followed by secondary symptoms which include cane die-back and sap oozing from vines.

Based on Italian experience with PSA, and the fact that the Italian strain of PSA seems to be nearly identical to the PSA V detected in New Zealand, gold vines appear to be much more susceptible to PSA than green vines. Once PSA V appears in a gold orchard, the expectation is that any future crop is far from guaranteed. Following its appearance in a green orchard, informed opinion suggests that two more crops can be expected.

There is no known cure for PSA, but copper and/or streptomycin sprays offer some short term protection.

Theories differ as to how PSA is being spread in New Zealand but studies show it can be spread by footwear, vehicles and orchard tools, and climatic events such as storms and high winds.

PSA quickly multiplies and spreads and an affected vine will quickly infect plants around it. While PSA can survive on other plants, it cannot multiply until it enters a kiwifruit vine.

As of 10 November 2011, 78% of New Zealand kiwifruit hectares were

within a PSA Priority Zone (KVH) and 32% were within an orchard with a PSA V positive test result.

Kiwifruit Vine Health (an independent body set up to lead the response to PSA) is focussing its efforts on PSAV. Its board comprises Zespri staff, growers, post-harvest operators and MAF officials. Current research is directed towards developing commercially viable PSA resistant kiwifruit varieties, rather than a cure.

Immediate commercial challenges

The commercial challenge posed by PSA arises from die-back and subsequent loss of cropping ability. This leads to debt servicing issues and a significant reduction in the value of the orchard's assets.

The issue is partly to do with time delays. The capital that each grower invests in their crop must be spent up to nine months before the first Zespri payment is received. However, PSA can devastate a crop in less than a season. Therefore, the grower has no certainty that vines will survive long enough to provide a mature crop and a return on pre-season capital expenditure. Faced with this, some growers may decide to not grow a crop at all.

The main asset in every orchard is the land itself. Before November 2010, gold kiwifruit orchards in the Bay of Plenty were selling for around \$400k - \$450k per hectare, and green kiwifruit orchards for around \$250k - \$300k per hectare.

Without a fully productive kiwifruit orchard, the underlying land may be worth a lot less than this, particularly given the potential for the land being sold in "distressed" circumstances. That doesn't take into account a potential glut of ex-kiwifruit orchard land on the market, which could see prices reduced to as little as \$50k per hectare.

This prospect comes at a time when kiwifruit orchard debt gearing has been on the rise. While gearing was once typically around 50% of asset value, in recent times that figure has increased to 65% - 70%.

Then there is the impact on the kiwifruit industry in general. Current estimates suggest a 30% reduction in volumes is likely. This will lead directly to lower profits for post-harvest operators such as packhouses and for Zespri itself.

The industry believes that gold kiwifruit around Te Puke could be wiped out within one or two years. In fact, this could be true of gold kiwifruit throughout the entire Bay of Plenty.



How might growers and post-harvest operators react?

While no-one can say with certainty how growers and post-harvest operators will respond to the threat of PSA, experience and logic suggest some responses are more likely than others. Five such responses, and their potential repercussions, are discussed below. **Note:** this section does not constitute a set of recommendations. It simply outlines possible outcomes and their ramifications. Our recommended actions for growers and post-harvest operators can be found on page 6.

- 1 Post-harvest operators could engage in a “price war” in order to maintain short term packing volumes. This would inevitably lead to reduced margins, profitability and cashflow which in turn could lead to rationalisation from smaller players banding together to compete with larger operators; or takeovers of smaller players as they struggle to survive the more competitive environment.
- 2 Post-harvest operators may enter long-term leases of PSA free orchards in order to guarantee a supply of healthy kiwifruit. This would give those operators certainty around prices and margins (albeit reduced) and reduce the risk of growers defecting to other post-harvest operators.
- 3 Growers may not invest in the next season’s crop for fear of losing their

working capital to PSA. It has been suggested that one major grower has invested as much as \$5m towards a crop over the next year from a portfolio of leased orchards. The full \$5m could be at risk if those orchards contract PSA.

- 4 Where shareholdings are linked to supply volumes, grower shareholders in some cooperatives will need to be repaid if those cooperatives stop supplying certain packhouses, or if their crop volume declines below certain agreed levels. This could cause liquidity issues for cooperatives.
- 5 Kiwifruit growers are already trying to liquidate non-core assets such as their Zespri and Seeka shares. Zespri shares have fallen from \$1 to \$0.40 and Seeka shares have dropped from \$2.50 to \$0.85 in the year since PSA was discovered in New Zealand. Takeovers of these companies are not likely as Zespri’s constitution does not allow for shareholdings greater than 5% and Seeka’s three largest shareholders own 37% of the company and would be unlikely to sell.
- 6 The kiwifruit industry could fragment and become deregulated. Assuming post-harvest operators then begin selling and marketing kiwifruit, their earnings would become more volatile as currency

and market risk would no longer be shared across the whole industry. This scenario is also plausible if industry rationalisation leads to three or fewer major post-harvest operators who could push for deregulation to allow them to control the entire supply chain. Growers would then compete against one other and have to settle for whatever returns they are offered by post-harvest operators.

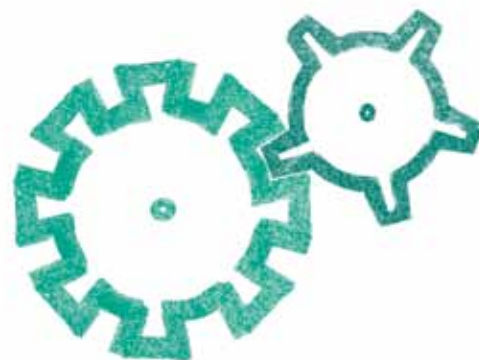


Solutions and suggested actions

Kiwifruit orchardists, post-harvest operators and other industry stakeholders must urgently get their businesses into an optimum position for countering the PSA threat. Reducing debt as much as possible is the obvious first risk-mitigation strategy. We also realise that this may be easier said than done. Here are eight possible strategies for reducing debt or mitigating risk:

- 1 Reducing dividends to either nil, or to a significantly lower level than in the past. At the same time post-harvest operators must weigh up the effect this could have on relationships with grower shareholders.
- 2 Selling non-essential assets such as surplus tractors, trucks and other machinery that is rarely used or can be provided by contractors. Orchardists will have similar investment in surplus plant and equipment, but on a smaller scale.
- 3 Restricting capital expenditure to essential items only. Priority should be given to items that may reduce the spread of PSA.
- 4 Owners with more than one orchard may wish to sell land to reduce debt on their remaining orchard(s) (assuming the land can command a price that delivers equity). Subdividing may also be an option for smaller orchardists.
- 5 Well-funded orchardists and post-harvest operators may wish to consider setting up “greenfields” operations in non-PSA V areas such as Hawkes Bay, Northland or Nelson. This is not a risk-free strategy. It would require substantial capital to fund the initial land purchase and subsequent development in the years before positive cashflow occurs, and there would be no guarantee that PSA V would not spread to these regions in due course.
- 6 Post-harvest operators may need to consolidate operations across fewer sites, thereby reducing fixed and variable costs. This could be achieved by subleasing unused sites, on-selling owned property, or exiting current leases on land.
- 7 Banks and other debt funders may need to find innovative ways to protect their principal debt, such as repayment holidays, capitalising of interest, or converting loans into equity stakes. Calling in loans is not an attractive option as current selling prices could mean that, in the short term, recovery could be as low as 15 cents in the dollar.
- 8 Post-harvest operators will need to find ways to secure crops long term. Options include crop financing and enticing growers into favourable long

term leases via generous margins. Such arrangements may be breakeven or even loss making for post-harvest operators, but losses could be recovered on packing and cool storage business.



How can Grant Thornton help?

In June 2010 the Government sought a professional firm with the credibility, skills, resources and experience to manage the politically sensitive and complex affairs of Allan Hubbard and looked no further than Grant Thornton New Zealand. With some 30 partners and over 250 professional staff in Auckland, Wellington and Christchurch, Grant Thornton has proven its ability to deliver superior outcomes from its advisory services.

You can count on:

- a consultative, partnering approach
- focus on achieving the best commercial outcomes for clients
- access to our wide network of independent experts, as required.

We have the industry skills and experience to help stakeholders in the kiwifruit industry effectively manage the enormous challenges posed by PSA. Below is an outline of our specialist services available.

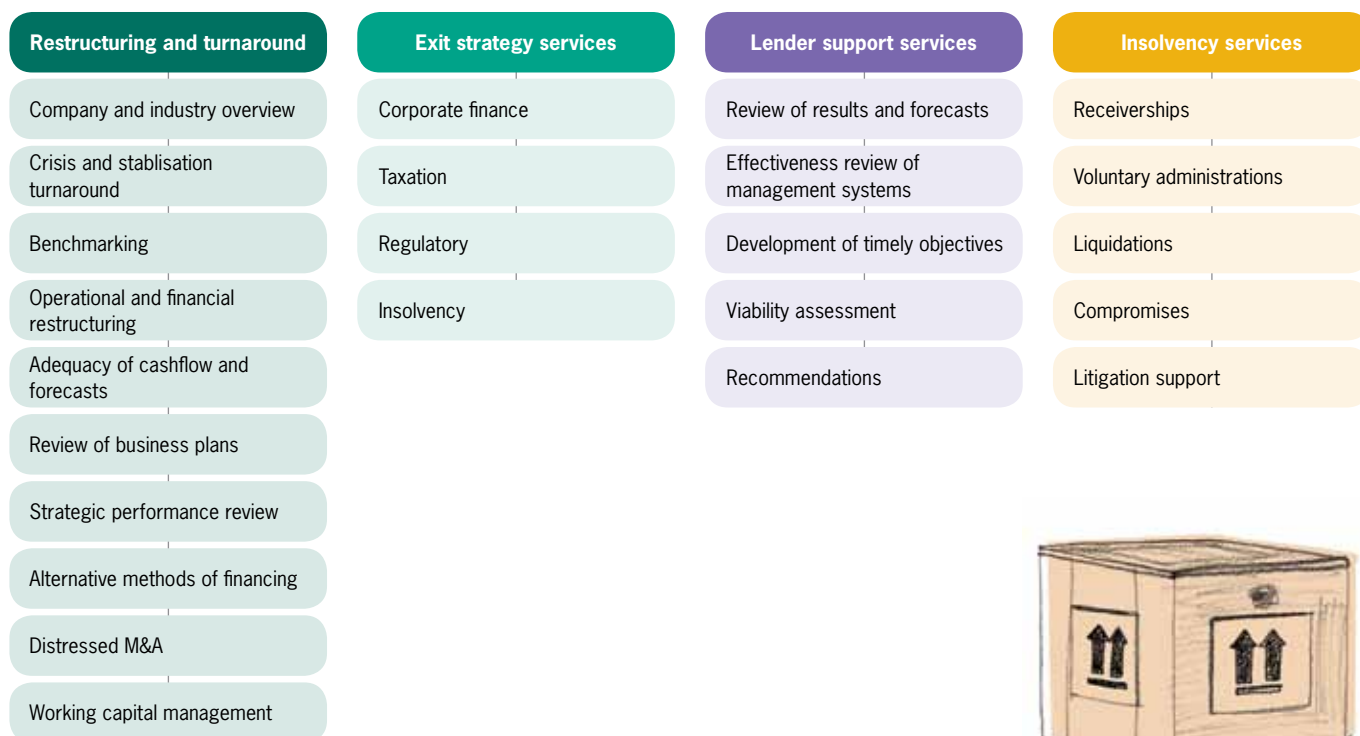
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