4 December 2009

Split fortunes

A look at recent trends in the manufacturing sector

- **Manufacturing sales in real terms have flat-lined since 2001.**
- **Rising costs and a strong NZD have squeezed manufacturing profits this decade, and the recent prolonged recession has also put considerable pressure on manufacturers' profitability. Annual nominal profits in the 2008/09 year were no higher than in 2000/01 excluding the dairy and meat sector, which is a much more positive story.**
- **There are big opposing forces acting on manufacturing profitability going forward. A below-average NZD/AUD, broadly recovering commodity prices and world/domestic economic growth are key positives, while the high NZD, strong international competition and the tail end of the recession are key risks.**
- **Manufacturers currently have very negative profitability expectations. A positive surprise is likely over the next year as economic growth here and overseas recovers.**

Profile of the manufacturing sector

New Zealand's manufacturing sector has a strong – and increasing – concentration in food processing, but is otherwise diverse *(Table 1)*.

Table 1: Manufacturing sector sales – year to June 2009

	Year to June 2009		Peak last 15 years	Date of peak
	Ann sales ($m)	% of total	% of total	Year to
Meat & dairy products	26,361	32.1	32.1	Jun 09
Other Food	8,868	10.8	11.3	Jun 99
Metal products	7,900	9.6	10.6	Dec 05
Machinery & equipment	7,229	8.8	9.7	Dec 04
Rubber, plastic, other chemical products	4,692	5.7	7.0	Mar 07
Wood products	4,083	5.0	6.9	Jun 00
Beverage, malt & tobacco	3,858	4.7	4.9	Jun 06
Printing, publishing & recorded media	3,558	4.3	6.7	Mar 99
Petroleum & industrial chemicals	3,344	4.1	5.5	Mar 95
Paper & paper products	2,915	3.5	5.7	Sep 95
Non-metallic mineral products	2,750	3.3	3.8	Mar 06
Transport equipment	2,674	3.3	5.9	Sep 94
Textile & apparel	2,108	2.6	6.4	Jun 94
Furniture & other	1,807	2.2	3.5	Sep 99
Total Manufacturing	**82,147**	**100**		

Nominal manufacturing sales have increased for ten consecutive years *(Figure 1)*. The dairy and meat subcomponent has provided an outsize share of this growth, with sales up 135% versus a 30% increase in other manufacturing sales since 1999.

The picture is less positive looking at real sales *(Figure 2)*, which are at 2002/03 levels after a particularly grim last 12 months courtesy of the recession and global financial crisis.

Figure 1: Manufacturing sales and growth

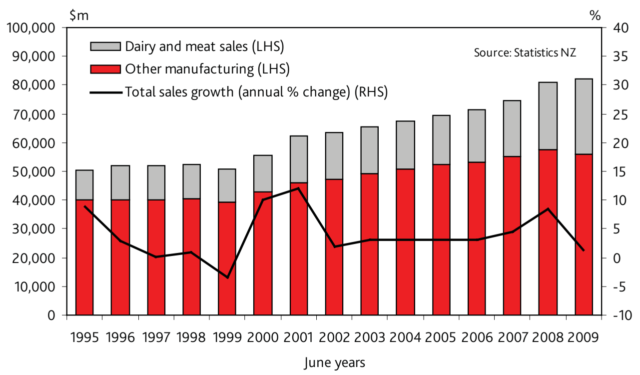
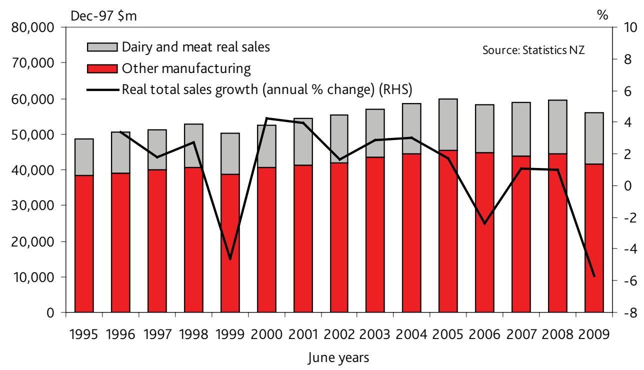


Figure 2: Manufacturing real sales and growth



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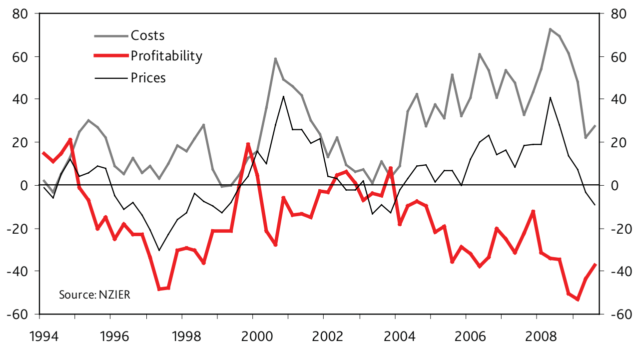
A grim decade for profits

Over the past five years manufacturers have been battling rising costs and slowing demand growth. The recession has knocked a bit off fuel and wage bills recently but, all up, costs have remained remarkably robust in the face of five quarters of recession, while there has been limited opportunity to pass these higher costs into prices.

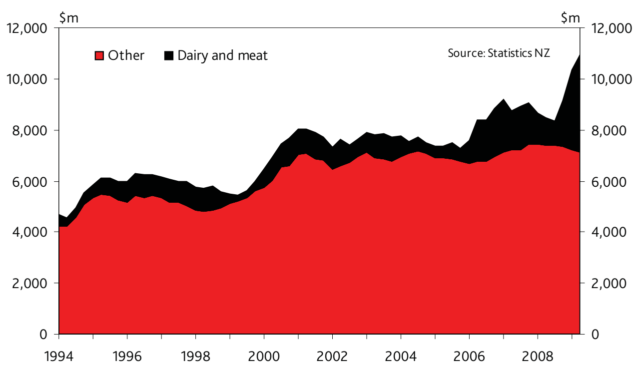
NZIER's quarterly survey of business opinion reflects these developments. The net share of manufacturing firms reporting cost increases has been at historic highs and remains elevated despite a marked drop in the past 6 months *(Figure 3)*. The gap between this and the proportion of firms reporting higher selling prices is at historically very wide levels. Little wonder a net 37% of manufacturers reported declining profitability in the latest survey, an improvement off recent lows but still around Asian Crisis levels.

Figure 3: QSBO Manufacturing costs, prices, profitability
Net % of firms reporting increases



Despite the high share of manufacturing firms reporting lower profits, overall manufacturers' gross profits have in fact improved markedly over the past three years, but it's all due to one narrow sector: dairy *(Figure 4)*.[1] Excluding the dairy and meat sector, gross manufacturing profits have stagnated since the 2000/01 exchange-rate-driven surge.[2]

Figure 4: Manufacturing sector annual profits

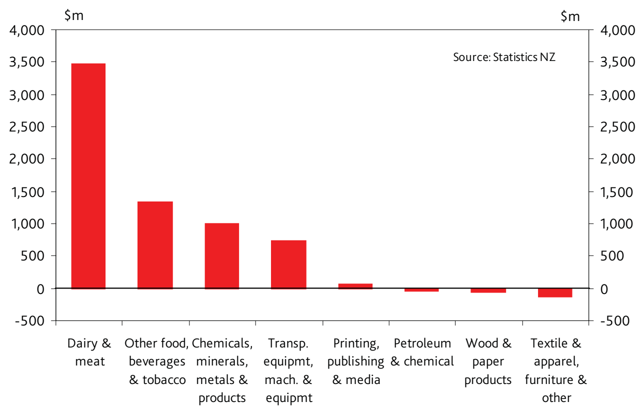


[1] A dairy/meat manufacturing split is not available.

[2] We have estimated manufacturing sector profits from Statistics NZ's Survey of Manufacturing by subtracting labour costs and other expenses from operating income. This gives a net earnings before interest and tax (EBIT) measure of profit.

Figure 5 gives a more detailed breakdown of the change in profit over the past 15 years. Outside of food, there are few good news stories.

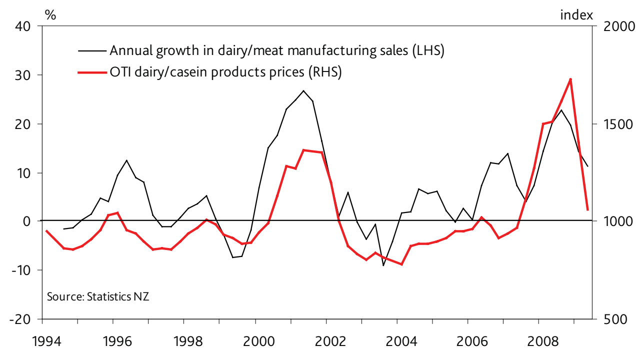
Figure 5: Change in manufacturing sub-sector annual profits since 1994



What drives profitability?

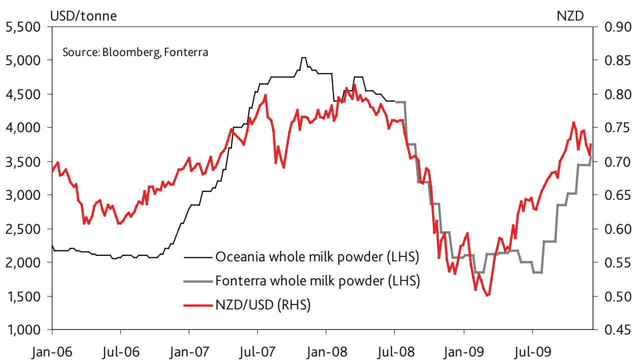
Dairy: Sales and profitability in the dairy/meat manufacturing subsector have been driven by the global dairy price boom, which has been only partly offset by the generally strong NZD in recent years *(Figure 6)*.

Figure 6: NZ dairy/casein export price index and growth in sales of dairy/meat manufacturing



Since dairy products are New Zealand's largest export and a key driver of the economy, the NZD tends to follow USD dairy prices *(Figure 7)*. In the bad times this cushions returns for dairy farmers; in good times it shares the joy around the economy

Figure 7: USD dairy prices and the NZD/USD

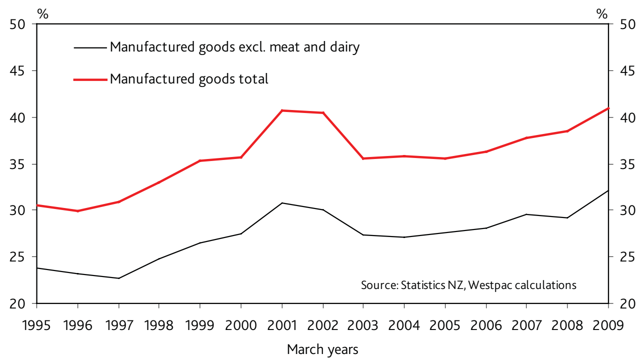


by making imports cheaper for all. The NZD therefore buffers returns to the NZ dairy industry.

But other exporters will be buffered only to the extent that their world prices are correlated with dairy prices. And this unfortunately is not as common as one might hope, meaning that for our non-dairy exporters of manufactures the exchange rate is likely a source of volatility, rather than smoothing returns.[3] At the extreme, one hugely successful export industry can wipe out others in a phenomenon known as Dutch Disease. This is typically associated with large natural resource finds, such as oil, that cause a large, permanent appreciation in the real exchange rate, undermining the competitiveness of other export industries (though of course the nation as a whole is much better off – who wouldn't want to be Norway!). New Zealand is not in this camp, but it is probably fair to say that our other manufacturing exporters have not been net winners from dairy's good fortunes over recent years.

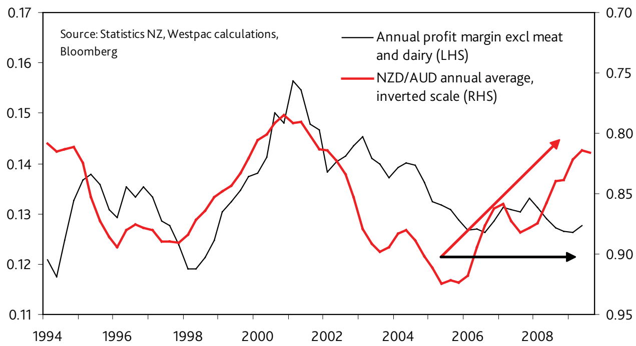
Other manufactures: In 2008, 38% of manufacturing firms were direct exporters,[4] and the export share of both dairy/meat and other manufacturers' sales has increased over time *(Figure 8)*.[5]

Figure 8: Manufacturing exports as percentage of sales



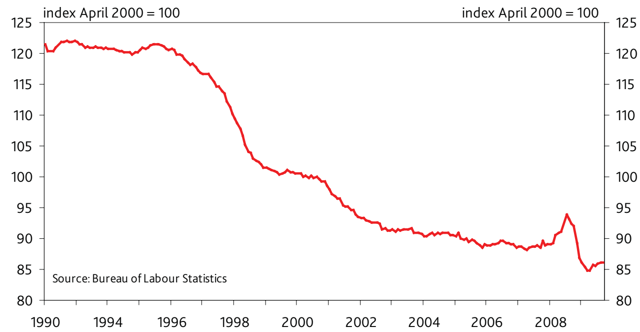
But despite this increasing openness it's not as simple as "low NZD good, high NZD bad". Australia is a major market for New Zealand's non-dairy manufactured exports, and profit margins are inversely related to the value of the NZD/AUD *(Figure 9)* (the exchange rate scale is inverted).[6] The current mix of cross rates is actually helpful for the not-insignificant proportion of manufacturers who import capital and other inputs in USD but then export finished products to Australia, against whom our exchange rate is below historical average levels. However, other factors have dominated in recent years: despite the slide in the NZD/AUD since 2006, manufacturing profit margins outside the meat and dairy sector have tracked sideways.

Figure 9: Profit margin and the NZD cross rate against Australia



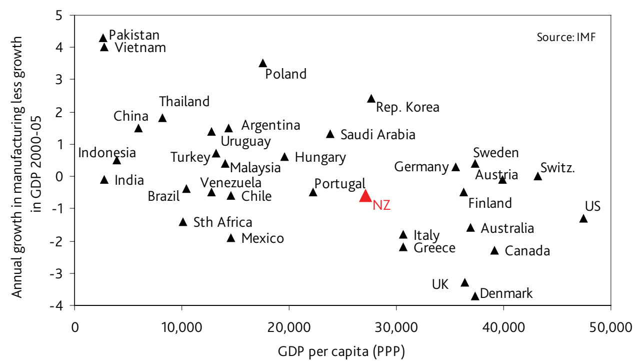
What else is going on? Increased competition from developing Asian nations in producing all manner of manufactured goods is part of the story. Figure 10 shows the US import price index for goods from Hong Kong, Taiwan, Singapore and South Korea. The price has dropped almost 30% in 15 years. This at a time when general consumer prices have gone up 45% in the US!

Figure 10: US price index for imports from Hong Kong, Singapore, South Korea and Taiwan



Not surprisingly, the past 10 years has seen a reduction in the importance of the manufacturing in Western economies generally, as their manufacturers struggle to compete with the low costs of production in developing countries. Figure 11 shows that growth in manufacturing tends to outpace overall GDP growth in poorer countries, and under-perform in richer countries. New Zealand's experience is typical of this pattern.

Figure 11: Manufacturing outperformance vs. wealth



[3] See our Bulletin *"Buffet or Buffer"* (24 September 2009) for more detail.

[4] Statistics NZ Business Operations Survey 2008 *Hot of the Press.*

[5] Official data does not split sales into their export and domestic components. We have roughly split manufacturing sales using external trade data.

[6] The gross profit margin is estimated by dividing our measure of profit by total sales.

The future of NZ manufacturing: Where to from here? Opposing forces will influence manufacturing profitability over the next couple of years. On the positive side are:

- A bounce-back in global food prices – already dramatic for dairy products;
- Recovering growth in our trading partners, especially in Asia and Australia;
- Improving domestic demand;
- The NZD/AUD likely remaining below its historical average;
- Only a short-lived decline in dairy prices, limiting the negative impact on NZ supply.

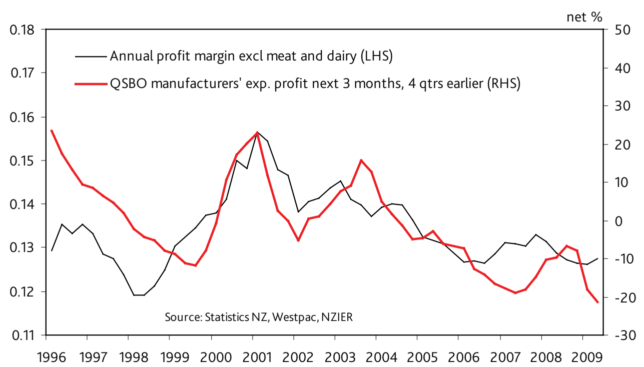
Offsetting these positive influences will be:

- Strong international competition, especially for non-food manufactures;
- Rising costs as the labour market strengthens and prices for the commodities we import, such as oil, also rise to reflect strong demand from Asia;
- Likely a persistently high exchange rate against the US (though, as noted, this is net positive for some manufacturers).

Performance will vary considerably across manufacturing sub-sectors as well as by individual firm, depending on the relative exposures to each of the influences above, and micro factors.

Judging by manufacturers' own expectations for their profitability, the negative factors seem to have the upper hand. Profitability expectations tend to lead actual profit margins by around four quarters, and point to significant further margin compression over the coming year for non-dairy/meat manufacturers *(Figure 12)*.

Figure 12: Profit margin and firms' profitability expectations



Will these expectations be met?

The non-food manufacturing sector in NZ does appear to be stagnating, and it is not obvious that this is due to turn around any time soon. The rush of free trade agreements NZ has signed recently will encourage further specialisation in areas of comparative advantage, and for NZ, that's making cheap, good food. Although bright ideas in all kinds of areas will continue to be transformed into successful manufacturing enterprises, the overall share of non-food manufacturing as a percentage of GDP is likely to continue to wane as New Zealand continues to adjust to a world of structurally higher food prices and increasing competition in the supply of other kinds of manufactured goods.

But over the very near term, we think that most forecasters are undercooking the likely speed of the recovery in the domestic economy. QSBO respondents are likely to be doing the same thing. Over the next 6-12 months, therefore, a positive surprise seems likely for manufacturers and others.

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