



Valuable Advice from Workshop 3

Living with a higher interest rate regime: What does this mean for your business and the economy?

Held on Thursday 3 August 2017

Executive Summary

New Zealand's Official Cash Rate (OCR) is at its lowest ever level since being introduced in 1999. Most people see that as good news, and many people also regard it as a good indicator of general interest rate trends.

The fact, however, is that after many years of downward pressure, interest rates are now starting to rise, albeit slowly. That raises important questions for investors and business. For example, are we at the start of a long term trend? If so, how high might interest rates rise, and what are the potential impacts on business and the economy? And what are the implications for investors?



(L-R) Jacque Lethbridge (Co-Chair) with Michael Gordon, Matthew Goodson, Grant Graham and Michael Anderson (Co-Chair)

The Speakers

Michael Gordon, Senior Economist, Westpac

Michael has been part of Westpac's economics and strategy team since 2006 including currency and interest rate strategy, inflation, growth and financial market forecasts, and research. Michael also acted as the bank's Chief Economist from July 2016 to July 2017. Michael previously worked at the Reserve Bank of New Zealand in the Financial Stability department.

Grant Graham, a Partner at KordaMentha, is widely respected for his corporate finance and advisory nous, notably in valuation and restructuring and acts as an expert witness. He has written numerous Independent Advisors' reports for listed company activity subject to NZX listing rules and the New Zealand Takeovers' Code and has a reputation for his clear and concise communication style, and pragmatic advice.

Matthew Goodson, Managing Director of Salt Funds Management, has 24 years' experience in the finance sector. His company manages approximately \$1.8bn of listed equities on behalf of its clients. Matthew's career includes seven years in New York working for BZW and Goldman Sachs JB Were as Director, Wholesale Equities. He returned to New Zealand in 2004 to work for First NZ Capital followed by BT Funds Management. He founded Salt Funds Management with Paul Harrison in 2013.

CO-CHAIRS

Lowndes Director Michael Anderson specialises in banking and finance, securities, corporate recovery and insolvency law. Mike has acted for the receivers on two of New Zealand's largest receiverships. He also has extensive experience in banking and finance on both the bank and borrower sides.

Lowndes Director Jacque Lethbridge specialises in commercial and civil litigation with a focus on insolvency and restructuring, and also has experience in regulatory and serious fraud cases.

What They Said

Michael Gordon: Higher interest rates are here to stay.

Michael put a firm stake in the ground, stating he believes we are in a new high interest regime. The reasons, he said, are clear.

First, the world economy is picking up after years of disappointing growth. That phenomenon is more or less global, and includes major countries like Japan and the US that have been among the more disappointing performers.

Along with that growth, inflation – although still low – is rising.

As to concerns that President Trump might derail global growth by implementing some of his big-spending policies, Michael doesn't see that happening. "It's not that easy to make those things happen," he said, "especially when his own Republican Party doesn't like deficits."

Second, New Zealand banks don't have the same easy access to funds that they have enjoyed over the last decade or so. While the OCR is still at an historical low, it is only one indicator of the real cost of money – you also have to consider the cost of money from sources other than the Reserve Bank, and for other periods of time besides overnight.

One of those sources is customer deposits, which have been slowing since 2016 for reasons that aren't certain. Whatever the cause, banks have to close that gap, and whatever sources they use, they are going to be more expensive.

Michael found it telling that when the OCR fell in November 2016, that new rate wasn't passed on by the banks to their customers. "The banks may have found the limit to how low they can go (with interest rates)," he observed.

As to how high interest rates could go, Michael believes the OCR will likely remain steady for another year. "The market's doing the work for the Reserve Bank," he said. "Interest rates are being driven up by the market, and this is normal. If the demand for money is up, interest rates will go up."

That points to inflation also rising, but still remaining within the 1-3% band set by government. It also suggests that the housing price boom may be over. The Auckland market has already slowed, and Michael's view is that interest rates have a greater impact on prices than lending restrictions.

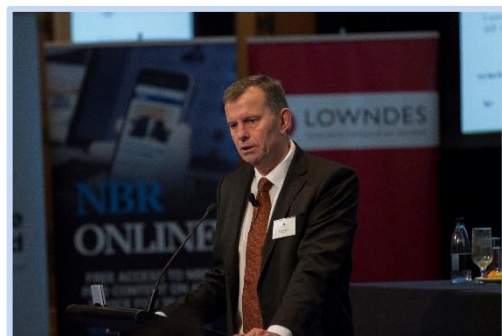


Grant Graham: Tougher, yes; but dire, no.

The burning question for Grant is what impact higher interest rates will have on business insolvencies. Like Michael, he is certain we are entering a higher interest rate regime, evidenced by various credible forecasts of 90-day interest rates, 5-year swap rates, 10-year government bond rates and residential mortgage rates.

One question then becomes, how high do interest rates have to rise to have a meaningful impact on business solvency? Probably, the OCR would need to hit 4%, said Grant.

At that point, small businesses, which comprise 97% of all New Zealand businesses, would be exposed. Often they have few tangible assets and their borrowings are secured by things like the owner's family home. As interest rates rise and the relative value of property falls, that means business owners' collateral suffers.



At that point, banks become more vigilant, particularly with marginal businesses experiencing cash flow constraints who have borrowed against property. They will likely increase the security required for new small business loans, and also demand more earnings relative to interest expense.

The upshot? It will get tougher to do business if you are a borrower and the proportion of "non-performing loans" will rise. That's when insolvencies increase.

Is that inevitable? Not necessarily. In practice, banks tend not to use insolvency if the environment is good – ie, money is available and relatively cheap – and they can see that a customer has time to recover. That is one reason, albeit not the only one, that they have taken a long term view with distressed dairy farmer customers. Likewise, while property development has slowed in the last two years, Grant doesn't see the banks taking a harder line against that sector.

One sector that could come in for a bad time, however, is retail. Discretionary spend is likely to fall in the near future, and retail margins are historically thin. Couple that with the imminent arrival of Amazon, and retailers have good reason to be wary.

How does a business prepare for this environment? If you are in retail, a strong online presence is advisable. And the higher the quality of the security underpinning your lending, the better off you will be.

But that is something of a worst-case scenario view. In reality, Grant doesn't expect to see a sudden surge in business failures over the next few years. Given his experience in managing insolvencies and helping distressed business recover, that's an encouraging view indeed.

