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APPLES | MARKET INSIGHT

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INSIDE THIS REPORT

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An analysis of the trends influencing the apple market prepared by Con Williams - Head of Investment Research.

SUMMARY

The apple sector remains well on track to attain the title of being a $1 billion export earner.

The Asian boom continued in 2019. China became the largest export market for the first time ever surpassing both the United Kingdom and United States. It is also the highest paying market so it will be interesting to see what market share is retained this season with a larger domestic crop in 2019 and the leap in exports seen last year.

Other South Asian markets were empty in 2019 too. Many Asian markets continue to grow driven by the pursuit of healthier lifestyles supporting fruit consumption; expanding middle classes that are willing and able to spend more on high quality and exotic fruits; and greater penetration into new and existing markets through channels such as e-commerce.

It's not such good news for commodity apples, especially those heavily exposed to European markets, which were particularly tough in 2019 due to an overhang of domestic product. Things should improve this coming season, but cost increases in recent years mean the only sure way to make money in orcharding is attaining upper quartile production outcomes and/or producing premium branded varieties that are now delivering a 40% price premium.

THE SEASON THAT WAS – ASIAN BOOM AND EUROPEAN GLOOM

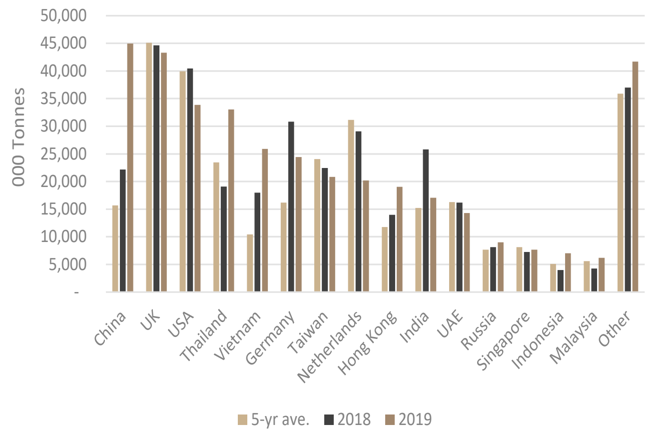
With the pool payments for the 2019 apple crop nearly finalised it is timely to take a look at last year's market trends. In short, the boom times continued in Asian markets lead by China, but Europe was a lot tougher. It's now crucial to be growing varieties that are preferred by Asian markets; or with multiple market appeal that can take advantage of annual market imbalances.

In the last season the market imbalance was caused by a smaller domestic crop in China. With the Chinese crop reduced to some 35 million tonnes (20% lower than 2018) this left both its own market and other importing countries in South-East Asia relatively empty when Southern Hemisphere exporters started shipping.

The impact was so extreme China became New Zealand's largest export market in 2019 for the first time ever, surpassing both the United Kingdom and United States which have duelled for top spot throughout the past 10+ years. Total exports to China were 45,000 metric tonnes, more than 2.3 times previous years. A similar trend was seen in other major Asian markets too with a significant increase in export volumes to Thailand, Vietnam and Hong Kong.

The opposite was true in Europe where an overhang of product from Poland and wealthier western European markets, such as Germany that are the main target of New Zealand exports, weighed heavily on demand.

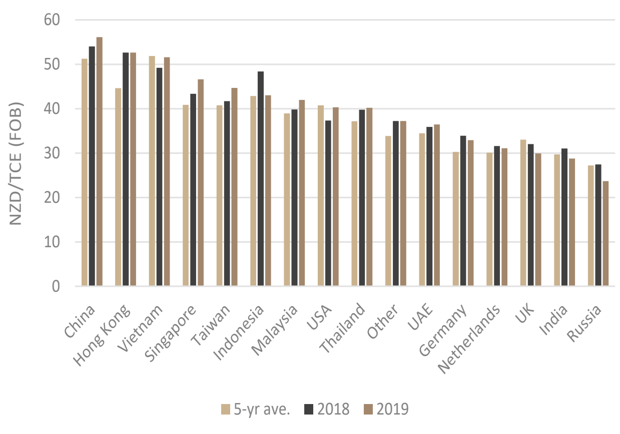
Figure 1: New Zealand apple export volumes by major market in recent years



Source: MyFarm, Statistics New Zealand

What is most impressive is the significant premiums that are consistently being generated out of major Asian markets. In fact, out of all the top export destinations, Asian markets dominate the leader board for being the highest paying. China and Hong Kong occupy top spot recently cracking through the $50/TCE level and are followed closely by a range of other South-East Asian markets.

Figure 2: Export prices by major export market



Source: MyFarm, Statistics New Zealand

At the other end of the spectrum is a range of European countries where the prices received are nearly a third less than the top performing Asian markets. This partly reflects higher freight costs to ship product to markets that are further afield and a different varietal mix, but nonetheless it's what ends up in New Zealand exporters/growers back pockets that matters for bottom-lines.

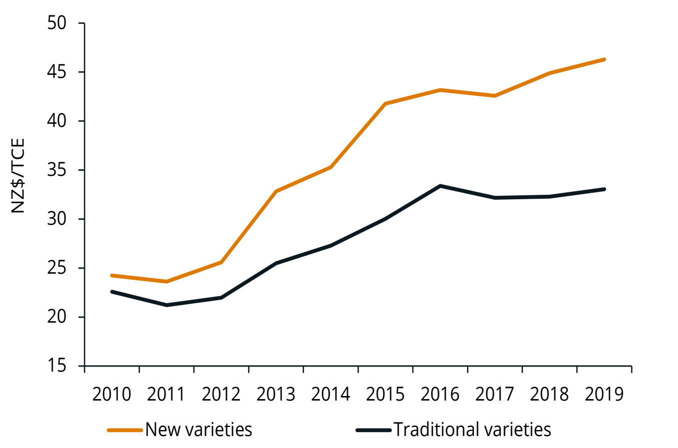
It will be interesting to watch the 2020 season. China has had a better growing season in 2019 and has committed to buying more US food products, although for pipfruit US production is counter seasonal to New Zealand production. In contrast European supply has fallen with the Polish crop looking to have become biennial bearing in nature recently, but with broad based reductions in most other countries too. So New Zealand exports to China could shift back a gear, but to what degree will be interesting to watch given the step change that occurred in 2019. In contrast European markets should at least stabilise, if not improve.

WHICH VARIETY IS WINNING THE HEARTS OF CONSUMERS?

The newer apple varieties continue to garner the interest of consumers. The price premium between more traditional varieties and new or club varieties is now at 40% and has continued to climb since 2016.

Of course, for growers there are some higher royalty and a range of other commitments attached with growing plant right variety (PVR) protected apples, which means that the entire premium doesn't make it all the way back to the orchard gate. Nevertheless, it's always going to produce a better economic outcome if you're exporting the apple of choice when a consumer is choosing their daily apple to keep the doctor away!

Figure 3: Export price premium between different varieties



Source: MyFarm, Statistics New Zealand, Pipfruit New Zealand.

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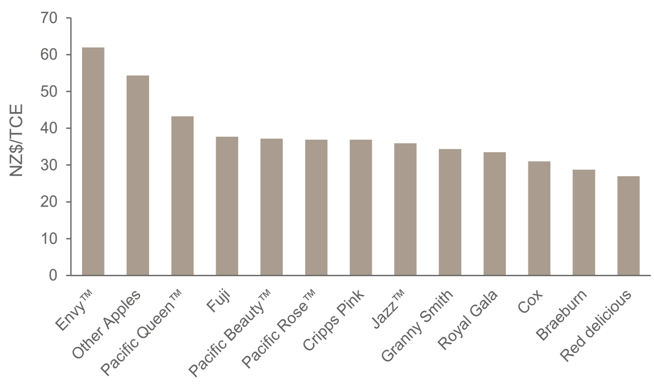
Of the main varieties Envy™ continues to standout maintaining a selling price in the low/mid $60/TCE, combined with good orchard productivity metrics it is a variety that growers want. Interestingly the 'Other apples' category (Figure 4) is second placed at $54/TCE but represents many of the new up and comers where export volumes are currently smaller.

The likes of Rockit™ (miniature sized apple, sold in distinctive packaging) will fit in this category and has averaged $74.6/TCE over the past three years, but total volumes are less than the likes of Envy™ at present.

Third in the ranking is Pacific Queen™ at $43/TCE and a group of other newish or higher colour varieties such as Fuji, Pacific Beauty™, Cripps Pink and Jazz™ in the mid/high $30/TCE.

At the end of the league table from the high-$20's to mid-$30's range are the more traditional varieties, including Braeburn and Royal Gala that account for 45-50% of total exports.

Figure 4: Export prices by major apple variety

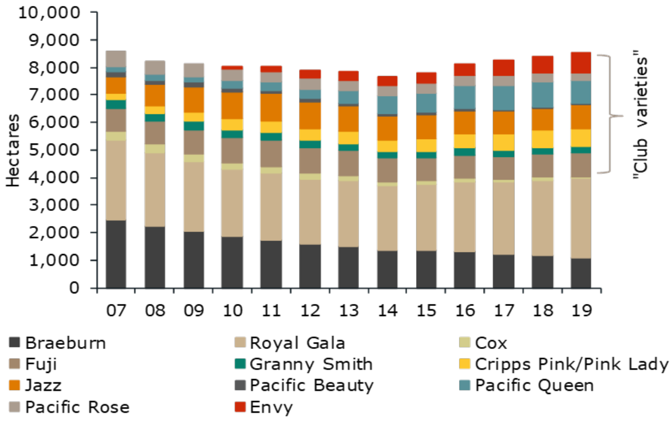


Source: MyFarm, Statistics New Zealand

SUCCESS LEADING TO NEW PLANTINGS

The success of new varieties is now supporting further investment and an acceleration in new plantings and re-grafting of apple trees from traditional to new or club varieties. It's estimated new or club varieties now account for some 45-50% of total production and this is only set to increase further as newly planted areas reach full productivity.

Figure 5: Apple area by major varietal in New Zealand



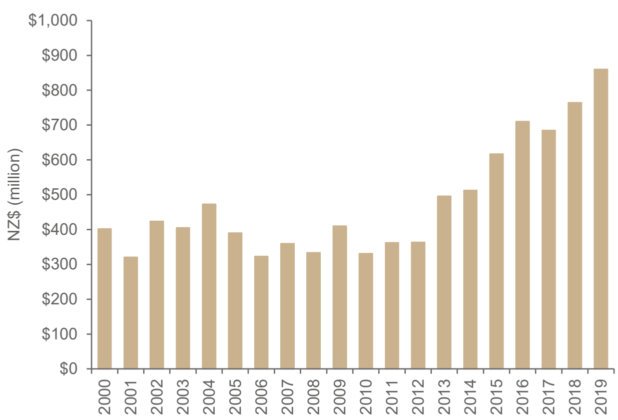
Source: MyFarm, Statistics New Zealand, Pipfruit New Zealand.

Looking forward the area of new plantings could be in the realm of 400-500 hectares per year into the early 2020's (growth of 4-5% per year on the existing area). The four main constraints to growth at present are the availability of suitable trees, IP restrictions on certain apple varieties, skilled staff and access to water in the main growing area Hawke's Bay (the region currently accounts for 60-65% of New Zealand's growing area).

Such growth in the planted area at higher density, utilising modern structures, with a greater proportion of new or club varieties and world-class orchard/ supply chain management (i.e. productivity improvements) means total production and export volumes are set to further increase over coming years.

The higher values and increased volumes have the sector well on track to hit its target of $1 billion in export revenue in the near future.

Figure 6: New Zealand apple export earnings



Source: MyFarm, Statistics New Zealand

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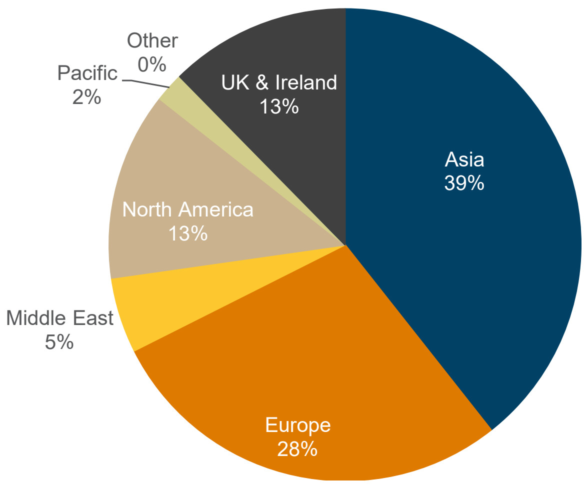
WHAT DOES THE FUTURE HOLD?

New Zealand now services what appears to be a well-balanced mix of export markets. The question is where future growth will come from to sell the anticipated lift in export supply over coming years?

Figure 7: New Zealand's export mix by major market



Source: MyFarm, Pipfruit New Zealand.

THE KEY OPPORTUNITIES ARE LIKELY TO EVOLVE AROUND:

Traditional markets

There will be continued supply of the counter-seasonal window into wealthier Northern Hemisphere countries. The main focus is likely to be the UK, US and wealthier Western European countries that already produce their own fruit. But other markets where import dependence is higher due to less local supply, such as the Nordic countries, offer opportunities too.

The counter-seasonal window is expected to remain competitive due to improved storage technology and continued industry improvement in lower-cost producers in close proximity.

The key elements to success are likely to be an ability to:

1. Deliver superior quality/consistency of fruit that meets retailers' rigorous standards;
2. Stock varieties that deliver a point of difference, as well as provide retailers superior returns;
3. Meet regulatory and retailers phyto-sanitary requirements;
4. Develop and maintain brand presence; and
5. Offer a variety of products.

The last attribute requires either collaboration and/or scale to meet the requirements of large retailers.

Regionalisation and Asia

The regionalisation and organic growth of trade in Asia is expected to continue reflecting:

1. Increasing fruit consumption driven by societal health goals.
2. An expanding middle class that is willing and able to spend more on high quality and exotic fruits. Fresh fruit consumption generally follows similar macro drivers to the protein story. Rising incomes, urbanisation, westernisation of diets etc leads to increased consumption.
3. Greater penetration into new and existing markets. This is driven by new marketing initiatives, globalisation of many cuisines/fruits, improved cool chain, new channels to market (i.e. e-commerce) and better market access.
4. There are a number of heavily populated, non-apple producing countries in Asia where consumption still has significant upside.

Figure 8: Per capita consumption in non-producing Asian countries (kg/capita/year)

COUNTRY	CURRENT
Indonesia	0.5
Hong Kong	18.0
Malaysia	3.7
Philippines	1.5
Singapore	7.3
Taiwan	7.3
Thailand	2.8
Average	**1.9**

Source: MyFarm, World Apple review 2018

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The likes of Thailand, Indonesia, Philippines and Malaysia would seem to offer significant upside with the right product offering. Indeed, a consumption increase of just 0.80 kg/capita/year across non-producing pipfruit markets equates to New Zealand's current export supply of fresh apples. Given global apple consumption averages 12 kg/capita and the likes of Hong Kong and Taiwan having experienced significant growth in recent years there would seem to be ample upside.

The main challenges in these markets are likely to be competition from less-expensive locally produced fruits, lower quality, cheaper Chinese pipfruit, and non-tariff barriers. China is the major pipfruit producer within Asia and forms base-pricing in many key markets.

Non-tariff barriers include compliance with quota restrictions, grade standards, fumigation requirements, disease requirements, additional product testing, and labelling and packaging rules. In some markets these are more restrictive than others, sometimes even when free trade agreements are in place. Reducing these barriers is expected to remain a work in progress.

Many of New Zealand's specialised orchard and pack-house management programs are uniquely positioned to meet many of the sanitary and phyto-sanitary rules that exist across different markets which provides a competitive advantage.

Countering the other competitive aspects of lower-priced fruit, it's about creating exclusivity and delivering a premium product aligned to customer preferences. New Zealand is already achieving this in Asia, and relative to key Southern Hemisphere competitors.

The main drivers of the premiums appear to be a New Zealand brand premium given superior quality and freshness due to proximity, varieties that have eating qualities more suited to the Asian palate and the protected nature of certain new "club" varieties providing exclusivity.

THE FUTURE OF "CLUB" VARIETIES

The view from the World Apple Review is the proliferation of "club" varieties has changed the marketing of apples. Many of the major vertically integrated grower-packer-exporters offer a portfolio approach, including traditional varieties to large retailers. Many retailers have also changed their apple stocking, merchandising and pricing strategies. While most continue to stock traditional major varieties at normal prices, shelf space for some is being reduced in favour of newer varieties. Many retailers now charge customers substantial price premiums for newer or exclusive varieties that can differentiate their offerings from those of competing retailers.

Some of the early pioneers of managed new varieties, such as Pink Lady® and Jazz™, have led the way in creating such values. Pink Lady® positioned itself as the apple for progressive, active young females. Its visual presentations hint at love and romance. Jazz exploited the fun, risqué mood of the jazz music scene. More recently, Kiku Fuji has built a strong association with outdoor sports. Opal has exploited its image of sustainability with a strong, anti-GMO stance. The challenge for each new, emerging apple variety will be to build unique associations with lifestyle choices that will appeal to a substantial segment of potential customers. There are many lifestyle choices that appeal to very narrow segments of society. However, such narrow segments will rarely be able to win sufficient space on retail shelves, or enjoy broad enough sales appeal, to sustain the management, packaging, and promotion of a new variety.

Newer apple varieties have been forced to follow the path of product differentiation and price discrimination that consumer products have been following for more than a century. At the core of such a strategy is establishing a brand, associating that brand with distinctive intrinsic and extrinsic attributes, and reinforcing that brand with a suitable product name, product image, packaging, and promotional themes or story lines that repeat a uniform message to consumers.

New Zealand has been at the forefront of many of the key innovations in this space and remains well placed to continue to benefit. The reality of business means changing consumer trends and competitive forces require continuous innovation and investment to stay at the front of the pack.

For more information regarding investment opportunities in the pipfruit sector visit our website: www.myfarm.co.nz