

Private Wealth  
Research

Key data

|                |          |
|----------------|----------|
| Code           | ZGL      |
| Current price  | NZ\$8.25 |
| FY18 PE ratio  | 9.8x     |
| FY18 net yield | 8.8%     |
| Market cap (m) | NZ\$996m |

# Zespri

## Good as Gold

Zespri (ZGL) is the legislated "single desk" export marketer of NZ kiwifruit exports, owns the Plant Variety Rights to the new and extremely popular SunGold kiwifruit variety (which has been a game-changer post the devastating vine-killing disease Psa), and has invested offshore to provide year round supply. ZGL is well positioned to continue to benefit from the growth in global demand for kiwifruit. Our DCF derived value for ZGL is between \$6.20 and \$9.50/share with the wide range reflecting the uncertainty relating to the tenure of SunGold licence revenues.

### Export volumes have recovered well post Psa and the outlook is strong

The arrival of Psa affected NZ Gold kiwifruit volumes (-60%) between 2012-2014. However, SunGold was in development and has proven more Psa tolerant. Its introduction has seen NZ Gold export volumes 65% above the previous peak and ZGL forecasts global kiwifruit sales to lift 8% CAGR to FY25. This is supported by growth in traditional and new markets, creating pools of diversified demand highlighted by China and Taiwan becoming major markets over the past 5 years.

### SunGold creates fundamental change in earnings profile

Over the past 15 years, ZGL's traditional export business has delivered NPAT of \$10-30m/annum. However, ZGL is currently experiencing a fundamental change to its earnings profile because of strong SunGold demand and the sale of licences to grow it that has seen ZGL guide to FY18 NPAT of \$100-103m. While SunGold licence sales underpin the significant earnings uplift in the near to medium term, ZGL has cautioned that licences should be viewed as extraordinary income given sales will reduce as SunGold supply catches up with demand.

### Forecasts, valuation and risks

We forecast FY18 NPAT of \$102m, up 30% YoY, FY19 NPAT of \$155m, but FY25 NPAT of \$84m due to reduced SunGold licence sales. Our DCF derived equity valuation range is NZ\$1,100m to NZ\$1,600m that is then discounted by 30% given lack of liquidity in ZGL's shares to a range of NZ\$740m to NZ\$1,140m. This reflects ZGL being a private company where only growers can acquire shares. Our valuation range implies an FY18F PE of 7.3x-11.3x and net yield of 7.7-11.9%. Risks include biosecurity, market access, competition, lower demand than forecast, product contamination and economic volatility.

| Year end March 30 | 2016  | 2017  | 2018E | 2019E  | 2020E  |
|-------------------|-------|-------|-------|--------|--------|
| EBIT (\$m)        | 43.6  | 104.7 | 143.0 | 219.1  | 227.8  |
| Net profit (\$m)  | 27.8  | 78.8  | 101.7 | 155.1  | 161.5  |
| EPS (cps)         | 23.0¢ | 65.3¢ | 84.3¢ | 128.5¢ | 133.8¢ |
| PER (x)           | 27.8  | 13.5  | 9.8   | 6.4    | 6.2    |
| DPS (cps)         | 24¢   | 25¢   | 73¢   | 103¢   | 107¢   |
| Net yield         | 2.9%  | 3.0%  | 8.8%  | 12.5%  | 13.0%  |

Source: Craigs Investment Partners, company data

Produced by:

Chris Byrne

Private Wealth Research

craigsip.com

NZX Firm

# ZGL

# Horticulture

30 March balance date

| Key valuation metrics | FY16 | FY17 | FY18F | FY19F | FY20F |
|-----------------------|------|------|-------|-------|-------|
| P/E                   | 27.8 | 13.5 | 9.8   | 6.4   | 6.2   |
| Dividend yield (net)  | 2.9% | 3.0% | 8.8%  | 12.5% | 13.0% |

| Key ratios                       | FY16  | FY17F | FY18F | FY19F | FY20F |
|----------------------------------|-------|-------|-------|-------|-------|
| ROE (NPAT normalised/SHF)        | 21.2% | 45.8% | 55.7% | 71.8% | 65.3% |
| Net interest cover (EBIT) (x)    | na    | na    | na    | na    | na    |
| Net debt/book equity             | na    | na    | na    | na    | na    |
| NTA per share (cents)            | 83    | 117   | 126   | 152   | 180   |
| Optg cash flow per share (cents) | 30    | 65    | 96    | 127   | 148   |

| Profit & loss (NZ\$m)      | FY16  | FY17F | FY18F | FY19F | FY20F |
|----------------------------|-------|-------|-------|-------|-------|
| Sales revenue              | 1,881 | 2,315 | 2,492 | 2,674 | 2,968 |
| Sales growth               | 28.9% | 23.1% | 7.7%  | 7.3%  | 11.0% |
| <b>EBITDA</b>              | 52.7  | 116.5 | 155.5 | 233.0 | 243.0 |
| EBITDA/sales               | 2.8%  | 5.0%  | 6.2%  | 8.7%  | 8.2%  |
| Depn & amort expense       | 9.1   | 11.8  | 12.6  | 13.9  | 15.1  |
| Other income               | 0     | 0     | 0     | 0     | 0     |
| EBIT                       | 43.6  | 104.7 | 143.0 | 219.1 | 227.8 |
| EBIT/Sales                 | 2.3%  | 4.5%  | 5.7%  | 8.2%  | 7.7%  |
| Net interest expense       | -2.9  | -2.4  | -2.4  | -2.5  | -2.9  |
| <b>NPBT</b>                | 46.5  | 107.1 | 145.4 | 221.6 | 230.7 |
| Tax expense                | 10.7  | 33.4  | 43.6  | 66.5  | 69.2  |
| Abnormals (A/T)            | 0     | 0     | 0     | 0     | 0     |
| Minorities                 | 0     | 0     | 0     | 0     | 0     |
| Plus Equity Acc'd Earnings | 0     | 0     | 0     | 0     | 0     |
| <b>Reported NPAT</b>       | 35.8  | 73.7  | 101.7 | 155.1 | 161.5 |

|                                |       |        |       |       |       |
|--------------------------------|-------|--------|-------|-------|-------|
| Shares (m)                     | 120.7 | 120.7  | 120.7 | 120.7 | 120.7 |
| EPS (reported) (cps)           | 29.7  | 61.1   | 84.3  | 128.5 | 133.8 |
| <b>EPS (normalised) (cps)</b>  | 23.0  | 65.3   | 84.3  | 128.5 | 133.8 |
| <b>EPS (normalised growth)</b> |       | 183.5% | 29.1% | 52.4% | 4.1%  |
| DPS (cps)                      | 24    | 25     | 73    | 103   | 107   |
| DPS/EPS (normalised)           | 104%  | 38%    | 87%   | 80%   | 80%   |

| Key cash flow items (NZ\$m)      | FY16  | FY17F | FY18F | FY19F  | FY20F  |
|----------------------------------|-------|-------|-------|--------|--------|
| <b>Cash flow from operations</b> | 35.6  | 79.0  | 115.4 | 156.2  | 176.1  |
| Capex                            | -22.6 | -14.6 | -47.7 | -38.7  | -20.8  |
| <b>Free cash flow</b>            | 13.0  | 64.4  | 67.6  | 117.5  | 155.3  |
| Other investing cash flows       | 0     | 0     | 0     | 0      | 0      |
| Dividends paid                   | -14.5 | -32.6 | -90.5 | -123.4 | -128.6 |
| Other equity cash flows          | 0     | 0     | 0     | 0      | 0      |

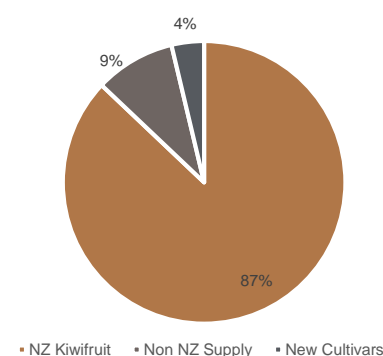
|                     |      |      |       |      |      |
|---------------------|------|------|-------|------|------|
| <b>Surplus cash</b> | -1.5 | 31.8 | -22.9 | -5.9 | 26.8 |
|---------------------|------|------|-------|------|------|

| Key balance sheet items (NZ\$m) | FY16 | FY17F | FY18F | FY19F | FY20F |
|---------------------------------|------|-------|-------|-------|-------|
| Cash                            | 165  | 187   | 187   | 187   | 214   |
| Net debt                        | -165 | -187  | -164  | -158  | -185  |
| Working capital                 | 86   | 97    | 98    | 85    | 70    |
| Shareholders' funds             | 131  | 172   | 183   | 215   | 248   |
| Net tangible assets             | 100  | 141   | 152   | 184   | 217   |
| Total assets                    | 482  | 553   | 601   | 642   | 702   |

|                |                     |
|----------------|---------------------|
| Share price:   | \$8.25              |
| Mkt cap (\$m): | NZ\$995.9           |
| DCF range:     | NZ\$6.20-9.50/share |

| DCF assumptions |       |         |       |
|-----------------|-------|---------|-------|
| WACC            | 9.2%  | RF rate | 4.30% |
| Equity Beta     | 1.1   | Term GR | 2.00% |
| Equity RP       | 6.50% |         |       |

## Revenue Breakdown (FY17)



## Valuation compcos

|                              | FY18 PE     |
|------------------------------|-------------|
| <b>ZGL</b>                   | 9.7         |
| Delegat Group Ltd            | 18.9        |
| Scales Corp Ltd              | 18.8        |
| Comvita Ltd                  | 20.6        |
| New Zealand King Salmon Inve | 18.3        |
| Fonterra Shareholders Fund   | 13.0        |
| <b>Median</b>                | <b>18.8</b> |
| <b>NZX</b>                   | <b>20.8</b> |

## Executive Summary

### Who is Zespri?

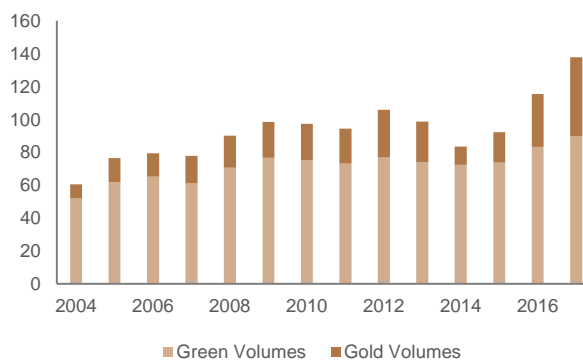
Zespri (ZGL) provides exposure to NZ's primary sector growth story underpinned by increasing European and Asian demand. Kiwifruit continues to be New Zealand's largest horticultural export at c1/3 of horticultural exports by value. ZGL is the legislated "single desk" export marketer of NZ's kiwifruit exports outside Australia other than collaborative marketing, owns the Plant Variety Rights (PVR) to the new and extremely popular SunGold and has invested in offshore supply to provide year round supply to customers.

### Industry growth profile

NZ kiwifruit exports have grown from 60m trays in 2004 to 140m trays in FY17 at a CAGR of 7%. However, this growth has not been linear. The arrival of Psa into NZ in 2010 resulted in kiwifruit export volumes declining c20%+ between 2012-2014, largely due to Psa's impact on the high value Hort16A Gold variety (volumes -60%). NZ kiwifruit export volumes subsequently recovered strongly due to the successful development of SunGold, a gold variety with greater tolerance to Psa. This recovery has seen ZGL's NZ kiwifruit exports for the year ending March 2017 of \$2.1bn, c40% above the average value for the five years 2012-2016.

NZ gold kiwifruit exports have grown from 9m trays in 2004 to 48m trays in FY17 at a CAGR of 14%. NZ green kiwifruit exports have grown from 52m trays in 2004 to 90m trays in FY17 at a CAGR of 4%, noting FY17 was an above average year for yields.

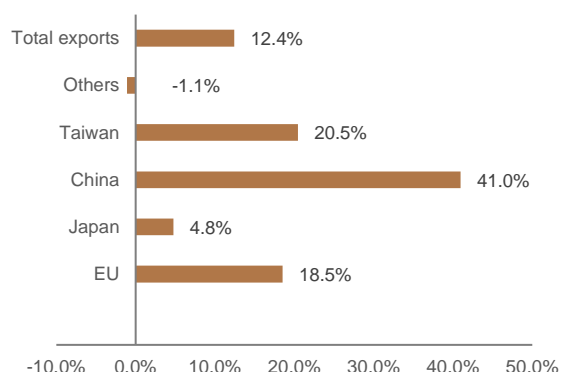
**Figure 1: NZ kiwifruit export volumes (trays, millions)**



Source: Company data

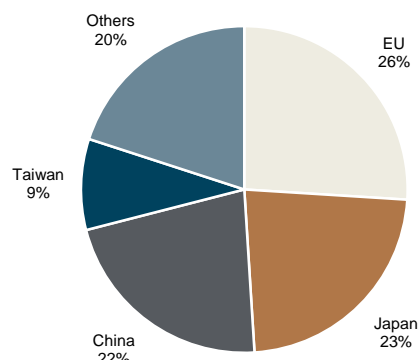
## Market expansion and diversification

Figure 2: 4 year CAGR in exports FY12-16



Source: Fresh facts

Figure 3: Key export markets 2016



Source: Fresh facts

The appetite for kiwifruit continues to grow beyond the traditional markets of Europe and Japan, evidenced by China and Taiwan becoming major markets over the past 5 years.

### Competitive landscape

The competitive landscape for NZ kiwifruit exports is good. NZ exports kiwifruit to the northern hemisphere in its low season with the only real competitor being Chile, which only exports c1/3 the volume and 1/5 of the value of NZ, and currently exports of Gold are limited. NZ also produces premium fruit vs Chile as highlighted by the c100% price premium NZ kiwifruit has achieved in Europe over 2011-2016. Zespri's internal target is to be at least 20-40% above the nearest kiwifruit competitor. The position of ZGL's New Cultivars business is also strong. Due to biosecurity regulations, foreign plant material cannot currently be imported into NZ, so any competition for ZGL's SunGold has to be developed in NZ which takes time and money. This, combined with ZGL's significant branding in offshore markets is driving strong orchard gate returns which in turn is seeing strong demand for SunGold licences from NZ growers.

### SunGold creates fundamental change in earnings profile

Over the past 15 years, ZGL's traditional export business has delivered NPAT of \$10-30m/annum. However, ZGL is currently experiencing a fundamental change to its earnings profile because of strong SunGold demand and the sale of licences to grow it that has seen ZGL guide to FY18 NPAT of \$100-103m. While SunGold licence sales underpin the significant earnings uplift in the near to medium term, ZGL has cautioned that the sale of licences should be viewed as extraordinary income given sales will reduce as SunGold supply catches up with demand.

ZGL's New Cultivar segment generates revenue through the sale of SunGold licences and ongoing royalty streams. Revenues were up 900% in FY17 to \$88m and with high EBIT margins (81%), contributed 68% of FY17 Group EBIT, significantly higher than any time in ZGL's history.

The fundamental change in ZGL's earnings profile has occurred due to the inherent value of the SunGold PVR. The factors driving this are:

- (1) The impact of Psa on the previous Gold (Hort16A) effectively removed it from the market. This means that the new SunGold is effectively the only

commercialised Gold option for NZ growers. ZGL holds the plant variety rights (PVRs) for SunGold until 2039.

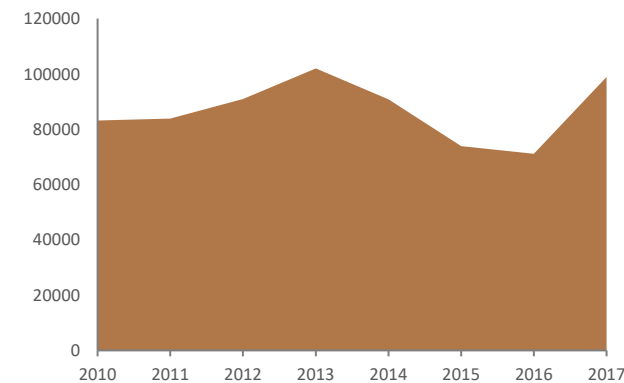
(2) Growing global demand for Zespri Gold kiwifruit as outlined above by increasing export volumes.

(3) ZGL limiting SunGold supply to maintain pricing. ZGL is only licencing 750 (conventional and organic) hectares p.a. over the next 5 years as long as demand allows.

(4) Excellent on-orchard performance of SunGold in terms of yield, size and flavour.

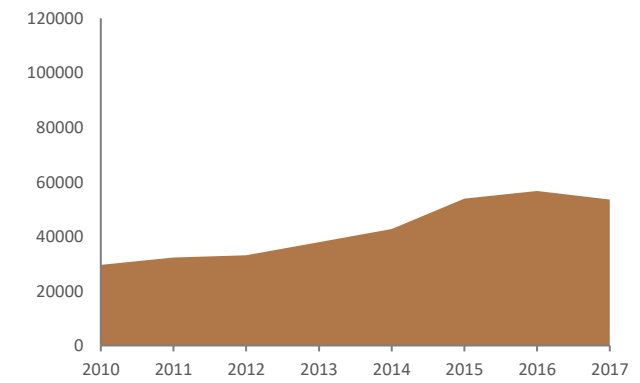
The above factors have resulted in FY17 orchard gate returns (OGR) per hectare (h) increasing to c\$99k/h for SunGold and \$111k/h in FY18. With on-orchard costs at c\$37k/h, a quasi EBITDA is c\$60-70k/h for SunGold that compares with green EBITDA at c\$20k/h.

**Figure 4: Orchard gate returns – Gold (NZ\$/h)**



Source: Company data

**Figure 5: Orchard gate returns – Green (NZ\$/h)**



Source: Company data

The strong OGRs for SunGold has generated a significant market for SunGold licences that did not previously exist. Licence fees paid for SunGold were c\$170k/h in FY17 generating \$67m in licence revenue from \$3m in FY16. The March/April 2017 auction, which will fall into FY18, saw prices lift to a median of \$235k/h, generating \$98m revenue. There is very little additional cost for ZGL meaning this converts mostly to EBIT. While providing significant cashflows in the short to medium term, the ability of ZGL to continue to sell licences at current rates also provides the largest earnings uncertainty over the longer term.

As ZGL has stated: "a final decision on a future release in any given year would not be finalised until the end of each season based on the variety's performance and projected future demand relative to projected future supply. Revenues for future licence rounds will depend on the actual performance of SunGold in each successive season, hectares actually licenced, and the value bid for the licence by growers. Shareholders should note that this revenue stream is potentially lumpy over time as Sun Gold licensing in NZ inevitably slows". ZGL has commented that the licence sales can be seen as extraordinary income.

SunGold licences also generate an ongoing royalty income of 1.65% of global SunGold sales values, which generated c\$17m in revenue in FY17, up from less than \$1m in FY13/14. These are much more secure cashflows than licence revenue given they are tied to ongoing SunGold export values, not additional licence sales.

ZGL continues to invest c\$10-15m/annum in new varieties breeding programme to develop differentiated cultivars (including a new red and green variety) which could attract new consumers to the kiwifruit category and earn supermarket shelf space. The prospect and timing of these being commercialised is uncertain and consequently our numbers do not include revenues from new varieties.

### ZGL growth outlook and CIP forecasts

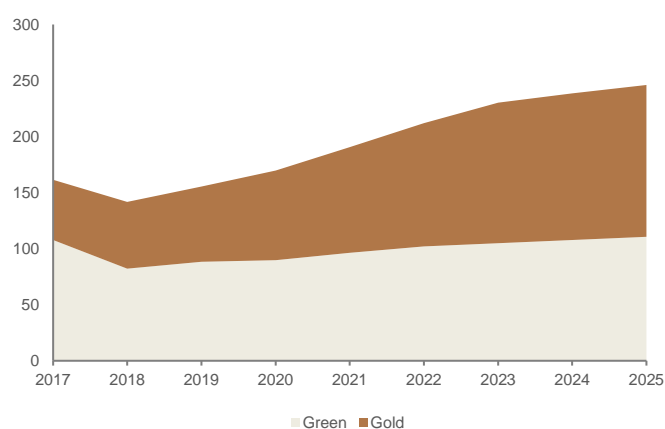
ZGL is projecting global kiwifruit sales to grow to 210m trays by FY22, or a CAGR of c5%. This will be driven by SunGold plantings, with NZ volumes expected to reach 88m trays by FY22, a CAGR of 13%. To achieve this growth ZGL will release 750 hectares/annum of SunGold licences for the next five years (700 SunGold and 50 greenfield organic SunGold). This is subject to an annual review that would consider risks to the demand outlook.

NZ green kiwifruit volumes have moderated to c70m trays after a bumper FY17 crop and are now expected to increase at c2m trays per annum.

ZGL is projecting non New Zealand volumes to grow strongly to c45m trays by FY22 or a CAGR of c20%, underpinned by the licensing of 1,800 hectares of SunGold in Europe which will see SunGold volumes grow at a 25% CAGR between FY17-22.

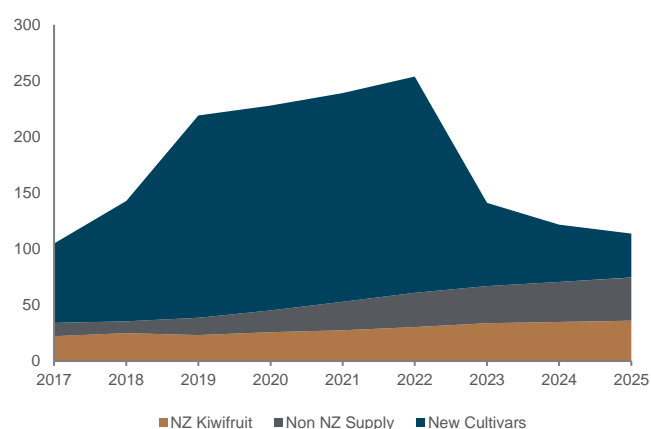
Further out, ZGL is also projecting global kiwifruit sales to grow to 260m trays by 2025, a CAGR of 8% over FY17-25, and generate \$4.5bn sales revenue.

**Figure 6: Kiwifruit sales volumes FY17 – 25 (mte)**



Source: Craigs Investment Partners

**Figure 7. EBIT by division – FY17 – 25 (NZ\$m)**



Source: Craigs Investment Partners

Our forecasts are slightly more conservative than ZGL's. We believe some of the risks we outline in this note should serve to temper ZGL's forecasts, in particular, competition. There is already some competition for gold kiwifruit emerging in the Northern Hemisphere and while Chile, ZGL's major Southern Hemisphere competitor, currently produces low volumes of gold kiwifruit, foreign direct investment by the likes of the Chinese could lift the volumes exported from Chile over the next 5 years. This would heighten the competition on Zespri's Gold exports. ZGL's forecasts assume a continued lack of Chilean Golds.

As a result we are more circumspect at this stage in terms of the quantity of SunGold that can be supplied to the market without impacting price. ZGL's forecast of an additional 3750h of SunGold licences over the next 5 years is an increase of 80% over current levels. This is a significant amount of additional supply to any market.

We forecast 750 hectares of SunGold licences sold FY19-FY22, 200 in FY23, 100 in FY24 and 50 in FY25. **This results in us forecasting global kiwifruit sales to grow to 245m trays by FY25 vs ZGL's forecast of 260m trays.**

For FY18 ZGL has guided to FY18 NPAT of \$100-103m. We forecast FY18 NPAT of \$102m in FY18 and \$155m in FY19 as ZGL steps up its release of SunGold licences from 400 in FY18 to 750 in FY19.

Zespri, being a marketer of kiwifruit and owner of intellectual property, has very low capex requirements and modest working capital (as receivables and inventory are generally matched by payments to suppliers). As a result, the company earns a very attractive return on capital and generates strong free cash flows. The balance sheet remains strong, in a net cash position.

### Valuation

We value ZGL using a conventional DCF methodology given it best captures the unique attributes of ZGL that make it difficult to value using a capitalisation of earnings approach. This is due to the significant near-term contribution from SunGold licence revenues and the uncertainty relating to tenure of these revenues as outlined in this note. We then discount these valuations by 30% to reflect the fact that only growers can purchase ZGL shares. This results in low liquidity for ZGL shares that have only 1/10<sup>th</sup> the liquidity of NZX listed stocks of similar size.

Our DCF derived equity valuation range is NZ\$1,100m to NZ\$1,600m that is then discounted by 30% given lack of liquidity in ZGL's shares to a range of NZ\$740m to NZ\$1,140m. This is a valuation range of \$6.20 to \$9.50/share. Our valuation range implies an FY18F PE of 7.3x-11.3x and net yield of 7.7-11.9%.

## Financial Forecasts

### FY17 result and FY18 outlook

In the 12 months to March 2017 ZGL delivered revenue of \$2.3bn, representing a growth of 23% YoY including:

- New Zealand kiwifruit (NZK) revenue growth of 18% driven by a similar increase in kiwifruit export volumes.
- Non New Zealand supply (NNZS) revenue growth of 18%, backed by 15% volume growth combined with a 3% uplift in pricing.
- A 10-fold increase in new cultivars (NC) business driven by a significant increase in licence revenues through the release of 400 hectares of licences (FY16 110 hectares) and licence prices up 2000% to c\$168k/hectare. Royalty income also surged 3 fold driven by higher SunGold volumes.

ZGL's FY17 EBIT lifted 240% to \$104.7m including:

- Growth in NZK and NNZS EBIT of around 20% through modest margin expansion.
- A significant uplift in margins for the NC business driven by large revenue growth and a cost base which is more or less fixed, hence the significant lift in revenues flows directly to the bottom line.

### FY18 outlook

In the 12 months to March 2018 ZGL expects underlying NPAT of between \$100-103m from \$78.8m in FY17. We expect this is driven by:

- A significant uplift in the NC revenues with licence revenues growing from \$67m to \$98m underpinned by an increase in licence fees paid per hectare while royalty revenue will also have grown due to higher SunGold volumes.
- A decrease in NNZS EBIT as higher commission from selling fruit is offset by higher overheads costs. The higher overheads costs is due to the build-up of staff capability to handle higher volume in the future years.
- NZK EBIT lifting as a result of higher gold volumes (+8%) and pricing (+10%), while a 30% decline in Green volumes was offset by a 25-30% lift in prices.

ZGL has also provided guidance for an FY18 dividend of \$0.72-0.74/share, up 190% from \$0.25/share in FY17, reflecting the strong uplift in earnings as a result of SunGold licence revenue.

## Medium term forecasts and key assumptions

Whilst we include our medium term forecasts (to FY20) in the summary table over page, the key assumptions behind our forecasts out to our FY25 terminal year include:

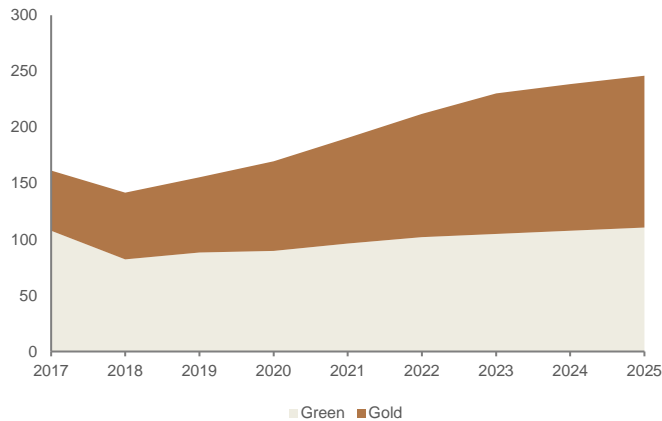
### New Zealand Kiwifruit (NZK):

- NZK revenue is expected to grow from \$2.0bn in FY17 to \$3.6bn in FY25, representing a CAGR of 7.5%. We forecast volumes to increase at a CAGR of 4% to 190 m trays. This growth will be driven by SunGold volumes that are forecast to rise by nearly 10% per annum on the back of new plantings and yield improvements. Green volumes will decline in FY18 vs FY17 after an above average year in FY17. We expect Green volumes to lift c2m trays/annum thereafter to FY25. We expect NZK EBIT margins to remain stable at around c1%, which is consistent with the company's long term



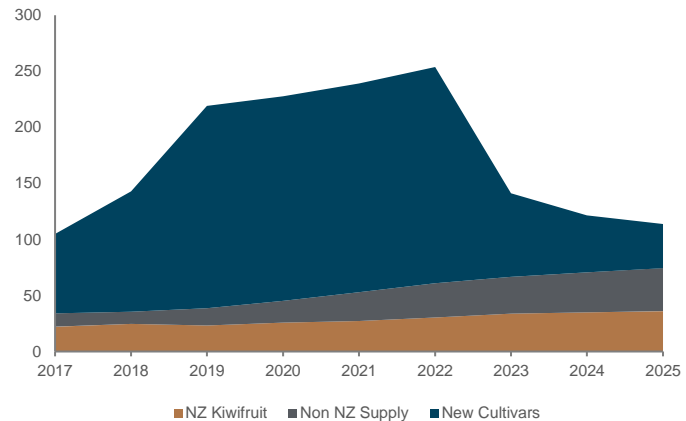
target and in line with the new enduring funding model which is currently being finalised with the industry. The objective of the funding model is to maintain Zespri NZ Supply EBIT at around 1% of net sales. We forecast NZK EBIT to lift from \$22m in FY17 to \$36m in FY25.

**Figure 8: Global kiwifruit sales volumes FY17 – 25 (mte)**



Source: Craigs Investment Partners

**Figure 9: ZGL EBIT by division – FY17 – 25 (NZ\$m)**



Source: Craigs Investment Partners

### Non-New Zealand Supply (NNZS):

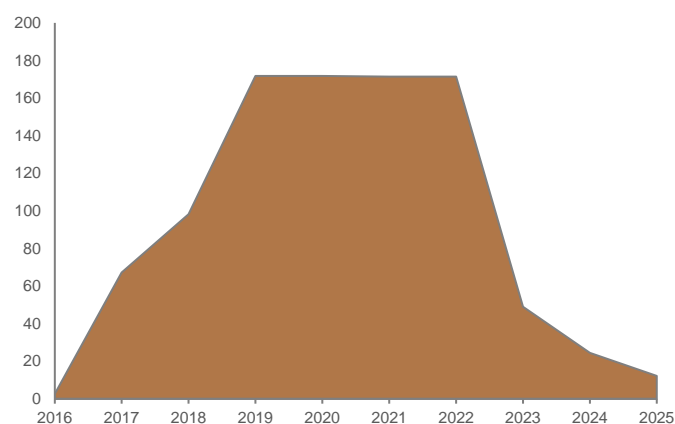
- NNZS revenue is projected to lift 340% to \$740m over FY17-FY25 or a CAGR of 16%, underpinned by a 350% lift in gold volumes and a 160% lift in green volumes. ZGL's gold volumes are expected to double to around 10m trays in FY20, reflecting the release of 1800 hectares of gold licences in Europe. Overall volumes to lift from 16.8m trays in FY17 to 43m trays in FY22 and 54m trays in FY25. We expect EBIT margins to decline in FY18 due to investment in cost to grow sales, but to recover back to 5.5% by FY25 resulting in NNZS EBIT lifting from \$12m in FY17 to \$40m in FY25.

### New Cultivars (NC):

- The new cultivar segment generates revenue through licensing, royalty streams and co-funded new cultivar research. We forecast NC revenue growth of c20% CAGR between FY17-22, but a decline of c35% annually between FY22-FY25. We forecast NC revenue will grow from \$88m to \$210m across FY17-FY22, but decline back to \$55m by FY25. The increase between FY17-22 is due to a substantial lift volumes and value of the licences that growers are willing to pay ZGL for the SunGold PVR. This reflects strong demand and prices for SunGold internationally.
- Licences:** We expect the company to release 750 hectares of licences from FY19-FY22 which will taper off to 100 hectares in FY24 and 50 by FY25 as supply starts to satisfy demand. We expect the value of SunGold licences to lift from approximately \$175k/hectare in FY17 to \$230K/hectare from FY18-FY25. Consequently, new licence revenue is expected to initially rise from \$67.2m in FY17 to c\$170m from FY19-FY22 before declining to c\$12m in FY25.
- Royalties:** ZGL also receives ongoing royalty payments of 1.65% of SunGold revenues. Consequently, we project royalty turnover to lift from \$17m to c\$40m over FY17-FY25, or a CAGR of 10%. The main

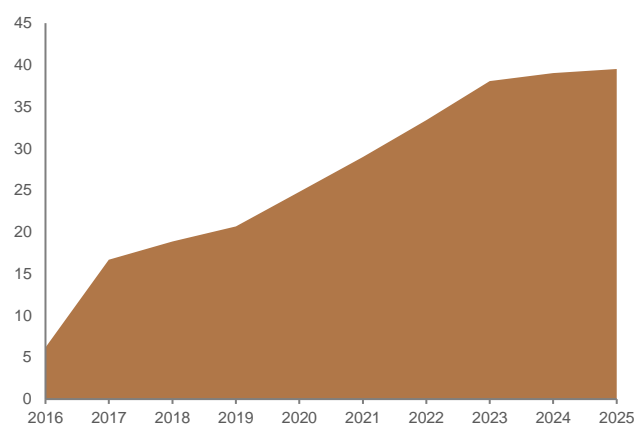
operating costs associated with the NC business are the research and development costs and amortization of new cultivars.

**Figure 10: ZGL SunGold licence revenues FY16 – 25 (NZ\$m)**



Source: Craigs Investment Partners:

**Figure 11. ZGL SunGold royalties – FY16 – 25 (NZ\$m)**



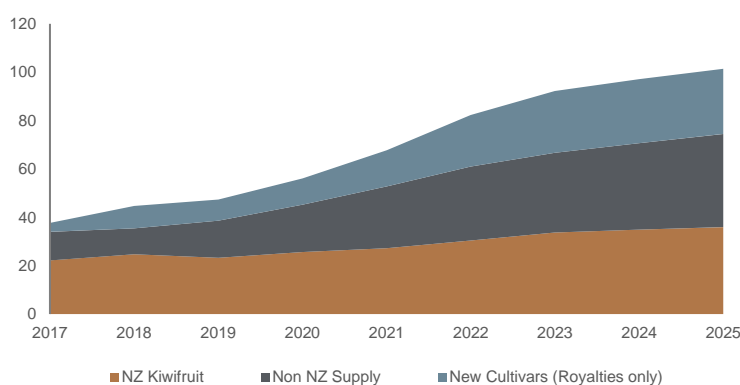
Source: Craigs Investment Partners

- We expect R&D expenditure to lift through to FY22, as we believe the company (in partnership with Plant and Food research) will continue to develop new kiwifruit varieties to have a robust pipeline of products for future growth. We expect NC EBIT to increase from \$71m in FY17 to \$190m by FY22, but then to decline to c\$40m in FY25 reflecting higher royalty revenues which is more than offset by significant reduction in licence revenues as SunGold supply starts to match demand.

## Zespri Group forecasts

Overall our EBIT forecasts for ZGL lift from \$44m in FY16 to a peak of \$250m in FY22 before declining back to \$115m in FY25. This earnings profile relates to licence sales. Given licence sales can be viewed as quasi-extraordinary income, it is worth analysing the more annuity like earnings base for ZGL by excluding licence sales. This provides a better understanding of the growth in ZGL's underlying and recurring earnings base.

**Figure 12. ZGL EBIT excluding licence sales (NZ\$m)**



Source: Craigs Investment Partners

As we can see in the chart above, ZGL's recurring earnings base lifts from \$38m EBIT in FY17 to \$100m in FY25, or a CAGR of 14%, underpinned by growth in SunGold royalty and export revenues and non-NZ supply revenues.

**Table 1: ZGL earnings forecasts**

|                               | Historical |         |        | Forecast |        |
|-------------------------------|------------|---------|--------|----------|--------|
| NZ\$m                         | 2016A      | 2017A   | 2018F  | 2019F    | 2020F  |
| Revenue                       | 1,881      | 2,315   | 2,492  | 2,674    | 2,968  |
| – Costs                       | 1,828      | 2,199   | 2,337  | 2,441    | 2,725  |
| Operating EBITDA              | 52.7       | 116.5   | 155.5  | 233.0    | 243.0  |
| – Depreciation & Amortisation | 9.1        | 11.8    | 12.6   | 13.9     | 15.1   |
| Operating EBIT                | 43.6       | 104.7   | 143.0  | 219.1    | 227.8  |
| – Net Interest                | (2.9)      | (2.4)   | (2.4)  | (2.5)    | (2.9)  |
| PBT                           | 46.5       | 107.1   | 145.4  | 221.6    | 230.7  |
| – Taxation                    | 10.7       | 33.4    | 43.6   | 66.5     | 69.2   |
| NPAT                          | 35.8       | 73.7    | 101.7  | 155.1    | 161.5  |
| Adjusted NPAT                 | 27.8       | 78.8    | 101.7  | 155.1    | 161.5  |
| <b>EPS &amp; DPS</b>          |            |         |        |          |        |
| Adjusted EPS                  | 23.0¢      | 65.3¢   | 84.3¢  | 128.5¢   | 133.8¢ |
| Adjusted EPS Growth           | +29.3%     | +183.5% | +29.1% | +52.4%   | +4.1%  |
| DPS                           | 24¢        | 25¢     | 73¢    | 103¢     | 107¢   |
| Payout Ratio                  | 104%       | 38%     | 87%    | 80%      | 80%    |
| <b>Revenue</b>                |            |         |        |          |        |
| New Zealand Kiwifruit         | 1,724      | 2,048   | 2,153  | 2,209    | 2,441  |
| Non New Zealand Supply        | 184        | 217     | 253    | 303      | 364    |
| New Cultivars                 | 9          | 87      | 124    | 199      | 201    |
| Land and Building             | -          | 1       | 1      | 1        | 1      |
| Other                         | (36)       | (38)    | (38)   | (38)     | (38)   |
| Group                         | 1,881      | 2,315   | 2,492  | 2,674    | 2,968  |
| <b>EBIT</b>                   |            |         |        |          |        |
| New Zealand                   | 37.2       | 22.2    | 24.8   | 23.2     | 25.6   |
| Non New Zealand               | (4.0)      | 11.9    | 10.7   | 15.5     | 19.7   |
| New Cultivars                 | -          | 70.9    | 107.5  | 180.4    | 182.5  |
| Other                         | -          | (0.3)   | -      | -        | -      |
| Group                         | 43.6       | 104.7   | 143.0  | 219.1    | 227.8  |
| <b>Revenue Growth</b>         |            |         |        |          |        |
| New Zealand                   |            |         | +5.1%  | +2.6%    | +10.5% |
| Non New Zealand               |            |         | +16.7% | +20.0%   | +20.0% |
| New Cultivars                 |            |         | +42.3% | +59.8%   | +1.1%  |
| Group                         | -          | -       | +7.7%  | +7.3%    | +11.0% |
| <b>EBIT / Revenue</b>         |            |         |        |          |        |
| New Zealand                   |            | 1.1%    | 1.1%   | 1.0%     | 1.0%   |
| Non New Zealand               |            | 5.5%    | 4.3%   | 5.1%     | 5.4%   |
| New Cultivars                 |            | 81.0%   | 86.3%  | 90.7%    | 90.8%  |
| Group                         | 2.3%       | 4.5%    | 5.7%   | 8.2%     | 7.7%   |

### Management's long-term forecasts

Our forecasts are more conservative than ZGL's. We believe some of the risks we outline in this note should serve to temper ZGL's forecasts, in particular, competition. There is already some Gold kiwifruit competition emerging in the Northern Hemisphere while Chile, ZGL's major Southern Hemisphere competitor, currently produces low volumes of Gold kiwifruit and pest and disease issues continue to hamper efforts to lift production. However, China could, via foreign direct investment, lift the volumes exported from Chile over the next 5 years. This would heighten the competition on Zespri's Gold exports. We note ZGL's forecasts assume a continued lack of Chilean Golds.

As a result we are more circumspect at this stage in terms of the quantity of SunGold that can be supplied to the market without impacting price.

ZGL has provided longer term forecasts in its outlook document, which are outlined in the table below:

**Table 2: Management's long-term forecasts**

|  | FY17       | FY22E        | CAGR        | FY25       |
|--|------------|--------------|-------------|------------|
| <b>Total global sales</b> (million trays equivalent) | <b>154</b> | <b>209.0</b> | <b>6.3%</b> | <b>260</b> |
| <b>New Zealand Supply</b>                            |            |              |             |            |
| Gross Supply of Kiwifruit (million trays equivalent) | 138.0      | 164.0        | 3.5%        |            |
| Green Supply (million trays equivalent)              | 89.0       | 76.0         | -3.1%       |            |
| Gold Supply (million trays equivalent)               | 48.0       | 88.0         | 12.9%       |            |
| <b>Non-NZ Supply</b>                                 |            |              |             |            |
| Gross Supply of Kiwifruit (mTE)                      | 16.6       | 45           | 22.1%       |            |
| Green Supply (mTE)                                   | 11.3       | 25           | 17.2%       |            |
| Gold Supply (mTE)                                    | 5.3        | 20           | 30.4%       |            |
| <b>Group turnover (\$bn)</b>                         | 2.3        |              |             | 4.5        |
| <b>Royalty income</b>                                |            |              |             |            |
| Global Gold Turnover (\$bn)                          | 1.2        | 2.1          | 11.8%       |            |
| Global royalty income (\$mn)                         | 17.0       | 30.0         | 12%         |            |
| <b>Gold licences released</b>                        |            |              |             |            |
| New Zealand Gold (hectares), maximum guidance levels | 4116       | 7316         | 12.2%       |            |

Source: Company data

### Balance sheet

ZGL has a capital light balance sheet with minimal capex requirements. At 31 March 2017 ZGL had \$553m in total assets, comprising just \$18.3m of property plant and equipment, \$123m of debtors and inventory, \$187m in cash and \$52m in foreign exchange derivatives. The company has no interest bearing liabilities.

### Cashflow statement

Net cash flow from operating activities rose to \$79.1m in FY17 from \$35.6m in FY16. A significant proportion of that increase was due to an uplift in licence fees from the release of 400 hectares of land for the planting of the SunGold variety of kiwifruit. However, cash from licence sales in FY17 were not received in its entirety, which under the deferred payment scheme will be paid from FY19-FY21. Free cash flow was \$64m versus \$13m as capex dropped to \$14.6m from \$22.6m. Operating cash flow is expected to increase to \$99m in FY18 due to a further increase in licence payments while free cash flow will be tempered by higher land and building capex, which is expected to remain elevated in FY18 and FY19 before winding down to circa \$20m per annum.

### Dividends

ZGL's board currently has a policy of paying between 70% to 90% of each year's available profits as dividends and we have assumed that the company distributes 80% of its profits as dividends.

## Valuation

We value ZGL using a conventional DCF valuation given it best captures the unique attributes of ZGL that make it difficult to value using a capitalisation of earnings approach. This is due to the significant near-term contribution from SunGold licence revenues and the uncertainty relating to tenure of these revenues as outlined in this note. We then discount these valuations by 30% to reflect the marketability discount as discussed below.

Finally, we crosscheck our DCF valuation by comparing the PE multiple range implied by our DCF valuation against a set of comparable NZX listed companies.

## Summary

- We use a scenario approach to derive a bear, base and bull case DCF valuation range.
  - Our bear case, outlined below, produces an equity valuation of \$1.1bn.
  - Our base case valuation, based on the forecasts outlined in the forecasts section of the report, produces an equity valuation of \$1.3bn.
  - Our bull case valuation, outlined below, produces an equity valuation of \$1.6bn.
- Our DCF valuation range implies an FY18 PE range of 10.5x-16.0x. This correlates with the current trading multiples of NZX listed agriculture/horticulture peers at 13x (FSF.NZ) to 20.6x (CVT.NZ) with a median of 18.8x.
- We discount our DCF valuations by 30% to reflect the lack of liquidity in ZGL shares to reach an equity value range of NZ\$740m– NZ\$1,140m, or \$6.20–\$9.50 per share. Our base case is NZ\$920m, or NZ\$7.65 per share. With ZGL guiding to an FY18 dividend of 72-74cps, our valuation range implies a net yield of 8%-12% with our base case valuation implying a c10% yield.

## DCF valuation

In assessing a DCF value for ZGL we have used scenarios that vary the key drivers of earnings, creating a bull, base and bear case.

**Table 3: Scenarios**

|   | Bear Case                                   | Base Case   | Bull Case  |
|---|---|---|--|
| Equity value (\$m)                                | 1,100                                       | 1,320   | 1,600  |
| Equity value incl liquidity discount of 30% (\$m) | 740   | 920   | 1,140  |
| Global volumes (mte) CAGR FY17-FY25               | 3.5%  | 5.5%  | 7.0%   |
| Non-NZ volumes (mte) CAGR FY17-FY25               | 10%   | 15%   | 20%  |
| NZ Gold Volumes (mte) CAGR FY17-FY25              | 10%   | 11%   | 12%  |
| NZ Pricing \$/tray CAGR FY17-FY25                 | 2.0%  | 3.0%  | 3.2%   |
| Licence release (hectares) FY18-FY25              | 750 for 3 years, 400 in FY22, 50 thereafter | 750 for 4 years trending down to 200 in FY23 and 50 in FY25 | 750 for 5 years down to 400 in FY24 and 50 in FY25 |
| Licence price(\$)/hectare                         | 230k/h to FY21 then down to 140k/h          | 230k/h for all years  | 230k/h for all years                               |
| Licence revenues FY17-FY25 NZ\$m                  | \$800                                       | \$940   | \$1,100  |
| Royalty revenues CAGR FY17-FY25                   | 10%   | 12%   | 13%  |

### Base case

Our base case valuation assumptions are outlined in the forecasts section.

### Bear case assumption:

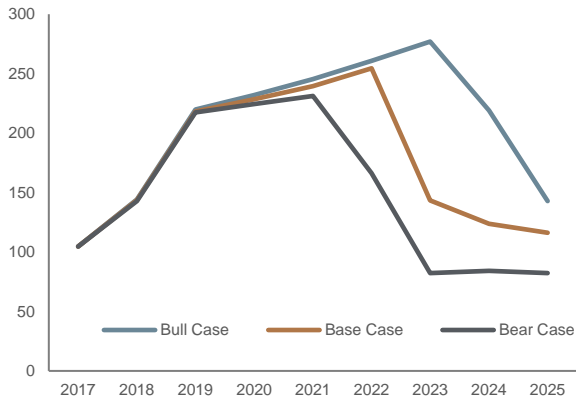
- **New cultivars (NC):** Across all three scenarios we forecast 3 years of 750 hectares of licences sold at strong prices. However, from year 4 to 8 our assumptions capture differing outlooks. In our bear case we assume the c90% uplift in gold volumes over FY17-22 starts to meet/outstrip demand and therefore pricing pressure emerges. To support pricing and hence orchard gate returns ZGL reduces licence sales from FY22. This resets FY23 NC EBIT to c\$45m, versus c\$135m in FY22. Royalty revenue in this scenario tracks lower than the base case due to reduced NZ SunGold volumes.
- **New Zealand Supplies (NZS):** SunGold volumes only reach 100m trays by FY25 compared with c110m trays in our base case. We expect green volumes of c75m trays in FY25, versus 80m trays in our base case. This results in a 20% reduction in New Zealand supplies EBIT in FY25 versus our base case.
- **Non-New Zealand supplies (NNZS).** While we expect kiwifruit volumes to more than double to 36m trays in FY25, a 10% CAGR, this is still below the 54m trays we expect in our base case forecast. Furthermore, as indicated above, we expect competition from other producers to result in pricing pressure such that the pricing between FY17-FY25 is forecast to be -0.5% CAGR versus a CAR of +0.5% in our base case forecast. This underpins a 40% reduction in NNZS EBIT in FY25 versus our base case.
- We forecast total ZGL kiwifruit volumes to be 215m trays in FY25, compared with c250m trays in our base case.

### Bull case assumptions:

- **New Cultivars:** We assume demand continues to outstrip supply for SunGold, which allows ZGL to sell 750 hectares/annum for 5 years until FY23, in line with ZGL's guidance. We then forecast this to drop to 400 hectares in FY24 and 50 hectares in our terminal year. We also expect licence sale prices to remain strong at c\$230k/hectare. This generates c\$200m more licence sales revenue compared to our base case over FY22-24. Royalty revenue also grows at a CAGR of 13% over FY17-25 compared with 12% in our base case.
- **New Zealand Supply:** Due to the increased licence sales from FY22, SunGold volumes reach 125m trays by FY25 compared with 115m trays in our base case. We also expect green volumes of 80m trays in FY25, in line with our base case. This underpins a 13% lift in New Zealand supplies EBIT in FY25 versus our base case.
- **Non NZ Supply:** We expect kiwifruit volumes to grow to 75m trays in FY25, a 20% CAGR. This is c40% above the 54m trays we expect in our base case forecast. Pricing between FY17-FY25 is forecast to grow at c+1.0% CAGR compared with 0.5% in our base case forecast. This underpins a 40% lift in Non-New Zealand supplies EBIT in FY25 versus our base case.

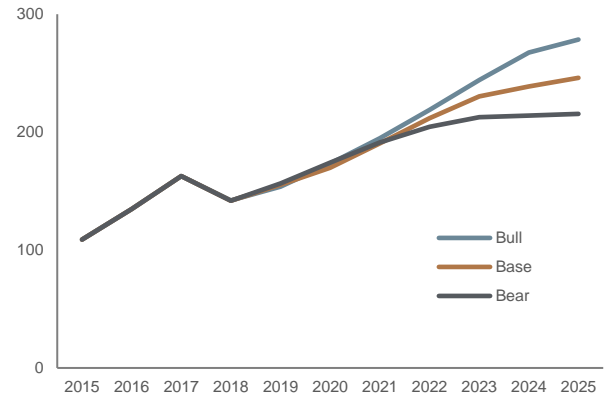
- We forecast total ZGL kiwifruit volumes to be 280m trays compared with c250m trays in our base case and ahead of ZGL's target of 260m trays by 2025.

**Figure 13: EBIT scenarios FY17-25 (NZ\$m)**



Source: Craigs Investment Partners

**Figure 14: Kiwifruit volumes scenarios (NZ\$m)**



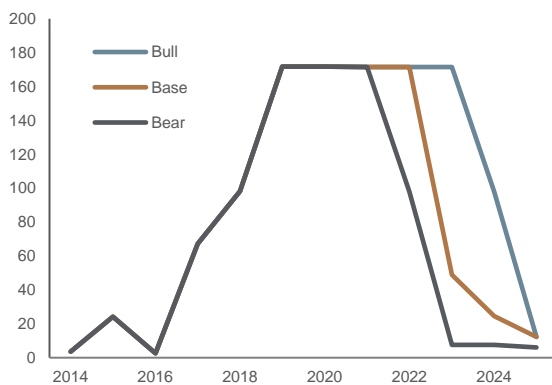
Source: Craigs Investment Partners

Figure 13 highlights the ZGL EBIT forecasts for each of the three scenarios outlined above. From FY22 the EBIT forecasts diverge significantly and decline after an initial lift, despite kiwifruit volumes continuing to increase as seen in figure 14. This is because of the profile of SunGold volumes and licence revenues.

Excluding licence EBIT allows us to examine the underlying earnings for the more annuity-like businesses which are the NZ kiwifruit supply, non-NZ kiwifruit supply and SunGold royalties.

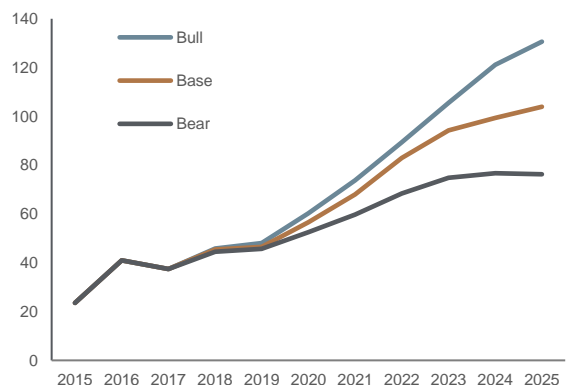
In the charts below we show the licence EBIT paths for each scenario. What is obvious is that there is a significant lump of licence revenue between FY17-25, which is likely to reduce to a much lower level over this period. Stripping out the licence revenue, we can see the more consistent EBIT track for ZGL's recurring revenue base over the forecast period, which follows the lift in kiwifruit sales volumes.

**Figure 15: Licence EBIT Scenarios (NZ\$m)**



Source: Craigs Investment Partners

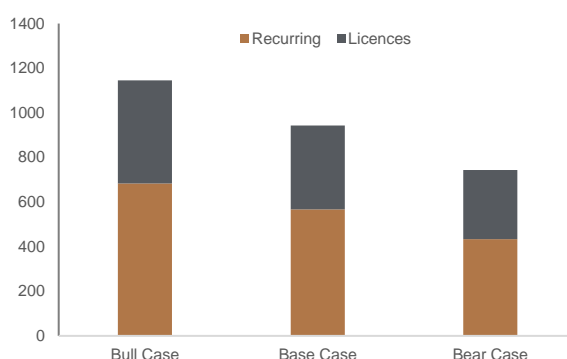
**Figure 16: EBIT scenarios excl licence EBIT (NZ\$m)**



Source: Craigs Investment Partners

In figure 17 below we show what proportion of the valuation in each scenario is derived from the licence revenues versus the more recurring type revenue.

**Figure 17: Valuation scenarios split into recurring and licence values (NZ\$m)**



Source: Craigs Investment Partners

The following table outlines the assumptions used to derive our WACC for ZGL of c9.2%:

**Table 4: WACC calculation**

|                            |       |
|----------------------------|-------|
| Risk free rate (terminal)  | 4.3%  |
| Equity beta                | 1.1   |
| Equity market risk premium | 6.5%  |
| Cost of equity             | 10.5% |
| Target debt/equity         | 20.0% |
| Cost of debt               | 5.9%  |
| WACC                       | 9.2%  |

Source: Craigs Investment Partners

Our terminal growth rate is set at 2% in line with long run NZ inflation.

### Multiples cross check

The high level of quasi-extraordinary revenues in ZGL's current earnings base makes it difficult to utilise a capitalisation of earnings approach to value ZGL. However, it is worth considering the implied multiples from our DCF valuation and how these compare to ZGL's NZX listed comparable companies.

**Table 5: Peer group valuation**

|                              | FY18        | FY19        |
|------------------------------|-------------|-------------|
| Delegat Group Ltd            | 18.9        | 16.6        |
| Scales Corp Ltd              | 18.8        | 16.3        |
| Comvita Ltd                  | 20.6        | 16.1        |
| New Zealand King Salmon Inve | 18.3        | 17.6        |
| Fonterra Shareholders Fund   | 13.0        | 11.0        |
| <b>Median</b>                | <b>18.8</b> | <b>16.3</b> |
| ZGL                          | 9.8         |             |

Source: Bloomberg

We believe the most comparable companies to ZGL are Delegats, Scales, Comvita NZ King Salmon and Fonterra given the following characteristics (1) export earnings make up a significant proportion of earnings, (2) agri-type based products and risks, (3) branded businesses.



However, we do note that there is no pure play equivalent to ZGL given its legislated market position and capital light business model.

Our DCF valuation range before the liquidity discount implies an FY18 PE range of 10.5x-16.0x. This is a c15%-45% discount to the median FY18 PE of ZGL's NZX listed compcos which trade on a median FY18 PE of 18.8x.

In our view if ZGL traded on the NZX, it would trade at a discount to these peers because of a) uncertainty relating to the sustainability of licensing income which makes up c70% of FY17 EBIT and b) recent earnings track record which highlights a higher risk profile compared to peers due to higher biosecurity-risk, for example Psa and the Brown Marmorated Stink Bug. This is partially offset by a lower capital-intensive business model and strong near term earnings growth.

When we discount our DCF valuation range by 30% to reflect ZGL's low liquidity, this implies an FY18 PE range of 7.3x to 11.3x, or a 40-60% discount to NZX listed compcos. We note that on the Unlisted market, ZGL currently trades on an FY18 PE of 9.8x (mid-point of guidance range), within the implied PE range.

### **Marketability/Low liquidity Discount**

While ZGL's shares are traded on the Unlisted market, it is a private company and ZGL shares are only allowed to be acquired by growers, of which there are only c2500. This results in low liquidity for ZGL shares that have only 1/10th the liquidity of listed stocks of a similar size. The value of ZGL shares traded on the unlisted market was \$17m over the past 12 months, or c2% of market capitalisation. This compares to an average of 35% for companies listed on the NZX50 with market capitalization of less than \$1bn.

An asset that has low liquidity will trade at a discount to similar assets with good liquidity. We utilize two approaches to assessing the general marketability discount for ZGL. These include empirical studies and secondly given ZGL trades on the unlisted market we can deduce a discount versus a group of comparable companies trading on the NZX.

Empirical studies of private companies have shown that the lack of liquidity discounts the value of a private company by as much as 50% if there is no benchmark for valuing private companies on a daily basis. Typically, a liquidity discount of 20-30% is applied.

With ZGL trading on the unlisted market, there is a public benchmark for valuing the company on a daily basis. As a result, we do not believe it should trade at a 50% discount. The more common 20-30% discount is appropriate in our view.

Given ZGL trades on the unlisted market, we have price discovery via willing buyers and sellers. We can utilize our FY18 EPS (based on public ZGL outlook projections) to derive the PE it is trading on. We can then compare this with the multiple we believe it would trade on if listed on the NZX to infer the marketability discount for ZGL.

Based on our FY18 EPS of 84cps, in line with company guidance, ZGL is trading on a PE of 9.8x on the unlisted market. Comparing this to the median PE multiple of c19x for a basket of comparable NZX listed companies implies a discount of c50%. In our view this discount to ZGL's NZX compcos is a mix of liquidity discount and uncertainty relating to the sustainability of ZGL's licence revenues. Approximately 60-70% of

FY18F NPAT will be attributable to licence sale revenue. ZGL has guided to strong licence sales over the next 5 years, but do caution that licence sales will be reviewed each year. If, SunGold demand does not eventuate as forecast by ZGL then this licence revenue could decline sooner with a significant impact on NPAT. Given the quasi-extraordinary nature of licence revenues, shareholders are prudent to discount the capitalisation of licence earnings.

Giving consideration to both the empirical studies and ZGL's discount to NZX listed peers, we apply a liquidity discount of 30% to both our DCF-derived valuation.

## Key Risks

**Non New Zealand Supply business:** - The ZGL Non-New Zealand Supply is inherently riskier and more complex than the New Zealand business with each growing location bringing with it all the complexity of growing and doing business in foreign jurisdictions.

**Industry deregulation:** The kiwifruit industry is regulated and governed by a single point of entry (SPE) market structure. ZGL holds an SPE for the NZ industry ensuring that all of NZ's kiwifruit exports (excluding Australia and collaborative marketing) are directed through the company. There will always be a risk that the SPE structure is unwound which would likely cause a significant fall in kiwifruit exports through ZGL. However, there appears to be widespread support for the SPE. In a referendum conducted in 2015, 97% of growers voted to keep the Single Point of Entry (65% of growers who produced 80% of the exported kiwifruit volume voted).

**Licensing revenues:** - The value of licensing revenue could fall due to a deterioration in demand or oversupply of SunGold. Also, the commercialisation of a new variety of Gold by competitors both in New Zealand and abroad could impact licensing demand and prices that ZGL is able to charge its growers.

**Biosecurity risks:** - NZ is largely free of many of the pests and diseases found in other countries, giving us a unique comparative advantage in primary sector production. New pests and diseases can undermine this advantage and create a significant risk for primary producers, at both the orchard and industry level. The significant impact of the bacterial kiwifruit vine disease Psa on the kiwifruit industry provides a graphic example of the adverse impact pests and diseases can have on business.

**Competition:** - NZ generally competes with Chilean kiwifruit producers for a share of Northern hemisphere volumes. In recent years, Chile has lost market share to NZ due to issues with Psa and inferior quality fruit. However, if Chilean producers improve co-ordination and co-operation and started producing quality fruit then that could potentially impinge on New Zealand's and ZGL's market share. In the longer term China could suppress kiwifruit prices, if the expected rapid expansion in kiwifruit production resulted in China becoming a net exporter of kiwifruit.

**Market Access/tariffs:-** ZGL's revenues and earnings could be impacted should it be shut out of any market or markets. For example, in the mid 1990's ZGL's was banned from selling fruit in the US for 10 years (a significant market at that time) because it was found to engage in dumping of fruit. Any issues with China (comprising nearly a quarter of kiwifruit exports and growing strongly) would significantly impact volumes.

**Product recall:** - ZGL's brand image could be a risk if products are found to be contaminated, tampered with, or do not meet required quality standards. This could adversely impact volumes. Last year the Chinese authorities suspended imports of kiwifruit from New Zealand because of the discovery of a fungus in a batch of kiwifruit, forcing Zespri to undertake comprehensive product testing before normal shipments could resume.

**Currency:** - ZGL's growers and to lesser extent the company are sensitive to the movement of the NZD versus the USD, Euro and the Japanese Yen. The company adopts a hedging strategy to protect grower returns.

## Zespri Group Limited

### Regulatory landscape

ZGL was formed in 1999 facilitated by a large network of New Zealand kiwifruit growers who worked with the New Zealand government to pass the Kiwifruit Industry Restructuring Act and Kiwifruit Export Regulations in 1999. As a result of the Kiwifruit Industry restructuring Act 1999, Zespri Group Ltd is the single desk export marketer of kiwifruit to countries other than Australia. Kiwifruit New Zealand (KNZ – the government appointed regulator) was also established on April 1, 2000.

The export orientated provisions of the Regulations operate to only permit Zespri or collaborative marketers approved by KNZ to export New Zealand grown kiwifruit. The Regulations do not apply to the sale of such kiwifruit in New Zealand, or its export for consumption in Australia (which from 2004 is regulated by the Horticultural Export Authority).

Kiwifruit exported to Australia are a prescribed product under the New Zealand Horticulture Export Authority Act, and the 14 HEA-licenced exporters to Australia are represented by Kiwifruit Exporters to Australia (KETA, [www.keta.co.nz](http://www.keta.co.nz)). Kiwifruit can be exported to countries other than Australia by applying to the industry regulator, Kiwifruit New Zealand, for a collaborative marketing programme. In 2016/17 there were 12 companies operating 25 collaborative marketing sales programmes with Zespri.

### Company description

Zespri Group Limited is the world's largest marketer of kiwifruit, accounting for around a third of the global trade in kiwifruit, employing around 600 people (in New Zealand and offshore). The company supplements New Zealand supplies with globally sourced kiwifruit, mainly from growers in Italy, France, Japan and Korea to supplement sales from New Zealand and offers 12 months supply to key Northern Hemisphere customers.

Zespri manages kiwifruit innovation, supply management, distribution management and marketing of Zespri Green, Zespri SunGold, Zespri Organic, Zespri Gold and Zespri Sweet Green Kiwifruit. Zespri operates an integrated marketing system, comprising long-term partnerships between growers, post-harvest operators, port and shipping companies, distributors, wholesalers and retailers, all focused on delivering kiwifruit to consumers in over 50 countries. Zespri's major markets are Japan, China, Europe and Taiwan, with strong growth also coming from South East Asia, Latin America, North America, India and the Middle East.

### Ownership model

Zespri Group Ltd is a private company, owned by current and past New Zealand kiwifruit growers. Only growers can purchase ZGL shares. Growers need to own sufficient ZGL shares to maximise the voting entitlement that is based on the production from their orchards. ZGL's constitution provides that shareholders can only vote their ZGL shares in proportion to their kiwifruit production. Growers buying orchards generally tend to buy shares from the vendor as part of the orchard purchase. However, a growing number of New Zealand orchard owners do not own Zespri shares, and over 18 million shares are held by people who have left the kiwifruit industry. ZGL believes that the growing misalignment between producing and non-producing shareholders is a source of destabilisation to the future growth of the industry, because an increasing proportion of growers will not have a stake in Zespri as shareholders.

To address the issue, ZGL is proposing a number of changes to its constitution that are designed to firstly reduce and then secondly reverse non-alignment over time (see Appendix A).

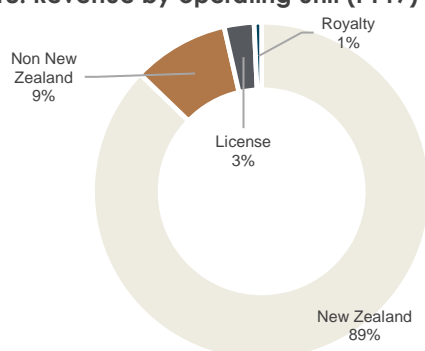
ZGL shares are traded through the Unlisted share trading platform ([www.unlisted.co.nz](http://www.unlisted.co.nz)).

## Business model

### Revenue Model

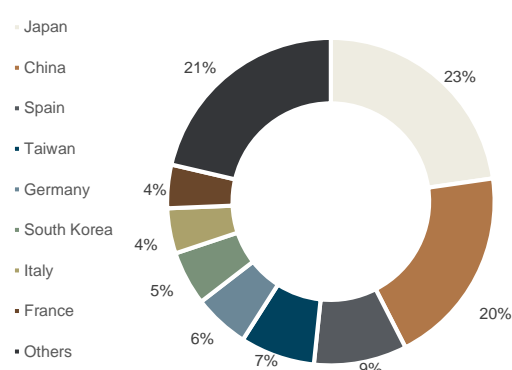
The company derives its revenues from selling New Zealand and non-New Zealand supplied kiwifruit as well as from selling licences and earning royalty income from plant variety rights (PVR).

Figure 18: Revenue by operating unit (FY17)



Source: Company data

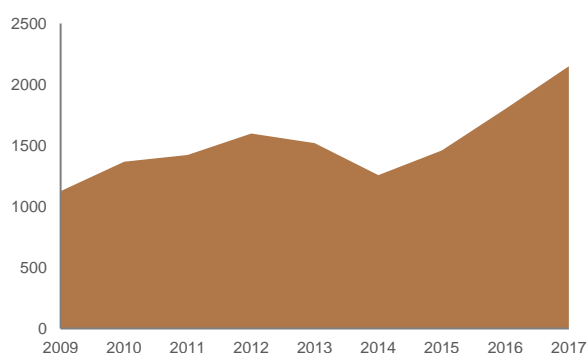
Figure 19: Revenue by geography (FY17)



Source: Company data

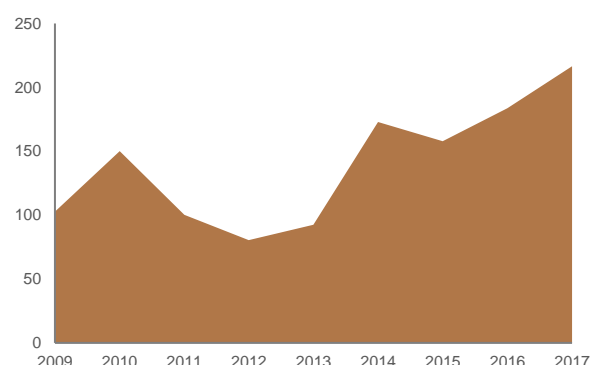
Zespri's has three main revenue segments.

Figure 20: NZ Kiwifruit Revenues (NZ\$m)



Source: Company data

Figure 21: Non NZ Supply revenues (NZ\$m)



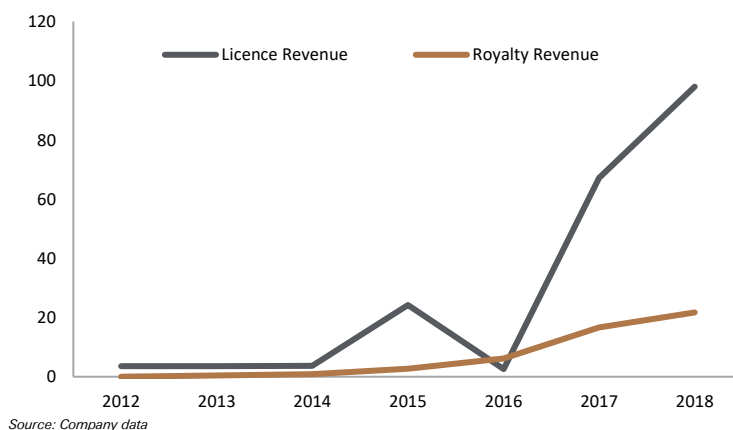
Source: Company data

**New Zealand Kiwifruit:** 89% of FY17 Group revenues. ZGL markets and exports kiwi fruit supplied by New Zealand growers to international retailers and wholesale suppliers. In fiscal FY17 New Zealand fruit exports (including collaborative marketing) comprised 89.5% of group revenues. ZGL sold 137.7m trays of kiwifruit (an increase of 17.6% on the prior period) in 2017 resulting in total sales of \$2.05bn (including \$19.1m market return from collaborative marketing). The Gold variety continued to be a key driver, achieving 48% growth to 48m trays. The business has achieved a CAGR of 6% in revenues over the last five years, with years FY13 and FY14 being impacted by

Psa. The green and the gold varieties comprised 61% and 35% of the fiscal FY17 volumes.

**Non New Zealand Supplies:** 9% of FY17 Group revenues ZGL sources premium quality kiwifruit from Northern Hemisphere orchards to supply the global market for the few months of the year when NZ-grown kiwifruit is not available, with orchards in Italy, France, Korea and Japan. The majority of ZGS fruit is grown in Italy. This allows ZGL to provide its customers year round supplies of kiwifruit.

**Figure 22: Licence and Royalty Revenues (NZ\$m)**



**New cultivars:** 4% of FY17 Group revenues. This segment earns revenues from selling SunGold licences and ongoing royalties.

**Licence revenues:** 3% of FY17 Group revenues. ZGL partners with Plant and Food Research (PFR) (a government research and scientific body) to develop new varieties of kiwifruit. The most notable ones being the Hort16A Gold variety of kiwifruit (which was significantly impacted by Psa) and its replacement SunGold which is more tolerant to Psa. ZGL own the Plant Value Rights (PVR) for SunGold which lasts for approximately 23 years until 2039. ZGL charges growers a one-off licence fee to grow SunGold. Due to the demand for SunGold licence revenue has lifted from \$8000/hectare in FY14 to c\$170k/hectare in FY17 and c\$240k/hectare in FY18. In addition, ZGL, on the back of this strong demand, has significantly lifted the SunGold licences for sale from 150 hectares in FY14 to 400 hectares in FY17 and is expected to release another 3750 hectares over the next five years, subject to an annual review. As a result, the licence revenue has risen from \$3.5m in FY13 to \$67.2m in FY17 and \$98m in FY18.

**Royalty revenues:** 1% of FY17 Group revenues: In addition to licence fees, ZGL charges royalties on PVR varieties (which currently is the SunGold variety) at the rate of 3% of the overall turnover of kiwifruit. This is shared 1.65% to ZGL and 1.35% to PFR. The significant increase in volumes of SunGold (from 21.1m trays in FY13 to 47.9m trays in FY17 in New Zealand) along with improved pricing has lifted royalty revenues from \$0.5m in FY13 to \$16.7m in FY17.

### Cost model

Cost of sales totalled \$2,254m in FY17 which included cost of procuring New Zealand and non-New Zealand fruit, freight, promotion and other costs, corporate overheads, research and development costs and depreciation and amortization expenses. The largest items were:

- Cost of Fruit procurement and loyalty premium accounted for 71% of FY17 operating costs.
- Freight, promotion duties and other direct onshore and offshore costs comprised 22% of operating costs
- Corporate and other overhead expenses were 6% of FY17 operating costs.
- R&D, depreciation and amortization were approximately 1% of total costs. New cultivar development remains the biggest investment in Zespri's innovation portfolio, with combined investment of around \$20 million a year in its joint breeding programme with Plant & Food Research and with support from the New Zealand Government.

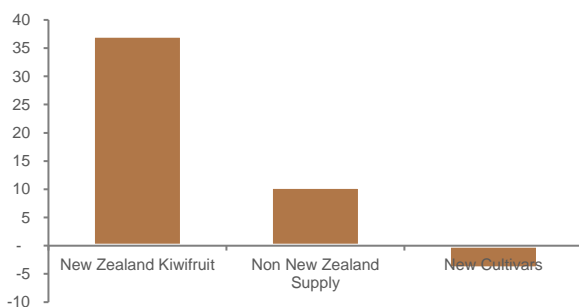
### Divisional earnings contributions

**New Zealand Kiwifruit (NZK):** The division posted an EBIT of \$22.2m in FY17 and accounted for 21.2% of Group EBIT. EBIT margins were 1.1% for FY17 and the company is targeting margins of 1% over the medium term.

**Non New Zealand Supply (NNZS):** The division posted an EBIT of \$11.9m in FY17 and accounted for 11.3% of Group EBIT. EBIT margins were 5.5% for FY17 and the company has targeted margins of between 5-5.5% over the medium term.

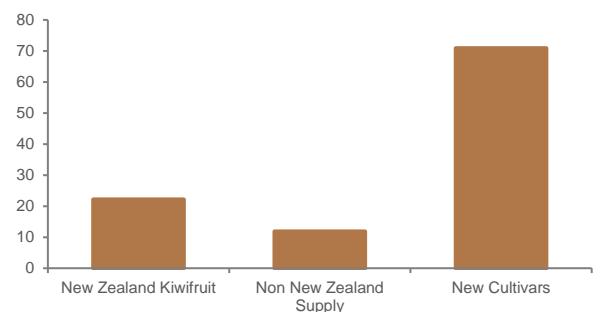
**New Cultivars (NC):** The division posted an EBIT of \$70.9m in FY17 and accounted for 68% of Group EBIT. EBIT margins were 81% for FY17. This highlights the strong demand for the SunGold variety of kiwifruit which is propelling licence and royalty revenues.

**Figure 23: FY16 EBIT by operating unit (CIP estimate) (NZ\$m).** FY16 NZK had a +\$13m adj for a China provision.



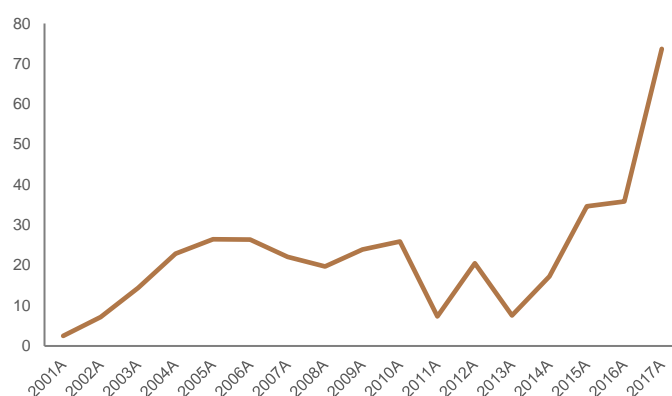
Source: Company data, CIP

**Figure 24: FY17 EBIT by operating unit (NZ\$m) – the rise of SunGold is obvious**



Source: Company data

**Figure 25: ZGL NPAT history (NZ\$m)**



Source: Company data

ZGL's long-term NPAT performance highlights some volatility in earnings. After a strong rise in profitability 2001-2005, NPAT levelled off between 2005-2010, and declined into 2013. This reflected the impact of the GFC, which dampened demand, and then the onset of Psa which significantly affected Gold volumes and Zespri also incurred costs to combat Psa. NPAT has recovered significantly between 2013 and 2017 reflecting improving global economic conditions and the success of the new SunGold variety as we outline in this note.



## Industry overview

### The NZ kiwifruit export industry

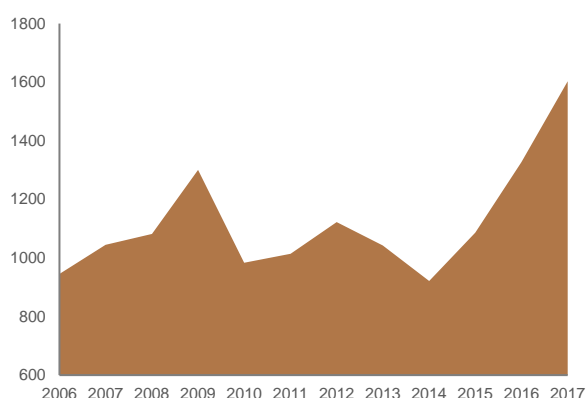
**Table 7: Industry statistics**

| Season (ends 31 March)      | 2000   | 2005   | 2010   | 2015   | 2016   | 2017   |
|-----------------------------|--------|--------|--------|--------|--------|--------|
| <b>General Statistics</b>   |        |        |        |        |        |        |
| Yield (trays/ha)            | 5,295  | 7,847  | 8,546  | 8,662  | 10,157 | 11,838 |
| Area planted # (ha)         | 10,234 | 10,934 | 12,525 | 11,233 | 12,185 | 12,578 |
| Growers/suppliers           | 2,681  | 2,760  | 2,711  | 2,540  | 2,516  | 2,435  |
| Packhouses                  | 118    | 88     | 71     | 50     | 51     | 50     |
| Coolstores                  | 106    | 89     | 77     | 62     | 64     | 73     |
| Orchard Gate Return (\$/ha) | 15,366 | 34,738 | 39,142 | 57,369 | 60,758 | 68,868 |

Source: Zespri

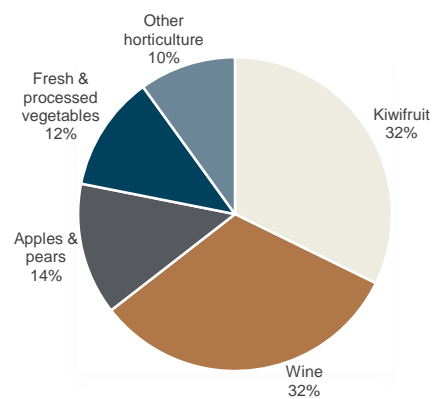
The New Zealand kiwifruit industry has 2,435 growers and 3000 registered orchards, with over 12k hectares in planted kiwifruit vines. New Zealand is endowed with a favourable temperate climate and the volcanic soil produces ideal growing conditions to grow the fruit. The Bay of Plenty comprises over 80% of New Zealand's kiwifruit produce.

**Figure 26: NZ kiwifruit export revenue (\$NZm)**



Source: Statistics NZ

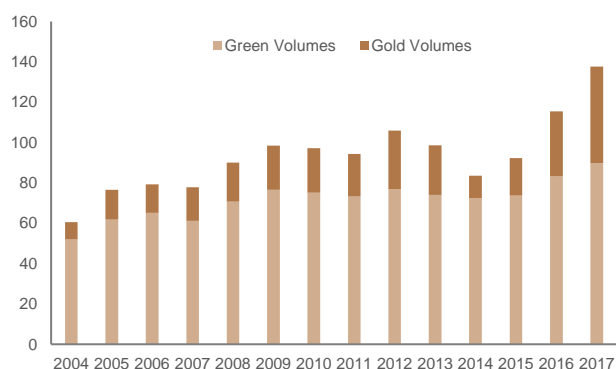
**Figure 27: NZ Horticulture Exports**



Source: Statistics NZ

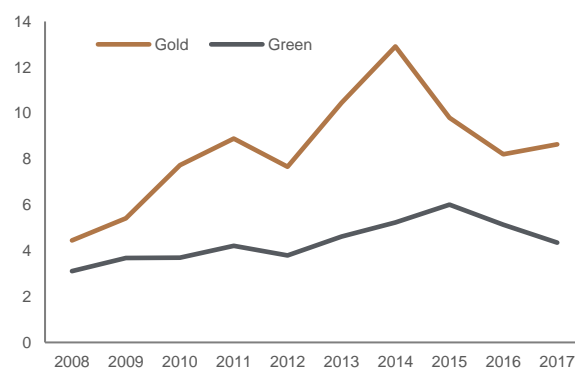
Kiwifruit continues to be New Zealand's largest single horticultural export by volume and value, constituting c1/3 of horticultural exports by value.

**Figure 28: NZ kiwifruit export volumes (trays, millions)**



Source: Company data

**Figure 29: NZ kiwifruit exports – price per tray (NZ\$)**



Source: Company data

NZ kiwifruit exports have grown from 60m trays in 2004 to 140m trays in FY17 at a CAGR of 7%. However, this growth has not been linear. The arrival of Psa into NZ in

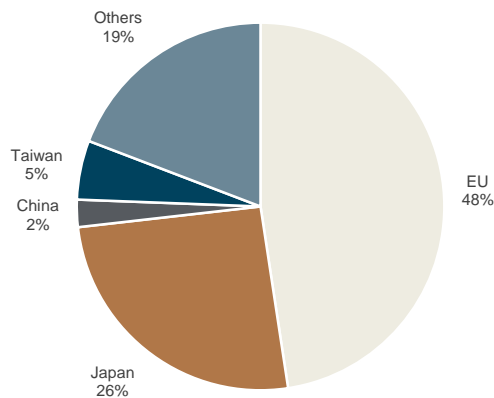
2010 resulted in kiwifruit export volumes declining c20%+ between 2012-2014, largely due to Psa's impact on the high value Hort16A Gold variety (volumes -60%). NZ kiwifruit export volumes subsequently recovered strongly due to the successful development of SunGold, a gold variety with greater tolerance to Psa, for which ZGL owns the PVR until 2039.

Data from Statistics NZ shows that Kiwifruit exports for the year ending June 2017 were \$1.7 billion, relatively unchanged from the previous year. However, this is c65% above the average value of \$1.0b for the five years 2011-2015. At \$1.7 billion in the 12 months to June 2017.

Export volumes reached 146 million trays in the year to March 2017 (up 14 percent from the previous year) setting new records for the New Zealand kiwifruit industry. These increases were driven by high yields for green kiwifruit orchards, maturing gold kiwifruit orchards recovering from Psa, and good market performance.

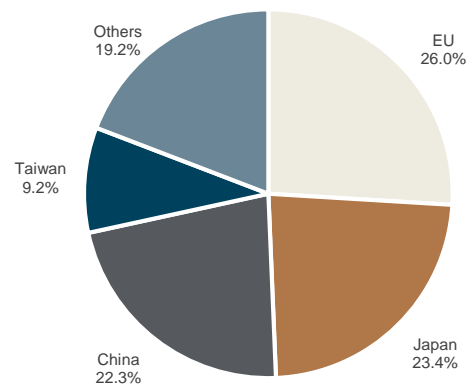
### Expanding markets beyond traditional customers has driven demand for NZ kiwifruit exports, particularly China

Figure 30: Key export markets 2008



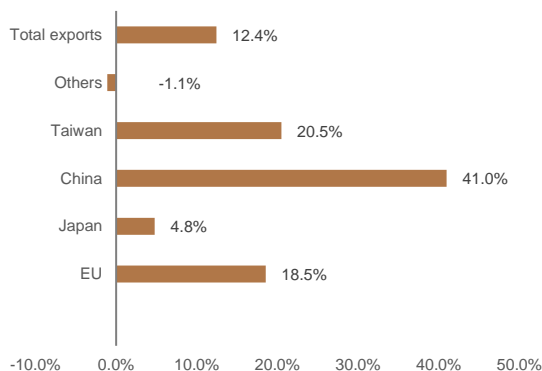
Source: Fresh Facts

Figure 31: Key export markets 2016



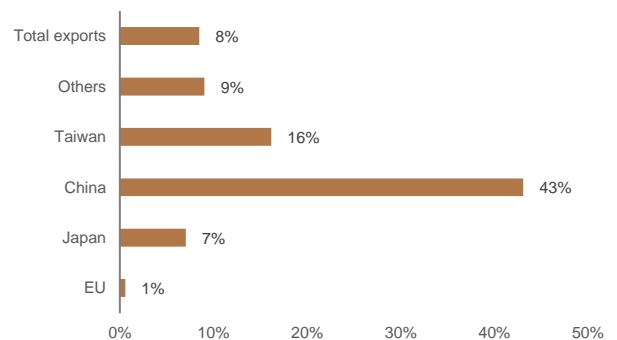
Source: Fresh Facts

Figure 32: 4 year CAGR in exports



Source: Fresh Facts

Figure 33: 8 year CAGR in exports



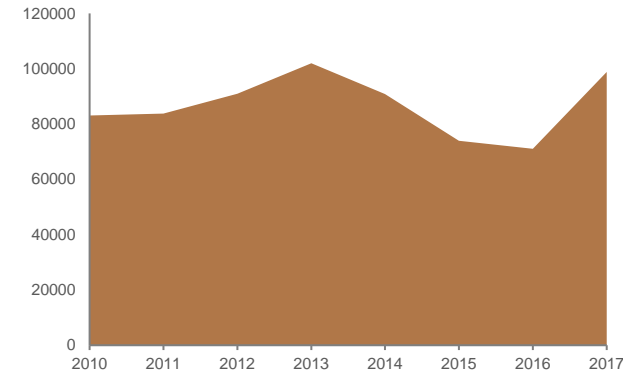
Source: Fresh Facts

The appetite for kiwifruit continues to grow beyond the traditional markets of Europe and Japan, evidenced by the opening of the Chinese market and more focus on the likes of Taiwan. The European Union (26%) and Japan (23%) currently take c50% of all kiwifruit exported, by value, down from 75% in 2008. China (22%) and Taiwan (9%) round out the four major markets. Of the major markets the strongest growth

came from China, up 43% CAGR between 2008 and 2016, followed by Taiwan up 16% CAGR over the same period.

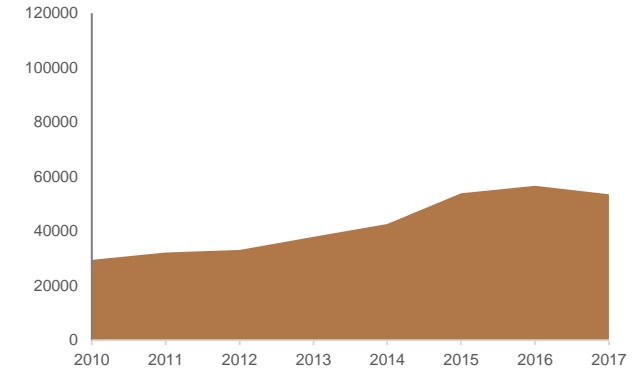
### NZ orchard gate returns strengthen back to pre Psa returns and are expected to lift further

Figure 34: Orchard gate returns – Gold (\$/h)



Source: Company data

Figure 35: Orchard gate returns – Green (\$/h)



Source: Company data

The success of SunGold has resulted in average orchard gate returns (OGR) per hectare increasing to more than \$60k across the industry in 2017, substantially higher than a decade ago when returns were around mid \$30k. OGRs for 2016/17 were c\$54k/hectare for Green and c\$99k/hectare for SunGold. For FY18 OGRs for green have held at \$57k/h while OGRs for SunGold have lifted from \$99k/h to \$111k/h.

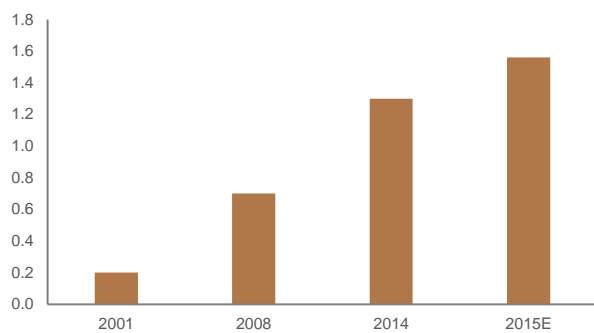
With on-orchard costs at \$32k/ha and c\$37k/ha for green and gold respectively, a quasi EBITDA for Green kiwifruit is c\$25k/ha and c\$60-70k/ha for SunGold.

### China is an opportunity but also a risk

Chinese consumption of kiwifruit has grown exponentially over the last 10-15 years from 0.2m in 2001 metric tonnes to an estimated 1.6m metric tonnes in 2015. This is being underpinned by a growing middle class. The New Zealand kiwifruit industry has benefited immensely from this trend, evidenced in the rapid increase in exports of kiwifruit to China, lifting nearly 3-fold in the last five years. China now comprises 22% of total New Zealand exports, the third largest market after EU and Japan. Additionally, New Zealand accounts for an estimated 70% of the overall kiwifruit imports into China, significantly above its nearest rival Chile. China will continue to remain a long-term opportunity given its expected mid-teens growth in kiwifruit consumption and New Zealand's competitive advantage over Chile in terms of the quality and taste of the kiwifruit (especially the gold variety). Additionally, southern hemisphere producers have a distinct advantage of supplying kiwifruit to China and other northern hemisphere customers due to seasonality factors i.e. kiwifruit is supplied during spring and summer when northern hemisphere kiwifruit is not available.

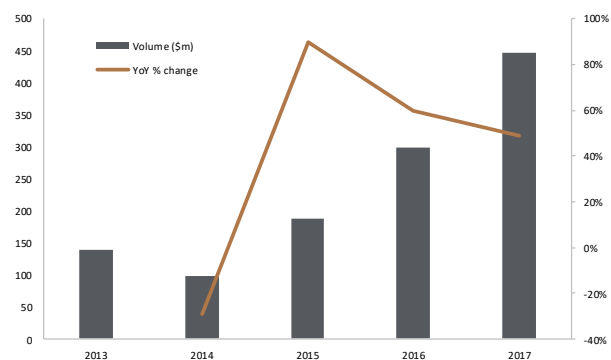
Nonetheless, the growing dependence on China does present a risk for Zespri. Chinese production of kiwifruit is also growing and the fruit is now available during the shoulder season i.e. between August and October somewhat overlapping with the New Zealand kiwifruit supply. In 2016, Zespri's exports to China were temporarily impacted after the Chinese border control found a shipment of kiwifruit carrying fungus. Zespri halted shipments and worked with the Ministry of Primary Industries (MPI) to resolve the issue.

**Figure 36: China's Kiwifruit consumption trends (metric tonnes, millions)**



Source: World Kiwifruit Review

**Figure 37: Zespri sales to China (\$m)**

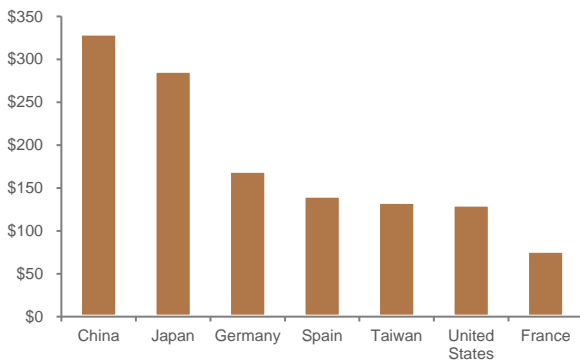


Source: Company data

## The global kiwifruit market

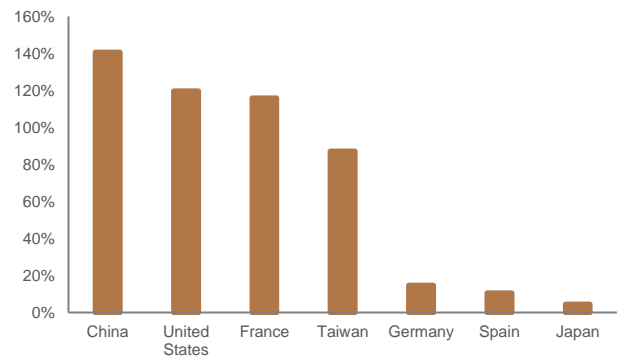
### Key importers of Kiwifruit

Figure 38: kiwifruit net importers (US\$m)



Source: World Kiwifruit Review

Figure 39: Change to net imports since 2012



Source: World Kiwifruit Review

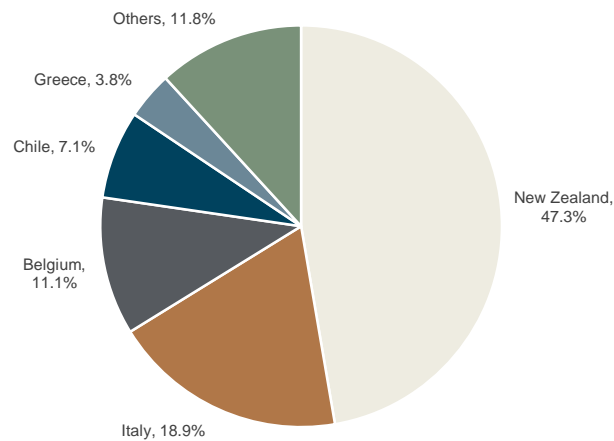
Kiwifruit remains a niche product in the global fruit bowl, making up just 0.22 percent of globally traded fruit, which brings significant challenges for winning shelf space and consumer attention in markets. However, world exports of kiwifruit have been showing good growth averaging around 2.7% per annum over the last 15 years with the European Union being the main driver of world trade and the chief importer (comprising over 60% of world imports) of kiwifruit.

In recent years Asia, particularly China, has seen strong growth in kiwifruit imports as China's large population of middle-income consumers and rising affluence underpins demand for kiwifruit. More importantly Chinese imports of kiwifruit continue to be dominated by Southern Hemisphere countries like New Zealand and Chile. In terms of worldwide exports of kiwifruit, Italy, New Zealand, Chile and Greece dominate the trade accounting for almost 90% of overall kiwifruit exports. Despite efforts to improve quality and storage, the kiwifruit category remains a commodity category. Around 70 percent of the global volume of kiwifruit is sold in the same continent in which it is grown, with over 80 percent of globally traded kiwifruit consumed in the northern hemisphere.

Globally, the kiwifruit industry is seeing a significant shift in production as volumes in China increase. The growth in volumes in China and an increasing number of new varieties – in particular competitor gold varieties – means that, at some point in the next decade, China is likely to become a significant exporter of kiwifruit, particularly to Asia, and a competitor to northern hemisphere kiwifruit-growing countries.

Generally, kiwifruit produced in either the Northern or Southern Hemisphere is sold before off season supplies become available from the other hemisphere. In most years, supplies from the two hemispheres are complementary rather than competing. However, as global production has increased, the possibility for overlaps has increased. For example, Chinese kiwifruit is available in August/September as opposed to November in other Northern Hemisphere countries.

**Figure 40: Share of kiwifruit global exports**



Source: World Kiwifruit Review

New Zealand kiwifruit competes mainly with Chilean producers for a share of Northern Hemisphere's volumes. This is because southern hemisphere producers sell their produce to Northern Hemisphere buyers between April-Nov when Northern Hemisphere fruit is generally not available (barring places like China which sells its produce from August).

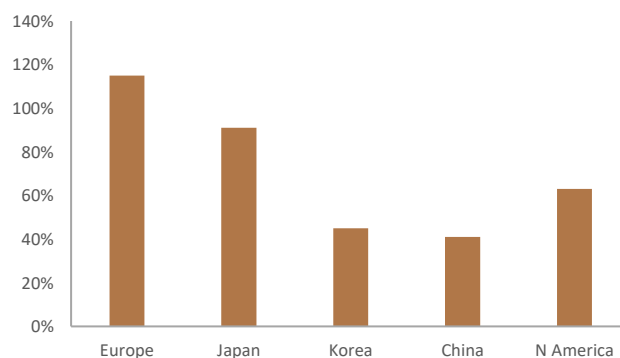
However, New Zealand growers are able to command significantly higher prices than their Chilean counterparts due to its superior quality and better tasting fruit. Also, Chilean growers mainly operate in the green variety of kiwifruit and are more or less absent in the gold variety due to lack of innovation, weather related issues and the impact of the Psa outbreak.

New Zealand's innovation (due to investment in R&D to develop new cultivars) and its ability to produce a more Psa tolerant premium gold kiwifruit will spur industry growth for the foreseeable future.

### **NZ Kiwifruit commands premium pricing across all regions**

Zespri's internal target is to be at least 20-40% above the nearest kiwifruit competitor. In Europe the target is to be above 40% whilst in North America the target is to be above 20%. In China, Zespri was able to attract a high premium due to a shortage of supply of Chilean fruit. The following chart reflects the premium for Zespri's green variety of kiwifruit versus Chilean green in various regions for 2016.

**Figure 41: Region wise premium pricing (2016)**



Source: Company data

## Appendix A

### The Kiwifruit Industry Strategy Project (KISP)

When Zespri was first corporatised, all growers had a share in Zespri and could benefit both in terms of grower returns and from the value created by their marketer. However, over time this has changed.

ZGL proposes recommendations on changes to its constitution, to be voted on at the March 2018 Special Meeting, including the following:

1. A maximum shareholding of four shares for each tray of production. A producer would not be able to acquire more shares if they are overshadowed or if the acquisition would make them overshadowed. A producer that has been overshadowed for a continuous period of three years or more would have to dispose of their overshadowed shares. However, for those producers that are overshadowed as at the date the constitutional changes take effect, a transitional period of seven years will apply.
2. Dividend restrictions on shareholders who are no longer producing growers. A dividend would not be paid to a shareholder that is not a producer as at the record date for that dividend and has not been a producer for three years. However, for those who are dry at the time of the change in the constitution dividends would cease seven years after the change. Note that the amended regulations do not permit a requirement for dry shareholders to sell their shares.
3. A change to voting entitlements. To be based on one voting share for each tray of that property's production, or the number of shares the producer holds, whichever is the lesser. Voting rights would be shared between the owner and lessee according to the landowner priority rule. If both landowner and lessee hold shares, the landowner takes priority to use the votes attached to the shares as a result of production.

Please note that the information above is simplified and does not cover all aspects of the changes. The recommendations are still being finalised and some could potentially change before being put to a shareholder vote in March 2018.

| Table 6: KISP Dates | Action   |
|---------------------|--|
| Late Feb 2018       | Notice of meeting and voting forms distributed |
| 14-Mar-18           | Zespri Special Meeting                         |
| Late 2018           | Targeted share buyback and issue programme     |

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