

Reference: 20170126

19 June 2017



Thank you for your Official Information Act request, received on 4 April 2017. You requested the following:

What advice has Treasury provided shareholding ministers since 2013 about the financial state of Landcorp, including any concerns Treasury had about its financial performance, and any advice provided on how to improve its financial performance?

What advice has Treasury provided Ministers since 2013 about continued ownership of Landcorp?

A Treasury official contacted you on 13 April 2017 to discuss the scope of the request. You agreed to refine the scope to:

Provide all Treasury Reports excluding quarterly financial reporting reports which Treasury has provided shareholding ministers since 2013 about the financial state of Landcorp, including any concerns Treasury had about its financial performance, and any advice provided on how to improve its financial performance.

In accordance with section 15(1AA) of the Official Information Act, your request has been deemed to have been received by the Treasury on 13 April 2017.

Information Being Released

Please find enclosed the following documents:

Item	Date	Document Description	Proposed Action
1.	17 May 2013	Treasury Report: Landcorp Briefing for Minister with Chair and CEO (with attachment)	Release in part
2.	23 Aug 2013	Treasury Report: Landcorp 2013 Draft Statement of Corporate Intent and Business Plan	Release in part
3.	28 Aug 2013	Aide Memoire: Landcorp 2013/14 SCI Dividend Forecasts, Capital Expenditure and Debt	Release in part
4.	30 Aug 2013	Treasury Report: Landcorp Extension to Statement of Corporate Intent Deadline	Release in part

5.	25 Oct 2013	Treasury Report: Landcorp Revised 2013 Statement of Corporate Intent and Briefing ahead of Annual Meeting	Release in part
6.	18 Jun 2014	Letter: Response from Acting Chairman of Landcorp to Minister Tony Ryall	Release in part
7.	24 June 2014	Landcorp Farming Ltd: Strategic Review - Final by Deloitte	Release in part
8.	15 Jul 2014	Treasury Report: Landcorp Findings from Strategic Review and 2014 Statement of Corporate Intent	Release in part
9.	24 Oct 2014	Treasury Report: Landcorp Change of Company Name	Release in part
10.	17 Mar 2015	Aide Memoire: Budget Initiative - \$100m fresh water fund	Release in part
11.	19 Mar 2015	Treasury Report: Landcorp's Wairakei Contract, Financial Position, and Sheep Milking	Release in part
12.	20 May 2015	Cabinet Paper: Landcorp Financial Position and Strategic Options	Release in part
13.	21 Aug 2015	Treasury Report: Landcorp 2015/16 Business Plan and Statement of Corporate Intent	Release in part
14.	7 Jun 2016	Letter: From Chief Financial Officer Steven McJorow to Ant Shaw	Release in part
15.	16 Jun 2016	Treasury Report: Landcorp Capital Structure Review (plus attachment)	Release in part
16.	2 Aug 2016	Treasury Report: Landcorp 2016/17 Business Plan and Statement of Corporate Intent	Release in part
17.	19 Sep 2016	Treasury Report Landcorp 2016/17 Updated Statement of Corporate Intent	Release in part

I have decided to release the relevant parts of the documents listed above, subject to information being withheld under one or more of the following sections of the Official Information Act, as applicable:

- personal contact details of officials, under section 9(2)(a) – to protect the privacy of natural persons, including deceased people
- commercially sensitive information, under section 9(2)(b)(ii) – to protect the commercial position of the person who supplied the information, or who is the subject of the information, and
- Direct Dial numbers of Treasury staff under section 9(2)(k) – to prevent the disclosure of official information for improper gain or improper advantage.

We have redacted the direct dial phone numbers of staff members in order to reduce the possibility of staff being exposed to phishing and other scams. This is because information released under the OIA may end up in the public domain, for example, on websites including Treasury's own website.

Information Publicly Available

The following information is also covered by your request and is publicly available on the Landcorp website:

Item	Date	Document Description	Website Address
1.	July 2013	Landcorp 2013-16 Statement of Corporate Intent	www.landcorp.co.nz
2.	July 2014	Landcorp 2014-17 Statement of Corporate Intent	www.landcorp.co.nz
3.	July 2015	Landcorp 2015-18 Statement of Corporate Intent	www.landcorp.co.nz
4.	July 2016	Landcorp 2016-19 Statement of Corporate Intent	www.landcorp.co.nz

Accordingly, I have refused your request for the documents listed in the above table under section 18(d) of the Official Information Act – the information requested is publicly available.

Information to be Withheld

There are additional documents covered by your request that I have decided to withhold in full under the following section of the Official Information Act:

- commercially sensitive information, under section 9(2)(b)(ii) – to protect the commercial position of the person who supplied the information, or who is the subject of the information.

In making my decision, I have considered the public interest considerations in section 9(1) of the Official Information Act.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This reply addresses the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Chris Gregory
Manager, Commercial Operations - Governance and Performance

OIA 20170126

Information for Release

1.	<u>Treasury Report: Landcorp Briefing for Minister with Chair and CEO (with attachment)</u>	1
2.	<u>Treasury Report: Landcorp 2013 Draft Statement of Corporate Intent and Business Plan</u>	66
3.	<u>Aide Memoire: Landcorp 2013/14 SCI Dividend Forecasts, Capital Expenditure and Debt</u>	82
4.	<u>Treasury Report: Landcorp Extension to Statement of Corporate Intent Deadline</u>	86
5.	<u>Treasury Report: Landcorp Revised 2013 Statement of Corporate Intent and Briefing ahead of Annual Meeting</u>	95
6.	<u>Letter: Response from Acting Chairman of Landcorp to Minister Tony Ryall</u>	104
7.	<u>Landcorp Farming Ltd: Strategic Review - Final by Deloitte</u>	107
8.	<u>Treasury Report: Landcorp Findings from Strategic Review and 2014 Statement of Corporate Intent</u>	209
9.	<u>Treasury Report: Landcorp Change of Company Name</u>	226
10.	<u>Aide Memoire: Budget Initiative - \$100m fresh water fund</u>	231
11.	<u>Treasury Report: Landcorp's Wairakei Contract, Financial Position, and Sheep Milking</u>	233
12.	<u>Cabinet Paper: Landcorp Financial Position and Strategic Options</u>	243
13.	<u>Treasury Report: Landcorp 2015/16 Business Plan and Statement of Corporate Intent</u>	258
14.	<u>Letter: From Chief Financial Officer Steven McJorow to Ant Shaw</u>	269
15.	<u>Treasury Report: Landcorp Capital Structure Review (plus attachment)</u>	273
16.	<u>Treasury Report: Landcorp 2016/17 Business Plan and Statement of Corporate Intent</u>	284
17.	<u>Treasury Report Landcorp 2016/17 Updated Statement of Corporate Intent</u>	297

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Treasury Report: Landcorp Farming Ltd: Briefing for Meeting with Chair and CEO

Date:	17 May 2013	Report No:	T2013/1285
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Agree to the recommendations	Tuesday 21 May
Associate Minister of Finance (Hon Steven Joyce)	For your information	None
Minister for State Owned Enterprises (Hon Tony Ryall)	Agree to the recommendations and sign the report	Tuesday 21 May
Associate Minister of Finance (Hon Dr Jonathan Coleman)	For your information	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Heidi Giles	Senior Advisor	s9(2)(k)	N/A (mob)
James Cunningham	Manager, Monitoring - Commercial	s9(2)(a)	

Minister for State Owned Enterprises' Office Actions

Return signed report to Treasury

Enclosure: Yes (attached)

[Landcorp: Economic Review and Future Focus \(draft\):2634168](#)

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17 May 2013

SE-2-8-1

Treasury Report: Landcorp Farming Ltd: Briefing for Meeting with Chair and CEO

Purpose of Report

1. You are meeting with Landcorp Farming Ltd's (Landcorp's) Chair, Bill Baylis, and CEO, Chris Kelly on Tuesday 21 May 2013 at 4.30pm. This briefing provides background information in preparation for the meeting.
2. It also recommends that an Independent Strategic Review of Landcorp be commissioned for completion by late-2013.
3. Appendix One contains suggested talking points for the meeting.

Background

4. You last met with Landcorp's Chair and CEO in December 2012. In this meeting Landcorp informed you that its Board was going to carry out a review of the company's historical performance which it would use to identify possible strategies for the future.
5. The Board has now concluded this work and produced a document titled 'Landcorp Farming Ltd: Economic Review and Future Focus' (the document). The purpose of the meeting on Tuesday 21 May is to discuss the content and recommendations contained in the document.
6. COMU met with Landcorp's Chair and CEO on Thursday 9 May to discuss the contents and recommendations in the document. COMU has not sought to validate any of the data in the document at this stage, although we have no reason to query its accuracy/validity.
7. The historical information contained in the document provides a range of interesting and useful information. This information raises questions as to what Landcorp's future focus should be and as a consequence we think that this would be an ideal time to commission an Independent Strategic Review of the company.
8. We introduced the concept of an Independent Strategic Review in the meeting with Landcorp, and the Chair and CEO agreed this would be a good idea, particularly if it assists in clarifying what Landcorp's future focus should be.

Document Content and Recommendations

9. In the document Landcorp proposes four main recommendations:
 - a. that Landcorp be able to continue to improve underdeveloped land
 - b. that Landcorp slowly sells off more land and continues to increase the area of land it leases
 - c. that Landcorp discusses with shareholding Ministers the possibility of selling significant parts of its land holdings, and
 - d. that, to a limited extent, Landcorp continues to fund 'industry good' activities.

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10. Data and analysis in the document shows that the rate at which land owned by Landcorp has increased in value is significantly above the rate of the Land Price Index. Landcorp attributes this advantage to its ability, over a number of years, to develop poor farming land into high value farming land.
11. For this reason Landcorp argues it is able to produce the highest Total Shareholder Return (TSR) when it has the flexibility to sell-off high value, mature farmland and use some of the proceeds to re-invest in low value, underdeveloped farmland.
12. Landcorp is able to successfully develop farmland as it has the capital, expertise and experience required. It is a large company, with many income streams, which means it does not need to rely on unproductive land producing a return in the early years of development.
13. Landcorp has advised that there is still considerable underdeveloped land available for development into profitable farmland in New Zealand. It believes it can play a role in this development which is of benefit to New Zealand.
14. Landcorp's two largest current projects, management of the Shanghai Pengxin farms and the Wairakei Pastoral development, involve Landcorp farming on leased land. In the document, Landcorp has carried out analysis to compare the returns on capital employed over the past five years on land-owned versus land-leased. Its results show that the difference is minimal; 2.9% for land-owned compared to 2.7% for land-leased.
15. Given that there is only a small difference in the returns on leased and owned land, the big advantage of leasing land is that it frees up capital, which could then be distributed to the shareholders.
16. As Treaty of Waitangi settlements progress there appears to be an opportunity for Landcorp to lease back land transferred from Landcorp to Iwi under settlements. This opportunity has arisen as, at the time of settlement, the Iwi often don't have the capital and skills required to farm these properties.
17. Landcorp has calculated that it currently spends approximately \$1.8 million per year on 'industry good' activities. These include sponsorships in local communities and of rural initiatives, research and development work and environmental stewardship.
18. Landcorp believes these industry good initiatives are important to continue to lift Landcorp's profile and also to help New Zealand meet its agricultural goals. However, Landcorp does recognise that these activities require funding from its profits, and therefore would like to test whether shareholding Ministers are supportive of this.

Next Steps

19. We recommend that an Independent Strategic Review (the Review) of Landcorp be carried out to help determine what its future focus should be. We think this would be most effective if it were a joint undertaking between the Landcorp Board and COMU.
20. We suggest that the Review be carried out in the first half of the 2013/14 financial year. This would allow for any outcomes to be included in the Letter of Expectations for 2014/15 which will be sent to Landcorp in late-2013.
21. Due to the suggested timing of the Review we understand Landcorp's 2013/14 Statement of Corporate Intent (SCI) and Business Plan are just a refresh of the 2012/13 documents. Any strategic changes coming out of the Review would be reflected in the 2014/15 SCI and Business Plan.

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Recommended Action

We recommend that you:

- a **note** the contents of this report
- b **note** Landcorp has conducted an Economic Review of its business in order to consider options for the future focus of its business
- c **agree** that an Independent Strategic Review of Landcorp be commissioned for completion by late-2013, and

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister for State Owned Enterprises

- d **note** some suggested discussion points/questions are listed in Appendix One.

James Cunningham
Manager, Monitoring - Commercial

Hon Tony Ryall
Minister for State Owned Enterprises

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Appendix One

Suggested Discussion Points

Landcorp's Economic Review

- In your report you recommend discussing with shareholding Ministers the possibility of selling large parts of Landcorp's land.
 - Is there a market for this land?
 - Would this have to be done over a long term to avoid flooding the market?
- One recommendation that you make is to move towards leasing land rather than owning land.
 - What do you see as the barriers to doing this?
 - Are there more risks to the shareholders in leasing rather than owning farmed land?
- Your report recommends a 'sell-buy-develop' approach
 - What portion of Landcorp's current land holdings would be mature, high-value farmland ready for sale?
 - What portion of sales proceeds would be re-invested into under-developed land?
- Your report recommends both a 'sell-buy-develop' strategy and a strategy of increasing leased land while decreasing owned land.
 - How do you see these two strategies working together or do you see it as one or the other?
- Have you worked through these scenarios to establish in each case what capital could be freed up for the shareholders?
- Do you see any of the scenarios you have proposed as having an impact on staff numbers?
- What benefits does 1) Landcorp and 2) New Zealand get from the 'industry good' activities that Landcorp is involved in?

Independent Strategic Review

- As a joint undertaking between the Landcorp Board and COMU we would like an Independent Strategic Review of Landcorp to be commissioned for completion by late-2013.

DRAFT

Landcorp Farming Ltd

Economic Review and Future Focus

April 2013

DRAFT

1. OVERVIEW

The Directors of Landcorp Farming Ltd have been engaged in a wide ranging review of the Company's activities. The main purpose of this has been to review the financial and relative performance of the Company and seek agreement and clarity as to the strategic direction that Landcorp should pursue in endeavouring to maximise its performance for the Shareholder.

As a State Owned Enterprise, Landcorp's purpose in terms of the State Owned Enterprises Act, inter alia, is to operate a successful business "...as profitable and efficient as comparable businesses that are not owned by the Crown...". It is also noted in the other aspects of the SOE Act, viz, that to be a good employer and have a duty of social responsibility are of equal importance

Landcorp's Directors believe the time has come where there needs to be a clear understanding of Landcorp's role as an SOE and its wider responsibilities, in particular its role in assisting the wider Agricultural community to double export revenue from \$28 million to \$60 million by 2025.

It is widely acknowledged that continuation of the status quo will not achieve this target.

Directors are also mindful of the volatility in revenues in what is essentially a commodity business and therefore the need for modest debt.

What Landcorp Is Good At

As part of its commercial activities, Landcorp has demonstrated an ability to successfully bring into production marginal land that would otherwise not be developed. Landcorp has also demonstrated an ability to develop underperforming land through superior farming methods and to successfully

engage in land use change developments where the benefits of doing so have been clearly identified.

Landcorp has been a strong performing investment for the owners. Landcorp's initial capital of \$125 million has been grown to around \$1.4 billion along with dividends of \$485 million. The overall return to the Shareholder has averaged around 14% per annum.

What Landcorp Needs to Maximise this Ability

If Landcorp is to continue such activities within its current capital and land holding footprint, there needs to be able to redeploy capital.

Potential Benefits of Working with Others

The analysis undertaken shows that there is real merit in pursuing lease opportunities whereby Landcorp's investment is confined to stock and lessees improvements. That analysis shows that engaging in this way will result in higher cash returns to the shareholder (as distinct from Total Shareholder Return). This may well also result in the opportunity to work more intensely with Maori where they currently do not have the management capability or in many cases the capital to invest in stock as well as the land.

Spill-over Benefits ("Industry Good")

It is Landcorp's view that, notwithstanding the Company's objective, Landcorp has a part to play in the wider industry to assist the Government in achieving its objective of doubling NZ's agricultural exports in real terms by 2025 and for the wider benefit of NZ Inc.

This has resulted in Landcorp undertaking a number of activities that strictly speaking might be seen to fall outside of its prime commercial objectives but which Landcorp has nonetheless been encouraged to participate in and in some cases lead.

The extent to which Landcorp should engage in these areas, either as Landcorp or in collaboration with others, needs to be explored.

Topics of Discussion with the Shareholder

A thorough review has been undertaken of Landcorp's activities.

This review has highlighted that there is a need to get a clear understanding from the shareholder on two issues:

- (a) The option for Landcorp to buy, develop and sell agriculture land; and
- (b) For Landcorp to continue to be involved in Spill-over Benefits to boost national GDP

Actions to be Undertaken

There are a number of recommendations that have been identified in the body of this report. The following is a summary of actions as a result of this analysis:

- (1) That Landcorp continues moderate investment in ongoing land use change, development and sales to generate economic value for the shareholder..
- (2) That Landcorp continue its product diversification strategy and optimise profits from its farming operations to optimise dividend distribution at around 75% of Net Operating Profit (NOP).

- (3) That Landcorp engage in spill-over activities that demonstrate a value to the New Zealand Agricultural sector; and
- that the SCI is modified accordingly; and
 - the activities are monitored and costs and benefits quantified.
- (4) That Landcorp retains flexibility in its deployment of capital (within the confines of the Business Plan).

2 Background

Landcorp has been a strong performing investment for the owners. Landcorp's initial capital of \$125 million has been grown to around \$1.4 billion along with dividends of \$485 million. The overall return to the Shareholder has averaged around 14% per annum.

Landcorp has historically operated within two main paradigms being Pre Long Term Hold (before 2001) and Post Long Term Hold (post 2001).

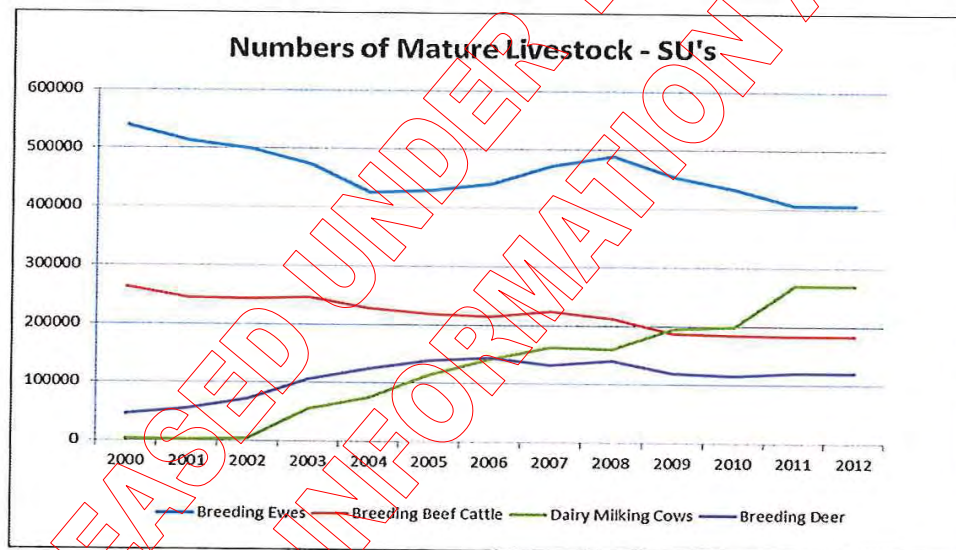
Pre Long Term Hold was characterised by the following:

- A mandate of being prepared for sale.
- Significant "sell-down" of various assets. This included Landcorp Property Ltd that was sold to Knight Franks and sale of other land based financial assets (deferred payment licences and mortgages).
- Limited or no capital reinvestment, low debt, no "strategy".
- Settlement of Ngai Tahu.
- Dividends significantly above profits.
- Major reduction in land portfolio.
- Investment in and then exit of meat processing and marketing.

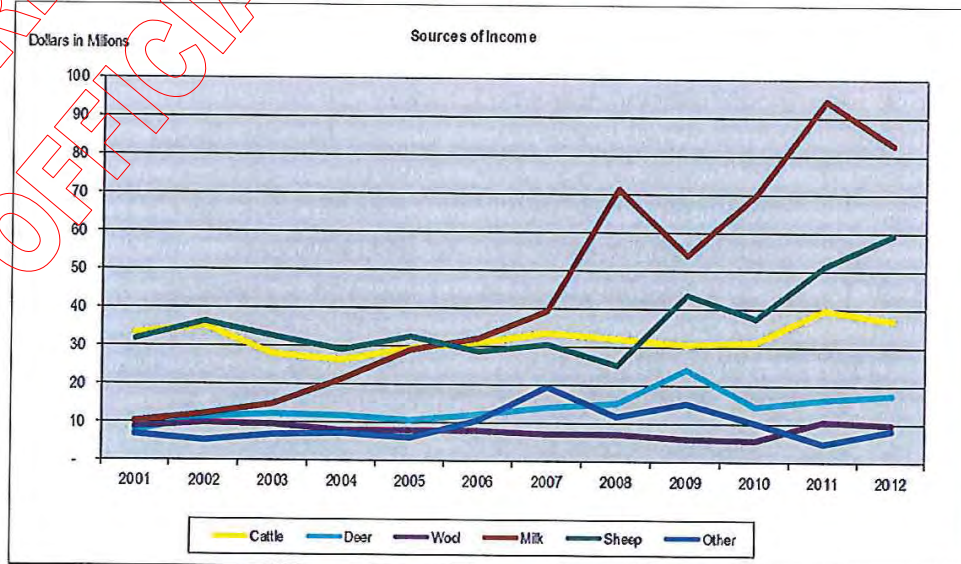
Prior to Long Term Hold, Landcorp's farming operations were predominantly sheep and beef with some sharemilkers engaged in dairy operations. As the

graphs below illustrate, Landcorp owned no dairy cows in 2000 and had only limited revenue from dairy farming.

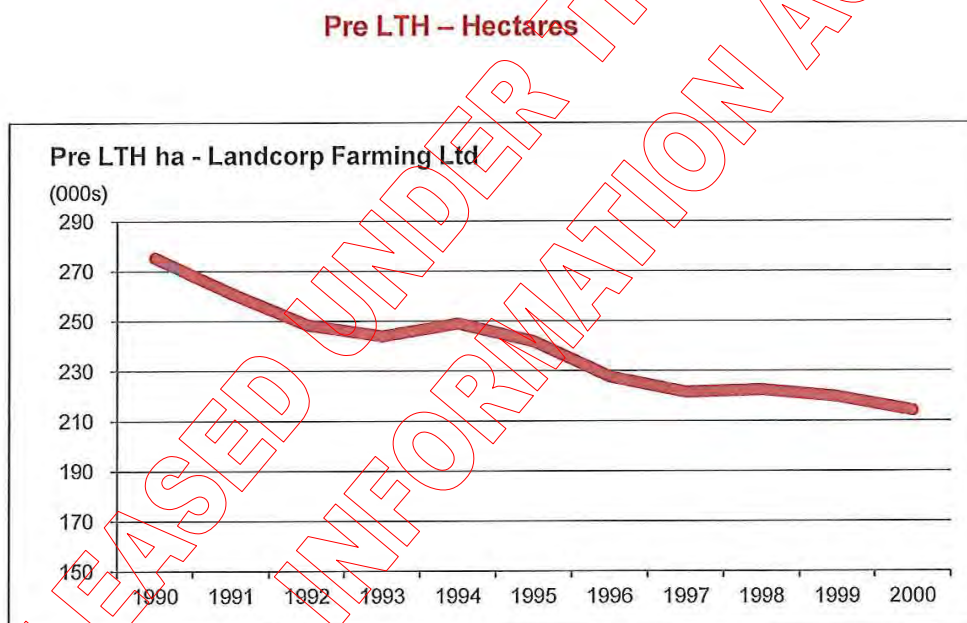
Post LTH – Breeding Livestock



Post LTH – Revenue



The graph below shows the changes in Landcorp's hectares prior LTH. This illustrates the extent to which Landcorp was "sold down" prior to 2000.



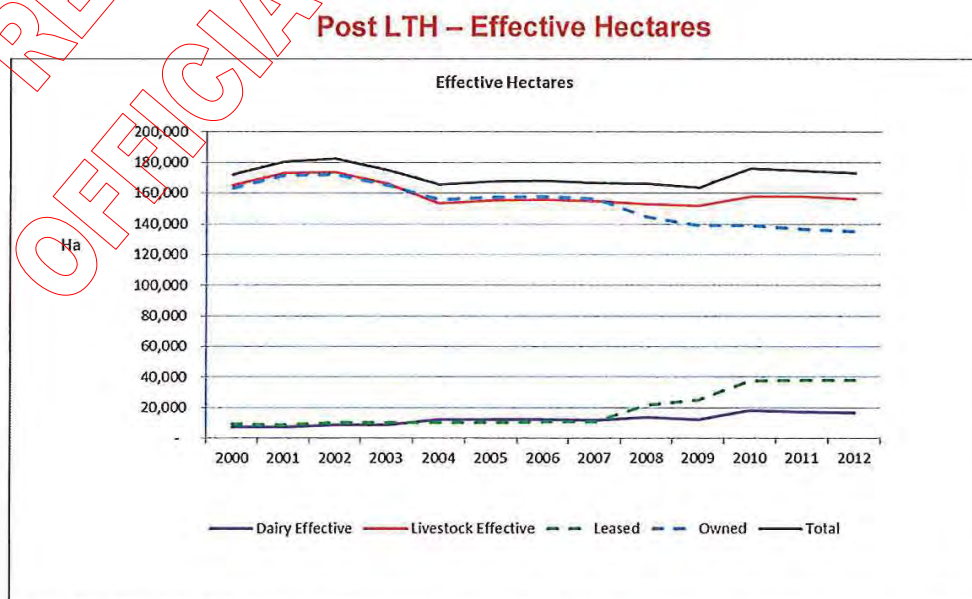
The Long Term Hold policy for SOEs was established in 2001.

The post Long Term Hold period has been characterised by the following:

- Developing a strategic plan and vision.
- Transformation of Landcorp from sheep and beef farming to a mixed species of sheep, beef, deer and dairy.
- Post LTH, Landcorp has grown its dairy and deer herd numbers, and milk income and sheep revenue despite lower sheep numbers.

- Significant land development and capital reinvestment including around 6,000 hectares of dairy conversions and 20,000 hectares of deer conversions, with an investment of around \$180 million.
- Alignment of the property portfolio (eg, exiting Lake Taupo catchment and “clustering” of Landcorp farms).
- A strong mandate from the owner not to “sell down in stealth” and to be sensitive to Treaty issues as part of any land sales. This included a period of extended Maori occupation over several properties that ultimately lead to the formation of Landcorp Holdings Ltd.
- Significant development of and investment in industry good.
- A focus on increasing returns by farming on non Landcorp owned land.

The graph below presents the change in Landcorp’s land portfolio Post Long Term Hold.



As illustrated above, the Landcorp revenue and value base has been grown on progressively less owned land.

Political Constraints

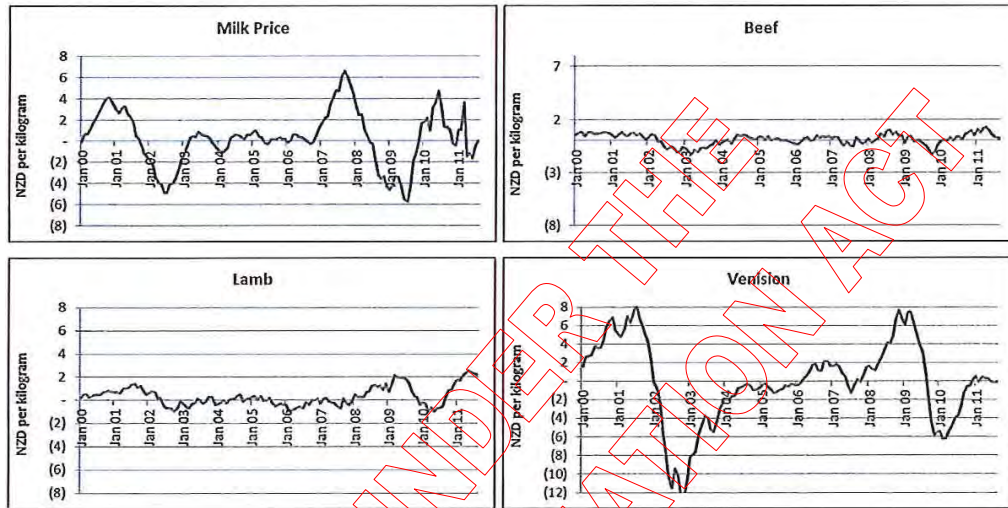
Landcorp's portfolio is extremely sensitive given the expectations surrounding the Treaty of Waitangi, the right of first refusal on completed treaty claims and more recently concerns around overseas ownership of New Zealand farm land.

These factors are in addition to the Long Term Hold policy and stated current position that only specified SOEs would be considered for the mixed ownership model. This raises a valid question concerning the actual liquidity and fungibility of the Landcorp farmland portfolio. Since Long Term Hold, the owners have expressed more of a "status quo" rather than significant change of operating model. Suggestions by Landcorp to consider mixed ownership, large scale sell off (eg to the NZ Superannuation Fund), "Buy, develop, sell" models have been considered on several occasions with limited and muted support for change by the owners.

In general, the owners have opted for "status quo" type models. The current mandate by the owner is on maximising dividends and not value.

Volatility of Operations

The post LTH period has seen a notable increase in volatility of product prices as illustrated in the analysis below.



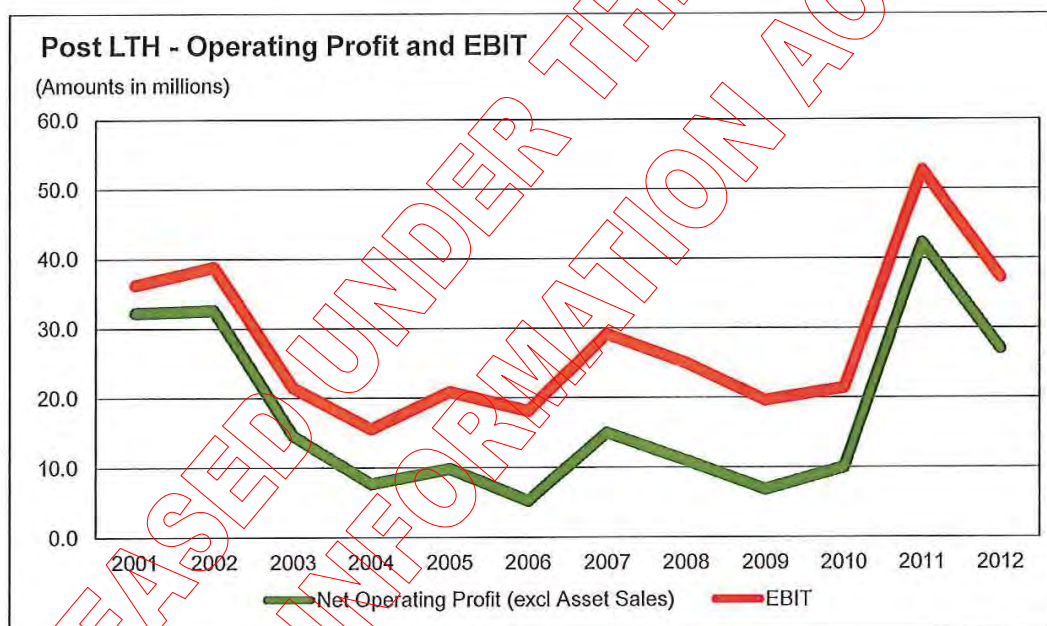
Product prices have varied due to both changes in underlying commodity prices and the value of the New Zealand dollar, as evidenced in the USD and milk price (see below).

NZD/USD and Dairy Prices (79%)


BANCORP
BANCORP TREASURY SERVICES LIMITED



The volatility is reflected in Landcorp's operating profits fluctuating significantly due to both product and climatic impacts.¹ This is illustrated in the graph below.



As a result of this volatility, debt has been relatively constant and in line with typical farming (commodity) businesses.

Summary

Landcorp has performed soundly within significant political constraints and increasing revenue volatility due to product prices, exchange rates and climatic impacts. Landcorp's improved performance has been on progressively less owned hectares.

¹ Climatic impacts are a reality of farming. For example, the February 2004 storm damage resulted in a one-off cost of around \$3 million to \$5 million. The 2008 drought is estimated to have cost Landcorp around \$16.6 million in 2008 and \$9.8 million in 2009. The spring storms of 2010 killed circa 60,000 lambs with an income potential of around \$6 million. These figures can be further analysed in the respective Landcorp Annual Reports.

2. HISTORICAL ANALYSIS

2.1 Review of Landcorp's Returns

2.1.1 **Total Shareholder Return and Distributable Profit**

Pre Long Term Hold (LTH)

- Pre LTH returns averaged around 17% or \$50 million per annum. Pre LTH distributable profit averaged around 12% or \$30 million. This included profit from asset sales².
- Pre LTH cumulative returns amounted to around \$580 million and distributable profits around \$340 million (see Appendix 1 for tables).

Post LTH

- Post LTH returns averaged around 11% or \$85 million per annum, and distributable profit averaged around 3% and \$26 million.
- Post LTH return cumulative amounted to around \$1.1 billion and distributable profits around \$340 million (see Appendix 2 for tables).

2.1.2 **Operating Margin**

Excluding land sales profits, the operating margin is between 4% and 19% of revenue. This illustrates that Landcorp is profitable from its revenue base of around \$200 million. However, revenue and profits are volatile (see Appendix 3 for table).

² Profit on asset sales is calculated as the difference between carrying value of the asset and sale value of the asset. Given Landcorp revalues its assets annually, profit on asset sale is much lower than the difference between original purchase price and sales value.

- Landcorp has added more value post LTH in dollar terms (\$1.1 billion versus \$580 million pre LTH) although this is a smaller percentage reflecting the increased asset value.
- Distributable Profit of around \$340 million is similar, although pre LTH had a higher proportion of profit from asset sales (\$123 million post LTH compared to \$235 million pre LTH).
- Therefore, excluding profits on asset sales, Landcorp has successfully increased both Shareholder value and operating profits in dollar terms post LTH. The LTH policy has added significant value to Landcorp.

RECOMMENDATION

1. That Landcorp continue to focus on developing under-performing land to lift performance through superior farming methods.

2.1.3 Asset Growth

It could be argued that Landcorp has been “lucky” in terms of its asset growth and that the Shareholder return merely reflects the change in rural land values. In order to test this assumption, Landcorp’s opening land assets have been inflated by the annual average change in an indexed land portfolio.³

Pre LTH

- Landcorp’s farmland assets would have increased from around \$80 million to around \$200 million (\$120 million) using an average farmland value change index.

³ This index takes actual land price changes and then “standardises” the change into a comparative Landcorp index reflecting the original mix of Landcorp’s land class.

- Landcorp's actual total assets increased by \$370 million over the period representing a marginal increase of \$250 million over and above average farmland value increases (see Appendix 4).

Post LTH

- Landcorp's farmland assets would have increased from around \$200 million to around \$430 million (\$230 million) using an average farmland value change index (see Appendix 5).
- Landcorp's actual total assets increased by around \$1.2 billion over the period representing a marginal increase of \$980 million. This increase would probably reduce by around \$100 million after allowing for debt increases over the same period.
- Landcorp has added significant value from its investment in farmland of around \$880 million over and above "average" farm value change post LTH.
- Landcorp adds value from land development.

RECOMMENDATION

2. That Landcorp continues moderate investment in ongoing land use change and development to generate economic value.

2.1.4 Dividends

Landcorp's total dividends of \$485 million represent around 26% more than Net Operating Profits (excluding asset sales) since incorporation (see Appendix 6).

Pre LTH

- Pre LTH dividends of \$300 million were around \$180 million higher than cumulative operating profits, excluding asset sales (see Appendix 7).
- Pre LTH dividends averaged \$25 million per annum and operating profits excluding asset sales averaged \$10 million per annum (see Appendix 8).
- Pre LTH dividends were significantly boosted by asset sales. Excluding dividends from asset sales, post LTH dividends were around \$65 million or 50% higher than Pre LTH.

Post LTH

- Post LTH dividends averaged \$14 million per annum and operating profits excluding asset sales averaged \$18 million (see Appendix 9).
- Post LTH dividends of \$185 million were \$50 million lower than cumulative operating profits excluding asset sales (see Appendix 10).
- Landcorp has increased its average operating profit post LTH by around \$10 million per annum.
- Post LTH dividends have averaged 78% of net operating profits.
- Landcorp has increased its dividend base post LTH and has distributed a significant level of operating profits.

RECOMMENDATION

3. That Landcorp continue its product diversification strategy and optimise profits from its farming operations to optimise dividend distribution at around 75% of NOP.

2.2 Benchmarking

2.2.1 High Level Benchmarking

We have undertaken high level benchmarking analysis as follows:

- Beef and lamb average farm returns.
- Dairy base average farm returns.
- Rural Equities.
- A proportional Beef & Lamb and Dairy base average.

There are several issues that should be considered in interpreting the benchmarking results including:

- (i) ***Landcorp's portfolio composition versus the "average" composition.***

Landcorp's portfolio of farms is not representative of the New Zealand average. The table below presents the proportion of average beef and lamb farm composition versus the Landcorp composition.

Class of Farm	Beef + Lamb (no. farms)		Landcorp (SU's)		Variance
S.I. High Country	220	1.7%	0	0.0%	-1.7%
S.I. Hill Country	850	6.7%	211,150	21.7%	15.0%
N.I. Hard Hill Country	1,155	9.2%	121,616	12.5%	3.4%
N.I. Hill Country	4,020	31.9%	291,075	29.9%	-1.9%
N.I. Intensive Finishing	1,570	12.5%	83,221	8.6%	-3.9%
S.I. Finishing Breeding	2,790	22.1%	249,689	25.7%	3.6%
S.I. Intensive Finishing	1,390	11.0%	15,435	1.6%	-9.4%
S.I. Mixed Finishing	615	4.9%	0	0.0%	-4.9%
All Classes N.Z.	12,610	100.0%	972,188	100.0%	

*Excludes Leased Farms

The same issue impacts the Dairy Base averages and the table below illustrates Landcorp's dairy portfolio compared to Landcorp.⁴ Landcorp's portfolio is generally on marginal, poorer and younger soils than "averages".

	Dairy Base (owner operator farms)		Landcorp (SU's)		Variance
Northland	809	10.5%	31,997	10.5%	-0.1%
Waikato	2,579	33.6%	113,875	37.2%	3.6%
Bay of Plenty	608	7.9%	1,300	0.4%	-7.5%
Taranaki	1,027	13.4%	-	0.0%	-13.4%
Lower North Island	807	10.5%	56,672	18.5%	8.0%
West Coast-Tasman	414	5.4%	72,152	23.6%	18.2%
Marlborough-Canterbury	694	9.0%	15,088	4.9%	-4.1%
Otago-Southland	739	9.6%	14,758	4.8%	-4.8%
All Classes NZ	7,677	100.0%	305,840	100.0%	

*Includes Leased farms

It should be recognised that Landcorp's "Waikato" farms are the newly converted Landcorp pastoral farms (raw pumice from forestry) and Pourira (young peat). **Appendix 11 tabulates this distribution.**

⁴This was completed for the Beef and Lamb data and reduced the Beef and Lamb comparable average to 1.1% versus Landcorp at 1.3% for opening profit versus equity. Shareholder returns dropped from 3.9% to 2.9%.

Close to 25% of Landcorp's dairy operations are on the lower profitability based West Coast farms. Landcorp has a small presence in Canterbury and Otago and no Taranaki presence. Landcorp's Waikato farms include a significant number of new farms at Landcorp Pastoral.

(ii) ***Data and measurement differences***

We have identified several differences between the Landcorp accounting and measurement versus both Beef and Lamb and Dairy Base. For example, Landcorp calculates depreciation on annually revalued fixed assets whereas Beef and Lamb and Dairy Base use tax depreciation based on historic cost.

Beef and Lamb do not include any allowance for owner's time, only paid managers. The "average" New Zealand Beef and Lamb farm profit is between \$10,000 per annum to \$150,000 per annum. A manager's wage would be around \$75,000 per annum.

Landcorp revalues its assets annually using registered valuers. Both Beef and Lamb and Dairy Base "approximate" market value.

These factors would be expected to overstate the benchmark averages relative to Landcorp.

The summary of benchmarks for operating profit excluding land sales over average equity are:

- Landcorp Group has averaged 1.3% over the last five years and exceeded the average Beef and Lamb farmer who has averaged 1.2%.
- Landcorp has exceeded Rural Equities five year average of 1.2%.

- Landcorp is close to the proportional Beef and Lamb and Dairy Base mix of 1.4%.
- Landcorp's returns are 1% lower than the average Dairy Base return of 2.3%.
- Including profits on land sales, Landcorp Group operating profits are very close to dairy operating profits at 2.2%.

The summary of benchmarks for the five year Total Shareholder return over average equity is presented below. Key findings include:

- Landcorp Group's five year average of 4% is marginally higher than Beef and Lamb of 3.9% and slightly less than the proportional benchmark of 4.2%.
- Landcorp Group five year returns are significantly higher than Rural Equities and around 1.2% lower than dairy returns of 5.3%.

High Level Benchmarking Conclusions

- Landcorp is marginally better than average Beef and Lamb farms based on the raw benchmarking and would be expected to demonstrate even higher than average returns if the benchmark data was "sanitised" and the averages were restated to represent a similar and portfolio to Landcorp.
- Including profit on asset sales, Landcorp's operating profits are close to dairy and far exceed other benchmarks. This supports the proposition that Landcorp could increase operating returns through more "buy, develop, sell" activity.

- Total returns are similar to Beef and Lamb and proportional averages and are around 1% lower than dairy returns .

(See Appendix 12)

2.2.2 Farm Specific Benchmarking

An alternative method of benchmarking is to compare and benchmark at a farm specific level. This has been previously completed in conjunction with Baker and Associates and Dairy Base. The results for 2011 using this approach have been averaged and extrapolated to approximate the difference between a Landcorp sample and a Baker and Associates or Dairy Base sample. This difference has then been grossed up to approximate the net benefit across the Landcorp dairy and livestock portfolio respectively. This was done by calculating relative profit differential per hectare and factoring this by total livestock and dairy hectares.

The advantages of using this benchmark data is that significant time has been invested in "cleansing" the benchmark data so that it can be validly compared.

Dairy

Landcorp would be expected to generate around \$4.6 million per annum more than comparative average non-Landcorp dairy farms.

Livestock

Landcorp would be expected to generate around \$4.7 million more per annum across its livestock farm, than the average non-Landcorp Baker and Associates livestock farms.

It should be noted that the Baker and Associates sample are typically high performing and leading livestock farmers (see Appendix 13).

Conclusion

Landcorp's strategy of large-scale farming, clustering, leveraging buying power and training means the Company is more profitable than equivalent private sector farms.

RECOMMENDATION

4. That Landcorp continue to leverage its critical mass, buying power, training and use of technology to maximise farming returns.

2.2.3. Productivity Benchmarking

Landcorp has calculated farm productivity and compared this to industry productivity since 2004 using a multifactorial productivity model. This takes account of all changes in inputs and outputs and eliminates the effects of price changes.

The industry productivity has been averaged to reflect various recalculations over the sample period.

See Appendix 14 for results.

Landcorp productivity has been significantly higher than average industry productivity since 2004 averaging slightly over 3% various industry average of around 2%. Note 2008 and 2009 reflect drought impacts and 2011 significant winter storms.

RECOMMENDATION

5. That Landcorp continue to benchmark its productivity with the industry and that aggressive productivity targets be set.

2.3 Overhead Analysis

2.3.1 Overhead Costs

Overhead costs are basically the Corporate Office costs. The graph below presents total overhead costs and includes an estimate of required on-farm admin costs. On-farm admin costs have been estimated based on Beef and Lamb and Dairy Base benchmark costs for finance, administration and IT. These costs are those that would be incurred on farm solely for administration type purposes.

See Appendix 15 for costs by year.

When calculated relative to production, overhead costs have fluctuated but have remained relatively constant.

See Appendix 16 for results.

2.3.2 Overhead Benefits

Overhead Benefits

Overhead benefits have been calculated using the following matrix for benefit calculation.⁵

Stock Agent Savings ⁶	4% of All Sales
Breeders Margin Savings	50% of Genetics Transfers
Estimate of Retail Savings	12% Total Retail Costs
Interest Savings	2% margin on average annual debt
Price premium Savings	Premium in Balanced Scorecard
Medical Savings	Medical Insurance 50% less
ACC Savings	14% Saving Industry Benchmark

⁵ This is not an exhaustive list of benefits, for example, training benefits, benefits of Research and Development, and Industry sponsorship have not been estimated.

⁶ For example, PGW standard fees for dairy cow sales is 7%, sheep and cattle are 6%.

Total overhead costs relative to overhead benefits are presented in **Appendix 17**. The net benefit has been calculated after excluding the benchmark farm administration costs on the basis that administration costs are essential for operating a farm. The marginal overhead cost is Landcorp's additional overhead cost.

The total amount that Landcorp saves is between \$21 million and \$29.7 million per year, and the marginal benefit is between \$10 million and \$18.5 million per year.

RECOMMENDATION

6. That Landcorp continue to monitor overhead costs on an annual basis and ensure:
 - (a) They deliver a net benefit;
 - (b) Costs do not rise as a percentage of stock units.

2.4 Returns from Leases versus Owned Operations

The five year returns (EBIT) on leased land versus owned land have been calculated relative to capital employed. This calculation takes a Landcorp Farming approach and excludes the value of land owned by Landcorp Holdings.

The summary of five-year returns is presented in the graph and further analysed in **Appendix 18**.

Comparisons between status quo (**Appendix 19**), Landcorp as a Lessee (**Appendix 20**) and develop and sell model (**Appendix 21**) were undertaken.

- Over five years, Landcorp's returns of owned farms have averaged 2.9% versus leased operations that have averaged 2.7% (excluding Molesworth).
- The Landcorp Pastoral and "other" leases (Sweetwater, Te Karae and Te Raite) have averaged highest lease returns over the last two years.
- The Molesworth lease has averaged only 0.4% over five years. There is around \$20 million of assets (land development, livestock and plant) invested in Molesworth by Landcorp. The terms of the Molesworth Lease were specifically agreed with the Shareholder and are acknowledged as "marginal".

RECOMMENDATION

7. That Landcorp continue to lease more land and have an on-going orderly sell down of owned land, that the Molesworth lease is specified in the SCI as a "public good" and that Landcorp Board engage owners to progress the Develop and Sell scenario.
8. That Landcorp discuss with Shareholders the possibility of selling significant parts (land) of the Company.

2.5 Landcorp Generic Industry Good

A reasonable measure of the success or otherwise of generic activities is a before and after test.

Prior to the current CEO, very little generic activity was undertaken (except sponsorship).

THEN	NOW
➤ Company insular relatively unknown.	➤ Sought after for partnerships. ➤ Focus farms.
➤ Hard to attract staff.	➤ A sought after place to work.
➤ Not well liked in local communities.	➤ Where present, well respected and accepted (c.f. Cheltenham Downs).
➤ High staff turnover.	➤ Lower staff turnover.
➤ Siloed and “unknown” within the Ag Sector.	➤ Understood and sought after for advice.
➤ Treated with suspicion.	➤ Respected.
➤ Often criticised and forced to defend.	➤ Held out as an exemplar.

Costs can be quantified (see Appendix 22). Benefits are more qualitative than quantitative.

An attempt to quantify national benefits has been made (see Appendix 23)

RECOMMENDATION

9. That Landcorp continue to fund to a limited extent, industry good activities consistent with the SOE Act and that:

- (a) Costs are tracked annually and KPIs established in relation to costs as a percentage of revenue; and
- (b) These activities are overtly acknowledged in the SCI; and
- (c) The Company tests including an “Industry Good” component of the Company with the Owner.

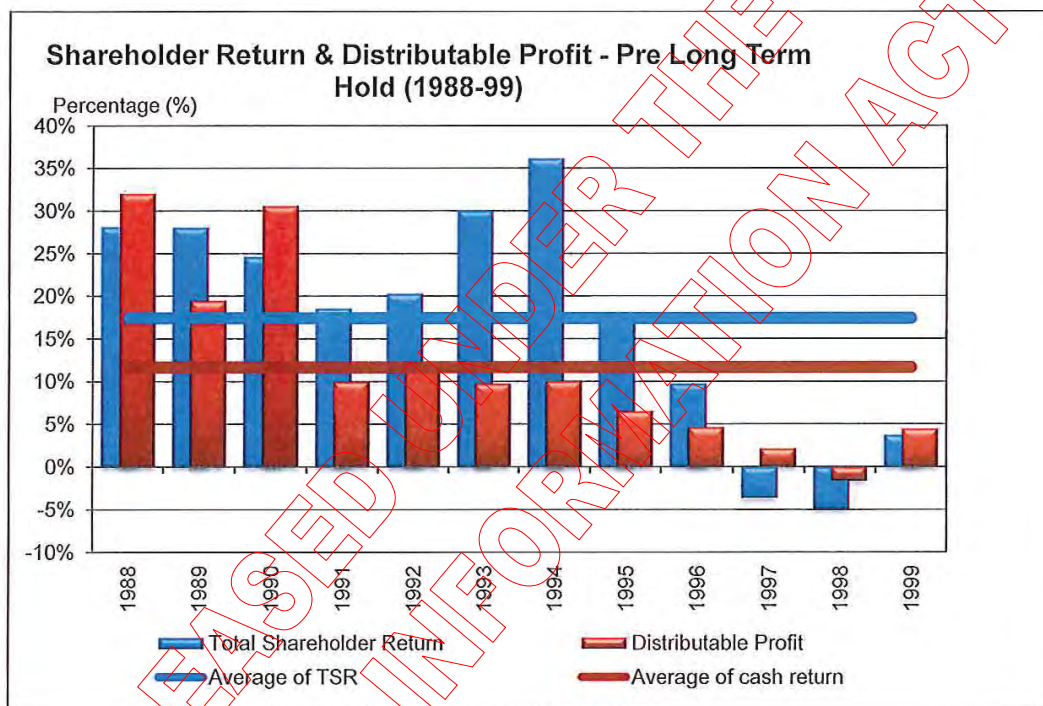
3. KEY RECOMMENDATIONS

1. That Landcorp continue to have some flexibility to continue to improve underdeveloped land, product diversification strategy, leverage critical mass and benchmarking to improve overall performance.
2. That Landcorp continue to lease more land and have an on-going orderly sell down of owned land, that the Molesworth lease is specified in the SCI as a “public good” and that Landcorp Board engage owners to progress the Develop and Sell scenario.
3. That Landcorp discuss with Shareholders the possibility of selling significant parts (land) of the Company.
4. That Landcorp continue to fund to a limited extent, industry good activities consistent with the SOE Act and that:
 - (a) Costs are tracked annually and KPIs established in relation to costs as a percentage of revenue; and
 - (b) These activities are overtly acknowledged in the SCI; and
 - (c) The Company tests extending an “Industry Good” model with the Owner.

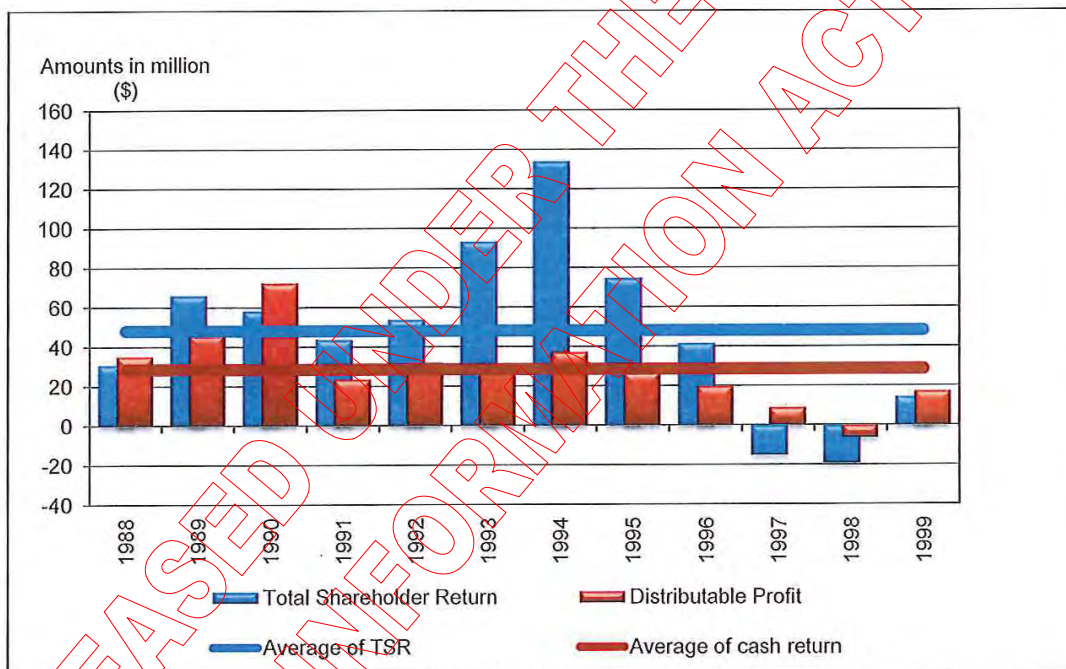
APPENDICES

RELEASED UNDER THE
OFFICIAL INFORMATION ACT

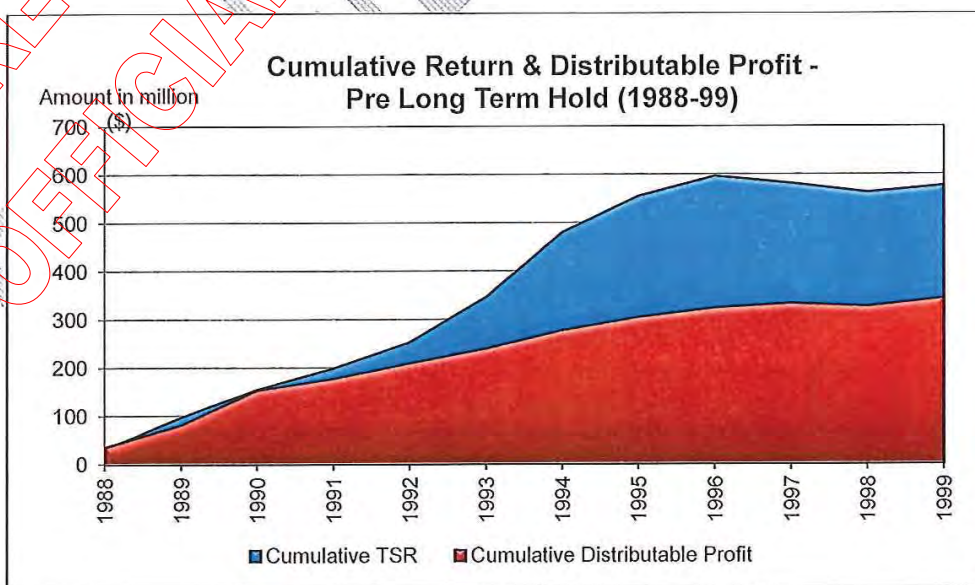
Appendix I



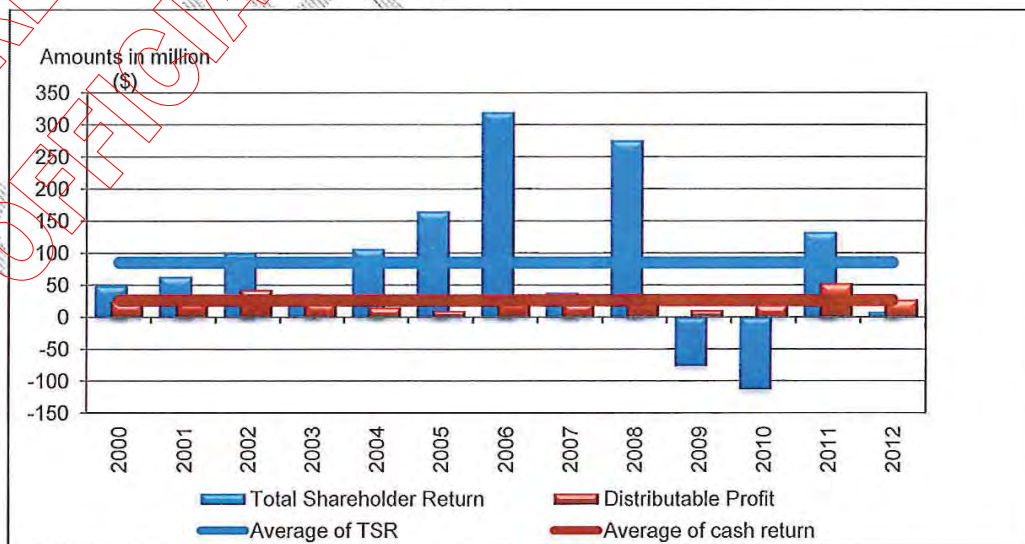
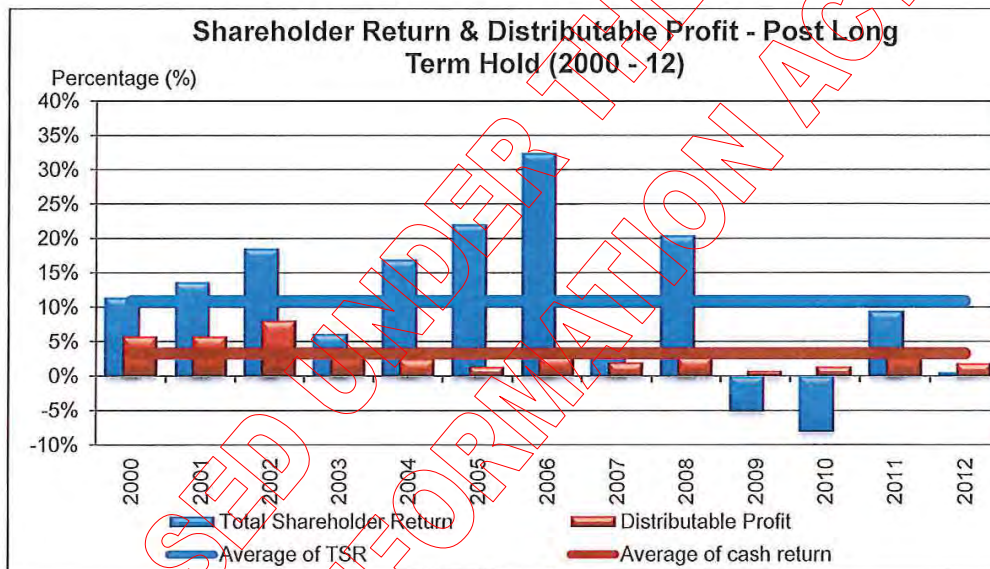
Total Shareholder Return & Distributable Profit

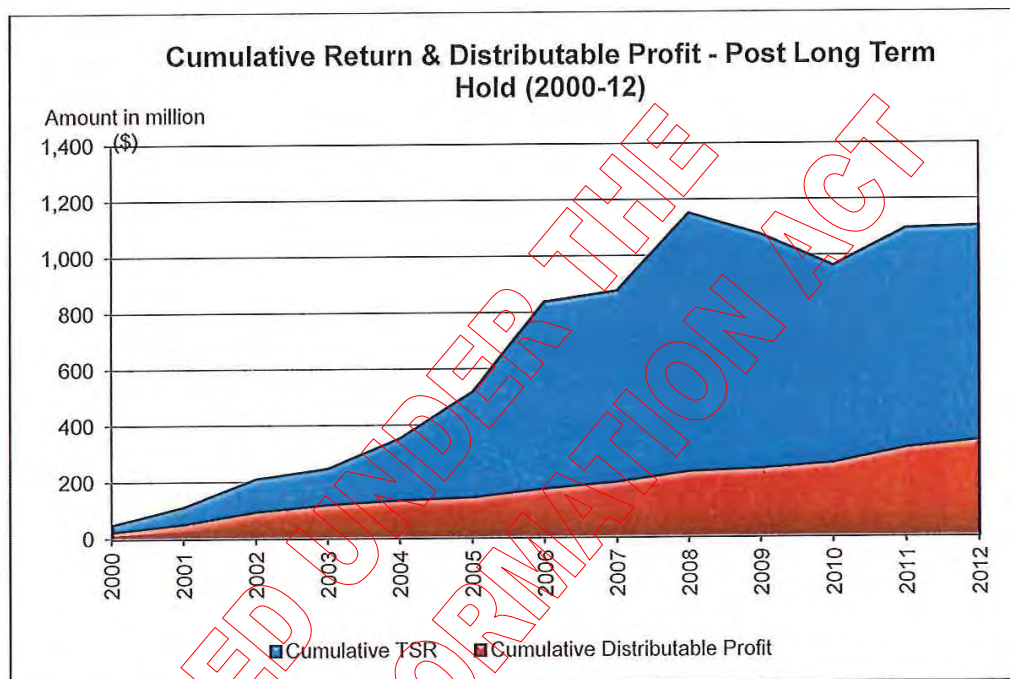


Cumulative Return & Distributable Profit - Pre Long Term Hold (1988-99)

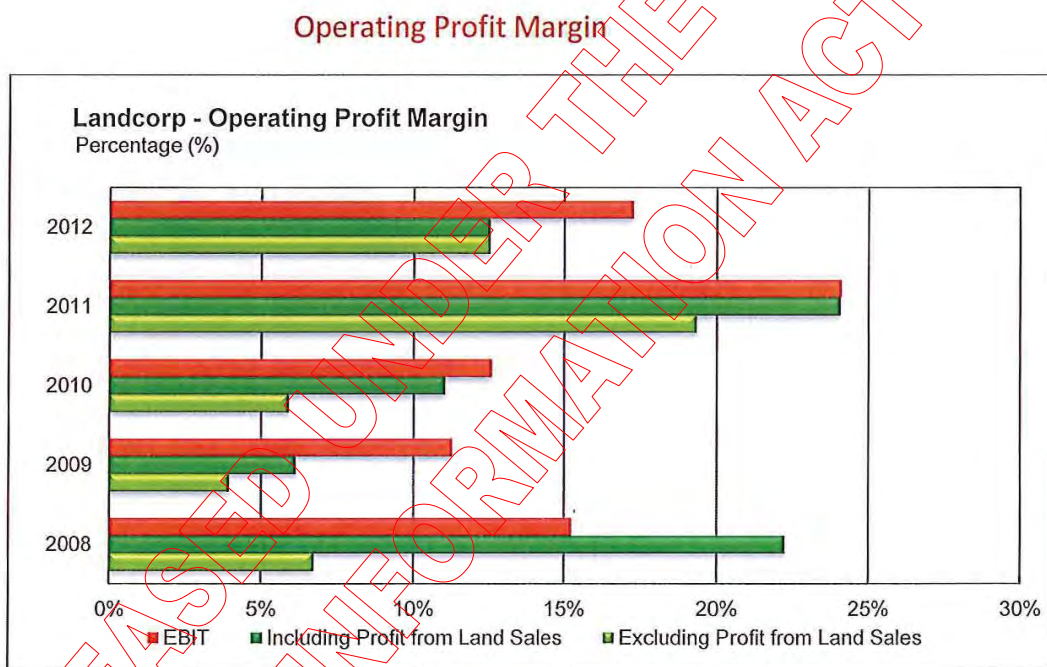


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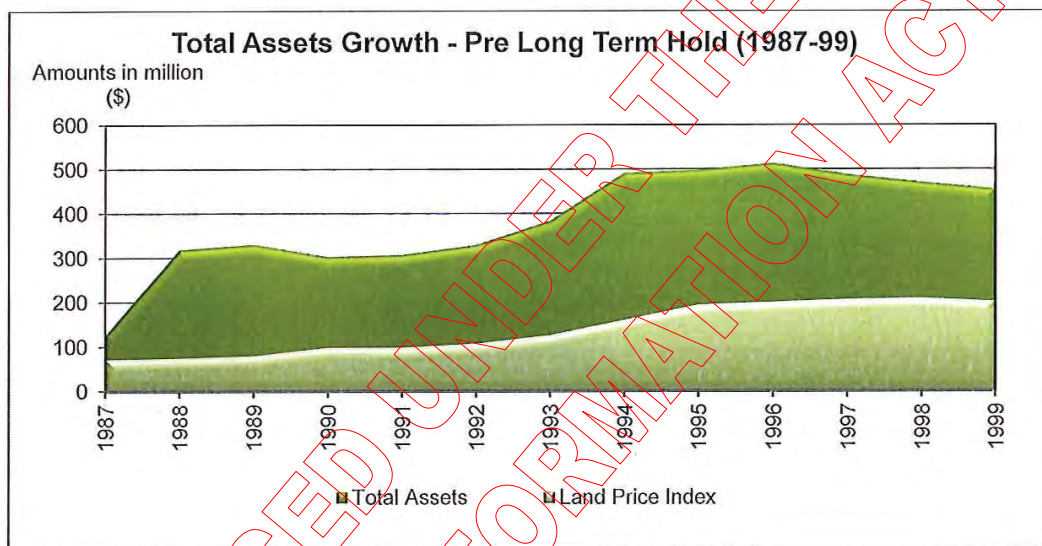




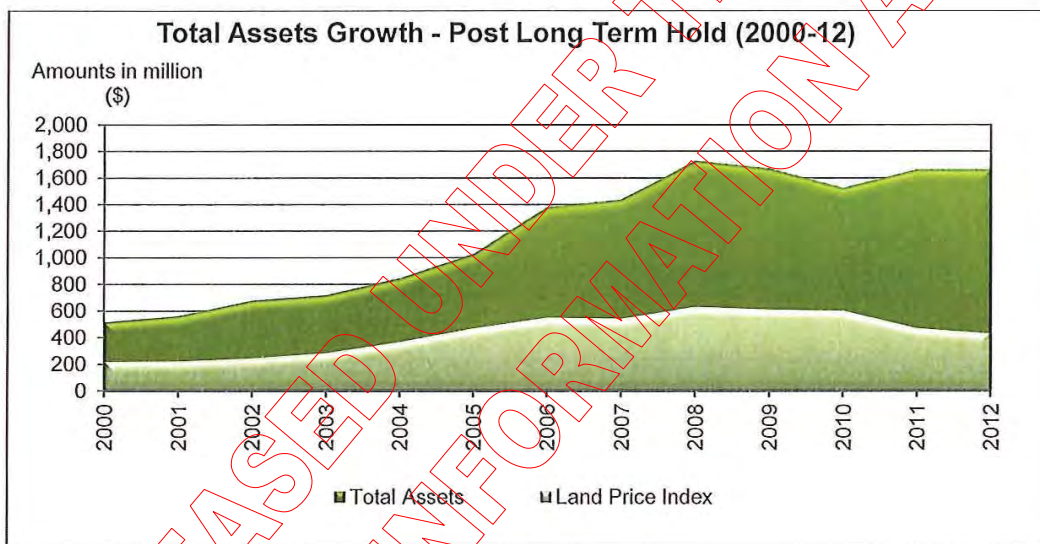
Appendix 3



Appendix 4



Appendix 5

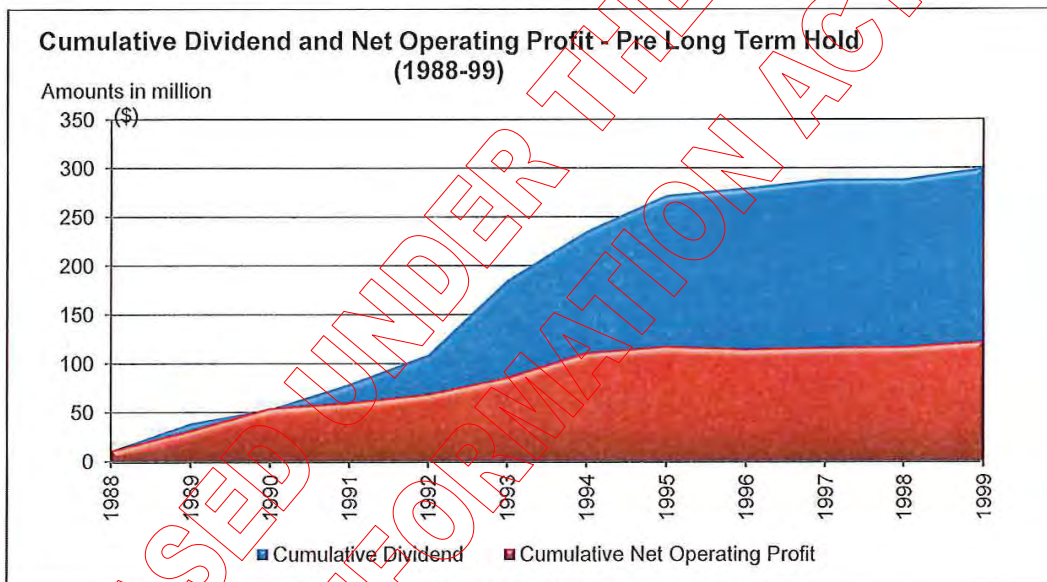


Appendix 6

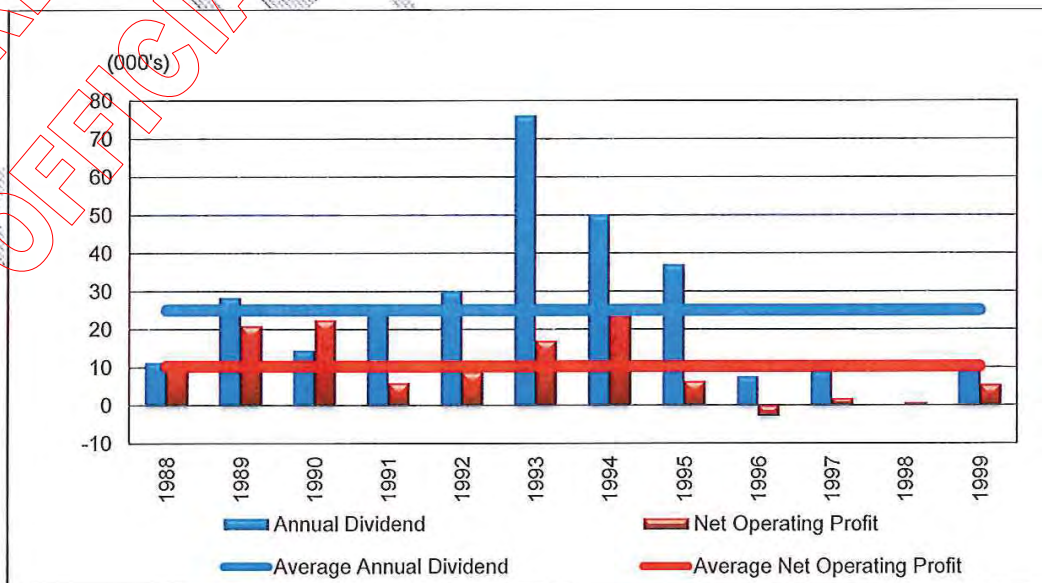
DIVIDEND AND NOP AND ASSETS SALES PROFIT					
Amounts in millions	Annual Dividend	NOP	Div less NOP	Profit from ¹ Asset Sales	Div less NOP & Profit from Asset Sales
1987/88	11.2	11.8	(0.6)	13.4	(14.0)
1988/89	28.3	20.8	7.4	25.1	(17.7)
1989/90	14.4	22.4	(8.0)	50.0	(58.0)
1990/91	25.6	5.8	19.8	17.7	2.1
1991/92	29.9	8.7	21.2	23.3	(2.1)
1992/93	76.0	16.9	59.1	13.3	45.8
1993/94	50.0	25.1	24.9	12.1	12.8
1994/95	37.0	6.3	30.7	20.5	10.2
1995/96	7.5	(2.8)	10.3	22.5	(12.2)
1996/97	9.0	1.7	7.3	7.3	(0.0)
1997/98	0.0	0.6	(0.6)	5.0	(5.6)
1998/99	11.2	5.3	5.9	14.4	(8.5)
1999/2000	8.2	21.5	(13.3)	15.2	(28.5)
2000/01	12.2	32.2	(20.0)	9.3	(29.3)
2001/02	19.6	32.6	(13.0)	12.6	(25.5)
2002/03	34.4	14.6	19.8	9.7	10.1
2003/04	2.0	7.7	(5.7)	7.7	(13.4)
2004/05	5.0	9.9	(4.9)	0.2	(5.0)
2005/06	3.0	5.2	(2.2)	27.1	(29.3)
2006/07	12.0	15.0	(3.0)	7.9	(10.8)
2007/08	13.0	11.0	2.0	25.4	(23.4)
2008/09	10.0	6.9	3.1	3.8	(0.7)
2009/10	18.0	10.0	8.0	8.7	(0.7)
2010/11	27.5	42.2	(14.7)	10.3	(25.1)
2011/12	20.0	27.0	(7.0)	0.0	(7.0)
Total	485.0	358.3	126.6	362.4	(235.8)
1988 to 1999	300.1	122.6	177.5	224.6	(47.1)
2000 to 2012	184.9	235.7	(50.8)	137.9	(188.7)

¹ Profit from asset sales is the difference between book value and sale price. Landcorp estimates that there has been around \$230 million increased value (asset value increases) that has been "cashed" up when assets were sold. See the value of "other equity" Landcorp Annual Report 2012.

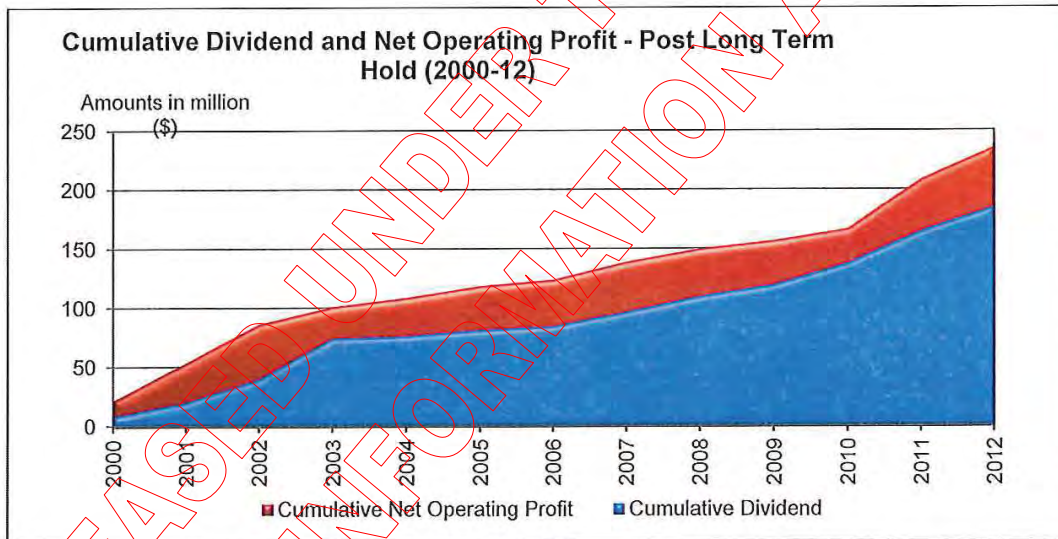
Appendix 7



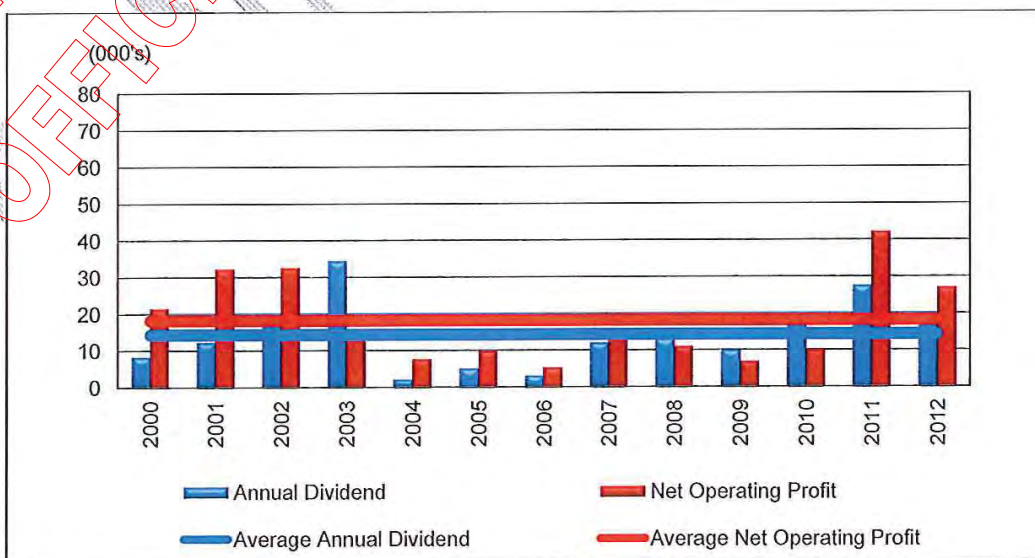
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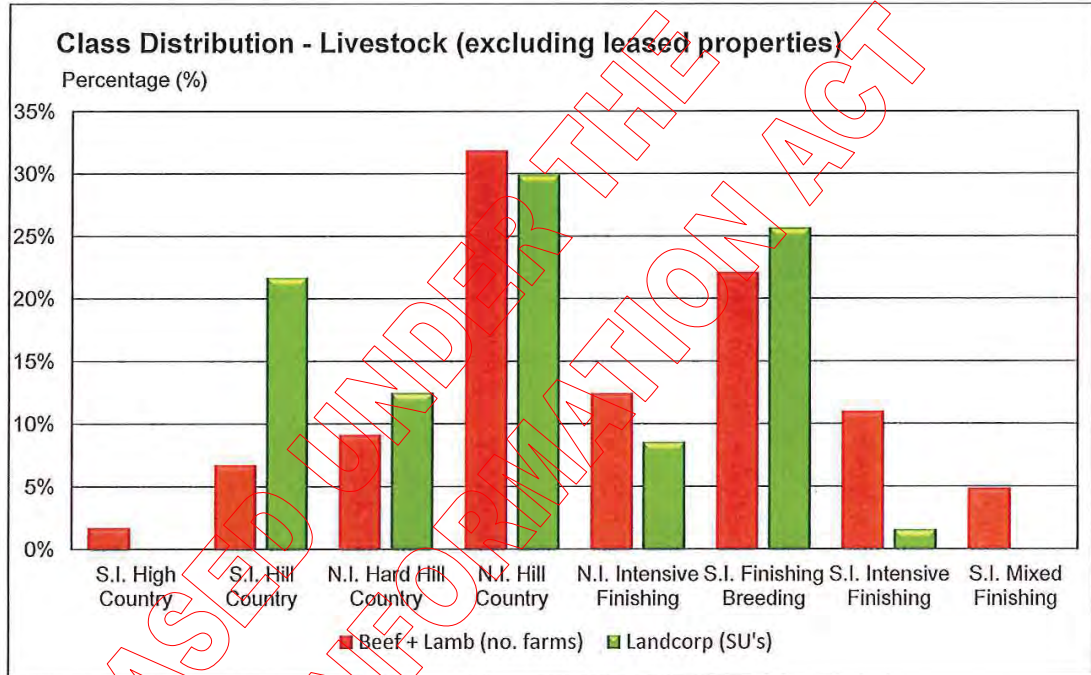
Appendix 9



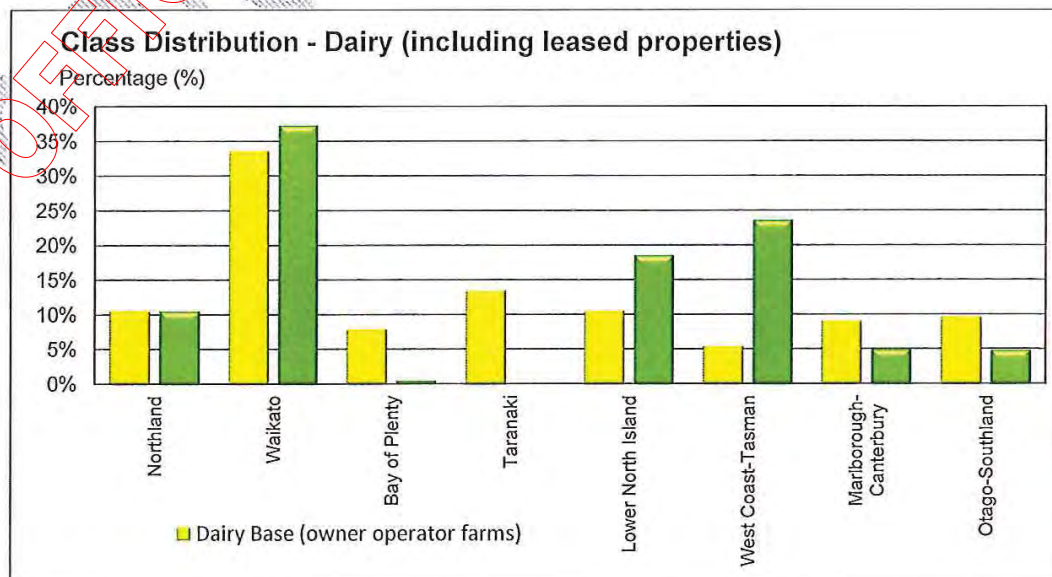
Appendix 10



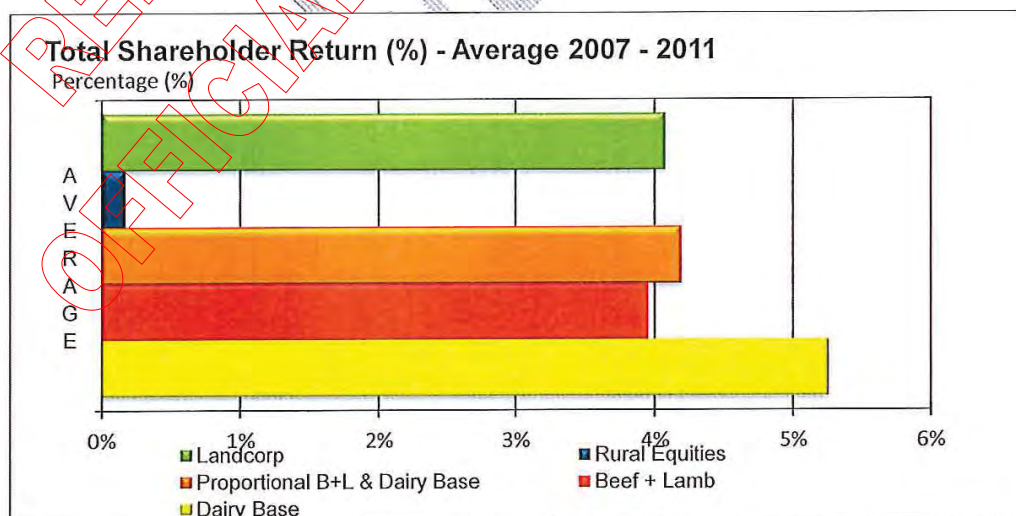
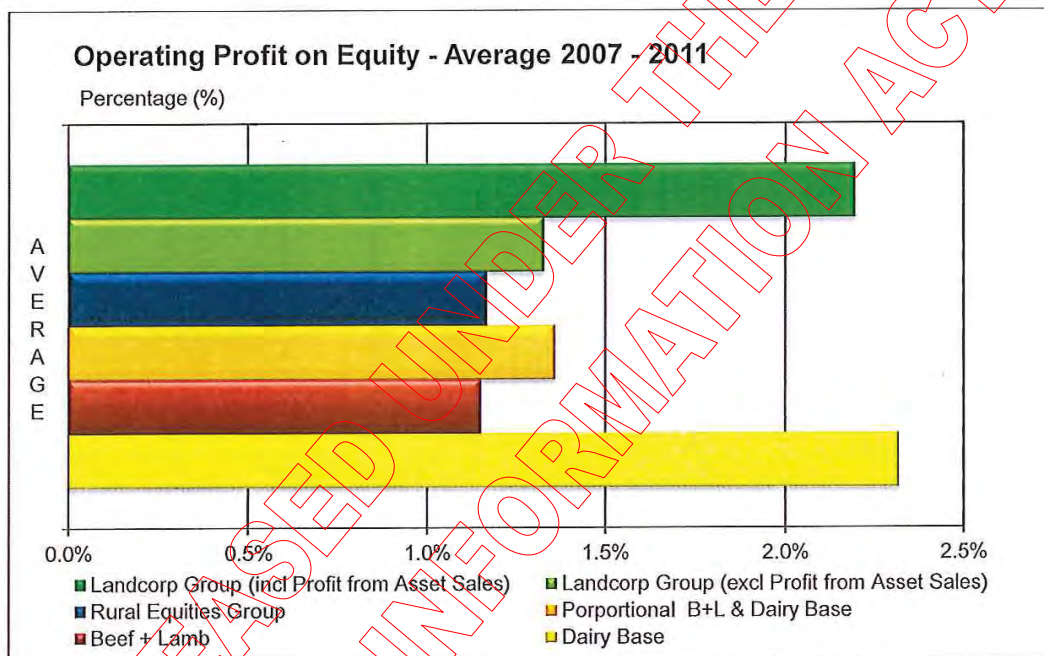
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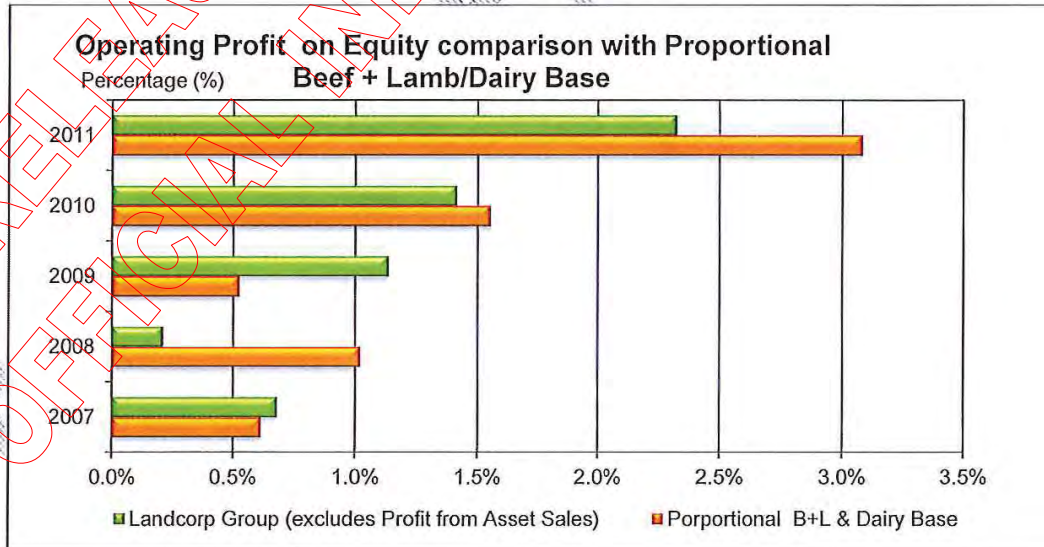
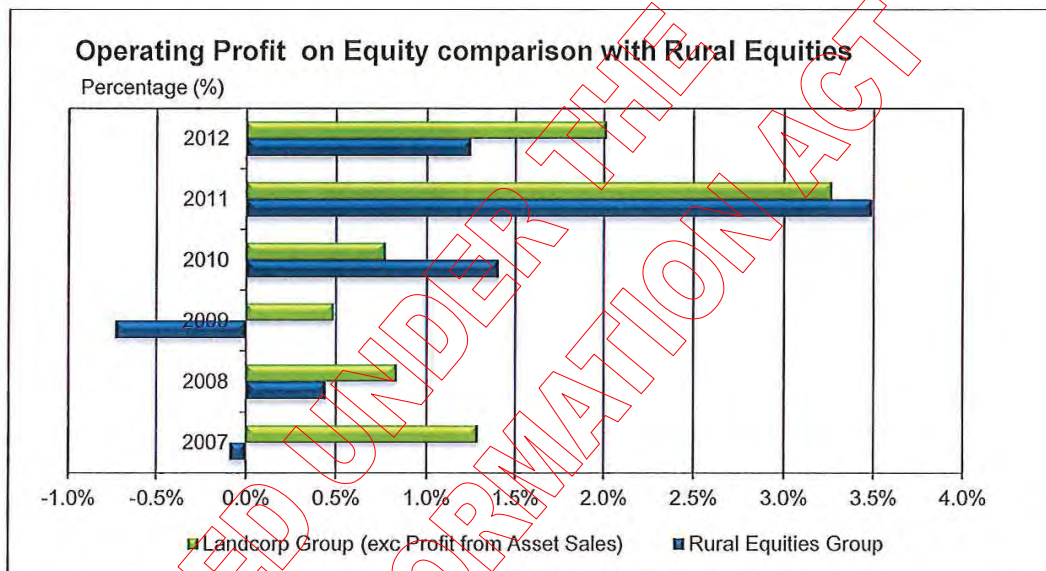


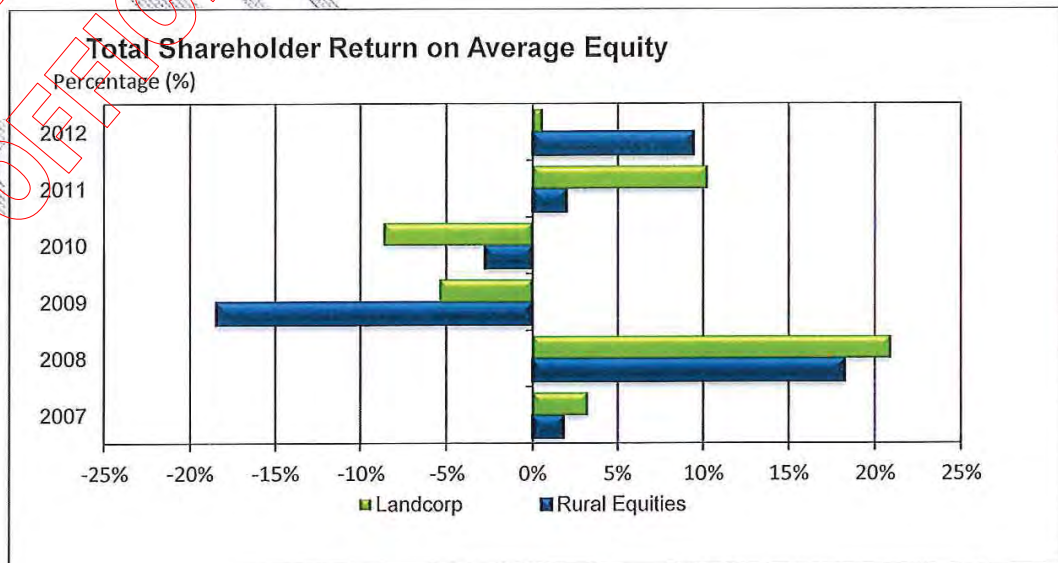
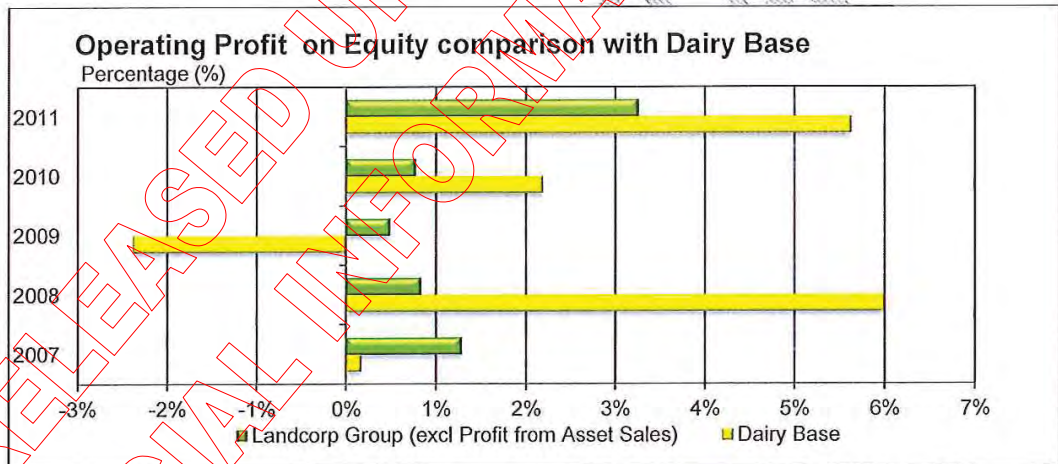
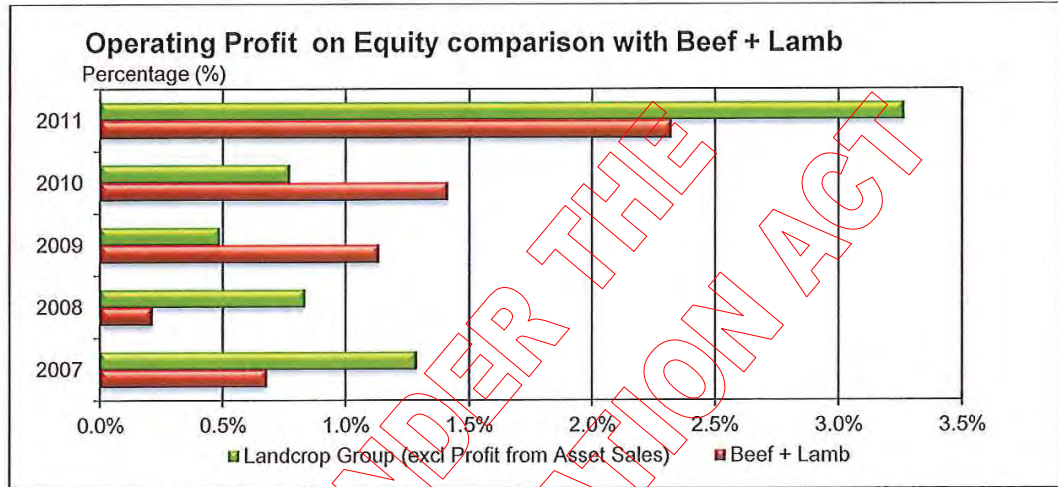
Landcorp has a disproportionate level of South Island high country and less than average finishing. Generally, finishing farmland is more profitable than store farming on hill country.

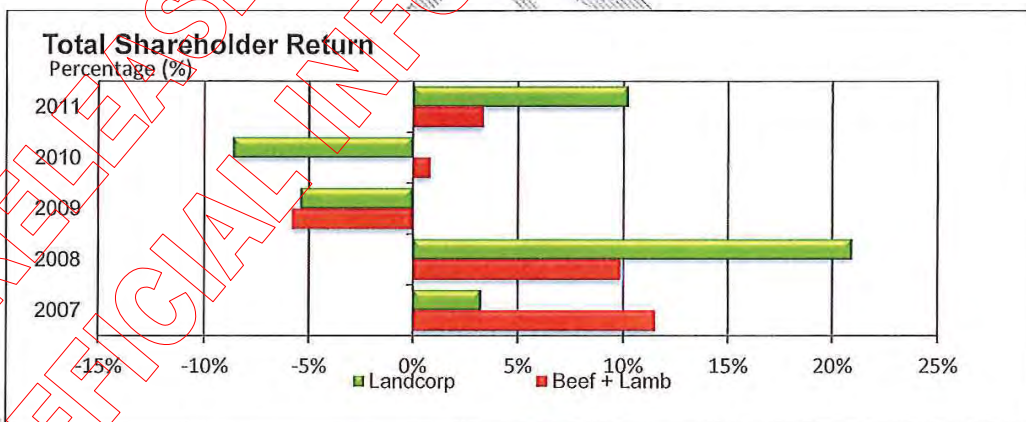
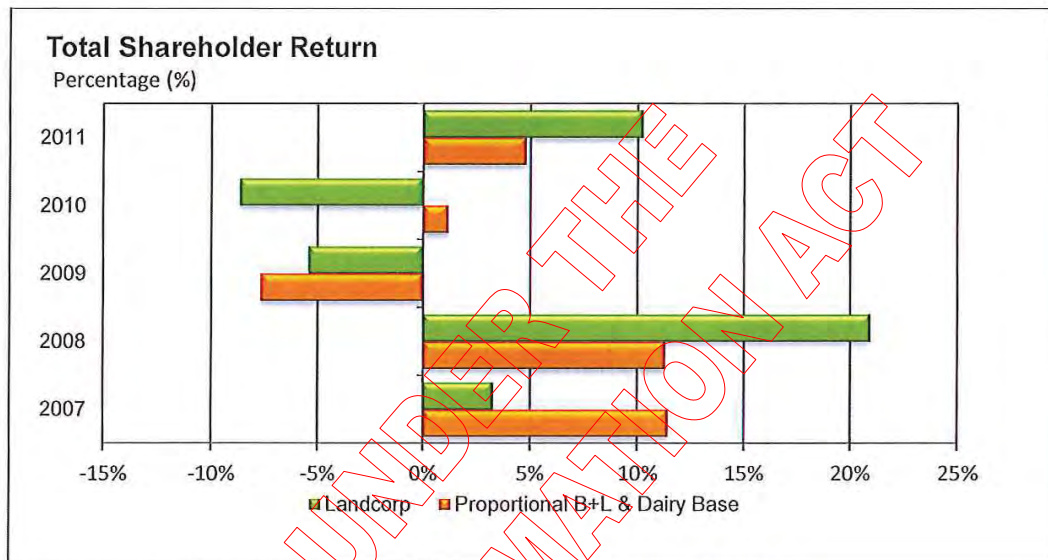


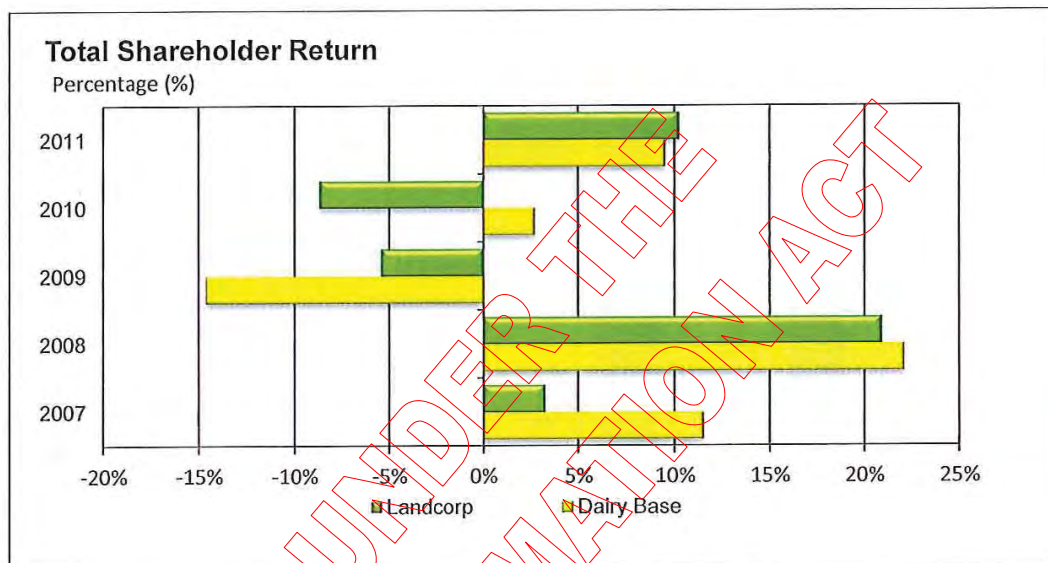
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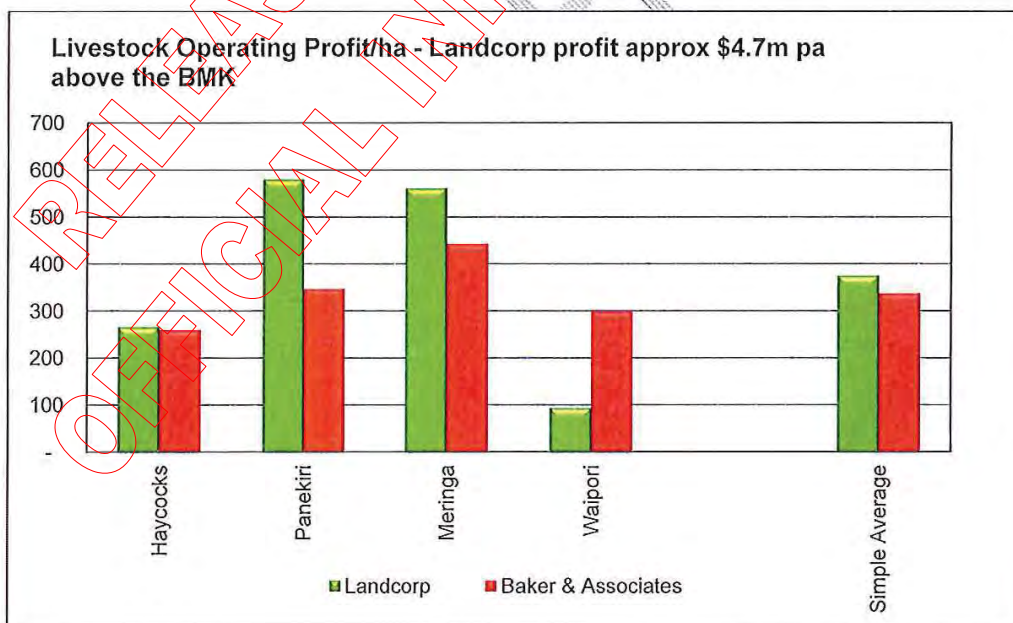
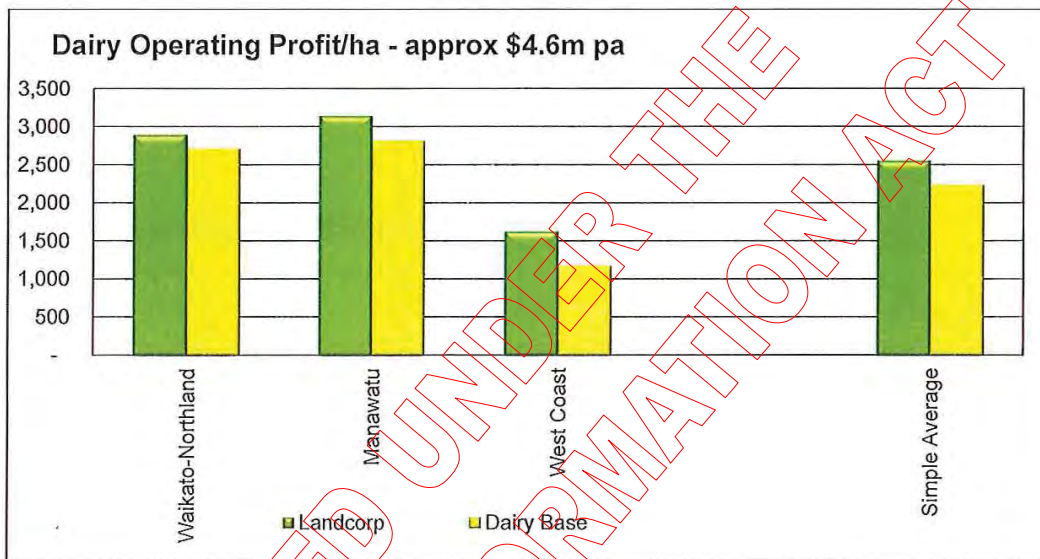




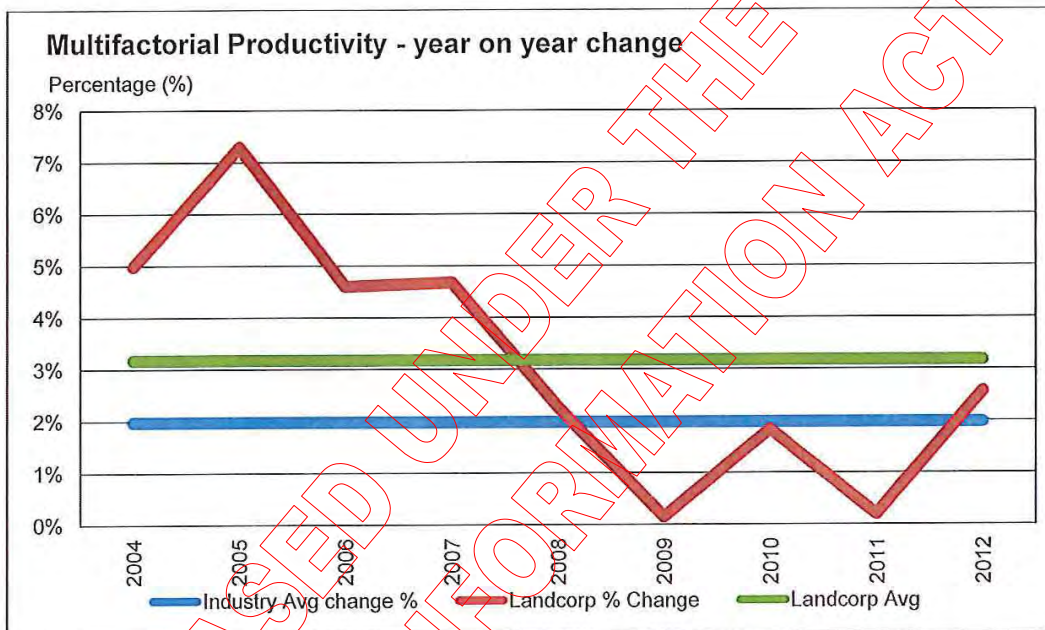




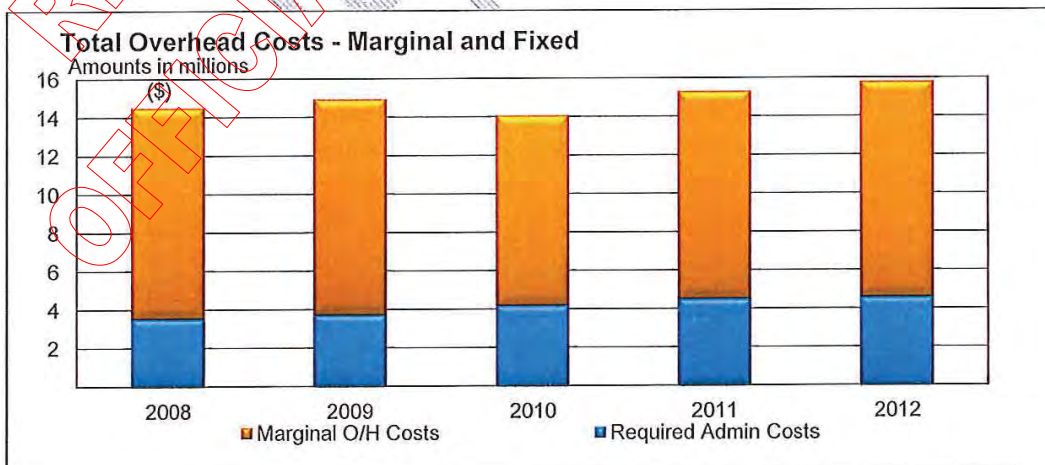
Appendix 13



Appendix 14



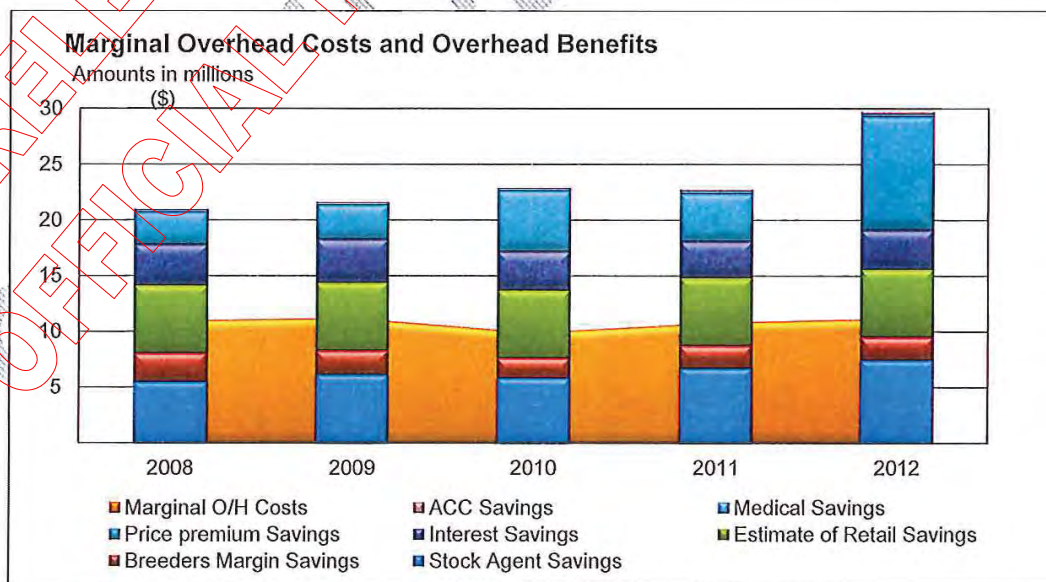
Appendix 15



Appendix 16

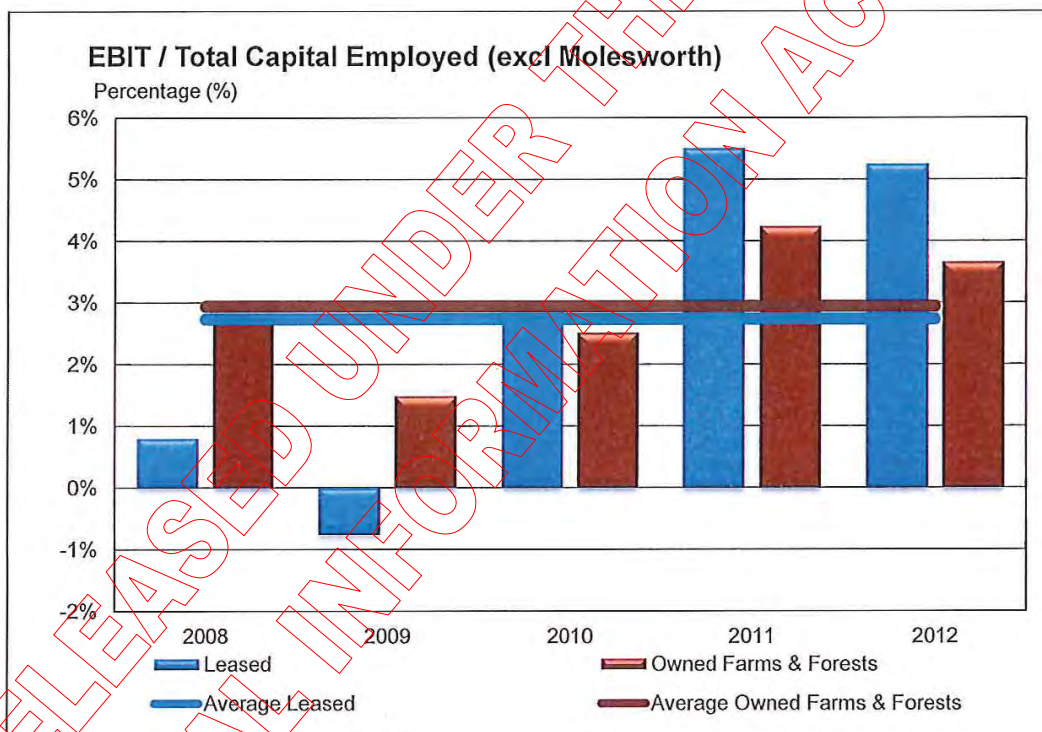


Appendix 17



	Overhead Costs and Benefits (m)				
	2008	2009	2010	2011	2012
Total O/H Cost	14.5	14.9	14.1	15.3	15.8
Beef & Lamb Admin	2.7	2.9	3.0	3.4	3.4
Dairy Admin	0.8	0.9	1.2	1.2	1.2
Less Total Industry Admin Costs	3.5	3.7	4.2	4.5	4.6
Marginal O/H Costs	11.0	11.2	9.9	10.8	11.2
Stock Agent Savings	5.5	6.1	5.8	6.7	7.4
Breeders Margin Savings	2.6	2.2	1.8	2.0	2.1
Estimate of Retail Savings	6.1	6.1	6.1	6.1	6.1
Interest Savings	3.7	3.9	3.5	3.3	3.5
Price premium Savings	2.9	3.1	5.5	4.3	10.2
Medical Savings	0.2	0.2	0.2	0.2	0.3
ACC Savings	0.1	0.1	0.1	0.2	0.2
Total Savings	21.0	21.6	22.9	22.7	29.7
Benefit of O/H	10.0	10.4	13.0	12.0	18.5

Appendix 18



	EBIT / TOTAL CAPITAL EMPLOYED					
	2008	2009	2010	2011	2012	Average
<u>Total</u>	2.7%	1.3%	2.5%	4.3%	3.7%	2.9%
<u>Leased</u>						
Pastoral	(0.2)%	(3.3)%	1.5%	4.6%	4.4%	1.4%
Holdings	10.5%	5.2%	4.8%	3.9%	5.5%	6.0%
Other	(17.0)%	2.4%	4.6%	10.0%	7.5%	1.5%
Total Leased	0.8%	(0.8)%	2.9%	5.5%	5.3%	2.7%
Leased Capital (\$m)	65	91	176	100	99	
<u>Molesworth</u>	1.4%	0.5%	(0.4)%	0.2%	0.2%	0.4%
Molesworth Capital (\$m)	21	21	19	21	18	
<u>Owned Farms & Forests</u>	2.8%	1.5%	2.5%	4.2%	3.7%	2.9%
Owned Capital (\$m)	1,369	1,482	1,288	1,313	1,310	

Appendix 19

These scenarios are, of necessity, high level with Year 1 being best estimate of year-end position in the 2012/2013 year.

Status Quo					
	Years				
(millions)	1	2	3	4	5
Operating Profit (before tax)	5.3	22.9	23.0	30.1	31.6
Equity	1,666.4	1,748.3	1,820.1	1,910.4	1,922.0
Operating Profit on Equity (%)	0.3%	1.3%	1.3%	1.6%	1.6%
Dividend from NOP	20.0 ²	3.0	17.2	17.3	20.0
Dividend from Land Sales	0	1.0	2.8	12.8	0
Debt	251.8	203.2	252.7	273.8	287.5
Interest Coverage	2.65	3.61	2.96	4.09	4.09

² Dividend earned in 2011/2012 year but paid in 2012/2013 year

The Status Quo assumptions include:

- Years 1 to 3 were based on the Landcorp 2012 Business Plan.
- Continuation of expansion and investment in Landcorp Pastoral (around \$20 million per annum).
- A continuation of the 2012 Business Plan farm sales programmes.
- No more farm purchases.
- Ongoing management of SPG farms.
- Assumes recovery of product prices.

Appendix 20

Lessee Company					
	Years				
(millions)	1	2	3	4	5
Operating Profit (before tax)	1.7m	13.6m	35.1m	36.5m	36.4m
Equity	722.6	707.9	672.7	636.1	599.6
Operating Profit on Equity (%)	0.2%	1.9%	5.2%	5.7%	6.1%
Dividend from NOP	27.5	0	10.2	26.3	27.4
Dividend from Land Sales*	820.0	0	0	0	0
(Deposit) Debt	(97.1)	(20.6)	21.3	32.8	34.3
Interest Coverage	NA	NA	0.9	2.2	2.3

*Includes special dividends

The Lessee Model assumes:

- Landcorp sells all land, buildings and forests, and retain all livestock and employees.
- Landcorp pays an annual lease rental of 1.5% per annum of property value on livestock farms and \$1.10 per kilogram of milksolids on dairy farms.
- Debt is retired and on-off "special dividend" is available.
- This is a theoretical model and in reality could not occur all in one year.
- A "lessor" model was also considered but rejected as being impractical.

Appendix 21

Buy/Develop/Sell					
	Years				
(millions)	1	2	3	4	5
Operating Profit (before tax)	17.0	17.5	41.0	46.1	45.4
Equity	1,590	1,496.8	1,384	1,272.9	1,162.6
Operating Profit on Equity (%)	1.1%	1.2%	3.0%	3.6%	3.9%
Dividend from NOP	27.5	12.8	13.1	20.0	25.0
Dividend from Land Sales		37.3	22.9	0	0
Debt	202.0	256.0	276.0	290.0	310.0
Interest Coverage	4.0	2.9	3.2	3.5	3.6

Develop and sell is based on status quo and assumes:

- Higher sale of existing farm holdings and purchase and development of new farms.
- Assumes development profit.
- Farm purchase and development new develop for sale entity.
- Five new farm purchases in year one and six for year two to five respectively at 200 hectares per farm.
- Total capital required for farm purchases - \$133.8 million.
- 12 farms are being sold between year three and five at \$88.2 million with sales profit of \$21.6 million.
- The remaining 17 farms are planned to be sold in the following three years.

Summary

(millions)	Cumulative Profits	Cumulative Dividends	Closing Debt	Average Operating Profit on Equity (%)
Status Quo	112.9	94.0	287.5	1.2
Buy/Develop/Sell	167.0	158.5	310.0	2.5%
Lessee Company	123.3	911.4	34.3	3.8%

Appendix 22

GENERIC ACTIVITIES

ACTIVITY	FUNCTION	BENEFIT	(1) COST (p.a.) \$	HOURS (pa)
➤ Lifting company profile.	<ul style="list-style-type: none"> ➤ Addresses to groups. ➤ Attending functions. ➤ Field days on farms. 	<ul style="list-style-type: none"> ➤ "First mover advantage". ➤ (SPG/WPL). ➤ Acceptance in communities. ➤ Sharing of "best practice". 	75,000	350
➤ Sponsorships.	<ul style="list-style-type: none"> ➤ Increasing mana in local communities. ➤ Supporting rural initiatives. ➤ Specific support (school buses). 	<ul style="list-style-type: none"> ➤ Staff feel "wanted" in communities. 	250,000	10
➤ Environmental stewardship.	<ul style="list-style-type: none"> ➤ QEII and associated activities. 	<ul style="list-style-type: none"> ➤ Landcorp nationally recognised. ➤ Keeps the "greens" on side – saves \$ on "fighting fires". 	600,000	400
➤ Policy Influencing.	<ul style="list-style-type: none"> ➤ Attending workshops. ➤ Early engagement of DOC, MfE, MPI. 	<ul style="list-style-type: none"> ➤ Early warning of policy changes. ➤ Ability to influence outcomes in Landcorp's favour. 	30,000	100
➤ R & D.	<ul style="list-style-type: none"> ➤ Funding specific initiatives. 	<ul style="list-style-type: none"> ➤ Subsidised funding of some Landcorp specific issues: <ul style="list-style-type: none"> ▪ Manuka Beetle ▪ Johnes in deer ▪ Triplet survival. 	800,000	20
			\$1,755,000	880

(1) Includes Capital

Appendix 23

Industry Good Model

It is extremely difficult to estimate the overall benefit of extending industry good activities as this will depend on the nature and extent of the extension.

The following are examples of possible benefits and further detailed analysis would be required to quantify this further.

Some relevant considerations include:

1. Improving industry productivity: Journeaux in 2012³ has analysed productivity of sheep, beef and dairy farmers. Key findings include:

- In 2011/12 the top 10% of dairy farms were 65% more profitable than the average farm and 185% more profitable than the bottom 10%.
- In 2009/10 the top 10% of sheep and beef farms were around twice as profitable as the average and 32 times more profitable than the bottom 10%.
- The value to the dairy industry if the average farm was lifted to that of top farms using 2010/11 data, was estimated at \$3 billion.

³ See "The relentless treadmill. The need for productivity gains" NZIPM Magazine, Volume 16, Number 4, December 2012.

2. Training

- AGITO have calculated the average value added to a dairy farm by an Agriculture ITO trainee per year to be \$8,327⁴.
- The ratio of return on dairy training investment is 3.4:1.
- The dairy returns include:

Feed utilisation	\$ 4,437
Heat detection	\$ 2,284
Lameness	\$ 925
Mastitis	<u>\$ 691</u>
	\$ 8,337

- Sheep and beef farms have average value added by AGITO trainee per year of \$17,400 or \$60 per hectare.
- The ratio of return on sheep and beef investment is 4.9:1.
- The sheep and beef returns include:

Animal Management	\$ 7,250
Stockmanship	\$ 2,900
Pasture Management	<u>\$ 7,250</u>
	\$17,400

- ## 3. In 2009, Landcorp and AgResearch were reviewing the potential benefits of a merged operation⁵:

⁴ 2005 figures.

⁵ Outlined in the confidential draft report on the merger.

- The report estimated that lifting 25% of average farmers to Landcorp's current productivity level would provide approximately \$80 million annual gain (18% increase in on-farm EBIT) to the industry.
- Landcorp adopted AgResearch's recommendations for managing drench resistance around 2000 and has no significant drench resistance problems. This is in contrast to the wider industry where drench resistance is estimated to cost \$20 million per annum.

4. In 2007, COMU considered various alternatives for Landcorp to deal with sensitive land sales. Ultimately this resulted in the creation of Landcorp Holdings Ltd. One option considered was that Landcorp cease to be an SOE and would become an entity under the Crown Entity Act 2004, with a range of semi-commercial and/or commercial objectives.

The benefits are perceived as:

- Providing Ministers more flexibility in terms of determining the use for Landcorp assets.
- Potentially the company could continue with some success as a commercial farmer, depending on the strength of the commercial imperatives of the Crown Entity Company. However, these commercial imperatives would be weaker than those of an SOE Act company.

The costs were perceived to include:

- Landcorp's profitability could diminish significantly and there would be a loss of commercial value.

- The option does not deal with the issue of Landcorp requiring capital to meet its contractual obligations and debt servicing. There would be some initial establishment costs and on-going maintenance costs. Separate legislation would be required to remove Landcorp from the SOE Act.
- These costs were considered to override any potential benefits at that time. It is very uncertain in the current political environment whether anything material has changed in this regard.

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Treasury Report: Landcorp: 2013 Draft Statement of Corporate Intent and Business Plan

Date:	23 August 2013	Report No:	T2013/1367
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Agree to the recommendations	Friday, 30 August 2013
Associate Minister of Finance (Hon Steven Joyce)	For your information	None
Minister for State Owned Enterprises (Hon Tony Ryall)	Agree to the recommendations and sign the attached letter to the Chair of Landcorp Farming	Friday, 30 August 2013
Associate Minister of Finance (Hon Dr Jonathan Coleman)	For your information	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Heidi Giles	Senior Advisor	s9(2)(k) N/A (mob)	✓
James Cunningham	Manager, Monitoring - Commercial	s9(2)(a)	

Minister for State Owned Enterprises' Office's Actions

Send the attached letter to Landcorp Farming Ltd's Chair and a copy to the Chief Executive.

Enclosure: Yes ([Landcorp 2013 SCI \(01.07.13 version\):2699575](#))

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23 August 2013

SE-2-8-1

Treasury Report: Landcorp: 2013 Draft Statement of Corporate Intent and Business Plan

Executive Summary

Landcorp Farming Ltd (Landcorp) has delivered its draft 2013 Statement of Corporate Intent (SCI) and Business Plan.

The SCI and Business Plan discuss Landcorp's nine key initiatives for the three years of the plan, of which COMU considers the following to be the most significant:

- Sale and purchase of land
- Shanghai Pengxin Group (SPG) and overseas partnerships; and
- Wairakei Pastoral Limited (WPL) agreements.

Special dividends and property sales

Landcorp has budgeted for property sales of \$115 million over the three-year plan compared to \$151 million in the prior year's plan. Landcorp has reduced the overall level of sales expected as a response to market conditions i.e. it is proving more difficult to sell properties than originally expected. The largest sale expected in 2012/13, the Pouarua dairy complex for over \$50 million is now expected to occur in late-2013/early-2014.

Even with this reduced level of planned property sales, COMU believes that achieving these sales will be challenging and that poses a significant risk to Landcorp's 2013-2016 Business Plan. Should these not be achieved the special dividends will not be paid and some WPL development would potentially need to be delayed.

The proceeds from the budgeted sales will be used for two main purposes: the first is to fund special dividends of \$30 million forecast over the three years of the plan, and the second is to fund the capital expenditure program.

In total, the 2012/13 plan included special dividends of \$64 million compared to \$30 million in the current plan. This decrease is mainly due to the reduction in expected property sales of \$36 million. Landcorp has already planned to increase debt levels to help fund the capital expenditure program given it has decreased revenue expectations, and therefore there is no room to maintain special dividends at the level previously forecast.

Property acquisitions

Landcorp considers it has skills in the development of farms and recognises there are opportunities for it to selectively purchase properties for development and later sell them for a profit. The prior plan included a total budget of \$37 million for the purchase of such properties. Landcorp has not included a budget in the current plan for purchases for development, as it has decided to wait until the impending independent Strategic Review has been completed before clarifying its strategy in this regard.

However, as in the prior year, Landcorp has budgeted \$9 million over this three-year plan to acquire, in certain circumstances, properties adjacent to existing Landcorp farms which would enable productivity efficiencies to be derived. This is small scale and makes commercial and economic sense.

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Shanghai Pengxin and Wairakei Pastoral Joint Ventures

During 2012/13 Landcorp commenced farming, under a joint venture agreement, land owned by SPG in New Zealand (previously known as the Crafar farms). Landcorp supplies the stock, management and development expertise and to this end took over the share milking agreement at the start of the new season on 1 June 2013. In 2012/13 Landcorp spent approximately \$30 million to purchase dairy cattle and machinery for this venture.

Landcorp is contractually bound, under agreements signed in August 2004, to provide capital to develop infrastructure on land deforested by WPL for dairy farming. During this plan, Landcorp expects to spend \$91 million on the development of WPL farms and on the construction of dairy infrastructure. Additionally, it expects to spend \$21 million on the acquisition of approximately 18,000 dairy cattle for the WPL farms.

Financial Forecasts

Landcorp's financial forecasts show a decrease in Net Operating Profits (NOP) for the 2013/14 and 2014/15 years from the prior plan. This is due to the ongoing impact of the drought in early-2013 and also due to the deferred timing of milk revenue from the WPL conversions.

As well as financial performance targets, Landcorp measures its performance against a range of non-financial performance targets. COMU believes it is appropriate that Landcorp places strong emphasis on non-financial performance targets as these ensure that its operational performance, stripping out the impact of the fluctuating commodity prices, can be tracked.

Landcorp faces an inherent business risk from exposure to fluctuating international commodity prices and has carried out sensitivity analysis on the potential impact of this in the 2013/14 financial year. If commodity prices realised are as budgeted Landcorp expects to achieve a net profit after tax (NPAT) of \$6 million. As an indication of the level of sensitivity, a +/- 10% movement in these prices is expected to result in an NPAT in the range of -\$16 million to +\$28 million. If the downside scenario were to eventuate it would impact on Landcorp's ability to pay an ordinary dividend. Conversely, there is the potential for an increased ordinary dividend should the upside scenario eventuate.

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Recommended Action

We recommend that you:

- a **note** that Landcorp has delivered its draft 2013/14 Statement of Corporate Intent (SCI) for shareholding Ministers' comments
- b **note** that Landcorp has not included any property purchases for development purposes in this plan
- c **note** that during the three-year term of this plan Landcorp has budgeted s9(2)(b)(ii) of capital expenditure in relation to the Wairakei Pastoral Limited agreements. This is for the development of farmland, dairy farming infrastructure and the purchase of approximately 18,000 dairy cattle
- d **note** that Landcorp intends to realise \$115 million from property sales over the next three years and to use \$30 million of these proceeds to pay special dividends. The balance will be used to fund the capital expenditure program
- e **note** that if planned sales do not eventuate this will impact on Landcorp's ability to pay special dividends
- f **note** that COMU and Landcorp will be jointly commissioning an independent Strategic Review later this calendar year, and
- g **agree** that the Minister for State Owned Enterprises should sign the attached letter to the Chair of Landcorp, on behalf of shareholding Ministers, asking the company to submit 50 copies of its SCI for tabling in the House of Representatives.

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister for State Owned Enterprises

James Cunningham
Manager, Monitoring - Commercial

Hon Bill English
Minister of Finance

Hon Tony Ryall
Minister for State Owned Enterprises

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Treasury Report: Landcorp Farming Ltd: 2013 Business Plan and Draft Statement of Corporate Intent

Purpose of Report

1. This report provides a summary of the key issues and content of Landcorp Farming Ltd's (Landcorp's) draft 2013 Statement of Corporate Intent (SCI) and Business Plan and recommends that the SCI, in its final form, be tabled in the House of Representatives.

Background

2. As an asset-intensive company, Landcorp's total shareholder return is strongly linked with the long-run history of increasing farm values. For the Crown to realise these gains on an ongoing basis, Landcorp considers it would need to be able to freely purchase, develop and sell properties.
3. Landcorp has not included any land purchases for development purposes in this plan. It has decided to wait until the impending independent Strategic Review has been completed to help determine its future strategy.
4. As a result this plan is largely in line with the prior year's plan and could be described as a "business as usual" plan. We believe this is an appropriate position for Landcorp to take at this point in time.

Strategy and Risks

Strategy

5. Although a significant part of Landcorp's operational focus will be on "business as usual" there are nine key initiatives identified in the 2013 SCI:
 - people and capability development
 - optimisation of the use of water assets throughout the farming portfolio
 - Farm^{IQ} Systems Limited – Landcorp is a partner in Farm^{IQ} whose vision is to create a demand driven integrated value chain for red meat
 - benchmarking will be used to lift on-farm performance
 - use of productivity measures and marketing
 - sale and purchase of land
 - Shanghai Pengxin Group (SPG)
 - overseas partnerships; and
 - Wairakei Pastoral Limited (WPL) agreements.

Sale and Purchase of Land

6. Landcorp has budgeted for property sales of \$115 million over the three-year plan (\$75 million in 2013/14, \$23 million in 2014/15 and \$18 million in 2015/16), compared to \$151 million in the prior year's plan. Landcorp has reduced the overall level of sales expected as a response to market conditions, i.e. it is proving more difficult to sell properties than originally expected.

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7. Landcorp forecasts that in 2012/13 \$9 million of land and developments will have been sold compared to the budget of \$67 million for this period included the prior year's plan. This budget included the expected sale of the Pouarua dairy complex for over \$50 million. Pouarua is being purchased by an Iwi consortium using the proceeds of a Treaty of Waitangi settlement and the sale is now expected to occur in late-2013/early-2014.
8. The proceeds from the budgeted sales will be used for two main purposes, the first is to fund the special dividends of \$30 million forecast over the three years of the plan and the second is to fund the capital expenditure program.
9. Landcorp considers it has skills in the development of farms and recognises there are currently opportunities for it to selectively purchase properties for development, which could then be sold at a profit. In the prior year's plan Landcorp budgeted \$37 million over the three years for the purchase of farms for development, but no purchases eventuated in the 2012/13 year. In the current plan Landcorp has not budgeted any purchases for development opportunities. Landcorp has indicated that it will wait until the impending independent Strategic Review has been concluded before progressing this strategy, if it is progressed at all.
10. As in the prior year's plan, Landcorp has included a nominal amount of \$3 million per year for small strategic land purchases. This budget would be utilised if, for example, a section of land came onto the market, in a location where Landcorp could leverage off infrastructure on one of its existing farms. Compared to Landcorp's current land and improvements holdings, which are in excess of \$1.3 billion, we think this amount is reasonable and makes commercial sense.

Shanghai Pengxin Group (SPG) and Overseas Partnerships

11. Landcorp has identified that Asia, and China in particular, is becoming a more significant trading partner to New Zealand. New Zealand food products, especially milk solids are being sought after and valued by the Chinese.
12. Landcorp's 'China strategy' has three stages. The first is to understand the Chinese way of doing business in a farming context. This stage is already underway with Landcorp farming, under a joint venture agreement, land owned by SPG in New Zealand (previously known as the Crafar farms). Landcorp supplies the stock, management and development expertise and took over the share milking agreement at the start of the new season on 1 June 2013. In 2012/13 Landcorp spent approximately \$30 million to purchase dairy cattle and machinery for this venture.
13. The second stage is to understand farming in China and the third will see Landcorp investigating ways to assist its Chinese partners with exports of New Zealand produced and packaged dairy products into China. Landcorp has confirmed that it will take a considered approach to expanding its business interests in China.

Wairakei Pastoral Limited (WPL)

14. Landcorp is contractually bound, under agreements signed in August 2004, to provide capital to develop infrastructure on land deforested by WPL for dairy farming.
15. A further 4,500ha is being deforested by WPL for farming and will be developed by Landcorp during the 2013-2016 period. This will require considerable expenditure by Landcorp s9(2)(b)(ii) for the development of milking facilities and the purchase of approximately 18,000 dairy cows.

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Risks

16. Landcorp identifies that the main risks it faces in trying to meet its financial performance targets are the fluctuating exchange rates and international commodity prices. Additionally, COMU considers there is a risk in the 2013 plan if the planned sales of properties do not eventuate or do not realise the expected return. In the 2012/13 financial year one property sale did occur but Landcorp feels that the market is moving slower than it had expected a year ago. As a result, it has reduced the level of property sales it is expecting in the current plan, but we feel that this lower level will still be challenging to achieve.
17. Landcorp attempts to manage the financial risk resulting from fluctuating exchange rates by implementing financial risk management policies in line with Landcorp's Treasury Policies.
18. Landcorp aims to mitigate the risk around fluctuations in commodity prices by maintaining a mix of species, i.e. sheep, deer, dairy and beef. Additionally, Landcorp has again included marketing in the 2013 SCI as a key initiative, with a continuing focus on using its size in the industry to try and increase the amount of product sold through fixed price agreements.
19. Landcorp has carried out sensitivity analysis on the potential impact of fluctuating international commodity prices in the 2013/14 financial year. If commodity prices realised are as budgeted, Landcorp expects to achieve an NPAT of \$6 million. As an indication of the level of sensitivity, a +/- 10% movement in these prices is expected to result in an NPAT in the range of -\$16 million to +\$28 million. If the downside scenario were to eventuate it would impact on Landcorp's ability to pay an ordinary dividend. Conversely, there is the potential for an increased ordinary dividend should the upside scenario eventuate.
20. Treasury has considered Landcorp's expectations of commodity prices over the period of this plan and we are comfortable that the figures used in this plan are broadly in line with the expectations published by the Ministry for Primary Industries.
21. The series of special dividends referred to in this plan (\$30 million in total) are dependent on the planned property sales occurring. If no sales were to occur in the 2013/14 year then, even without paying any special dividend, Landcorp would have a cash shortfall and be unable to meet its planned capital expenditure programme. Landcorp has confirmed to COMU that should this situation arise it has the option to slow down capital expenditure on WPL. An example of this would be to defer the planned irrigation of certain paddocks.
22. Subsequent to the drought in early-2013, on 31 March 2013, Landcorp had an interest coverage ratio of 1.29 compared to the ratio of 2.25 required by its lending banks. As this ratio is only tested at 30 June and 31 December each year, this did not result in Landcorp breaching its covenants. This was a short-term situation and the ratio was within the banking covenants when next tested on 30 June 2013. However, this event did show how quickly and significantly climatic conditions can impact its cash flow, and hence its interest coverage ratio. For this reason we believe it is appropriate for Landcorp to avoid significantly increasing its bank debt from the current level.

COMMERCIAL-IN-CONFIDENCE**Performance****Financial Performance – 2012/13**

23. At the time of preparing the SCI Landcorp forecast its 2012/13 NPAT to be \$2 million compared to a budget set at the start of the year of \$13 million. However, subsequent to this, at the end of July 2013, Landcorp announced that it now expects its 2012/13 NPAT to be around \$13 million (NB: this will be subject to final adjustments and audit). We believe that this is a good result for Landcorp given the impact of the drought in early-2013 and the low commodity prices during the year.

Financial Performance – Forecasts**Table 1. Forecast outlook and comparison with last year's SCI**

Net Operating Profit (excl land and stock revals) (\$ millions)	2012/13	2013/14	2014/15	2015/16
2012 SCI	12.7	17.8	32.4	
2013 draft SCI	2.0*	6.1	15.9	29.0
Variance	-10.7	-11.7	-16.5	n/a

Source: Landcorp's 3-year Business Plan 1 July 2013 – 30 June 2016

* Subsequent to preparing this plan and submitting it for shareholding Ministers' comments, Landcorp has stated that it expects its 2012/13 Net Operating Profit to be \$13 million.

24. The reduction in expected 2013/14 Net Operating Profit (NOP) is largely due to a reduction in livestock revenue. This reflects a lower number of cattle and lambs available for sale and fewer finishing farms carrying over previous season's lambs as a result of the drought in early-2013.
25. The 2014/15 NOP expectation has also decreased from the prior year's plan. This is due to the WPL conversions being slower than expected one year ago and lower expectations of commodity prices impacting on budgeted livestock revenue.
26. In our view Landcorp's financial forecasts appear reasonable taking into account the inherent uncertainty around commodity prices and the exchange rate.
27. A full list of performance metrics is included in Annex 1.

Non-Financial Performance – 2012/13

28. Along with financial performance targets, Landcorp maintains a framework of non-financial KPIs and performance targets. Table 2 below shows four of the key targets over the time span of this plan.

Table 2. Key Performance Indicators (KPIs)

KPI	2011/12 Actual	2012/13 Actual	2015/16 KPI
Grow livestock Kg per hectare	257 Kg/ha	281 Kg/ha	302 Kg/ha
Grow core* milk solids per hectare	912 KgMS/ha	892 KgMS/ha	1,086 KgMS/ha
Drop the nominal livestock cost of production	\$2.27 per kg	\$2.17 per kg	\$2.05 per Kg
Drop the core* nominal dairy cost of production	\$5.49 KgMS	\$5.44 KgMS	\$4.82 KgMS

Source: Landcorp's 3-year Business Plan 1 July 2013 – 30 June 2016

Core*: excludes both farms under management (e.g., SPG farms) and new WPL farm developments as at 30 April 2013

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29. Overall, the targets indicate that Landcorp continues to maintain a focus on increasing productivity and output from its farms.
30. 'Grow core milk solids per hectare' was the only KPI of the four listed in Table 2 which did not improve from 2012/12 – 2013/14. This decreased as the drought in early-2013 forced Landcorp to dry its dairy cattle off earlier than would normally be the case.
31. Due to fluctuating commodity prices, it is important that Landcorp reports on non-financial performance measures as these will provide a picture of its underlying operational performance. As can be seen in Table 2 above, Landcorp has set itself ambitious targets over this plan. It is appropriate that as well as targets to increase production levels per hectare there are also a number of targets alongside these to either constrain or reduce the related operating costs.

Capital Expenditure, Dividend Policy and Capital Structure**Capital Expenditure**

32. Capital expenditure in recent prior periods has been \$58 million (2012/13 forecast), \$57 million (2011/12 actual) and \$65 million (2010/11 actual). Planned capital expenditure in years one and three of this plan are largely in line with this. Year two, 2014/15, is significantly higher at \$92 million due to the planned \$49 million of expenditure on the development of farming land and infrastructure on WPL farms.
33. Expenditure on the development of WPL farms and the acquisition of livestock for these farms accounts for 54% (\$112 million) of the planned capital expenditure over this plan. Landcorp is contractually bound to provide capital to develop infrastructure on land deforested by WPL for dairy farming. The remaining budgeted capital expenditure appears reasonable for a farming business of this size, and when compared to prior years' expenditure.

Table 3. Capital Expenditure 2013/14 – 2015/16

Capital Expenditure (\$ millions)	2013/14	2014/15	2015/16	Total
Development of farming land and infrastructure under Wairakei Pastoral Leases	14.9	49.1	26.7	90.7
Buildings, staff accommodation and other on-farm buildings	9.1	16.8	11.1	37.0
Replacement of vehicles and plant	10.1	10.0	6.4	26.5
Livestock purchases	4.0	8.7	8.3	21.0
Purchase of farms	3.0	3.0	3.0	9.0
Forestry planting	3.2	2.1	1.5	6.8
Replacement of fences	1.6	2.5	2.1	6.2
Dairy conversion on Eyrewell farm (Christchurch)	4.3	-	-	4.3
Land development on Maronan Dairy (Ashburton)	2.4	-	-	2.4
Other	2.4	-	-	2.4
Total	55.0	92.2	59.1	206.3

Source: Landcorp's 3-year Business Plan 1 July 2013 – 30 June 2016

COMMERCIAL-IN-CONFIDENCE**Dividends****Table 4. Forecast dividends**

Dividend declared (\$ millions)	2011/12 Actual	2012/13 Forecast	2013/14 Plan	2014/15 Plan	2015/16 Plan
Ordinary Dividends	20.0	1.0*	2.0	11.0	20.0
Special Dividends	-	-	5.0	5.0	20.0
Total Dividends	20.0	1.0	7.0	16.0	40.0
NPAT	35.3	2.0	6.1	15.9	29.0
Ordinary Dividend / NPAT	56.6%	49.1%	33.0%	69.2%	68.9%
Total Dividend / NPAT	56.6%	49.1%	115.4%	100.7%	137.8%

Source: Landcorp's 3-year Business Plan 1 July 2013 – 30 June 2016

* Subsequent to preparing this plan and submitting it for shareholding Minister's comments, Landcorp has stated that it expects to pay a 2012/13 dividend of \$5.0 million.

34. Landcorp budgets to pay dividends in October after the year-end results have been determined. Any change in the milk payout, lamb schedule or exchange rates has a significant impact on Landcorp's ability to pay a dividend.
35. Landcorp's dividend policy is to distribute up to 75% of net operating profit after tax, as ordinary dividends, subject to maintaining a target interest cover ratio of 3:1 (acceptable range of 2.75:1 – 3.25:1). We are comfortable with this policy as it reflects the low cash flow that farming businesses realise.
36. In the three years covered by this plan, the Board also intends to declare a series of special dividend payments, totalling \$30 million, from the surplus available, should the planned sale of properties occur. As previously mentioned, should these sales not occur the special dividends will not be paid. Due to market conditions, we think it may be challenging for Landcorp to achieve the level of land sales proposed in the second and third years, whilst still obtaining reasonable prices.
37. Last year's plan included a special dividend of \$33 million in the 2012/13 year. As land sales did not occur to the extent planned in 2012/13 no special dividends will be declared for that year. The largest planned sale in 2012/13, the Pouarua dairy complex for more than \$50 million, is now expected to occur in the 2013/14 financial year. We believe this sale will proceed as a group of Iwi are purchasing the property, using a Treaty of Waitangi settlement which Cabinet approved in early-2013.
38. In total, the 2012/13 plan included special dividends of \$64 million compared to \$30 million in this plan. This decrease is mainly due to a reduction in expected property sales of \$36 million. Landcorp has already planned to increase debt levels to help fund the capital expenditure program given the decreased revenue expectations and therefore, in the absence of the property sales, there is no room to maintain special dividends at the level previously forecast.

COMMERCIAL-IN-CONFIDENCE**Capital Structure****Table 5. Forecast capital structure**

\$ millions	2011/12 Actual	2012/13 Forecast	2013/14 Plan	2014/15 Plan	2015/16 Plan
Total Assets	1,663	1,750	1,777	1,900	1,993
Total Liabilities	213	268	226	279	293
Equity	1,450	1,483	1,552	1,621	1,700
Interest Bearing Debt	171	251	208	260	274
Interest bearing debt to debt plus equity (Gearing)	10.6%	14.5%	11.8%	13.8%	13.9%
Equity to total assets	87.2%	84.7%	87.3%	85.3%	85.3%

Source: Landcorp's Statement of Corporate Intent 2013-2016

39. Over the three years covered by this SCI and Business Plan, Landcorp intends to increase its debt by approximately 9%. This increase is needed, along with the excess funds from property sales after special dividends are paid, to fund its capital expenditure programme. Should planned property sales in the 2013/14 year not occur, then instead of repaying \$44 million of debt, Landcorp would need to raise approximately \$28 million of additional debt in that year.
40. Like many other farmers in New Zealand, Landcorp's cash flow was significantly impacted by the droughts in early 2013. During this time Landcorp's interest coverage ratio slipped below its loan covenant requirement of 2.25. However, this ratio is only tested on 31 December and 30 June each year, and by 30 June 2013 Landcorp's cash flow had improved, resulting in it meeting the covenant at that testing date.
41. Landcorp has informed us that if property sales do not proceed as budgeted it has the ability to delay the timing of WPL capital expenditure in order to avoid raising additional debt. Landcorp will try to balance this to ensure that it progresses WPL as close to plan as possible while also ensuring its debt levels mean it is able to meet its loan covenants.

Commercial Valuation

42. The directors' estimate of the value of the Crown's investment in Landcorp is as follows:

Table 6. Change in commercial value

(\$ billions)	2012 SCI	2013 SCI	\$ change	% change
Commercial value of the Crown's investment	1.45	1.45	0.00	0.0%

Source: Landcorp's Statement of Corporate Intent 2013-2016

43. Prior to the 2011 business planning round shareholding Ministers requested that each SOE, including Landcorp, use a discounted cash flow (DCF) methodology to calculate its commercial value.
44. In 2013, as in the two prior years, the Landcorp Board has explicitly stated that its preference is to use a (market) value-based methodology because it better reflects the value of rural property (particularly changes in farm prices). COMU is comfortable with this approach, because Landcorp commissions independent valuations of its properties at the end of each financial year resulting in its equity equalling market value.

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45. However, the Board goes some way to meeting shareholding Ministers' expectations each year through commissioning an independent assessment of the 2009 DCF valuation. This year the assessment again confirmed that the assumptions from that valuation had not materially changed as at 30 June 2013. On this (DCF) basis, Landcorp's commercial value would be \$0.98 billion¹.
46. Both valuations and the relevant assumptions have been included in the SCI. Landcorp's commercial valuation is an estimation of its closing equity value (less the redeemable preference shares). Therefore, its return on equity directly relates to its commercial value.

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¹ The implied equity value of Landcorp using a DCF approach is estimated to be between \$0.33 billion and \$1.80 billion within an 80% confidence interval and an average of \$0.98 billion.

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ANNEX 1: FINANCIAL PERFORMANCE

Table 7. Financial Performance Metrics

	2011/12 Actual	2012/13 Forecast	2013/14 Plan	2014/15 Plan	2015/16 Plan
Shareholder returns					
Total shareholder return	5.5%	1.4%	4.8%	5.0%	5.7%
Dividend yield (ordinary)	1.9%	1.4%	0.1%	0.1%	0.7%
Dividend yield (ordinary + special)	1.9%	1.4%	0.1%	0.4%	1.0%
Dividend payout (ordinary)	71.2%	(181.4%)	20.1%	56.7%	40.4%
Dividend payout (ordinary + special)	71.2%	(181.4%)	20.1%	198.6%	58.8%
Adjusted return on equity	9.2%	4.8%	4.6%	4.8%	5.7%
Profitability/efficiency					
ROCE	9.0%	2.9%	4.1%	6.6%	9.5%
Operating margin	22.5%	14.6%	16.2%	20.2%	24.1%
Leverage/solvency					
Gearing	11.4%	14.5%	11.8%	13.8%	13.9%
Interest cover	4.75	2.56	2.72	3.19	3.35
Solvency	2.78	1.15	1.09	1.08	1.07

Source: Landcorp's Statement of Corporate Intent 2013-2016 and COMU's 2012 Annual Portfolio Report

Note: the adjusted return on equity and solvency ratio have been calculated by Landcorp using different classifications of numbers than COMU would use when taking the data from the Crown Financial Information System Network (CFISnet). However, we are not especially concerned by this because in both cases the COMU calculation would result in a higher percentage/ratio and show a more favourable position for Landcorp.

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Table 8. Performance metrics definitions

Measure	Description	Calculation
Total shareholder return	Performance from an investor perspective – dividends and investment growth.	$(\text{Commercial value}_{\text{end}} \text{ less Commercial value}_{\text{beg}} \text{ plus dividends paid less equity injected}) / \text{Commercial value}_{\text{beg.}}$
Dividend yield	The cash returned to the shareholder as a proportion of the value of the company.	Dividends paid/Average commercial value.
Dividend payout	Proportion of an SOE's net operating cash flows paid out as a dividend to the shareholder after an allowance is made for capital maintenance.	Dividends paid/Net cash flow from operating activities less depreciation expense.
Return on equity ²	How much profit a company generates with the funds the shareholder has invested in the company.	Net profit after tax/Average shareholders' equity.
Return on capital employed	The efficiency and profitability of a company's capital from both debt and equity sources.	Earnings before interest and tax (EBIT) adjusted for IFRS fair-value movements / Average capital employed.
Operating margin	The profitability of the company per dollar of revenue.	Earnings before interest, tax, depreciation, amortisation and fair value adjustments (EBITDAF) / Revenue.
Gearing ratio (net)	Measure of financial leverage - the ratio of debt (liabilities on which a company is required to pay interest) less cash, to debt less cash plus equity.	Net debt/Net debt plus equity.
Interest cover	The number of times that earnings can cover interest.	EBITDAF/Interest paid.
Solvency	Ability of the company to pay its debts as they fall due.	Current assets/Current liabilities.

² For some SOEs, this measure has become less meaningful as a result of International Financial Reporting Standards (IFRS) requiring fair value movements to be recognised in the income statement.

Mr Bill Baylis
Chair
Landcorp Farming Ltd
PO Box 5349
WELLINGTON 6145

Dear Mr Baylis

2013 STATEMENT OF CORPORATE INTENT AND BUSINESS PLAN

Thank you for providing shareholding Ministers with Landcorp Farming Limited's (Landcorp's) draft 2013 Statement of Corporate Intent (SCI) and Business Plan. We appreciate all of the time and effort which has gone into producing these documents.

Landcorp has a busy three years ahead with the further development of dairy farms under the Wairakei Pastoral joint venture along with the ongoing management of the Shanghai Pengxin farms. We expect that considerable capital expenditure and staff time will continue to be required for these two ventures and we look forward to hearing about progress via the regular Quarterly Reporting process.

We are pleased to see that Landcorp is planning to pay special dividends of \$30 million over the next three years from the proceeds of planned property sales. We understand that these special dividends are dependent on property sales occurring. We therefore expect that Landcorp will advise COMU at the earliest possible opportunity about progress in achieving these sales.

We understand that COMU and Landcorp will work together to commission an independent Strategic Review later this calendar year. We look forward to being informed of the findings of this review.

We wish you every success in the year ahead. Please now have 50 copies of the final SCI forwarded to my office, for tabling in the House of Representatives.

Please also pass on our thanks to the rest of your Board, the management and staff of Landcorp for their continuing efforts.

Yours sincerely

Hon Tony Ryall
Minister for State Owned Enterprises
on behalf of shareholding Ministers

cc Mr Steven Carden, Chief Executive Officer, Landcorp Farming Ltd, PO Box 5349, Wellington 6145

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Reference: T2013/2248

SE-2-8-1

Date: 28 August 2013

To: Minister of Finance (Hon Bill English)
Minister for State Owned Enterprises (Hon Tony Ryall)

CC: Associate Minister of Finance (Hon Steven Joyce)
Associate Minister of Finance (Hon Dr Jonathan Coleman)

Aide Memoire: Landcorp: 2013/14 SCI Dividend Forecasts, Capital Expenditure and Debt

Purpose

The purpose of this aide memoire is to provide shareholding Ministers with additional information, as requested, on options to get Landcorp Farming Ltd (Landcorp) to prioritise dividends over planned capital expenditure.

Background

In its 2012/13 Statement of Corporate Intent (SCI) Landcorp planned to declare dividends of \$109 million over three years whereas the 2013/14 SCI projects a reduced level of dividends of \$63 million over three years. Refer to Table 1.

Table 1. Planned Dividends

\$ millions	2012/13 Total	2013/14 Total	2014/15 Total	2015/16 Total	Total Ordinary	Total Special	3-year Total
2012/13 SCI	42	28	39	n/a	45	64	109
2013/14 SCI	n/a	7	16	40	33	30	63
Difference	n/a	(21)	(23)	n/a	(12)	(34)	(46)

In order for Landcorp to be able to pay a higher level of dividends than projected it would need to raise additional debt, reduce capital expenditure or increase the planned level of property sales.

Debt

Cash flow is the main dimension that constrains Landcorp's level of debt. Using Standard and Poor's financial and business risk profile matrix as a basis, suggests that a company of Landcorp's risk profile can afford a FFO¹ (funds from operations) to Debt ratio of between 30% and 45% to maintain an 'investment grade' rating (i.e. BBB or better). Landcorp's FFO is quite variable, but, historically appears to run at about

¹ FFO - Net income from continuing operations plus depreciation, amortisation, deferred income taxes, and other noncash items.

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\$50m per annum. This suggests that a debt level of \$166 million would appear reasonable when using 30%.

As Landcorp has projected year-end debt levels ranging from \$208 million to \$274 million throughout the three-years of the plan COMU does not think it has room to significantly increase debt.

The drought in early-2013 impacted on Landcorp's cash flow and as a result, its ability to comply with its banking covenants. At 31 March 2013, Landcorp reported in its Quarterly Report to shareholding Ministers, that its interest coverage ratio was only 1.29. Landcorp's banking covenants require it to achieve an interest coverage ratio of 2.25, when tested on 30 June and 31 December each year. Landcorp's interest ratio met the 2.25 target on 30 June 2013 when tested, largely due to one-off revenue items such as an increase in the milk payout. However, this is an example of the significant impact that climatic events can have on Landcorp's ability to meet its banking covenants, at its existing level of debt.

Capital Expenditure

Table 2 below shows a summary of Landcorp's planned capital expenditure over the three-year plan. The largest planned expenditure is in relation to the development of Wairakei Pastoral Leases (WPL) farms which we understand Landcorp is contractually committed to under a joint venture agreement. In order to determine whether this full amount is required, and whether it can be delayed, we would need to seek legal advice on the contract.

Table 2. Capital Expenditure

#	Capital Expenditure (\$ millions)	2013/14	2014/15	2015/16	Total
1	Development of farming land and infrastructure under Wairakei Pastoral Leases	s9(2)(b)(ii)			
2	Buildings, staff accommodation and other on-farm buildings				
3	Replacement of vehicles and plant				
4	Livestock purchases				
5	Purchase of farms				
6	Forestry planting				
7	Replacement of fences				
8	Dairy conversion on Eyrewell farm (Christchurch)				
9	Land development on Maronan Dairy (Ashburton)				
10	Other				
	Total				

Landcorp have reviewed this table of capital expenditure and they believe all of the planned capital expenditure needs to be carried out and have not offered any options for delaying any part of this. In particular, Landcorp states the following:

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1. Contractually required under the JV agreement with Wairakei Pastoral Leases.
2. Largely staff accommodation related to the contractual obligation of the JV agreement of WPL and replacing uninhabitable housing.
3. These are either for contractually required as part of the JV agreement with WPL or replacement of obsolete vehicles and upgrading quads for Health and Safety.
4. The livestock purchases are associated with the SPG and WPL farms and contractually required.
5. Purchases of farms are related to opportunistic purchases to consolidate existing farms to maximise shareholder value and cash flow.
6. These are already committed for the current year 2013/14 and reflect replacing of cutover.
7. These are for fences which require replacing to ensure stocks are kept within boundaries and do not enter road ways and keep stock out of riparian areas.
8. Continued dairy conversion projects which were approved in the previous business plan. Commitments have been made to third parties.
9. Continued dairy conversion projects which were approved in the previous business plan. Commitments have been made to third parties.
10. This is predominately relates to FarmIQ implementation commitments.

Other comments made by Landcorp are as follows:

- In the 2013/14 Business Plan Landcorp has focused on deferring non-contractual projects, prioritising on SPG and WPL commitments, while meeting its legislative requirements such as Health and Safety and environmental management.
- For this Business Plan, the dividend has been maximised reflecting that debt levels are significantly higher than previous Business Plan. Landcorp continues to carefully monitor debt covenants to ensure breaches do not occur, however, there is limited scope to increase debt. Banking covenants came under pressure in 2012/13 at lower debt levels.
- Given current commodity prices, Landcorp expects Net Operating Profit for 2013/14 to exceed the budgeted \$4 million by up to \$10 million at current commodity prices. If this is achieved Landcorp will increase its dividend from operating cash flows.
- Landcorp will continue to optimise dividends as evidenced in 2013 where Landcorp declared a \$5 million dividend while the Business Plan forecast only \$1 million. This was achieved despite a national wide drought which impacted on revenue from livestock and milk.
- Landcorp is actively seeking to sell farms to maintain debt levels. Where extra capital is realised, this will be prioritised to dividends.

Property Sales

Landcorp has budgeted for property sales of \$115 million over the three-year plan compared to \$151 million in the prior year's plan. These sales have a direct impact on the funds available to pay special dividends. Landcorp has reduced the overall level of sales expected as a response to market conditions i.e. it is proving more difficult to sell properties at their current valuation than originally expected. We do not think it would be viable for Landcorp to realise a higher level of property sales unless properties are sold at a loss, which would result in a loss of potential value to be returned to the Crown.

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Next Steps

Shareholding Ministers have an opportunity to provide comments on the SCI to Landcorp's Board for its consideration. As the current extension for Landcorp's SCI ends on 31 August 2013, this would necessitate shareholding Ministers providing Landcorp with a further extension, which COMU can arrange.

If shareholding Ministers are not comfortable with the position that Landcorp's Board takes in response to any comments on the SCI, the Ministers do have the following power under section 13(b) of the State Owned Enterprises Act 1986:

- the shareholding Ministers may, by written notice to the board, determine the amount of dividend payable in respect of any financial year or years.

However, there is a process to follow prior to taking this step and we would need to obtain legal advice on this. In addition to the legal process, consequences of this action would need to be first considered as it would be a fairly extreme step to take. We suggest that rather than using this statutory power, it would be preferable to try and resolve the issue around planned dividends with Landcorp's Board through discussions.

Terms of Reference are currently being developed for the independent Strategic Review of Landcorp, due to commence in late-2013. This review will consider options for Landcorp returning equity to the Crown and would provide another avenue to continue discussions with Landcorp about dividends.

Heidi Giles, Senior Advisor, COMU Monitoring - Commercial, s9(2)(k)
James Cunningham, Manager, Monitoring - Commercial, COMU Monitoring - Commercial, s9(2)(k) or s9(2)(a)

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Treasury Report: Landcorp: Extension to Statement of Corporate Intent
Deadline

Date:	30 August 2013	Report No:	T2013/2261
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Agree to the recommendations	2 September 2013
Associate Minister of Finance (Hon Steven Joyce)	For your information	None
Minister for State Owned Enterprises (Hon Tony Ryall)	Agree to the recommendations and sign the attached letter to the Chair of Landcorp Farming	2 September 2013
Associate Minister of Finance (Hon Dr Jonathan Coleman)	For your information	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Heidi Giles	Senior Advisor, Monitoring - Commercial	s9(2)(k) N/A (mob)	✓
James Cunningham	Manager, Monitoring - Commercial	s9(2)(a)	

Minister for State Owned Enterprises' Office's Actions

Send the attached letter to Landcorp Farming Ltd's Chair and a copy to the Chief Executive

Enclosure: Yes (attached)

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30 August 2013

SE-2-8-1

Treasury Report: Landcorp: Extension to Statement of Corporate Intent Deadline**Purpose of Report**

1. The purpose of this report is to provide shareholding Ministers with additional information on options for Landcorp to prioritise dividends, and constrain debt levels, by reconsidering its levels of planned capital expenditure and property sales.
2. Additionally, this report seeks shareholding Ministers' approval for a further extension for the receipt of Landcorp's final 2013 Statement of Corporate Intent (SCI), under section 14 of the State Owned Enterprises Act 1986. This will allow time for the Board to consider formal comments from the shareholding Ministers on its draft SCI. COMU has drafted a suitable letter for you to send to the Chair, should you agree.

Background

3. Shareholding Ministers have previously granted Landcorp an extension, until 31 August 2013, for the receipt of its final SCI. As this date has almost been reached, and the shareholding Ministers would like to provide the Board with comments on the draft SCI for its consideration, we recommend that a further three month extension now be approved.
4. In its 2012/13 Statement of Corporate Intent (SCI) Landcorp planned to declare dividends of \$109 million over three years whereas the 2013/14 SCI projects a reduced level of dividends of \$63 million over three years. Refer to Table 1.

Table 1. Planned Dividends

\$ millions	2012/13 Total	2013/14 Total	2014/15 Total	2015/16 Total	Total Ordinary	Total Special	3-year Total
2012/13 SCI	42	28	39	n/a	45	64	109
2013/14 SCI	n/a	7	16	40	33	30	63
Difference	n/a	(21)	(23)	n/a	(12)	(34)	(46)

5. In order for Landcorp to be able to pay a higher level of dividends than projected it would need to raise additional debt, reduce capital expenditure, increase the planned level of property sales or achieve a better operating result.

Debt

6. Cash flow is the main dimension that constrains the level of debt that Landcorp can hold. Using Standard and Poor's financial and business risk profile matrix as a basis, suggests that a company of Landcorp's risk profile can afford a FFO¹ (funds from operations) to Debt ratio of between 30% and 45% to maintain an 'investment grade' rating (i.e. BBB or better). Landcorp's FFO is quite variable, but historically appears to run at about \$50 million per annum. This suggests that a debt level of approximately \$160 million to \$170 million would appear reasonable when applying a 30% FFO ratio.

¹ FFO - Net income from continuing operations plus depreciation, amortisation, deferred income taxes, and other noncash items.

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7. As Landcorp has projected year-end debt levels ranging from \$208 million to \$274 million throughout the three-years of the plan COMU does not think it has room to significantly increase debt. Instead it appears that Landcorp is potentially holding too much debt.
8. The drought in early-2013 impacted on Landcorp's cash flow and as a result, its ability to comply with its banking covenants. At 31 March 2013, Landcorp reported in its Quarterly Report to shareholding Ministers, that its interest coverage ratio was only 1.29. Landcorp's banking covenants require it to achieve an interest coverage ratio of 2.25, when tested on 30 June and 31 December each year.
9. Landcorp's interest ratio met the 2.25 target on 30 June 2013 when tested, largely due to an increase in the milk payout and one-off revenue items. However, this is an example of the significant impact that climatic events can have on Landcorp's ability to meet its banking covenants, based on its existing level of debt.

Capital Expenditure

10. Landcorp's management has reviewed the capital expenditure included in its 2013/14 SCI and has informed us that all of the planned capital expenditure is required, due to contractual commitments, a need to maintain and replace current assets, or for Health and Safety reasons. Appendix One shows a table of the planned capital expenditure and the comments provided by Landcorp's management in relation to this. We have also discussed this with Landcorp's Chair who has reiterated these points.
11. We have reviewed this and consider that planned capital expenditure, not related to the Wairakei Pastoral Leases capital commitments or normal maintenance and replacement of assets, is minimal and not unreasonable for an entity of this size and nature.
12. However, we would recommend that shareholding Ministers encourage the Board to reconsider its planned capital expenditure. Specifically, we recommend asking Landcorp to consider whether there are any items which could reasonably be delayed within the terms of its current contractual commitments, without compromising the Health and Safety of its staff. We have included a comment to reflect this in the attached draft letter to the Chair.

Property Sales

13. Landcorp has budgeted for property sales of \$115 million over the three-year plan compared to \$151 million in the prior year's plan. These sales have a direct impact on the funds available to pay special dividends.
14. Landcorp has reduced the overall level of sales expected as a response to its view of market conditions i.e., it believes it is proving more difficult to sell properties at their current valuation compared to what was originally forecast.
15. Landcorp may have to lower its selling prices in order to increase land sales, which may result in some properties being sold at a loss relative to book values (which equates to market values because the properties are revalued annually). Selling assets at a loss to fund alternative ventures, is a decision that commercial entities often have to make. We recommend that shareholding Ministers encourage the Board to consider this, in a limited way, and have included a comment to reflect this in the attached draft letter to the Chair.

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Next Steps

16. Shareholding Ministers have an opportunity to provide formal comments on the SCI to Landcorp's Board for its consideration. As the current extension for Landcorp's SCI ends on 31 August 2013, this necessitates shareholding Ministers providing Landcorp with a further extension. A draft letter to the Chair, providing comments on the draft SCI and an extension for the final SCI is attached for your consideration.
17. If shareholding Ministers are not comfortable with the position that Landcorp's Board takes in response to comments on the SCI, Ministers do have the following power under section 13(b) of the State Owned Enterprises Act 1986:
 - the shareholding Ministers may, by written notice to the board, determine the amount of dividend payable in respect of any financial year or years.
18. However, there is a process to follow prior to taking this step and we would wish to obtain, and provide you with, legal advice on this. In addition to the legal process, consequences of this action would need to be first considered as it would be a fairly extreme step to take. We suggest that rather than using this statutory power, it would be preferable to try and resolve the issue around planned dividends through discussions with Landcorp's Board. To that end, we have already had discussions with Landcorp's Chair about the contents of the attached draft letter.
19. Terms of Reference are currently being developed for the independent Strategic Review of Landcorp, due to commence in late 2013. This review will consider options for Landcorp returning equity to the Crown and would provide another avenue to continue discussions with Landcorp about dividends.

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Recommended Action

We recommend that you:

- a **note** that Landcorp has delivered its draft 2013/14 Statement of Corporate Intent (SCI) for shareholding Ministers' comments
- b **note** that Landcorp has decreased its planned three year dividends by \$46 million from last year's SCI
- c **note** that COMU considers Landcorp may not be able to service debt above the planned level, and that its Capital Expenditure program appears to have little room for movement. Accordingly to minimise debt or pay higher special dividends would necessitate increasing land sales which may require a reduction in sale prices
- d **note** that shareholding Ministers are able to extend the deadline for submission of Landcorp's final SCI under s14(4) of the SOE Act 1986, and
- e **agree** that the Minister for State Owned Enterprises should sign the attached letter to the Chair of Landcorp, on behalf of shareholding Ministers, asking the Board to consider Ministers' comments on the draft SCI and providing a further three month extension for submission of Landcorp's final SCI.

Agree/disagree
Minister of Finance

Agree/disagree
Minister for State Owned Enterprises

James Cunningham
Manager, Monitoring - Commercial

Hon Bill English
Minister of Finance

Hon Tony Ryall
Minister for State Owned Enterprises

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Appendix One – Landcorp's Comments

Table 2. Capital Expenditure

#	Capital Expenditure (\$ millions)	2013/14	2014/15	2015/16	Total
1	Development of farming land and infrastructure under Wairakei Pastoral Leases	s9(2)(b)(ii)			
2	Buildings, staff accommodation and other on-farm buildings				
3	Replacement of vehicles and plant				
4	Livestock purchases				
5	Purchase of farms				
6	Forestry planting				
7	Replacement of fences				
8	Dairy conversion on Eyrewell farm (Christchurch)				
9	Land development on Maronan Dairy (Ashburton)				
10	Other				
	Total				

Landcorp has made the following comments in relation to the planned capital expenditure:

- Contractually required under the Joint Venture (JV) agreement with Wairakei Pastoral Leases (WPL).
- Largely staff accommodation related to the contractual obligation of the JV agreement of WPL and replacing uninhabitable housing.
- These are either contractually required as part of the JV agreement with WPL or for replacement of obsolete vehicles and upgrading quad bikes for Health and Safety.
- The livestock purchases mainly for the WPL farms and contractually required.
- Purchases of farms are related to opportunistic purchases to consolidate existing farms to maximise shareholder value and cash flow.
- These are already committed for the current year 2013/14 and reflect replacement of cutover land.
- These are for fences which require replacing to ensure stocks are kept within boundaries and do not enter road ways and keep stock out of riparian areas.
- Continued dairy conversion projects which were approved in the previous business plan. Commitments have been made to third parties.
- Continued dairy conversion projects which were approved in the previous business plan. Commitments have been made to third parties.
- This predominantly relates to FarmIQ implementation commitments.

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Other comments made by Landcorp are as follows:

- In the 2013/14 Business Plan Landcorp has focused on deferring non-contractual projects, prioritising on Shanghai Pengxin Group (SPG) and WPL commitments, while meeting its legislative requirements such as Health and Safety and environmental management.
- For this Business Plan, dividends has been maximised reflecting that debt levels are significantly higher than the last year's Business Plan. Landcorp continues to carefully monitor debt covenants to ensure breaches do not occur, however, there is limited scope to increase debt. Banking covenants came under pressure in 2012/13 at lower debt levels.
- Given current commodity prices, Landcorp expects Net Operating Profit for 2013/14 to exceed the budgeted \$4 million by up to \$10 million. If this is achieved Landcorp will increase its dividend from operating cash flows.
- Landcorp will continue to optimise dividends as evidenced in 2013 where Landcorp declared a \$5 million dividend while the Business Plan forecast only \$1 million. This was achieved despite a nation-wide drought which impacted on revenue from livestock and milk.
- Landcorp is actively seeking to sell farms to minimise debt levels. Where extra capital is realised, this will be prioritised to dividends.

Mr Bill Baylis
Chair
Landcorp Farming Ltd
PO Box 5349
WELLINGTON 6145

Dear Mr Baylis

2013 STATEMENT OF CORPORATE INTENT AND BUSINESS PLAN

Thank you for providing shareholding Ministers with Landcorp Farming Limited's (Landcorp's) draft 2013 Statement of Corporate Intent (SCI) and Business Plan. We appreciate all of the time and effort that has gone into producing these documents.

Landcorp has a busy three years ahead with the further development of dairy farms under the Wairakei Pastoral joint venture along with the ongoing management of the Shanghai Pengxin farms. We look forward to hearing about progress via the regular Quarterly Reporting process.

We understand that COMU and Landcorp will work together to commission an independent Strategic Review later this calendar year. We look forward to being informed of the findings of this review.

We have the following formal comments on the draft SCI, and would appreciate the Board's consideration of these before it submits its final SCI for tabling in the House of Representatives:

- Landcorp's 2012 SCI included planned property sales of approximately \$151 million over three years. In the 2013 SCI, this has been reduced to \$115 million. We would encourage you to review the assumptions behind this decrease and to consider whether property sales could be maintained in line with the 2012 plan.

- We understand that the planned capital expenditure program included in the 2013 SCI, mainly consists of contractual commitments in relation to the Wairakei Pastoral Leases and routine asset maintenance and replacement. We would however encourage you to review this plan to determine whether there is any room to defer any of the expenditure, in order to reduce the company's planned level of debt.
- The SCI shows term borrowings increasing from \$251 million to \$274 million over the three years of the plan. We understand that the drought in early-2013 had a significant impact on Landcorp's cash flow and for a period of time Landcorp's interest coverage ratio was significantly below the level that is required under its debt covenants, when this is tested on 30 June and 31 December each year. Shareholding Ministers' preference would be that Landcorp constrains its debt level, and to not increase debt over the period of this SCI.
- Moreover, shareholding Ministers expect that surplus funds, from above budget performance or increased property sales, should first be directed to stabilising debt and then towards the payment of additional dividends.

We appreciate that the Board will require time to consider the comments that we have made and therefore, pursuant to section 14(4) of the State Owned Enterprises Act 1986, shareholding Ministers agree to extend the deadline for Landcorp to submit its final SCI to 30 November 2013.

We look forward to receiving your comments and final SCI in due course.

Yours sincerely

Hon Tony Ryall
Minister for State Owned Enterprises
on behalf of shareholding Ministers

cc Mr Steven Carden, Chief Executive Officer, Landcorp Farming Ltd, PO Box 5349, Wellington 6145

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Treasury Report: Landcorp: Revised 2013 Statement of Corporate Intent and Briefing ahead of Annual Meeting

Date:	25 October 2013	Report No:	T2013/2619
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Agree recommendations	Wednesday 30 October 2013
Associate Minister of Finance (Hon Steven Joyce)	For your information	None
Minister for State Owned Enterprises (Hon Tony Ryall)	Agree recommendations and sign attached letter to Landcorp's Chair	Wednesday 30 October 2013
Associate Minister of Finance (Hon Dr Jonathan Coleman)	For your information	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Ant Shaw	Senior Advisor, Monitoring – Commercial	s9(2)(k)	N/A (mob) ✓
Bevan Searancke	Senior Advisor, Monitoring – Commercial		N/A (mob)

Minister for State Owned Enterprises' Office's Actions (if required)

Once signed, send letter to Landcorp's Chair. Return the signed report to Treasury.

Enclosure: Yes (attached)

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25 October 2013

SE-2-8-1

Treasury Report: Landcorp: Revised 2013 Statement of Corporate Intent and Briefing ahead of Annual Meeting**Executive Summary****Updated draft 2013 Statement of Corporate Intent (SCI)**

On 14 October 2013, Landcorp Farming Limited's (Landcorp's) Chair, Mr Bill Baylis, responded to the Minister for State Owned Enterprises' (SOEs) letter of 9 September 2013, which asked Landcorp to consider a number of factors, before finalising its 2013 SCI by 30 November 2013.

The table below summarises Landcorp's response to Ministers' comments on its original draft SCI.

	Ministers' comments	Landcorp's response
1	Is there an opportunity for planned property sales to be returned to the levels in the 2012 SCI?	Property sales (over the 3-year period) have increased from \$115 million in the draft 2013 SCI to \$136 million in the updated SCI (compared to \$151 million in the 2012 SCI).
2	Is there an opportunity for any planned capital expenditure to be deferred?	\$6 million of capital expenditure has now been deferred from 2014/15 to 2015/16, and an additional \$6 million deferred post 2015/16.
3	Debt is forecast to peak at \$274 million. Is it possible to reduce this to the peak level in the 2012 SCI (of \$251 million)?	Peak debt level over the period of the SCI has now reduced to \$252 million in the updated SCI, as a result of increased property sales and deferred capital expenditure noted above.
4	Communicating Ministers' preference for surplus cash to first be put towards reducing debt, rather than payment of additional dividends.	Noted and agreed by Landcorp and this will be implemented should surplus cash become available.

We believe that Landcorp has adequately considered Ministers' comments on its draft SCI, and made changes accordingly. We believe the SCI now meets shareholding Ministers' expectations, and recommend that the Minister for SOEs sends the attached letter to Landcorp's Chair, requesting that Landcorp provides 50 copies of its SCI for tabling in the House of Representatives.

Annual Meeting

Landcorp's Annual Meeting is scheduled for Wednesday 30 October at 2pm, and we understand the Minister for SOEs plans to attend the meeting on behalf of shareholding Ministers. Some topics the Minister may wish to discuss with the Board include:

- Landcorp's updated 2013 SCI as noted above
- Landcorp's 2012/13 performance, which we consider as satisfactory given the drought conditions experienced over much of the country, and

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- The planned Strategic Review of the company. Landcorp does not appear to see the value that can be gained from undertaking the review.

Recommended Action

We recommend that you:

- a **note** that Landcorp has provided Ministers and COMU with an updated version of its 2013 SCI after consideration of Ministers' feedback on the original draft
- b **note** that in COMU's view, Landcorp's SCI now more closely aligns with Ministers' expectations following changes it has made to take account of Ministers' feedback, and it is suitable for tabling in the House of Representatives
- c **agree** that the Minister for State Owned Enterprises signs the attached letter, on behalf of shareholding Ministers, to Landcorp's Chair, Mr Bill Baylis, requesting that Landcorp provides 50 copies of its final SCI for tabling in the House of Representatives
- | | |
|---|--|
| <i>Agree/disagree.</i>
Minister of Finance | <i>Agree/disagree.</i>
Minister for State Owned Enterprises |
|---|--|
- d **note** that Landcorp's Annual Meeting is being held at its office in Wellington on Wednesday 30 October at 2pm, and
- e **note** some suggested topics for discussion at the Annual Meeting including Landcorp's financial performance for 2012/13, its updated SCI, and the planned strategic review of the company.

Bevan Searancke
Senior Advisor, Monitoring - Commercial

Hon Bill English
Minister of Finance

Hon Tony Ryall
Minister for State Owned Enterprises

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Treasury Report: Landcorp: Revised 2013 Statement of Corporate Intent and Briefing ahead of Annual Meeting

Purpose of Report

1. This report updates Ministers on Landcorp's revised 2013 SCI, and recommends the Minister for SOEs signs the attached letter to Landcorp's Chair, requesting Landcorp to provide 50 copies of its final SCI for tabling in the House of Representatives.
2. This report also provides a briefing for the Minister for SOEs ahead of Landcorp's Annual Meeting, scheduled for Wednesday, 30 October 2013, at 2pm. We understand the Minister plans to attend the meeting on behalf of shareholding Ministers.

Background

3. Landcorp previously submitted its draft 2013 SCI to Ministers (Treasury Report 2013/1367 refers). On 9 September, the Minister for SOEs wrote to Landcorp's Chair, Mr Bill Baylis, requesting further consideration be given to a number of areas before the SCI is finalised and tabled in the House of Representatives. A further extension to 30 November 2013 was provided (T2013/2261 refers) for consideration of Ministers' comments and finalisation of the SCI, following an initial extension to 31 August 2013.

2013 Statement of Corporate Intent

4. Ministers requested the following areas be considered by Landcorp, before finalisation of its 2013 SCI:
 - The assumptions behind the reduction in planned property sales from \$151 million (over three years) in the 2012 SCI, to \$115 million in the 2013 draft SCI
 - Whether any planned capital expenditure over the three years could be deferred in order to reduce the company's planned level of debt
 - Whether debt levels could be maintained at the levels in the 2012 SCI (peaking at \$251 million), rather than increasing to \$274 million as forecast in the 2013 draft SCI, and
 - Shareholding Ministers' preference that surplus funds (from above budget performance or increased property sales) should first be directed to stabilising debt, before the payment of additional dividends.
5. On 14 October 2013, Landcorp's Chair, Mr Bill Baylis, responded to Ministers' letter of 9 September. We note the following changes from the draft SCI originally provided to Ministers.

Property Sales

6. Landcorp has increased property sales from \$115 million (over the three years) in the draft SCI to \$136 million in the updated SCI. The increase is mainly due to the inclusion of two dairy properties on the West Coast of the South Island and a dairy property near Paengaroa.

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7. Land sales are still lower than the planned level of sales in last year's SCI, mainly as a result of two factors. Firstly, \$8 million of sales were included last year as part of Landcorp's "buy, develop, sell" strategy, which shareholding Ministers did not support earlier this year. The corresponding purchase of these properties has therefore been removed from this year's SCI as well (and was already reflected in lower capital expenditure than in last year's SCI), explaining the reduction in sales. Secondly, there is a \$6 million reduction due to the timing of planned property sales that will now not be ready for sale during the three-year forecast period.
8. The achievability of these planned land sales will largely depend on market conditions over the next two to three years. History has shown that the period of time it has taken for Landcorp to sell farms has varied considerably, and is largely reflective of the wider market and economic conditions.
9. We believe Landcorp has adequately addressed Ministers' concerns regarding the level of planned property sales that were originally presented in its draft SCI. The updated forecasts are now more in line with last year's plan.

Capital Expenditure

10. Landcorp has deferred \$6 million of planned expenditure on the Wairakei Pastoral farms from 2014/15 to 2015/16. It has also deferred a further \$6 million of capital expenditure (over the three years) post 2015/16, which reduces total planned capital expenditure to \$200.4 million over the period of the SCI from \$206.4 million in the original draft SCI.
11. Given that a high proportion of Landcorp's capital expenditure is contractually committed as part of the Wairakei Pastoral leases, and that its remaining capital expenditure appears relatively modest (around 1% of land values each year), we consider it has adequately considered this request from Ministers.

Interest-bearing debt

12. As a result of the increase in planned property sales and reduced capital expenditure, Landcorp has managed to reduce its peak interest-bearing debt amount over the three years from \$274 million (at 30 June 2016) in its original draft SCI, to \$252 million in its updated SCI. This is in line with the peak debt level forecast in its 2012 SCI, and now more aligns with Ministers' expectations.

Surplus funds directed to stabilising debt

13. As noted above, the planned reduction in debt is consistent with Ministers' preference for the company to prioritise stabilising its debt levels ahead of paying additional dividends when it has surplus funds (either from higher land sales or greater than budgeted performance). As a result, planned dividends (of \$63 million over the three years) remain unchanged from the original draft SCI.
14. Overall, we think Landcorp has adequately considered all of the comments Ministers raised in relation to the original draft SCI. We have viewed a Board paper that was presented to Landcorp's Board last month, and it is clear that the company has taken the feedback seriously, and thoroughly investigated options for making changes accordingly. We therefore recommend the Minister for SOEs signs the attached letter to Landcorp's Chair, requesting Landcorp to provide 50 signed copies of its final SCI for tabling in the House of Representatives.
15. Note that the remainder of the SCI remains unchanged from the previous draft considered by Ministers (T2013/1367 refers), with changes only having been made if directly impacted by the factors noted above.

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Annual Meeting

16. Landcorp's Annual Meeting is being held on Wednesday, 30 October 2013, at 2pm at Landcorp's office, 15 Allen Street, Wellington. We understand the Minister for SOEs plans to attend the meeting. We have provided some commentary on a number of topics that the Minister may wish to discuss with the Board at this meeting.

Updated 2013 SCI

17. The Minister may wish to discuss the changes the Board has made to its original draft SCI, as discussed earlier in this report. We recommend that the Board should be thanked for seriously considering Ministers' views, and making amendments accordingly.

Planned Strategic Review

18. We have previously advised that Landcorp has been reluctant to evenly share the costs of the planned Strategic Review with COMU. We now have agreement for both parties to evenly share the costs. A Request for Proposals will shortly be sent to a number of entities (including investment banks and the big four accounting firms), with responses due back in November. We will update Ministers when a timeframe for completion of the review becomes more apparent.
19. However, it is evident that Landcorp does not see the benefits that can be achieved from undertaking the review, and is somewhat of an unwilling participant in the process. We believe it would be an opportune time to inform the Board of the importance that shareholding Ministers place on this review and reiterate the benefits that such reviews can provide. We believe the review will provide the opportunity to identify:
- a shared view on the entity's objectives, accountabilities and strategic direction
 - an enduring strategy for the entity, and
 - a pathway for the entity to deliver that strategy.
20. Implementing the programme of Strategic Reviews across the SOE portfolio is part of the government's focus on driving better performance from the state sector. It aligns with the government's intention to more actively manage the Crown's balance sheet, i.e., being more informed and engaged as owners. More actively managing the balance sheet is expected to protect value, enhance performance and better manage risk. It is expected that increased scrutiny, such as Strategic Reviews, will help to drive better performance.

21. s9(2)(b)(ii)
- 

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2012/13 Performance

22. The table below summarises Landcorp's financial performance for the year ended 30 June 2013, in comparison to the targets in its SCI or business plan (as some of the targets below are not disclosed in its SCI).

\$ million (unless otherwise stated)	2012/13 Actual	2012/13 Target	\$ Variance	% Variance
Revenue	203.1	215.2	(12.1)	(5.6%)
Net operating profit	13.0	12.7	0.3	2.3%
Net profit / (loss) after tax	(18.1)	12.7	(30.8)	Not meaningful
Dividend declared	5	42	(37)	(88.1%)

23. Revenue was below budget mainly as a result of the impact of the drought, which Landcorp estimates cost the company \$11.3 million during the year, due to reduced livestock sales values, and reduced milk revenue.
24. This revenue shortfall did not flow through to net operating profit, as it was offset by the tight management of costs, and some one-off gains that were unbudgeted, including the increase in value of the Fonterra shares Landcorp owns. Net operating profit is the key financial performance metric that Landcorp's performance should be measured against. Overall, we believe Landcorp performed satisfactorily considering the impact of the drought on a number of its farms.
25. The net loss after tax was adversely impacted by fair value adjustments required under International Financial Reporting Standards (IFRS), and this can be materially impacted by the change in market value of the livestock it holds each year. This was the case in the current year, with a \$36 million reduction in the value of livestock held. Such valuation changes are not budgeted for, as it is difficult to predict the market value of livestock at 30 June each year. This explains why the budgeted net operating profit is the same as the budgeted net profit after tax, as fair value movements such as this are not budgeted for.
26. Landcorp has declared a dividend of only \$5 million for the year, compared to a target of \$42 million. The significant shortfall was mainly the result of a delay in the planned sale of the Pouarua dairy complex for over \$50 million. Pouarua is being purchased by an Iwi consortium using the proceeds of a Treaty of Waitangi settlement, and is expected to be finalised within the next few weeks.

Governance

27. The table below shows Landcorp's current Board members. The Chair, Mr Bill Baylis, is in his second term as a Board member, but his first as Chair. He replaced Jim Sutton as Chair on 1 May 2012.

	Board Member	Position	Term	Start date	Expiry
1	Mr Arthur William (Bill) Baylis	Chair	2	1/11/2009	30/04/2015
2	Ms Traci Houpapa	Deputy Chair	2	1/05/2010	30/04/2016
3	Mr John Brakenridge	Director	1	1/05/2011	30/04/2014
4	Mrs Nicole Peta (Nikki) Davies-Colley	Director	1	1/05/2012	30/04/2014
5	Mr Christopher (Chris) William Day	Director	1	1/05/2012	30/04/2015
6	Ms Pauline Norma Lockett	Director	1	1/05/2012	30/04/2015
7	Mr Basil James Morrison (CNZM, JP)	Director	2	1/05/2008	30/04/2014
8	Mr David Richard Nelson	Director	1	1/05/2013	30/04/2016

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28. Landcorp has had some significant changes at governance and executive level in the 2013 year to date. In April 2013, Deputy Chair Warren Larsen retired and Traci Houpapa was elevated to Deputy Chair. David Nelson also joined the Board as a Director. Within the executive team, Chris Kelly retired as CEO and was replaced by Steven Carden (previously at Pyne Gould Guinness Wrightson Seeds Australia, and prior to that McKinsey in New York).
29. In early 2014, three directors' terms expire, Nikki Davies-Colley and John Brakenridge complete their first terms and Basil Morrison completes his second term (six years). At least one new director is likely to be required and we will report back to you by December on the skills to be sought in a call for nominations.

Administrative matters

30. The Minister of Finance has appointed the Minister for SOEs as his proxy for the AGM. If the Minister for SOEs is unable to attend the meeting, both Ministers have provided for a COMU official to act as alternative proxy. Officials from COMU will be in attendance, and can meet with the Minister before the meeting if required.
31. At the meeting, you will be requested to agree to resolve a number of straight forward resolutions. We recommend you agree to vote 'For' all of these, which are listed below:
- Resolve that the Minutes of last year's AGM be confirmed as a true and correct record (we can confirm that the minutes accurately reflect last year's meeting)
 - Resolve that the 2013 Annual Report and Financial Statements be received
 - Resolve that the Auditors' report for the year ended 30 June 2013 be received
 - Resolve to note that KPMG has been appointed as Landcorp's auditor for the year ending 30 June 2014, and
 - Resolve to note that a dividend of \$5 million be paid to shareholders relating to the financial year ended 30 June 2013.

Mr Bill Baylis
Chair
Landcorp Farming Ltd
PO Box 5349
WELLINGTON 6145

Dear Mr Baylis

2013 STATEMENT OF CORPORATE INTENT

Thank you for your letter of 14 October 2013 regarding Landcorp Farming Limited's (Landcorp's) revised 2013 Statement of Corporate Intent (SCI).

We appreciate the efforts the Board has made to address Ministers' comments on the original draft document, and we are now more comfortable with its content. Accordingly, please now have 50 copies of the final SCI forwarded to my office, for tabling in the House of Representatives.

We look forward to receiving the Board's feedback early next year on any recommendations arising from the planned independent Strategic Review of the company, to be jointly-commissioned with COMU. We place a high importance on this review, and see it as an ideal opportunity to align views on the strategic direction of the company.

We wish you every success for the year ahead. Please pass on our thanks to the rest of the Board, the management and staff of Landcorp for their continuing efforts.

Yours sincerely

Hon Tony Ryall
Minister for State Owned Enterprises
On behalf of shareholding Ministers

cc Mr Steven Carden, Chief Executive Officer, Landcorp Farming Ltd



18 June 2014

Hon Tony Ryall
Minister for State Owned Enterprises
Parliament Buildings
WELLINGTON

Dear Minister


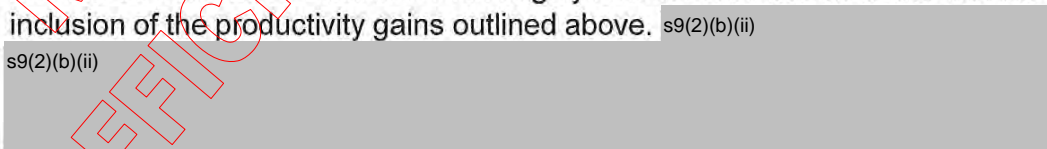
RESPONSE TO STRATEGIC REVIEW REPORT

The Board of Directors (Board) of Landcorp Farming Limited (Landcorp) acknowledge receipt of the Strategic Review report completed by Deloitte at the request of the Shareholding Ministers. The Board is appreciative of the time and effort by both Deloitte and Landcorp's management in completing this review.

The Strategic Review conducted by Deloitte has coincided with a significant internal strategic review undertaken by Landcorp's Board and management. We are pleased that there is general alignment between Deloitte's review and that of Landcorp's.

The Board has given careful consideration to all the matters raised in the review and is supportive of the general thrust of the report. Nevertheless, the Board wishes to comment as follows on a number of specific items raised in the report.

- Landcorp's total returns over the last decade to the Crown average 10% per annum (compound) comprising an average cash yield and capital gains of 1.6% and 8.3% per annum respectively. This compares favourably to the 8.1% average annual compound Total Shareholder Return for both the NZX50 and S&P gross indices over the comparable period.
- The Board acknowledges the inherent issues in the comparability of the data in the benchmarking performance analysis. Indeed, Landcorp has proactively sought such data in the past with limited success. These issues include the differing approach to treating interest and gearing, cashflow timing and accrual differences, application of depreciation rates and differences related to owners' drawings and salaries. It is therefore difficult to draw meaningful conclusions from the analysis.

- The Board acknowledges that Landcorp undertakes a significant contribution towards industry good/leadership activities that other farmers choose not to.
- The Board acknowledges that head office costs have nearly doubled over the last twelve years. Adjusting for inflation the real increase is \$5.7 million. This increase follows the diversification of the business into dairy and deer and an expansion of industry good/leadership activities. The Board notes Deloitte's recommendation to undertake a cost reduction programme focussed on both farming and head office costs. Landcorp has targeted a significant productivity improvement program in its 1 July 2014 to 30 June 2017 Business Plan.
- The Board notes that Deloitte is supportive of Landcorp's approach to the 'Other People's Money' (OPM) strategy. Through leveraging its farming expertise it is envisaged that Landcorp will be able to recycle capital, increase its volumes, diversify revenue sources and provide additional returns to its shareholders. The Board acknowledges that a review of Landcorp's brand and positioning is necessary in light of this new strategic focus.
- s9(2)(b)(ii)

- The Board acknowledges that the financial information included in the 1 July 2014 to 30 June 2017 Business Plan largely reflects business as usual with the inclusion of the productivity gains outlined above. s9(2)(b)(ii)
s9(2)(b)(ii)

- The Board was disappointed that Deloitte chose not to provide detailed comment on the relevant performance metrics (reference has been made to the nine standard metrics to measure SOE's shareholders returns, profitability/efficiency and leverage/solvency) or Landcorp's dividend policy. Such comment would have been useful in advising future strategic and operational directions.
- The Board notes that the tax effect of the sale of the whole business as outlined in the strategic options has not been considered by Deloitte nor the wider implications of this.
- The Board has requested management undertake a review of the Wairakei Pastoral lease arrangements.

Finally, both the Board and Management Team are committed to delivering on Landcorp's new strategy that has been developed over the last 8 months. We believe that this strategy, as conveyed in this year's Statement of Corporate Intent and consistent with Deloitte's review, will lift Landcorp's performance to the benefit of Landcorp's shareholder and the country.

Yours sincerely



Traci Houpapa
Acting Chairman

C.C... Hon Bill English
Minister of Finance

Ant Shaw
Senior Advisor
The Treasury

Chas Cable
Partner
Corporate Finance
Deloitte



Landcorp Farming Ltd

Strategic Review

24 June 2014

Strictly private and confidential



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Glossary



Term	Definition
BAU	Business as usual
CAGR	Compound Annual Growth Rate
Companies Act	Companies Act 1993
Dairy	The dairy division of Landcorp
DCF	Discounted cash flow
E ha	Effective hectares
EBIT	Earnings before interest and tax
EIU	Economist Intelligence Unit
FAO	Food and Agriculture Organisation
Farm IQ	Farm IQ Systems Limited
Focus Genetics	Focus Genetics Limited Partnership
Forecasts	Landcorp's draft SCI forecasts for the period FY15F-FY17F (as at mid-April 2014)
FWE	Farm working expenses
FYXXA	Historical financial year ended 30 June 20XX
FYXXF	Forecast financial year ended 30 June 20XX
IRR	Internal rate of return
kgMS	Kilograms of milk solids
Landcorp	Landcorp Farming Limited (including subsidiaries)
Livestock	The livestock division of Landcorp
LEL	Landcorp Estates Limited
LFL	Landcorp Farming Limited
LHL	Landcorp Holdings Limited
LIC	Livestock Improvement Corporation
LPL	Landcorp Pastoral Limited
MPI	Ministry for Primary Industries

Term	Definition
NAV	Net asset value
NPAT	Net profit after taxation
PGP	Primary Growth Partnership
PNZFML	Pengxin New Zealand Farm Management Limited
Protected Land Agreement	Agreement with the Crown relating to eight properties protected from sale pending Treaty settlements.
OECD	Organisation for Economic Co-operation and Development
Operating profit	Profit from operations after interest but before tax
OPM	Other people's money
ROE	Return on equity
RPS	Redeemable preference shares
SCI	Statement of Corporate Intent
Shareholders, or Shareholding Ministers	The Minister of Finance and the Minister for State-Owned Enterprises
SOE	State-Owned Enterprise
SOE Act	State-Owned Enterprises Act 1986
SPG	Shanghai Pengxin Group, the owner of the so-called Crafar portfolio of North Island dairy farms
SPG JV	A sharemilking joint venture between Landcorp and SPG
Strategic Plan	The draft business plan and forecasts currently being developed by Landcorp for its FY15F – FY17F SCI
Strategic Review	This strategic review undertaken by Deloitte
SU	Stock unit
TSR	Total shareholder return
WPL	Wairakei Pastoral Limited, the owner of a former forestry estate in the central North Island

1. Executive summary

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OFFICIAL INFORMATION ACT

1. Executive summary

Landcorp is an SOE and New Zealand's largest corporate farmer. Deloitte has been engaged to undertake a strategic review of the business and consider options to enhance shareholder value.

1.1. Introduction

- Landcorp Farming Limited (Landcorp, or LFL) is a company established under the State-Owned Enterprises Act 1986 (SOE Act). The Crown owns 100% of Landcorp's shares, held beneficially by the Minister of Finance (50%) and the Minister for State-Owned Enterprises (50%), (the Shareholders or the Shareholding Ministers).
- Landcorp was created in 1987 following the restructuring of the now disestablished Lands and Survey Department. Its core business is pastoral farming. Landcorp is recognised as New Zealand's largest corporate farmer, with assets of \$1.7 billion. At June 2013 operations comprised 137 farms, covering 173,400 effective hectares (owned and leased) and 1.6 million stock units, and employing 688 permanent staff, of which 79 were Wellington based corporate staff.
- Operations are broadly categorised into two major divisions, Livestock and Dairy. The Livestock division currently covers 79 mixed and sole purpose sheep, beef and deer farming operations. The Dairy division currently covers 58 farms, including significant recent investments in:
 - a commercial joint venture with Wairakei Pastoral Limited (WPL) to develop and lease a portfolio of dairy farms near Taupo;
 - a sharemilking/management arrangement with the Shanghai Pengxin Group (SPG), a Chinese company that owns the so-called "Crafar" portfolio of North Island dairy farms.
- Other ancillary operations include the development, subdivision and sale of landholdings with higher value uses than farming, and managing a portfolio of property protected from sale under an agreement with the Crown. Landcorp also owns a controlling interest in a livestock genetics business (Focus Genetics) and a minority interest in company that develops farm information management software and systems (Farm IQ).

1.2. Background to strategic review

- Treasury has embarked on a programme of commissioning independent reviews of all State-Owned Enterprises (SOEs).
- Under this programme the Board of Landcorp and Treasury, as the Shareholders' representatives, have requested Deloitte to undertake an assessment of Landcorp's existing strategy, business model, historical and future forecasts, and also an analysis of strategic options that may be able to enhance shareholder value and improve future returns whilst recognising Landcorp's contribution to New Zealand's primary industry (the Strategic Review).
- Landcorp's current strategic plan is effectively captured within its published Statement of Corporate Intent (SCI) and supporting business plan, which was developed in early 2013 then revised and approved by the Board and Shareholding Ministers in October 2013. This strategic plan covers the financial years ending June 2014 (FY14F), June 2015 (FY15F) and June 2016 (FY16F).
- However, coinciding with the recent appointment of Landcorp's new Chief Executive, Steven Carden, and also Landcorp's annual planning processes, which include updating its three year business plan, the Board and Management of Landcorp are undertaking an internal strategic review process.
- As a result, Deloitte's independent Strategic Review has been undertaken in parallel with Management's internal strategic planning process. The Strategic Review considers Landcorp's historical performance, its current operations and asset portfolio, its new draft forecasts for FY15F to FY17F, output from Landcorp's internal strategic review process, and alternative strategic scenarios.



1. Executive summary

We have analysed Landcorp’s past and forecast performance, and considered a series of questions focused on the validity of the corporate farming model, industry leadership roles and alternative strategic options.

1.3. Deloitte’s approach

- Farming in New Zealand has been described as an “asset rich, cash poor” activity, providing low cash yields on the capital invested but with capital gains traditionally boosting total returns. Landcorp is no exception, and therefore as an SOE it presents a challenge for a government focussed on its fiscal position: the cash yield is low and political considerations constrain the ability to access the capital gains via asset sales.
- Putting political considerations to one side, Deloitte has been asked to assess Landcorp’s current strategy and forecasts, and consider the strategic options available to enhance shareholder value and future returns, whilst recognising Landcorp’s contribution to New Zealand’s primary industry.
- To do this, we have set out to answer a series of questions. These questions, and the sections of the report where they are addressed, are shown in the table opposite.
- Two central issues are (i) why does Landcorp exist? and (ii) should it be in Crown ownership? A framework for addressing these questions is:
 - Do Landcorp’s farms perform as well as equivalent owner-managed farms?
 - Beyond that, are there volume, price and/or cost benefits due to Landcorp’s scale and integrated network of farms, and do these benefits exceed Landcorp’s corporate overhead costs?
 - If the answer is yes, then Landcorp’s existence (but not necessarily Crown ownership) is justified on commercial grounds.
 - If the answer is no, then is Landcorp’s existence justified on industry good/leadership grounds (which might also justify Crown ownership)?
 - In either case, how is shareholder value best maximised?

Questions addressed	Section
What is Landcorp?	2
Does it have an industry good/leadership role?	2
What sector trends are driving Landcorp’s value and performance?	3
How has Landcorp performed over the last 10 years, as a whole and by division?	4
How are Landcorp’s farms performing today compared with their peers?	4
What are the costs and benefits of Landcorp’s scale and corporate model?	4
How is Landcorp expected to perform in the future and are these forecasts reasonable?	5
What is Landcorp’s strategic plan?	5
What alternative strategies could enhance shareholder value?	6



1. Executive summary

Over the last five years Landcorp's asset base has been relatively stable but financial performance has been relatively volatile, mostly due to fluctuations in farmgate prices and climatic events.

1.4. Overview of Landcorp

- The tables opposite provide an overview of Landcorp's operations at June 2013 (FY13A) and financial performance for FY10A to FY14F.
- Landcorp's core farming operations are separated into the Dairy and Livestock divisions. Dairy operations include owned, leased and managed farms. Livestock operations include owned and leased farms.
- Landcorp currently operates a total of 131 farms covering 178,880 effective hectares (E ha), comprising 55 dairy and 76 livestock (sheep, beef and deer) farms. In addition, Landcorp share-milks two Wharere farms and has four WPL farms under development.
- Of the 76 livestock farms, 44 are located in the North Island and 32 are located in the South Island. Of the 55 dairy farms, 37 are located in the North Island and 18 are located in the South Island.
- Landcorp operates its farms as clusters, with each farm having a manager. The related groups of farms, or clusters, are assigned regional business managers. Dairy clusters (also referred to as complexes) are geographically linked, but the Livestock definition of cluster is broader than just geographical proximity, referring more to an integrated operational relationship. The benefits of an integrated cluster approach and also of Landcorp's scale include:
 - Optimisation of stocking rates and production volumes;
 - Procurement and funding cost savings;
 - In-market price benefits (e.g. the Tesco lamb contract); and
 - Growing farm management talent and proprietary knowledge.
- Most of these benefits are captured in the individual farm financial performance and related metrics. However, there is also an unallocated head office cost of approximately \$21 million per annum.

Overview

	Livestock	Dairy	Other	Total
\$m				
Operations (current):				
Number of farms ⁽¹⁾	76	55	-	131
E ha (000s)	156.7	22.1	-	178.9
Stock units (000s)	842.3	414.3	-	1,256.6
Financials (FY13A):				
Revenue	96.7	75.8	30.6	203.1
EBITDA (before head office costs)	19.2	8.1	29.4	56.8
Assets	984.3	477.5	233.1	1,694.9

Source: Annual Reports, Management

(1) Excludes two Wharere share-milked farms and four WPL farms under development

Summary of Landcorp's financial performance FY10A - FY14F

		Actual			Forecast
\$m	FY10A	FY11A	FY12A	FY13A	FY14F
Revenue	169.9	218.4	215.7	203.1	256.7
EBITDA	33.9	65.1	50.5	37.4	55.4
EBIT	21.4	52.6	37.3	23.8	41.4
Operating profit	10.0	42.2	27.0	13.0	32.1
NPAT	(5.8)	114.6	(9.4)	(18.1)	40.0
Total assets	1,521.9	1,663.0	1,662.9	1,694.9	1,633.3
EBIT / assets (%)	1.4%	3.2%	2.2%	1.4%	2.5%
TSR (%) ¹	(8.3)%	10.7%	0.6%	0.4%	(0.4)%
TSR (%) ²	(8.1)%	9.4%	0.5%	(0.1)%	4.8%

Source: Annual Reports, Management and Deloitte Analysis

¹ TSR calculated as the change in equity plus prior year dividends declared, divided by opening equity.

² TSR is calculated in accordance with SCI as the change in commercial value plus dividends paid less equity injected, divided by opening commercial value

1. Executive summary

As an SOE, Landcorp's primary focus is on efficiency and profitability. However Landcorp also undertakes a significant level of industry good/leadership activity.

1.5. Landcorp's industry leadership role

- Landcorp's current SCI refers to maximising economic production "primarily within Landcorp but also in the wider pastoral sector". Similarly, the scope for this Strategic Review refers to ways to "improve future returns whilst recognising Landcorp's contribution to New Zealand's primary sector". Notwithstanding these statements, and obligations to be socially responsible and a good employer, Landcorp is not obliged under the SOE Act or the SCI framework to undertake or facilitate any industry good initiatives that may be considered outside of its core commercial farming objectives.
- As an SOE, and New Zealand's largest corporate farmer, in pursuing its commercial farming activities Landcorp has the potential to demonstrate leadership and provide ancillary 'spill-over' benefits for both the sector and wider economy. Also, it is commercially rational for a business with Landcorp's scale and strategy to undertake a level of investment in industry good or corporate citizenship activities.
- However, management believes that Landcorp's expenditure on industry good/leadership activities (the direct costs plus investment of management time) is at a significantly higher level than an equivalent privately-owned corporate farmer would undertake.
- These activities are outlined in section 2.4 and Appendix 8, and include:
 - Research and development;
 - Environmental leadership;
 - Investment in FarmIQ;
 - Assisting iwi with land development and staff training; and
 - Demonstrating the potential to develop integrated supply chains in the red meat sector.
- The red meat sector in particular is arguably one area where Landcorp is better placed than its private sector peers to act as an exemplar. Developing an integrated supply chain with Silver Fern Farms to supply the Tesco lamb contract involves:
 - Operating a network of farms all to Tesco's standards (i.e. FarmPride certified);
 - Using genetics to provide superior and uniform lambs;
 - Using Landcorp's geographic spread to stage lambing across as long a season as possible; and
 - Managing the logistics of finishing lambs to meet the weekly supply commitments to Tesco.
- Landcorp's management believes that industry leadership is an important, but not overriding, consideration in relation to developing Landcorp's strategy and future role. However, a number of industry stakeholders interviewed on this topic suggested that focusing on efficiency and profitability would be Landcorp's best opportunity to demonstrate leadership.
- No explicit mandate exists to undertake non-commercial industry good initiatives, and the cost of such activities has not been quantified. Deloitte believes that Landcorp should identify and cost the activities that fall into this category and discuss with Treasury:
 - Whether the Shareholders wish Landcorp to continue with some or all of these activities; and
 - If so, whether the associated costs should be excluded when considering Landcorp's performance.

1. Executive summary

We expect the recent agri-sector trends to continue: strong global demand; a positive outlook for product prices and land values; further corporatisation of farming; and a focus on the environment.

1.6. Sector trends and issues

Demand, prices and land values

- Agricultural commodity prices, particularly dairy commodity prices, have grown strongly in recent years, even in real terms, and global trends indicate a continued strong demand for New Zealand's agricultural products.
- In addition to real growth in farm gate prices, there have been gains in productivity (output per effective hectare), largely attributable to irrigation and feed supplements but also contributions from better management systems and genetics.
- Increases in farm gate prices and productivity have driven strong growth in both dairy and livestock profitability and land values. However, livestock profitability and land values are at much lower absolute levels than dairy. This has been a major driver of land use change (dairy conversions) and an overall decline in livestock production. In many respects the change in Landcorp's farming mix over the last decade has mirrored these trends.
- New Zealand's high farm land values imply that investors are:
 - Assuming further productivity gains and price increases; and
 - Using low required rates of return, reflecting the current low interest rate environment and, at the margin, interest from foreign investors with low costs of capital and other objectives such as security of supply.
- While the outlook for product prices is generally positive, a caveat to note regarding dairy prices is that the supply/demand balance in internationally traded dairy commodities can be materially influenced by large domestic producers (particularly the US) increasing or decreasing their export volumes (such as when the balance between grain and dairy prices changes).

Other key trends and issues

- Somewhat related to the increase in land prices is the emergence of corporate ownership (reflecting the greater levels of capital investment required) and alternative operating models. Large foreign investors looking for entry into the New Zealand agri-sector are typically interested in doing so on a large scale, and often seek professional New Zealand farm managers to run their properties. Landcorp's partnerships with WPL, SPG and also iwi reflect this trend.
- Agricultural intensification creates a range of environmental issues and as a consequence there has been increased focus on sustainability and environmental practices by customers, processors, and regulators. This is leading to increased regulation and may constrain further productivity gains. As an SOE and New Zealand's largest corporate farmer, Landcorp is expected to demonstrate at least full compliance, if not industry leadership, in its environmental practices.
- In contrast with the dairy processing sector there is considerable dysfunction in the red meat sector. Processors have excess capacity, compete fiercely both to procure supply and in overseas markets, and several have suffered large losses in recent years due to the consequent squeeze on processing margins. The increased need for product to be on specification and for certainty of supply has led to some suppliers and processors collaborating down the value chain, and the collaboration between Landcorp and Silver Fern Farms on the Tesco lamb contract is an example. This is likely to become more common with the emergence of more larger scale commercial farmers.
- The importance of agriculture to the economy has led the Government to focus policy initiatives on growing agricultural sector exports. The availability of suitably skilled labour is recognised as one of the key potential limitations for growth in the agricultural sector.



1. Executive summary

Over FY04-FY13 Landcorp has delivered total compound returns to the Crown averaging 10% p.a. (1.6% cash yield; 8.3% capital gain). Livestock’s contribution to this TSR is similar to Dairy’s.

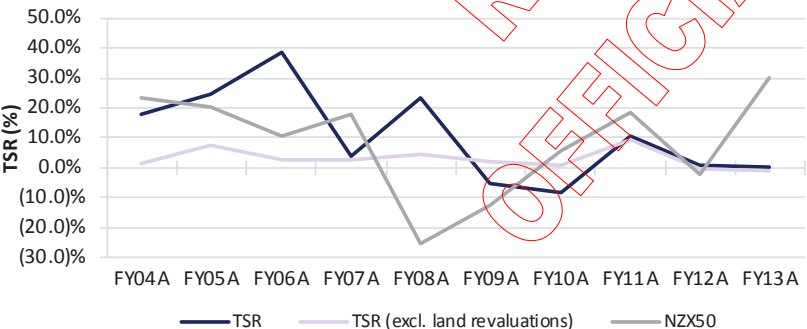
1.7. Landcorp’s historical performance

- We have considered various aspects of Landcorp’s performance, including total shareholder returns (TSR), relative divisional performance, benchmarking against peers, cost trends and budgeting track record.

Overall shareholder returns

- Over the last decade Landcorp has delivered total returns to the Crown averaging 10% p.a. (compound), comprising an average cash yield of 1.6% p.a. and capital gains averaging 8.3% p.a. This compares favourably to the 8.1% average annual compound TSR for both the NZX50 and S&P500 gross indices over the same period.
- The analysis below shows the annual TSR for Landcorp and the NZX50. We also show Landcorp’s TSR excluding land revaluations, highlighting the significant impact that land revaluations have on Landcorp’s TSR and their volatility.

Annual TSR (FY04A-FY13A)



Source: Annual Reports, Capital IQ and Deloitte Analysis

Divisional returns

- We undertook divisional IRR analysis based on operating and investing cash flows between FY04A and FY13A and starting and finishing asset and equity values over that period. Core Dairy’s returns exclude WPL’s operations to remove any impacts due to WPL’s leasing arrangements or farm immaturity.
- Two approaches were undertaken (i) ungeared and excluding corporate costs, interest and taxation and (ii) geared and including an allocation of corporate costs, interest and taxation.
- Both approaches showed that Livestock has made a similar contribution to Landcorp’s overall returns as Core Dairy, while WPL’s returns to date have been negative (reflecting the high capital cost of dairy conversions and the immaturity of WPL’s farms over the period analysed). The table below summarises the results of the ungeared approach:

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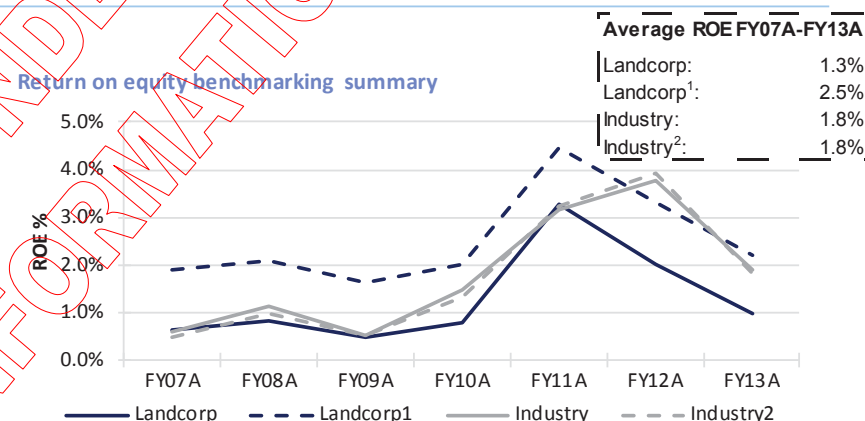
1. Executive summary

Landcorp's on-farm performance appears to be ahead of or on par with its peers, but on par or behind once corporate overheads are included. Data issues mean firm conclusions cannot be drawn.

1.7. Landcorp's historical performance (continued)

External benchmarking

- Landcorp's integrated cluster approach and economies of scale should generate benefits in on-farm performance. The key questions are whether these benefits are sufficient to offset Landcorp's head office costs of approximately \$21 million per annum, and whether overall Landcorp's performance exceeds its peers?
- Landcorp has previously undertaken benchmarking analysis at both the company level (return on equity comparisons) and at the farm specific level. There are significant shortcomings with both types of benchmarking, therefore it is difficult to draw firm conclusions.
- As shown in the chart opposite, Landcorp's operating return on equity appears to have been on par with industry benchmarks over the period FY07 to FY11, below in FY12 and FY13, and averaged 1.3% versus the industry average of 1.8%. Landcorp believes that the performance gap in FY12 and FY13 may be partly explained by its exposure to extreme weather events in particular regions, and by increased costs incurred in those years (e.g. in pasture renewal), the benefits from which will accrue in future years.
- Over the period covered, Landcorp's corporate overheads have averaged 1.2% of equity. If we exclude these costs, Landcorp's on-farm performance exceeds the benchmark (averaging 2.5% versus the benchmark's 1.8%).
- Farm specific benchmarking appears to show farms performing on par with or better than their industry peers, but we note that in this analysis Landcorp farms' financial performance did not include an allocation of corporate overheads.
- Again, Landcorp has highlighted a range of issues regarding the comparability of data meaning that strong conclusions cannot be drawn from the benchmarking analysis.



Source: Annual Reports, Management Analysis and Deloitte Analysis

1: Excluding corporate overheads

2: Adjusted to reflect Landcorp's geographic composition

Head office costs

- Over the last 12 years head office costs have nearly doubled from \$11.1 million to \$22.1 million. Adjusting for inflation the real increase is \$5.7 million.
- Two factors contributing to this increase in costs are the diversification of the business into dairy and deer (with the different and more intense farming methods requiring additional overheads), and an expansion of industry good/leadership activities.

Budgeting track record

- Landcorp has a sound (i.e. conservative) budgeting track record. In the last four years Landcorp's actual operating profit has exceeded the SCI target set in the prior year, and is forecast to do so again in FY14F.

1. Executive summary

Landcorp's draft strategic plan and financial forecasts have been developed in two separate exercises. Therefore Landcorp's FY14F SCI forecasts may not fully reflect Management's intended path for the business.

1.8. Draft Strategic Plan and Forecasts

Introduction

- Landcorp's internal strategic planning process is currently in two parts:
 - The development of a new strategic vision and plan, being led by the new CEO Steven Carden in a collaborative process with Landcorp's Board (draft Strategic Plan).
 - A business as usual (BAU) roll-forward and update of three year financial forecasts (FY15F-FY17F) to be used in this year's SCI (draft Forecasts).
- This means that the draft Strategic Plan and the draft Forecasts are currently two rather unconnected exercises. As a result, Landcorp's FY14F SCI and the draft Forecasts may not accurately reflect Management's vision and strategy for the business.

Draft Strategic Plan

- The table opposite summarises the key areas of focus and strategies being considered. Consistent with Deloitte's views, the draft Strategic Plan:
 - Makes explicit the objective of cost efficiency and prioritises this as the main focus over the next two years;
 - While seeking new thinking on how to grow Landcorp, has narrowed the range of options being considered and started to plan how they would be sequenced; and
 - Acknowledges that many of the revenue growth initiatives are not likely to involve material investment or impact on Landcorp's financial performance until FY17F or beyond.

Summary of key strategies

"What we will farm"	
Volume	▪ In partnership with Maori and others, significantly expand the quantity of livestock farmed, across an integrated portfolio of farms nationwide.
Value	▪ Integrate our products into value chains focussed on niche markets, driven by a deep understanding of future consumer requirements.
Diversity	▪ Explore opportunities to diversify what we farm or what our products are used for in the value chains we supply.
"How we will farm"	
Efficiency	▪ Drive adoption of science, systems and new thinking that will boost the cost effectiveness and efficiency of our farm operations.
Environment	▪ Lead the industry on showcasing rejuvenation and profitability potential of our environmentally-savvy farming.
People	▪ Lead the industry in people practices, providing the safest, most enriching work environment for talented and motivated people.

Source: Draft Strategic Plan



1. Executive summary

Milk production is forecast to double by FY17F. This primarily reflects the SPG arrangements, significant planned expansion of the WPL operations and also further conversion and development of the Canterbury dairy farms.

1.8. Draft Strategic Plan and Forecasts (continued)

Draft Forecasts

- The table opposite summarises the key assumptions and output of the draft Forecasts (as at mid-April 2014 – see note below).
- Milk production is forecast to double by FY17F. This primarily reflects the SPG arrangements, significant planned expansion of the WPL operations and also further conversion and development of the Canterbury dairy farms. Milk prices in FY14F reflect this season's record forecast payout. Landcorp's milk price assumptions going forward are at the more conservative end of the industry's forecast range.
- Lamb production is forecast to increase from 453,000 in FY13A to 494,000 in FY17F, an increase of 42,000 lambs (growth of 9%). Lamb prices are forecast to recover in FY14F from FY13A levels and thereafter reflect a slightly more positive outlook but still within the range achieved between FY11A and FY12A.
- FY14F operating profit of \$32.1 million largely reflects this season's record forecast milk payout. Operating profit is forecast to decrease in FY15F and FY16F, reflecting the lower milk price assumptions. FY17F operating profit is forecast to increase to \$25.1 million which is primarily related to increased milk volume combined with a \$0.50 per kgMS increase in the forecast milk price assumption.
- Forecast balance sheets presented opposite do not reflect land appreciation assumptions. Landcorp's 25 year average capital growth rate is 5.1%, which is likely to be the basis of revaluation assumptions in the final Board-approved forecasts.
- Bank borrowings are forecast to peak at \$250.6 million (gearing 15.5%) in FY16F. We understand that forecast borrowings are within existing facility limits and are forecast to be compliant with stipulated covenant ratios.

Summary of draft Forecasts

	Actual FY13A	FY14F	FY15F	FY16F	FY17F
Key assumptions					
Milk price (\$/kgMS) ¹	6.05	8.55	6.90	6.30	6.85
Milk production (tonnes)	12,761	18,595	20,340	22,864	24,716
Lamb price (\$ / head)	86	97	98	100	104
Lambs (000's sold)	453	458	464	479	494
Key profit and loss lines					
Total revenue	203.1	256.7	249.7	265.7	289.4
EBITDA	37.4	55.4	43.1	49.7	60.1
Interest	(10.8)	(9.3)	(11.5)	(15.7)	(18.0)
Operating profit	13.0	32.1	15.6	16.9	25.1
Key balance sheet lines					
Total assets	1,694.9	1,633.3	1,719.5	1,767.0	1,767.0
Bank loans	229.1	168.9	220.4	250.6	246.3
Total liabilities	377.6	321.3	373.3	403.9	399.9
Net assets	1,317.3	1,311.9	1,346.2	1,363.2	1,367.1

Source: Management

¹ FY13A is implied weighted average based on gross milk revenue and milk production. FY14F-FY17F are based on Fonterra milk price assumptions

Landcorp's revised forecasts

The draft Forecasts presented above are based on a version provided to Deloitte on 11/04/14. Analysis of trends presented within this report, including scenario analysis summarised on pages 80 and 81, reflects the above version of the draft Forecasts. Landcorp provided Deloitte with revised forecasts on 16/05/14 which reflect some assumption changes. We have included a summary of the incremental impacts of these revised forecasts in Appendix 10 of the report. We understand that the revenue, operating cost and capital cost components of these revised forecasts have been approved by Landcorp's Board, but the sale of Wharere for \$19.2 million was deferred to FY15F, dividends were decreased across the plan period and therefore debt levels and interest expense were also lowered.

1. Executive summary

Landcorp's strategic options are shaped by the Crown's objectives, the aspirations of management and the Board, and operational realities.

1.9. Strategic options

Factors driving strategic options

- The following considerations shape the strategic options available to Landcorp:
 - Most of Landcorp's TSR has been in the form of capital gains;
 - Access to additional equity or debt capital to fund growth is limited;
 - The Minister for SOEs has requested that Landcorp explore sell-down options;
 - Treasury and the Board both desire improved operating profitability;
 - Management aims to grow Landcorp's farming "footprint" utilising its expertise and "other people's money" (OPM);
 - The dairy sector is buoyant and Landcorp's development gains in Core Dairy have mostly been achieved (except in the Canterbury complex). It may be opportune to realise some of these gains;
 - There may be relatively more future upside in Livestock;
 - Head office costs have grown materially over the last decade, and now match the EBIT produced by the Livestock division; and
 - This partly reflects the considerable (but unquantified) level of industry good / leadership activities undertaken by Landcorp.
- Taking these and other factors into account, we have considered:
 - Options for the Crown to sell Landcorp as a whole;
 - Options to grow Landcorp using the OPM strategy;
 - Certain other growth opportunities; and
 - A scenario involving the sale of certain assets and cost reductions.
- Our focus is on options relating to Landcorp's asset ownership, asset mix, cost structure and capital structure. This focus reflects:
 - The constraints outlined above;
 - The fact that these areas are by their nature more directly under management control and able to be actioned in shorter time frames and with greater certainty than new revenue initiatives; and
 - That Landcorp's growth initiatives are mostly at the evaluation stage and Landcorp will require time to complete its assessment of these opportunities. While we comment on certain opportunities, the prioritisation and sequencing of initiatives will largely be a tactical matter for management and the Board.

1. Executive summary

The sale of Landcorp could release circa. \$1.3 billion of capital to the Crown. Maximising proceeds is likely to require the involvement of foreign investors.

1.9. Strategic options (continued)

Sale of whole business

- Although Landcorp has delivered a credible TSR over the last decade, most of this is in the form of capital gains. The “asset rich, cash poor” nature of farm ownership is not well matched to the Government’s fiscal objectives.
- A sale of the whole business could net in the vicinity of \$1.3 billion of capital for the Crown (based on the June 2013 farm valuations).
- The Minister of Finance has publicly stated that the Crown has no plans to sell any more assets following the election. However in Deloitte’s view there is no compelling reason for Landcorp to be in Crown ownership. It is predominantly a commercial farming operation and these activities would continue under private ownership within a competitive sector. Arguably private ownership would be beneficial for Landcorp if it provided more ready access to capital for its growth plans, and a sharper focus on cost efficiency.
- A sale of Landcorp would need to address certain issues:
 - The retention (or transfer to an alternative Crown entity) of LHL and its protected land;
 - The first rights of refusal held by iwi over certain land (and, more generally, iwi interests in other Landcorp farms);
 - The assignment or novation of Landcorp’s obligations under the WPL, SPG, Sweetwater and other contracts;
 - Whether the Crown would want to continue (and separately fund) the non-commercial industry good/leadership activities currently being undertaken by Landcorp.
- Beyond these matters, it should also be acknowledged that a sale of \$1.6 billion of farming assets would be unprecedented in New Zealand. Careful consideration would be needed to determine the optimal sale structure and process (e.g. sale as a whole; sale of Dairy and Livestock separately; approach to marketing; etc.). These decisions will depend largely on assessments of the interest levels from different categories of potential investors.
- Possible sale variants include:
 - Unconstrained sale. This would maximise proceeds to the Crown, but would likely involve foreign investors.
 - Sale to New Zealand investors (e.g. NZ Superfund) with a management contract. Seen as a sale to “NZ Inc.”, this would release capital to the Crown and reinvent Landcorp as a lower risk management company.
 - Sale of assets to a “Treaty Fund” with a management contract. Interests in the fund could be used to settle Treaty claims, relieving the Crown of the equivalent funding requirement.



1. Executive summary

Traditional OPM strategies (farm leasing or sharemilking) increase the volatility of returns while also foregoing capital gains on land. Landcorp is pursuing an alternative approach of agri-funds management.

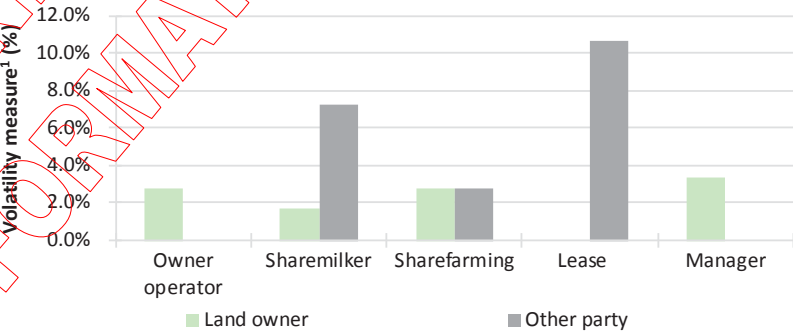
1.9. Strategic options (continued)

The OPM strategy

- Traditional OPM strategies in farming, such as sharemilking and leasing, effectively increase the relative volatility of returns to the non-land owning party, who are also foregoing capital gains. The chart opposite shows the volatility of different farming models on an illustrative dairy farm.
- Our analysis of WPL, a leasing arrangement, indicates that it will materially increase the sensitivity of Landcorp’s earnings to changes in the milk price.
- Negotiating leasing or other arrangements with farm owners, and the on-going interactions, are time consuming and would be impractical for Landcorp to do on a farm-by-farm basis.

s9(2)(b)(ii)

Alternative farming models - volatility measure



Source: Deloitte Analysis

¹ The volatility measure is the % change in EBIT for a 1% change in milk price

- Deloitte concurs with Landcorp’s approach to the OPM strategy. If successful, it would provide additional returns to Landcorp by leveraging its farming expertise. However, Landcorp should be prepared to “walk away” if it cannot negotiate sensible commercial arrangements. To some degree, Landcorp’s negotiating leverage will be influenced by its ability to demonstrate superior returns on its existing operations.



1. Executive summary

In Deloitte’s view, Landcorp’s growth efforts should be focussed on a few large opportunities with the potential scale to impact Landcorp’s performance.

1.9. Strategic options (continued)

Other growth opportunities

- In our view, Landcorp should focus on a limited number of large scale opportunities that are capable of making an impact on Landcorp’s performance, rather than risk entering too many sub-scale ventures.

s9(2)(b)(ii)

OPM and iwi

- The Sweetwater and Pouarua sharemilking arrangements demonstrate Landcorp’s ability to work constructively with iwi. In many respects iwi are logical partners for Landcorp under the OPM strategy, given their land base, long-term view on returns, and (typically) the potential to develop farm productivity and improve farm management skills.

s9(2)(b)(ii)

Sheep milking

- Landcorp sees significant opportunities to develop and sell sheep milk based dairy products into China. Landcorp is currently developing a business case for a sheep milking operation to tap into this market. To avoid a potential conflict of interest/confidentiality issue, the details of this proposal have not been shared with Deloitte.

- The key challenge involved in sheep milking in New Zealand is to develop sheep capable of yielding sufficient milk per hectare to compete with traditional dairying (noting that sheep milk based products typically sell at a premium to equivalent cows milk products). Landcorp believes its expertise in sheep genetics means it is well placed to tackle this issue. Deloitte believes this opportunity deserves consideration.

Central North Island milk venture

- The two main issues associated with Landcorp’s arrangements with WPL and SPG are (i) the potential volatility of returns from WPL and (ii) the short-term nature of the SPG contract. A potential key to addressing both of these issues lies in the fact that, taken together, Landcorp will control over 40 dairy farms producing circa 15 million kgMS, sufficient to underwrite the development of a new processing plant in the Central North Island (e.g. for infant formula or UHT milk).

s9(2)(b)(ii)



1. Executive summary

The proposed scenario of selling c. \$200 million of farms, repaying debt and reducing costs could materially improve operating profits and protect Landcorp in low milk price years.

1.9. Strategic options (continued)

Alternative scenario – asset sell down and cost reduction

- The quickest and most certain way to improve operating profitability is to sell non-core farms yielding below the cost of debt, repay debt, and reduce costs. We have therefore asked Landcorp to model a scenario involving:

s9(2)(b)(ii)

- In FY17, the first year showing the full impact of these changes, forecast operating profit increases 54% from \$25.1 million in the business as usual (BAU) draft Forecasts to \$38.8 million. The ROE improves from 1.8% to 2.8%, and debt drops from \$246 million to \$34 million.
- Important points to note regarding the alternative scenario are:
 - The actual use of proceeds from farm sales is a matter for Shareholders and the Board. Repaying debt is in our view sensible given the WPL expansion, and modelling this provides an easy means to measure the financial impact (via FY17F operating profit); and
 - Landcorp should retain borrowing headroom, and could redraw on those facilities when attractive investment opportunities arise. This could include utilising Landcorp’s skills to recycle capital more aggressively under a “buy, develop, sell” strategy.

Impact of WPL

- The table below illustrates the potential impact of the expanded WPL operation on Landcorp in a low payout year. For the purposes of illustration we have combined approximations of the FY17F performance of Livestock, Core Dairy and Corporate, with an estimate of a mature WPL operation.

Illustrative impact of mature WPL and low milk price

\$m	BAU SCI \$7 milk price	BAU SCI \$5 milk price	Alternative scenario \$5 milk price
Livestock EBITDA	s9(2)(b)(ii)		
Core Dairy EBITDA			
WPL EBITDA			
Corporate overheads			
Cost reductions			
Total EBITDA			
Depreciation			
Interest			
Operating profit			
Source: Deloitte Analysis			

s9(2)(b)(ii)

- This table demonstrates the defensive benefits of the alternative scenario. Given Landcorp’s heightened exposure to the milk price from the expansion of WPL, Deloitte believes that serious consideration should be given to reducing or mitigating this exposure.



1. Executive summary

From this Strategic Review, Deloitte has formed a number of conclusions and recommendations.

1.10. Key conclusions and recommendations

Conclusions

- Over the last decade Landcorp has delivered credible total returns to the Crown averaging 10% p.a. (compound). Capital gains have been the major component of Shareholder returns (averaging 8.3% p.a.).
- Livestock and Core Dairy have made similar contributions to Landcorp's returns.
- Landcorp undertakes a significant level of industry good/leadership activity, but this has not been explicitly mandated nor the costs quantified.
- Annual financial performance is relatively volatile due to fluctuations in farmgate prices and climatic events. Head office costs have increased materially in real terms over the last 11 years.
- Data comparability issues mean firm conclusions cannot be drawn about Landcorp's performance relative to its peers. However, it appears that Landcorp's on-farm performance equals or exceeds its peers, but when corporate overheads are included the financial performance drops to being on par or below its peers.
- Operating profit is forecast to grow primarily due to expansion of WPL and other dairy farms, and will become increasingly sensitive to the milk price.
- WPL's size and lease arrangements will materially increase the percentage sensitivity of Landcorp's EBIT to changes in the milk price. WPL has not been fully modelled.

Recommendations

- Deloitte recommends that Landcorp should:

1. s9(2)(b)(ii)
2. Undertake a cost reduction programme targeting savings of \$7 million to \$10 million (i.e. 3.5% to 5% of total operating costs), focusing on both farming and head office costs.
3. Identify and cost its non-commercial industry good/leadership activities and discuss with Treasury:
 - Whether the Shareholders wish Landcorp to continue with some or all of these activities; and
 - If so, whether the associated costs should be excluded when considering Landcorp's performance.
4. Focus its growth efforts on opportunities that have the potential scale to lift Landcorp's performance. Possible candidates include the OPM strategy and leveraging Landcorp's control of WPL and SPG milk volumes into better commercial outcomes.
5. Improve its ability to quantify and articulate the benefits of the integrated corporate farming model (e.g. through better benchmarking analysis and quantifying the production gains from the network farming approach).
6. Undertake a full financial analysis of its WPL arrangements (cash flows, IRR, sensitivity analysis, etc.).
7. Consider options to reduce or mitigate its growing exposure to the milk price (discussed in section 6.5).

2. Overview of Landcorp

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2. Overview of Landcorp

Landcorp was created in 1987 from the Lands and Survey Department. The period to 2001 was characterised by significant land divestments for Treaty settlements and paying dividends in excess of operating profits.

2.1. History

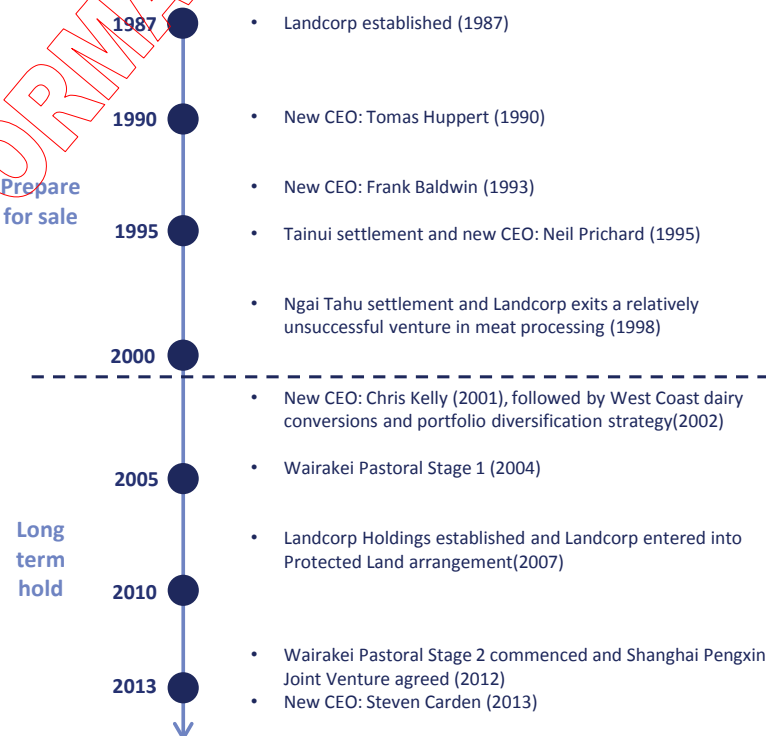
- Landcorp was created in 1987 following the restructuring of the now disestablished Lands and Survey Department. A large proportion of the original land portfolio vended to Landcorp was characterised as relatively poor quality or marginal farming land, which historically had been unsuccessfully farmed by the private sector. Other land within the original portfolio had been provided to the Lands and Survey Department by other Government agencies as it was considered surplus to requirement and/or potentially suitable for farming.
- Following is a brief summary of the key events and major influencing factors in the development of Landcorp, and the chart opposite highlights some key events in Landcorp's history, which can be broadly categorised into two periods: (i) 1987 – 2001 reflecting a period of extended uncertainty regarding the longer term ownership intentions of Government; and (ii) the period since the Government signalled a longer term hold policy for SOEs in 2001.

Prepare for sale: 1987 – 2001

- During this period Landcorp's business was almost entirely based on livestock farming with some property development activity and only limited dairy farming (predominantly sharemilking). The period was characterised by the following :
 - Limited new business investment and/or land purchases;
 - Dividends being significantly in excess of operating profits; and
 - Significant land divestments in relation Treaty settlements.
- Land under management reduced by around 60,000 hectares, including land distributed in connection with the significant Treaty settlements for Waikato-Tainui in 1995 and Ngai Tahu in 1998. Total operating profits over the period were \$144 million, compared with total dividends paid of \$314 million, being significantly funded by asset sales.

Timeline of key events

Key events and milestones



Source: Landcorp Annual Reports (1988-2013), "Footprints to the Future" by Gavin Muirhead, and other information provided by Landcorp

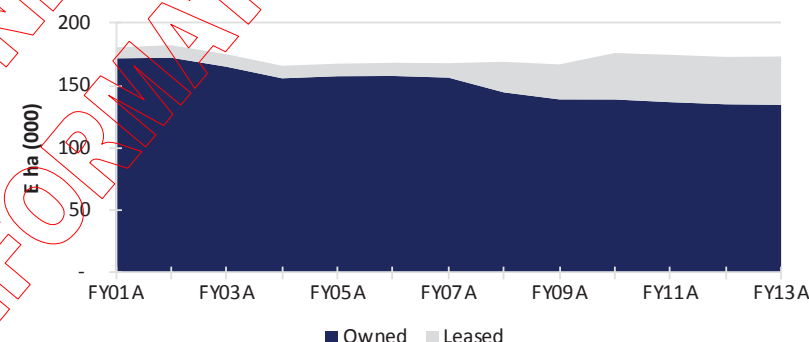
2. Overview of Landcorp

Since 2001, the long term hold policy for SOE's has seen diversification into dairy and deer farming, integration of farms into clusters, greater focus on performance and dividends aligned with operating profits.

Long term hold: 2001 – current

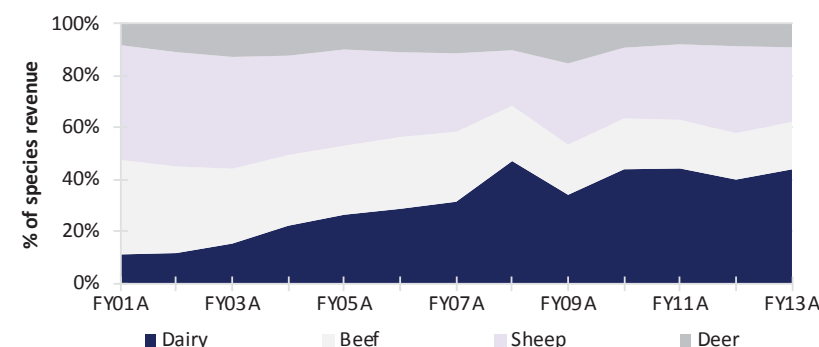
- During 2001 a long term hold policy for SOEs was confirmed by the Government. Confirmation of this policy coincided with the appointment of Chris Kelly as chief executive and the development of a long term strategic plan, which importantly included the transformation from a predominantly sheep and beef farming operation into a more diversified farming operation, including dairying and deer farming. This has included significant capital investment (around \$180m to date) in relation to dairy conversions, dairy farm acquisitions, and deer farming. Other notable features during this period have included:
 - Clustering of farms and an integrated approach to farming operations (e.g. integration of breeding and finishing farms);
 - Legal restructuring of a portfolio of land reserved for iwi settlements;
 - Focus on increasing on-farm productivity, benchmarking and improving farm financial performance; and
 - Investment in strategic partnerships, including increasing Landcorp's portfolio of farms under management through leasing and commercial sharemilking arrangements.
- The charts opposite highlight Landcorp's operational transformation since 2001. The top chart shows the net reduction in land ownership and increasing leased land. The bottom chart shows the change in Landcorp's revenue mix as a consequence of its strategic investment into dairy farming operations.
- Over FY01A – FY13A Landcorp's cumulative operating profits were \$227 million compared with total dividends paid of \$185 million, indicating that dividend payments were covered by operating profits. Capital from the sale of land was reinvested principally into the development of dairy farms.

Effective hectares by ownership type



Source: Management Analysis

Revenue by species



Source: Management Analysis

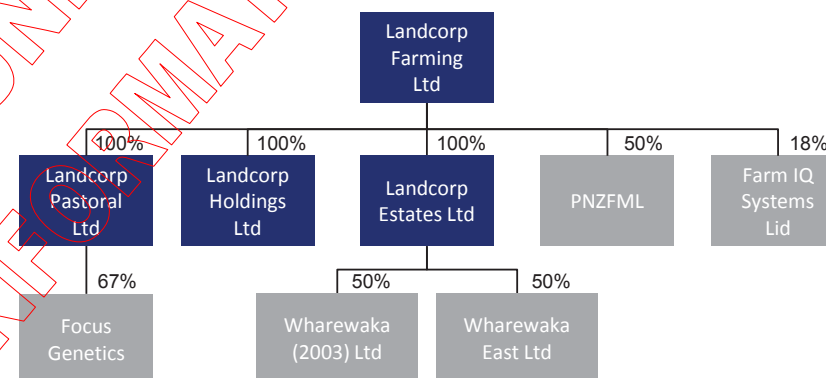
2. Overview of Landcorp

Landcorp owns \$1.7 billion of livestock and dairy farming assets, and has extended its farming “footprint” through leasing, sharemilking or management arrangements on land it does not own.

2.2. Group structure

- The diagram opposite summarises Landcorp’s group structure. The parent company, Landcorp Farming Limited (LFL), holds the great majority of the group’s farming assets. It also has three wholly owned subsidiaries:
 - Landcorp Estates Limited (LEL) develops and sells land considered to have a higher value use than farming;
 - Landcorp Holdings Limited (LHL) holds Landcorp property protected from sale under an agreement with the Crown; and
 - Landcorp Pastoral Limited (LPL) holds a 67% investment interest in the Focus Genetics Limited Partnership (Focus Genetics), which is involved in the development of genetically superior rams for sale to farmers.
- LFL includes an unincorporated partnership with Wairakei Pastoral Limited (WPL) to convert forestry land into a dairy and livestock portfolio. The commercial arrangements are based on two 40 year leases. Significant further investment is planned over the next three years in respect of WPL.
- In addition, LFL holds a 50% ownership interest in Pengxin New Zealand Farm Management Limited (PNZFML), an entity established to manage a joint venture between Landcorp and Shanghai Pengxin Group (SPG). This is a commercial sharemilking arrangement whereby Landcorp has agreed to provide development and ongoing farm management services to SPG as the owner of the former Crafar farms.
- LFL also holds an 18% equity interest in Farm IQ Systems Limited, a company established in partnership with cooperative meat processor Silver Fern Farms Limited to provide research and development for red meat value chain integration.
- Landcorp Estates Limited holds a 50% ownership interests in Wharewaka (2003) Limited and Wharewaka East Limited, which are jointly-owned property development companies with land investments near Taupo.

Landcorp group structure



Source: Companies Office

Note: Appendix 1 provides further description of the activities for each of Landcorp’s entities.

Landcorp group - summary FY13A consolidation

\$m	LFL	LEL	LHL	LPL	+ / -	Group
Revenue	201.2	2.3	8.0	1.9	(10.2)	203.1
Expenses	(173.4)	(0.5)	(1.3)	(0.7)	10.1	(165.8)
EBIT	14.4	1.8	6.5	1.1	(0.1)	23.8
NPAT	(24.2)	1.1	4.0	1.1	(0.1)	(18.1)
Assets	1,701.7	25.1	139.3	5.1	(176.3)	1,694.9
Liabilities	395.8	0.4	16.0	1.0	(35.6)	377.6
Equity	1,305.9	24.7	123.4	4.1	(140.7)	1,317.3

Source: Annual Reports and Deloitte Analysis

2. Overview of Landcorp

As an SOE, Landcorp's primary focus is to be a successful business and as profitable as comparable private farmers. Landcorp has no explicit mandate to undertake industry good roles...

2.3. Landcorp's Statement of Corporate Intent (SCI)

- As a State Owned Enterprise, Landcorp is required to operate as a successful commercial business, be a good employer, be socially responsible, and follow all relevant statutory and regulatory requirements including those established by the SOE Act and summarised in the Owners' Expectation Manual for State-Owned Enterprises.
- A central requirement is to publish an SCI each year, setting out objectives, activities, and financial targets for the three years ahead. The SCI is Landcorp's key accountability document and effectively establishes the framework for its business strategy and planning. It is developed in consultation with the Shareholding Ministers and officials before finalised for tabling in Parliament.
- Landcorp's most recent published SCI and corresponding business plan was approved in 2013 and covers the three forecast financial years FY14F to FY16F. Landcorp is currently updating its three year financial forecasts as part of the annual planning process, to cover the period FY15F to FY17F.
- In further reviewing Landcorp's SCI and wider operating framework we note the following requirements:
 - SOEs are required to be as efficient and profitable as comparable corporates not owned by the Crown, but will be compensated by the Crown if asked to perform non-commercial activities.
 - SOEs should operate with an optimal capital structure, consistent with holding a BBB credit rating. The Crown does not guarantee or support any borrowings by Landcorp.
 - The level of dividends paid will be determined by the SOE's optimal capital structure and future investment requirements, and also by the preferences of Shareholding Ministers. Any surplus capital will be returned to the Crown.

Approval is required from Shareholding Ministers for any major transactions (as defined in the Companies Act 1993). In general, the Shareholders have powers over and above those in the Companies Act to require company information, request changes in strategy and approve, or be consulted on, significant transactions.

- In addition, SOEs have comprehensive reporting and accountability obligations intended to substitute for the equity market disciplines applying to publicly-traded companies.

Landcorp's industry good role

- Landcorp's current SCI refers to maximising economic production "primarily within Landcorp but also in the wider pastoral sector". Similarly, the scope for this Strategic Review refers to ways to "improve future returns whilst recognising Landcorp's contribution to New Zealand's primary sector".
- Notwithstanding these statements, and obligations to be socially responsible and a good employer, Landcorp is not obliged under the SOE Act or the SCI framework to undertake or facilitate any industry good initiatives that may be considered outside of its core commercial farming objectives, and it has no explicit mandate to undertake such activities.
- As an SOE, and New Zealand's largest corporate farmer, in pursuing its commercial farming activities Landcorp has the potential to demonstrate leadership and provide ancillary 'spill-over' benefits for both the sector and wider economy. Also, it is commercially rational for a business with Landcorp's scale and strategy to undertake a level of investment in industry good or corporate citizenship activities.
- However, management believes that Landcorp's expenditure on industry good/leadership activities (the direct costs plus investment of management time) is at a significantly higher level than an equivalent privately-owned corporate farmer would undertake.

2. Overview of Landcorp

...however Landcorp's expenditure on non-commercial industry good/leadership activities is significant, although this has not been quantified.

2.4. Industry leadership and stakeholder views

Landcorp's leadership activity

- Landcorp undertakes industry good/leadership activities that it believes are far more extensive than an equivalent privately-owned farmer would undertake. Management's summary of these activities is set out in Appendix 8 and aspects are summarised below:
 - **Environmental leadership:** Farming, and intensive dairy farming in particular, is subject to increased regulatory and public scrutiny in relation to its environmental practices. Landcorp prioritises capital and operational expenditure to ensure its environmental farming practices are well above minimum regulatory compliance standards. For an indication of the size of this expenditure Landcorp estimates that they have spent \$2.9 million since 2007, primarily on QEI covenant protection
 - **Staff development:** Landcorp estimates that it invests approximately \$1.3 million p.a. in development of its people through in-house and external training programs. This is an investment well beyond the standard training funding most private individuals receive, and helps build the talent base of the primary sector. In addition, Landcorp currently invests \$100k+ p.a. in its training program at Aratiatia and will invest a further * from FY15F to run a dairy academy in conjunction with SPG.
 - **FarmIQ:** Landcorp will invest a total of \$3.4 million in the FarmIQ PGP. In addition it has invested significant managerial time in the formation then ongoing governance of the PGP, and significant amounts of IT team time to develop the Farm Management System with FarmIQ.

Research and development: Landcorp invests around \$900k annually in core R&D funding (principally to support organisations undertaking the research). Investments include Johne's disease research in the deer industry, and funding the Sequenom machine at Auckland University that measures the environmental impact of genes transferred between generations of sheep.

Red meat sector leadership: The red meat sector is challenged with a range of structural issues manifesting in low profitability. Through its scale Landcorp is able to demonstrate potential pathways for wider sector reform, including opportunities for greater value chain integration. An example of this is Landcorp's current fixed supply contract with Silver Fern Farms and Tesco's supermarkets in the UK.

- **Maori/iwi development:** Landcorp has entered into significant JV relationships with two iwi in NZ (at the Sweetwater (Northland) and Pouarua (Hauraki) dairy complexes). These partnerships are the first of their kind and will involve investment in two Maori farming scholarships per partnership to help build a base of local farm staff. Landcorp is in discussions with other iwi about similar partnerships in other parts of the country. While partnerships are not entered into on a non-commercial basis, the returns on these partnerships are modest (typically 5%-8% p.a.).
- No explicit mandate exists to undertake non-commercial industry good initiatives, and the cost of such activities has not been quantified. Deloitte believes that Landcorp should identify and cost the activities that fall into this category and discuss with Treasury:
 - Whether the Shareholders wish Landcorp to continue with some or all of these activities; and
 - If so, whether the associated costs should be excluded when considering Landcorp's performance.

*=withheld under s9(2)(b)(ii)

2. Overview of Landcorp

Several industry participants interviewed saw focusing on efficiency and profitability as Landcorp's best opportunity to demonstrate industry leadership.

Stakeholder views

- As part of this Strategic Review we interviewed an agreed cross section of representatives from a range of Landcorp's stakeholders, covering the following organisations:
 - Industry bodies: Federated Farmers and Dairy NZ;
 - Ministry for Primary Industries: representatives from Sector Policy, Maori Primary Sector Partnerships and Primary Growth Partnerships;
 - Agribusinesses: a meat processor, research organisations and representatives from organisations involved in commercial joint ventures and partnerships with Landcorp; and
 - Agribusiness consultants: Baker and Associates.
- The purpose of these interviews was to gather views and perceptions held by industry participants regarding Landcorp's track record and performance as a corporate farmer, its current contribution to the development of the agricultural industry, and its potential future industry leadership role.
- The following is a summary of the main views expressed and collated from the stakeholder interviews:
 - Landcorp should first focus on being a good efficient farmer. Through this Landcorp can demonstrate to the sector ways to be more efficient and profitable. Examples include the use of farm management systems and genetics.
 - The majority of those interviewed had a positive perception of Landcorp (including being a good neighbour and participating in the community). Some stakeholders saw a greater potential industry leadership role for Landcorp.
 - Landcorp is helpful in trialling new farming methods but larger private farmers also do a significant amount of this. However Landcorp's geographic diversity and farming mix make it a valuable partner for certain research projects.
 - The dairy sector is functioning well and includes a range of efficient large scale farmers. In contrast the livestock sector has a range of structural issues and limited participants of genuine scale. As a result it is more likely that Landcorp can make a greater contribution to industry leadership through its Livestock business.
 - Landcorp's investment in corporate head office capability appears significant and its Wellington centric base did not feel very 'agricultural'.
 - Landcorp is collaborating more in the value chain to support efforts in market and to learn what they can do differently back on farm.
 - There is an increased demand for large scale asset management but Landcorp does not appear to have a clear strategy or offering in this space. It is likely that emerging private sector asset managers will also compete in this space.
 - Landcorp sometime tries to develop internal solutions when industry-developed options were available "off-the-shelf" (albeit these are often targeted at the family farm).
 - Landcorp could be more open in sharing its internally developed intellectual property and making it more useable for the average family farm.
 - Landcorp should work more closely with industry bodies to make maximum use of available public funding for industry development (particularly in the red meat sector).

2. Overview of Landcorp

The breadth of Landcorp's stakeholders reflects its commercial scale, and industry position.

Processors	Public Sector, NGO's and Industry Organisations
<ul style="list-style-type: none"> ▪ Dairy: Landcorp supplies Fonterra, Synlait, Open Country Dairy, Westland Milk Products and Miraka. Landcorp is continuing to look for fixed price supply contracts for a portion of milk it produces. Landcorp is also seeking a premium based on volume and quality, which Fonterra has indicated it is not prepared to consider. In contrast to Fonterra, Synlait is offering differentiated pricing based on the quality of on-farm practices. ▪ Red Meat: Landcorp currently supplies Silver Fern Farms, Alliance Group, Five Star Beef, Firstlight Venison and Firstlight Wagyu. Landcorp prefers to avoid the spot market, opting to increase the proportion of contracted supply to processors. The Silver Fern Farms' Tesco contract is aligned to this approach, attracting a premium for quality genetics and on-farm practices, and providing product to specification. ▪ Wool: Landcorp has opportunities in conjunction with PGG Wrightson's direct export business to take fixed pricing for forward supply. 	<ul style="list-style-type: none"> ▪ Public Sector: Landcorp, as an SOE, maintains good relationships with the public sector including Treasury, Ministry for Primary Industries, ACC, Ministry for the Environment, Office of Treaty Settlements, Department of Conservation, Regional and District Councils. For example, Landcorp has a MOU with the Ministry for Primary Industries which underpins initiatives for mutual benefit, has been working with ACC to improve on farm safety and health, and working closely with Government on Treaty settlements. ▪ NGOs: Landcorp, as a large corporate farmer and experienced manager of farm assets, is developing relationships with the Federation of Maori Authorities and Te Tumu Paeroa. ▪ Industry Organisations: Landcorp, as a large levy payer and corporate farmer, has strong relationships with industry representative organisations including Beef+Lamb New Zealand, DairyNZ, Deer Industry NZ, Federated Farmers and OSPRI. Joint initiatives are often undertaken, such as the Dairy Primary Growth Partnership.
Suppliers	Science, Research and Technology
<ul style="list-style-type: none"> ▪ Supplier arrangements: Landcorp has a number of preferred supplier arrangements, and receives a discount due to the high volume of purchases. Landcorp also has the opportunity to access specialist advice as part of this service. 	<ul style="list-style-type: none"> ▪ Collaborations: Landcorp collaborates with organisations through a variety of mechanisms. For example: <ul style="list-style-type: none"> – The Pastoral Greenhouse Gas Research Consortium; – Farm IQ Systems Limited a joint venture with Silver Fern Farms; – Focus Genetics, a joint venture with Rissington Breedline, in red meat genetics.



2. Overview of Landcorp

Landcorp currently operates a total of 131 farms covering 178,880 effective hectares (E ha), comprising 55 Dairy and 76 Livestock (sheep, beef and deer) farms.

2.5. Assets and operations

- The table opposite provides a summary of Landcorp's farming operations at FY13A. The following pages provide more detailed summary of Landcorp's respective Livestock and Dairy operations, and Landcorp's significant WPL leasing arrangements and other commercial arrangements in respect of managing dairy farms owned by other parties.
- Extending back over the last 15 years (or since the Ngai Tahu Treaty of Waitangi settlement) Landcorp has reduced its land holdings by approximately 31,000 total hectares or around 15% (not including land transferred to Landcorp Holdings Limited). This reduction largely reflected a combination of Landcorp's desire to create efficiencies through clustering farms and disposing of outliers, withdrawal from the Taupo catchment, further Treaty settlements and also transferring land considered suitable for subdivision to Landcorp Estates Limited. We understand that over this 15 year period Landcorp has disposed of approximately 55,000 total hectares offset by strategic acquisitions of around 24,000 total hectares.
- Over the last five years Livestock stock units have declined from 761,000 to 700,800, or a decrease of 60,200 (7.9%). This decrease primarily reflects dairy conversions and some farm divestment. Over the corresponding period Dairy stock units had remained relatively stable up until FY13A when around 17,000 cows were purchased to facilitate the SPG sharemilking arrangements.
- Operational employee numbers had remained relatively stable over the last five years, averaging around 510, but increased by 94 during FY13A due to the SPG sharemilking arrangements. Corporate staff headcount has remained relative stable over the last five years, averaging around 77.

Operational summary

\$m	Livestock	Dairy	Total
Number of farms (current):			
North Island	44	37	81
South Island	<u>32</u>	<u>18</u>	<u>50</u>
Total	76	55	131
Area farmed (current E ha):			
Owned	140.1	7.9	148.0
Leased	<u>16.6</u>	<u>14.2</u>	<u>30.8</u>
Total	156.7	22.1	178.9
Other operational KPIs (FY13A):			
Livestock SU (000s)	700.8	379.8	1,080.6
Operational staff	325	264	589
Production (Tonnes)	26,528	12,761	39,289

Source: Annual Reports, Management



2. Overview of Landcorp

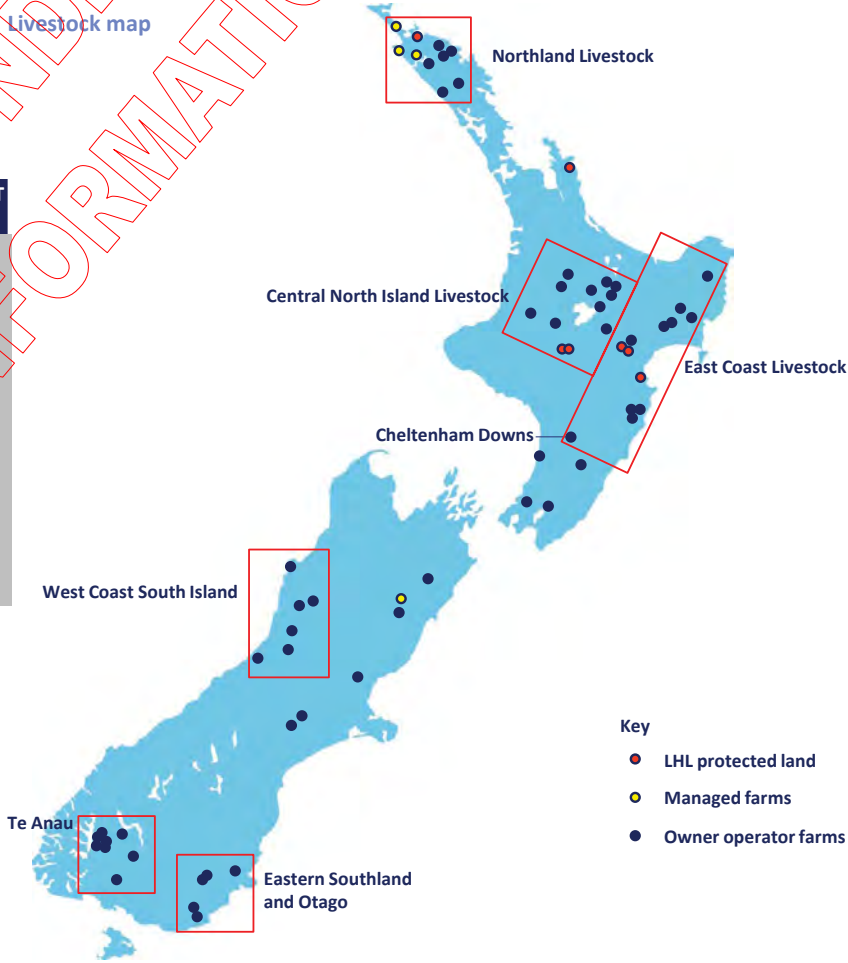
Of the 77 FY15F Livestock farms, 44 are located in the North Island and 33 are located in the South Island. The main Livestock farm clusters are outlined below.

FY15F Livestock operations*

	No of	E ha	FY14F sales volumes (kgs 000)			FY13A	FY15F	FY15F EBIT
						ssets \$m	EBIT \$m	/ assets
s9(2)(b)(ii)								

Source: Management Analysis and Deloitte Analysis
* The figures presented in the table above relate to a longitudinal measure of farms from FY13A to FY15F. As such these figures represent FY15F farms plus any current farms that are forecast to be sold prior to FY15F. For simplicity we have referred to these as FY15F farms.

Livestock map



2. Overview of Landcorp

Of the 74 FY15F Dairy farms, 57 are located in the North Island and 17 are located in the South Island. The main Dairy farm clusters are outlined below.

FY15F Dairy operations*

	No of farms	Tenure	E ha (000)	FY14F KgMS (tonnes)	FY13A assets \$m	FY15F EBIT \$m	FY15F EBIT / assets
s9(2)(b)(ii)							

Source: Management Analysis and Deloitte Analysis

* The figures presented in the table above relate to a longitudinal measure of farms from FY13A to FY15F. As such these figures represent FY15F farms plus any current farms that are forecast to be sold prior to FY15F. For simplicity we have referred to these as FY15F farms.



2. Overview of Landcorp

Landcorp has significantly grown its dairy operations by managing farms owned by others. Only 41% of FY14F production is forecast to come from the owner-operator model.

SPG (Sharemilking)	WPL (Lease)
<ul style="list-style-type: none"> Commercial sharemilking arrangement whereby Landcorp provides development and ongoing farm management services to the Shanghai Pengxin Group (SPG) as the land owner. Joint venture arrangements structured through interests held in PNZFML. Landcorp originally took over the management of 16 farms owned by SPG in December 2012 and the arrangements became effective from June 2013, with Landcorp sharemilking 11 of the 13 dairy units, and further managing two marginal dairy units and three dry stock farms. Landcorp owns the livestock and SPG pays for capital improvements. Landcorp's share of the revenue reduces as pay-out increases and operating costs are apportioned s9(2)(b)(ii) 	<ul style="list-style-type: none"> An unincorporated partnership between Landcorp (lessor) and WPL (lessee) to convert forestry land into a dairy and livestock portfolio. There are two 40 year adjacent leases, the Waikato (14,900 ha) and Tauhara (10,800 ha) leases. s9(2)(b)(ii) Current operations comprise 6 dairy farms (covering 3,400 ha, milking 7,800 cows and producing around 3 million kgMS pa) and also grazing farms, Rolls Peak (3,700 ha) and Orakonui (1,200 ha). Significant development planned over the next four years related to the conversion of a further 8,000 hectares resulting in another 25 dairy farms.
Sweetwater (Sharemilking)	Pouarua (Sharemilking)
<ul style="list-style-type: none"> Commercial sharemilking arrangement between Landcorp and Crown in connection with 3 dairy farms (977 E ha) in Northland. Arrangement was established in 2010 and remains until the Crown transfers the land to relevant iwi. Landcorp's role is to operate and manage the dairying and connected drystock operations. FY14F budgeted production of nearly 1 million kgMS. Landcorp owns the livestock and Crown pays for capital improvements. Landcorp incurs all costs and receives all revenue associated with the operation. Landcorp then pays an annual licence fee to the owner based on a revenue less costs valuation model. 	<ul style="list-style-type: none"> Commercial sharemilking arrangement between Landcorp and iwi in connection with 8 dairy farms (1,652 E ha) in the Waikato. Land was sold to iwi in November 2013 and the transition to sharemilking arrangements commenced in FY14F. Landcorp's role is to operate and manage the dairying operations. FY14F budgeted production of around 1.7 million kgMS. s9(2)(b)(ii)

(1) The table above describes Landcorp's four most significant non-farm ownership commercial joint ventures. WPL and SPG are described in more detail within Appendices 2 and 3.

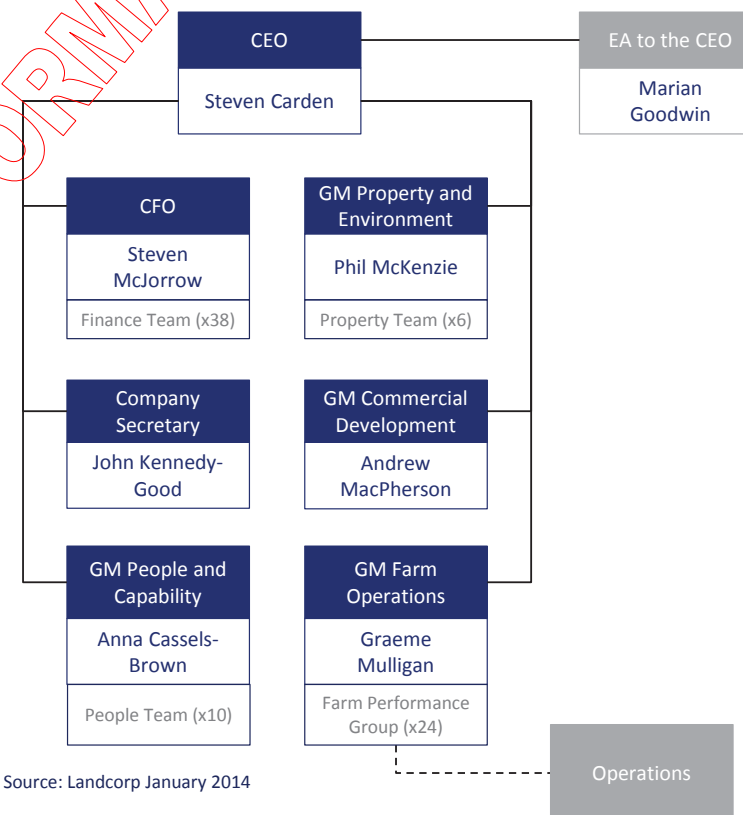
2. Overview of Landcorp

Landcorp had 668 permanent employees at June 2013 comprising 79 corporate (86 at January 2014) and 589 operational staff. The CEO is supported by 6 general managers.

2.6. Management structure

- The chart opposite summarises Landcorp's management team. Steven Carden was appointed to the role of Chief Executive Officer (CEO) in August 2013 following the retirement of long serving former CEO, Chris Kelly. There are six general managers that report to Steven Carden covering operations, property and valuation, strategy, human resources and finance and administration. Landcorp had 668 permanent employees at June 2013 comprising 79 corporate (86 at January 2014) and 589 operational staff.
- Steven McJorror is the newly appointed Chief Financial Officer (CFO). There are 38 corporate staff that work within the finance and administration function.
- Andrew MacPherson is General Manager Commercial Development and joined Landcorp in December 2010. Anna Cassels-Brown joined Landcorp in December 2013. Anna is the General Manager People and Capability and there are 10 corporate staff supporting this function. Phil McKenzie joined Landcorp in February 1981. Phil is the General Manager Property and there are six corporate staff supporting this function. John Kennedy-Good joined Landcorp in August 2005 and is Landcorp's Company Secretary.
- Graeme Mulligan joined Landcorp in January 1978. As General Manager Farm Operations, Graeme has overall responsibility for coordinating the farming operations and performance. Graeme has a team of 24 corporate staff and managers. Graeme's key direct reports are National Dairy Manager Mark Julian, Senior Business Managers with responsibility for WPL development and operations, Ross Shepherd and Bruce Hunter respectively, and the North Island and South Island Livestock Managers, Mike Gaukrodger and Andrew Beijeman respectively. These senior managers are supported by various business managers, and other specialists. This group oversees the individual farm managers and their day-to-day operational support staff.

Landcorp management team





2. Overview of Landcorp

Operating profits can vary widely with climatic conditions and commodity prices. Over FY09A-FY13A operating profit has averaged \$20 million (or \$47 million before interest and corporate costs).

2.7. Financial overview

Financial performance

- The table opposite summarises Landcorp's reported financial performance over the last five financial years (FY09A to FY13A), FY14F is also provided for context. Reported operating profit has ranged from \$6.9 million in FY09A to \$42.2 million in FY11A, with an average over the period of \$19.8 million. Interest costs averaged \$11.1 million over the period, and corporate overheads averaged \$16.3 million. EBIT before these two items (essentially on-farm EBIT) averaged \$47.2 million.
- Variations in operating results primarily reflect climatic conditions and the associated impacts on production, and farmgate prices as influenced by the prevailing commodity prices and foreign exchange rates. Landcorp estimates that drought events in FY09A and FY13A negatively impacted operating profit by \$9.8 million and \$11.3 million respectively. FY11A operating profit of \$42.2 million reflected favourable climatic conditions and record farmgate prices for Dairy and beef.
- Non-operating revenues have had a significant impact on recent results, in particular \$26.4 million in FY13A which included reimbursement of protected land losses of \$7.0 million.
- Operating expenses include direct farming costs and other operating costs, including corporate overheads. Increased costs over the last five years are mostly related to increased cropping and feed costs and also personnel costs, and are largely attributable to Landcorp's expanded dairy operations.
- Historically there have been significant differences between reported operating profit, net profit after taxation (NPAT) and other comprehensive income, mostly reflecting gains or losses on sale of assets and revaluations of livestock and land and buildings. Landcorp undertakes annual valuations of livestock and land and buildings and carries these assets at fair value.

Summary profit and loss

\$m	FY09A	FY10A	Actual FY11A	FY12A	FY13A	Forecast FY14F
Revenue						
Livestock revenue	104.5	89.4	119.0	124.5	96.7	107.2
Milk revenue	54.2	70.2	94.6	83.0	75.8	139.2
Other operating revenue	1.7	3.4	5.8	3.1	4.2	4.0
Operating revenue	160.3	163.0	219.4	210.5	176.7	250.5
Non-operating revenue	13.7	6.9	(1.0)	5.2	26.4	6.2
Operating expenses	(142.2)	(135.9)	(153.3)	(165.2)	(165.8)	(201.2)
EBITDA	31.8	33.9	65.1	50.5	37.4	55.4
Depreciation	(12.2)	(12.6)	(12.5)	(13.3)	(13.6)	(14.0)
EBIT	19.6	21.4	52.6	37.3	23.8	41.4
Net interest	(12.7)	(11.4)	(10.4)	(10.2)	(10.8)	(9.3)
Operating profit	6.9	10.0	42.2	27.0	13.0	32.1
KPIs						
E ha (000)						
Dairy	15.4	18.1	17.0	16.8	16.9	27.3
Livestock	151.7	158.0	157.7	156.2	156.4	151.6
Total E ha	167.1	176.2	174.7	173.1	173.4	178.9
Stock units (000)						
Dairy	194.3	199.3	269.5	269.5	379.8	414.3
Livestock	761.0	731.6	708.9	708.9	700.8	842.3
Total stock units	955.3	930.9	978.4	978.4	1,080.6	1,256.6
Production (tonnes)						
Dairy	11,210	11,504	12,500	13,357	12,761	18,595
Livestock	26,284	24,690	22,221	25,073	26,528	34,279
Total production	37,494	36,194	34,721	38,430	39,289	52,874

Source: Annual Reports, Management Analysis

2. Overview of Landcorp

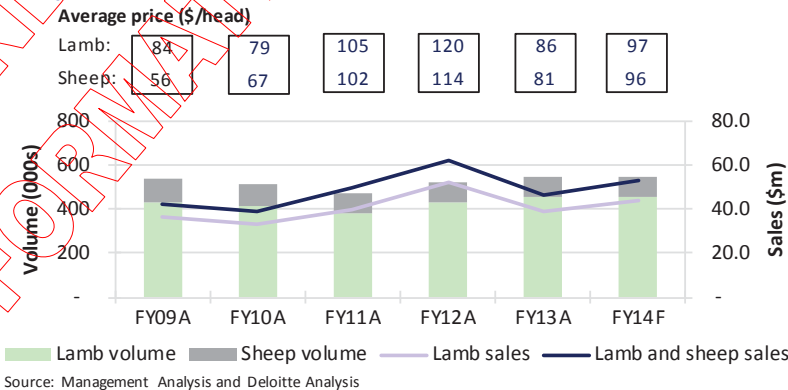


Over FY09A-FY13A, Livestock revenue reached a high in FY12A based on strong sheep and lamb prices. Production grew in FY13A but this was more than offset by lower prices.

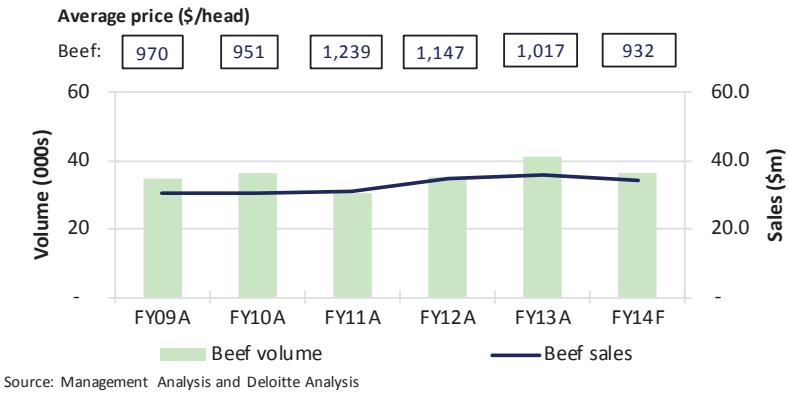
Livestock revenue

- The charts opposite show sheep, lamb and beef revenues over the last five financial years, FY14F is also provided for context. Revenue is a function of the farm gate price received and the volume of livestock sold, plus corresponding accounting adjustments for the changes in value related to costs of sales and also net natural increases or decreases. The charts show recent historical changes in production volumes and farm gate prices and the resulting impact on sales.
- Combined sheep, lamb and beef sales accounted for around 75% of total Livestock revenue over FY09A-FY13A. Other significant sources of Livestock revenue include deer and wool, representing on average around 15% and 8% respectively. The historical sales mix is broadly consistent with the current trends and mix within this division.
- Specifically lamb sales have accounted for around 38% of Landcorp's Livestock revenue over the last five years. Volumes of lambs sold increased from 432,000 in FY09A to 453,000 in FY13A, an increase of 21,000 lambs (growth of around 5%). During the intervening period production volumes variances were mostly attributable to prevailing climatic and seasonal conditions as related to lambing percentages and also decisions to retain livestock for capital replacement. Average annual prices per head varied from a minimum of \$90 in FY10A to a peak of \$144 in FY12A, or a variance of \$55 (61%). The average price received was \$112 over this period. Sheep sales mostly reflect culled breeding animals at the end of their productive life. Volumes of sheep sales have remained relatively steady, averaging around 96,000 per year.
- Beef sales accounted for around 30% of Landcorp's Livestock revenue over the last five years. Volumes sold increased from 35,000 in FY09A to 41,000 in FY13A, an increase of 6,000 head (growth of around 15%). Average annual prices per head varied from a minimum of \$1,001 in FY10A to a peak of \$1,239 in FY11A, or a variance of \$239 (24%). The average price received was \$1,090 over this period.

Sheep and lamb sales



Beef sales



2. Overview of Landcorp

Over FY09A-FY13A, Dairy revenue was highest in FY11A based on average payout of \$7.11. FY14F is forecast to be a record year, with Dairy revenue of \$163.8 million.

Dairy revenue

- Milk revenue is a function of the farm gate price received and the volume of milk sold, measured in kgMS, less the sharemilkers' share of production. The analysis shown opposite demonstrates recent historical changes in production volumes and farm gate prices and the resulting impact on milk revenue. FY14F is also provided for context.
- Between FY09A and FY12A milk production steadily increased from 11,210 tonnes of milk solids to 13,357 tonnes of milk solids. Decreased production in FY13A reflected the impact of the 2012-13 drought.
- Landcorp's overall growth in production over this period primarily reflects increased contributions from the maturing WPL portfolio (from 2,657 tonnes in FY09A to 3,097 tonnes in FY12A) and also the more recent Canterbury conversions.
- Over the five year historical period milk revenue varied significantly, from a peak of \$94.6 million in FY11A to a low of \$54.2 million (or a variance of \$40.4 million). Revenue volatility mostly reflects milk prices, which over the corresponding period ranged from a peak of \$7.71 kgMS to a low of \$4.99 in FY09A.
- FY14F is expected to produce record milk revenues of \$163.8 million due to an increase in production to 18,596 tonnes of milk solids and the record forecast milk price of \$8.55/kgMS.



Source: Management Analysis and Deloitte Analysis

KPIs	FY09A	FY10A	FY11A	FY12A	FY13A	FY14F
Average price \$ / kgMS ¹	4.99	6.22	7.71	6.33	6.05	8.55
Cows	52,463	52,202	50,342	50,352	67,304	
E ha's 000	15.4	18.1	17.0	16.8	16.9	27.3
Milk production (kgMS tonnes)						
Landcorp owned farms	6,877	7,133	8,092	8,651	8,604	7,699
WPL	2,657	2,777	2,982	3,097	2,530	3,144
Other partnerships	1,675	1,594	1,426	1,609	1,627	7,753
Milk production	11,210	11,504	12,500	13,357	12,761	18,596

Source: Annual Reports, Management Analysis and Deloitte Analysis

¹ FY09A-FY13A is implied weighted average based on gross milk revenue and milk production. FY14F is based on Fonterra milk price assumptions



2. Overview of Landcorp

The Livestock division accounts for 58% of Landcorp's assets. Dairy accounts for 28% but this proportion is expected to continue to grow.

Financial position

- The table opposite summarises Landcorp's assets at FY13A. Total assets as at FY13A of \$1,694.9 million were comprised of land and buildings which represented around 74% of total assets, livestock which accounted for around 15% and the remaining 11% included dairy cooperative shares, plant and equipment and other assets.
- Livestock's assets were \$984.3 million (or around 58%) while Dairy's assets were \$477.5 million (or around 28%) in FY13A. Dairy's proportion is expected to continue to grow with the investments in WPL and elsewhere. LHL assets were \$139.3 million (or around 8%), LEL assets were \$25.1 million (or around 2%) and Landcorp's other assets of \$68.7 million primarily related to accounts receivable (\$19.7 million), forests (\$18.0 million), inventories (\$11.9 million), and deferred tax assets (\$9.6 million).
- Land and buildings together with livestock and cooperative shares are revalued annually and are carried at fair value. Buildings and plant and equipment are depreciated in accordance with their estimated useful asset lives. Over the last five years assets have remained relatively consistent, with Landcorp's net investment offsetting depreciation and changes in land and livestock valuations. Asset values were impacted by material downward revaluations of land and buildings in FY09A and FY10A with some subsequent recovery since then.
- Assets at FY13A were funded by bank borrowings of \$229.1 million (representing net gearing of 14.8%), redeemable preference shares (RPS) of \$117.8 million and shareholders' equity of \$1,317.3 million.
- Over the last five years net working capital balances have ranged between net asset and net liability amounts primarily related to movements in milk receivables and corresponding milk pay-out.

FY13A balance sheet breakdown

\$m	Dairy	Livestock	LHL	LEL	Other	Total
Assets						
Cooperative shares	61.4	-	-	-	-	61.4
Livestock	93.3	152.6	-	-	0.0	245.8
Land and buildings	304.4	808.4	119.2	22.4	0.3	1,254.8
Other assets	18.5	23.3	20.1	2.7	68.3	132.9
Total	477.5	984.3	139.3	25.1	68.7	1,694.9
KPI's						
% of assets	28.2%	58.1%	8.2%	1.5%	4.1%	100.0%
Eha (000)	16.9	146.9	9.6	-	-	173.4
Stock units (000)	379.8	700.8	-	-	-	1,080.6

Source: Annual Reports, Management Analysis

- Bank debt has increased over the last five years from \$181.8 million (11.8% gearing) in FY09A to \$229.1 million (14.8%). Landcorp has a total facility of \$297 million and its peak draw-down period typical occurs during September to October.
- The RPS are securities issued to the Crown in connection with eight properties protected from sale under an agreement with the Crown (the Protected Land Agreement). Landcorp has effectively sold these properties to the Crown but continues to provide interim management and stewardship for these properties. The assets remain on Landcorp's balance sheet but they are structured so as to have a neutral impact on Landcorp's performance and balance sheet.

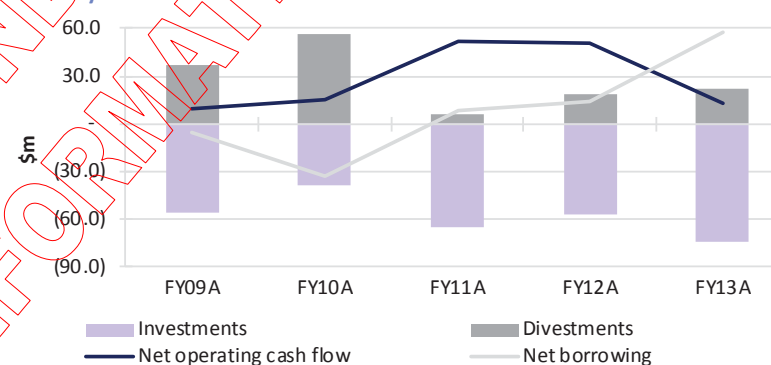
2. Overview of Landcorp

Over FY09A-FY13A asset sales and increased debt were required to fund new investments which exceeded operating cash flows. Capital was directed towards Dairy and prime Livestock properties.

Cash flow

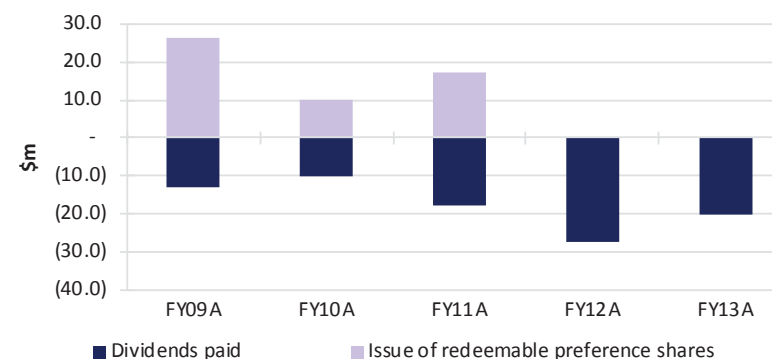
- The charts opposite summarise Landcorp's cash flows over the five years FY09A to FY13A. Cumulative cash inflows over the period of \$376.4 million comprised operating cash flows of \$140.9 million, sale of capital assets of \$140.7 million, increased borrowings of \$41.3 million and \$53.6 million in RPS issued by Landcorp under the Protected Land Agreement. These cash inflows have been used to fund investments of \$289.5 million and dividends to the Crown of \$88.5 million (noting that the Crown reinvested dividends to fund the purchase of RPS).
- Operating cash flows were positive in each year between FY09A and FY13A and broadly reflect operating profits after adjusting for movements in working capital, depreciation charges and other non-cash accounting revenues and costs.
- Landcorp have provided us with the following details of major divestments and investments over the period:
 - Major sales over the period included Sweetwater in FY10A (\$26.5 million), Aratiatia farm (\$24.2 million from FY09A to FY11A), and National Park and Waihora farms in FY09A (\$12.5 million and \$17.5 million respectively).
 - Major purchases were Cheltenham Downs in (\$25.3 million from FY11A to FY13A), and Parikanapa Station (\$6.4 million from FY09A to FY11A).
 - Major developments over the period included WPL (\$5.6 million from FY09A to FY13A), Maronan dairy (\$4.4 million in FY11A), Blairs dairy unit (\$5.2 million over FY09A and FY10A), and Weka farm (\$3.5 million from FY09A to FY12A).
 - Other investments included \$12.1 million for other WPL investments, primarily livestock purchases, from FY09A to FY13A and \$27.0 million for SPG investments, primarily livestock purchases, in FY13A.

Summary of cash flow



Source: Annual Reports and Deloitte Analysis

Shareholder cash flows



Source: Annual Reports and Deloitte Analysis

3. Sector trends and issues

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3. Sector trends and issues

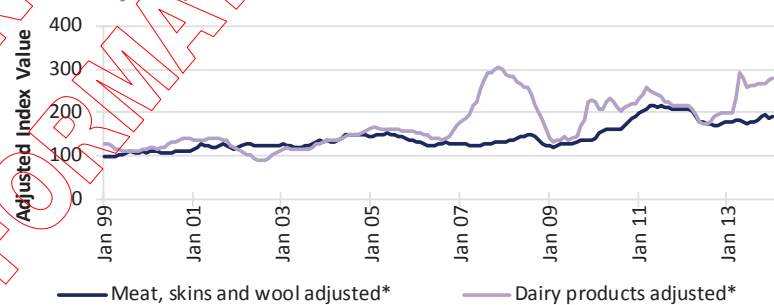
Global trends indicate a continued strong demand for New Zealand's agricultural products. Agricultural commodity prices have grown strongly in recent years, even in real terms.

3.1. Price trends

World agricultural commodity price trends

- Over the last 15 years there has been real growth in agricultural commodity prices, with dairy being stronger (116%) but more volatile than meat (90%).
- Strong growth in international agricultural commodity prices, particularly dairy products, is underpinned by a combination of increasing demand for quality protein-based foods and also supply constraints. Real price growth has largely occurred as a result of:
 - Expanding Asian demand for food products due to population growth, increasing life expectancy and economic growth. For example, China is already by far the major importer of New Zealand dairy products, notably butter and milk powder.
 - Greater recognition of the importance of food quality and safety and an increasing concern about the environmental sustainability of food production (i.e. carbon footprint, water use, nutrient use etc.).
 - Challenges to increasing food production globally, including resource constraints and degradation issues.
 - Increased focus on food security. This has resulted in significant direct foreign government expenditure on improving their domestic production levels but also investing in food value chains offshore.
- Global dairy and meat commodity prices are expected to continue to increase, with dairy increasing more than meat (based on the OECD FAO outlook to 2022). The report specifically notes that "global consumption of dairy products in developing countries is projected to grow faster than production, with higher exports from the United States, the European Union, New Zealand, Australia and Argentina."

ANZ real commodity price indices (international currencies, inflation adjusted)



Source: ANZ, <http://www.rateinflation.com/> and Deloitte Analysis
* Reported nominal index values adjusted for US/UK CPI changes

- Further, according to the EIU "the size of the global food retail market in nominal US-dollar terms is expected to grow by 36% between 2013 and 2017, to US\$10.7trn". The EIU expects that "New Zealand's exports will continue to grow over the forecast period as Chinese demand for imported dairy and meat increases and global prices for soft commodities remain high."

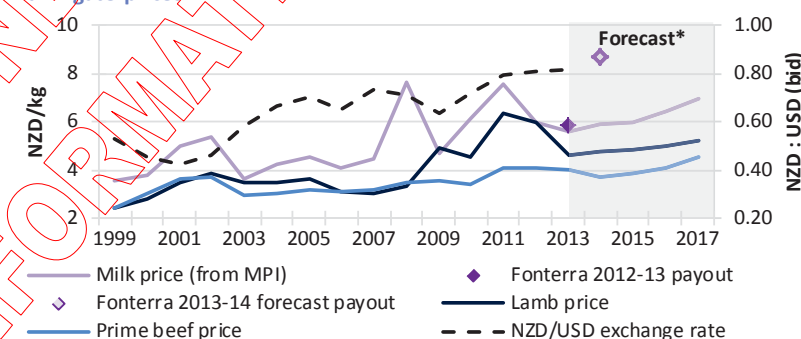
3. Sector trends and issues

Farm gate prices, in both dairy and livestock, reflect global commodity prices and the exchange rate. They have historically been volatile but have a strong outlook.

New Zealand farm gate price trends

- The chart opposite summarises dairy and livestock farm gate prices for the 15 year period, from 1999 to 2013, together with price forecasts for 2014 to 2017 from the Ministry for Primary Industries (MPI).
- Dairy returns have been especially strong, and are forecast to continue to increase, with the recent increase driven by a short-term imbalance between supply and demand. ANZ is predicting “strong farm gate cash flow well into 2015”, partially due to “tight global stocks and good Chinese demand”. Fonterra has announced a 35 cent lift in its milk price for the 2013-14 season to \$8.65/kgMS. The new forecast would be a record pay-out from the cooperative. Price volatility in the dairy industry has been high in recent years and according to NZX, is expected to continue.
- Livestock returns are also forecast to increase, but be more volatile than in the past. Historically price has been impacted by climate conditions. The forecast decline in lamb supply in 2013–14 is expected to continue to result in procurement pressure because export lamb slaughter in 2013–14 will be the lowest in many decades.
- The chart opposite also plots the prevailing average New Zealand dollar exchange rate (NZD/USD). In broad terms the New Zealand dollar is negatively correlated to international commodity prices, and therefore the exchange rate has historically had a partial hedging effect on movements in international commodity prices (i.e. reducing the volatility in New Zealand dollar prices relative to international commodity prices). Currently the New Zealand exchange rate is high, and is forecast to remain high for some time. Movements in the exchange rate have substantial impacts on New Zealand farm gate returns, adding uncertainty to decision making.

Farm gate prices



* Forecasts are from MPI

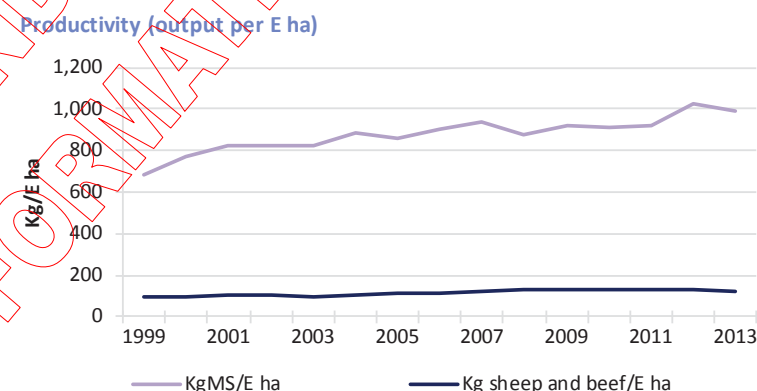
Source: Beef + Lamb New Zealand Economic Service, MPI, Fonterra and Oanda

3. Sector trends and issues

Productivity (output per effective hectare) has also increased, particularly in the dairy sector.

3.2. Productivity trends

- In addition to real growth in farm gate prices, there have been gains in productivity (output per effective hectare), particularly in the dairy sector.
- Livestock productivity has grown modestly at a compound average growth rate (CAGR) of 1.7% p.a. over 1999-2013.
- Over the same period, milk solids per effective hectare have grown at a CAGR of 2.7% p.a. This reflects growth in both the number of cows per hectare and the kgMS production per cow.
- These growth rates would have been slightly higher but for a the dip in productivity in 2013 due to the 2012-13 drought. However, output for 2013-14 is expected to rebound to the growth trend line.
- The major factors which have contributed, and are expected to continue to contribute, to increases in productivity include:
 - More irrigation. ANZ notes in an October 2013 report that “over the last five years there has been a 17 percent increase in the land area in New Zealand under irrigation....Additionally there are currently plans in place for 16 new water storage and irrigation schemes around the country... these have the potential to nearly double the total irrigable land to...12 percent of New Zealand’s total agricultural land”
 - Greater use of feed supplements, such as crops and palm kernel extract to maintain the quality of production and higher stocking rates.
 - Better management systems and technology, such as Farm IQ, Farm Management System and Farmax, to underpin informed on-farm decision making, and MilkHub, which tracks performance to support decisions.
 - More investment in genetics, such as Farm IQ’s High Density SNP Genotyping Chip for the Sheep Genome and the work of the Livestock Improvement Corporation (LIC) in dairy.



Source: DairyNZ, Beef + Lamb New Zealand Economic Service, MPI

3. Sector trends and issues

Increases in farm gate prices and productivity have driven growth in both dairy and livestock profitability and land values. However, livestock profitability and land values are at much lower absolute levels than dairy.

3.3. Farm profitability and land price trends

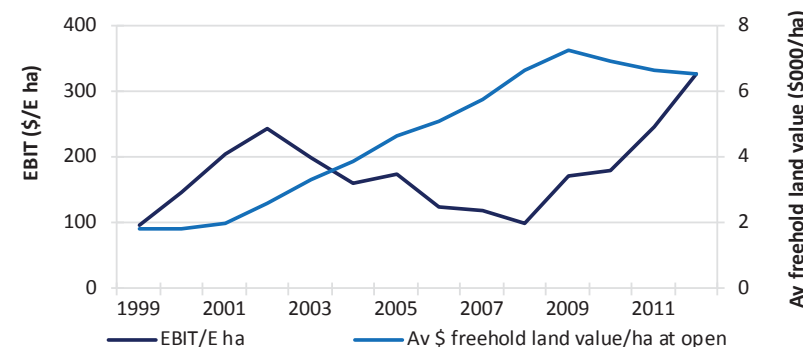
- The charts opposite show dairy (top) and livestock (bottom) profitability per hectare and land prices over the 14 year period from 1999 to 2012.
- Factors that have driven profitability and land values are the productivity gains and strong farm gate prices noted previously. This has been most evident in the dairy sector. In livestock the increase in profitability has been more modest, however land values have still risen strongly, partly as a spill-over from dairy land values and the demand for dairy grazing support.
- The charts show, for the period 1999-2012:
 - Dairy land price growth of 200% compared to a corresponding growth in farm profitability of 512%.
 - Livestock land price growth of 259% compared to a corresponding growth in farm profitability of 243%.
- More recently dairy land values have increased further, due to the strong outlook for dairy farm gate prices, combined with low interest rates and international investor interest.
- Although livestock profitability has increased since 2007, relative to dairy and the cost of land the returns are low. Discussing the livestock industry, Rabobank New Zealand CEO Ben Russell said “in recent years, many farmers have voted with their feet by leaving the industry, due to low and inconsistent profitability, if this trend is to be stopped, we need to see more consistent on-farm returns for farmers.”

Dairy profitability per ha and land price



* Based on owner-operator model
Source: DairyNZ

Livestock profitability per ha and land value



Source: Beef + Lamb New Zealand Economic Service

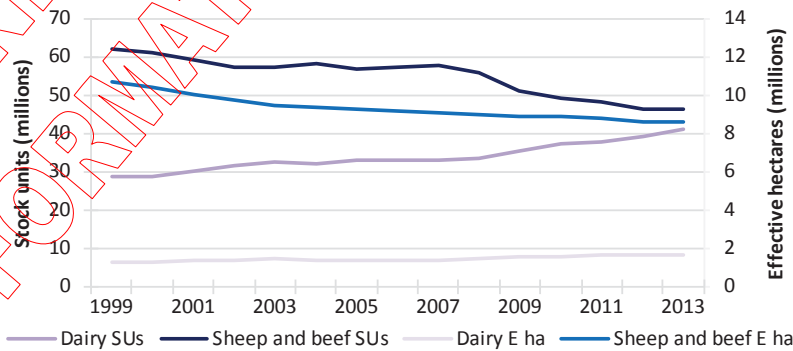
3. Sector trends and issues

Dairy stock units, effective hectares and production have been steadily increasing due to farm conversions and productivity gains, while livestock numbers and effective hectares have steadily declined.

3.4. Production trends

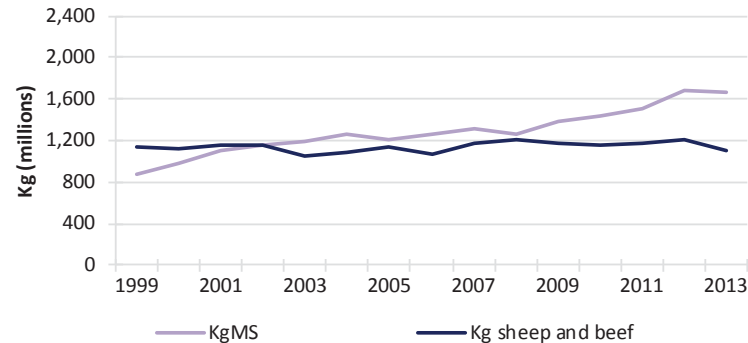
- Dairy has been more profitable per hectare than other pastoral land uses, encouraging conversions from other farming systems – especially in the South Island. The top chart opposite illustrates the substantial increase in dairy stock unit numbers and effective hectares under dairy production, and the corresponding reduction in livestock numbers and effective hectares under livestock production.
- The bottom chart shows total dairy and livestock production volumes for the 1999 – 2013 period. The domestic sheep flock has decreased in head count, however improvements in lambing rates and carcass weights has substantially offset the reduction in animal numbers. Similarly, the reduction in beef head count is partially offset by productivity improvements.
- Dairy and livestock output in 2013 was impacted by the 2012-13 drought. Production is expected to rebound in the 2013-14 season.
- The shift in land use from livestock farming and forestry into dairying, and the increased use of irrigation, is mirrored in Landcorp's changing land mix and activities since 2001.

Stock units and effective hectares



Source: DairyNZ, Beef + Lamb New Zealand Economic Service

Production



Source: DairyNZ, Beef + Lamb New Zealand Economic Service, MPI

3. Sector trends and issues

Given the steady increase in land prices and the relatively low cash yields, some have questioned whether NZ farm land is overvalued. Somewhat related to this is the emergence of corporate ownership/operating models.

3.5. New Zealand farm land prices

- Given the low cash yields in farming, some commentators have questioned whether New Zealand farm land is overvalued.
- ANZ has assessed whether dairy land is currently overvalued, noting in a February 2014 report “dairying cash rates of return are likely to average 8-10 percent this year. This is the highest level since the early 2000s and well up on the 10 year average of 5 percent. If we normalise the cash rate of return to the long-term average of 5 percent, by changing the land value component of the equation and using an average milk pay-out of \$7.25/kgMS this implies land values have scope to move up by \$3,000/ha, or 9 percent on the 2012-13 season. The recent move up of \$3,500/ha implies the market is making a similar assessment. However, it also suggests *land values could have started to enter overheated territory when assessed against historical returns.*”
- Livestock finishing and grazing land values have also been increasing over the last three years. This is partly due to the spill-over effect of a large number of dairy conversions, and increasing need for dairy support driven by the greater returns available in the dairy industry. ANZ has also considered whether livestock land is currently overvalued relative to observed returns: “recent prices don’t seem too out of whack with history, but do imply rising expectations for dairy grazing and cash crop prices, as well as more conversions. *A move substantially higher with already slim rates of return seems unlikely – or at least unwarranted.*”
- In our view, New Zealand farm land values are not “irrationally high”, however they do imply that investors are:
 - Assuming a continuation of productivity gains and real commodity price increases; and
 - Using low required rates of return, reflecting the current low interest rate environment and, at the margin, interest from foreign investors with low costs of capital and other objectives such as security of supply.

3.6. The emergence of alternative corporate ownership/operating models

- Farming is becoming “big business”:
 - The average farm size is increasing as farmers seek economies of scale;
 - The increase in farm size and price per hectare means that more capital is required to enter farming on an economic scale;
 - There has been a corresponding rise in corporate farming, corporate farm management, and corporate leasing/sharemilking models.
- Similarly, large foreign investors looking for entry into the New Zealand agri-sector are typically interested in doing so on a large scale, and often seek professional New Zealand farm managers to run their properties.
- Examples of corporate leasing/sharemilking models to manage farms without owning the land include Big Sky Dairy Farm in Maniototo after Harvard University’s endowment fund bought the land in 2010.
- Landcorp has again mirrored this trend, for example with its WPL leasing and SPG sharemilking arrangements.

3. Sector trends and issues

The increased awareness and regulation of environmental issues, and dysfunction in red meat sector processing and marketing, are imposing costs on New Zealand farmers.

3.7. Sustainability and environmental issues

- Agricultural intensification creates environmental issues such as increased risk of water pollution, loss of biodiversity and dependence on non-renewable fossil fuels. There has been increased focus on sustainability and environmental practices by the market, processors, and regulators.
- This is leading to increased regulation and may constrain further productivity gains. The productive sectors are subject to a range of compliance initiatives originating from many regional councils to give effect to the National Policy Statement for Freshwater Management (2011). These environmental initiatives in some instances limit the legal productive capacity of farming operations.
- These, and processor and market driven initiatives, are significantly increasing the complexity of on-farm operations. For example the core tool to manage nutrients, OVERSEER®, currently underpins the nutrient management advisory components of Ballance and Ravensdown's businesses, and will increasingly be linked to farm management systems, providing farmers the ability to balance production decisions with environmental impacts.
- The cost of mitigation mechanisms such as fencing off streams, riparian buffers, effluent disposal systems and constructing wetlands is also impacting profitability.
- As an SOE and New Zealand's largest corporate farmer, Landcorp is expected to demonstrate at least full compliance, if not industry leadership, in its environmental practices.
- Related to environmental and sustainability issues is the growing consumer interest in traceability. Landcorp is proactively involved in this opportunity through its investment in Farm IQ, which has at its core, electronic identification tagging of individual animals.

3.8. Dysfunction in red meat sector processing and marketing

- With Fonterra responsible for processing and marketing approximately 90% of New Zealand's dairy exports, and several of the smaller processors pursuing value-add strategies, the processing and marketing of New Zealand's milk production has been relatively efficient and successful.
- By contrast, there has been a level of dysfunction in the red meat sector. Processors have excess capacity, compete fiercely both to procure supply and in overseas markets, and several have suffered losses in recent years due to the consequent squeeze on processing margins.
- Federated Farmers, in a recent 'Meat Industry Options' discussion paper, said "supply chain participants...often behave in an uncoordinated manner, and there is a lack of transparent information and communication between the sector's participants. This results in an inability to achieve scale, or coordinate activities in the manner necessary to take advantage of opportunities, and maximise returns to the sector. There is also an inherent lack of trust in the sector. Furthermore, participants can often end up competing against one another both for the procurement of stock and again in the international market place."
- Initiatives such as Farm IQ's integrated value chain concept and the Red Meat Profit Partnership's implementation of part of the red meat sector strategy are working to address parts of the problem.
- The increased need for product to specification and certainty of supply has led to suppliers and processors collaborating down the value chain through either ownership/investment or contracts. The collaboration between Landcorp and Silver Fern Farms on the Tesco lamb contract is an example of this. This trend looks likely to continue as larger scale commercial farms become more common.



3. Sector trends and issues

Growing agriculture exports is a key focus for the Government.

3.9. Government agri-sector objectives

Significance of agriculture to NZ economy

- More than any other developed country, New Zealand's economy, people and environment depend on the success of its land-based industries. For example:
 - In 2010, the NZIER said a \$1 kgMS rise in Fonterra's pay-out makes every New Zealander nearly \$300 better off.
 - In September 2013, Statistics New Zealand reported dairy production drove a 1.4 percent increase in GDP and was the main contributor to a 17% rise in agriculture, which makes up about 5 percent of the New Zealand economy.
- New Zealand is the world's largest dairy, sheep meat, venison and kiwifruit exporter. New Zealand has successfully built competitive and efficient primary production systems exporting throughout the world. Productivity in the primary sectors has grown. MPI estimates that the agricultural sector's total productivity increased by a compound annual growth rate of 3.3% from 1984 to 2007.
- The importance of agriculture to the economy has led the Government to focus policy initiatives on growing agricultural sector exports. This has included the funding of sector strategies, funding for Maori economic development on-farm through Te Puni Kokiri, and funding of sector initiatives through the Ministry for Primary Industries Primary Growth Partnership. This focus looks set to continue.
- The table opposite summarises the bold production growth targets set by the Government and industry bodies for the agri-sector
- Landcorp's potential leadership role in contributing to the achievement of these objectives, beyond being an efficient large scale farmer, is discussed in section 2.4.

Government and Sector Objectives

Government (MPI and MBIE) Objectives by 2025			
Increase the ratio of exports to GDP from the current 30% to 40%			
Double agricultural sector exports			
Increase the sector's output from \$32 billion in exports last year to \$64b			
Dairy Sector Objective by 2020	Red Meat Sector Objective by 2025	Deer Sector Objective by 2022	Maori Sector Objective by 2040
Profit from productivity increases by \$15/ha per year	\$3.4 billion (or approximately \$420 per hectare) of real growth for the sector	\$1.27 per kg venison increase in EBIT	Productivity of Māori assets equals national averages
Dairy export earnings increase by 55%		Increase venison tonnage by 50%	The growth rate of the Māori asset base equals national average rate

Capability limitations

- A potential limit on productive capacity is the availability of suitably skilled labour. The Ministry for Primary Industries recognises that the current capability in the dairy and red meat sectors may not be sufficient to meet ambitious growth targets. The Ministry is currently undertaking a project to quantify and articulate this gap. In the red meat sector, succession planning is a major issue, with a high estimated average age of farmers of 58.
- Landcorp's commitment to training farm managers, and its desire to increase farms under management, help to address both of these issues.

4. Performance analysis

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4. Performance analysis

We have considered various aspects of Landcorp's performance, including total shareholder returns, relative divisional performance, benchmarking against peers, cost trends and budgeting track record.

4.1. Introduction

- In this section we consider Landcorp's performance from a variety of different perspectives:
 - The total returns on shareholder equity provided over the last decade, and how this is split between cash yield and capital gains;
 - The relative contributions of Livestock, Dairy and WPL to this return;
 - The current cash yields of Livestock and Core Dairy, and the expected future yield and breakeven point for WPL;
 - How Landcorp's performance compares with private sector peers;
 - Trends in on-farm and corporate costs;
 - Landcorp's dividend track record;
 - Landcorp's budgeting track record; and
 - An overall assessment of Landcorp's strengths and weaknesses.
- Related to the issue of performance, Deloitte has also been asked to comment on the various metrics that could be used to measure Landcorp's performance.

4. Performance analysis

Landcorp has delivered total returns to the Crown averaging 10% p.a. (compound) over the last 10 years, comprising an average cash yield of 1.6% p.a. and average capital gains of 8.3% p.a.

4.2. Landcorp's overall shareholder returns

- We have assessed Landcorp's total shareholder return (TSR) over the period FY04A to FY13A using two different approaches:

- Treating Landcorp's net asset value (NAV) at the start of FY04A and the end of FY13A as the Crown's "entry cost" and "exit value" respectively, and dividends received during the period as the cash yield on the Crown's investment, then calculating the internal rate of return (IRR) on these investment cash flows.
- Expressing Landcorp's reported comprehensive income each year as a percentage of that year's starting NAV, and averaging the results for the last 10 years. This approach also enables the return to be split out into its component parts: operating profit and capital gain (being land and livestock revaluations, and gains on asset sales).

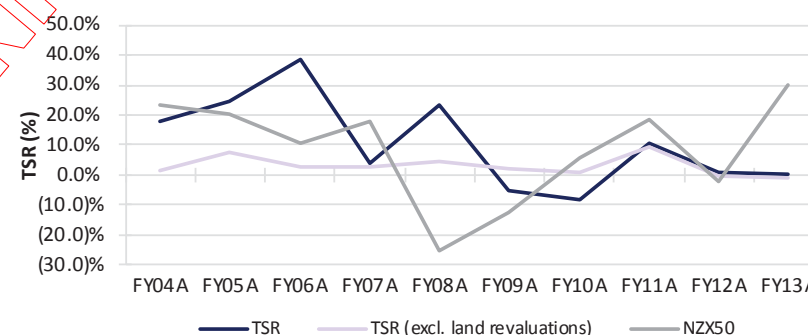
- The table opposite (top) summarises the results of the two approaches, and the detailed analysis is contained in Appendix 5.
- Our analysis indicates that Landcorp has provided a TSR of approximately 10% per annum (compounding) over the last decade, comprising an average cash yield of approximately 1.6% per annum and capital gains averaging 8.3% per annum. This compares favourably to the 8.1% average annual compound TSR for both the NZX50 and S&P500 gross indices over the same period.
- In undiscounted dollar terms, the returns to the Crown totalled \$868 million over the 10 year period, comprising capital gains of \$723 million (83%) and dividends of \$145 million (17%).
- The chart opposite (bottom) shows the annual TSR covering the 10 year period FY04A to FY13A for Landcorp and the NZX50. We also show Landcorp's TSR excluding land revaluations, further highlighting the significant impact (positive and negative) that land revaluations have on Landcorp's TSR.

Total shareholder returns FY04A-FY13A

Average compound % p.a.	Approach 1	Approach 2
Cash yield	1.6%	1.3%
Capital gain	8.3%	9.3%
Total shareholder return	10.0%	10.7%

Source: Annual Reports and Deloitte Analysis

Annual TSR (FY04A-FY13A)



Source: Annual Reports, Capital IQ and Deloitte Analysis

- The pattern of Landcorp's TSR broadly matches that of the NZX50, reflecting the impact that pre-and post-GFC market conditions had on asset values generally.



4. Performance analysis

Divisional IRR analysis shows that Livestock has made a similar contribution to Landcorp’s overall returns as Core Dairy.

4.3. Divisional returns from Livestock, Core Dairy and WPL

- The table opposite summarises divisional IRR analysis based on operating and investing cash flows between FY04A and FY13A and starting and finishing asset and equity values over that period. Core Dairy’s returns exclude WPL’s operations to remove any impacts from WPL’s leasing arrangements or farm immaturity. WPL commenced its operations around FY05A and accordingly the WPL IRR analysis is based on an 8 year historical period.
- The analysis shows two approaches to calculating IRRs: (i) ungearred and excluding corporate costs, interest and taxation and (ii) geared and including an allocation of corporate costs, interest and taxation. The allocations were broadly based on a blend of divisional revenue and asset values. The second approach is conceptually closer to the TSRs calculated for Landcorp as a whole in section 4.2.
- The IRRs are split into a capital component (using investing cash flows and changes in asset or equity values) and an operating component (implied from the total IRR and the capital gain component). This breakdown was not appropriate for WPL due to its low starting asset values.
- The analysis shows that, interestingly:
 - Livestock has made a similar contribution to Landcorp’s overall returns as Core Dairy;
 - The split between operating yield and capital gain is also similar in Livestock and Core Dairy; and
 - WPL’s IRR is negative even before allocating a portion of corporate overheads to those farms. This reflects the initial capital expenditure for dairy conversions and the immaturity of these farms over the period being analysed.

Divisional returns FY04A-FY13A

Average compound % p.a.	Livestock	Core Dairy	WPL ¹
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- Forecast FY15F cash yields are also presented for context as a proxy for normalised current operating yields (i.e. assuming normal climatic conditions, prices close to the expected medium term levels, and no abnormal items). These show higher current cash yields for Core Dairy and WPL than the 10 year average, reflecting the higher current milk price and higher productivity from maturing farms.



4. Performance analysis

WPL is a effectively a leveraged investment, but without the benefit of capital gains on land in its return. In percentage terms, the sensitivity of its EBIT to changes in the milk price is much higher than for owned farms.

4.4. WPL breakeven analysis and other observations

- In addition to WPL's current dairy operations, comprising six farms and covering around 3,400 E ha, Landcorp is contractually committed to a significant expansion which over the next four years will add a further 8,000 E ha, resulting in a combined WPL dairy portfolio of 31 farms covering around 11,400 E ha, of which 4,300 E ha will be irrigated. Appendix 2 sets out further detail in relation to the existing operations and planned expansion.
- The expanded WPL complex will materially increase Landcorp's exposure to dairy returns, with annual production from the mature expanded WPL portfolio estimated to be around 11.4 million KgMS, greater than Landcorp's total existing non-WPL annual dairy production.
- The table opposite shows the sensitivity of WPL's earnings to changes in the milk price and costs of production (COP). The analysis is based on a mature and fully developed WPL portfolio with an average base case breakeven of \$6.13/kgMS and an assumed mid point milk price of \$7.00 kgMS, which may be considered a reasonable reflection of the longer run expectation for milk prices. The analysis highlights WPL's sensitivity to a volatile milk price. A \$1.00/kgMS variation results in an \$11.5 million EBIT impact. If the milk price decreased to \$5.00 kgMS, and assuming base case costs, WPL would incur an estimated operating loss of around \$13.0 million. The sensitivity to milk price changes is the same as an owner operator farm in absolute dollar terms, but in percentage terms WPL's EBIT is almost 2.5 times more volatile than an owner operated farm.
- This sensitivity is the result of Landcorp's investment being structured through long term lease arrangements which effectively introduce a form of leverage. The lease charges s9(2)(b)(ii) have a similar impact to interest on debt, reducing margins and therefore increasing the percentage volatility of operating profits.

WPL annual EBIT sensitivity

COP + lease cost per kgMS		
	-\$0.50	Base
\$m		
s9(2)(b)(ii)		

Source: Management Analysis and Deloitte Analysis

- Furthermore, as lessee Landcorp does not get the benefit of any capital gains on the land but rather its lease costs increase in proportion to increases in the market value of the leased land. Landcorp estimates that capital gains within its portfolio over the last 25 years have averaged around 5% p.a.
- We note that Landcorp forecasts the cost of bank borrowings to climb to 5.9% by FY17F, or around 1% in excess of the post-concession period lease rate. Had Landcorp borrowed at this interest rate to own a WPL-type investment outright, and assuming long run average capital gains persist, Landcorp would be able to generate returns 4% higher than the existing lease arrangements (i.e. reflecting the long run average capital gain less the premium of bank borrowings to the WPL lease rate).

4. Performance analysis

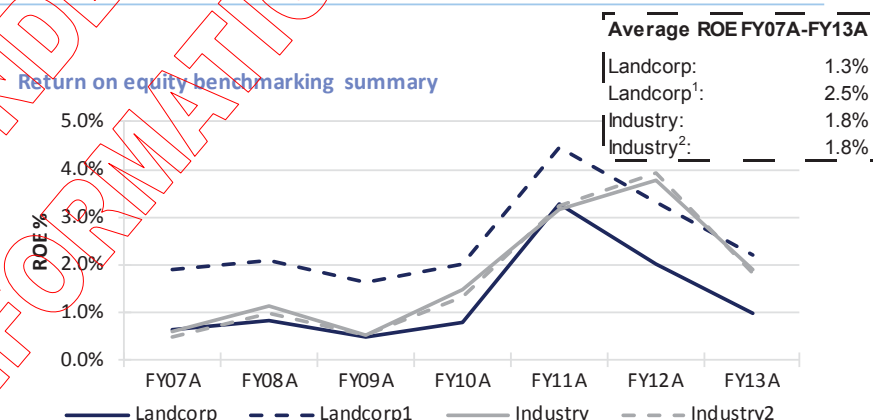
Over the period FY07A to FY13A Landcorp's operating returns on equity have been similar to comparable industry benchmarks. After excluding corporate overheads, its on-farm performance has been higher than average.

4.5. Benchmarking analysis

- Landcorp has previously undertaken benchmark analysis at both the company level (return on equity comparisons) and at the farm specific level. Individual Livestock farm benchmarking was undertaken by independent agribusiness consultants Baker & Associates, and Dairy farm benchmarking used data sourced from DairyBase.
- There are significant shortcomings with both types of benchmarking, primarily related to the quality and comparability of the data. It is therefore difficult to draw firm conclusions regarding Landcorp's farming performance relative to its peers. The commentary in this section should be read with this overriding caveat.
- Landcorp's integrated cluster approach and economies of scale should generate benefits in on-farm performance. Key questions are whether these are sufficient to offset Landcorp's head office costs of approximately \$21 million per annum, and whether overall Landcorp's performance exceeds its peers.

Benchmarking of corporate returns

- The chart opposite compares Landcorp's operating return on equity (measured as operating profit excluding gains on asset sales/shareholder equity) with average industry returns sourced from DairyBase and Beef + Lamb, and weighted to reflect Landcorp's Livestock/Dairy mix. The analysis effectively reflects the cash yield on equity and does not incorporate the capital growth component of the returns from farming.
- An adjusted industry benchmark is also incorporated to reflect the impact of the geographic composition of Landcorp's farm portfolio. However, on balance this adjustment is immaterial as over the period covered the average adjusted industry benchmark return was the same as the unadjusted return of 1.8%.



- The analysis shows that Landcorp's ROE performance was on par with benchmark averages over FY07-FY11, below in FY12 and FY13, and averaged 1.3% versus 1.8% for the industry benchmark. Landcorp believes that the performance gap in FY12 and FY13 may be partly explained by increased costs incurred in those years (e.g. in pasture renewal), the benefits from which will accrue in future years.
- Over the period covered, Landcorp's corporate overheads have averaged 1.2% of equity. If we exclude these costs, Landcorp's on-farm performance exceeds the benchmark (averaging 2.5% versus the benchmark's 1.8%).
- Potential issues regarding the comparability of the data include: differing approaches to treating interest and gearing; cash flow timing and accrual differences, application of depreciation rates and differences related to owners' drawings and salaries.



4. Performance analysis

Due to a range of data and measurement comparability issues we are unable to draw firm conclusions regarding the performance of Landcorp’s Livestock operations relative to benchmarked farms.

Livestock farm benchmarking

- Livestock farm benchmarking analysis has been completed by independent agribusiness consultants Baker & Associates. This analysis has been consistently performed in relation to a sample of 14 farms in FY11A and FY12A, but in some case data has been collected over a period covering up to six years.
- For the most part the selected benchmarked farms are intended to be representative of the wider Livestock portfolio in terms of performance and geographic spread, but in some instances farms were selected as they were identified as being harder to farm than the district average, including Omamari, Takakuri, Tutamoe and Waitere. Parikanapa is also included in this category as it was recently purchased and was in a rundown state, and benchmarking provided the opportunity to track improving performance over time.
- We understand the Baker & Associate benchmark process is a paid service and accordingly tends to attract higher performing and leading livestock farms. As a result Landcorp believes it is comparing itself against above average farms and will be required to demonstrate better than average management over an extended period of time in order to outperform the benchmarks.
- The table opposite summarises, for each of the benchmarked farms, the average variances from its peers on two measures: lambing percentage and economic surplus per stock unit. Lambing percentages have been normalised by Landcorp to adjust for the different methodology applied by Baker & Associates.

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4. Performance analysis

Due to a range of data and measurement comparability issues we are unable to draw firm conclusions regarding the performance of Landcorp's Livestock operations relative to benchmarked farms.

Livestock farm benchmarking (continued)

- On the face of the Baker & Associates benchmark analysis, Landcorp's lambing % performance is above the benchmark in all but four cases (Meringa, Waipori, Waitere and Parikanapa) and Landcorp's financial performance is mixed with six farms above and eight farms below the respective average benchmarks. Landcorp's farm economic returns do not reflect an allocation of Landcorp's corporate overhead, and including this would lower Landcorp's relative financial performance.
- Management provided the following further explanation on sources of potential inaccuracies within the farm benchmarking analysis:
- Farm size differences suggest significant differences in population. This is particularly important for South Island high county farms where cropping is a key function of livestock production. Specific farms impacted include Waipori, Thornicroft, Dawson Downs, Dale, Lynmore and to a lesser extent Haycocks.
- Benchmarks include standardised fertiliser and repairs and maintenance expenditure. Landcorp has significant procurement savings and these savings have not been recognised.
- Benchmarks are based on cash livestock sales and purchases plus an adjustment to reflect the change in inventory aligned to the taxation livestock values. This significantly differs from Landcorp's NZ IFRS accounting policies.
- Baker & Associates' analysis attempts to reflect a normalised salary for Managers who have a financial interest in the farm.
- Landcorp's one paddock/many farms approach tends to dampen the impact of good and bad years (weather and commodity). This is achieved by internal stock movements using a transfer price model, which can significantly distort the returns achieved by a particular farm during particular periods.

4. Performance analysis

Notwithstanding previously highlighted benchmarking issues, summary analysis appears to show that Landcorp's Dairy farms are generally performing on par or better than their industry peers.

Dairy farm benchmarking

- Dairy farm benchmarking analysis was completed in FY12A and FY13A internally by Landcorp but with reference to DairyBase. This analysis was based on a sample of seven farms intended to be representative of the wider portfolio in terms of performance and geographic spread. We understand that four of the seven farms are recognised within Landcorp's top-ten portfolio performers, whereas Basset, Achilles and Pouarua are relatively lower ranked farms. In particular it was highlighted that Achilles and Pouarua were particularly impacted by drought conditions. Maronan is a recent Mid-Canterbury development yet to achieve its expected levels of productive potential and cost efficiency.
- The table opposite summarises each of the benchmarked farms and variance from its benchmark on three measures, kg/MS per cow, kgMS per hectare and operating cost per KgMS.
- On balance, benchmark analysis suggests that the financial and operational performance of Dairy's farms is broadly similar to or above average benchmark performance.
- However, similar to the Livestock benchmarking exercise, management explained there are a range of material inconsistencies between the benchmarks and Landcorp's inputs that impact on comparability. Primarily, financial benchmark data broadly reflects cash based accounting and taxation values, whereas Landcorp's financial inputs reflected NZ IFRS accounting.
- Management's view is that more valid comparisons can be made in relation to the operational benchmarks. Management also made the point that when looking at any farm system a key determinant of profitability is the base resource or pasture production grown and eaten per hectare. When this metric is compared to the benchmark groups and then compared against financial performance per hectare, Landcorp believes its performance is generally above the benchmark.

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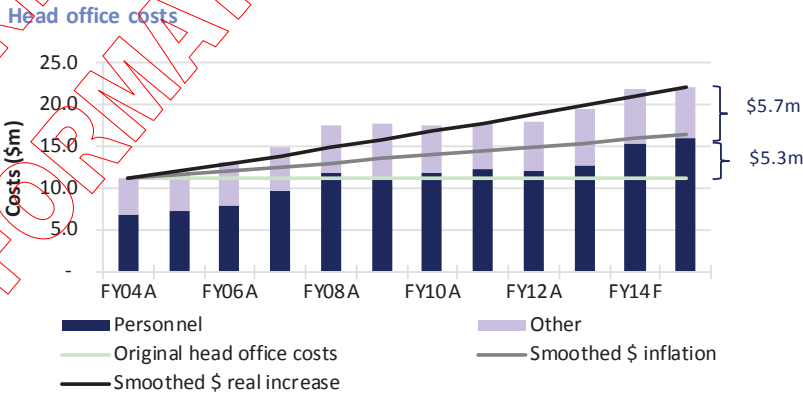
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4. Performance analysis

Since FY04A head office costs have increased in real terms by around \$5.7 million. This is partly related to Landcorp's diversification into dairy and deer during the early to mid-2000s, and Landcorp's industry leadership activities.

4.6. Operating cost analysis

- Over the last five years total operating costs increased from \$142.2 million in FY09A to \$165.8 million in FY13A, an increase of \$23.5 million (16.5%), or a 3.9% compounded annual growth rate.
- Increased costs during this period were mostly related to increased cropping and feed costs associated with expanded Dairy operations, personnel costs and general inflation.
- A potential concern is that over a 12 year period head office costs have doubled from \$11.1 million in FY04A to a forecast \$22.1 million in FY15F, or a nominal increase of \$11.0 million. We note that 'head office' costs differ from 'corporate' costs which we have referred to in other places in the report. Corporate costs include head office costs plus other items such as supplier rebates and licence fee costs associated with Focus Genetics.
- The chart opposite shows the increase in head office costs over this 12 year period, split between inflationary and real growth. After taking into account inflation, the real increase in corporate costs since FY04A has been \$5.7 million.
- We understand that this increase was partly due to increased headcount following Landcorp's diversification into new and more intensive dairy and deer farming during the early to mid-2000s. It also presumably reflects an expansion of Landcorp's industry good/leadership activities.
- Previous analysis undertaken by Landcorp aims to demonstrate that benefits of over \$20 million per annum accrue to Landcorp as a result of its scale, and that these offset head office costs. However these benefits will largely be captured in the farms' financial performance, and accordingly head office costs should also be included in any analysis of Landcorp's overall performance.





4. Performance analysis

Over the period FY09A to FY13A, total dividends paid were approximately 80% of cumulative operating profits. However the payout ratio varied widely over the period.

4.7. Analysis of Landcorp's dividends

- The table opposite provides an analysis of dividends declared over the five year period FY09A to FY13A and some related metrics. Dividends are declared in the financial year to which they relate but are normally paid in October of the following financial year.
- Landcorp's dividend policy, as outlined in their SCI, is to distribute up to 75% of operating profit subject to meeting fiduciary and commercial responsibilities, including compliance with banking covenants and maintaining Landcorp's target capital structure. Landcorp targets a capital structure based on an interest cover ratio of 3x EBITDA but with an expected range of between 2.75 and 3.25x EBITDA.
- Although dividend policy is referenced to operating profit, this is an accounting figure that contains material non-cash components. The figure may therefore be significantly different to the cash flow available for the payment of dividends. Therefore Landcorp has historically also taken cash flow into account when setting dividends.
- Dividends over the period ranged from a low of \$5 million in FY13A to a high of \$27.5 million in FY11A. The ratio of dividends to operating profits (pay-out ratio) was above the 75% target in FY09A and FY10A, below target in FY11A-FY13A, and ranged from 39% in FY13A to 180% in FY10A.
- Dividend yield, calculated as dividends divided by total equity, can be considered as the product of two measures: (i) the return on equity (ROE) and (ii) the pay-out ratio. Landcorp's ROE has varied between 0.5% and 3.1% over the five year period, fluctuating broadly in line with operating profits. However, we note that the denominator or shareholder equity is impacted by other comprehensive income, including annual revaluations of livestock and land and buildings.

Summary dividend analysis

\$m	FY09A	FY10A	Actual FY11A	FY12A	FY13A
Profitability					
Operating profit	6.9	10.0	42.2	27.0	13.0
Operating cash flow	9.2	15.3	51.8	51.1	13.4
Capital investments	37.5	55.9	5.8	19.0	22.5
Cash flow before capital investments	46.7	71.2	57.6	70.2	35.9
Capital investments	(55.4)	(38.1)	(65.0)	(56.6)	(74.3)
Free cash flow ¹	(8.7)	33.1	(7.4)	13.5	(38.4)
Dividends declared					
Ordinary	10.0	9.0	27.5	20.0	5.0
Special	-	9.0	-	-	-
Total dividend	10.0	18.0	27.5	20.0	5.0
Dividend policy					
Dividend target (% of operating profit)	75.0%	75.0%	75.0%	75.0%	75.0%
Implied target dividend	5.1	7.5	31.7	20.3	9.7
Variance to target	4.9	10.5	(4.2)	(0.3)	(4.7)
KPIs					
ROE ²	0.5%	0.8%	3.1%	2.0%	1.0%
Pay-out ratio ³	145.8%	179.8%	65.1%	74.0%	38.6%
Dividend yield	0.7%	1.5%	2.0%	1.5%	0.4%
Net gearing	11.8%	10.8%	10.4%	11.4%	14.8%
Interest cover ⁴	2.5	3.0	6.3	4.9	3.5

Source: Annual Reports and Deloitte Analysis

¹ Free cash flow based on annual operating cash flows plus annual net investing cash flows

² ROE calculated as operating profit divided by total equity

³ Payout ratio calculated as total dividend declared divided by operating profit

⁴ Interest cover is calculated as EBITDA divided by net interest expense



4. Performance analysis

Landcorp appears to be conservative in its forecasting, with actual results having exceeded budgeted profit targets in the last four years (and is forecast to do so in FY14F).

4.8. Budgeting track record

- The table opposite summarises Landcorp's budgeting track record over the period FY09A to FY13A, showing the variance of actual performance from Landcorp's stated SCI targets and assumptions set in the prior year.
- The table shows that Landcorp has met or exceeded its forecast operating profit target in every year except FY09A (and is forecast to do so in FY14F). As previously highlighted, variations in operating results primarily reflect climatic conditions and the associated impacts on production, and farmgate prices as influenced by the prevailing commodity prices and foreign exchange rates.
- In particular, Landcorp has estimated that drought events in FY09A and FY13A negatively impacted operating profit by \$9.8 million and \$11.3 million respectively. However the FY13A result was significantly assisted by unbudgeted non-operating revenues. The FY11A operating profit of \$42.2 million reflected favourable climatic conditions and record farmgate prices for both Dairy and Livestock.
- On balance this analysis indicates that Landcorp's budgeting processes have historically resulted in conservative outlooks in terms of prices and production volumes, but budgeted operating profit may still be significantly impacted by climatic events and abnormal items.
- Regarding the FY13A dividend, the \$37 million negative variance to budget reflected a range of non-cash adjustments to operating profit and also that closing debt was higher than budgeted. Effectively Landcorp did not have sufficient cash to fund the budgeted dividend.

Historical budget variance analysis

\$m	Variance to budget				
	FY09A	FY10A	FY11A	FY12A	FY13A
Operating revenue					
Livestock	20.2	(6.9)	29.3	24.8	(9.6)
Dairy	(21.8)	12.1	22.1	(3.5)	(3.3)
Other	(7.1)	(4.6)	(1.1)	(8.2)	(10.4)
Total	(8.8)	0.6	50.3	13.0	(23.3)
Non operating revenue	5.4	2.9	(3.2)	(0.8)	21.5
Operating expenses	(6.4)	1.7	(11.8)	(5.0)	(0.5)
EBITDA	(9.8)	5.1	35.3	7.2	(2.2)
Depreciation and amortisation	0.7	0.7	0.4	0.5	1.5
EBIT	(9.1)	5.9	35.7	7.8	(0.7)
Net interest income / (expense)	1.1	1.5	3.7	2.9	1.0
Operating profit	(8.0)	7.4	39.4	10.6	0.3
Production (Tonnes)					
Milk	(794)	(610)	166	327	(804)
Sheep meat	(402)	(557)	(1,494)	220	133
Beef	1,907	1,023	(352)	882	129
Dividends					
Actual	10.0	18.0	27.5	20.0	5.0
Budget	13.0	18.0	10.0	15.0	42.0
Variance	(3.0)	-	17.5	5.0	(37.0)

Source: Annual Reports, Management and Deloitte Analysis

4. Performance analysis

Landcorp's strengths in part reflect its unique scale and position in the sector. However it needs to address certain weaknesses to prove the corporate farmer model.

4.9. Organisational strengths and weaknesses

- s9(2)(b)(ii)
- Based on our own observations, we would concur with this assessment, and add the following points:
 - Landcorp's staff show high levels of motivation and enthusiasm, and a belief in Landcorp's role and future;
 - There is probably upside in the Farm Performance Group's ability to realise benefits from operating an integrated portfolio of farms;
 - Landcorp could improve the external benchmarking of its performance;
 - There has been insufficient focus on corporate overheads as a drag on profitability;
 - Landcorp cannot yet demonstrate that the benefits of scale and the integrated network of farms exceeds its corporate overhead costs; and
 - WPL represents a large and leveraged exposure to the milk price that is likely to increase the volatility of Landcorp's future returns.



4. Performance analysis

No single measure provides a complete picture of Landcorp's performance, which will always involve short-term volatility in cash returns and long-term capital value changes.

4.10. Performance metrics and debt ratios

Performance metrics

- Treasury uses nine standard metrics to measure SOEs' shareholder returns, profitability/efficiency and leverage/solvency (see page 105 of its "2013 Annual Portfolio Review"). Deloitte has been asked by Landcorp's management to comment on the various metrics that could be used to measure Landcorp's performance.
- The focus on the choice of performance metrics for Landcorp appears to stem from concerns that:
 - By its nature, Landcorp's operating profitability is volatile due to the influence of climate and market conditions on volumes and prices respectively; and
 - Landcorp's net income is further influenced by non-operating movements in the fair-value of assets.
- However in our view these issues are understood by Treasury, who:
 - Accept that returns from year-to-year will be influenced by market volatility, and are seeking a secular positive trend in key metrics;
 - Include five year averages in its report to smooth historic volatility; and
 - Use ROE, return on capital employed and operating margin measures that are adjusted to exclude changes in the value of assets.
- There is no one measure that provides a complete picture of Landcorp's performance, and therefore it is necessary to use a suite of metrics combined with an understanding of the underlying market and climatic conditions.

- Different measures serve different purposes. For example, if the objective is to measure farm management performance over time, production or cost efficiency measures (that are not influenced by market prices) are likely to be preferred (e.g. output per hectare, operating cost per unit of production, etc).
- Given the objectives of reducing costs, improving operating profitability and growing using OPM, and given the importance of capital gains in farming, three important measures are:
 - EBITDA (before fair value adjustments), which measures the absolute progress in growing revenue, reducing costs and growing operating profits;
 - Operating ROE, which captures Landcorp's gearing and the level of capital invested by the Crown at that time (but which will be suppressed over time by the continued revaluation of the asset base and hence the denominator in the ratio); and
 - TSR, which captures both the cash and capital returns from farming, and is the ultimate long-term measure of shareholder returns.

Debt ratios

- We have also been asked to comment on the appropriate gearing ratio for Landcorp (i.e. debt as a percentage of total capital).

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5. Draft strategic plan and forecasts

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5. Draft strategic plan and forecasts

Landcorp's draft strategic plan and financial forecasts have been developed in two separate exercises. Therefore Landcorp's FY14F SCI forecasts may not fully reflect Management's intended path for the business.

5.1. Introduction

- Deloitte's Strategic Review has been undertaken in parallel with Landcorp's internal strategic planning process. This process is currently in two parts:
 - The development of a new strategic vision and plan, being led by the new CEO Steven Carden in a collaborative process with Landcorp's Board. This represents a fresh examination of Landcorp's purpose, objectives and business strategies. We refer to this as the draft Strategic Plan.
 - The roll-forward and update of three year financial forecasts (FY15F-FY17F) to be used in this year's SCI. We refer to these as the draft Forecasts (as provided to Deloitte in mid-April 2014 – see note below).
- In this section we summarise and review both these components of Landcorp's planning process.
- Reflecting the desire for bold new thinking to reinvent or transform Landcorp, early versions of the draft Strategic Plan canvassed a wide range of potential initiatives to grow volume, value and improve "corporate health". There was little focus on cost efficiency, although arguably it was implicit in the setting of a financial performance target (to average a 6% return on capital employed). Also, the initiatives were not prioritised.
- Consistent with Deloitte's views, the draft Strategic Plan now:
 - Makes explicit the objective of cost efficiency;
 - Prioritises this as the main focus over the next two years;
 - Has narrowed the range of options being considered and started to plan how they would be sequenced; and
 - Acknowledges that many of the revenue growth initiatives would only be in the evaluation stages over the next two years, so are not likely to involve material investment or impact on Landcorp's financial performance until FY17F or beyond.
- The draft Forecasts, while updated for current views on prices, exchange rates, output volumes, etc., are essentially based on a roll-forward of last year's capital plan (i.e. the programme of intended farm sales, new investment, etc.). In other words, the draft Forecasts do not take account of:
 - The costs or benefits of the new initiatives in the draft Strategic Plan; or
 - Any change in the capital plan or farm asset/ownership mix that might result from the draft Strategic Plan.
- This is understandable given that it is easier to forecast based on what is known rather than on initiatives and opportunities that are yet to be specified in detail or formally approved. However, this means that the draft Strategic Plan and the draft Forecasts are currently two rather unconnected exercises. As a result, Landcorp's FY14F SCI and the draft Forecasts may not accurately reflect Management's vision and strategy for the business.

Landcorp's revised forecasts

The draft Forecasts presented above are based on a version provided to Deloitte on 11/04/14. Analysis of trends presented within this report, including scenario analysis summarised on pages 80 and 81, reflects the above version of the draft Forecasts. Landcorp provided Deloitte with revised forecasts on 16/05/14 which reflect some assumption changes. We have included a summary of the incremental impacts of these revised forecasts in Appendix 10 of the report. We understand that the revenue, operating cost and capital cost components of these revised forecasts have been approved by Landcorp's Board, but the sale of Wharere for \$19.2 million was deferred to FY15F, dividends were decreased across the plan period and therefore debt levels and interest expense were also lowered.

5. Draft strategic plan and forecasts

The draft Strategic Plan assumes an industry leadership role for Landcorp, and contains a wide range of initiatives.

5.2. Draft Strategic Plan

- Landcorp's proposed vision is to become the premium supplier of meat, milk and fibre aimed at global niche markets, and its stated purpose is strengthen New Zealand farming by leading the way. Landcorp aims to achieve its proposed vision as follows:
 - Deliver total shareholder returns of 12% p.a. sustainably over the business cycle.
 - Help supply 5% of New Zealand's pastoral livestock production, of the highest quality, to partners in premium value chains around the world.
 - Become the partner of choice for Maori, external investors, and other organisations investing in the growth of New Zealand farming.
 - Lead the industry in terms of people employed, animals under care and the environment Landcorp has been entrusted to farm in.
- The table opposite summarises Landcorp's key strategies to achieve its aims, which are set out in terms of 'what we will farm' and 'how we will farm', each with three key components. The table overleaf sets out the respective underpinning strategies and implications for both Livestock and Dairy over the next three years. Some of the key strategies are to:
 - Expand Landcorp's "footprint" through partnership models that combine Landcorp's intellectual property and other people's money.
 - Enforce a continued push to achieved higher levels of efficiency.
 - Explore opportunities to partner in the value chain, develop branding, and exploit niche market opportunities.
 - Focus on lowering Landcorp's environmental impact.
- Appendix 9 contains two key slides from the draft Strategic Plan (as at early April 2014), including the proposed sequencing of the initiatives.

Summary of key strategies

"What we will farm"	
Volume	▪ In partnership with Maori and others, significantly expand the quantity of livestock farmed, across an integrated portfolio of farms nationwide.
Value	▪ Integrate our products into value chains focussed on niche markets, driven by a deep understanding of future consumer requirements.
Diversity	▪ Explore opportunities to diversify what we farm or what our products are used for in the value chains we supply.
"How we will farm"	
Efficiency	▪ Drive adoption of science, systems and new thinking that will boost the cost effectiveness and efficiency of our farm operations.
Environment	▪ Lead the industry on showcasing rejuvenation and profitability potential of our environmentally-savvy farming.
People	▪ Lead the industry in people practices, providing the safest, most enriching work environment for talented and motivated people.

5. Draft strategic plan and forecasts

The specific action points flowing from the draft Strategic Plan are still being developed, and their costs and benefits are yet to be quantified.

	Livestock	Dairy
What we will farm	<ul style="list-style-type: none"> Develop partnership models that combine Landcorp IP and other people's money. Enforce a continued push to achieved higher levels of productivity. Increase product value through branding, niche marketing of core products and identifying new markets for co-products. Investigate alternative livestock options such as goat meat, goat and sheep milk, game and grass fed pork. 	<ul style="list-style-type: none"> Limit future investment in dairy expansion to existing commitments. Develop partnership models that combine Landcorp IP and other people's money. Enforce a continued push to achieved higher levels of productivity. Explore working with a value chain partner with WPL milk. Utilise derivatives to limit milk price volatility. Explore other niche market premium opportunities. Strive for better returns from dairy livestock via stronger integration with Livestock. Develop flexibility to supply alternative products as market conditions changes e.g. colostrum.
How we will farm	<ul style="list-style-type: none"> Implement new information systems and improve KPI reporting and performance monitoring. Lead the development of new technology and research to drive efficiencies and productivity. Development of internal and external benchmarking systems to identify strengths and weaknesses. Build internal expertise within in the FPG and closer relationships with industry leaders. Finalise Land Environment Plans and progress to implementation. Foster mutually beneficial partnerships with regional councils and environmental groups. Develop a culture that cares for the environment and animal welfare. Progress graduate recruitment programs. Increase expertise, numeracy and literacy at all levels of the Livestock group. Development of staff retention strategies and demonstrate leadership in farm safety. 	<ul style="list-style-type: none"> Implement new information systems and improve KPI reporting and performance monitoring. Lead the development of new technology and research to drive efficiencies and productivity. Use partnerships to find dairy models that lower cost of production, limit environmental impact, increase productivity. Build internal expertise within in the Farm Performance Group and demonstrate innovation in farm development. Significant focus on how to lower Landcorp's environmental impact across its dairy operations, especially on water, nutrient run-off and carbon. Invest in new technologies that lower environmental impacts. Develop a culture that cares for the environment and animal welfare. Develop programs to significantly improve the calibre of people recruited in Dairy. Implement Dairy Academy. Development of staff retention strategies and demonstrate leadership in farm safety.



5. Draft strategic plan and forecasts

Milk production is forecast to double by FY17F. This primarily reflects the SPG arrangements, significant planned expansion of the WPL operations and also further conversion and development of the Canterbury dairy farms.

5.3. Draft SCI Forecasts

Key assumptions underlying the draft Forecasts

- The table opposite shows some of the key assumptions that underpin the draft Forecasts covering the period FY15F to FY17F, together with FY13A and also expected outturn for FY14F. Landcorp's draft Forecasts are primarily based on a bottom up process. Farm budgets were aggregated and reviewed by senior operational managers and then submitted to an internal budget and planning meeting, following which further refinements and adjustments were made in anticipation of Board approval.
- Lamb production is forecast to increase from 453,000 in FY13A to 494,000 in FY17F, an increase of 42,000 lambs (growth of 9%). Management explained that forecast lamb volume growth is primarily related to changes in lambing % and mated ewe hogget assumptions. Forecast production levels from other livestock operations are broadly consistent with recent production trends and do not reflect any significant changes in growth over the forecast period.
- Milk production is forecast to materially increase from around 12.8 million kgMS in FY13A to 24.7 million kgMS in FY17F, an increase of 11.9 million kgMS (growth of 94%). This primarily reflects the SPG arrangements which commenced this season, the planned significant expansion of the WPL operations and also further planned conversion and development of the Canterbury dairy farms.
- Forecast price assumptions were established with reference to the historical trends and market outlook, including discussions with invited industry analysts. In forming its forecast price expectations Landcorp is assuming a 9% depreciation in the value of the New Zealand dollar between FY14F and FY17F. Lamb prices are forecast to recover in FY14F from FY13A levels and thereafter reflect a slightly more positive outlook but still within the range achieved between FY11A and FY12A. Milk prices in FY14F reflect this season's record forecast payout. Landcorp's milk price assumptions going forward are at the more conservative end of the industry's forecast range.

Draft Forecast assumptions

	Actual FY13A	FY14F	Forecast		
			FY15F	FY16F	FY17F
Sales volume (000's)					
Lamb	453	458	464	479	494
Sheep	91	91	87	92	92
Beef	41	37	35	39	40
Deer	43	47	43	44	46
Milk (tonnes)	12,761	18,595	20,340	22,864	24,716
Prices					
Lamb \$ / head	86	97	98	100	104
Sheep \$ / head	81	96	95	100	105
Beef \$ / head	1,017	932	995	1,013	1,066
Deer \$ / head	366	336	360	379	390
Milk \$ / kgMS ¹	6.05	8.55	6.90	6.30	6.85
Farming area (E ha 000s)					
Dairy owned	10.1	11.4	12.1	12.1	12.1
WPL	3.4	4.6	6.2	7.1	7.5
SPG	-	6.3	6.3	6.3	6.3
Dairy other	3.5	5.0	4.9	4.9	4.9
Livestock owned	124.5	122.7	125.1	124.7	124.7
Livestock leased	31.9	28.9	27.3	27.4	27.4
Total E ha	173.4	178.9	181.8	182.5	182.9
Other					
Exchange rate (USD / NZD)	0.82	0.82	0.80	0.78	0.75

Source: Management Analysis

¹ FY13A is implied weighted average based on gross milk revenue and milk production. FY14F-FY17F are based on Fonterra milk price assumptions



5. Draft strategic plan and forecasts

FY14F operating profit of \$32.1 million largely reflects this season's record forecast milk payout. Landcorp's operating profit will become increasingly more sensitive to milk price as forecast milk production increases.

Group financial performance

- The table opposite summarises Landcorp's draft Forecast consolidated financial performance. Revenues and costs in relation to sharemilking arrangements are presented net of the respective partners' share of revenue and costs.
- Increased FY14F operating profit largely reflects increased dairy revenue related to the record forecast payout in this season combined with favourable growing conditions relative to the drought conditions which impacted FY13A's operating profit. Operating profit is forecast to decrease to more normative levels through FY15F and FY16F, reflecting of the lower milk price assumptions. FY17F operating profit is forecast to increase to \$25.1 million which is primarily related to increased milk volume combined with a 50 cent increase in the forecast milk price assumption.
- Revenue is forecast to increase from \$249.7 million in FY15F to \$289.4 million in FY17F (16% growth) primarily related to the lamb and milk volume growth and price assumptions as set on the previous page. Other revenue is forecast to range between \$6.7 million in FY17F and \$10.4 million in FY16F, significantly lower than the FY13A result of \$30.6 million which included several significant one-offs.
- Operating expenses include direct farming working expenses and other operating costs. Operating costs per effective hectare are forecast to increase from approximately \$1,000 in FY14F to \$1,100 in FY17F, reflecting the expanded Dairy operations which have a greater operating cost intensity. Corporate costs include head-office costs net of supplier rebates and also administration cost associated with Focus Genetics, which are accounted for on a consolidated basis as from FY14F following Landcorp's recent step acquisition to control this entity.

Group financial performance

\$m	Actual FY13A	FY14F	Forecast		
			FY15F	FY16F	FY17F
Revenue					
Livestock	96.7	107.2	116.9	125.7	130.6
Dairy	75.8	139.2	124.1	129.6	152.1
Other	30.6	10.3	8.7	10.4	6.7
Total	203.1	256.7	249.7	265.7	289.4
Operating costs					
Operating expenses	(149.7)	(180.3)	(183.5)	(192.5)	(205.7)
Corporate costs	(16.1)	(20.9)	(23.0)	(23.5)	(23.6)
Total	(165.8)	(201.2)	(206.6)	(216.0)	(229.3)
EBITDA	37.4	55.4	43.1	49.7	60.1
Depreciation	(13.6)	(14.0)	(16.0)	(17.1)	(17.0)
Interest	(10.8)	(9.3)	(11.5)	(15.7)	(18.0)
Operating profit	13.0	32.1	15.6	16.9	25.1

Source: Annual Reports and Management Analysis

- Forecast increases in interest costs reflect both increased bank borrowings and higher interest rates. Bank debt is forecast to increase from \$168.9 million in FY14F to \$246.3 million in FY17F. Over the corresponding period the average annual effective cost of borrowing is assumed to increase from 4.7% in FY14F to 5.9% in FY17F. Depreciation charges are forecast to increase in line with recent historical and ongoing capital expenditure related to the expanded dairy operations.



5. Draft strategic plan and forecasts

Analysis of divisional forecast performance highlights a steadily increasing contribution from Livestock and a fluctuating contribution from Dairy, largely driven by forecast milk price and volume assumptions.

Divisional financial performance

- The table opposite breaks down forecast EBITDA by division: Livestock, Core Dairy (including SPG and other sharemilking arrangements) and WPL. Divisional analysis is grossed up based on internal transactions, but these net out at the gross contribution level.
- Gross contribution from Livestock is forecast to improve significantly. Livestock revenue is forecast to increase from \$106.4 million in FY13A to \$127.7 million in FY17F (growth of 20%), which is primarily due to the assumed improvements in lamb prices and volumes discussed previously. Direct operating expenses are forecast to increase from \$87.1 million in FY13A to \$89.5 million in FY17F (growth of 3%).
- Gross contribution from Core Dairy is forecast to significantly increase in FY14F reflecting the current season milk price, and thereafter decrease in FY15F, with subsequent improvement in FY17F. Core Dairy revenue is forecast to increase significantly from \$60.0 million in FY13A to \$120.7 million in FY14F and then decreasing to \$102.9 million in FY15F and recovering to \$114.9 million in FY17F due to the price and volume assumptions discussed previously. Direct operating expenses are forecast to increase from \$50.9 million in FY13A to \$79.4 million in FY14F (growth of 56%) reflecting the commencement of the SPG arrangements.
- Gross contribution from WPL is forecast to increase as new farms commence operations. WPL revenue is forecast to increase from \$20.1 million in FY13A to \$54.9 million in FY17F (growth of 174%), and direct operating expenses are forecast to increase from \$21.1 million in FY13A to \$47.1 million in FY17F (growth of 124%).
- Other expenses are forecast to be significantly higher than other revenue in every year leading to a consolidated EBITDA forecast lower than the combined gross contributions of Livestock, Core Dairy and WPL.

Divisional financial performance

	Actual	Forecast			
\$m	FY13A	FY14F	FY15F	FY16F	FY17F
\$9(2)(b)(ii)					



5. Draft strategic plan and forecasts

Forecast balance sheets do not reflect land appreciation assumptions. Landcorp's 25 year average capital growth rate is 5.1%, which is likely to provide the basis of revaluation assumptions in the final Board-approved forecasts.

Group balance sheets

- The table opposite summarises Landcorp's forecast balance sheet. Assets are broadly categorised between land and buildings, cooperative shares, livestock, working capital and other assets; and are funded by bank borrowings, RPS securities and shareholder funds.
- Cooperative shares (or units) are not forecast to increase despite a significant increase in forecast milk production over the corresponding period. Landcorp believes that it does not have a supplier share shortfall in FY15F and longer term it has a range of available strategies to manage any potential shortfalls and related contingent liabilities. For example Fonterra now offers deferred payment plans whereby suppliers can share-up over an agreed contractual period. Alternatively Landcorp may cash up some its Fonterra units and elect to supply other independent processors. We also understand that Landcorp has not yet made any long term milk supply decision related to WPL.
- Livestock is forecast to increase from \$276.8 million in FY14F to \$345.3 million in FY17F, an increase of \$68.5 million. This increase mostly reflects the expanded WPL operations, whereby milking cows are forecast to increase from around 8,300 in FY14F to 20,900 in FY17F, this will be achieved primarily through internal transfers but will also involve external purchases.
- Land and buildings are revalued annually and are carried at fair value. However, the draft Forecasts do not reflect any land revaluation assumptions. We understand that Landcorp's 25 year average capital growth rate is 5.1%, which is likely to provide the basis for an annual land revaluation assumption to be included in the final Board-approved forecasts.
- Bank borrowings are forecast to peak at \$250.6 million (gearing 15.5%) in FY16F. We understand that forecast borrowings are within existing facility limits and forecast to be compliant with stipulated covenant ratios. RPS securities are forecast to decrease by \$10.1 million in FY14F related to the removal of one of the LHL properties under the Protected Land agreement.

Group balance sheets

\$m	Actual FY13A	FY14F	Forecast		
			FY15F	FY16F	FY17F
Assets					
Accounts receivable	38.6	14.6	10.8	10.8	10.8
Inventories	11.9	12.4	12.4	12.4	12.1
Cooperative shares	61.4	60.3	55.2	55.2	55.2
Biological assets	264.8	276.2	327.3	337.9	345.3
Land and buildings	1,135.4	1,098.2	1,139.6	1,179.5	1,175.8
Protected land	119.4	109.3	109.3	109.3	109.3
Plant and equipment	45.4	48.1	50.7	47.9	44.4
Other assets	17.9	14.2	14.2	14.2	14.2
Total assets	1,694.9	1,633.3	1,719.5	1,767.0	1,767.0
Liabilities					
Bank loans	229.1	168.9	220.4	250.6	246.3
Preference shares	117.8	107.7	107.7	107.7	107.7
Other liabilities	30.7	44.7	45.2	45.6	45.9
Total liabilities	377.6	321.3	373.3	403.9	399.9
Net assets	1,317.3	1,311.9	1,346.2	1,363.2	1,367.1
KPIs					
Net gearing (%)	14.8%	11.4%	14.1%	15.5%	15.3%
Interest cover	2.2	4.4	2.4	2.1	2.4
KgMS (tonnes)	12,761	18,595	20,340	22,864	24,716

Source: Management Analysis

5. Draft strategic plan and forecasts

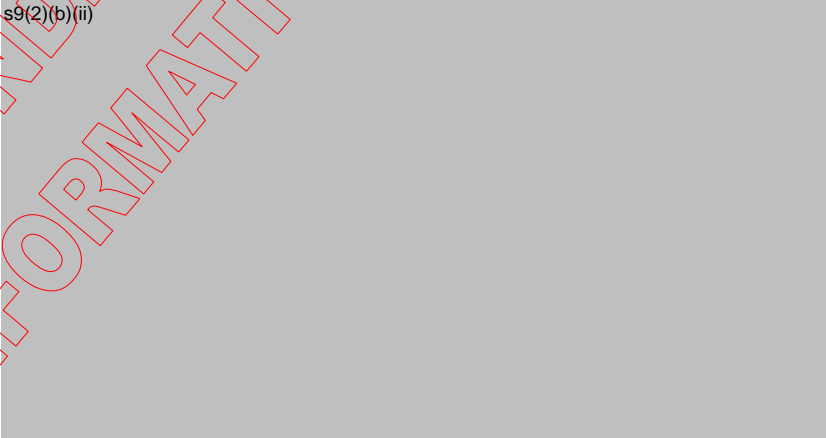


Capital expenditure over FY15F-FY17F is forecast to total \$188.8 million, of which \$91.3 million is related to WPL, \$15.2 million is for expanding Canterbury dairy operations and \$82.3 million relates to existing operations.

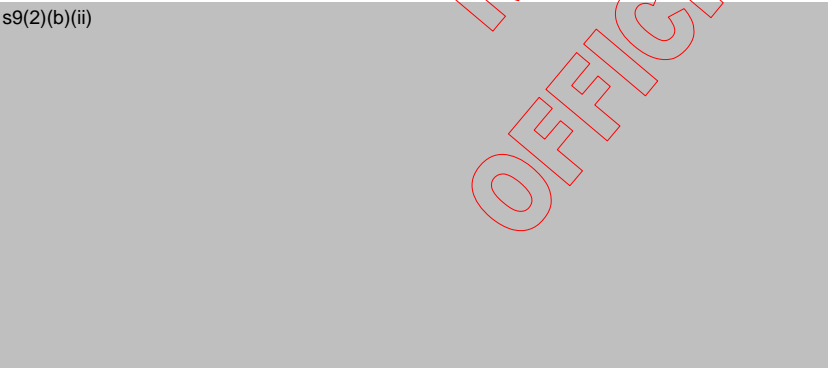
Group cash flow

- The charts opposite summarise Landcorp's draft Forecast cash flows covering the period FY15F to FY17F, together with FY13A and also the expected outturn for FY14F.
- Forecast cumulative cash inflows over the period FY15F to FY17F of \$205.7 million comprise operating cash flows of \$83.9 million, sale of capital assets of \$44.1 million and increased borrowings of \$77.6 million. Forecast cash inflows are forecast to fund investments of \$188.8 million and dividends to the Crown of \$17.0 million. (Note: the revised forecasts feature significantly higher dividends – see Appendix 10).
- Operating cash flows are forecast positive in each year between FY15F and FY17F and broadly reflect forecast operating profits after adjusting for movements in working capital, depreciation charges and other non-cash accounting revenues and costs.
- Landcorp has provided us with the following details of forecast major divestments and investments over the forecast period FY15F to FY17F:

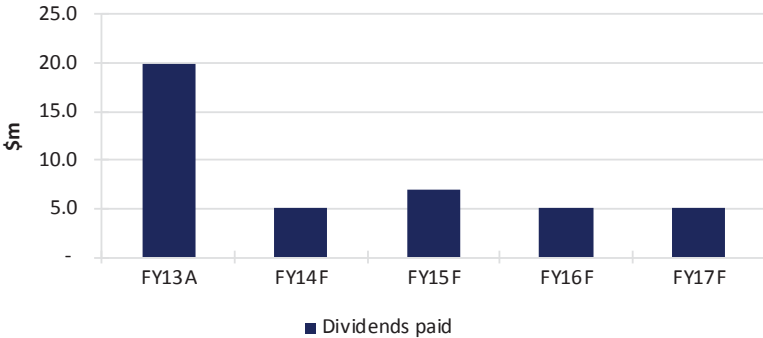
s9(2)(b)(iii)



s9(2)(b)(ii)



Shareholder cash flows



Source: Management Analysis and Deloitte Analysis

5. Draft strategic plan and forecasts

The draft Strategic Plan combines a near-term focus on cost efficiency and a longer term plan to grow revenue. The draft SCI Forecasts are currently a “business as usual” projection.

5.4. Deloitte’s observations on the draft Strategic Plan and Forecasts

Draft Strategic Plan

- The framework employed for developing the draft Strategic Plan intuitively appeals as being sensible and comprehensive (i.e. “What we will farm”/“How we will farm” and the six components: volume, value, etc.). The possible exception to this is “Diversity”, which we do not think should be pursued for its own sake if it led to involvement in new but sub-scale ventures.
- In many areas the high level strategies have not been developed into specific action plans, and the costs and benefits have not been quantified. However we acknowledge that this is a work-in-progress.
- We are concerned that the breadth of the plan and the number of initiatives are beyond Landcorp’s resources to execute. Decisions on which initiatives to prioritise are tactical in nature and lie with management and the Board, and Deloitte has not considered this question.
- In the push to develop “new thinking”, there is a risk that management becomes distracted and less focus is applied to improving Landcorp’s cost efficiency and profitability, even though this has been made the top priority over the next two years.
- In our view the effort to grow revenue should focus on those opportunities which have the potential scale to make a material difference to Landcorp’s performance (e.g. downstream partnership opportunities based on WPL and SPG milk).
- There is considerable focus on expanding Landcorp’s farming footprint using alternative models and “other people’s money” (e.g. leasing rather than owning the land). However:
 - In section 6 we explore some of the difficulties with this approach; and
 - Landcorp needs to clearly articulate the benefits expected to flow from greater scale.

Draft Forecasts

- The WPL and SPG arrangements are forecast to have a significant impact on Landcorp’s operational and financial performance and position.
- Key volume assumptions (particularly for lamb and milk) are driving a significant portion of the forecast revenue increases. If these volume assumptions are not met, this could materially impact Landcorp’s financial performance.
- The process used to derive price assumptions, involving outside consultants, and the assumptions adopted, appear reasonable. The milk price is the single most influential assumption.
- We have not reviewed the financial model used to generate the forecasts for mathematical accuracy, nor have we undertaken a detailed due diligence on the forecasts.


6. Strategic options

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6. Strategic options

Landcorp's strategic options are shaped by the Crown's objectives, the aspirations of management and the Board, and operational realities.

6.1. Factors driving strategic options

- A variety of considerations, discussed below, shape the strategic options available to Landcorp.
- Landcorp has delivered total returns to the Crown averaging 10% p.a. (compound) over the last 10 years. Interestingly, the returns have been similar in Livestock and Core Dairy. In each case capital gains make up the bulk of the return, while Landcorp's cash yield has been low (averaging 1.6% of NAV).
- The Crown, as shareholder, has a low appetite for funding growth opportunities by injecting additional equity capital. On the contrary, the Minister for State Owned Enterprises has explicitly requested that Landcorp explore asset sell-down options as part of its strategic review.
- s9(2)(b)(ii) 
s9(2)(b)(ii) Treasury believes that a discussion between shareholding Ministers and the Board should be had following any asset-sell down, to agree an appropriate use for the funds generated from such a sale.
- Treasury has also expressed a desire for improved financial performance, particularly in relation to Landcorp's cash yield. Treasury accepts that Landcorp's operating profits will be volatile due to fluctuations in climate and market prices. However it seeks a secular improvement in Landcorp's profitability.
- The Board's view that "the status quo is not an option" is also primarily a reference to the need for improved operating and financial performance. The draft Strategic Plan expresses the Board's willingness to consider new activities and take additional risks to achieve this objective.
- One of management's key strategic objectives is to grow Landcorp's farming "footprint", leveraging its expertise and gaining even greater economies of scale, particularly in the Livestock division. To achieve this without additional shareholder or debt capital, management proposes to enter into arrangements with other land owners or investors whereby Landcorp does not own the land but manages the farming operations. Landcorp refers to this as its "other people's money" or OPM strategy.
- Management believes that Landcorp has been investing considerable funds and executive time on industry good/leadership activities that an equivalent privately-owned farming business would not undertake. Landcorp has not quantified the cost of this non-commercial activity, which management says reflects its SOE status and industry position. It appears that some industry participants are calling on Landcorp's assistance in such areas, while other stakeholders interviewed thought Landcorp should "focus first on being the most efficient and profitable farmer, and leading by example in that way".
- The greatest opportunity for Landcorp to provide a unique exemplar to the industry appears to be in Livestock and is commercially motivated: the potential to demonstrate improved returns in the red meat sector through Landcorp's integrated farm network, scale, genetics and an integrated supply chain with Silver Fern Farms and Tesco. By comparison, there is less to distinguish Landcorp's Dairy operations from its private sector peers.
- The dairy sector is buoyant, with high forecast payouts, strong investor interest and recent increases in land values. In Core Dairy, the bulk of Landcorp's development gains have probably already been achieved and reflected in asset values (except in the Canterbury complex). It may be opportune to realise some of these gains. The commitments to WPL mean that Landcorp will continue to have a significant exposure to dairy farming. In fact WPL's highly leveraged exposure to the milk price argues for Landcorp reducing its dairy exposure elsewhere and reducing its financial leverage.

6. Strategic options

We have considered various options for Landcorp, focussed principally on variations in asset ownership, asset mix, cost structure and capital structure.

6.1. Factors driving strategic options (continued)

- While Livestock's TSR has been reasonable over the last 10 years, compared to dairy the sector is less buoyant and cash yields are low. Combined with Landcorp's integrated supply chain initiatives, and a reversal of the under-investment in recent years, there may be relatively more upside in Livestock.
 - A number of factors should support Landcorp's OPM expansion strategy:
 - The trend towards corporate farming, boosting the demand for farm management services;
 - Landcorp's growing relationships with iwi and the potential to improve the productive output from Maori farm land; and
 - The growing interest from offshore investors in the New Zealand agri-sector, and their desire to partner with credible local farm managers.
 - However, expanding Livestock's footprint using OPM has a number of issues discussed in section 6.3. Furthermore, Landcorp has not yet been able to:
 - Quantify the production benefits of the integrated farming approach in Livestock;
 - Quantify the benefits of an expanded Livestock farming footprint; or
 - Demonstrate that the benefits of Landcorp's farming scale exceed its corporate overheads.
 - Head office costs have grown materially in real terms over the last decade, and are forecast to increase further to \$22.5 million in FY16F. This is similar to the average EBIT produced by the Livestock division in recent years. Some of the increase will be due to the direct and indirect costs of industry good/leadership activities.
- Taking these and other factors into account, the following sub-sections consider:
 - Options for the Crown to sell Landcorp as a whole;
 - Options to grow Landcorp using the OPM strategy;
 - Certain other growth opportunities; and
 - A scenario involving the sale of certain assets and cost reductions.
 - Our focus is on options relating to Landcorp's asset ownership, asset mix, cost structure and capital structure. This focus reflects:
 - The constraints outlined above;
 - The fact that these areas are by their nature more directly under management control and able to be actioned in shorter time frames and with greater certainty than new revenue initiatives; and
 - That Landcorp's growth initiatives are mostly at the evaluation stage and Landcorp will require time to complete its assessment of these opportunities. While we comment on certain opportunities, the prioritisation and sequencing of initiatives will largely be a tactical matter for management and the Board.

6. Strategic options

The sale of Landcorp could release circa. \$1.3 billion of capital to the Crown. Maximising proceeds is likely to require the involvement of foreign investors.

6.2. Sale of whole business

- Although Landcorp has delivered a credible TSR over the last decade, averaging 10% p.a., most of this (8.3% p.a. on average) has come in the form of capital gains. The “asset rich, cash poor” nature of farm ownership is not well matched to the Government’s fiscal objectives.
- A sale of the whole business, whether structured as a sale of assets or shares, could net in the vicinity of \$1.3 billion of capital for the Crown (based on the June 2013 farm valuations).
- We note that the Minister of Finance has publicly stated that the Crown has no plans to sell any more assets following the election, and that a sale of Landcorp was restricted by negotiations over Treaty settlements. The mixed ownership model sales have concluded, and we are not aware of any other planned sale processes.
- However in Deloitte’s view there is no compelling reason for Landcorp to be in Crown ownership. It is predominantly a commercial farming operation and these activities would continue under private ownership within a competitive sector. Arguably private ownership would be beneficial for Landcorp if it provided more ready access to capital for its growth plans, and a sharper focus on cost efficiency.
- A key distinguishing feature of Landcorp’s current operations, and an exemplar for the red meat sector, is the integrated network of Livestock farms and the development of an integrated lamb supply chain with Silver Fern Farms and Tesco. This is a commercially rational arrangement and would be expected to continue under private ownership (unless the sale led to a break-up of the network of farms).
- A sale of Landcorp would need to address certain issues:
 - The retention (or transfer to an alternative Crown entity) of LHL and its protected land;
 - The first rights of refusal held by iwi over certain land (and, more generally, iwi interests in other Landcorp farms);
 - The assignment or novation of Landcorp’s obligations under the WPL, SPG, Sweetwater and other contracts;
 - Whether the Crown would want to continue (and separately fund) the non-commercial industry good/leadership activities currently being undertaken by Landcorp.
- Beyond these matters, it should also be acknowledged that a sale of \$1.6 billion of farming assets would be unprecedented in New Zealand. Careful consideration would be needed to determine the optimal sale structure and process (e.g. sale as a whole; sale of Dairy and Livestock separately; approach to marketing; etc.). These decisions will depend largely on assessments of the interest levels from different categories of potential investors.
- The table on the following page discusses possible sale variants. Because the Government has no stated intention to sell Landcorp, we have not explored these options in any greater detail.

6. Strategic options

There are a variety of ways to structure a sale, depending on the main objectives (e.g. maximising price; retaining NZ ownership; involving iwi; etc.).

6.2. Sale of whole business (continued)

Option	Rationale	Comment
1. Unconstrained sale	<ul style="list-style-type: none"> Maximises proceeds to Crown. 	<ul style="list-style-type: none"> Structured as a sale of assets or shares. Maximising price likely to involve foreign investors. Potential loss of the integrated Livestock exemplar and industry leadership activities. Potential loss of Landcorp team and knowledge.
2. Sale of assets to NZ investors (e.g. ACC; Superfund) with a management contract	<ul style="list-style-type: none"> Releases capital to Crown while retaining Landcorp's team and skills. 	<ul style="list-style-type: none"> Seen as a sale to "NZ Inc." May not maximise price (but no loss of value to NZ). Crown retains Landcorp shares, and effectively reinvents the SOE as a farm management company, with a lower risk earnings stream. Execution issues (term of contract; renewal risk; control of strategy; etc.).
3. Sale of assets to a "Treaty Fund" with a management contract	<ul style="list-style-type: none"> Interests in Fund used to settle Treaty claims. Relieves Crown of equivalent funding requirement. Retains Landcorp's team and skills. 	<ul style="list-style-type: none"> As in 2, plus the need to determine iwi interests in the Fund and their role in the governance structure.
4. Sale of all assets with lease back	<ul style="list-style-type: none"> As in 2 or 3, but with exposure to performance outcomes. 	<ul style="list-style-type: none"> As in 2 or 3, but involves a leveraged exposure to price volatility (see section 6.3).

6. Strategic options

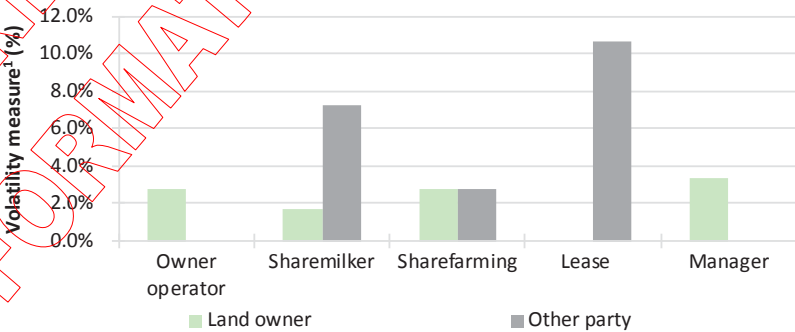
While reasonable ROAs can be structured in the base case in a range of models, Landcorp's EBIT in the sharemilking and leasing options would be more volatile, so these models are both more risky and miss out on land capital gains.

6.3. The OPM strategy

Alternative farming models

- To assist in considering Landcorp's OPM strategy, we have prepared an illustrative analysis summarising alternative commercial farming models compared to the traditional owner operator model. Specifically this analysis shows the respective returns, in terms of EBIT and ROA, earned by the land owner and the farming partner under a range of commercial partnerships, based on a dairy farming example.
- The analysis is based on an illustrative 355 E ha dairy farm milking 1,200 cows and producing 450,000 kgMS p.a. Further detailed input assumptions are summarised in Appendix 7.
- As shown on the following page, under the base case assumptions the farm generates an EBIT of \$1.2 million, providing an ROA for the owner operator of 9.4% including revaluations. Corresponding returns related to alternative models, and underlying assumptions are:
 - For sharemilking arrangements we have assumed apportionment based on 50:50 milk revenue and 65:45 operating costs splits. This generates EBITs of \$0.9 million and \$0.2 million and ROA's including revaluations of 9.5% and 8.7% for the land owner and the sharemilker respectively.
 - For sharefarming arrangements we have assumed an agreed EBIT split intended to achieve the same net returns as sharemilking arrangements.
 - For leasing we have assumed a lease cost of 4% of the capital value of the land). This generates an EBIT of \$0.9 million and an ROA including revaluation of 9.0% for the land owner. The leasee receives an EBIT of \$0.3 million and ROA including livestock revaluation of 11.1%.
 - For management arrangements we have assumed a fee of 1% based on the value of assets. This generates an EBIT of \$1.0 million and an ROA including revaluation of 8.4% for the land owner. The manager receives an EBIT of \$0.2 million with no assets invested.

Alternative farming models - volatility measure



Source: Deloitte Analysis

¹ The volatility measure is the % change in EBIT for a 1% change in milk price

- We have also tested the sensitivity of EBIT in each of these models to changes in the milk price. The chart above shows the % change in EBIT for a 1% change in the milk price, as an illustrative volatility measure. In the leasing and sharemilking models EBIT is more volatile in percentage terms for the counterparty because the EBIT margin is smaller in the base case (i.e. the lease charge is akin to financial leverage).
- The key conclusion from this analysis is that while reasonable ROAs can be structured in the base case in a range of models, Landcorp's EBIT in the share milking and leasing options would be proportionally much more volatile, so these models are both more risky and miss out on land capital gains.
- By way of example, based on these volatilities a 10% change in the milk price would see Landcorp's EBIT go to zero in the leasing model, while in the ownership model it would still have over 70% of the EBIT, as well as access to capital gains on land. Our analysis of the WPL leasing model in section 4.4. shows a similar result.

6. Strategic options

In the lease and sharemilking models the volatility of the land owner's returns to changes in output prices goes down, but for the counterparty it increases materially.

	Owner operator		Sharemilker/Sharefarming		Lease		Manager	
	Owner		Owner	Sharemilker	Owner	Lessee	Owner	Manager
Illustrative returns	EBIT (\$m)	▪ 1.2	EBIT	▪ 0.9 ▪ 0.2	EBIT	▪ 0.9 ▪ 0.3	EBIT	▪ 1.0 ▪ 0.2
	Revaluations (\$m)	▪ 0.8	Revals	▪ 0.7 ▪ 0.1	Revals	▪ 0.7 ▪ 0.1	Revals	▪ 0.8 ▪ -
	Avg. assets (\$m)	▪ 20.7	Avg. assets	▪ 17.3 ▪ 3.4	Avg. assets	▪ 17.3 ▪ 3.4	Avg. assets	▪ 20.7 ▪ -
	ROA (%)	▪ 9.4%	ROA	▪ 9.5% ▪ 8.7%	ROA	▪ 9.0% ▪ 11.1%	ROA	▪ 8.4% ▪ n/a
	Volatility measure ¹	▪ 2.8%	Volatility	▪ 1.7% ▪ 7.2%	Volatility	▪ 0.0% ▪ 10.6%	Volatility	▪ 3.4% ▪ 0.0%
Issues and observations	<ul style="list-style-type: none"> The owner operator receives all of the returns from operations, all of the returns related to changes in the value of land and livestock and also dividends from cooperative shares. If profitable operations and real growth in land and livestock are assumed (as is the case here), this model will generate the highest absolute profit. However, it also requires the highest investment in assets (along with the owner of a managed farm) so ROA may be lower than other models. The owner operator is exposed to volatility in operational profits as well as land and livestock values. 		<ul style="list-style-type: none"> Sharemilking: Milk revenues and associated operating costs are split between the owner and the sharemilker. Returns from changes in the value of land and livestock and any other returns such as dividends accrue to the owner of the asset concerned. Sharefarming: Returns from operations are split between the owner and the sharefarmer. Returns from changes in the value of land and livestock accrue to the owner of the asset. Sharefarming is seen as a simpler model for corporate farmers. 		<ul style="list-style-type: none"> The lessee pays the owner a fixed charge (usually based on the capital value of the land) and receives all of the returns from operations and all of the returns from changes in the value of livestock. The owner or lessor receives the fixed charge and all of the returns from changes in the value of land. Other returns such as dividends accrue to the owner of the asset. The lessee is exposed to volatility in operational profits and livestock values. 		<ul style="list-style-type: none"> The owner pays the manager a fixed service charge (such as % of assets under management) and receives all of the returns from operations, all of the returns from changes in the value of land and livestock and any other returns such as dividends. The manager receives the fixed charge. The owner is exposed to volatility in operational profits as well as land and livestock values. We note that an ROA is not a valid measure for a farm manager as they have no assets invested. 	

¹ The volatility measure is the % change in EBIT for a 1% change in milk price



6. Strategic options

A solution to issues related to alternative farming models would be to create a single large entity through which Landcorp executes the OPM strategy. This is the approach that Landcorp is pursuing.

6.3. The OPM strategy (continued)

Fund concept

- The alternative farming models discussed above are the typical options currently employed in the industry (but other than sharemilking they are not widespread). In addition to the issue of leverage/volatility, there are a number of other problems with such models for Landcorp:
 - The initial and on-going interactions with counterparties can be very time consuming, adding costs to the arrangements;
 - Often the contract terms are too short to justify the set-up costs;
 - Entering such deals on a farm-by-farm basis is impractical because of these costs, and because it would not have the scale to materially influence Landcorp's performance;
 - The operating margins in Livestock are typically too low for traditional leasing arrangements; and
 - Capital gains on land are a major component of farming returns, and traditional OPM models could leave Landcorp with a disproportionate level of risk without an offsetting share of the capital gains.

s9(2)(b)(ii)

s9(2)(b)(ii)

- Deloitte concurs with Landcorp's approach to the OPM strategy, with the main cautionary notes being:
 - It will still be important to quantify the benefits to Landcorp of growing its "footprint" via the OPM strategy (versus the do nothing option);
 - Landcorp should be prepared to "walk away" if it cannot negotiate sensible commercial arrangements. To some degree, Landcorp's negotiating leverage will be influenced by its ability to demonstrate superior returns on its existing operations; and
 - Given Landcorp's exposure to the milk price via WPL, any "dairy fund" would preferably not be structured so that Landcorp's exposure to the milk price increased further.

6. Strategic options

In Deloitte's view, Landcorp's growth efforts should be focussed on a few large opportunities with the potential scale to impact Landcorp's performance.

6.4. Other growth opportunities

- In our view, Landcorp should focus on a limited number of large scale opportunities that are capable of making an impact on Landcorp's performance, rather than risk entering too many sub-scale ventures.
- In section 6.3 we discussed Landcorp's OPM strategy. If successful, it has the potential to utilise Landcorp's farm development and management skills to generate an additional stream of lower risk fund management fees, expand Landcorp's farming footprint, and maintain access to a share of capital gains, without requiring additional equity capital.
- We comment below on three other opportunities that potentially have the requisite scale.

OPM and iwi

- The Sweetwater and Pouarua sharemilking arrangements demonstrate Landcorp's ability to work constructively with iwi. In many respects iwi are logical partners for Landcorp under the OPM strategy, given their land base, long-term view on returns, and (typically) the potential to develop farm productivity and improve farm management skills.
- In section 6.2 we mentioned the possibility of iwi contributing land to the OPM fund concept, in return for an equity interest in the fund. However, this would not be palatable for iwi wishing to maintain direct, long-term ownership of their land. An alternative OPM structure would be required to provide for this.
- Landcorp is developing such a structure, which contemplates:
 - A long-term (say, 20 years) lease of iwi land at low or zero lease rates;
 - Outside investors providing the funds to develop the land;
 - Landcorp managing the development and farm operations, and training Maori farm staff and managers;

- An agreed three-way (investors/Landcorp/iwi) sharing of profits and capital gains; and
- The land reverting to iwi control, fully developed and staffed, at the end of the lease.
- s9(2)(b)(ii) the key is to reduce transaction costs by developing a standard, repeatable structure that is fair to all parties, and for Landcorp to be prepared to "walk away" if acceptable terms cannot be agreed.

Sheep milking

- Landcorp sees significant opportunities to develop and sell sheep milk based dairy products into China. Landcorp is currently developing a business case for a sheep milking operation to tap into this market. To avoid a potential conflict of interest/confidentiality issue, the details of this proposal have not been shared with Deloitte.
- There is a small sheep milking operation based in Southland, called Blue River Dairy Products Limited, selling into the New Zealand and Chinese markets.
- The key challenge involved in sheep milking in New Zealand is to develop sheep that are both suited to the New Zealand climate and capable of yielding sufficient milk per hectare to compete with traditional dairying (noting that sheep milk based products typically sell at a premium to equivalent cows milk products). Landcorp believes its expertise in sheep genetics means it is well placed to tackle this issue.
- Deloitte believes this opportunity deserves consideration. It has the potential, if successful, to transform the economics of sheep farming in New Zealand, and also addresses some of the environmental issues with bovine dairy farming on sensitive land.

6. Strategic options

Landcorp's control of a significant volume of milk in the Central North Island might provide leverage to improve its commercial outcomes in WPL and SPG.

6.4. Other growth opportunities (continued)

Central North Island milk venture

- The two main issues associated with Landcorp's arrangements with WPL and SPG are (i) the potential volatility of returns from WPL and (ii) the short-term nature of the SPG contract. A potential key to addressing both of these issues lies in the fact that, taken together, Landcorp will control over 40 dairy farms producing circa 15 million kgMS, sufficient to underwrite the development of a new processing plant in the Central North Island (e.g. for infant formula or UHT milk).

s9(2)(b)(ii)



6. Strategic options

Selling circa. \$200 million of less strategic properties and repaying debt, and reducing costs by \$7 million p.a., could improve FY17F operating profits from \$25 million to \$39 million.

6.5. Alternative scenario - asset sell-down and cost reduction

- Shareholders and the Board share a desire for stronger financial performance. Landcorp's draft Strategic Plan has prioritised improved performance, cost efficiency and portfolio rationalisation. We also note that:
 - Certain Dairy farms are mature yet are relatively low yielding;
 - Some Livestock farms are also in poorer performing areas and/or are not part of the integrated network servicing the Tesco contract;
 - Landcorp's forecast average annual cost of debt in FY17F is 5.9%, and the farms referred to above have ROAs lower than this;
 - Selling these farms and repaying debt would therefore boost operating profits (although future capital gains would be forgone on these farms); and
 - Reducing financial leverage at the corporate level is sensible given the growing volatility in earnings likely with the expansion of WPL.
- We also believe that, with total forecast operating expenses of approximately \$200 million p.a. (including head office costs of \$21 million), it would be reasonable for Landcorp to target cost reductions of \$7 million to \$10 million p.a. (3.5% to 5%).
- We have therefore asked Landcorp to model a scenario involving a sell-down of its less strategic farms, and (unspecified) cost reductions of \$7 million.

▪ The scenario assumes that:

- Some of the properties are sold in mid-2015, but the bulk are sold as a package in mid-2016;
- The proceeds are used to repay debt;
- Costs are reduced by \$7 million by mid-2016; and
- FY17F therefore shows a full-year impact from these changes.

▪ The table below shows the forecast impact on Landcorp's financial performance in FY17F compared to the draft BAU SCI forecast. Operating profit increases 54% from \$25.1 million to \$38.8 million, and the return on equity increases from 1.8% to 2.8%. Debt at the end of FY17F drops from \$246.3 million to \$39.4 million.

Summary FY17F financial impacts of alternative scenario

\$m	Draft BAU SCI forecast	Alternative scenario	Change
Revenue	289.4	262.4	(27.0)
Operating expenses ¹	(246.3)	(225.1)	21.2
Cost savings	-	7.0	7.0
EBIT	43.2	44.3	1.2
Interest	(18.0)	(5.5)	12.5
Operating profit	25.1	38.8	13.7
Debt	246.3	39.4	(207.0)
Equity	1,365.8	1,386.3	20.5
ROE	1.8%	2.8%	1.0%

Source: Management Analysis and Deloitte Analysis

¹ Including depreciation and excluding cost savings

s9(2)(b)(ii)



6. Strategic options

The asset sell-down/cost reduction strategy has important benefits in protecting Landcorp from major earnings downturns in a low milk price year.

6.5. Alternative scenario asset sell-down and cost reduction (continued)

- Important points to note regarding the alternative scenario are:
 - It is illustrative, and the actual properties to be sold, the timing of sales, and the extent of cost reductions could ultimately vary for valid reasons;
 - The actual use of proceeds from farm sales is a matter for Shareholders and the Board. Repaying debt is in our view sensible given the WPL expansion and modelling this provides an easy means to measure the financial impact (via FY17F operating profit);
 - Landcorp should retain borrowing headroom, and could redraw on those facilities when attractive investment opportunities arise. This could include utilising Landcorp’s skills to recycle capital more aggressively under a “buy, develop, sell” strategy.

Impact of WPL

- Having said this, we do believe that the future scale and volatility of the WPL operations means that Landcorp should aim to run low corporate leverage and boost profitability elsewhere as a buffer in low milk payout years.
- The table opposite illustrates, in very broad terms, the potential impact of the expanded WPL operation on Landcorp in a low payout year. For the purposes of illustration we have combined approximations of the FY17F performance of Livestock, Core Dairy and Corporate, with an estimate of a fully mature WPL operation.

s9(2)(b)(ii)

s9(2)(b)(ii)

- This table demonstrates the defensive benefits of the alternative scenario. Given Landcorp’s heightened exposure to the milk price from the expansion of WPL, Deloitte believes that serious consideration should be given to reducing or mitigating this exposure. Options to do this include:
 - Directly reducing Landcorp’s interest in the WPL arrangements;
 - Trying to improve the commercial outcomes from WPL, as discussed in section 6.4;
 - Utilising derivatives (to the extent they are available) to limit the impact of low milk price periods (albeit at a cost to average returns over time);
 - Selling other dairy farms as WPL ramps up; and
 - Maintaining low corporate financial leverage and boosting profitability in non-dairy areas.

Appendices

Appendices

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Appendix 1: Subsidiaries and investments

Introduction

- The body of the report sets out Landcorp's legal ownership structure and the table opposite summarises a deconsolidated analysis of Landcorp at FY13A. LFL is the parent, or group holding company, and it is also the main trading entity. LFL has three wholly owned subsidiaries.

Landcorp Holdings Limited

- Landcorp Holdings Limited (LHL) was established to hold Protected Land, in accordance with the Protected Land Agreement, on behalf of the Crown until it is required to be transferred to the Crown for public policy purposes, such as Treaty settlement, or is released for open market sale.
- At FY13A there were eight properties classified as Protected Land, comprising around 16,483 hectares with a net carrying value of around \$119.4 million (including buildings and improvements). Only the land and improvements assets are owned by LHL, and all other associated farming assets (e.g. livestock and chattels) are owned by LFL.
- The net carrying value of the Protected Land properties on the LHL balance sheet is the fair value at the date of classification/transfer of the Protected Land plus the cost of any subsequent capital investment less accumulated depreciation.
- Protected Land properties owned by LHL are managed by LFL in accordance with standard Landcorp policies and management practices. The properties are maintained at the standard, in terms of weed control, fencing and maintenance, as at the time of initial transfer. LFL leases the Protected Land properties from LHL based on an annual rent charge equal to each respective properties EBIT.
- Capital costs are charged directly to LHL in addition to the management fee charged by LFL. Audit fees, relevant professional fees, legal costs, interest and income tax expenses are also charged directly to LHL.

Landcorp group - summary FY13A consolidation

\$m	LFL	LHL	LEL	LPL	+ / -	Group
Revenue	201.2	8.0	2.3	1.9	(10.2)	203.1
Expenses	(173.4)	(1.3)	(0.5)	(0.7)	10.1	(165.8)
EBIT	14.4	6.5	1.8	1.1	(0.1)	23.8
NPAT	(24.2)	4.0	1.1	1.1	(0.1)	(18.1)
Assets	1,701.7	139.3	25.1	5.1	(176.3)	1,694.9
Liabilities	395.8	16.0	0.4	1.0	(35.6)	377.6
Equity	1,305.9	123.4	24.7	4.1	(140.7)	1,317.3

Source: Annual Reports and Deloitte Analysis

- Protected Land properties have been funded by Redeemable Preference Shares (RPS) issued by LFL to the Crown in accordance with the Protected Land Agreement. The RPS, classified as liabilities on the balance sheet of LFL, were issued at the fair value of the Protected Land properties at the date of classification (c \$117.4 m), and were largely paid for by the Crown by way of reinvested dividends and cash contributions.
- The original intent of the Protected Land Agreement was that any accumulated losses and/or profits associated with the ongoing management and maintenance of the Protected Land properties would be refunded by the Crown following a disposal. However the Protected Land Agreement was recently amended to reflect an annual wash-up process and this resulted in recognised revenue of \$6.95 m in FY13A. This amount along with previously recognised revenue and capital reimbursements was refunded to Landcorp during the current financial year.
- In summary Landcorp's management and stewardship of the Protected Land properties has been structured in such a way as to have a neutral impact on Landcorp's performance and balance sheet. The Business Plan assumes no further changes (transfers in or out) to the existing Protected Land portfolio.



Appendix 1: Subsidiaries and investments

Landcorp Estates Limited

- Landcorp Estates Limited (LEL or Estates) was established to develop and sell land considered to have a higher value than it would otherwise from farming.
- The table opposite summarises Estate's current projects. As at FY13A the LEL balance sheet comprised \$22.4 million of land held for sale, equity accounted investments of \$2.4 million, other assets of \$300,000, liabilities of \$441,000, with shareholder equity of \$25.1 million.
- LEL's equity accounted investments are related to its 50% interests held in Wharewaka (2003) Limited and Wharewaka East Limited, which are property development companies with land bank investments near Taupo.
- The primary activities during FY13A related to the completion and divestment of development sections located at Eyrewell, North Canterbury and Moturau Heights, Manapouri. FY13A financial performance reflected \$2.2 million of profit recognised on land divestments less other net operating revenues and costs of \$402,000, resulting in an EBIT of \$1.8 million and a NPAT of \$1.1 million.
- Corresponding FY13A cash flows reflected a negative operating cash outflow of \$366,000, a positive cash inflow of \$7.2 million from land divestments, and a negative financing cash outflow of \$5.4 million as related to internal debt and equity restructuring.

Landcorp Pastoral Limited (Focus Genetics)

- Landcorp Pastoral Limited (LPL) was originally established to lease developed land for farming purposes, LPL's activities were merged with LFL in FY10A and the LPL entity was retained as an investment holding company. From FY11A LPL has been the Limited Partner in Focus Genetics Limited Partnership (Focus Genetics), which is now LPL's primary activity.
- Focus Genetics is a joint venture seeking to enhance genetics in sheep, cattle and deer, and market these genetics to farmers throughout New Zealand. During FY13A LPL acquired an additional 16.67% partnership interest in Focus Genetics to take its total interest to 66.67%.

Landcorp Estates Limited - current projects

	Location	Total Area (ha)	Total sections	Remaining to Sell
Wharewaka Point (JV)	Taupo	21	212	32
Wharewaka East (JV)	Taupo	78	510	510
Lakeside Terraces	Taupo	11	65	16
Wakelins	Paihia	697	30	17
Moturau Heights	Manapouri	38	16	1
Weka	Lake Brunner	68	20	20
Eyrewell	Waimakariri	214	41	3
Stuart	Te Anau	226	26	26
Total		1,353	920	625

Source: Management Analysis

- As at FY13A LPL's balance sheet comprised \$3.4 million of intangible assets, cash, accounts receivable and inventory of \$1.1 million, equity accounted investments of \$255,000, other assets of \$247,000, liabilities of \$944,000, with shareholder equity of \$2.8 million and non-controlling interests of \$1.3 million.
- Equity accounted investments are related to Focus Genetics, including Focus Genetics' 100% interest in South American sheep breeding company Rissington Uruguay SA and 8% interest in computer software company Practical Systems Limited.
- FY13A financial performance reflected a \$1.6 million accounting gain resulting from the Focus Genetics step acquisition transaction, and also \$198,000 net earnings from equity accounted investments, less costs of \$722,000, resulting in an overall EBIT of \$1.1 million and a NPAT of \$1.1 million.
- Corresponding FY13A cash flows reflected a positive operating cash inflow of \$218,000, a negative cash outflow of \$1.3 million from net acquisition costs and a positive financing cash inflow of \$1.4 million as related to share capital issued.

Appendix 1: Subsidiaries and investments

Pengxin New Zealand Farm Management Limited

- Pengxin New Zealand Farm Management Limited (PNZFML) was established in FY13A as the entity to manage a joint venture agreement with between Landcorp and the Shanghai Pengxin Group (SPG). This is a commercial sharemilking arrangement whereby Landcorp has agreed to provide development and ongoing farm management services to SPG as the land owner.
- Landcorp originally took over the management of 16 farms owned by SPG in December 2012. The SPG arrangements became effective from June 2013, with Landcorp sharemilking 11 of the 13 dairy units, and further managing two marginal dairy units and three dry stock farms.

Farm IQ Systems Limited

- Farm IQ Systems Limited (FarmIQ) was established following a successful bid to the Government's Primary Growth Partnership (PGP) funding programme with a vision to create an integrated value chain for New Zealand red meat. LFL has an 18% interest in FarmIQ. Other partners include Silver Fern Farms Limited and Tru-Test.
- There are currently six projects that FarmIQ is undertaking including projects focussed on farm management systems, genetic and genomic research and On farm capability development.
- FY13A revenue was \$19.7 million and consisted solely of Government PGP grants and contributions from the Partners. Expenses were \$17.9 million and NPAT was \$1.8 million.
- FY13A assets were \$7.9 million and largely consisted of a farm management database system (an intangible asset). Liabilities were \$5.6 million and largely related to deferred revenue. Shareholder equity was \$2.3 million.

Appendix 2: WPL lease arrangements

Background and current operations

- In 2004 Landcorp and Wairakei Pastoral Limited (WPL) formed an agreement to convert forestry land into a dairy and livestock portfolio. These are known as the Waikato and Tauhara leases.
- Operations are located near Taupo on two blocks, the Tauhara lease for 10,824 ha, primarily be used for a sheep and beef unit, and the Waikato lease for 14,868 ha primarily utilised for dairy and beef production. The forestry estate was originally purchased by WPL prior to its commercial arrangements with Landcorp.
- Under the terms of the commercial arrangements with WPL, Landcorp is a lessee of the developed land, and commenced the development of cut-over forestry land into pasture using WPL's funds. Once land is developed to a pasture ready state, Landcorp leases the land on which it then invests its own funds; building all the structural facilities to operate dairy and livestock operations including dairy sheds, support buildings and houses. Landcorp purchases the cows, shares and employees staff to run the farms.
- Operations on current developments comprise six dairy farms, covering approximately 3,400 ha, milking 7,700 cows and producing around 3 million kgMS pa; and also include a sheep and beef farm, Rolls Peak (3,700 ha) and Orakonui (1,200 ha) which is predominantly utilised for dairy grazing and support.
- The first established dairy units have been operating for seven seasons, and since establishment there has been significant improvements in productivity, attributable to the maturing pastures and the application of fertiliser and trace minerals, such as Cobalt. These inputs are essential for pasture growth on the naturally infertile and mineral deficient volcanic and pumice soils.
- Operations to date have been constrained by the lack of irrigation. Water consents and approval to draw from on-farm bores and the near-by Waikato river were finally approved in January 2012 after a lengthy and complex process.
- Current dairy production equates to around 940 kgMS per ha and 385 kgMS per cow. Production levels reflect low stocking rates attributable to relative immaturity of the properties and the lack of irrigation. Management believe with increased pasture maturity and irrigation infrastructure that the established farm units have high dairying potential and are capable of producing around 1,500 kgMS per ha.
- Landcorp confirmed it has s9(2)(b)(ii) to establish the current six Wairakei Pastoral dairy units, including purchasing livestock and supplier shares. This does not include costs associated with the dry stock farm Rolls Peak or the dairy support unit Orakonui.

s9(2)(b)(ii)

s9(2)(b)(ii)

- The table overleaf summarises recent historical performance and investment (FY12A – FY13A) and forecast performance and investment covering the period FY14F – FY17F.

Appendix 2: WPL lease arrangements



Development plans

- All conversions were put on hold in 2007 due to conditions imposed by the ETS and the high cost of carbon credits at that time. More recently WPL was able to address this issue by purchasing sufficient low cost carbon credits to enable the completion of the originally intended development.
- A long term development plan was agreed between Landcorp and WPL October 2012. Following this updated agreement, Landcorp is contractually committed to the development and conversion of a further 8,000 hectares into dairy, that will increase the WPL portfolio from 6 to 31 farms. This development assumes a five year programme with approximately 22 farms being developed over the next five years with 4 being developed each year over the period of the plan.
- Upon completion the WPL complex is forecast to have a combined dairy platform of 11,400 ha (including the existing 3,400 ha) of which Landcorp is proposing to irrigate 4,300 ha.

Cash flow analysis

s9(2)(b)(ii)

WPL historical and forecast analysis

\$m	Actual		Forecast			
	FY12A	FY13A	FY14F	FY15F	FY16F	FY17F
s9(2)(b)(ii)						

Appendix 3: SPG joint venture

Background and current operations

- Pengxin New Zealand Farm Management Limited (PNZFML) was established in FY13A as the entity to manage a joint venture agreement with between Landcorp and the Shanghai Pengxin Group (SPG). This is a commercial sharemilking arrangement whereby Landcorp has agreed to provide development and ongoing farm management services to SPG as the land owner.
- Landcorp originally took over the management of 16 farms owned by SPG in December 2012. The SPG arrangements became effective from June 2013, with Landcorp sharemilking 11 of the 13 dairy units, and further managing two marginal dairy units and three dry stock farms. Landcorp invested \$24.7 million in cows in FY13A before commencing the sharemilking arrangements in June 2013.
- The arrangement is formalised in a suite of three co-dependent agreements: (i) A Joint Venture Shareholders Agreement, (ii) A Property Management Agreement, and (iii) A Farm Operation Agreement. The term of the main agreement (the Farm Operation Agreement) is to April 2016, with the ability to extend for two further terms of 3 years each. SPG, as owner of the land, provides sufficient funds to PNZFML to meet monthly expenditure and capital expenditure for development of the portfolio. PNZFML jointly develops the plans and budgets with Landcorp, and is responsible for signing off those plans.
- Landcorp receives a management fee for it's development role. s9(2)(b)(ii)
s9(2)(b)(ii)
- The table opposite summarises SPG's recent historical and forecast performance and investment covering the period FY13A – FY17F (as provided to Deloitte on 22 May 2014)



Appendix 4: Historical and projected financial statements

Landcorp profit and loss

\$m	FY09A	FY10A	Actual FY11A	FY12A	FY13A	FY14F	Forecast FY15F	FY16F	FY17F
Revenue									
Livestock revenue	98.5	83.5	108.1	114.3	89.1	98.3	108.8	117.2	123.2
Dairy revenue	54.2	70.2	94.6	83.0	75.8	139.2	124.1	129.6	152.1
Wool revenue	6.0	5.9	10.9	10.2	7.6	8.9	8.1	8.4	7.4
Forestry revenue	1.1	2.7	5.2	1.9	3.6	3.5	2.6	1.5	1.8
Other produce revenue	0.6	0.6	0.6	1.2	0.6	0.5	0.6	0.7	0.5
Operating revenue	160.3	163.0	219.4	210.5	176.7	250.5	244.2	257.5	285.0
Non operating revenue	13.7	6.9	(1.0)	5.2	26.4	6.2	5.5	8.2	4.4
FWE	(69.0)	(62.9)	(74.0)	(82.5)	(81.9)	(90.2)	(92.1)	(98.2)	(108.6)
Personnel	(41.5)	(42.1)	(44.2)	(45.4)	(45.6)	(55.1)	(57.6)	(58.9)	(60.2)
Maintenance	(11.2)	(10.9)	(11.3)	(12.9)	(11.9)	(14.9)	(14.8)	(15.1)	(15.7)
Other operating expenses	(20.5)	(20.1)	(23.8)	(24.4)	(26.3)	(41.1)	(42.0)	(43.8)	(44.8)
EBITDA	31.8	33.9	65.1	50.5	37.4	55.4	43.1	49.7	60.1
Depreciation and amortisation	(12.2)	(12.6)	(12.5)	(13.3)	(13.6)	(14.0)	(16.0)	(17.1)	(17.0)
EBIT	19.6	21.4	52.6	37.3	23.8	41.4	27.2	32.6	43.2
Net interest income / (expense)	(12.7)	(11.4)	(10.4)	(10.2)	(10.8)	(9.3)	(11.5)	(15.7)	(18.0)
Operating profit	6.9	10.0	42.2	27.0	13.0	32.1	15.6	16.9	25.1
Profit / (loss) on sale of land	3.8	8.7	10.3	-	0.2	7.8	0.0	-	-
Revaluation gains / (losses)	(12.9)	(21.1)	74.8	(44.7)	(32.6)	-	-	-	-
NPBT	(2.2)	(2.4)	127.4	(17.7)	(19.4)	39.9	15.7	16.9	25.1
Tax income / (expense)	12.6	(3.5)	(12.8)	8.3	1.3	0.1	-	-	-
NPAT	10.3	(5.8)	114.6	(9.4)	(18.1)	40.0	15.7	16.9	25.1
Other revaluations gains / (losses)									
Land and improvements	(97.9)	(120.5)	17.7	13.3	(1.9)	-	-	-	-
Intangible assets	-	-	-	(1.1)	(0.9)	-	-	-	-
Financial assets	(7.1)	(0.1)	0.5	0.1	21.8	-	-	-	-
Subtotal	(105.0)	(120.6)	18.2	12.4	18.9	-	-	-	-
Transfers to profit and loss	10.2	11.2	1.6	5.6	(2.1)	-	-	-	-
Income tax recognised in equity	8.5	2.8	(2.0)	(0.7)	(0.3)	-	-	-	-
Subtotal	18.7	14.0	(0.4)	4.9	(2.4)	-	-	-	-
Total comprehensive income	(76.0)	(112.5)	132.5	7.8	(1.5)	40.0	15.7	16.9	25.1

Source: Annual Reports, Management Analysis



Appendix 4: Historical and projected financial statements

Landcorp balance sheets

\$m	Actual					Forecast			
	FY09A	FY10A	FY11A	FY12A	FY13A	FY14F	FY15F	FY16F	FY17F
Assets									
Cash and cash equivalents	0.0	0.7	0.5	0.6	-	-	-	-	-
Accounts receivable	20.8	28.2	44.5	22.5	38.6	14.6	10.8	10.8	10.8
Inventory	12.5	10.9	9.7	10.1	11.9	12.4	12.4	12.4	12.1
Biological assets	226.7	222.5	313.9	282.0	264.8	276.2	327.3	337.9	345.3
Property, plant and equipment	1,304.9	1,156.3	1,217.1	1,195.5	1,217.4	1,235.1	1,280.9	1,319.5	1,323.4
Property held for sale	38.9	37.6	25.4	87.8	82.9	20.5	18.7	17.1	6.1
Intangible assets	2.2	2.3	1.7	1.7	5.4	3.4	3.4	3.4	3.4
Other financial assets	41.8	43.5	45.2	48.9	61.4	60.3	55.2	55.2	55.2
Other assets	20.9	19.9	5.0	13.8	12.5	10.8	10.8	10.8	10.8
Total assets	1,668.7	1,521.9	1,663.0	1,662.9	1,694.9	1,633.3	1,719.5	1,767.0	1,767.0
Liabilities									
Bank overdraft	-	-	-	-	0.7	4.0	0.1	0.0	0.0
Accounts payable and accruals	23.0	16.5	19.6	18.5	14.5	35.1	35.4	35.7	36.0
Employee entitlements	6.6	7.8	8.3	8.6	8.2	8.5	8.7	8.8	8.8
Redeemable preference shares	90.4	100.4	117.8	117.8	117.8	107.7	107.7	107.7	107.7
Other liabilities	189.1	160.1	165.7	186.1	236.4	166.0	221.4	251.7	247.4
Total liabilities	309.1	284.8	311.3	330.9	377.6	321.3	373.3	403.9	399.9
Equity									
Share capital	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0
Retained earnings	106.2	100.3	123.3	124.2	118.2	-	-	-	-
Reserves	931.9	789.8	874.2	853.4	835.4	-	-	-	-
Other equity	196.6	222.1	229.2	229.4	237.4	1,185.6	1,219.9	1,236.8	1,240.8
Non-controlling interests	-	-	-	-	1.3	1.3	1.3	1.3	1.3
Total equity	1,359.6	1,237.2	1,351.6	1,332.0	1,317.3	1,311.9	1,346.2	1,363.2	1,367.1
Total liabilities and equity	1,668.7	1,521.9	1,663.0	1,662.9	1,694.9	1,633.3	1,719.5	1,767.0	1,767.0

Source: Annual Reports, Management Analysis



Appendix 4: Historical and projected financial statements

Landcorp cash flow

\$m	FY09A	FY10A	Actual FY11A	FY12A	FY13A	FY14F	Forecast FY15F	FY16F	FY17F
Operating									
Receipts from customers	169.9	162.5	211.6	229.3	200.9	266.8	248.1	286.1	299.6
Interest received	0.1	0.1	0.1	0.0	-	0.3	-	-	-
Dividends received	1.3	0.4	0.2	0.9	0.4	1.1	-	-	-
Payments to suppliers	(110.0)	(101.1)	(113.5)	(125.1)	(132.6)	(156.0)	(167.6)	(184.4)	(192.4)
Payments to employees	(36.6)	(36.2)	(41.9)	(43.8)	(44.4)	(56.8)	(53.4)	(55.0)	(56.0)
Interest paid	(12.8)	(10.7)	(10.1)	(10.0)	(10.5)	(10.4)	(10.6)	(14.3)	(16.2)
Net tax paid	(2.7)	0.4	5.4	(0.2)	(0.5)	1.5	-	-	-
Operating inflow/(outflow)	9.2	15.3	51.8	51.1	13.4	46.4	16.4	32.5	35.1
Investing									
Sale of land and improvements	33.0	55.0	4.5	18.6	8.4	86.7	13.3	10.9	14.9
Sale of plant and equipment	0.9	1.0	1.0	0.7	2.0	9.9	4.0	0.7	0.3
Sale of intangible and other assets	3.6	0.0	0.3	(0.3)	12.2	-	-	-	-
Purchase and development of land	(40.8)	(18.9)	(46.5)	(36.4)	(30.5)	(29.1)	(35.4)	(38.4)	(16.0)
Purchase of plant and equipment	(11.8)	(9.6)	(11.3)	(14.3)	(14.7)	(28.2)	(43.1)	(30.9)	(25.0)
Purchase of intangible and other assets	-	-	-	(1.3)	(0.1)	(0.5)	-	-	-
Purchase of shares and advances	(0.6)	(9.7)	(7.2)	(4.7)	(4.5)	(0.0)	-	-	-
Purchase of livestock and breeding stock	(2.2)	-	-	-	(24.6)	(8.6)	-	-	-
Investing inflow/(outflow)	(17.9)	17.8	(59.3)	(37.6)	(51.8)	30.2	(61.1)	(57.7)	(25.8)
Financing									
Net borrowing receipts	-	-	7.8	14.1	57.1	-	51.6	30.3	-
Issue of redeemable preference shares	13.2	-	-	-	-	-	-	-	-
Net borrowing repayments	(5.3)	(32.4)	-	-	-	(73.6)	-	-	(4.3)
Dividends paid	-	-	(0.7)	(27.5)	(20.0)	(5.0)	(7.0)	(5.0)	(5.0)
Financing inflow/(outflow)	7.9	(32.4)	7.1	(13.4)	37.1	(78.6)	44.6	25.3	(9.3)
Net cash surplus/(deficit)	(0.8)	0.7	(0.3)	0.1	(1.3)	(2.1)	(0.1)	0.1	(0.0)
Opening cash	0.8	0.0	0.7	0.5	0.6	(1.3)	0.1	(0.1)	(0.0)
Closing cash	0.0	0.7	0.5	0.6	(0.7)	(3.4)	(0.1)	(0.0)	(0.0)

Source: Annual Reports, Management Analysis



Appendix 5: Analysis of total shareholder returns

Approach 1 - IRR of Crown investment cash flows (FY04A-FY13A)

\$m	FY03A	FY04A	FY05A	FY06A	FY07A	Actual FY08A	FY09A	FY10A	FY11A	FY12A	FY13A
Starting NAV	(594.0)	-	-	-	-	-	-	-	-	-	-
Dividends	-	34.4	2.0	5.0	3.0	12.0	13.0	10.0	18.0	27.5	20.0
Finishing NAV	-	-	-	-	-	-	-	-	-	-	1,317.3
Total cash flows	(594.0)	34.4	2.0	5.0	3.0	12.0	13.0	10.0	18.0	27.5	1,337.3
TSR (IRR)	10.0%										
Capital component	8.3%										
Implied cash component	1.6%										

Source: Annual Reports and Deloitte Analysis

Approach 2 - Annual TSR (FY04A-FY13A)

%	FY04A	FY05A	FY06A	FY07A	Actual FY08A	FY09A	FY10A	FY11A	FY12A	FY13A	Average
Operating profit	1.3%	1.5%	0.6%	1.3%	0.9%	0.5%	0.7%	3.4%	2.0%	1.0%	1.3%
Asset sales	1.3%	0.0%	3.3%	0.7%	2.1%	0.3%	0.6%	0.8%	0.0%	0.0%	0.9%
Land revaluations	16.3%	17.4%	36.1%	1.2%	18.8%	(7.2)%	(8.9)%	1.5%	1.0%	1.5%	7.8%
Livestock revaluations	(0.5)%	6.2%	(0.9)%	(0.2)%	1.7%	0.5%	(0.3)%	6.1%	(2.2)%	(2.7)%	0.8%
Other	(0.5)%	(0.3)%	(0.5)%	0.9%	(0.4)%	0.7%	(0.4)%	(1.1)%	(0.2)%	0.6%	(0.1)%
Total	18.0%	24.8%	38.6%	3.8%	23.3%	(5.2)%	(8.3)%	10.7%	0.6%	0.4%	10.7%

Source: Annual Reports, Management Analysis and Deloitte Analysis

Appendix 6: Analysis of divisional returns



10 year ungeared IRR analysis

	Actual										
\$m	FY03A	FY04A	FY05A	FY06A	FY07A	FY08A	FY09A	FY10A	FY11A	FY12A	FY13A
s9(2)(b)(ii)											

Appendix 6: Analysis of divisional returns



10 year geared IRR analysis

\$m	FY03A	FY04A	FY05A	FY06A	FY07A	Actual FY08A	FY09A	FY10A	FY11A	FY12A	FY13A
s9(2)(b)(ii)											



Appendix 7: Analysis of alternative farming models

Illustrative analysis of alternative commercial structures (base case using a representative dairy farm)

Illustrative analysis of alternative commercial structures (base case using a representative dairy farm)										
\$m	Owner operator	Sharemilker		Sharefarming		Lease		Manager		
		Owner	Sharemilker	Owner	Sharefarmer	Owner	Lessee	Owner	Manager	
		SM rev %:	50.0%							
		SM cost %:	65.0%	SF EBIT %:	20.0%	L. % of assets:	4.0%	M. % of assets:	1.0%	
Assets (open)										
Land	14.2	14.2	-	14.2	-	14.2	-	14.2	-	
Shares	2.8	2.8	-	2.8	-	2.8	-	2.8	-	
Livestock	2.1	-	2.1	-	2.1	-	2.1	2.1	-	
Plant	1.3	-	1.3	-	1.3	-	1.3	1.3	-	
Total assets	20.3	16.9	3.4	16.9	3.4	16.9	3.4	20.3	-	
Revenue										
Milk	3.2	1.6	1.6			-	3.2	3.2	-	
Dividend	0.2	0.2				0.2	-	0.2	-	
Lease/management fee	-	-	-			0.7	-	-	0.2	
Livestock	0.2	-	0.2			-	0.2	0.2	-	
Total revenue	3.6	1.8	1.8			0.9	3.4	3.6	0.2	
Costs	(2.5)	(0.9)	(1.6)			-	(3.1)	(2.7)	-	
EBIT	1.2	0.9	0.2	0.9	0.2	0.9	0.3	1.0	0.2	
Land revaluations										
Land revaluations	0.7	0.7		0.7	-	0.7	-	0.7	-	
Livestock revaluations	0.1	-	0.1	-	0.1	-	0.1	0.1	-	
ROA (excl. revaluations)	5.6%	5.4%	6.5%	5.4%	6.8%	5.0%	8.9%	4.6%	n/a	
ROA (incl. revaluations)	9.4%	9.5%	8.7%	9.5%	9.0%	9.0%	11.1%	8.4%	n/a	
Volatility measure ¹	2.8%	1.7%	7.2%	2.8%	2.8%	0.0%	10.6%	3.4%	0.0%	

Source: Deloitte Analysis

¹ The volatility measure is the % change in EBIT for a 1% change in milk price

Key Assumptions

Effective hectares	355	Land + buildings (\$/E ha)	40,000	Milk price (\$/kgMS)	7.25
Cows	1,175	Livestock (\$/kgMS)	4.80	Dividend (\$/kgMS)	0.40
Production (kgMS/ha)	1,200	Shares (\$/kgMS)	6.20	FWE (\$/kgMS)	5.50

Appendix 8: Industry good activities

- The following description of Landcorp's industry good/leadership activities has been provided by management.

Category	Description/comment
Training and development	<ul style="list-style-type: none"> Landcorp invests approximately \$1.3 million p.a. in development of its people through in-house and external training programs. This is an investment well beyond the standard training funding most private individuals receive. This is building the talent base of the primary sector. In addition to the above expenditure, Landcorp currently invests \$100k+ p.a. in its training program at Aratiatia with some graduates being employed by Landcorp and others joining the private sector. From FY15F, Landcorp will invest a further \$350k p.a. to run a dairy academy in conjunction with SPG. The participants will be from a range of Landcorp/SPG farms and external properties. Other training and development activities include student scholarships (at Massey, Lincoln, Taratahi, Telford and Aratiatia) to help good quality graduates stay in the sector, and Landcorp's written policies and procedures where staff can learn what 'good' looks like and apply this in other settings.
Maori/iwi development	<ul style="list-style-type: none"> Landcorp has entered into significant JV relationships with two iwi in NZ (at the Sweetwater (Northland) and Pouarua (Hauraki) dairy complexes). These partnerships are the first of their kind and will involve investment in two Maori farming scholarships per partnership to help build a base of local farm staff. Landcorp is in discussions with other iwi about similar partnerships in other parts of the country. Landcorp have noted that while partnerships are not entered into on a non-commercial basis, the returns on these partnerships are not spectacular (5-8% typically p.a.). Landcorp note that where possible, they try to make the partnership work to help build iwi economic independence in the broader interests of the country. Landcorp has a reasonably close working relationship with the Office of Treaty Settlements, given Landcorp's role in Treaty settlements. This is a complex area requiring significant management time to handle appropriately. The sale of a single property to iwi can consume a large amount of time.
Sector leadership	<ul style="list-style-type: none"> Landcorp is taking a leadership role in health and safety which has included investment in health and safety training of approximately \$250k over the last 3 years and an additional \$250k investment in a campaign to raise awareness of safety across Landcorp. A video from this campaign is likely to be licenced to Worksafe NZ. Landcorp is also trialling new technologies to equip safer Quad bikes. While this may have commercial returns, there are significant set up and management costs. Landcorp also regularly opens its farms for field days to the local community, and frequently speaks at farming and on-farming conferences on a wide range of issues. It has a significant profile as the largest farmer, and is often required to make media comment.
Industry groups	<ul style="list-style-type: none"> Landcorp chairs MPI's Animal Welfare CEO's forum – a group of industry CEOs that meet to discuss ways to drive more effective animal welfare outcomes Landcorp sponsors Agri Women's Development Trust and Rural Women NZ serves to help expand the leadership capability of rural communities through growing the abilities of women from these communities. Landcorp also provides sponsorship (about \$150k annually) to a range of non-profit groups including: Foundation for Youth Development, Hawkes Bay Helicopter Rescue Trust, Otago Rescue Helicopter Trust, NZ Nuffield Farming Scholarship Trust, Massey University (re Healing Working Dogs), Ohuka School Bus, and Tolaga Bay Sheep Dog Trial Club.

Appendix 8: Industry good activities

Category	Description/comment
Research and development	<ul style="list-style-type: none"> Landcorp invests around \$900k annually in core R&D funding (principally to support organisations undertaking the research). Some of the significant investments include: Pastoral Greenhouse Gas Research Consortium, Johne's disease research in the deer industry, investment in the Liggins institute, funding the Sequenom machine at Auckland University, that measures the environmental impact of genes transferred between generations of sheep, and investment with AgResearch in a CT scanner to improve genetic breeding in the industry. Landcorp are also participating in Manuka Beetle research on the West Coast and have been approached by Lincoln University to set up a demo farm on the West Coast to showcase best-practice dairying.
Molesworth	<ul style="list-style-type: none"> Landcorp has a long-term lease with the Dept. of Conservation to farm the iconic Molesworth station. To date Landcorp has invested about \$10m into buildings, infrastructure and stock since taking over the property. The property only generates \$50-200k of EBIT per year. Landcorp has worked closely with DOC to eradicate Broom and Wildling Pine, and this will continue to take up additional funds (both cash and in-kind work) over the next 3-4 years to get properly under control – for example, we have committed to reinvest any profits over the next 3 years back into wildling pine eradication. The commercial return of the pest eradication is negligible, but Landcorp considers the partnership with DOC in caring for NZ's most iconic farm requires us to actively invest in mitigating the impact of noxious pests.
Marginal land development	<ul style="list-style-type: none"> Landcorp has tackled some large scale, complex dairy conversions (e.g. on the West Coast and Central Plateau) that no other groups would be equipped to do. While these developments have been great for their local communities, it is debatable whether this is an industry good spillover. Landcorp undertook these developments not on the request of the government, but on the basis of a viable commercial return. While these developments could perhaps not have occurred without Landcorp's scale, Landcorp should not receive credit for the positive externalities that resulted from it (e.g., emergence of other farms in the area, development of supporting industries, etc.). However, this is an example of work that would not have occurred had Landcorp not existed.
FarmIQ	<ul style="list-style-type: none"> Landcorp will invest a total of \$3.4m in the FarmIQ PGP. In addition it has invested significant managerial time in the formation then ongoing governance of the PGP. While Landcorp will get a Farm Management System from its investment, it won't receive a system any cheaper than had it purchased it off-the-shelf. Landcorp has invested significant amounts of IT team time to develop a product with FarmIQ – a product which management believe is superior as a result of Landcorp's involvement. Further, Landcorp was a foundation shareholder in a program to build a pasture-to-plate value chain – it used its credibility as the largest farmer to promote establishment of the PGP.

Appendix 8: Industry good activities

Category	Description/comment
An innovator in the red meat sector	<ul style="list-style-type: none"> Landcorp is developing unique value chain models with its meat. Landcorp has the scale to experiment with supply more 'niche' products (e.g., sheep milk) that smaller operators cannot afford to risk or who cannot invest the years required to improve the system (e.g., breeding of appropriate animals). Landcorp has the expertise to engage in commercial discussions with other co-product providers (e.g., velvet co-products).
A voice for the industry and a unique partner	<ul style="list-style-type: none"> No farming entity speaks with the authority of Landcorp. Unlike DairyNZ and Fed Farmers, Landcorp are farmers first and foremost and speak as practitioners. We therefore can provide a unique perspective and profile as the largest industry player. Landcorp provides opportunities for discussions with local and offshore parties that would otherwise be unable to engage effectively with smaller private farming entities. For example on a recent trip to China Landcorp management received incredible access to significant investors of capital in China. Landcorp is also able to deal direct with processors to develop unique value chain models for replication elsewhere in the industry. It is the only entity capable of taking our farming expertise offshore quickly, if desired. If Landcorp can attract productive investment from on-shore and off-shore parties into NZ agriculture, that will have a positive impact on the industry – especially if it can broker involvement of iwi land
Environment	<ul style="list-style-type: none"> Landcorp has been a prolific support of DOC and QEII covenant work across its farms. For QEII covenants alone Landcorp has 145 covenants in place which is 35% of the total NZ QEII registered covenants (5% of the total area). Since 2007 Landcorp has spent \$2.9 million primarily on QEII covenant protection. This has all been part of dairy and deer expansion projects and has leveraged additional funding of between 25% and 55% by combining the contributions across QEII, Waiau Trust and Regional Councils. Landcorp directly sponsors the work of the Trust and accepts a lower subsidy on fencing by 50% to allow the trust to support more farmers in the industry with the additional amount available. By the end of the FY15F financial year, every Landcorp farm will have a substantial land and environment plan that outlines in much detail the plans for environmental rejuvenation across the farm unit Landcorp are also active in a range of other environmental initiatives including: the regional council environmental programme partnerships program, the sustainable dairying water accord, the Waiau Habitat Enhancement and Fisheries Trust in Southland, regional actions strategies, the Manuka Research Partnership PGP, the Ballance Farm Environment Awards, and agricultural waste recovery initiatives such as Agrecovery. Landcorp has also entered into a supply agreement with the Lower Hutt City Council to take all of the Bio-Solids produced from their sewerage treatment plant. The Horizons Regional Council have worked with Landcorp to monitor the environmental impact and also grant consents. Massey University have designed a tractor towed applicator to inject this material into the subsoil structures. This research will help other regional councils to understand the use of biosolids. This programme also required close discussions with Fonterra and Beef & Lamb NZ so that all parties are aware of the work and results.

Appendix 9: Landcorp's draft strategic plan – two key slides



Our Strategic Plan

Our vision: To become the premium supplier of meat, milk and fibre aimed at niche markets globally

Our purpose: To strengthen NZ farming, by leading the way

Our aims to achieve our vision:

- 1

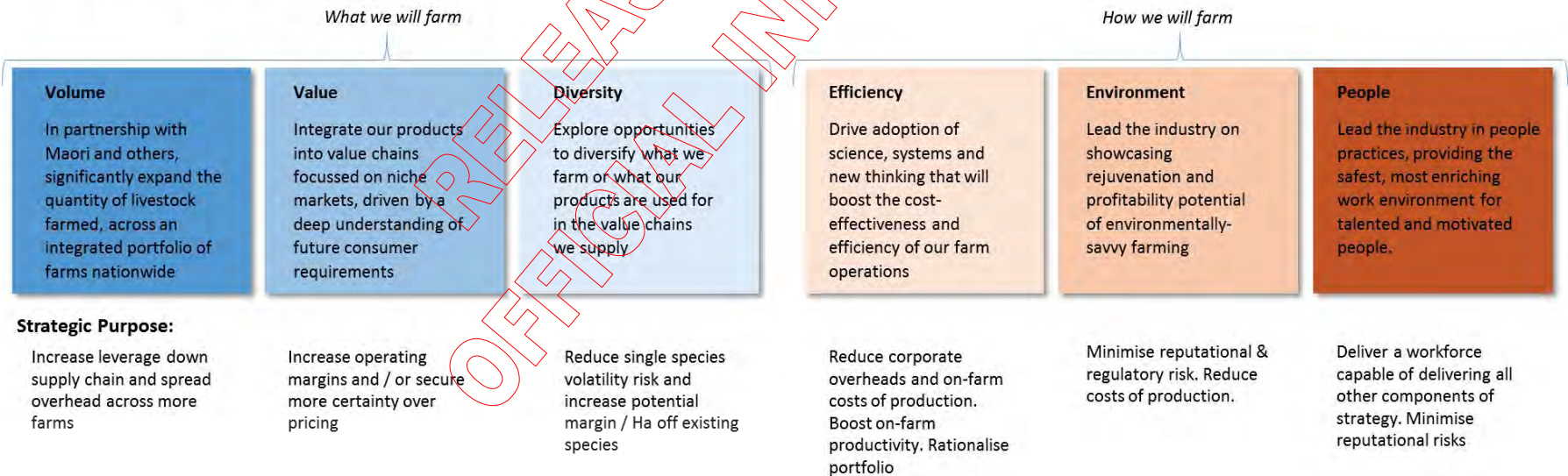
Deliver [6%] ROACE sustainably over the business cycle
- 2

Help supply 5% of NZ's pastoral livestock production, of the highest quality, to partners in premium value chains around the world
- 3

Become the partner of choice for Maori, external investors, and other organisations investing in the growth of NZ farming
- 4

Lead the industry in our care for, and investment in, the people we employ, the animals under our care and the environment we are entrusted to farm in

Our key strategies to achieve our aims:





Appendix 10: Landcorp's revised forecasts

Impacts of revised forecasts

\$m	Forecast				Revised 16 May				Changes			
	FY14F	FY15F	FY16F	FY17F	FY14F	FY15F	FY16F	FY17F	FY14F	FY15F	FY16F	FY17F
Base case:												
Key profit and loss lines												
Revenue	256.7	249.7	265.7	289.4	255.3	248.8	264.2	287.6	(1.4)	(0.9)	(1.5)	(1.8)
EBITDA	55.4	43.1	49.7	60.1	63.4	47.3	53.2	63.3	7.9	4.1	3.5	3.2
Interest	(9.3)	(11.5)	(15.7)	(18.0)	(9.3)	(11.1)	(14.7)	(17.6)	-	0.5	1.1	0.4
Operating profit	32.1	15.6	16.9	25.1	40.1	20.2	21.4	28.4	8.0	4.6	4.5	3.3
Key balance sheet lines												
Total assets	1,633.3	1,719.5	1,767.0	1,767.0	1,632.6	1,776.7	1,881.9	1,942.5	(0.7)	57.2	114.9	175.6
Bank loans	168.9	220.4	250.6	246.3	168.3	235.5	274.1	280.2	(0.7)	15.1	23.5	33.9
Total liabilities	321.3	373.3	403.9	399.9	320.6	388.4	427.4	433.8	(0.7)	15.1	23.5	33.9
Net assets	1,311.9	1,346.2	1,363.2	1,367.1	1,311.9	1,388.4	1,454.5	1,508.8	-	42.1	91.4	141.6
Dividends	5.0	7.0	5.0	5.0	5.0	24.0	15.0	16.0	-	17.0	10.0	11.0
Scenario:												
Key profit and loss lines												
Revenue	256.7	250.0	271.6	262.4	255.3	249.1	269.4	260.6	(1.4)	(0.9)	(2.3)	(1.8)
EBITDA	55.4	43.3	56.6	59.4	63.4	47.5	56.3	57.6	7.9	4.2	(0.3)	(1.8)
Interest	(9.3)	(11.5)	(14.1)	(5.5)	(9.3)	(11.0)	(12.9)	(5.0)	-	0.5	1.3	0.5
Operating profit	32.1	15.9	25.7	38.8	31.2	20.4	29.6	37.4	(0.9)	4.5	3.9	(1.4)
Key balance sheet lines												
Total assets	1,629.2	1,705.0	1,581.1	1,580.5	1,632.9	1,761.8	1,686.4	1,741.0	3.6	56.8	105.3	160.5
Bank loans	164.9	206.7	67.0	39.4	168.5	221.7	88.2	75.8	3.6	15.1	21.1	36.4
Total liabilities	317.3	359.5	220.3	192.9	320.9	374.6	241.4	229.3	3.6	15.1	21.1	36.4
Net assets	1,311.9	1,345.5	1,360.8	1,387.6	1,311.9	1,387.2	1,445.0	1,511.6	-	41.7	84.2	124.0
Dividends	5.0	7.0	5.0	5.0	5.0	24.0	15.0	16.0	-	17.0	10.0	11.0

Source: Management Analysis and Deloitte Analysis

Note: Analysis of forecasts presented in the report, including scenario analysis, was based on the draft Forecasts provided to Deloitte on 11/04/14. Landcorp provided Deloitte with revised forecasts on 16/05/14 which we understand have been approved by the Board and reflect the following assumption changes: (i) included annual land revaluation assumption of 5.1% covering the period FY14 to FY17 (ii) relatively minor changes to forecast FY14 outturn and closing adjustments flowing into the forecast periods (iii) inclusion of a \$3.0 million farm purchase in each of the three years FY15 to FY17 (iv) forecast dividends paid increased in line with policy. We understand that the revenue, operating cost and capital cost components of these revised forecasts have been approved by Landcorp's Board, but the sale of Wharere for \$19.2 million was deferred to FY15F, dividends were decreased across the plan period and therefore debt levels and interest expense were also lowered.



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Treasury Report: Landcorp: Findings from Strategic Review and 2014 Statement of Corporate Intent

Date:	15 July 2014	Report No:	T2014/1073
		File Number:	SE-2-8-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Agree recommendations	Tuesday 22 July 2014
Associate Minister of Finance (Hon Steven Joyce)	For your information.	None
Minister for State Owned Enterprises (Hon Tony Ryall)	Agree recommendations Sign attached letter to Landcorp's Chair	Tuesday 22 July 2014
Associate Minister of Finance (Hon Dr Jonathan Coleman)	For your information.	None

Contact for Telephone Discussion (if required)

Name	Position	1st Contact
Ant Shaw	Senior Analyst, Governance and Performance	s9(2)(k) ✓
David Stanley	Principal Advisor, Governance and Performance	

Actions for the Minister for State Owned Enterprises Office's Staff (if required)

Send letter to Chair once signed. Treasury recommends waiting until after shareholding Ministers' meeting with Landcorp's Chair and Chief Executive on 28 July 2014 to send the letter.

Enclosure: Executive Summary of Deloitte's Strategic Review (I-Manage: 2952375)
Landcorp's Response to Strategic Review (I-Manage: 2951859)
Letter to Landcorp's Chair (attached)

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Treasury Report: Landcorp: Findings from Strategic Review and 2014 Statement of Corporate Intent

Executive Summary

Deloitte's Strategic Review

Deloitte's key findings from its strategic review of Landcorp were:

- Over the last 10 years, Landcorp has delivered credible total returns to the Crown averaging 10% per annum. Capital gains (increases in land values) have been the major component (8.3%) of this total shareholder return, with cash returns (dividends) averaging only 1.7% per annum,
- Landcorp undertakes a significant level of industry good/leadership activities, but these have not been explicitly mandated nor the costs quantified,
- Annual head office costs have increased materially in real terms over the past 12 years. Adjusting for inflation, the real increase is \$5.7 million over that time, and
- Landcorp's on-farm performance equals or exceeds its peers, but when corporate overheads are included the financial performance drops to being on or below its peers.

s9(2)(b)(iii)

- Undertakes a cost reduction programme targeting \$7 - \$10 million per annum, focusing on both farming and head office costs,
- Identifies and costs its industry good / leadership activities and discusses the findings with Ministers and Treasury, and
- Focuses on few key growth opportunities of scale, such as its Other People's Money¹ (OPM) strategy, and does not progress smaller scale strategies that will require time and resources.

The Board and Treasury are in relative alignment with the key recommendations made by Deloitte; however, we think Landcorp should only progress its OPM strategy if it can be structured appropriately.

¹ Landcorp's Other People's Money (OPM) strategy is to grow its farming business without owning additional land. This will be achieved by entering into agreements where it undertakes a combination of sharemilking, share farming, leasing, or managing farms owned by other parties.

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2014 Business Plan and Statement of Corporate Intent

Landcorp's OPM strategy has been developed by the Board, as part of its own strategy development process, which has been undertaken independently from Deloitte's review. The company is also investigating diversifying into different products such as sheep milk, and generating more value further up the supply chain.

As analysed by Deloitte, the success of OPM strategies is heavily influenced by how they are structured, and the sharing of risks, returns and investment requirements between investors and Landcorp will be critical. s9(2)(b)(ii)

s9(2)(b)(ii)

We are sceptical of Landcorp's intentions to diversify into different products and different parts of the supply chain. However, such plans are not well advanced and have not yet had businesses cases prepared to assess their commercial viability. We think the company will have limited capacity to implement these growth initiatives on top of Deloitte's recommendations, and it is our preference that these diversification strategies are not pursued.

Landcorp is in a period of high capital investment, which is constraining its ability to pay dividends to the Crown, with dividend payments having reduced from last year's SCI. It now forecasts only \$5 million in dividends in each of 2014/15 and 2015/16 (compared with \$16 million and \$40 million previously). s9(2)(b)(ii)

s9(2)(b)(ii)

We therefore understand Landcorp's reluctance to pay higher dividends, on the assumption that it cannot materially change the key factors influencing the level of dividends (earnings, property sales, capital expenditure and debt levels). We do not believe these can be materially amended in the short term, but recommend the Crown's preference for enhancing cash returns over balance sheet growth be clearly communicated to the Board, in order to influence its long-term strategy development.

Treasury has a "chew" session with shareholding Ministers on 22 July 2014 to discuss Landcorp. Ahead of that meeting we will provide slides for further areas of discussion regarding other possible ownership objectives for the company, such as using more of Landcorp's properties in Treaty settlements. Such options have not been covered in this report. Shareholding Ministers also have a meeting with Landcorp's acting Chair, Ms Traci Houpara, and Chief Executive, Mr Steven Carden, on 28 July 2014.

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Recommended Action

We recommend that you:

- a **note** that Deloitte has completed its strategic review of Landcorp and that the Board and Treasury are generally in agreement with the key recommendations
- b **note** that shareholding Ministers have a “chew” session with Treasury at 4pm on Tuesday 22 July 2014 at 4pm to discuss Landcorp, and this report provides background to that meeting
- c **note** that shareholding Ministers are meeting with Landcorp’s acting Chair, Ms Traci Houpapa, and Chief Executive, Mr Steven Carden, at 9am on Monday 28 July 2014 and this report also provides background for that meeting
- d **note** that Landcorp has provided Treasury with its 2014/15 business plan and draft Statement of Corporate Intent (SCI) and in Treasury’s view the SCI is suitable for tabling in the House of Representatives, and
- e **agree** that the Minister for State Owned Enterprises sends (after 28 July) the attached letter to Landcorp’s acting Chair, Ms Traci Houpapa, requesting the company sends 50 copies of its final SCI for tabling in the House of Representatives.

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister for State Owned Enterprises

David Stanley
Principal Advisor, Governance and Performance

Hon Bill English
Minister of Finance

Hon Tony Ryall
Minister for State Owned Enterprises

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Treasury Report: Landcorp: Findings from Strategic Review and 2014 Statement of Corporate Intent

Purpose of Report

1. This report summarises the key findings from the strategic review of Landcorp, and the Board's response to Deloitte's recommendations. The report also summarises the content of Landcorp's Statement of Corporate Intent, and recommends this be finalised and tabled in the House of Representatives. Shareholding Ministers approved an extension for Landcorp finalising its SCI until 31 August 2014 due to the delayed completion of the strategic review (T2014/932 refers).

Background

2. Treasury is currently mid-way through a programme of undertaking strategic reviews of all state owned enterprises (SOEs) over a three to four year period. The strategic reviews completed to date have had relatively consistent terms of reference for each company, but are amended to take into account specific intricacies of each entity or industry. The reviews focus on assessing SOEs' existing strategies, business models, historic and forecast performance, and an analysis of strategic options that may enhance shareholder value and improve future returns.
3. Consistent with the other strategic reviews undertaken to date, Deloitte's review of Landcorp focuses on opportunities for the company to improve its financial performance under the current policy realms (i.e. Landcorp being an SOE). The review was jointly commissioned by Treasury and the Board, and accordingly focussed on the business. It did not extend to assessing possible changes in policy with regards to the Crown's ownership of Landcorp, as that is outside the Board's mandate.
4. There may still be value in addressing possible other ownership objectives for Landcorp. In particular, the Minister of Treaty of Waitangi Negotiations has indicated that he would like to explore using more Landcorp properties in Treaty settlements. Treasury has a "chew" session with shareholding Ministers on 22 July 2014. At that meeting we will discuss the commercial options available to Landcorp but will also discuss the merits of options available to Ministers to facilitate the use of Landcorp properties in Treaty settlements. We will provide further information for the chew session by 18 July.

Strategic Review

5. The strategic review commenced in January 2014. At the same time as it was being completed, Landcorp's Board was undertaking its own strategy development process, independent from Deloitte's review. Deloitte has advised that most of the strategies identified by the Board have not yet been well developed, and as a result Deloitte was unable to properly assess these from a financial perspective. Instead it focused on options relating to Landcorp's asset ownership, asset mix, cost structure and capital structure. Landcorp's internal strategy development is discussed further in paragraphs 14 to 24.
6. Deloitte has not identified any "silver bullets" that will materially change the financial outlook for the company. This is unsurprising given that farming in New Zealand is a mature industry. Deloitte's recommendations therefore focus on cost control, risk reduction and use of Landcorp's scale advantages.

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7. Overall, Deloitte has undertaken a comprehensive review of the company, and identified options available for it to enhance its returns to the shareholder. The executive summary of Deloitte's report is attached to this report for Ministers' information.

Key Findings from Deloitte

8. Deloitte's key findings from its review were:
- Over the last 10 years, Landcorp has delivered credible total returns to the Crown averaging 10% per annum. Capital gains (increases in land values) have been the major component (8.3%) of this total shareholder return, with cash returns (dividends) averaging only 1.7% per annum,
 - Landcorp undertakes a significant level of industry good/leadership activities, but these have not been explicitly mandated nor the costs quantified,
 - Annual head office costs have increased materially in real terms over the past 12 years. Adjusting for inflation, the real increase is \$5.7 million over that time,
 - Landcorp's on-farm performance equals or exceeds its peers, but when corporate overheads are included the financial performance drops to being on or below its peers,
 - There is no compelling reason for Landcorp to be in Crown ownership. However, Deloitte notes that the Crown has no further plans to sell assets, and
 - Operating profits are forecast to grow, but are increasingly exposed to milk price fluctuations due to the expansion of Landcorp's dairy farm operations (in particular the Wairakei Pastoral development in the central North Island).
9. The findings are not surprising, and highlight the fact that Landcorp's returns to the Crown have predominantly been in the form of an increase in the value of its land.

Deloitte's Recommendations and Board's Response

10. Deloitte's key recommendations, along with the Board's response and Treasury's views on the recommendations are included in the table below:

s9(2)(b)(ii)



² A cluster of (mainly dairy) farms on the West Coast has been identified as the farms most appropriate to sell. Ngai Tahu has a right of first refusal (RFR) to purchase these farms in the event that Landcorp looks to sell them.

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	Deloitte Recommendation	s9(2)(b)(ii)	Treasury's View
2	Undertake a cost reduction programme targeting \$7 - \$10 million per annum, focusing on both farming and head office costs.		Agree. Although we expect it will be difficult to achieve savings of this magnitude in 2014/15.
3	Identify and cost its industry good / leadership activities and discuss findings with Ministers and Treasury.		Agree. Need to decide whether these activities should be continued or not.
4	Focus on few key growth opportunities of scale, such as Landcorp's Other People's Money (OPM ³) strategy, and not progress smaller scale strategies that will require time and resources.		Agree subject to conditions. Rationale discussed further in paragraphs 19 to 24.
5	Improve its ability to quantify and articulate the benefits of the integrated corporate farming model.		Agree.
6	Undertake a full assessment of its Wairakei Pastoral Lease (WPL) arrangement to better understand the risks.		Agree.
7	Consider other options to reduce or mitigate its growing exposure to the milk price.		Agree.

11. We agree with Deloitte's recommendations. The Board also appears to predominately agree. We expect it to take between 1 and 3 years to complete the sale of up to \$200 million of its properties, given the complexities and consultation required. Landcorp has indicated that on completion, its preference is to repay debt and/or reinvest the proceeds back into the business. It is our preference for the proceeds to be prioritised towards the repayment of debt and/or the payment of a special dividend, depending on the financial situation of the company at the time. We recommend that Ministers indicate this preference now.
12. As identified in recommendation 4 in the table above, Deloitte has recommended that Landcorp focuses on a few key strategies to materially grow its business, rather than many smaller scale strategic initiatives. As part of Landcorp's internal strategy development, it has identified some preliminary strategic options that it is investigating. These range in size and complexity from larger OPM strategies to smaller developments of niche products. These are discussed as part of our commentary on Landcorp's SCI and business plan in paragraphs 14 to 24.
13. We recommend Ministers support Landcorp's Board in implementing the recommendations made by Deloitte. The key recommendations focus on reducing the volume and value of assets held by Landcorp (through the proposed sale of up to \$200 million of farms), and finding cost efficiencies across the rest of its business. We

³ Landcorp's Other People's Money (OPM) strategy is to grow its farming business through not owning land, but instead by entering into agreements such as sharemilking, share farming, leasing, or managing farms owned by other parties.

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s9(2)(b)(ii)

Statement of Corporate Intent and Business Plan

Strategy

14. Landcorp has recently undertaken its own internal strategy development over the past 6-9 months, independent from Deloitte's strategic review. It has developed the table below, designed to guide its strategic decision making over the short to medium term.

"What we will farm"	
Volume	In partnership with Maori and others, significantly expand the quantity of livestock farmed, across an integrated portfolio of farms nationwide.
Value	Integrate our products into value chains focused on niche markets, driven by a deep understanding of future consumer requirements.
"How we will farm"	
Efficiency	Drive adoption of science, systems and new thinking that will boost the cost effectiveness and efficiency of our farm operations.
Environment	Lead the industry on showcasing rejuvenation and profitability potential of our environmentally-savvy farming.
People	Lead the industry in people practices, providing the safest, most enriching work environment for talented and motivated people.

15. Landcorp has reshaped its SCI from previous years, and the document is structured to reflect its five key strategies as outlined in the table above. The document is not specific in identifying particular strategic initiatives and there is no identifiable linkage between these strategies and financial outcomes. However, the strategy development process is not complete and is likely to continue over the next 12 months as it further investigates options for improving its financial returns.
16. In our view, the document is not inconsistent with Ministers' expectations for the company, as it focuses on ways to improve its farming operations. It is apparent, however, that the company is looking to grow its business.
17. A Treasury official attended Landcorp's Board's strategy session in April 2014, at which a number of possible strategic initiatives were identified, including:
- Landcorp's OPM strategy s9(2)(b)(ii)
 - The development of niche farming products such as sheep milk,
 - Identifying opportunities where more value could be extracted further up the value chain (e.g. end customers), and
 - Refreshing the Landcorp brand.
18. It is likely the Board will progress some of these to the business case stage over the next few months. In the attached letter, we request Landcorp shares the results of its analysis with Treasury prior to it making final implementation decisions.

s9(2)(b)(ii)

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19. We expect development of Landcorp's OPM strategy to be the highest priority for the Board over the next 12 months. Such a strategy does have merits, but it also has risks. A combination of Deloitte's and Treasury's views are outlined here:

Landcorp's "Other People's Money" Strategy	
Advantages from the Crown's perspective	Disadvantages from the Crown's perspective
<ul style="list-style-type: none"> • Growth achieved without purchasing more properties, • Depending on the structure, Landcorp's exposure to fluctuations in commodity prices may be reduced, • It may provide further opportunities for Landcorp to partner with Iwi, and • It may result in enhanced cash returns to Landcorp and the Crown in the long-term. 	<ul style="list-style-type: none"> • Depending on the structure, it may result in more debt funded growth in Landcorp's balance sheet (as experienced in the WPL arrangement), • It is likely to add more corporate overheads to the business, and • Depending on the structure, Landcorp may not be exposed to land value appreciation, which is traditionally where most gains in farming are derived from.

20. If structured appropriately (i.e. with the right mix of risk/reward shared between Landcorp and property owners), Landcorp's OPM strategy could generate enhanced cash returns. If Landcorp is to progress this strategy, we believe it needs to have the following:

- Minimal upfront investment by Landcorp, to avoid a repeat of the WPL arrangement which has significant investment requirements even though Landcorp does not own the associated land,
- Minimal growth in corporate overheads to support the initiative,
- Landcorp's returns weighted towards the generation of cash ahead of balance sheet growth, and
- Landcorp's exposure to fluctuating commodity prices is limited.

s9(2)(b)(ii)

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s9(2)(b)(ii)

24. At the Board's strategy session, we emphasised the Crown's preference for the company to focus on improving its core business in order to increase its cash returns, ahead of diversification and growth strategies. We recommend this message is further communicated by Ministers when meeting with Landcorp's acting Chair, Ms Traci Houppapa, and Chief Executive, Mr Steven Carden, on 28 July 2014.

Projected Earnings

25. Revenue for 2014/15 is forecast to decrease by 4.7% from the 2013/14 level of \$248.6 million. Whilst production volumes for both dairy and livestock are forecast to increase, revenue is forecast to decrease mainly due to the large (24%) forecast drop in the milk price (from the historic high of \$8.55 per kilogram in 2013/14). As a result, Net Operating Profit⁵ (NOP) is also forecast to reduce in 2014/15. Forecasts for both, with comparisons to last year's SCI and historical actuals, are illustrated in the tables below:

Revenue (\$ millions)
Actual / Forecast
2013/14 SCI
2014/15 draft SCI
% change

NOP (\$ millions)
Actual / Forecast
2013/14 SCI
2014/15 draft SCI
% change

26. Current forecasts for both revenue and NOP for 2014/15 are broadly in line with what was projected in last year's SCI. However, for 2015/16, both revenue and NOP forecasts have reduced. This is the result of a reduction in the forecast production of both milk and livestock volumes, as commodity price assumptions are similar to last year's SCI.

27. Within the NOP forecast for 2014/15, Landcorp is targeting \$5 million of productivity improvements – across both its on-farm practices and its corporate overheads.

s9(2)(b)(ii)

s9(2)(b)(ii)

We believe achieving even \$5 million efficiencies in 2014/15 will be a challenge, as cost savings initiatives will only begin during the year.

⁵ Net Operating Profit is the key operating performance metric for Landcorp as it represents profit before livestock revaluations, which are non-cash items that can fluctuate significantly each year and materially impact on the reported Net Profit After Tax.

COMMERCIAL-IN-CONFIDENCE**Dividends**

28. Landcorp is forecasting to pay a dividend of \$7.0 million in 2013/14, in line with the forecast in its 2013/14 SCI. However, its forecast dividend payments for 2014/15 and 2015/16 are significantly lower than what was included in last year's SCI, as outlined in this table::

Dividends Declared (\$ millions)	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Actual / Forecast	20.0	5.0	7.0			
2013/14 SCI			7.0	16.0	40.0	
2014/15 draft SCI				5.0	5.0	20.0
%age change				(56%)	(88%)	

29. Landcorp's level of dividend payments are influenced by:
- Operating earnings,
 - Property sales (not included within operating earnings)
 - Capital expenditure, and
 - Debt levels.
30. The reason for the lower dividend forecasts is a reduction in planned property sales, an increase in capital expenditure and higher debt levels. Landcorp's forecast operating earnings (discussed in paragraphs 25 to 27) and the forecasts have not materially changed from last year's SCI.

Property Sales

31. Planned property sales have reduced from last year's SCI, as evidenced in this table:

Property Sales (\$ millions)	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Actual / Forecast	19.0	22.5	60.3 ⁶			
2013/14 SCI			86.0	41.6	20.5	
2014/15 draft SCI				38.5	13.5	21.1
% change				(7.5%)	(34%)	

32. Landcorp has removed the sale of Wharere farm from its forecast land sales for the next three years given the uncertainty surrounding if/when this property can be sold. This is the main reason for the lower forecast sales in 2013/14 compared to the target in last year's SCI. s9(2)(b)(ii)
- s9(2)(b)(ii)
33. Landcorp has not included Deloitte's recommended sale of up to \$200 million of farms in its SCI, (even though the Board has indicated it agrees with this recommendation) as

⁶ Land sales in 2013/14 were bolstered by the sale of the Pouarua station of dairy farms to a conglomeration of Iwi for \$53 million.

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it has not yet undertaken the investigations needed to assess the complexities associated with this sale, including the necessary consultations. We agree with this approach. Should Landcorp implement this sale, it will have a material impact on debt levels, and provide the possibility of a special dividend. In our view, Landcorp has adequately explained the reduction in forecast land sales from last year's SCI.

Capital Expenditure

34. Landcorp's capital expenditure continues to be weighted towards the development of the WPL farms, the replacement of vehicles and equipment, on farm improvements (yards, tracks etc.), land contouring and grassing, the replacement of fences, and further costs associated with the dairy conversion of its Eyrewell farm in Canterbury. The table below highlights increased forecast capital expenditure from last year's SCI:

Capital Expenditure (\$ millions)	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Actual / Forecast	56.6	74.3	54.6			
2013/14 SCI			51.0	73.2	55.3	
2014/15 draft SCI				84.0	72.3	41.4
% change				14.8%	30.7%	

35. For 2014/15 and 2015/16 combined, planned capital expenditure has increased by \$27.8 million (21%) from last year's SCI. This is mainly due to:

- s9(2)(b)(ii)



36. The two main components of the increase do not seem unreasonable; however, this continues a recent trend of the company prioritising investment for future growth ahead of cash returns for the shareholder. We recommend conveying to the company the preference of the shareholder for it to focus on enhancing its cash returns once this period of heavy investment is over.

s9(2)(b)(ii)



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s9(2)(b)(ii)

41. In our view, the current level of debt and the level forecast over the three year period is appropriate for the business. We understand the Board's reluctance to further increase debt levels above those forecast, particularly given the company's exposure to fluctuations in commodity prices. In its business plan, Landcorp has indicated that if commodity prices were to drop by about 10% more than forecast, it would put the company into a loss-making position in each of the next two years. This has contributed to the Board's conservatism in forecasting dividend payments over that period.

Conclusions on Dividends, Capital Expenditure and Capital Structure

42. Landcorp is in a period of high capital investment, which is constraining its ability to pay dividends to the Crown. Over the next two years, its annual forecast capital expenditure s9(2)(b)(ii) is higher than the combination of its annual operating earnings (averaging \$22 million), its annual property sales (averaging

⁷ The large reduction in interest bearing debt in 2014 was due to the sale of the Pouarua station of dairy farms to a conglomeration of Iwi for \$53 million.

⁸ This measures the financial leverage of the company and is calculated as Net debt/Net debt plus equity.

⁹ This measures the number of times earnings before interest, tax depreciation and amortisation (EBITDA) can cover the company's interest expense.

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\$26 million) and its annual depreciation expense (\$16 million), meaning a portion of its capital expenditure is therefore being funded by debt.

43. Landcorp is also effectively borrowing in order to pay the forecast \$5 million of dividends in each of the next two years. We therefore recognise the Board's reluctance to pay higher dividends. However, this is based on advice from the company that it cannot materially reduce its planned capital expenditure over the period and we are unable to explicitly validate this.
44. In our view, this is a longer term issue for the company, and one that cannot be solved by requesting changes to Landcorp's SCI, on the basis that:
- Operating earnings are largely a function of commodity prices, and the Board is unlikely to be able to materially increase its earnings forecasts,
 - Property sales have proven inherently difficult for Landcorp to achieve, and are likely to continue to be so, following the issues experienced with Wharere farm,
 - Last year, shareholding Ministers wrote to Landcorp's Chair (T2013/2261 refers) stating a preference for the company to stabilise debt ahead of the payment of dividends, and
 - The company is in a high period of capital investment, and it has advised that it cannot materially reduce planned capital expenditure that it is largely committed to spending.
45. Instead, we recommend key messages be given to Landcorp's Chair and Chief Executive regarding the Crown's long-term objectives for the company when you meet with them on 28 July 2014 in an attempt to influence the company's long-term strategic planning. These messages are outlined in paragraph 46 below.

Key messages for Landcorp's Chair and Chief Executive

46. Shareholding Ministers are meeting with Landcorp's acting Chair, Ms Traci Houpapa, and Chief Executive, Mr Steven Carden, at 9am on 28 July 2014. We recommend the following key messages be conveyed at that meeting:
- s9(2)(b)(ii) [REDACTED]
 - Support for Landcorp's drive to find productivity improvements and cost savings,
 - Request that Landcorp writes to shareholding Ministers after specifically identifying and quantifying its industry good/leadership activities and illustrating whether they derive any commercial benefits for the company. Following receipt of that information, a discussion should be had as to whether these activities should be continued or not,
 - Express the Crown's strong preference for the company to focus on improving its core farming operations in order to enhance cash returns for the company ahead of any plans to diversify into different products and services,
 - Question whether Landcorp's OPM strategy can be structured to avoid significant upfront investment, increased overheads, and be weighted towards enhancing cash returns ahead of balance sheet growth, and request that its business case

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assessing its commercial viability be shared with Treasury prior to any implementation decisions being made, and

- Question the capacity of Landcorp to implement all these initiatives at once, noting the Crown's preference for it to prioritise the sale of properties, and implementing cost savings and productivity improvements.
47. Comments incorporating the points above have been included in the attached letter to Landcorp's acting Chair, Ms Traci Houpapa. We recommend waiting until after the meeting with Landcorp on 28 July before sending the letter, as changes may need to be made following that meeting.

Board and Management

48. Traci Houpapa has been the Deputy Chair of Landcorp Farming since May 2013. Since May 2014 she has been acting as Chair, following the resignation of Bill Baylis. Having been appointed in 2010, Traci is now the longest serving director on Landcorp, following the retirement of senior directors Bill Baylis, Warren Larsen and Basil Morrison over the last year. A permanent Chair appointment is expected after the Election.
49. Tony Reilly joined the Board on 1 July 2014 as a replacement for Basil Morrison. A Takaka-based director, he is a dairy farmer with more than 30 years' industry experience including corporate farming of a similar scale to Landcorp. He has strong governance experience, and is currently a director of Ravensdown Fertiliser, Cold Storage Nelson, Co-operative Business NZ, and Network Tasman. Previous roles include Tasman Milk Products, Dairy Meats, New Zealand Dairy Board and Kiwi Co-operative Dairies.
50. Three positions come up in early 2015. Tony Reilly completes a 12 month term while Chris Day and Pauline Lockett also complete their first terms. At this stage we would see continuation being recommended. It would be desirable for the Board to have a period of stability following the anticipated Chair change to enable consolidation.
51. Steven Carden commenced his role as Chief Executive of Landcorp in August 2013, following the departure of his long-standing predecessor Chris Kelly. This is Steven's first Chief Executive role, after holding senior positions at PGG Wrightsons in New Zealand and Australia, and prior to that working at the McKinsey consulting firm in New York.

Ms Traci Houpapa
Acting Chair
Landcorp Farming Ltd
PO Box 5349
WELLINGTON 6145

Dear Ms Houpapa

**STRATEGIC REVIEW, 2014 BUSINESS PLAN AND STATEMENT OF
CORPORATE INTENT (SCI)**

Thank you for providing shareholding Ministers with Landcorp Farming Ltd's (Landcorp's) draft 2014 SCI and Business Plan. We appreciate all of the time and effort which has gone into producing these documents.

Thank you also for the Board's willingness to undertake a joint strategic review of the company with Treasury. We appreciate the time required by management to help facilitate a successful completion of the review.

It was good to meet with you and Steven on 28 July 2014 to discuss the strategic review and the Board's strategy development for the company, and thank you for your letter dated 18 June 2014 responding to Deloitte's recommendations.

Further to our discussion on 28 July, these are shareholding Ministers' preferences with regards to the future direction of Landcorp:

- s9(2)(b)(ii)
s9(2)(b)(ii) When clarity on achievability and timeframes becomes clearer, we look forward to discussing with the Board as to the best use of any proceeds from the sale,
- We support Deloitte's recommendation and Landcorp's commitment to find productivity improvements and cost efficiencies in the business. Please develop an appropriate mechanism for tracking progress against this initiative, and include progress updates in Landcorp's quarterly reports,
- In line with Deloitte's recommendation, we request you undertake a review of Landcorp's industry good/leadership activities and provide us with the details of

the activities that Landcorp undertakes, including an estimate of time and cost involved,

- It is this government's strong preference for Landcorp to focus on its core farming operations, and to not diversify into new products or markets outside its core business. There is a long history of SOEs failing when attempting to diversify, resulting in the loss of value to the taxpayer,
- It is our preference that should Landcorp advance its Other People's Money strategy, it be structured to avoid the need for significant investment by Landcorp (such as in the case of the Wairakei Pastoral Lease), to avoid the need to further increases in overheads to support the strategy, and for the benefits accruing to Landcorp be weighted towards enhanced cash returns ahead of growth in the value of Landcorp's balance sheet. Whilst we recognise this is a decision for the Board, we request that you share the assessment of the commercial viability of this strategy with Treasury prior to implementing it.

We recognise that implementing all these initiatives at once is likely to be challenging for the Board and management. Should this be unachievable, it is our preference for the sale of properties and the implementation of cost savings and productivity improvements to be prioritised over growth strategies.

We also note that Landcorp is currently in a period of high investment, partly as a result of arrangements the company has previously committed to. This is resulting in increasing debt levels and constraining dividend payments to the Crown. As a shareholder, it is the Crown's preference for enhanced cash returns ahead of growth in the value of SOEs' balance sheets, as such value is inherently difficult to realise. We request you consider this when developing future strategies for the business and be mindful of the planned level of investment in the business when this heavy period of investment is forecast to slow down in 2-3 years time.

Once completed, please share the analysis on the Wairakei Pastoral Lease agreement with Treasury so that it can better understand the risk profile associated with this arrangement.

Please now have 50 copies of the final SCI forwarded to my office by 10 August 2014, for tabling in the House of Representatives.

We wish you every success for the year ahead. Please pass on our thanks to the rest of your Board, the management and staff of Landcorp for their continuing efforts.

Yours sincerely

Hon Tony Ryall
Minister for State Owned Enterprises
on behalf of shareholding Ministers

cc: Mr Steven Carden, CEO, Landcorp Farming Ltd

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**Treasury Report: Landcorp: Change of Company Name**

Date:	24 October 2014	Report No:	T2014/1622
		File Number:	SE-2-8-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Agree recommendations	5 November 2014
Associate Minister of Finance (Hon Steven Joyce)	For your information	None
Associate Minister of Finance (Hon Dr Jonathan Coleman)	For your information	None
Minister for State Owned Enterprises (Hon Todd McClay)	Agree recommendations and sign attached letter on behalf of shareholding Ministers. Submit attached paper to next CBC meeting.	5 November 2014

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Ant Shaw	Senior Analyst, Governance and Performance	s9(2)(k)	N/A (mob) ✓
Fiona Chan	Manager, Governance and Performance		N/A (mob)

Actions for the Minister for State Owned Enterprise Office's Staff (if required)

Send attached letter once approved by shareholding Ministers and signed by the Minister for State Owned Enterprises.

Following receipt of the Companies Act certificate for Landcorp, **submit** the attached paper to the next available Cabinet Business Committee meeting.

Enclosure: Letter to Landcorp (attached)
[Landcorp Letter regarding Company Name Change \(Treasury:3042558v1\)](#)
[Landcorp: Change of Company Name CBC Paper \(Treasury:3024370\)](#)

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Treasury Report: Landcorp: Change of Company Name

Purpose of Report

1. This report facilitates changing the name of Landcorp Farming Ltd (Landcorp) to Pāmu¹ Farms of New Zealand Ltd, following the Board's resolution to change the company's name. A letter is attached to this report authorising the change in name of the company, if shareholding Ministers agree.

Background

2. Landcorp's Board has resolved to change the name of the company. The Board's rationale for doing so is that it has had the same name since its inception as a State Owned Enterprise in 1987, and it is now out of date with the current direction of the company.
3. The attached letter and briefing pack from Landcorp expands on the rationale for change and the choice of the new name, Pāmu Farms of New Zealand Ltd.

Process

4. Section 31 of Landcorp's Constitution allows the company to change its name once the Board has approved it and the shareholding Ministers have given written approval of the change in name.
5. Landcorp's Board has now approved the change in name (see attached letter), and seeks shareholding Ministers' approval. A letter is attached to this report for the Minister for State Owned Enterprises (SOEs) to sign, should Ministers agree.
6. Following receipt of Ministers' approval of the name change, Landcorp may apply to the Companies Registrar to change the name. Once the Companies Registrar has agreed to change Landcorp's name and issued a s23(3)(b) Companies Act certificate ("Certificate"), Landcorp must deliver the Certificate to the Minister for SOEs.
7. Section 30A of the SOE Act 1986 authorises the Governor-General to change the name of an SOE via an Order in Council (OIC) to ensure all relevant pieces of legislation are updated with the new name. Cabinet approval is required to submit the OIC to the Governor General.
8. Under paragraph 7.86 of the Cabinet manual, a paper seeking an OIC would normally have to first go to a Cabinet policy Committee for approval of the policy to change the name of Landcorp, and then go to the Cabinet Legislation Committee (LEG) for approval of the legislation change, before going to Cabinet. However, because the change in Landcorp's name is considered a minor policy, we recommend these steps be combined, and that both the policy and the legislative change be sought at the same time from the Cabinet Business Committee (CBC).

¹ Pāmu means "to farm" in Maori.

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9. A draft Cabinet paper is attached, seeking approval from CBC to change the name of Landcorp, and for the relevant OIC to be drafted by the Parliamentary Counsel Office. We recommend the Minister for SOEs submits the attached paper to the next available CBC meeting, following receipt of the Certificate from Landcorp confirming the name change.

Treasury View

10. In April 2014, a Treasury official attended a Landcorp Board meeting, at which the proposal to change the company's name was first discussed. We expressed scepticism as to how value would be gained from a change in company name that would justify the cost and resources needed to implement the change.
11. The Board chose to proceed, and the company has now gone through a process of consultation and research to establish a new name for the company that it considers appropriate. At a meeting with shareholding Ministers on 28 July 2014, Landcorp's acting Chair, Ms Traci Houpapa, and Chief Executive, Mr Steven Carden, advised Ministers of their intention to change the company's name. Ministers' message at that meeting was to ensure the name change was enabled at the lowest possible cost.
12. Whilst we are still sceptical that a change in the company's name will result in improved financial returns to the company or the Crown, we do not see value in trying to block the proposal at this point in the process. As noted above, Landcorp has already been through the process of establishing a new name for the company, with the only remaining step (once approval is obtained) being the rebranding exercise. We do not expect rebranding to incur a significant cost given the nature of the company, but recommend this point is reiterated to Landcorp in the attached letter.
13. We have no explicit view on the proposed new name of the company. If Ministers are comfortable with the new name, then we recommend Ministers sign the attached letter giving approval to Landcorp to change its name to Pāmu Farms of New Zealand Ltd.

Risks

14. With the name change occurring soon after the election, there is a risk that the media and opposition parties will see this as the first step towards privatising Landcorp. This risk can be mitigated somewhat by reiterating the Government's current policy that it has no intention of selling Landcorp.

Recommended Action

We recommend that you:

- a **note** that Landcorp's Board has resolved to change the company's name to Pāmu Farms of New Zealand Ltd
- b **agree** that the Minister for State Owned Enterprises signs the attached letter on behalf of shareholding Ministers approving the change in name, and

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister for State Owned Enterprises

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- c **agree** to submit the attached Cabinet paper to the next available Cabinet Business Committee meeting (following receipt of the Companies Act certificate from Landcorp), seeking approval for the company to change its name and for the Parliamentary Counsel Office to draft the associated Order in Council required to enable this change.

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister for State Owned Enterprises

Fiona Chan
Manager, Governance and Performance

Hon Bill English
Minister of Finance

Hon Todd McClay
Minister for State Owned Enterprises

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Ms Traci Houpapa
Acting Chair
Landcorp Farming Ltd
PO Box 5349
WELLINGTON 6145

Dear Ms Houpapa

CHANGE OF COMPANY NAME

Thank you for your letter dated 23 September 2014 advising shareholding Ministers of the Board's decision to change the name of Landcorp Farming Ltd (Landcorp) to Pāmu Farms of New Zealand Ltd.

As required under section 31 of Landcorp's constitution, shareholding Ministers approve the change in Landcorp's name to Pāmu Farms of New Zealand Ltd.

Please now provide a copy of a section 23(3)(b) Companies Act certificate from the Companies Registrar to Treasury and shareholding Ministers, confirming that the Companies Registrar has accepted the name change.

Following receipt of this certificate, the Governor-General will, under s30A of the State-Owned Enterprises Act 1986, change Landcorp's name in all relevant legislation by making an Order in Council. This requires Cabinet approval, and assuming that is given, the Order in Council will come into effect 28 days after it is signed by the Governor General. Please do not announce the new company name publicly until the 28 day period has passed.

As you have stated in your letter, please ensure that implementation of the name change is done at minimal cost.

Yours sincerely

Hon Todd McClay
Minister for State Owned Enterprises
on behalf of shareholding Ministers

cc: Mr Steven Carden, CEO, Landcorp Farming Ltd

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Reference: T2015/483

SH-10

Date: 17 March 2015

To: Minister of Finance (Hon Bill English)
Associate Minister of Finance (Hon Steven Joyce)
Associate Minister of Finance (Hon Paula Bennett)
Minister of State Owned Enterprises (Hon Todd McClay)

Deadline: 3:30pm 18/03/15

Aide Memoire: Budget initiative - \$100m freshwater fund

You have sought advice on funding the \$100m freshwater fund Budget initiative from dividends or asset sales from Landcorp.

Decisions on how this fund would be spent on have not yet been taken, meaning the fiscal impacts of funding it from Landcorp are not yet clear. If the fund focused on supporting clean-up initiatives, for example, there would be a negative impact on OBEGAL as this would involve using a capital inflow to fund an operating expense. However if the fund focused on capital acquisitions there may be no impact on OBEGAL. Either way, funding the initiative in this way would be net debt neutral over the life of the fund.

Budget initiative

Below is a summary of the \$100m Freshwater Fund Budget initiative:

Vote	Title	Description	Amount (\$000)				Treasury assessment	
			15/16	16/17	17/18	18/19	Value for money	Discretion
Env	\$100m Fresh Water Fund	Establishment of a fund (\$100 million over 10 years) to improve water quality through vehicles such as the purchase and retirement of selected areas of farmland next to important waterways.	2,200	4,200	6,200	8,200	Do not support – value for money not proven and policy unclear	Pre-election commitment

Treasury does not support funding this initiative at Budget 15. This is chiefly because no detail has been established on:

- the policy the fund would support;
- criteria for allocation or eligibility;
- the form of funding;
- management of the fund (including the costs of management);
- processes for monitoring and verification.

Initiatives to improve water quality are already supported under other funds administered by the Ministry for the Environment. The new regulatory regime implemented through the National Policy Statement for Freshwater Management will also deliver improvements, in a systematic and cost-effective manner.

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Funding from Landcorp

Under section 13(1)(b) of the State Owned Enterprises (SOE) Act 1986, shareholding Ministers have the authority to determine the amount of a dividend payable in any given year for any SOE. However, we are not aware of this power having been exercised at any time since the SOE Act was passed. Landcorp is currently in the middle of its business planning process (with a draft business plan due to Treasury on 1 May), meaning we do not have up to date financial forecasts for the company.

However, we expect that it will be difficult to impose dividend payments (in excess of those forecast in its normal course of business) on Landcorp in the foreseeable future due to the following factors:

- The current depressed milk price is likely to mean that Landcorp will generate minimal returns in the short term;
- The capital commitments s9(2)(b)(ii) under its Wairakei Pastoral Lease (WPL) agreement are significant, and are already forecast to be partially funded by debt and the sale of farms as Landcorp's free cash flows will not be sufficient to fund the contractually committed WPL investment;
- Any additional dividends will therefore need to be funded by debt, and whilst the Government has the legislative authority to determine the dividend amount, doing so will likely put the Board in a difficult position;

- s9(2)(b)(ii)

Officials intend to provide Ministers with advice on the risks associated with Landcorp's WPL commitments shortly, but note that full financial forecasts for the company will not be available until May. In Landcorp's 2014 Statement of Corporate Intent it has forecast to pay ~\$5 million in dividends each year, with this amount being included in the Crown's current financial forecasts. The 2014/15 SCI targeted an operating profit of \$20 million, but due to the depressed milk price it is now only forecasting to achieve between \$1 and \$6 million this year, which may impact on its forecast dividend for 2014/15.

For the reasons identified above, it will be difficult to fund the proposed freshwater fund from additional dividends from Landcorp.

Ben Parker, Senior Analyst, Natural Resources, s9(2)(k)
Melody Guy, Manager, Natural Resources, s9(2)(k)
Ant Shaw, Senior Analyst, Commercial Operations, s9(2)(k)
Fiona Chan, Manager, Commercial Operations, s9(2)(k)

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Treasury Report: Landcorp's Wairakei Contract, Financial Position, and Sheep Milking

Date:	19 March 2015	Report No:	T2015/382
		File Number:	SE-2-8-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Discuss this report with officials	None
Associate Minister of Finance (Hon Steven Joyce)	Note	None
Minister for State Owned Enterprises (Hon Todd McClay)	Discuss this report with officials	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Dominic Milicich	Principal Advisor, Governance and Performance	§9(2)(k)	✓
Fiona Chan	Manager, Governance and Performance	§9(2)(a)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury

Enclosure: No

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Treasury Report: Landcorp's Wairakei Contract, Financial Position,
and Sheep Milking

Executive Summary

Landcorp's current position is poor. It is exposed to volatile commodity prices, generates minimal cash returns, lacks diversification due to an increasing focus on dairying, has large capital expenditure requirements, expects poor investment returns from its Wairakei investment, and faces restrictions on its ability to sell farms to control debt and increase returns.

Two financial modelling exercises have been completed and are summarised in this report. The first relates to the forecast performance of Landcorp's contract with Wairakei Pastoral Limited (WPL) that involves a commitment to a significant land conversion project in the central North Island. The project involves the conversion of forestry land into a total of 39 dairy farms and the ongoing lease of those farms. At present, 9 dairy farms are operational, with the remaining farms scheduled for completion by around 2020. s9(2)(b)(ii)

s9(2)(b)(ii)

s9(2)(b)(ii)

s9(2)(b)(ii)

The two sets of scenario results place greater emphasis on the need for Landcorp to sell farms to reduce debt. This needs to be done quickly and efficiently. s9(2)(b)(ii)

s9(2)(b)(ii)

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s9(2)(b)(ii)

s9(2)(b)(ii)

Individual farm sales are possible and they would alleviate financial pressures but they are uncertain and can take a lengthy period to conclude s9(2)(b)(ii)

s9(2)(b)(ii)

s9(2)(b)(ii)

Recommended Action

We recommend that you **discuss** this report with officials to consider the next steps that you would like to respond s9(2)(b)(ii)

Fiona Chan
Manager, Governance and Performance

Hon Bill English
Minister of Finance

Hon Steven Joyce
Associate Minister of Finance

Hon Todd McClay
Minister for State Owned Enterprises

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Treasury Report: Landcorp's Wairakei Contract, Financial Position, and Sheep Milking

Purpose of Report

1. This report briefs you on: 1) the financial characteristics of Landcorp's Wairakei Pastoral contract including potential mitigating actions to improve the forecast financial impacts; 2) financial modelling to assess the impact of not selling farms; and 3) the sheep milking proposal.

Wairakei Pastoral Limited

2. In 2004 Landcorp signed a contract to conduct a significant land conversion project in the central North Island and to lease the resulting farms. The contract is with Wairakei Pastoral Limited (WPL). The main characteristics of the contract are as follows.

- The project involves the conversion of forestry land into a total of 39 dairy farms and the ongoing lease of those farms. At present, 9 dairy farms are operational, with the remaining farms scheduled for completion by around 2020. The lease operates until 2049.

- s9(2)(b)(ii)



Financial Assessment of the WPL Contract

3. Landcorp, assisted by Deloitte, has completed an assessment of the forecast financial performance of the contract. The review considers base, high and low scenarios that allow for differing levels of productivity from the farms. It then conducts Monte Carlo simulations across the scenarios for different milk price results.
4. The primary drivers of different results between the scenarios are assumptions regarding output growth and productivity (e.g. KgMS/ha¹ and costs/KgMS).

¹ KgMS/ha = kilograms of milk solids per hectare

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Table One: Assumptions for the Scenarios²

	Base Case	Low	High
Key Assumptions:	s9(2)(b)(ii)		
Output growth rate			
Dry year frequency			
FY16 milk price			
Price growth rate (long-term real)			
FY 15 Irrigated CMV \$/ha			
FY15 Non-irrigated CMV \$/ha			
CMV growth rate (long-term real)			
Real cost inflation			
Normal rainfall not-irrigated KgMS/ha			
Dry year not-irrigated KgMS/ha			
All years irrigated KgMS/ha			
FY15 Non-irrigated COP (\$/kgMS)			
FY15 Irrigated COP (\$/kgMS)			

5. The Monte Carlo analysis allows them to incorporate milk price volatility into the model by randomly generating milk prices between \$4.25 and \$8.75. EBITDA is iterated 1,000 times for each year (i.e. 35 years times 1,000) and then plotted.

Results

6. s9(2)(b)(ii)

Table Two: Modelling Results

Scenario	Internal Rate of Return (IRR)	EBITDA Per Annum
Base	s9(2)(b)(ii)	s9(2)(b)(ii)
Low		
High		

7. The primary driver of the poor performance is the level of rent payable. s9(2)(b)(ii)

² CMV = current market value. COP = cost of production

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Potential Mitigating Actions

8. Landcorp is considering actions it could take to reduce its exposure to particularly poor outcomes from the contract. s9(2)(b)(ii)

s9(2)(b)(ii)

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Sheep Milking

13. Landcorp's Board considered a sheep milking business case on 27 February and decided to proceed with the proposal. Landcorp management has now briefed us on the proposal. The main aspects of the project are as follows.

- Landcorp would enter into a 50/50 joint venture with an investment vehicle established by SLC Group Ltd ("a boutique investment and strategic support company based in Auckland"³).
- The first stage of the JV would involve establishing a single sheep milking farm on the St Kilda property (part of Wairakei). The JV includes the option to expand it over time to four farms.
- The business case projects an internal rate of return for sheep milking s9(2)(b)(ii)
s9(2)(b)(ii)
- s9(2)(b)(ii)

14. s9(2)(b)(ii)

15. The sheep milking proposal goes beyond the "farm gate" as the JV would be directly involved in the production, marketing and sale of retail products. This is a driver of the increased return over and above bovine dairying but introduces additional execution risks. Landcorp has indicated, however, that its estimate of the "farm gate" return to sheep milking is s9(2)(b)(ii)

s9(2)(b)(ii)

16. s9(2)(b)(ii) The project is structured in stages requiring separate approvals to proceed to place discipline on the JV partners to assess how the JV is tracking and whether it merits continued investment. The JV partners will be forced to consider learnings to date, fine tune the assumptions underpinning the later stages and recalculate expected returns.

17. The market for sheep milk is still developing and it is difficult to test some of the business case assumptions but we are comfortable that the investment is not material.

s9(2)(b)(ii)

³ www.slcgroup.co.nz

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s9(2)(b)(ii) These are not material amounts of capital for Landcorp to risk on this initiative.

Financial Stress Testing

18. We requested that Landcorp conduct financial modelling to stress test the financial position of the company. s9(2)(b)(ii)
s9(2)(b)(ii)
s9(2)(b)(ii) The results of that modelling are concerning.
19. Landcorp has completed a high level scenario analysis of its net profit, interest costs, closing debt balances and debt covenant ratios under varying milk price assumptions for a base case and downside scenario for the period FY2016 to FY2018. s9(2)(b)(ii)
s9(2)(b)(ii)
20. s9(2)(b)(ii)

Assumptions

21. The analysis presents two scenarios: base case and downside. Both scenarios assume "business as usual" with the only variable flexed between the two scenarios being the milk price. The milk price assumed is a full milk price, including dividends, where applicable, as follows:

Table Three: Milk Price Assumptions (\$/KgMS)

Scenario	FY2016	FY2017	FY2018
Base	\$6.20	\$6.50	\$6.50
Downside	\$5.00	\$5.20	\$5.60

22. Significantly, the downside case FY2016 milk price assumption is similar to the milk price forecast for the current FY2015 year. Milk production figures assume normal climatic conditions and no occurrence of any significant weather events including drought.
23. No sales of land and associated buildings, other than what is already underway, are assumed. Interest costs are assumed at the current FY2015 interest rate multiplied by the closing debt balance.

Results

24. s9(2)(b)(ii)

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Pages 9 withheld under s9(2)(b)(ii)

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Sensitivity Analysis

27. The downside scenario modelled is in no way a worst case scenario. In fact, it could be characterised as a continuation of current conditions whereas the base case scenario assumes some recovery in milk prices. Landcorp's net profit and debt covenant ratio are sensitive to a number of factors not adjusted in the scenarios, including milk production, capital expenditure and interest rates.
28. Sensitivity analysis confirms that there is significant further downside risk to the downside scenario. This is particularly relevant when considering the potential for:
- drought conditions in FY2016 following on from the dry conditions experienced to date with an impact on assumed production volumes (as seen in FY2015 where forecast production is 4.5% below budgeted production)
 - increased capex requirements for WPL during the forecast period based on any change in timing of deforestation, land development and commencement of operations, and
 - interest rate changes as Landcorp's total debt balances increase beyond the facility limit with the likelihood that interest rate/line fees charged on the facility may increase.
29. One countervailing feature is that the scenarios assume no farm sales. s9(2)(b)(ii)

s9(2)(b)(ii)

Cover Sheet for Cabinet/Committee Submissions

CAB101/12

Minister's Office to Complete [please print]

Title of Paper [for regulations and orders, please copy exact title from the regulation or order as drafted by PCO]

LANDCORP FINANCIAL POSITION AND
STRATEGIC OPTIONS

Tick box...	CAB	Cabinet [weekly]	ERD	Cabinet External Relations and Defence Committee [fortnightly, alternates with TOW meeting]
	STR	Cabinet Strategy Committee [first Monday of each sitting period]	DES	Cabinet Committee on Domestic and External Security Co-ordination [as required]
✓	EGI	Cabinet Economic Growth and Infrastructure Committee [weekly]	SEC	Cabinet Committee on State Sector Reform and Expenditure Control [weekly]
	SOC	Cabinet Social Policy Committee [weekly]	CER	Cabinet Committee on Canterbury Earthquake Recovery [fortnightly]
	LEG	Cabinet Legislation Committee [weekly]	APH	Cabinet Appointments and Honours Committee [weekly]
	TOW	Cabinet Committee on Treaty of Waitangi Negotiations [fortnightly, alternates with ERD meeting]	CBC	Cabinet Business Committee [during non-sitting weeks as required]

Date of meeting: 20/05/2015

☐ Round Robin

Classification: [default: In Confidence]

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Portfolio: STATE OWNED
ENTERPRISES

Department:

[mark "N/A" if written by Minister's office]

TREASURY

Contact name: s9(2)(a)

Extn:

9877

Cabinet Office to Complete

Date/time received in Cabinet Office: [or name of referring committee]

Identifier and Number:

Timeliness:

B L

No. of pages:

Exec Summary:

Y N N/A

Enveloping

Departments:

Y N

Ministers:

Y N

Unjustifiable breach of 28-day rule:

Y N N/A

AO:

Reviewer:

Attachment/s:

Y N

Registry date and time in:

Registry date and time out:

Comments:

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Office of the Minister for State Owned Enterprises

Chair
Cabinet Economic Growth and Infrastructure Committee

LANDCORP FINANCIAL POSITION AND STRATEGIC OPTIONS

Purpose

1. This paper briefs the Cabinet Economic Growth and Infrastructure Committee (EGI) on Landcorp Farming Limited's financial position and options to restructure its portfolio of farms in order to meet capital expenditure commitments, reduce debt, and increase returns.

Executive Summary

2. Landcorp faces difficult commercial conditions. It is exposed to volatile commodity prices, generates minimal cash returns, lacks diversification due to an increasing concentration in dairying, has large capital expenditure commitments, expects poor investment returns from its Wairakei investment, and faces restrictions on its ability to sell farms to fund capital expenditure commitments, control debt, and increase returns.
3. Recognising these challenges, Landcorp has been proactive in exploring options that will both lower risk and enhance returns.

4. s9(2)(b)(ii)

- 5.

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s9(2)(b)(ii)

6.

7. The two forecasting exercises place greater emphasis on the need for Landcorp to be proactive in managing risk. The primary mechanism for doing so is to sell farms. As a state owned enterprise, Landcorp does not require permission to execute any of the proposals in this paper and Shareholding Ministers do not have the authority to make directions regarding the operations of the business. Landcorp, however, wants to understand its shareholders' preferences so these can be fully considered by the Board in its decisions.

8. s9(2)(b)(ii)

9.

Background

10. Landcorp, a state owned enterprise, is New Zealand's largest pastoral farmer. As at 30 June 2014 it had assets of \$1.7b, owned 137 farms covering over 160,000 hectares, with 1.6 million stock units, and around 700 staff. It also manages an additional 227,000 hectares on behalf of third parties including iwi groups. Like most farming activity in New Zealand, its financial performance,

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while good, has typically involved low cash yields with capital gains boosting returns.

11. In early 2014 a strategic review of the business was conducted. s9(2)(b)(ii)

s9(2)(b)(ii)

12. More recently the company has conducted forecasts of its performance under various scenarios to assess the strength of its financial position in light of the ongoing weakness in milk prices. This emphasises the need for Landcorp to sell farms, s9(2)(b)(ii)

s9(2)(b)(ii)

13. Below we discuss Landcorp's financial position, focusing on the most recent forecasts. We outline the main options available to sell farms to reduce the potential for financial distress. s9(2)(b)(ii)

s9(2)(b)(ii)

Financial Position

14. There are two aspects to the financial modeling that has been completed: 1) the Wairakei Pastoral contract; and 2) the overall company position.

Wairakei Pastoral Limited

15. In 2004 Landcorp signed a contract to conduct a significant land conversion project in the central North Island and to lease the resulting farms. The contract is with Wairakei Pastoral Limited (WPL). The project involves the conversion of forestry land into a total of 39 dairy farms and the ongoing lease of those farms. At present, 9 dairy farms are operational, with the remaining farms scheduled for completion by around 2020. s9(2)(b)(ii)

s9(2)(b)(ii)

16. The financial review of the contract considered base, high and low scenarios that allow for differing levels of productivity from the farms. The primary drivers of different results between the scenarios are assumptions regarding output growth and productivity (e.g. KgMS/ha² and costs/KgMS). Milk price volatility is also incorporated with prices fluctuating between \$4.25 and \$8.75 per KgMS.

17. s9(2)(b)(ii)

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18. s9(2)(b)(ii)

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Overall Financial Position

22. Landcorp conducted financial modelling to determine what market conditions would place the company in financial distress in the absence of farm sales. This modelling was completed independent of and earlier than the Landcorp business plan which is due for approval by the Board in May. The results are concerning.

23. The scenario analysis encompassed net profit, interest costs, closing debt balances and debt covenant ratios under varying milk price assumptions for a base case and downside scenario for the period FY2016 to FY2018. The scenarios assume no farm sales.

24. s9(2)(b)(ii)

25. Base case and downside scenario milk price assumptions are as follows.

Table One: Milk Price Assumptions (\$/KgMS)

Scenario	FY2016	FY2017	FY2018
Base	\$6.20	\$6.50	\$6.50
Downside	\$5.00	\$5.20	\$5.60

26. Significantly, the downside FY2016 milk price assumption is slightly higher than the milk price forecast for the current FY2015 year. Milk production figures

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assume normal climatic conditions and no occurrence of any significant weather events including drought. Interest costs are assumed at the current FY2015 interest rate multiplied by the closing debt balance.

Results

27. The results are shown in figure one. s9(2)(b)(ii)
s9(2)(b)(ii)

28.

Sensitivity Analysis


29. The downside scenario modelled is in no way a worst case scenario. In fact, it could be characterised as a continuation of current conditions whereas the base case scenario assumes some recovery in milk prices. Landcorp's net profit and debt covenant ratio are sensitive to factors not adjusted in the scenarios, including milk production, capital expenditure and interest rates.
30. Sensitivity analysis confirms that there is significant further downside risk to the downside scenario. This is particularly relevant when considering the potential for:

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- drought conditions in FY2016 following on from the dry conditions experienced to date with an impact on assumed production volumes (as seen in FY2015 where forecast production is 4.5% below budgeted production)
- increased capital expenditure requirements for WPL during the forecast period based on any change in timing of deforestation, land development and commencement of operations, and
- interest rate changes as Landcorp's total debt balances increase beyond the facility limit with the likelihood that interest rate/line fees charged on the facility may increase.

Strategic Options

s9(2)(b)(ii)



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s9(2)(b)(ii)

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s9(2)(b)(ii)

RELEASED UNDER THE
OFFICIAL INFORMATION ACT

41.

s9(2)(b)(ii)

RELEASED UNDER THE
OFFICIAL INFORMATION ACT

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s9(2)(b)(ii)

Short Term Actions

50. Landcorp is considering a number of short term actions in order to manage its position while a decision is made on the longer term strategic approach to farm sales. These actions save capital expenditure and minimise debt in the short term but may not be consistent with maximising long term returns. Options include:

- reducing capex on the Wairakei project through developing drystock properties rather than dairy properties even though returns will be lower
- exploring alternative land uses (such as sheep milk)
- sourcing alternative milk customers (other than Fonterra) where spending money on shares is not required (e.g., Miraka)
- handing back the Rolls Peak parcel of land under the lease (as allowed under lease provisions)
- exploring use of synthetic/derivative instruments to remove milk price volatility
- sub-leasing some of the Wairakei properties to third parties, and
- reducing expenditure on irrigation and fertiliser.

51. Landcorp is appropriately pursuing short term actions to minimise financial risk but these are no substitute for actions to efficiently sell farms and reduce debt in a sustainable manner.

s9(2)(b)(ii)

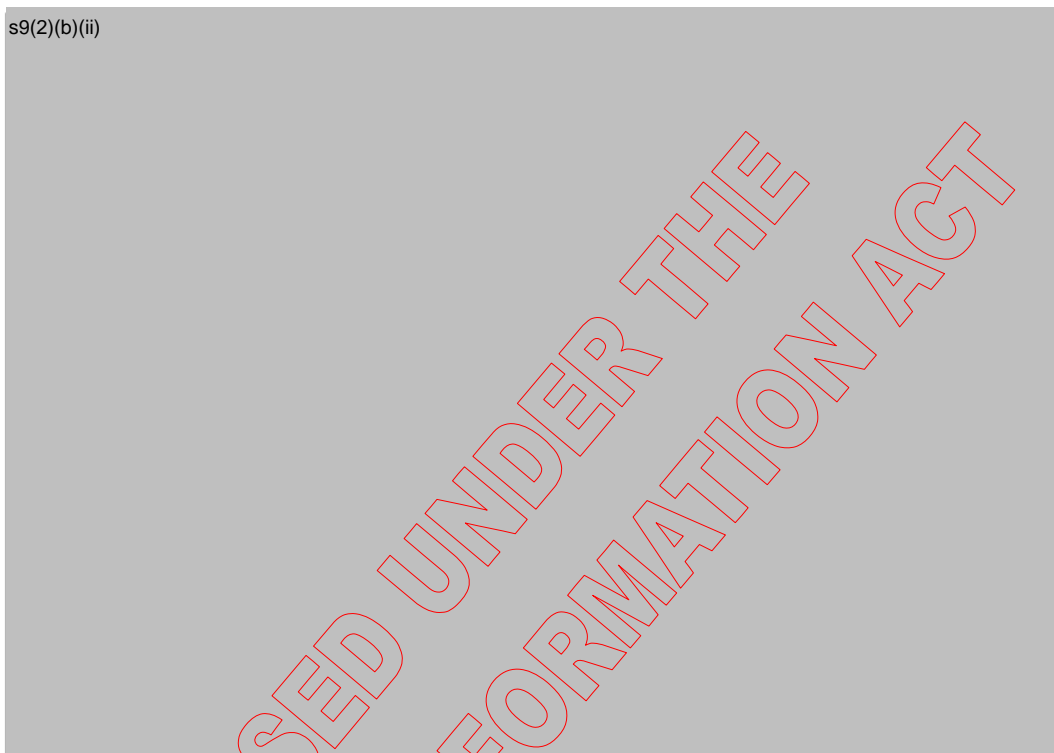
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s9(2)(b)(ii)

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OFFICIAL INFORMATION ACT

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s9(2)(b)(ii)



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Recommendations

61. We recommend that the Cabinet Economic Growth and Infrastructure Committee:

- a. **note** that Landcorp faces volatile commodity prices, large capital expenditure commitments, and growing debt

s9(2)(b)(ii)

- d. **note** that Landcorp is consulting its shareholders so that it can ensure that shareholders' preferences are fully considered by the Board when it decides which option to progress

s9(2)(b)(ii)

- f. **invite** Shareholding Ministers to hold further discussions with Landcorp, the Minister for Treaty of Waitangi Negotiations and OTS on both the fund and Treaty Settlement options with a view to providing a Shareholders preference to Landcorp.

Christopher Finlayson

for Hon Todd McClay
Minister for State Owned Enterprises

Date: 14 May 2015.

CAB 100/2012

Consultation on Cabinet and Cabinet Committee Submissions

Certification by Department:

Guidance on consultation requirements for Cabinet/Cabinet committee papers is provided in the CabGuide (see Procedures: Consultation):
<http://www.cabguide.cabinetoffice.govt.nz/procedures/consultation>

Departments/agencies consulted: The attached submission has implications for the following departments/agencies whose views have been sought and are accurately reflected in the submission:

Nil

Departments/agencies informed: In addition to those listed above, the following departments/agencies have an interest in the submission and have been informed:

Nil

Others consulted: Other interested groups have been consulted as follows:

Landcorp Farming Ltd & Ngai Tahu have been consulted as described in paragraph 54 of the paper.

Name, Title, Department: Fiona Chan, Manager, Treasury

Date:

14 May 2015

Signature

Certification by Minister:

Ministers should be prepared to update and amplify the advice below when the submission is discussed at Cabinet/Cabinet committee.

The attached proposal:

Consultation at Ministerial level

- ☐ has been consulted with the Minister of Finance
[required for all submissions seeking new funding]
☒ has been consulted with the following portfolio Ministers:
☒ did not need consultation with other Ministers

Discussion with National caucus

- ☐ has been or ☐ will be discussed with the government caucus
☒ does not need discussion with the government caucus

Discussion with other parties

- ☐ has been discussed with the following other parties represented in Parliament:
☐ Act Party ☐ Maori Party ☐ United Future Party
☐ Other [specify]
☐ will be discussed with the following other parties represented in Parliament:
☐ Act Party ☐ Maori Party ☐ United Future Party
☐ Other [specify]
☒ does not need discussion with other parties represented in Parliament

Portfolio

State Owned
Enterprises

Date

14 / 5 / 2015

Signature

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Treasury Report: Landcorp: 2015/16 Business Plan and Statement of Corporate Intent

Date:	21 August 2015	Report No:	T2015/1795
		File Number:	SE-2-8-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Agree recommendations	28 August 2015
Associate Minister of Finance (Hon Steven Joyce)	For your information	None
Associate Minister of Finance (Hon Paula Bennett)	For your information	None
Minister for State Owned Enterprises (Hon Todd McClay)	Agree recommendations and sign attached letter to Landcorp's Chair	28 August 2015

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Ant Shaw	Senior Analyst, Governance and Performance	s9(2)(k) N/A (mob)	✓
Chris Gregory	Manager, Governance & Performance	s9(2)(a)	

Actions for the Minister for State Owned Enterprises Office's Staff (if required)

Send letter once signed by the Minister for State Owned Enterprises and agreed by the Minister of Finance. Letter needs to be sent between 26 and 28 August, following Treasury providing feedback to Ministers' offices as to whether Landcorp's Board approves the draft SCI at its meeting on 25 August.

Return the signed report to Treasury.

Enclosure: Yes (attached)

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Treasury Report: Landcorp: 2015/16 Business Plan and Statement of Corporate Intent

s9(2)(b)(ii)

The most effective action Landcorp could take would be to sell individual farms on the open market; however this has proven problematic in the past. Alternatively Landcorp could sell farms to the Office of Treaty Settlements (OTS), which has identified specific farms (valued at ~\$30 million) it is interested in purchasing for the use in future Treaty settlements. Discussions have been held between the parties, and we will continue to encourage these discussions. Landcorp has already appropriately taken short-term actions to improve its financial position, including deferring non-essential capital expenditure and reducing operating expenditure (e.g., reducing corporate overheads and reducing expenditure on irrigation and fertiliser).

The sale of farms will provide cash to reduce debt, but (i) may not generate maximum value for the farms, and (ii) will not relieve Landcorp from its current position of generating cash losses due to the impact of the low milk price and its obligations under its Wairakei agreement. s9(2)(b)(ii)

s9(2)(b)(ii)

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s9(2)(b)(ii)

Recommended Action

We recommend that you:

s9(2)(b)(ii)

- d **note** that Landcorp is currently undertaking an internal review of its obligations under its Wairakei agreement, and
- e **agree** that the Minister for State Owned Enterprises, on behalf of shareholding Ministers, signs the attached letter to Landcorp's Chair, Traci Houppapa, requesting the company submits a final copy of its 2015/16 Statement of Corporate Intent for tabling in the House of Representatives.

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister for State Owned Enterprises

Chris Gregory
Manager, Governance & Performance


Hon Bill English
Minister of Finance

Hon Todd McClay
Minister for State Owned Enterprises

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Treasury Report: Landcorp: 2015/16 Business Plan and Statement of Corporate Intent

Purpose of Report

1. s9(2)(b)(ii)
- 

Background

2. Landcorp is likely to face difficult commercial conditions within the next 12 months if the milk price remains depressed and it is unable to sell farms. Landcorp is forecasting debt to increase as a result of cash flows from operations not being sufficient to meet its large capital expenditure commitments in relation to its Wairakei agreement. The company has faced challenges in the past when attempting to sell farms to fund capital expenditure commitments, control debt, and increase returns.


3. s9(2)(b)(ii)
- 

- 4.

Analysis

Business Plan

5. At the time of writing this report, Landcorp's Board has not yet approved the business plan numbers or the numbers included in its draft SCI. Board approval is expected at the next Board meeting on 25 August 2015. We are providing advice ahead of that time to ensure the extended deadline of 31 August 2015 for Landcorp finalising its SCI is met. In the event that material changes to the SCI and/or business plan forecasts are requested by the Board at its meeting on 25 August 2015, a further extension will be required. We will advise your offices if that is the case. We therefore recommend not sending the attached letter until after the Board meets on 25 August 2015 and we have provided your offices with feedback from that meeting.

6. s9(2)(b)(ii)
- 

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7. Landcorp updated its business plan and SCI following Fonterra's announcement on 7 August 2015 of its forecast milk payout for 2015/16 of \$4.15/kg¹. This has been factored into its forecast for 2015/16. s9(2)(b)(ii)

s9(2)(b)(ii)

FINANCIAL STATEMENTS	
Profit & Loss	s9(2)(b)(ii)
Weighted Average Milk payout	
Revenue (\$m)	
EBITDA (\$m)	
EBITDA/Interest (i.e. debt covenant)	
Net Profit after tax (\$m)	
Balance Sheet	s9(2)(b)(ii)
Total Assets (\$m)	
Interest Bearing debt (\$m)	
Total Liabilities (\$m)	
Total Equity (\$m)	
Gearing % (Net debt/net debt + equity)	
Cash Flows	s9(2)(b)(ii)
Net operating in/(out) flows (\$m)	
Net investing in/(out) flows (i.e. net \$m capex after farm sales)	
Net Financing in/(out) flows (i.e. \$m movements in debt)	

s9(2)(b)(ii)

8. Landcorp is predicting milk prices to recover in 2016/17. We have compared Landcorp's milk payout assumptions for 2016/17 and 2017/18 to recently released forecasts from ANZ and ASB. Landcorp's assumptions for 2016/17 and 2017/18 are broadly in line with these forecasts however, Landcorp is slightly more conservative about the 2016/17 payout, but more optimistic about the 2017/18 payout. The associated increase in revenue will be needed to fund the continued capital commitments in relation to its Wairakei agreement and constrain debt levels. If there is no recovery in prices, or a further reduction, it could put the company in a difficult financial position in 2016/17 or earlier, if it is unable to execute contingency plans ahead of that time (see paragraphs 28 to 32 below).
9. Landcorp is forecasting positive net operating cashflows in 2015/16 after factoring in the most recent milk payout forecasts. s9(2)(b)(ii)

s9(2)(b)(ii)

10. s9(2)(b)(ii)

¹ This comprises the forecast farm gate milk price of \$3.85/kg plus forecast dividend of ~30c per share (in line with Fonterra's dividend policy of paying out 70-75% of its earnings per share which is forecast to be between 40 and 50c).

² Landcorp had previously locked in a portion of its production at Fonterra's guaranteed milk price of \$5.25 for the season, and Landcorp also supplies milk to other parties in addition to Fonterra meaning its forecast payout will never correlate exactly to Fonterra's most recent payout forecast (of ~\$4.15/kg).

³ Included within its net capital expenditure forecasts are asset sales of \$25 million, \$19 million of which relates to Whareare farm (refer footnote 6). It does not assume additional farm sales that could be made to OTS etc. which are discussed in paragraphs 26 to 27.

⁴ Total forecast capital expenditure over the life of the lease is \$223 million.

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s9(2)(b)(ii)

11. It is difficult to assess the extent to which its 'stay in business' capital expenditure could be reduced in the event market conditions deteriorate further, however we expect it is unlikely to be material given the fact that Landcorp has advised us that it has already reduced and deferred non-essential capital expenditure in response to the continued drop in milk prices.

12. Landcorp has relatively low gearing, reflecting the value of its significant land assets compared to the value of its debt. s9(2)(b)(ii)

s9(2)(b)(ii)

s9(2)(b)(ii)

13. Whilst Landcorp is acutely exposed to the recent fall in dairy prices, and this exposure will only increase as more of its Wairakei dairy conversions commence production in the coming years, its diversified portfolio of farms does shelter its impact to some extent. At current milk prices, less than 40% of Landcorp's revenue in 2015/16 is forecast to come from dairy. Revenue from its livestock farms makes up most of the balance, and livestock prices have held up well in recent years.

14. s9(2)(b)(ii)

s9(2)(b)(ii)

15. s9(2)(b)(ii)

16.

17.

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27. s9(2)(b)(ii)




Contingency Plans

28. Landcorp has already taken actions to reduce costs including:

- sub-leasing some of the Wairakei properties to third parties (as in the case with its sheep milking joint venture)
- deferring capital expenditure, and
- reducing expenditure on irrigation and fertiliser.

s9(2)(b)(ii)



⁶ The most recent example of this was in 2013, when Landcorp attempted to sell Wharere Farm, in the Bay of Plenty. The sale was challenged by a local Iwi that claimed to have an historic interest in the land. An injunction was put on the sale by the District Court. An appeal was since heard in the High Court, and the case is currently being heard in the Supreme Court. Landcorp has therefore still not received the proceeds from this sale (~\$19 million) however it is forecasting to receive them in 2015/16.

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Capital Structure and Dividends

33. s9(2)(b)(ii)

34.

35.

Statement of Corporate Intent

36. s9(2)(b)(ii)

37.

38. Landcorp's strategy as disclosed in its SCI remains unchanged from last year. Its focus continues to be on the five following areas:

- Volume – expanding the quantity of livestock it is responsible for supplying, in partnership with Maori and others
- Value – extracting as much value from every hectare of farm land as possible
- Efficiency – ensuring the organisation is running cost-effective operations at both the farm and corporate level
- People – leading the industry in people practices, and
- Environment – showcasing the rejuvenation and profitability potential of environmental savvy farming.

39. Whilst the 'volume' strategy noted above could be seen as inappropriate for a company that could be in a difficult financial position in 6-12 months time, this is a long-term objective of the company, and there is no evidence of it pursuing ambitious growth projects in the current environment, outside those that it is already contractually committed to (e.g. Wairakei).

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40. Overall, we are comfortable that the SCI meets the requirements of the SOE Act and is appropriate for tabling in the House of Representatives. We therefore recommend the Minister for State Owned Enterprises signs the attached letter to Landcorp's Chair, requesting her to now provide final copies of the SCI.

Next Steps

41. s9(2)(b)(ii)
42. s9(2)(b)(ii)
- s9(2)(b)(ii) If milk prices do not recover, there is a risk that Landcorp will require additional cash in future years (through further land sales or from other sources) to fund its ongoing Wairakei obligations and potential operating losses. Landcorp's current review of its Wairakei agreement should inform whether there are any mitigation strategies that can be adopted by the company in relation to this agreement. The attached letter requests that Landcorp provides an update to Treasury and Ministers of the outcome of this review.
43. We will continue to work closely with the company, including:
- facilitating further engagement between Landcorp and OTS
 - s9(2)(b)(ii)
 - requesting Landcorp to provide Ministers and Treasury with updated rolling forecasts throughout the year, taking account of changing market conditions.
44. We will keep Ministers updated with developments over the coming months. If Ministers require further time to consider Landcorp's position before finalising its SCI, a further extension could be granted at any time prior to 31 August 2015.

Ms Traci Houpapa
Chair
Landcorp Farming Ltd
PO Box 5349
WELLINGTON 6145

Dear Ms Houpapa

2015/16 STATEMENT OF CORPORATE INTENT AND BUSINESS PLAN

Thank you for providing shareholding Ministers with Landcorp's draft 2015/16 Statement of Corporate Intent (SCI) and Business Plan. We appreciate the effort of the Board and Management in producing these documents.

s9(2)(b)(ii)

s9(2)(b)(ii)

We expect the Board to be developing comprehensive contingency plans for this outcome that are designed to strengthen Landcorp's balance sheet and mitigate against the risk of breaching covenants. Please provide Ministers and Treasury with details of these plans by 31 October. We would expect these plans to be sufficiently advanced for them to be able to be executed well in advance of 30 June 2016, which we understand is likely to be the key date with respect to the testing of banking covenants.

We understand that the Office of Treaty Settlements (OTS) has expressed an interest in purchasing some of Landcorp's farms. We encourage you to continue engaging with OTS as this could provide an opportunity for Landcorp to strengthen its balance sheet, as well as further strengthening Landcorp's, and the Crown's relationships with Iwi.

We recognise the challenges associated with the ongoing capital commitments under Landcorp's agreement with Wairakei Pastoral Limited. We understand that Landcorp is currently undertaking an internal review of its obligations under this agreement and whether there are opportunities to reduce risk. Please provide Ministers and Treasury with the key findings from this review by 31 October 2015, including a further assessment of the possibility of renegotiation of the contract's terms.

To enable Ministers and Treasury to keep abreast of how market conditions are impacting Landcorp's forecast financial position, please provide updated forecasts to Ministers and Treasury as part of your quarterly reporting requirements. Please ensure these forecasts illustrate the likely impact on banking covenants and debt levels.

s9(2)(b)(ii)

s9(2)(b)(ii)

We have no further comments on Landcorp's SCI. Please now send an electronic copy of the final SCI in PDF format to my office on 31 August 2015. Please ensure 50 printed copies of the final SCI are sent to my office, shortly thereafter, for tabling in the House of Representatives, and that the SCI has the appropriate shoulder number affixed to it.

I wish you every success for the year ahead. Please pass on our thanks to the rest of your Board, and the management and staff of Landcorp for their continuing efforts.

Yours sincerely

Hon Todd McClay
Minister for State Owned Enterprises
on behalf of shareholding Ministers

cc: Mr Steven Carden, CEO, Landcorp Farming Ltd



Landcorp Farming Limited
Level 2, 15 Allen Street, PO Box 5349
Wellington 6145, New Zealand
+64 4 381 4050
enquiries@landcorp.co.nz
landcorp.co.nz

7 June 2016

Ant Shaw
Senior Analyst, Governance and Performance
The Treasury
PO Box 3724
WELLINGTON 6140

Dear Ant

Landcorp's Comments on The Treasury's Report on the Capital Structure Review

Further to our recent discussions on Landcorp's proposed capital structure and dividend policy, it was agreed the Treasury's report contains a reasonable summary of the analysis undertaken and our conclusions regarding the appropriate capital structure and dividend policies for Landcorp. However we are concerned with some of the views then expressed by The Treasury, and with its recommendation not to endorse but rather to defer consideration of our proposed dividend policy.

Landcorp's Key Purpose - Establish Guiding Principles Now

Landcorp commissioned Deloitte's review for two main reasons:

- As part of a wider work programme to boost the quality of Landcorp's financial analysis and management and
- To establish some principles to guide capital structure and dividend decisions, s9(2)(b)(ii)

s9(2)(b)(ii)

Considering this second purpose, it is disappointing that The Treasury wishes to defer consideration of the dividend policy s9(2)(b)(ii)

s9(2)(b)(ii)

s9(2)(b)(ii)

Landcorp proactively sought received and invested in robust analysis from Deloitte that has been endorsed by our Board. We seek to establish the capital structure and dividend policies now, so that at each relevant juncture going forward they can efficiently guide our discussions with The Treasury.

Target Debt Level

s9(2)(b)(ii)

The Treasury seems to be confusing the issue of *setting* the target debt level and *managing* actual debt levels towards that target.

Contrary to footnote 2, the target debt level is not reset annually. Rather, for any given scenario regarding the level of business assets

s9(2)(b)(ii)

a target debt profile can be set using the base case assumptions. Each scenario's target debt profile happens to rise from year to year because of our assumptions regarding rising base case output and prices over time. However these profiles will only need to be reset whenever there is a material change to our view of the base case assumptions for the business. (Our base case EBITDA forecasts for the purpose of setting target debt levels should not be confused with our three year SCI forecasts, which are an attempt to forecast *actual* results and will change annually with the budget cycle).

So the (upwardly sloping) target debt level profile for each scenario will be relatively stable in the short-medium term.

s9(2)(b)(ii)

s9(2)(b)(ii)

However all that is required at this stage is to adopt the *principle* of how the target debt level should be set, so that it can be applied to whatever scenario actually eventuates

Dividend Policy

The Treasury is concerned that our proposed dividend policy prioritises approved expansionary capital expenditure over dividends (paragraph 30). s9(2)(b)(ii)

s9(2)(b)(ii)

s9(2)(b)(ii)

s9(2)(b)(ii) Again, what is required at this stage is acceptance that the proposed capital structure rule and dividend policy are appropriate. s9(2)(b)(ii)

s9(2)(b)(ii)

We believe our proposed dividend policy is appropriate for Landcorp, and that it would be inappropriate to elevate dividends above the repayment of debt down to the target level, or above high-returning expansionary projects. The preparation of Landcorp's capital budget will form part of the annual business planning process. That plan could well be a combination of high returning maintenance capex, high returning expansionary capex, and low returning committed (non-discretionary) capex (e.g. WPL), while some low returning maintenance capex might rightfully be deferred. We would continue to consult with Treasury (as is the case now), regarding the capex plan, particularly in relation to new expansionary projects. By its nature the capex plan will be adopted before it is executed, whereas the cash remaining to pay dividends will not be known until the end of the relevant financial period and will be subject to climatic and price variations during the period. In a company with volatile earnings, it makes sense to have dividends as the "residual" payment of remaining cash flow. Elevating dividends above some subset of capex has two main problems:

- As noted above, there is no single capex category that will always contain the inferior options above which dividends would rationally be preferred (e.g. elevating dividends could result in high return expansionary projects being foregone while low returning maintenance capex proceeds);
- It would in effect be an attempt to reduce agency risks by increasing the total quantum of dividends paid, regardless of whether that approach maximises shareholder value.

Our proposal takes a different and new path for an SOE, and one that is appropriate for Landcorp. We propose that:

- Any material new expansionary capex is supported by robust analysis and involves consultation with The Treasury. Rather than relying on the traditional indirect approaches to minimising SOE agency costs (via maximising debt and dividends), Landcorp and The Treasury would engage directly in the relevant debate: the trade-off at the margin between dividends and capex;
- Landcorp commits that, after debt is paid down to the target level and approved capex is funded, it will pay out all surplus cash as dividends; and
- The Crown accepts that those dividends will inevitably be volatile, but benefits from Landcorp's commitment in relation to dividends and from the debt level not being set at an unduly conservative level (taking into account the WPL lease, and reflecting the Board's willingness to tolerate reporting losses periodically).

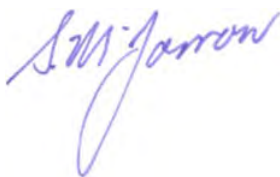
We believe this is a better approach to setting Landcorp's dividends, and reflects our efforts to raise the quality of our financial analysis and management across the board. s9(2)(b)(ii)

s9(2)(b)(ii)

s9(2)(b)(ii)

However our approach involves enhanced levels of engagement with The Treasury. To work properly it therefore requires The Treasury to make the necessary investment to understand our business and investment options, and to understand and embrace the logic of the capital structure and dividend policies being proposed.

Yours sincerely,



Steven McJorow
Chief Financial Officer

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Treasury Report: Landcorp: Capital Structure Review

Date:	16 June 2016	Report No:	T2016/426
		File Number:	SE-2-8-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Note recommendations	None
Associate Minister of Finance (Hon Steven Joyce)	For your information	None
Associate Minister of Finance (Hon Paula Bennett)	For your information	None
Minister for State Owned Enterprises (Hon Todd McClay)	Note recommendations	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Ant Shaw	Senior Analyst, Governance and Performance	s9(2)(a) N/A (mob)	✓

Actions for the Ministers' Offices' Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: [Appendix A: Summary Financial Analysis for Landcorp \(Treasury:3532416v1\)](#)
[Deloitte's Landcorp Capital Structure Review - Final Report \(Treasury:3416678v1\)](#)
[Landcorp letter to Treasury - Capital Structure Review \(Treasury:3529652\)](#)

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Treasury Report: Landcorp: Capital Structure Review

Executive Summary

Landcorp commissioned Deloitte to undertake a review of its capital structure and dividend policy. This report summarises the findings of the review.

Key considerations

Given Landcorp's financial profile (a strong balance sheet with ~\$1.4 billion of equity, but low cash yield), the ability to carry debt is not limited by concerns about the balance sheet gearing ratio but by the risk of interest cover covenant breaches and/or reporting losses in years with low prices and earnings. s9(2)(b)(ii)

s9(2)(b)(ii)

Landcorp has developed a plan to sell 9 non-strategic livestock farms (with a book value of ~\$90 million). Sales will commence at the start of 2016/17 and are expected to be executed by the end of the financial year. We are aligned with Landcorp selling these farms in order to reduce debt.

Proposed Dividend Policy

s9(2)(b)(ii)

An alternative dividend policy could be for Landcorp to pay out a proportion of its cash flows after cash has been applied to maintenance capex, contractually committed expansionary capex, and repayment of debt to the target level. However, Landcorp is not comfortable with such a policy, and has indicated it will take a strong position on this policy. Landcorp argues that under the proposed dividend policy it will only pursue high returning projects and if there are none, the cash will be returned to the shareholder. Landcorp also argues that restricting its ability to invest in value accretive projects (supported by strong business cases) will harm the commercial value of the company and limit its ability to meet its primary objective under

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the SOE Act of being as profitable and efficient as a comparable business that is not owned by the Crown.

We do not recommend Ministerial endorsement of the proposed dividend policy at this time. Doing so could be taken as a message that capital investments with forecast high-returns should be prioritised over dividends, which we expect is not the case.

s9(2)(b)(ii)

Recommended Action

We recommend that you:

s9(2)(b)(ii)

- d **note** that Deloitte recommends Landcorp's dividend policy be the payment of the residual amount left after meeting operating and capital expenditure requirements and paying debt to the target level, and
- e **note** that Treasury does not recommend an endorsement of the dividend policy at this time but that no action is required by Ministers now.

Ant Shaw
Senior Analyst, Commercial Operations - Governance and Performance

Hon Bill English
Minister of Finance

Hon Todd McClay
Minister for State Owned Enterprises

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Treasury Report: Landcorp: Capital Structure Review


Purpose of Report

1. This report advises Ministers of Deloitte's capital structure review of Landcorp. Deloitte's report is attached for your information.

Background

2. Landcorp commissioned Deloitte to undertake a review of its capital structure and dividend policy. The purpose of the review is to determine an appropriate capital structure for Landcorp allowing for the features of the pastoral farming sector. Landcorp is a pastoral farming company with sheep, beef, deer and dairy operations. The company comprises 140 farms over 158,500 hectares.
3. Summary financial analysis for Landcorp is presented in Appendix A. We make the following observations on Landcorp's current financial performance and financial position:
 - similar to other farming businesses, Landcorp generates a low level of cash returns relative to the size of its asset base. The low level of cash earnings is a limitation on Landcorp's ability to service its debt obligations
 - Landcorp's revenue is significantly influenced by underlying commodity prices. There is a high degree of volatility in commodity prices which in turn results in a high level of variability in Landcorp's earnings
 - on the other hand, Landcorp has a high level of fixed costs (i.e. farm labour, maintenance). While there is some degree of discretionary expenditure (i.e. fertiliser, chemicals, supplementary feed), reducing these expenses over the medium term is likely to impact the volume and quality of production. The company's level of capital expenditure is therefore key in managing cash outflow, and
 - Landcorp has taken action to mitigate the level of capital expenditure under the Wairakei Pastoral Ltd (WPL) contract (T2015/2981 refers). s9(2)(b)(ii)

s9(2)(b)(ii)



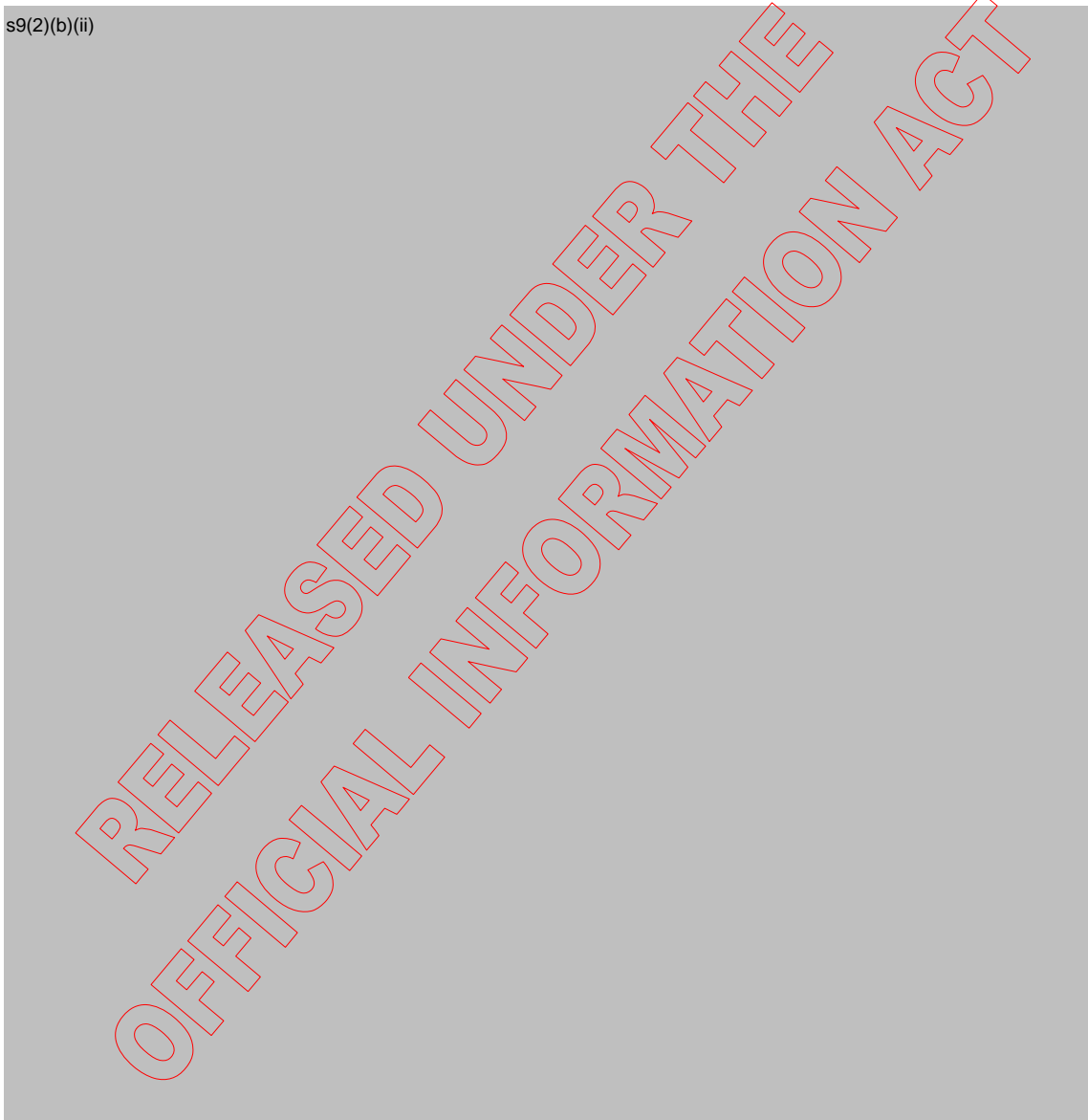
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5. Landcorp has involved the Treasury at key junctures to seek our input. Landcorp's Board discussed the key findings of the review and endorsed them for consultation with Treasury at its February Board meeting.

Key Findings from the Deloitte Review

6. We summarise Deloitte's key findings and recommendations below.

s9(2)(b)(ii)



¹ A new accounting standard is coming into effect from January 2019 that will require future lease costs to be included on a company's balance sheet as a liability. This will have the effect of increasing Landcorp's reported gearing % as a result of the future lease costs associated with the Wairakei Pastoral agreement.

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Pages 6-8 withheld under s9(2)(b)(ii)

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Pages 6-8 withheld under s9(2)(b)(ii)

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Pages 6-8 withheld under s9(2)(b)(ii)

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35. s9(2)(b)(ii)

36. It is also worth noting that per section 13(1)(b) of the SOE Act, Minister may, by written notice to the Board, determine the dividend payable by an SOE in respect of any financial year. While we are not aware of any precedent for use of this power, we frequently make SOEs aware of its existence, and the power is available if required.

s9(2)(b)(ii)

37. Landcorp's response to this report is attached for your information. Whilst the letter is from Landcorp's Chief Financial Officer, Landcorp's Chair, Traci Houpapa, has indicated that it accurately reflects the Board's position.

Next Steps

38. We note the following next steps:

- the Landcorp Board is expected to discuss Treasury's and Ministers' views on Deloitte's recommended capital structure and dividend policy at its meeting on 27 June
- we will work with Landcorp as it implements its Project Emerald which is the sale of 9 livestock farms with a book value of ~\$90 million
- we will provide further advice to Ministers on Landcorp's forecasts for reducing debt and paying dividends once we receive Landcorp's business plan for 2016/17 as part of the Statement of Corporate Intent process, and
- we continue to receive a summary of Landcorp's monthly financial statements and to monitor its debt position.

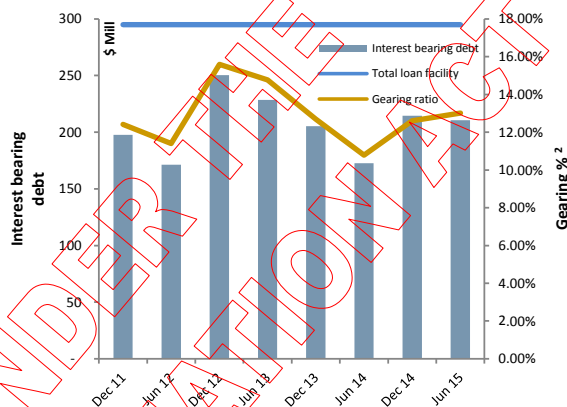
Appendix A: Summary Financial Analysis for Landcorp

1. Interest coverage ratio

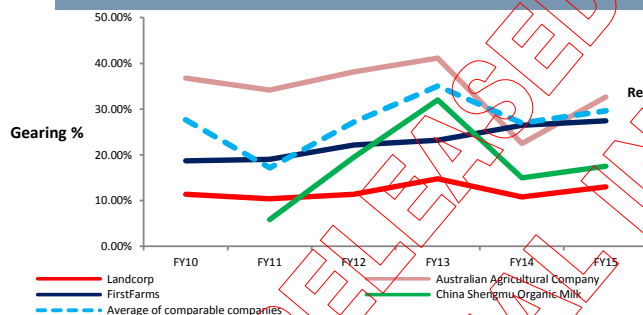
s9(2)(b)(ii)

EBITDA(F)¹
Interest
expense

2. Landcorp's historical debt structure



3. Gearing ratios of comparable companies

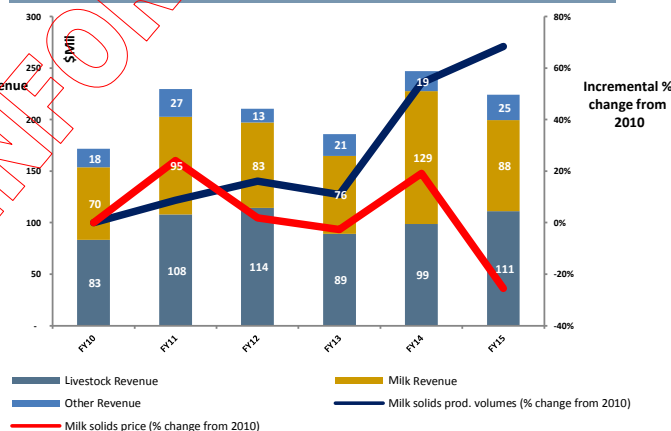


Australian Agricultural Company primarily produces beef products.

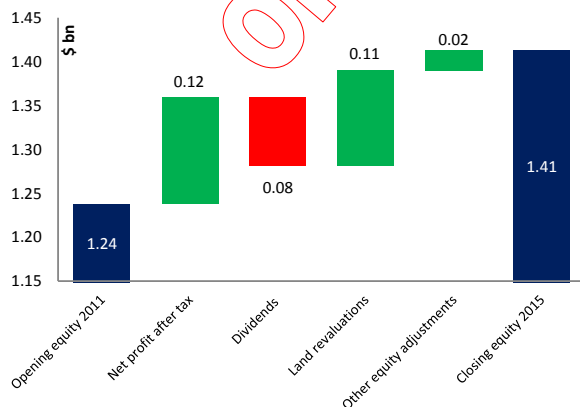
FirstFarms primarily produces milk and other agricultural products in Eastern Europe. FirstFarms' main focus is to operate and develop agricultural areas and not ultimately own them. Therefore, FirstFarms leases a large portion of the land it farms.

China Shengmu Organic Milk engages in the dairy farming and liquid milk businesses in the People's Republic of China.

4. Annual revenue compared to incremental % change in price and production volumes.



5. Movements in equity (2011-2015)



Commentary

s9(2)(b)(ii)

As shown in graph 3 Landcorp historically has maintained a low gearing % (13.01% - June 15) compared to similar companies in the agricultural sector. However,

It should be noted that Australian Agricultural Company (AAC) has not recently been paying a dividend, with no promise of dividends in the near future. We expect it to be unlikely for Landcorp to pay a dividend in the near future either.

The fourth graph shows that Landcorp has, over the last two years, greatly increased its exposure to dairy prices through its ~ 60% increase in the volume of milk solids it has produced. With the sharp downturn in dairy prices in 2014/15 and current prices remaining deflated, Landcorp's generation of free cash flow, needed to service debt, has reduced. This becomes particularly relevant given Landcorp's need to take on additional debt to fund the Wairakei Pastoral conversions. Accordingly, if dairy prices do not increase sufficiently then Landcorp faces the risk of breaching its banking covenants when its banks are likely to reinforce testing from December 2016 (following an 18 month waiver).

The fifth graph illustrates how equity has moved from 2011 to 2015. The increase to equity is ~ split between net profit after tax and land revaluations, however ~ % of net profit after tax has been paid out as dividends.

¹ Earnings before interest tax depreciation amortisation and fair value adjustments.

² Total debt (less cash)/[total debt (less cash) + equity].

³ If Landcorp is required to convert its assets to cash to meet debt payments it may prove difficult, creating additional risk.

Appendix B withheld under s9(2)(b)(ii)

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Treasury Report: Landcorp: 2016/17 Business Plan and Statement of Corporate Intent

Date:	2 August 2016	Report No:	T2016/959
		File Number:	SE-2-8-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Agree recommendations	Tuesday, 9 August 2016
Associate Minister of Finance (Hon Steven Joyce)	For your information.	None.
Associate Minister of Finance (Hon Paula Bennett)	For your information.	None.
Minister for State Owned Enterprises (Hon Todd McClay)	Agree recommendations and sign attached letter to Landcorp's chair	Tuesday, 9 August 2016

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Ant Shaw	Senior Analyst, Governance and Performance – Commercial Operations	s9(2)(k)	N/A (mob) ✓
Chris Gregory	Manager, Governance & Performance – Commercial Operations	s9(2)(a)	

Actions for the Ministers' Offices' Staff (if required)

Send letter once signed by the Minister for State Owned Enterprises and agreed by the Minister of Finance.
Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: Yes (attached)

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Treasury Report: Landcorp: 2016/17 Business Plan and Statement of Corporate Intent

Executive Summary

This report summarises the content of Landcorp Farming Limited's (Landcorp's) Statement of Corporate Intent (SOI) and Business Plan.

We recommend that Shareholding Ministers request the Landcorp Board to reconsider its dividend policy before the SCI may be finalised. We summarise the key issues with the SCI below.


Dividend Policy

We do not believe the proposed dividend policy meets shareholders' expectations. As currently worded, Landcorp is effectively relegating dividend payments as the residual cash payment after all other activities have been funded, including its investment in growth projects. We do not believe this aligns with the shareholders' preference for dividends over re-investment.

We recommend the attached letter be sent to the Chair of Landcorp requesting the Board to amend its dividend policy to one that meets shareholding Ministers' expectations. Landcorp's Board will consider the attached letter at its next meeting on 27 August 2016.

A further extension for the submission of the final SCI to 30 September 2016 is needed to give the Board enough time to consider whether an alternative dividend policy is more appropriate.

s9(2)(b)(ii)



Performance

Landcorp is forecasting increased revenue of 2.6% in 2016/17 driven by increased livestock and milk revenue. However, it is forecasting to make a net loss of \$13 million, largely as a result of the depressed milk price.

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Recommended Action

We recommend that you:

- a **note** that the Minister for State Owned Enterprises previously agreed to an extension to 31 August 2016 for Landcorp to provide shareholding Ministers with its final Statement of Corporate Intent (SCI)
- b **note** that Landcorp has now provided a Board approved draft SCI but the Treasury believes it does not meet shareholders' expectations due to its dividend policy potentially prioritising expansionary investment over the payment of dividends
- c **note** that the Treasury has had a number of discussions with Landcorp regarding its dividend policy, but it has been unwilling to amend it
- d **agree** that Landcorp's SCI as currently drafted does not meet shareholders' expectations
- Agree/disagree.*
Minister of Finance
- Agree/disagree.*
Minister for State Owned Enterprises
- e **agree** that the Minister for State Owned Enterprises signs the attached letter, on behalf of shareholding Ministers, to Landcorp's Chair requesting the Board to reconsider its dividend policy and further extend the date for submission of the final SCI to 30 September 2016, and
- Agree/disagree.*
Minister of Finance
- Agree/disagree.*
Minister for State Owned Enterprises
- f **note** that Treasury recommends holding off sending the attached letter until after shareholding Ministers' meeting with Landcorp's Chair and Chief Executive on 9 August 2016 to give Ministers a chance to discuss the company's dividend policy.

Chris Gregory
Manager, Commercial Operations

Hon Bill English
Minister of Finance

Hon Todd McClay
Minister for State Owned Enterprises

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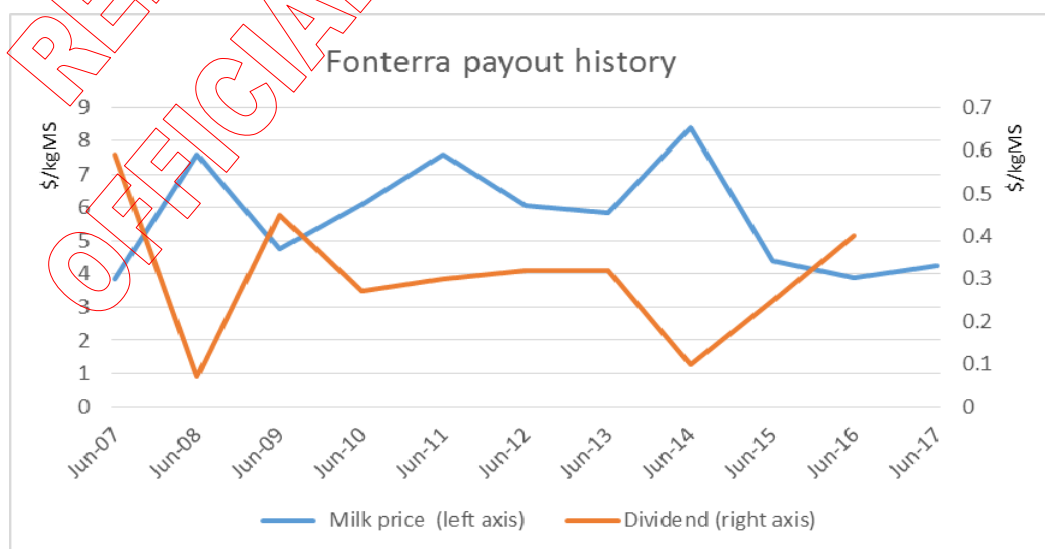
Treasury Report: Landcorp: 2016/17 Business Plan and Statement of Corporate Intent

Purpose of Report

1. This report summarises the content of Landcorp's Statement of Corporate Intent (SCI) and Business Plan.
2. The SCI meets the requirements of Section 14 of the State Owned Enterprises Act (SOE Act), subject to Landcorp (i) finalising its commercial valuation, and (ii) including an additional ratio in the SCI.

Background and Assumptions

3. The Minister for State Owned Enterprises (SOEs) agreed to an extension for Landcorp to provide its final SCI (MC16/061 refers). The final SCI is currently due for submission by 31 August 2016.
4. Landcorp's Board has approved the Business Plan and the draft SCI.
5. Landcorp updated its Business Plan following Fonterra's announcement on 16 May 2016 of its opening forecast milk price for the 2016/17 season of \$4.25/kg of milk solids. As a result Landcorp revised its forecast milk price down from \$4.60 in the earlier version of its Business Plan, to \$4.25¹.
6. Landcorp has forecast a Fonterra dividend payout of 45c for 2016/17. Landcorp's forecast dividend payment is higher than the average payout over the last six years of 26c, however dividend payments are usually higher when the milk price is low which is illustrated by the graph below. This is because when milk prices to farmers are low then Fonterra has low input costs, allowing for greater margins on products sold, and increasing Fonterra's profit which flows through to a higher dividend paid.



¹ This price excludes Fonterra's forecast dividends. It is expected that the forecast dividend per share for the 2016/17 financial year will be released shortly. This, along with the forecast milk price (currently \$4.25 for Fonterra), comprises the total available for payout from Fonterra.

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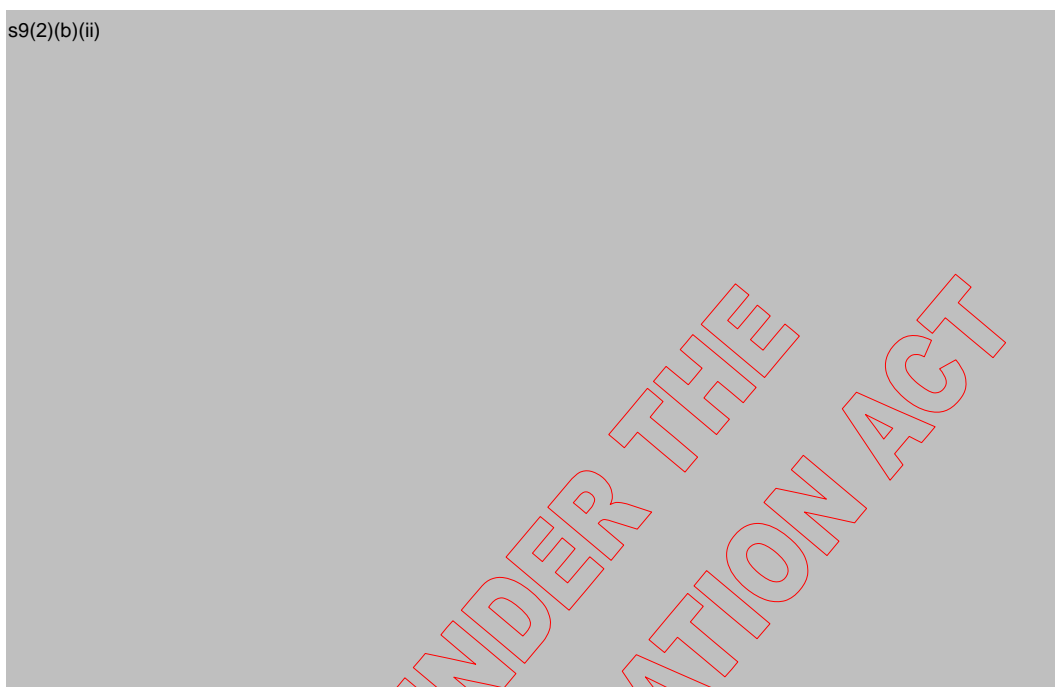
7. The Business Plan and SCI forecasts include the impact of Project Emerald, which is the plan to sell nine non-strategic livestock farms. s9(2)(b)(ii)
s9(2)(b)(ii)
s9(2)(b)(ii) We agree with Landcorp's objective of selling these farms in order to reduce debt.
8. The three out of nine farms included in Project Emerald that are not expected to sell in 2016/17 are North Island farms which the Office of Treaty Settlement has indicated are of potential interest for future Treaty settlements. Landcorp has therefore prudently assumed that the sale of these farms will take longer, and will not be concluded in 2016/17.
9. s9(2)(b)(ii)

Strategy

10. Landcorp's strategy focuses on three broad areas:
- Farming carefully – This involves (i) providing a safe workplace for employees, (ii) increasing animal productivity through animal management and welfare, and (iii) protecting the environment through savvy farming,
 - Farming smartly – This involves (i) using standardised processes and systems to drive best practice and (ii) adopting leading science and technology to improve people, animals and the environment, and
 - Creating value – aimed at extracting as much value from every hectare of farm land by focusing on high value niche markets.
11. In substance Landcorp's strategy disclosed in its SCI remains largely unchanged from last year. This strategy is centred on Landcorp moving up the value chain with the products it supplies. However, the focus areas to achieve this strategy have changed. Landcorp previously focused on 'efficiency' where it wanted to run a cost effective operation. It has now changed that to 'farming smartly' which involves using best practice systems and processes, as well as focusing on innovation. This change indicates that Landcorp is looking for ways it can increase output through implementing new processes rather than just trying to reduce costs. Landcorp has also moved away from the objective of achieving volume in the quantity of livestock that it is responsible for farming. We agree with the removal of this objective as it focuses Landcorp on the wrong types of outcomes, i.e. achieving ambitious growth strategies in a depressed market.
12. We have no particular concerns with Landcorp's strategy as disclosed in its SCI, and discussed above, as at this stage as there is no significant investment planned to implement it in 2016/17. However, this may change in future years, and we also note that the potential financial benefits from its planned move up the value chain remain unclear. It has been noted by Landcorp that that the strategy will take time to materialise into a bottom line impact.

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13. s9(2)(b)(ii)



14. As the initiatives discussed above are not included in the SCI and not intended for the current financial year we have not raised the issues in the attached letter from shareholding Ministers. We intend to have discussions with Landcorp to make sure any future initiatives fit with shareholding Ministers' expectations and will keep Ministers informed of any developments. We believe that by sending the attached letter, shareholding Ministers' expectations will be made clear regarding the expectation that dividends should be prioritised over expansionary investment.

Financial Analysis

15. Landcorp's financial results are extremely sensitive to commodity price movements with Landcorp being particularly exposed to milk price volatility in the 2016/17 financial year. This is accentuated by Fonterra no longer offering the Guaranteed Milk Price (GMP) protection and Landcorp's increased milk production (largely driven by Wairakei Pastoral conversions). Landcorp has estimated that based on its 2016/17 forecast production there is a ~\$4 million revenue impact for each 25c price change from the forecast \$4.25 Fonterra milk price and a ~\$2 million revenue impact for each 2.5% change in production.
16. Landcorp's forecasts for the next three years (including the impact of Project Emerald) are shown here:

FINANCIAL STATEMENTS	2016/17	2017/18	2018/19
Profit & Loss (including Project Emerald)			
Fonterra milk payout ²	s9(2)(b)(ii)		
Revenue (\$m)			
EBITDA (\$m)			
EBITDA/Interest (i.e. debt covenant measure)			
Net Profit/(Loss) after tax (\$m)			

² 65% of Landcorp's milk production is supplied to Fonterra with the remaining 35% split among other suppliers. Therefore Landcorp's forecast farm gate payout will never correlate exactly to Fonterra's farm gate payout.

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Balance Sheet (including Project Emerald)	
Total Assets (\$m)	s9(2)(b)(ii)
Interest Bearing debt (\$m)	
Total Liabilities (\$m)	
Total Equity (\$m)	
Gearing % (Net debt/net debt + equity) ³	
Cash Flows (including Project Emerald)	
Net operating in/(out) flows (\$m)	
Net investing in/(out) flows (i.e. net \$m capex after farm sales)	
Net Financing in/(out) flows (i.e. \$m movements in debt)	

Milk payout

17. The *Fonterra forecast milk payout* (price + dividends) has increased from \$4.35 - \$4.45 per kg of milk solids in the 2015/16 season to \$4.60 - \$4.70 in the 2016/17 season, however there is expected to be very little change between seasons in the average milk payout actually received by Landcorp. This is due to Landcorp having locked in a portion of its production at Fonterra's Guaranteed Milk Price (GMP) of \$5.25 in the 2015/16 season which increased its average price received. Fonterra is not offering the GMP scheme in the 2016/17 season. The average payout *received by Landcorp* is expected to be \$4.60 - \$4.70 for the 2016/17 season compared to an expected average payout of \$4.67 in the 2015/16 season. Landcorp is looking to use the NZX future contracts⁴ in the current season to manage the risk of price fluctuations but its use may be limited by the liquidity in the market.
18. We have compared Landcorp's milk price assumptions of \$4.25 and \$5.00 per kg of milk solids for 2016/17 and 2017/18 respectively to NZX future contracts payouts. The 2016/17 contract has traded at an average price of \$4.53, while the 2017/18 average contract price was \$5.60. Therefore, Landcorp's assumptions for 2016/17 and 2017/18 appear to be conservative. However, what has been made clear recently is that predicting future milk prices is exceedingly difficult with a myriad of different factors influencing price movements.

Revenue

19. Landcorp is forecasting increased revenue in 2016/17 driven by increased livestock and milk revenue. s9(2)(b)(ii)

s9(2)(b)(ii)

s9(2)(b)(ii)

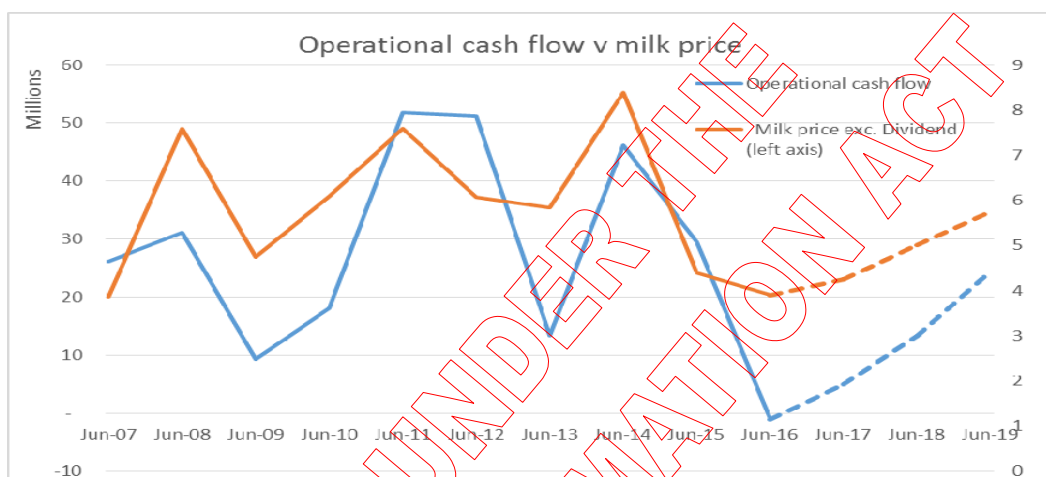
³ s9(2)(b)(ii)

⁴ A futures contract is an agreement to buy or sell a particular commodity or financial instrument at a predetermined price at a specified time in the future. NZX has recently launched NZ milk price futures contracts.

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Cash Flows

33. Landcorp is forecasting positive net operating cash flows in 2016/17 after factoring in the most recent milk payout forecasts. As shown by the graph below; changes in the milk price have become increasingly correlated to Landcorp's operational cash flows as Landcorp's dependence on dairy has increased over the period. Future operational cash flows are forecast to steadily increase in line with an assumed increasing milk price.



Capital Expenditure

34. Landcorp has deferred a number of capital expenditure projects as a result of the fall in forecast milk price⁵. s9(2)(b)(ii)

s9(2)(b)(ii)

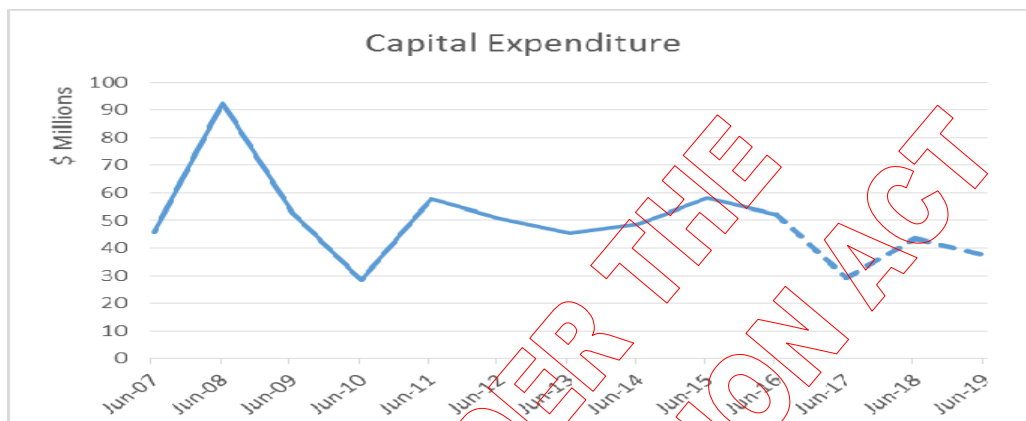
35. Our view is that the forecast capital expenditure for 2016/17 is appropriate given the depressed milk prices and the company's focus on reducing debt levels. However, forecast capital expenditure for years two and three are somewhat "placeholders" and we expect its plans for 2017/18 and beyond to be reassessed next year depending on market conditions and the strength of its balance sheet.

⁵ After Fonterra's opening milk price was released Landcorp revised its forecast milk price down from \$4.60 to \$4.25. This is still an increase from Fonterra's closing price for the 2015/16 season of \$3.90.

⁶ Total forecast capital expenditure over the life of the lease is \$197 million.

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36. The chart below shows Landcorp's capital expenditure over the last nine years, and its forecasts for the next three years. It shows that its forecast expenditure for 2016/17 is its lowest annual amount over that period, but Landcorp's management has assured the Treasury that it has not deferred or cut any capital expenditure relating to farm safety.



Commercial Valuation

37. Landcorp has not yet completed a commercial valuation, which is required to be disclosed in its SCI. Landcorp's commercial valuation is linked to the valuation of its land which is still being finalised for inclusion in its 30 June 2016 financial statements.
38. As at 30 June 2015 the Board estimated Landcorp's commercial valuation at \$1.39 billion which was based on the estimated market value of Landcorp's assets and liabilities at the time. Given the nature of Landcorp's business (i.e. high asset base with relatively low cash flows) we are comfortable with this method of calculating the commercial valuation. s9(2)(b)(ii)
39. s9(2)(b)(ii)

Dividend policy

40. Landcorp's dividend policy as worded in its draft SCI is:
- "Landcorp aims to distribute funds surplus to its ongoing and forecast operational and strategic requirements, subject to meeting its legal requirements. Directors will recommend dividends as are appropriate taking into account Landcorp's current and projected debt levels, projected financial performance, the delivery of the company's business plan and strategy (including capital expenditure plans), and the Board's risk appetite. The level of dividend will be reviewed annually as part of the business planning process and at the end of each financial year. The policy ensures that Landcorp manages its capital structure prudently and **allows for re-investment in accordance with its strategy and approved capital projects, where appropriate**".*

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41. We do not believe the stated dividend policy meets shareholders' expectations. The expectations letter sent to Landcorp earlier this year stated that:

"our preference is for dividends over reinvestment and any alternative capital allocation would require a suitably strong business case".

42. As currently worded, Landcorp is effectively relegating dividend payments as the residual cash payment after all other activities have been funded, including its investment in growth projects. We agree that dividends should be paid after maintenance and contractually committed (i.e. WPL) capital expenditure, and the repayment of debt to the target debt level. However, dividends should be considered in light of the shareholders' preference for dividends over reinvestment and the dividend policy should be worded to that effect.

43. s9(2)(b)(ii)

- 44.

45. We have had a number of discussions with Landcorp's management and its Chair, Ms Traci Houppapa, regarding its dividend policy, but the company has been unwilling to amend it. We therefore recommend a relatively strong worded letter be sent to the Chair, setting out Ministers' expectations and indicating that Ministers will consider using their powers under s13(1)(a) of the SOE Act which allows shareholding Ministers to direct the Board to amend certain aspects of an SOE's SCI, including its dividend policy.

46. s9(2)(b)(ii)

Next Steps

47. Landcorp's Board will consider the attached letter at its next meeting on 27 August 2016. If shareholding Ministers agree with the Treasury's recommendation that a further extension to 30 September 2016 be given for submission of the final SCI, this will give the Board enough time to consider whether an alternative dividend policy is more appropriate. We will provide further advice if and when Landcorp provides an updated SCI.
48. We will continue to work closely with Landcorp, including:

s9(2)(b)(ii)

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Appendix One – Summary of historical and forecast financial statements

NZD (000)	Actual						s9(2)(b)(ii)
	30-Jun-10	30-Jun-11	30-Jun-12	30-Jun-13	30-Jun-14	30-Jun-15	
Income Statement							
Revenue	171,672	229,727	210,541	185,800	247,000	224,100	
Earnings Before Interest Tax Depreciation Amortisation and Fair value adjustments (EBITDAF)	35,755	76,382	47,404	20,000	54,400	30,700	
Net Profit Before Tax (NPBT)	(2,373)	127,381	(17,726)	(19,300)	71,100	(24,400)	
Net Profit After Tax (NPAT)	(5,841)	114,592	(9,414)	(18,000)	54,700	(20,000)	
Revenue - Breakdown							
Livestock Revenue	83,469	108,093	114,323	89,100	98,700	111,300	
Milk Revenue	70,193	94,615	82,989	75,800	129,000	88,100	
Other	18,010	27,019	13,229	20,900	19,300	24,700	
Balance Sheet							
Total Current Assets	102,874	143,483	116,476	198,800	155,400	126,200	
Fixed assets	1,156,295	1,217,077	1,195,520	1,217,300	1,276,700	1,349,500	
Other non-current assets	262,780	302,413	350,888	278,100	316,400	299,000	
Total Non-Current Assets	1,419,075	1,519,490	1,546,408	1,495,400	1,593,100	1,648,500	
Total Assets	1,521,949	1,662,973	1,662,884	1,694,200	1,748,500	1,774,700	
Total Current Liabilities	24,293	28,737	41,860	30,700	39,900	43,400	
Interest-bearing debt	160,877	157,200	171,300	228,400	172,600	210,700	
Other non-current liabilities (Redeemable Preference Shares)	100,408	125,409	117,755	117,800	107,700	107,700	
Total Non-Current Liabilities	260,485	282,609	289,055	346,200	280,300	318,400	
Total Liabilities	284,778	311,346	330,915	376,900	320,200	361,800	
Total Equity	1,237,171	1,351,627	1,331,969	1,317,300	1,428,300	1,412,900	
Cash Flow Statement							
Net Cash Flows in/(out) from Operating Activities	18,085	51,843	51,127	13,400	46,200	29,500	
Investing activities							
Total Capital Purchases	(40,938)	(65,007)	(56,644)	(74,400)	(50,000)	(65,100)	
Total Capital Sales	55,941	5,753	19,027	22,600	65,800	4,500	
Net Cash Flows in/(out) from Investing Activities	15,003	(59,254)	(37,617)	(51,800)	15,800	(60,600)	
Financing activities							
Dividends Paid	(10,000)	(18,000)	(27,500)	(20,000)	(5,000)	(7,000)	
Debt Drawdowns/(Repayments)	(22,400)	25,147	14,100	57,100	(56,000)	38,100	
Net Cash Flows in/(out) from Financing Activities	(32,400)	7,147	(13,400)	37,100	(61,000)	31,100	
Total Cash in/(out) Flow	688	(264)	110	(1,300)	1,000	-	

Ms Traci Houpapa
Chair
Landcorp Farming Ltd
PO Box 5349
WELLINGTON 6145

Dear Ms Houpapa

2016/17 STATEMENT OF CORPORATE INTENT AND BUSINESS PLAN

Thank you for providing shareholding Ministers with Landcorp Farming Ltd's (Landcorp's) draft 2016/17 Statement of Corporate Intent (SCI) and Business Plan.

The dividend policy included in the draft SCI does not meet our expectations. As currently worded, dividends appear to be the residual payment after the company has made investments in accordance with its strategy outlined in its Business plan. This does not provide us with sufficient confidence that dividends will be paid.

We agree that maintenance capital expenditure, Wairakei Pastoral (i.e. pre-committed) investment, and the repayment of debt to the target level should be prioritised over dividends. However, as we have communicated in our Letter of Expectations (dated 01 December 2015), we have a preference for dividends over investment in growth or diversification projects.

Section 7.6.2 of the Owner's Expectations Manual provides guidance to State Owned Enterprises on what we consider to be an appropriate dividend policy. A dividend policy that sets dividends as a percentage of cash flows ensures that dividends are prioritised ahead of growth investment. Such a policy does not preclude investment in growth or diversification projects, but we would expect a very high threshold to be met when considering such investments.

As you will appreciate, the Government has numerous demands on where to invest its capital, most of which are a higher priority than reinvestment in its commercially focussed businesses. We therefore expect SOE Boards to be

conscious of the wider environment they are operating in, and make decisions regarding the use of capital on that basis.

Therefore, shareholding Ministers agree to further extend the deadline for Landcorp to submit its final SCI to 30 September 2016 in order for the Board to consider the comments in this letter. In order to meet this extended deadline, and to provide sufficient time for Ministers and the Treasury to consider the document, a Board approved draft SCI will need to be submitted to Treasury's Commercial Operations group by 15 September 2016.

Please note that should the SCI still not meet our expectations following consideration of this letter, we may decide to use our powers under s13(1)(a) of the SOE Act which allows shareholding Ministers to direct the Board to amend certain aspects of an SOE's SCI, including its dividend policy.

We are comfortable with the remainder of the SCI, and we look forward to receiving an updated SCI with an amended dividend policy that meets our expectations

Yours sincerely

Hon Todd McClay
Minister for State Owned Enterprises
on behalf of shareholding Ministers

cc: Mr Steven Carden, CEO, Landcorp Farming Ltd

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Treasury Report: Landcorp 2016/17 Updated Statement of Corporate Intent

Date:	19 September 2016	Report No:	T2016/1646
		File Number:	SE-2-8-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Agree recommendations	Tuesday, 27 September 2016
Associate Minister of Finance (Hon Steven Joyce)	For your information	N/A
Associate Minister of Finance (Hon Paula Bennett)	For your information	N/A
Minister for State Owned Enterprises (Hon Todd McClay)	Agree recommendations and sign attached letter to Landcorp's chair	Tuesday, 27 September 2016

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
s9(2)(g)(i)	Analyst, Governance and Performance – Commercial Operations	s9(2)(k)	N/A (mob) ✓
Chris Gregory	Manager, Governance and Performance – Commercial Operations	s9(2)(a)	

Actions for the Minister's Office Staff (if required)

Send letter once signed by the Minister for State Owned Enterprises and agreed by the Minister of Finance.
Return the signed report to Treasury.

Note any feedback on the quality of the report

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Enclosure: Letter to Landcorp's Chair (attached)
[2016 SCI - Final to Treasury 150916 \(002\) \(Treasury:3585741v1\)](#)

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Treasury Report: Landcorp 2016/17 Updated Statement of Corporate Intent

At a Glance

This report updates shareholding Ministers' on Landcorp Farming Limited's (Landcorp's) revised Statement of Corporate Intent (SCI), and recommends that the Minister for State Owned Enterprises' (SOEs) signs the attached letter to Landcorp's Chair, requesting Landcorp to provide 40 copies of its final SCI for tabling in the House of Representatives.

Dividend Policy

Landcorp has updated its SCI as a result of a letter sent from the Minister for SOEs in response to its initial draft SCI advising that the dividend policy did not meet shareholding Ministers' expectations (T2016/959 refers). We are comfortable that Landcorp's amended dividend policy now meets shareholders' expectations.

Landcorp's initial draft dividend policy was worded as follows:

"Landcorp aims to distribute funds surplus to its ongoing and forecast operational and strategic requirements, subject to meeting its legal requirements.

Directors will recommend dividends as are appropriate taking into account Landcorp's current and projected debt levels, projected financial performance, the delivery of the company's business plan and strategy (including capital expenditure plans), and the Board's risk appetite. The level of dividend will be reviewed annually as part of the business planning process and at the end of each financial year. The policy ensures that Landcorp manages its capital structure prudently and allows for re-investment in accordance with its strategy and approved capital projects, where appropriate".

The concern we had with this dividend policy was that dividend payments would be relegated to the residual cash payment after all other activities had been funded, including its investment in growth and diversification projects. Our view was that dividends should be considered in light of the shareholders' preference for dividends over reinvestment and the dividend policy should be worded to that effect.

Landcorp has taken into consideration shareholding Ministers' expectations and updated its dividend policy. Landcorp's updated dividend policy is:

Directors will consider dividends after achieving a target debt level consistent with the Board's risk appetite. Assuming the target debt level is achieved then Landcorp aims to pay Net Cash Flows From Operating Activities, less:

- *maintenance capital expenditure; and*
- *contractually committed capital expenditure.*

Investment in new business opportunities will be considered in light of the Shareholder's preference for dividends over new investment. The level of forecast dividend will be reviewed annually as part of the business planning process and at the end of each financial year. This policy ensures that Landcorp manages its capital structure prudently and allows for re-investment in accordance with its strategy, where appropriate.

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We believe that the new dividend policy is more aligned with shareholding Ministers' expectations.

The dividend policy will prioritise reducing debt to an acceptable level, paying for maintenance capital expenditure and contractually committed capital expenditure (such as for Wairakei Pastoral Limited) over paying dividends. We believe this is appropriate as this expenditure is required for Landcorp to maintain its current level of operations.

However, if Landcorp wants to invest in projects with the aim of expanding or diversifying its operations the Board must consider whether the investment should be prioritised over the shareholders' preference for dividends. This encourages the Board to give consideration to the public environment that Landcorp operates in, the continuous demand on capital that the Government faces, and as a result, the value that shareholding Ministers' place on receiving dividends ahead of capital being used for expansionary investment.

Landcorp has also agreed to lower the threshold for consultation with shareholding Ministers' from any investment over \$50 million to any investment over \$20 million.

Our view is that the amended dividend policy, coupled with the lower consultation threshold, will facilitate more robust discussions around the most appropriate use of Landcorp's capital.

While low commodity prices persist, it is unlikely that Landcorp will generate sufficient cash from operations to pay a dividend. However, Landcorp has announced its intention to sell nine farms. In the first instance the proceeds from the sales are likely to be used to reduce debt, however in the circumstances that there is surplus cash after Landcorp has reduced debt the revised dividend policy will become relevant.

Commercial Valuation

The Board considers the commercial value of Landcorp to be \$1.41 billion as at 30 June 2016. This is largely unchanged from last year's commercial valuation of \$1.39 billion. The commercial value has been determined using the 'Net Assets' approach (i.e. the market value of Landcorp's assets less the market value of its liabilities as at 30 June 2016). We believe that this approach is appropriate as it best captures the value of the land assets that underpin Landcorp's business operations.

Next Steps

We recommend the attached letter be sent to the Chair of Landcorp asking the Board to now submit final copies of the SCI for presenting to the House of Representatives.

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Recommended Action

We recommend that you:

- a. **note** that shareholding Ministers' previously agreed to an extension to 30 September 2016 for Landcorp to submit its final Statement of Corporate Intent (SCI),
- b. **note** that Landcorp has provided a Board approved draft SCI that contains an updated dividend policy and consultation threshold which the Treasury believes meets shareholders' expectations,
- c. **agree** that Landcorp's updated SCI meet shareholders' expectations, and
- | | |
|------------------------|--------------------------------------|
| <i>Agree/disagree.</i> | <i>Agree/disagree.</i> |
| Minister of Finance | Minister for State Owned Enterprises |
- d. **agree** that the Minister for State Owned Enterprises signs the attached letter, on behalf of shareholding Ministers, to Landcorp's Chair requesting the Board to now submit final copies of its SCI for presenting to the House of Representatives.
- | | |
|------------------------|--------------------------------------|
| <i>Agree/disagree.</i> | <i>Agree/disagree.</i> |
| Minister of Finance | Minister for State Owned Enterprises |

Chris Gregory
Manager, Governance and Performance – Commercial Operations

Hon Bill English
Minister of Finance

Hon Todd McClay
Minister for State Owned Enterprises

Ms Traci Houpapa
Chair
Landcorp Farming Ltd
PO Box 5349
WELLINGTON 6145

Dear Ms Houpapa

UPDATED 2016/17 STATEMENT OF CORPORATE INTENT

Thank you for taking into consideration shareholding Ministers' expectations when updating the 2016/17 Statement of Corporate Intent (SCI).

We are comfortable that the updated dividend policy now meets our expectations.

Please now send an electronic copy of the final SCI in PDF format to my office by 30 September 2016. Please ensure 40 printed copies of the final SCI are sent to my office, shortly thereafter, for tabling in the House of Representatives, and that the SCI has the appropriate shoulder number affixed to it.

We are encouraged by the steps Landcorp is taking to manage the company's financial stability in difficult market conditions, in particular the plans to sell non-strategic farms, the deferral of non-essential capital expenditure, the prudent management of operating costs, and the reassessment of future plans on the Wairakei Estate. In this regard please keep the Treasury informed of progress over the coming months.

I wish you every success for the year ahead. Please pass on our thanks to the rest of your Board, and the management and staff of Landcorp for their continuing efforts.

Yours sincerely

Hon Todd McClay
Minister for State Owned Enterprises
on behalf of shareholding Ministers

cc: Mr Steven Carden, CEO, Landcorp Farming Ltd