HUGOvision

Assessing the economic and political environment in New Zealand

April 3 2020 | Confidential to HUGO members

Insolvency 'safe harbour' and 'hibernation' provisions Page 4

This afternoon's announcements on new safe harbour provisions protecting directors from 'reckless trading' prohibitions in the Companies Act are both a relief for directors and a further new source of moral hazard for investors. The new business 'hibernation' scheme is an advance on what Australia is offering.

Life after covid-19 Page 2

As former PM John Key put it today, covid-19's impact will come to an end in a way determined by the life of the virus, unlike the GFC, where the implications remained comparatively open-ended. However, covid-19 is taking a far greater toll on the global economy than the GFC and life will change. What are some of the emerging mega-trends?

Coming out of lockdown - next week's Cabinet focus Page 5

The Cabinet will start looking in earnest next week at early thinking on how to emerge from lockdown, whenever that may be. The only things that are clear are that it will be gradual, progressing through the 4 alert levels; it will likely be regional, with less-affected regions returning to semi-normality ahead of those with clusters and outbreaks; and that large industrial plants and key industries capable of operating safely will be prioritised.

Economic outlook - down then up, but no clarity Page 6

Anyone claiming to know what the path for the NZ economy will be over the next two or three quarters should be regarded with great scepticism. The only things that are clear are that the economy will take an unprecedented pounding in Q2 before hopefully beginning a rebound that will probably not be as strong in Q3 and Q4. It may be 2023 before economic activity returns to pre-covid-19 levels.

A long period of relative isolation Page 3

The likelihood that NZ's borders will effectively be closed for months, if not more than a year and that it will take longer than that for international passenger air services to resume with great regularity means the country will be relatively isolated until the end of 2021, if not longer. Shortened supply chains may favour local e-commerce retailers and manufacturers.

Not much respite on regulatory agenda Page 6

Anyone hoping for a slower or amended regulatory agenda shouldn't count on it. Most existing regulatory and legislative reform is delayed by the covid-19 response and the suspension of Parliament. But RMA and freshwater reform, for example, are still on track, even if the govt tries to fast-track consents to make major infrastructure projects 'shovel-ready'.

Today's late issue

We apologise for the late despatch of today's issue of Hugovision. We were anxious to include detail of the govt's new insolvency and 'hibernation' packages, which came late afternoon today.

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Society and the economy post-covid-19

Difficult as it is to imagine right now, the coronavirus crisis will pass and a 'new normal' will eventually emerge.

It is too early to say exactly what that will look like but there is consensus that this event is so globally pervasive that it will have far-reaching and long term impacts on societies, economies, and politics.

At this early stage, a few clear, large-scale themes are already apparent:

Big govt is back

The sheer scale of govt interventions to attempt to cushion the economic impact of the response to a health crisis means the govt will be a much larger part of the economy in the next decade, at least, than it has been.

To the extent that the govt becomes guarantor or direct investor in some parts of the economy where it had either previously withdrawn or been a small or non-existent participant, it will also be a much more influential direct economic actor.

This will have implications not only for regulatory settings, but for competitive opportunity in areas where govt involvement is greater than in the past. For example, a desire to recreate a Ministry of Works-style govt-owned infrastructure capacity would significantly change the competitive dynamics of the construction and infrastructure sectors.

We are seeing some nascent signs that the govt will begin to pursue a more state-led economic development agenda (*see comments in trade union influence section*).

Implications of these trends include a greater need for businesses to be politically attuned and connected and a possible rise in the role and importance of lobbying. These are not necessarily welcome developments, but rather the likely implication of greater govt influence in all aspects of the economy by virtue of having to step in to 'save' it now.

More, not less tax

A blow-out in net Crown debt from around 20% of GDP to perhaps 50% or greater is not a disaster fiscally. Many other OECD countries have higher debt levels than that. However, restoring the Crown accounts from a position of deep deficit will likely spur a more progressive income tax scale, with potential for a higher top personal income tax than at present. There will be even less political sympathy for those still earning very high incomes in the recovery phase than there has been in the last two decades, especially if unemployment is at 10%-plus.

There is unlikely to be a willingness to revisit a capital gains tax, although if property prices fall in the coming two to three years, some form of capital or wealth tax may not be as difficult to achieve as in times of rampant asset price growth.

Minimum wage

The govt stuck to the April 1 increase the minimum wage to $18.90 from $17.70 on April 1.

Employer groups had called for its postponement but a combination of the relaxed terms for use of the wage subsidy (below 80% pay acceptable if preserving jobs) and govt commitments to the trade union movement made this a non-starter.

Grant Robertson suggested firms were well-prepared for the increase.

Civil liberty erosion is a risk

The extension of police and other regulatory powers during the state of national emergency is intended to be temporary.

NZ is also a notably tolerant liberal democracy. However, govts are often inclined to become accustomed to the use of authoritarian powers and can be slow to unwind them.

The highly concentrated approach to political messaging at present - only the PM and Finance Minister Grant Robertson have free rein to make public comment - may also become entrenched.

News media who are perceived to be being 'unhelpful' at a time that requires a high degree of cohesion and popular obedience are already finding themselves on the outer with key govt advisers. All media are struggling with the absence of many of their usual channels for information-gathering.

This makes the select committee overseeing the govt's actions during this time especially important. While it has operated in a fairly constructive manner to date, it is evident that MPs are as interested in playing to populist concerns as they are to the deep political and economic challenges ahead.

Briefings with Grant Robertson and Phil Twyford this week dwelt at surprising length on attempts to prise unknowable forecasts from the Treasury and questions on restrictions to various kinds of retail food outlets.

While important to a population locked down, that questioning soaked up time that meant important opportunities to examine the govt's plans for large industries and further economic support were missed.

Consumption patterns will change

Early evidence from China's 'return to normality' suggests that consumers don't just go straight back to the shops.

They are proving cautious, not only for ongoing health reasons, but also because so many have experienced an income hit.

The desire to consume entertainment, eat out and buy new consumer goods and travel experiences may be strong, but travel options are likely to remain limited and entertainment options underpinned by international tourism will not bounce back as strongly while national borders remain closed.

Falling values for residential real estate and equities are likely to engender caution among households.

Aviation, mass tourism

Air travel will be less ubiquitous, more expensive, and there will be more hassle when crossing borders than had become the norm.

Greater health screening is likely, even once this virus is under control, while prolonged border closures will hollow out the number of airlines offering international services. That will make airfare competition far less vigorous than it has been.

One possible trend could be converting more planes to larger freight and smaller passenger tasks.

Both long and short-haul business travel will revive, but to nothing like the same extent as in the past. A huge number of firms are discovering how effectively they can meet face-to-face on broadband-enabled channels rather than having to travel.

The savings in time and money, and therefore increased productivity, may shift business travel from the norm to occasional-as-needed for many businesses.

International tourism will recover, but numbers are likely to be far lower than in the past. The tourism sector's capacity to soak large numbers of poorly skilled and lowly educated NZers will diminish markedly.

Growth from migration

Immigration-driven growth will inevitably slow as international travel restrictions hinder previous patterns. That, along with the release of large numbers of AirBnB dwellings onto the domestic rental market, should place downward pressure on house prices and residential rents.

That may in turn reduce growth potential for retirement housing providers, with softer real estate valuations changing potential customers' tastes and ambitions for retirement accommodation.

International education

These trends will also **push NZ universities to offering more international education online** rather than the current reliance on students travelling to NZ. This was overdue, but will be a competitive and funding challenge.

Shorter supply chains = improved resilience

Globalised supply chains will resume, but their fragility in crisis has been highlighted by the impacts of the global pandemic. Govts are likely to consider local or nearby sources of supply for both essential and non-essential goods and services to be an investment in disaster resilience.

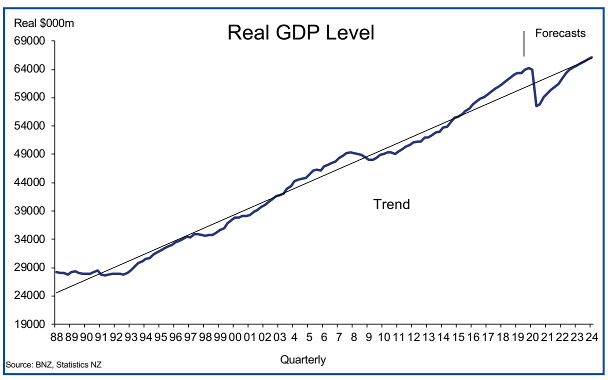
This will play into the hands of protectionist sentiment and will require careful balancing and adjustment to policy and diplomatic stances to accommodate the legitimacy of a concern for resilience.

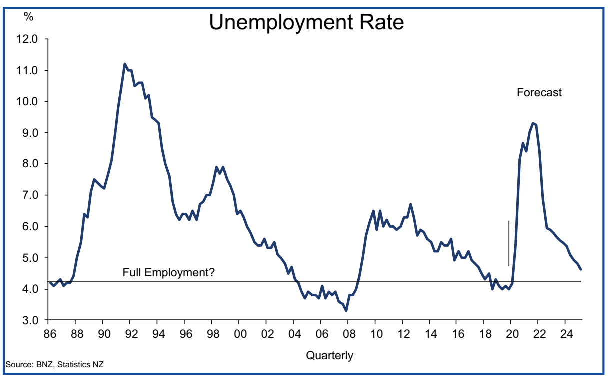
Domestic e-commerce may find itself with competitive advantage if international delivery times and freight costs rise.

Diversified trade - but China dependence will be hard to shake

Even before covid-19, the govt was beginning to attempt a trading partner diversification strategy to reduce reliance on China.

This will prove more challenging than it appears, particularly if China continues to emerge first and fastest from the covid-19 crisis. As a food supplier to





the world's most populous nation, and one which is reopening ports and supply chains that have been closed, NZ will find China hard not to entrench as our largest trading partner.

Trade union influence will rise

Particularly under a Labour-led govt, the influence of trade unions will become greater in a recovery phase dominated by very high rates of unemployment. The govt can be expected to pursue with greater vigour the kind of Scandinavian-style tripartite economic policy consensus that would, if successful, lead also to development of higher productivity industries.

The attitude of trade unions to a Universal Basic Income may be critical to whether that policy advances beyond catch-cry status.

Insolvency vs govt-guaranteed lending: moral hazard grows

This afternoon's announcement of a temporary six-month 'safe harbour' protection from being required to invoke normal insolvency tests introduces furthernnew moral hazard for investors and lenders.

The provision is intended only to apply to businesses that were solvent and viable before the covid-19 lockdown and not to absolve directors of their obligations to deal in good faith and to meet obligations to creditors.

A key test will be whether the business could meet its obligations at Dec 31 last year. While it may be tempting to assume that the focus of this relief is s.135 of the Companies Act, dealing with prohibitions on 'reckless trading', a view formed during policy formation that it was not necessarily 'reckless' to trade through the cashflow crisis of covid-19.

Rather, the more important test is s.136, which deals with directors' obligation not to incur obligations they do not believe they can perform.

Legislation has yet to be either tabled or introduced, will be retrospective to today, and may not go through a normal select committee process, Grant Robertson said. However, some form of parliamentary scrutiny will occur.

The same legislation will create a hibernation or 'business stand-still' process allowing businesses to negotiate with their creditors to suspend debt obligations until the company can begin trading normally again. This will require the agreement of 50% of creditors. Guidance is expected from the drafted bill, but that has yet to be drafted.

The hibernation process will give directors a month to negotiate and seek a vote from creditors to trigger a six month hibernation.

This is perhaps the last substantive move we can expect to see from the govt to take the pressure off directors facing cashflow crises created by the covid-19 lockdown. The other moves have come from:

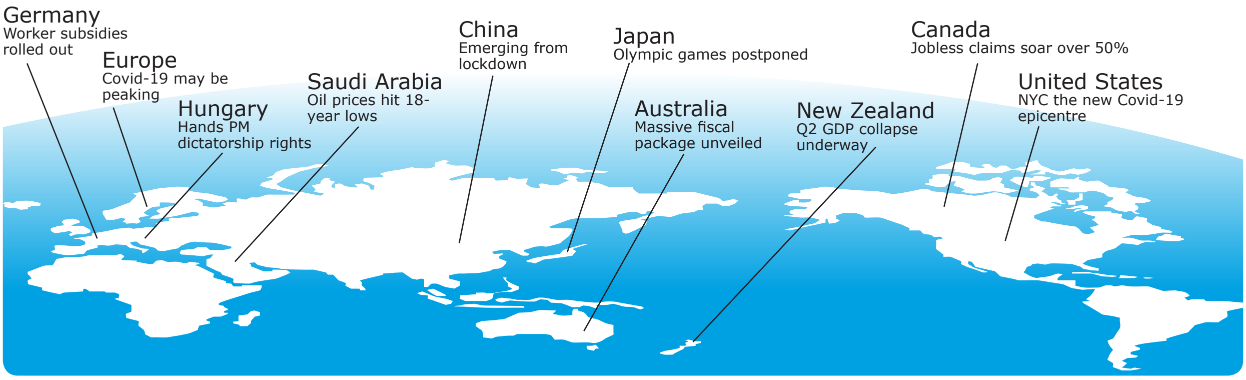
- the RBNZ encouraging freer lending by trading banks and a delay to new capital-holding requirements;
- the wage subsidy scheme, and;
- the 80% govt-guaranteed bank lending initiative allowing up to $6.25b of new, three year lending of up to $500,000 per business for firms turning over between $250,000 and $80m p.a.

While undoubtedly welcome for cash-strapped businesses, the banking sector and firms' advisers are concerned that the balance of moral hazard has tipped firmly favour of reckless trading.

The govt is effectively asking the banking sector to decide which businesses should be regarded as viable and likely to remain in or return to a solvent state post-lockdown. Bank processes are being reinvented in haste to make this possible.

Scope for further initiatives

While there are no obvious, new pan-corporate



policies being urged at present, tweaks to the wage subsidies and govt-backed lending schemes are still possible and there are numerous sector-specific interventions to come.

Commercial rent 'strikes'

The threats to commercial property owners and their tenants may be a source of early focus next week.

Many tenants have unilaterally informed their landlords they won't be paying the rent through the lockdown.

However, many others are negotiating reductions based on the provisions of the widely used Auckland District Law Society standard lease, which stipulates a tenant's right to seek a 'fair' reduction in rent if prevented from using their premises by a competent authority during events, including epidemics. The clause became standard in many leases after the Canterbury earthquakes. At least some are settling on a 50% reduction, with mutual agreement that if the govt stipulates a different formula, both sides will be bound by that. A govt relief package of some kind may yet emerge.

Infrastructure progress payments

Parties to the Construction Accord are understood to be working on an initiative to replicate the progress payments policy announced by NZTA this week for roading and other transport infrastructure providers. This will keep cash flowing on transport projects that are currently stalled.

A similar agreement for built infrastructure projects, probably only those that are public sector-funded, could assist construction companies that are threatened by highly leveraged balance sheets and potential to lose skilled workforces.

Staged return for major industry / regions

The govt will next week begin considering the potential to start bringing large industrial plant and sectors including forestry harvesting into production on a staged basis.

Criteria will focus on whether the plant or activity is near a covid-19 cluster or outbreak. If so, no dice; if not, the issue will be whether the operator or industry can operate physical distancing and sanitation protocols to satisfy Level 4 requirements.

More broadly, the govt is likely to start trying to bring regions out of lockdown progressively once more is known about community testing.

The areas of greatest concern at present are at either end of the country - Auckland and Southland.

News media

Bauer Media's decision to close its stable of household name magazines was a body blow to the govt, which is deeply concerned about the fragile state of the private news media.

It has no wish to become an owner or investor in any more media companies or to have to bail out any one sector because it will create expectations in others.

However, there are no obvious answers other than a revenue top-up or use by Stuff and NZME, which are still profitable in normal times, of the new safe harbour provisions.

A revenue top-up reflecting lost revenues is one mooted suggestion. The paucity of options was clear when ministers sought to suggest that currently minimal print media funding from NZonAir represented a possible avenue for assistance.

Mediaworks TV3 operation, which is unprofitable and like Bauer has been unable to attract a buyer, may be a more difficult proposition. The govt will, however, want to avoid more media shutdowns because of the disproportionate public confidence effects created by high-profile news operations disappearing at a time of voracious news consumption which, ironically, news publishers are unable to monetise at present.

Strategic messaging issues

The govt needs to adopt clear targets and timelines for eliminating the spread of covid-19, epidemiologist David Skegg told the new epidemic oversight select committee. Skegg said the current lockdown was a bold response, but not enough on its own to stamp out the virus.

Health Minister David Clark's decision to go for a mountain-bike ride and use his signage-plastered van to do so did not help consistent messaging.

Govt's modelling shows lower death toll than rhetoric

The confusion and potential to mislead the public was apparent in the modelling of the potential death toll released by the govt this week.

Early modelling by Otago University Medical School of worst case scenarios put the potential death toll at around 40,000.

However, their figure released this week, based on the constantly improving understanding of mortality rates from covid-19, put the worst case at 27,000.

That is consistent with, but surely **at the lower end of the "tens of thousands of deaths"** used when the lockdown was announced Sunday of the week before last.

It is also well below the figures produced by **Auckland University's Shaun Hendy**, who projected worst case death rates of closer to 90,000.

The Lancet, a respected medical journal, meanwhile published **new analysis this week suggesting the mortality rate may be around 0.66%**. That is well below the 1-2% rates being used in early modelling, based on the early statistics from the Chinese outbreak.

However, it is still six to seven times more deadly than influenza.

None of this is to question the wisdom of strong containment measures to attempt to eradicate the virus in NZ, but to demonstrate the **fluid environment - and the potential for dissent to build around conflicting evidence - that is developing** just one week into the lockdown.

Competing theories as to how best to respond, and of the appropriate balance between health and economic damage, will only intensify over the next three or more weeks that the current extraordinary measures continue.

This will be a huge test of not only the govt's capacity to manage the issue, but of **PM Ardern's capacity to carry the public with her as the economic pain and sheer disruption to normal life grinds on.**

Where to for regulatory agenda?

Environment Minister David Parker said work is underway to speed up consents for development and infrastructure projects during the recovery from covid-19. He said the govt did not want the standard RMA consenting processes to constrain the pace of recovery. It was hoped decisions would be made before the end of the current lockdown.

On **freshwater reform**, Parker acknowledges that it will proceed more slowly than the previously announced timetable. However, it will proceed and he is choosing to hear the view from the parts of the rural community who want closure and certainty rather than those elements who see covid-19 as an opportunity to stall the process.

Economic outlook

- A slump and then a bounce
- The magnitude is anyone's guess
- The bounce will not be a full reversal
- Four years to "normality"?
- And some permanent changes

Forecasts for the economic carnage being wrought in Q2 are almost absurdly wide, at between 17% and 33% reductions in activity, but are universally dauntingly large. Perhaps the only good thing about is the consensus, for now, that the greatest impact of covid-19 will be in the second quarter before some kind of recovery starts to occur.

However, there is no point in trying to be hard and fast about any expectations at this stage.

Suffice to say that the growth projection graphic at the foot of page 3 does indicate that the longer term trajectory for growth remains intact, since there will be a large shock followed by a large bounce.

However, the bounceback is likely to be smaller than the downward spike and it will take far longer than a quarter or two to return to a new normal.

2023 before pre-crisis economic level returns?

It could well take three to four years for activity to regain levels seen prior to covid-19.

StatsNZ is also likely to struggle for an accurate picture, partly because of the scale of this shock and also because there must be questions about the capacity of some data-providing firms to prioritise the task.

Strain on credit markets

There has been immense strain on corporate and bank credit markets over the past month, on a scale not seen since the GFC.

The primary market for bonds issued by investment-grade rated corporates and banks in US dollars and euros (the two biggest markets in the world for these bonds) effectively shut down for a period.

The yield spread between corporate and bank bonds and those of govtt bonds has widened dramatically. This has been the case in NZ as well.

The secondary market for bank and corporate debt in NZ is extremely strained and very illiquid. There has been no primary issuance in the NZ market since the turmoil kicked off.

While the RBNZ's big injections of liquidity have helped calm short-term funding markets to an extent, this has had little-to-no impact on the market for longer-term bank and corporate debt. The cost to banks of longer-term wholesale market funding, both in NZ and offshore, has increased substantially.

For NZ banks, deposits are by far the most important source of funding, accounting for more than 70% of funding for NZ registered banks. NZ term deposit rates have come down slightly this month, but much less (approximately 10bps to 20bps) than the 75bps cut to the OCR. All this means that bank funding costs have not fallen by anything like 75bp, if at all.

Primary sector

Tentative resumption of trade with China, which appears to be emerging from its coronavirus lockdowns, makes primary sector exports a rare economic brightspot.

Lobster exports, facilitated by govt-underwritten air freight services, resumed to Shanghai this week while demand for wholemilk powder and other dairy commodities remains robust.

Southland milk formula producer **Mataura Valley Milk** reported a significant spike in demand for nutritional products into China as European milk volumes stall.

Pork producers say they may have to cull 20,000 or more pigs in the next four weeks if food manufacturers and supermarkets are unable to fill the gap left by the closure of independent butchers and restaurants.

Transport, tourism and logistics

The govt will loan **Air NZ** up to $900m to keep the national carrier afloat and may convert that debt to equity. As part of the deal, Air NZ cancelled its upcoming dividend payment of 11cps. It is also looking to reduce staff as it drastically cuts flights. Before covid-19, it had annual revenue of around $5.8b. Based on current booking patterns it expects to turn over less than $500m annually.

Air NZ shares sank as investors judged the govt's $900m bailout. **Rickey Ward** at **JBWere**, said the size of the loan was too small given speculation $2b to $3b was needed. "Converting to equity is effectively nationalising the investment and diluting any other shareholder ownership. You can see why the market has said that it has become uninvestable."

Flight Centre, NZ's largest travel agency, made 250 workers redundant, following govt advice not to travel. The NZ subsidiary of ASX-listed Flight Centre Travel Group employs 1,200 staff and said it would close 33 of its 140 shops.

Tourism Holdings cancelled its first-half dividend, slashed director and executive pay and made its campervans available for emergency accommodation.

Banking, insurance and finance

Tower is filing proceedings seeking $80m from **EQC.** EQC ceo **Sid Miller** said they had been in talks with them and other insurers and was disappointed it was unable to reach a resolution with Tower outside of the courts. Tower said it was owed the money for rectifying building issues on EQC's behalf.

Energy and Resources

Electricity demand fell to a three-month low on the first days of the lockdown as businesses shut down. Power use fell to 93.86 gigawatt-hours, 14% less than the pre-lockdown Thursday and the lowest since Boxing Day. Transpower predicted demand would follow a typical Sunday as the lockdown continued.

Transpower increased its store of critical parts and may defer some planned maintenance if needed to reduce risk during the lockdown.

Refining NZ cut processing rates at Marsden Point to match a sharp drop in fuel demand. It also halted all non-critical work with its daily workforce dropping from 600 to about 200.

OMV has an international crew in isolation in Auckland so critical pipeline inspections and maintenance can be completed. The 45-day programme was put at risk when the border was shut, potentially preventing a mid-April specialist crew change. OMV said quick work by officials had enabled replacement crew to enter NZ.

NZ Oil & Gas said it is ready to pursue opportunities that the current market turmoil may provide. It started the year with $105m of cash on its books.

Todd Corp-backed plans to invest billions with Chinese investors in a WA iron ore mining venture have been delayed by covid-19. BBIG, a Todd-controlled partnership that seeks to build a railway and port to ship the ore has sought an 18 month extension on a WA govt railway agreement that is due to expire in Sept. Todd-controlled **Flinders Mines** is raising new capital in a dilutive rights issue to help fund work on a final investment decision.

Environmental activists are claiming victory after the **Court of Appeal** sent resource consents granted to would-be seabed ironsands miner **TransTasman Resources** back to the **Environmental Protection Authority.** The decision says the EPA's decision-making committee made "multiple overlapping errors of law" in granting consents in 2017 for mining to occur.

Construction and infrastructure

Fletcher Building withdrew its annual profit guidance, cancelling its first-half dividend and suspending its share buyback programme to focus on preserving liquidity.

Fulton Hogan advised shareholders the board was drawing the recently struck grey market price for the company's shares of $15.50 in light of the disrupted economic outlook and suspended buybacks from shareholders.

Manufacturing

Rio Tinto has yet to reach a final conclusion on closing the Tiwai Point aluminium smelter, indicating that electricity price negotiations remain ongoing. The smelter is, however, closing its smallest and fourth potline, in part to manage safety requirements in the wider plant, which is being allowed to continue operating during the lockdown.

Norske Skog is seeking permission to run its Tasman pulp and paper plant for longer than nine days it has been allowed during the lockdown. The plant has been only marginally profitable and was bailed out in 2018. There are fears it may not reopen if it closes during the lockdown.

That said, wood processors and contractors are also worried about fibre supplies as the govt enforces a complete lockdown on forestry harvesting. Most major sawmills and pulp plants are being shut as the govt focuses production on deemed essential products. Those still operating said the lack of raw material may pose problems in the weeks to come.

NZ Steel has all but closed the Glenbrook steel mill, although it is keeping the plant 'warm' to facilitate a swift and less costly return to production when the time comes. It primarily fabricates steel for domestic market use.

Telecommunications

Retailer telcos are butting heads with **Chorus** over the proportions of responsibility that each part of the sector should bear for the likely sharp rise in bad and doubtful debt the covid-19 response will cause. RSPs have pitched for Chorus, a regulated monopoly, to take 50% of the load. Chorus says that is unreasonable because it faces other potential sources of default, including the potential for failure among some of the smaller of the 80 or so RSPs. Negotiations continued this week after something of a breakdown between the parties at a Telecommunications Carriers Forum meeting on Friday last week.

Internet use hit new records in the early days of the lockdown at around at around 3 terabits per second. Before the lockdown, Chorus's all-time peak was 2.6Tbps during the Rugby World Cup 2019.

Media and entertainment

Mediaworks employees have been asked to take a 15% wage cut for up to six months or face redundancies.

NZME closed its **Radio Sport** station with immediate effect due to lower advertising sales. NZME said with the suspension of virtually all local, national and international sport it was looking closely at its level of sports coverage.

Capital markets

NZX is splitting out its regulatory functions from its commercial operations and the regulatory arm will have its own board independent of NZX and won't be expected to contribute to profit.

The NZ Superannuation Fund said global market volatility wiped $8.9b, or 19.5%, off its value but says it can withstand the disruption resulting from the coronavirus. The fund was worth $37.78b at the close of trading on March 17, down from $46.68b at Dec 31. Chief executive **Matt Whineray** estimated the fund could lose $25b from its $47b peak in mid-Feb from peak to trough over a 10-month period in a repeat of the GFC.

KiwiSaver fund managers reported an increase in the number of people switching funds, with a shift away from higher risk growth funds and into low-yielding cash funds. **Fisher Funds' Frank Jasper** said some people had panicked and made rash decisions.

Milford Asset Management significantly reduced its exposure to shares and increased its overall cash levels as it looks to weather the covid-19 fallout. The Milford Active Growth Fund has a share exposure of around 50% versus a "normal" market neutral share position of 80%.

Corporate actions

The **Abano Healthcare** takeover by private equity firm **BGH Capital** and the **Ontario Teachers' Pension Plan Board** was scrapped, and the company closed all its Australian dental clinics due to covid-19.

Smiths City was given four weeks to make its next payment to lender ASB Bank as it tries to find a new capital structure.

Ryman Healthcare withdrew its profit guidance and halted construction in NZ to comply with the lockdown. It continues to operate its retirement villages as an essential service.

ANZ NZ Investments voted against a plan to restructure Vital Healthcare Property Trust and list it on the ASX because the economics don't work for its investors. Craigs Investment Partners said the plan will mean those on 28% or higher tax rates will have to pay more tax.

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