Savings and the Equity Market

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Submission to the Savings Working Group

JBWere Investment Strategy Group

Strategist: Bernard Doyle
+64 9 357 3297
bernard.doyle@jbwere.com

Backdrop: The Domestic Equity Market is Losing Critical Mass

- **Shallow domestic capital markets are interlinked with a lack of investor sophistication, and consequently, poor savings decisions. This is an unmeasurable but obvious cost to the economy.**
- **The current lack of IPO's, waning international investor interest, and poor market liquidity are not simply a post-recession pause. They are indicative of an equity market in structural decline, which has become self-perpetuating.**
- **Left alone, we believe the domestic equity market is likely to decline to the point where its role in the economy is greatly diminished. With that, the potential role the domestic equity market can play in improving the quality and flow of savings in the New Zealand economy will also be deeply impaired.**

Policy Recommendations: Improved savings will require improved ways to save

- **We see considerable scope for public policy to both improve the quality of savings behaviour and return the domestic equity market to a self-sustaining development path.**

1. Support the "Sophisticated Co-Investor". Recommence NZ Superannuation Fund Contributions

- The Government should recommence contributions to the NZ Superannuation Fund, even at a much reduced rate of fundsflow.
- The Government could use funds from SOE sales to make contributions to the NZ Superfund. This "capital account" transaction would be conceptually equivalent to a diversification of the Crown's investment portfolio.
- The NZ Superannuation Fund's mandate should include an allocation toward cornerstone (>10%) stakes in strategic domestic assets (airports, banks, ports).

2. Strengthened National Interest provisions

- New Zealand needs to drop its peculiarly New Zealand attitude of not offending the overseas investment community. Most other advanced economies behave in an overtly self-interested manner when it comes to ownership of strategic assets.
- OIO application needs to specifically target the impact on New Zealand's capital markets. For example, extra credit given to OIO applications that specifically commit to participation in the domestic capital market.

3. The Government proactively seeks local listings from the mature unlisted sector

- Government can identify and remove impediments to large scale local listings with a strategic flavour. The listing of the NZ arm of one of the major Banks, for example would be large, complex transaction that would benefit from the positive involvement of Government.

4. Partial sell-down of State Owned Enterprises

- The Government needs to seek partial listings of non-core State Owned Enterprises (eg Air NZ, Solid Energy).
- The Government should investigate mechanisms to maximise domestic investor participation in SOE floats. Moreover ownership caps can be used to ensure long term NZ control.

5. An element of compulsion introduced into Kiwisaver

- Kiwisaver needs a element of compulsion, to ensure the scheme's critical mass is secured over its development phase.
- Compulsion will give industry participants reliant on Kiwisaver the confidence to make long term investment in the sector. It is also an efficient way of boosting financial literacy across a broad population base.

1.0 An Unsated Home Bias: The Capital Market and Savings Behaviour

"companies list on the exchange that raises the capital required at the least cost. In general, this will be where the company has a strong market presence and a good reputation so that investors are familiar with their product or services, and where there is good analyst coverage of their sector – generally their domestic market.

This is the phenomenon of 'home bias'"[1]

1.1 Home bias shows up one way or other

- Home bias is the well established preference of individuals to invest in their domestic market.
- In New Zealand, equity home bias suffered a setback following the 1987 sharemarket crash. This took a disproportionate toll on NZ investors, with 10 years for full capital recovery.
- Consequently a generation of New Zealanders have regarded equities as excessively risky. Risky capital subsequently found a home in finance companies and/or direct property.
- In other words, home bias will see capital allocated locally. Where it ends up and whether risks are efficiently priced or not is another matter.

1.2 Domestic Equities have a role to play in improving savings behaviour

- Domestic equities play an important role as a viable alternative for "at risk" investment capital.
- Our research shows retail investor ownership of the New Zealand market has held its own, rising from 17% to 23% of the NZ equity market from 1997 to 2010.

Ownership Structure of NZSX Primary Listed Stocks since 1997

	Dec-97	Dec-98	Dec-99	Dec-00	Dec-01	Mar-03	Mar-04	Mar-05	Mar-06	Mar-07	Jun-09	Jun-10
NZ Managed Funds	14.0%	15.2%	14.6%	16.1%	15.1%	14.2%	16.1%	15.6%	16.7%	15.8%	19.1%	19.8%
NZ Strategic Stakes	9.9%	9.8%	10.0%	13.3%	16.6%	18.1%	15.1%	17.1%	16.0%	16.6%	21.1%	20.7%
Offshore Strategic Stakes	29.4%	27.0%	23.2%	21.8%	24.9%	18.9%	16.5%	15.9%	12.0%	13.2%	15.2%	13.1%
Other Offshore Owners	30.9%	28.1%	31.3%	25.4%	22.1%	26.5%	29.5%	28.4%	29.4%	25.9%	22.9%	23.1%
NZ Retail Investors	15.8%	19.9%	21.0%	23.5%	21.3%	22.3%	22.7%	23.0%	26.0%	28.4%	21.7%	23.3%
Total Foreign Ownership	**60.3%**	**55.1%**	**54.5%**	**47.2%**	**47.1%**	**45.4%**	**46.0%**	**44.3%**	**41.4%**	**39.1%**	**38.1%**	**36.2%**

Source: GS&PNZ Research estimates, RBNZ

- Accordingly there remains a role to play for local equity markets as a relatively structured and efficient outlet for domestic investor home bias.
- We concur with the NZ Treasury that shallow domestic capital markets are interlinked with lack of investor sophistication. This is an unquantifiable but obvious cost to the economy.
- In our business, participation in local bond or equity markets is often a stepping stone into an orthodox, global diversified investment portfolio.
- **In other words, our experience is that local equities play an important role in satisfying investors' home bias, but also as an entree into balanced investing.**
- In the words of last years Capital Markets Development Taskforce: "a focus on domestic capital market development (is) an integral part of our economic growth strategy".[2]

1.3 Domestic Equities have a role to play in improving capital allocation

- The role of New Zealand's equity market in the economy has declined steadily over the past 15 years.
- The downstream impact of this decline will manifest slowly over time. We believe the dearth of new listings is both a symptom and a cause of the reduced role of the equity market.

[1] UK Competition Commission, "A Report on the proposed acquisition of London Stock Exchange plc by Deutsche Borse AG or Euronext NV", November 2005, p30
[2] "Capital Markets Matter", Report of the Capital Markets Development Taskforce, December 2009, p9

Source: Datastream

- Other countries' home bias (UK investors prefer to invest in the UK, Australians in Australia and so on), makes it more expensive for local companies to access capital outside their home market. A healthy domestic equity market mitigates this cost.

- Accordingly the declining role of the domestic market has unquantifiable negative spillovers. However we believe the impact is magnified by New Zealand's reliance on Small and Medium Enterprises (SMEs).

- The default exit path for medium sized enterprises is via trade sale, usually to international investors. Our Private Wealth business is introduced to many domestic investors who have exited businesses in the $10-$50m equity value range.

- Many of these firms are unknown to most New Zealanders, and are sold directly to international trade buyers.

- In our view, the lack of a vibrant domestic equity market means an alternative development path is precluded, thus a loss of growth options to the New Zealand economy and investor base.

- It is also likely that a lack of a domestic capital market development path means poor pricing tension is applied to early stage growth options.

- A further consequence of a weak domestic capital market is an impediment in the step from medium to large enterprise; or NZ focussed company to a company with trans-Tasman presence (Cavalier Carpets, Hallenstein Glasson, Pumpkin Patch, Infratil).

- The outbound migration of corporate head offices, senior management, and capital market expertise (analysts, traders, fund managers) are other symptoms of the weakening role of the equity market in the economy.

- The hollowing out of the capital market skill-set cannot be a positive trend for capital allocation and savings behaviour.

- The UK Competition Commission canvassed the reasons UK companies sought listing, and found the majority (~70%) were aiming *"to raise funds to continue growing the business".* Moreover the Commission found that there was limited substitutability between listed equity capital and other forms of capital:

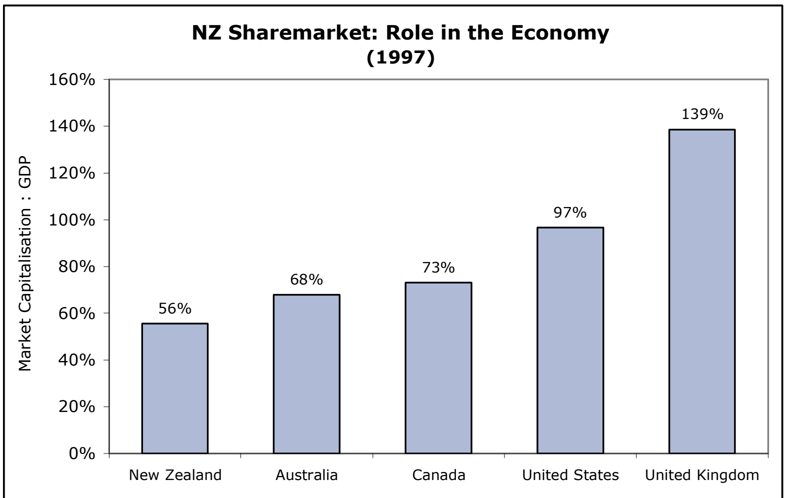
  "*We considered whether, in cases where raising funds was the primary purpose of a listing, alternative sources of finance were equally substitutable. We conclude, however, that this is unlikely to be the case: there are limits to the substitutability of debt for equity, and other sources of equity may place constraints on owners, for example, by providing a less liquid form of capital than an equity listing, or resulting in the imposition of both constraints and pressures that would not result from an IPO." (Ibid p 29)*

- **In summary, the declining role of NZ equities in the economy not only reflects and influences savings behaviour. It also reflects and influences the evolution of businesses most likely to drive economic growth and future wealth generation.**

2.0 The Current State of New Zealand's Equity Market

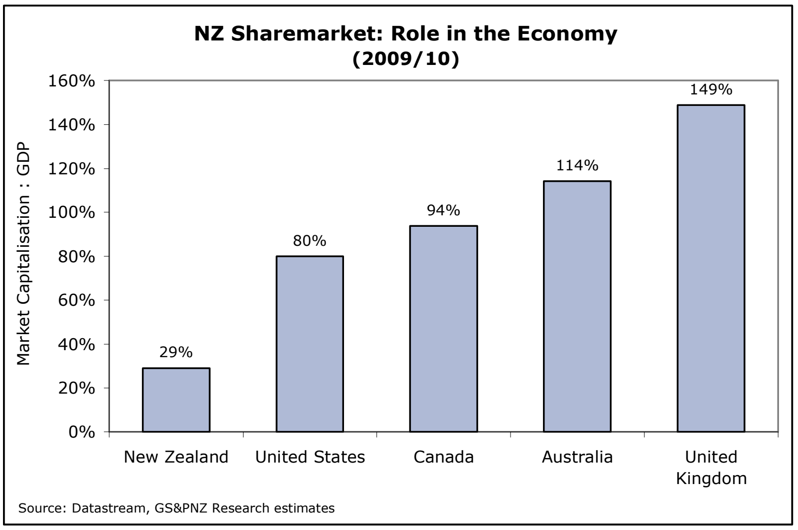
2.1 The New Zealand Equity Market is Losing Critical Mass

- The New Zealand equity market is close to losing the critical mass required to function as a stand alone entity.
- 15 years ago the NZ equity market's share of GDP was within range of our advanced economy peers, and close to Australia (56% versus 68%).



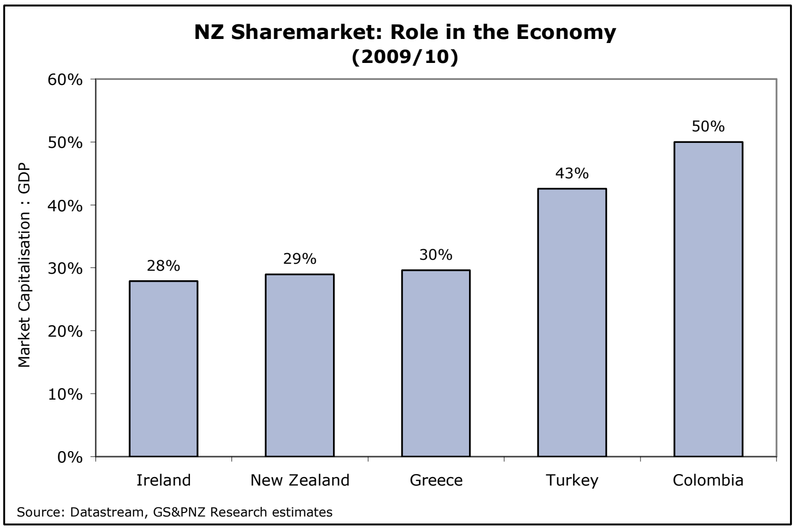
Source: Datastream, GS&PNZ Research estimates

- NZ's share has dropped to 29%, while our advanced economy peer group has grown. This snapshot probably flatters NZ post credit crisis, which unlike other advanced economies has no listed finance sector.



Source: Datastream, GS&PNZ Research estimates

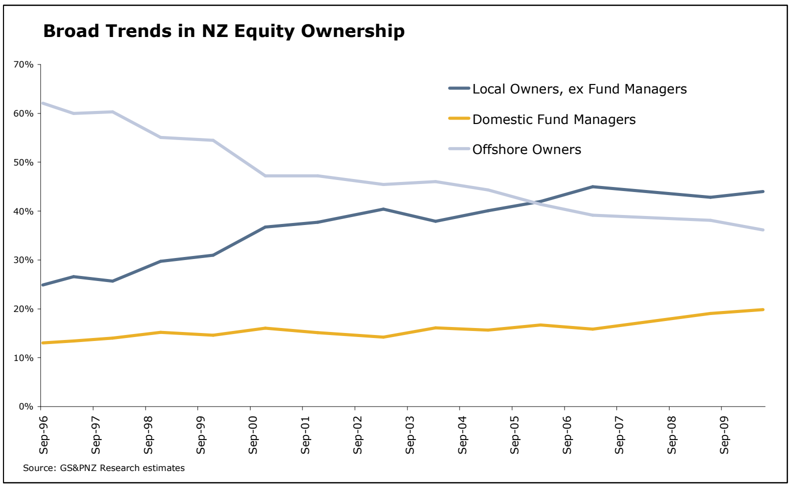
- Two types of economies tend to have an equity share of GDP at around the 25%-50% level: emerging economies (eg Colombia, Turkey); or advanced economies in a downward spiral (eg Ireland, Greece).



- In other words, 30% is unlikely to be an equilibrium level of market participation in the economy. This is an "up or out" position.

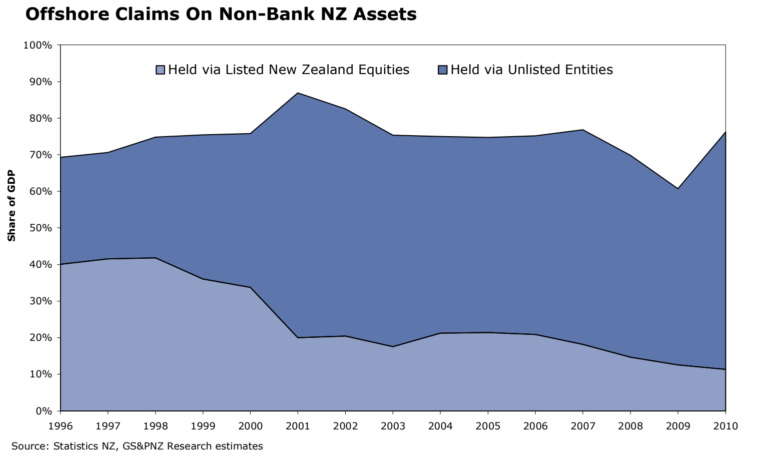
2.1 Approaching the Corner Solution: When strategic buyers meet portfolio sellers

- Offshore ownership has been in steady decline in the New Zealand market. The slack has been taken up by increased ownership from domestic managed funds and retail investors.



- However this trend needs to be seen in the context of the equity market's shrinking role in the economy. Accordingly the dominant trend is not who owns this shrinking pool. The dominant trend is the shift of ownership from the listed sector to the unlisted sector.

- Seen in this context, offshore investment in non-bank assets has remained steady as a proportion of GDP. However the nature of ownership is now primarily via the unlisted sector.



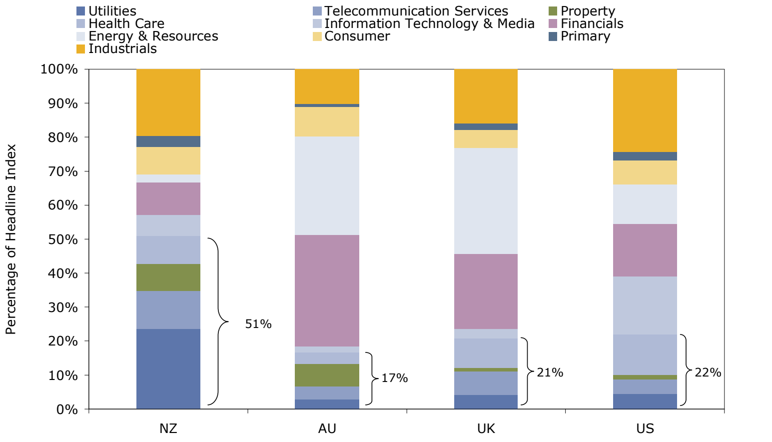
Source: Statistics NZ, GS&PNZ Research estimates

- We see no single driver of this trend. But we can make some observations that might explain some of the dynamics:

1. NZ is attractive destination for trade buyers (long term owners with existing industry involvement, an example being Holcim's ownership of Milburn cement).

2. Key to this is the monopoly, duopoly, and oligolpoly market structure that is prevalent in our economy. Moreover these companies are bite sized assets (or smaller) for international trade buyers.

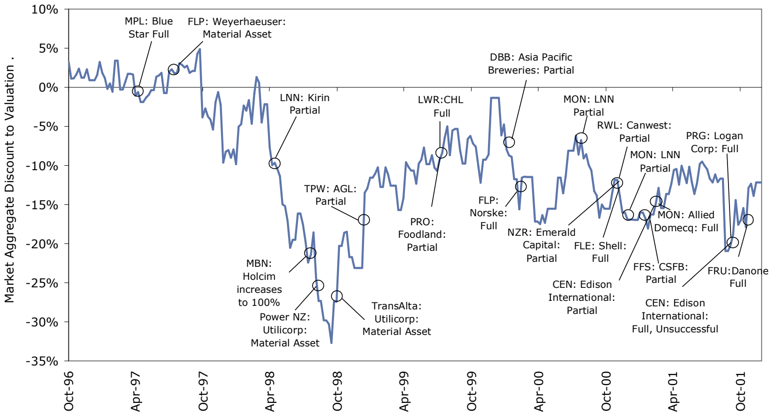
3. Linked to market structure, defensive sectors tend to be over-represented by our listed sector (51% of the market, below). These assets are long duration, with lower growth (Sky City, Telecom, Auckland Airport, Vector).



Source: GS&PNZ Research estimates, Bloomberg

4. Against that, the NZD is a high beta commodity currency that will occasionally provide attractive entry points to international investors. The 2000-01 period was one such episode where a low dollar contributed to elevated takeover activity.

M&A Activity Around Deep Value



Source: GS&PNZ Research estimates

5. NZ's history of weak savings flows has meant fund-starved domestic institutions have been poorly positioned to have a longer time horizon than strategic buyers. In other words relative performance seeking portfolio sellers have generally folded when a trade buyer arrives on the register.

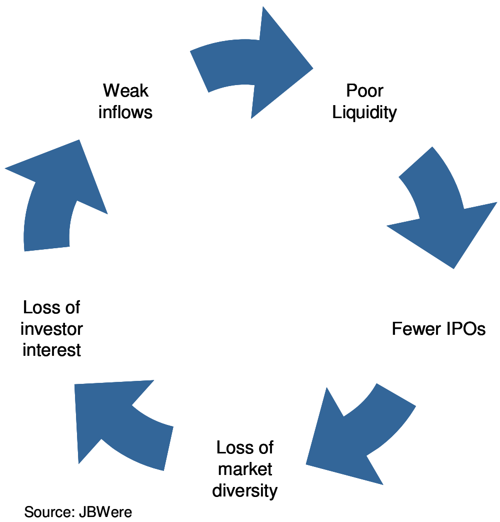
- In short, NZ's market structure, size, weak funds flow and occasionally cheap currency has combined to create a one way flow of the listed sector into the unlisted sector, usually via an international trade buyer.

- Our observation is that the current lack of IPO's, waning international investor interest, and poor liquidity are not simply a post-recession pause. They are indicative of an equity market in structural decline, which has become self-perpetuating.

- This is similar to the vicious circle highlighted by the Capital Markets Development Taskforce. [3]

- **Our industry experience suggests this cycle is more advanced than many outside observers perceive. The transition from slow steady decline to a rapid, irreversible wind-up may prove surprisingly rapid.**

An Equity Market Losing Critical Mass



Source: JBWere

[3] "Capital Markets Matter", Report of the Capital Markets Development Taskforce, December 2009, p59

3.0 Making domestic capital markets a Public Policy priority

3.1 New Zealand needs to decide whether it wants a domestic capital market

- Left alone, we believe the domestic equity market is likely to decline to the point where its role in the economy is greatly diminished.

- Against that, the domestic bond market shows that even a small, retail heavy market, can provide capital at a competitive price to the corporate sector.

- This undermines the notion that lack of scale is an impassable barrier for the equity market's survival. There is no reason a well structured, small, effective equity market cannot grow in line with, and assist the development of, the New Zealand economy.

- Policy makers need to decide whether a domestic equity market is a policy priority. We see it as highly improbable that the equity market can recover critical mass without public policy support.

- In the context of the Savings Working Group, the question becomes whether a domestic equity market can play a role in improving the quality and flow of savings in the New Zealand economy.

3.2 In contrast to peers, New Zealand's Public Policy stance has historically been unsupportive of domestic equities

- Historically, public policy has contributed to the declining role of the equity market in the economy, via:
    1. A ***tax regime*** that for many years discouraged equity investment, particularly via managed funds. Conversely property investment was implicitly encouraged.
    2. ***Public ownership*** of assets that would normally reside, at least partially, in the primary sector.
    3. A relatively passive approach to ***savings policy***, in contrast to other advanced economies.

- Australia provides a contrasting picture of the role of public policy in supporting the role of the equity market in the economy:
    1. The "Four Pillars" bank regime either actively (1990-1997) or passively (1997-present) neutralised the prospect of offshore takeover.[4]
    2. In 2001 the Howard Government rejected a $10bn Shell takeover of Woodside petroleum, a move that was panned by global financial markets. At that time oil was $U28/bbl. In the same year Apache and Shell completed acquisition of Fletcher Challenge Energy.

- The acquisition of Fletcher Energy highlights the contrasting behaviour between NZ's attitude toward strategic assets and other advanced economies. Aside from Australia, in 2005 a $US17bn CNOOC bid for Unocal oil company foundered when it became an issue of "National security". More recently, in 2010 the Canadian Government rejected BHP's bid for Potash Corp, citing National interest.

- Based on the performance of oil companies since 2001, if Fletcher Energy were still listed it would be more than twice the size of the next biggest company on the New Zealand Stock Exchange (Fletcher Building).

3.3 What are the opportunities for Public Policy to Influence Savings via improved Equity demand?

- Unlike equity *supply*, we believe the equity *demand* environment has already begun to improve:
    1. The tax regime is no longer skewed against equity investment. In particular the treatment of investment via managed funds is now no longer a glaring distortion.
    2. Kiwisaver has improved fundsflow into managed funds. Moreover we doubt this has cannibalised retail direct investment. Anecdotally, fund managers are increasingly referring to Kiwisaver as a meaningful source of inflows.

[4] http://www.mbs.edu/index.cfm?objectid=E7068BBD-D60E-CDDB-8A82754A4DFCDE08

3. The New Zealand Super Fund has had a positive impact on equity demand. In particular the fund's appetite for strategic holdings in long duration assets (Auckland Airport, the JV with Infratil to purchase the Shell assets) has introduced a dynamic usually only seen on the NZ market from trade acquirers.

- Unfortunately the parlous state of the local equity market has seen improving equity demand leak into the Australian market or further afield.

- Local fund managers now tend to have flexibility to either run trans-Tasman mandates or invest a portion of their NZ mandate into Australian equities. This is a relatively recent evolution, and is indicative of the NZ equity market's inability to service a growing demand pool.

- Similarly, our Private Wealth business has shown a growing dominance of direct investment into Australian equities at the expense of the New Zealand market, with even relatively small investors complaining about lack of diversity and liquidity.

3.4 What are the opportunities for Public Policy to Influence Savings via improved Equity supply?

- Improved domestic equity supply is critical for the domestic market to once again become self-sustaining.

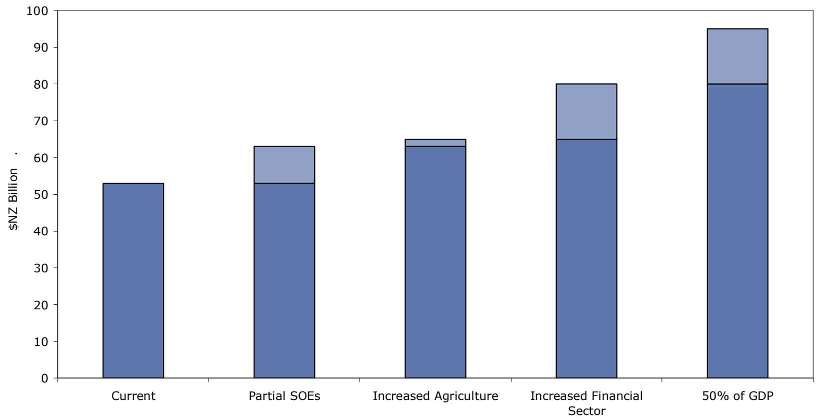
- Moreover improved local equity supply will also be instrumental in 1. incentivising improved savings behaviour (satisfying the home bias); and 2. capturing the positive externalities that come with improving savings behaviour, such as capital allocation efficiencies.

- We see three mains sources of domestic equity supply, two of which public policy has the ability to directly influence:

  1. Initial Public Offerings, as growing businesses evolve into public companies. At best these will keep pace with growth of the wider economy. Improved representation of the agricultural sector may eventually provide some support.
  2. SOE floats. The Government sits on significant (~$25bn) of equity market supply. A partial sell-down of SOEs is an important step toward the equity market regaining critical mass. Moreover the quality of these assets fits well with the objective of making quality savings vehicles available to domestic investors.
  3. Migration from the unlisted to the listed sector. We see significant opportunities for large, mature businesses to float or return to the listed sector. The four banks are obvious candidates. The trend toward multinationals shedding non-core assets will also provide potential opportunities for NZ investors (for example Vodafone Plc is under pressure from shareholders to divest non-core assets).

- The impact these three sources of equity supply shows a "self-sustaining" equity market, which we estimate at a minimum of 50% of GDP, is not out of reach. In particular, the partial floatation of SOE's plus the float of one large unlisted business (most realistically a bank) would move a good way toward this target (below).

Equity Supply: Critical Mass Within Reach



Source: JBWere

4.0 Policy Options: Improved savings will require improved ways to save

- We see considerable scope for public policy to both improve the quality of savings behaviour and return the domestic equity market to a self-sustaining development path.
- While we see a number of potential policy options, we see the most urgent, and accordingly the greatest impact, will come from improving domestic equity supply (4.1 to 4.4).

4.1 Recommence NZ Superannuation Fund Contributions

- The Government should recommence contributions to the NZ Superannuation Fund, even at a much reduced rate of fundsflow.
- The Government allocates funds from SOE sales to make contributions to the NZ Superfund. This "capital account" transaction would be conceptually equivalent to a diversification of the Crown's investment portfolio.
- The NZ Superannuation Fund's mandate should include an allocation toward cornerstone (>10%) stakes, especially in strategic domestic assets (airports, banks, ports). The Fund gives additional consideration to cornerstone investing in IPOs.
- Both of these mandate changes can be achieved without undermining the core purpose of the fund. However they enhance the positive externality of the Fund as a "sophisticated co-investor" for domestic equity investors, helping fill the void of a diminishing analyst community.

4.2 Strengthened National Interest provisions

- New Zealand needs to drop its peculiarly New Zealand attitude of not offending the overseas investment community. Most other advanced economies behave in an overtly self-interested manner when it comes to ownership of strategic assets.
- OIO application needs to specifically target the impact on New Zealand's capital markets.
- Extra credit could be given to OIO applications that specifically commit to participation in the domestic capital market – for example a commitment to a partial listing.

4.3 The Government proactively seeks local listings from the mature unlisted sector

- Government can identify and remove impediments to local listings with a strategic flavour. The listing of the NZ arm of one of the major Banks, for example would be large, complex transaction that would benefit from the positive involvement of Government.

4.4 Partial sell-down of State Owned Enterprises

- The Government needs to seek partial listings of State Owned Enterprises. Air New Zealand and Solid Energy are examples of assets most conducive to listed sector participation in the near term.
- The Government should investigate mechanisms to maximise domestic investor participation in SOE floats. This will assist in generating positive spill-overs into financial market participation and savings behaviour.
- For example, the Government could investigate a discounted SOE offering for KiwiSaver accounts. This would 1. encourage KiwiSaver uptake, and 2. aid widespread acceptance of SOE listings.
- Ownership caps can also be used on a case by case basis.

4.5 An element of compulsion introduced into Kiwisaver

- Kiwisaver needs a element of compulsion, to ensure the scheme's critical mass is secured over its development phase.
- Compulsion will give industry participants reliant on Kiwisaver the confidence to make long term investment in the sector. If will also lengthen the time horizon of fund managers, with poor security of funds inflow a classic driver of a short term mentality.
- As well as jumpstarting savings behaviour, compulsion is an efficient way of boosting financial literacy across a broad population base, with individuals seeing the power of compounding in practice.
- Any compulsory element need not be permanent. However the period of compulsion needs to be of sufficient duration (~10 years) whereby the local and offshore funds management industry are encouraged to invest in savings infrastructure.
- Additionally, Kiwisaver providers should be encouraged to provide an "NZ Focussed" option in their savings plans. This will, within prudent bounds, provide a plan with increased allocation into NZ capital markets.

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Auckland
Telephone +64 9 357 3200 Level 38
Facsimile +64 9 357 3248 Vero Centre
Freephone 0800 555 555 48 Shortland Street
Auckland 1010

Christchurch
Telephone (03) 364 5610 Level 6
Facsimile (03) 364 5611 HSBC Tower
Freephone 0800 555 553 62 Worcester Boulevard
Christchurch 8013

Wellington
Telephone +64 4 471 6260 Level 4
Facsimile +64 4 471 6261 NZX Centre
Freephone 0800 555 554 11 Cable Street
Wellington 6011