The New Zealand Export Credit Office

Annual Report

1 July 2011 – 30 June 2012

Prepared by the Export Credit Office's

Technical Advisory Committee

NEW ZEALAND EXPORT CREDIT OFFICE

NZECO Purpose

The purpose of the New Zealand Export Credit Office (NZECO) is to help grow New Zealand exports by providing specialised financial guarantees and services that complement those available in the private sector and which assist New Zealand exporters to:

- manage risk;
- access trade finance; and
- secure international contracts.

Since its establishment, NZECO has issued a total 316 policies across 82 exporters, supporting $1.45 billion worth of export transactions into 60 countries.

Summary of Performance for the year ended 30 June 2012

Priority 1: NZECO guarantees are delivered effectively and efficiently and this has led to an increase in exports

NZECO offers three types of guarantees covering:

- Political / country risks of the buyer's country;
- Overseas buyer repayment risks; and
- NZ exporter technical performance and financial capability risks.

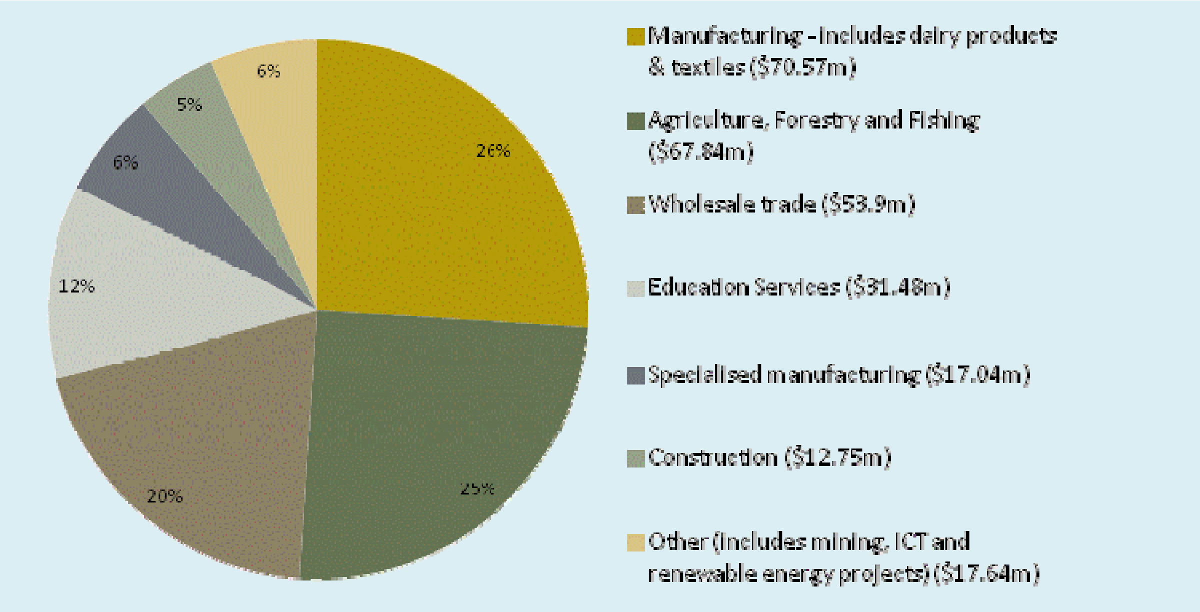
NZECO's support was provided to New Zealand exporters of all sizes and sectors, supporting their export sales into 31 countries. Examples ranged from dairy packaging system project in China to telecommunication equipment into Russia; from an education project in Saudi Arabia to small aircraft into the Pacific.

NZECO's performance in supporting exports is summarised in the following table:

Objective	2010/11 Actual	2011/12 Actual
Number of applications received	101	88
Number of New Policies Issued	59	70
Total New Exposure for the year	$161.9m	$104.1m
Value of Export transactions supported	$261.3m	$271.2m

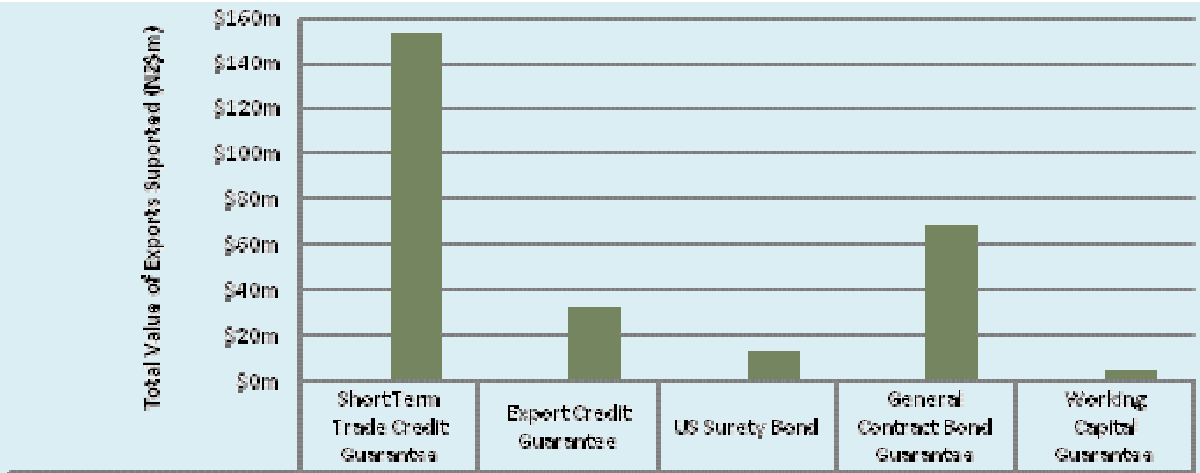
By industry sector, NZECO's level of support is summarised in the following graph.

NZECO's value of exports supported by Industry (to 30 June 2012)



SME exporters continued to face challenges in financing their export opportunities. Foreign buyers, who also face their own credit constraints, increasingly sought payment terms or bank guarantees from New Zealand exporters. Accordingly, the strongest demand was for NZECO's short term trade credit and general contract bonding products, as summarised below:

NZECO Support by Product to 30 June 2012



	Short Term Trade Credit Guarantee	Export Credit Guarantee	US Surety Bond	General Contract Bond Guarantee	Working Capital Guarantee
No. policies issued	45	3	3	17	2
Value of exports supported	153.47	32.28	13.27	68.04	4.16

<u>Short-term Trade Credit Insurance</u>

NZECO's higher level of support for food and beverage companies was through its short-term trade credit product. The market gap was primarily driven by private insurers' lack of appetite to insure single buyer risk, or exporters with low insurable turnover. Notwithstanding the steady demand for this product, several exporters that NZECO had supported since 2009 did not seek renewals because the private sector offered them cover.

An example of how NZECO's short-term trade credit product enabled an SME exporter to rapidly grow to a scale that made it attractive for the private insurers is K9 Natural Food.

When K9 Natural Food approached NZECO in early 2010, it had just secured its first significant foreign buyer – a publicly listed US pet store chain. The buyer wanted 60-day credit terms which K9 could not afford to offer without stifling the company's cashflow. NZECO and BNZ introduced the concept of using credit insurance as a way of accessing finance prior to repayment by the buyer. At the time, private sector insurers declined to cover the buyer because K9's total insurable turnover was insufficient and the sector had very limited appetite for single buyer risk. NZECO stepped-in to provide a credit insurance policy which was assigned to the BNZ to support a trade receivables funding facility. Over the following 2 years, NZECO insured additional buyers in Canada, UK and the US. This supported the growth of K9, leading them to being the fifth-fastest growing business in the Deloitte Fast 50 in 2011, with 800% p.a. growth the previous year. In January 2012, a private insurer stepped in to pick up the NZECO portfolio of buyers given the increase of K9's insurable sales. "*We would never have been able to offer the credit terms to the US buyer and obtain bank funding, without the NZECO cover*" - Calvin Smith, CEO of K9

Utilisation of NZECO's "top-up cover" co-insurance arrangement with the private insurer Euler Hermes increased this year, and provided additional capacity to exporters who required full insurance cover on all of their receivables in order to access trade finance from their banks.

Export Credit Guarantee

Demand and utilisation of the export credit guarantee was low during 2011/12. This reflected the challenges of exporters successfully negotiating a vendor finance option with a creditworthy foreign buyer, and then being able to obtain funding for these extended term deals because of limited expertise and systems within New Zealand banks to fund such export credits.

NZECO continues to work closely with the NZ banks to educate and facilitate the funding of longer–term export credit deals. A key benefit of this product is its ability for capital goods exporters to either differentiate (or match) its offer against competitors by offering a vendor finance option. Creditworthy buyers may also find a NZECO-supported extended loan attractive due to their own domestic banking lines being constrained. An example from 2011/12 that highlights this is the Robotics Technologies deal.

Robotic Technologies Limited (RTL), a joint venture company between Scott Technology and Silver Fern Farms, designs and manufactures automated meat processing equipment. RTL had a prospective Australian buyer in the meat processing industry that wanted to utilise equipment finance to purchase RTL's robotic processing system. To advance the sale, RTL offered a 5 year vendor finance option to the Australian buyer which it accepted. This arrangement was funded by ANZ and underwritten by NZECO. The benefit to the Australian buyer was that it received a line of credit for equipment finance, while preserving its own banking funding lines, with repayments beginning once the equipment was operational and generating revenue. "*NZECO's support was critical in advancing a sale that may otherwise have continued to be postponed*" – Chris Hopkins, CEO of Robotic Technologies.

NZECO forecasts improved results in 2012/13, in part due to a better pipeline of prospects combined with expected utilisation of a master guarantee arrangement with Canada's Northstar Trade Finance, and increasing experience of New Zealand banks in structuring and funding export credit deals.

US Surety Bond Guarantee

This product remains a critical ingredient for most New Zealand companies seeking to bid for US federal or state funded projects, which require 100% surety bonds. Through its indemnity relationship with Liberty Mutual, the NZECO can underwrite the issuance of these bid bonds and performance bonds. One example is the SME company Connexionz, who NZECO supported for a third time during 2011/12.

> The successful delivery of Connexionz's real time passenger information systems to local authorities in the greater Los Angeles region, was an influencing factor behind its award of a US$1.26 million contract with the City of Pasadena. NZECO has underwritten the surety bonds for the City of Pasadena, along with prior projects for the City of Santa Clarita and Tri Delta Transit in San Francisco. "*With our success, Connexionz is now strongly positioned to secure further contracts in the greater California area . . . and the NZ Export Credit Office has provided us with continued assistance in winning these projects*" - Roger Carruthers, CEO of Connexionz.

General Contract Bond Guarantee

Demand for this product has grown, from a mix of SME companies with insufficient balance sheet strength (often compounded by reduced demand in their export markets), and growing companies that lacked the bonding facilities to support large project requirements. For these exporters, the Contract Bond Guarantee has enabled them to bid for and win larger transactions, get paid during the construction period, and continue to receive their normal trade finance from their banks, without providing additional security. For example:

> During 2011/12, Christchurch-based composting technology company HotRot Organic Solutions successfully concluded two projects being delivered in the UK, including its largest UK sale to date. Both of these projects were underwritten by NZECO to enable HotRot's bank to provide an advance payment and performance bonds. The provision of these bonds enabled HotRot to receive milestone payments in advance which ensured it has the cash-flow to complete these large contracts. "*Neither of these contracts would have been possible without the NZECO bonding support, and their successful delivery have been critical to our expansion within the UK*" - George Pottinger, GM of HotRot.

Working Capital Guarantee

NZECO's focus during 2011/12 was to finalise acceptance of its modified working capital guarantee with additional New Zealand banks. By 30 June 2012, four banks had accepted NZECO's documentation. One example of additional lending to an SME exporter to enable them to fund a larger order was:

> Munga Ltd is an Auckland based SME that recently secured contracts to supply NZ-manufactured hair products to Boots UK. Boots required 90 day payment terms plus due to their scale (over 2000 stores) orders were larger than Munga typically received, requiring NZD 300k of additional working capital. In partnership with the ANZ, NZECO guaranteed a portion of a trade finance facility. The funds are accessed upon evidence of Boots' purchase orders and self liquidate when Boots repays. *"Due to the size of the orders and terms required by Boots UK, advancing cash-flows to pay our suppliers on time would not have been possible without the NZECO working capital guarantee that supports ViaSalon access additional bank trade finance facilities"* - Tim Cunningham, MD of Munga.

Priority 2: Risks are appropriately managed, in accordance with Export Credit Agency best practice

NZECO operates on a commercial basis and prices risks to ensure it covers all operating costs and claims over the longer term. Its risk assessment, management and governance processes are designed to manage risk to a reasonable level rather than eliminate all risk of loss.

Throughout the year, NZECO applied ECA underwriting standards and pricing, and operated within its delegated prudential limits. NZECO's Technical Advisory Committee (TAC) met nine times during the year, and provided specialist advice, assurance and oversight of NZECO's strategy, operations and risks to the Secretary to the Treasury, via the Deputy Secretary, Financial Operations.

During the year, John Pritchard concluded his eleven year tenor as a member of NZECO's TAC. Mr Pritchard, with his extensive trade credit insurance background, was a valuable contributor to NZECO particularly during the global financial crisis when NZECO's short-term trade credit insurance product was implemented. Tim Sole was appointed as his replacement, and he brings actuarial and general insurance experience to the TAC.

The Swedish ECA (Export Kredit Namnden - EKN) also remains a valued source of country, foreign bank, pricing and other technical expertise and experience for NZECO. During 2011/12, NZECO and EKN renegotiated and extended the terms of a services agreement until 2013/14.

In accordance with NZECO's Risk Management policies, foreign buyer repayments and New Zealand exporter performance were regularly monitored and reported on a monthly basis to NZECO's Technical Advisory Committee. Any delays in payment (beyond 10 days) or performance were actively managed. NZECO also undertook quarterly reviews of all policies to review premium charged in the context of potential future claims and the adequacy of premium rates applied to those policies.

No claims were submitted or paid by NZECO during 2011/12, and NZECO's notional cash balance increased by $1.12 million as cash received (via premiums and assessment fees) exceeded operating costs and claims paid (there were none). However on 30 June 2012 NZECO recorded a provision of $29.7 million on an export credit policy, under which NZECO considers a claim is likely to be lodged during 2012/13. This provision has resulted in NZECO recording a net loss of $18.64 million. The provision is offset with unearned premium on this policy of $7.3 million which is recorded in this year's operating revenue.

NZECO's financial performance for the year is summarised in the following table:

Objective	2010/11 Actual	2011/12 Actual
Operating Revenue (Earned premium and application fees)	$4.37m	$12.72m
Total Operating Costs (excluding claims)	$2.06m	$2.06m
Claims Paid	$0.19m	$0
Provision for Claims	$0	$29.71m
Net Income (including provision for claims)	$2.30m	($18.64m)
Cash Balance (notional) as at 30 June 2012	$15.48m	$16.60m

NZECO's claims record to date has been exceptionally good (with only three claims arising from 246 expired policies). Whilst NZECO's $29.7m provision is not unusual for an ECA, it has a greater impact on NZECO due to the loss relative to its smaller portfolio and notional cash reserves. It is also an example of how, by virtue of its role in filling market gaps and supporting exporter development, NZECO faces fluctuating business volumes and concentrations of risk, which can result in lumpy claims.

As at 30 June 2012, NZECO's actual exposures are relatively evenly spread across by NZECO product. NZECO's five largest policies remain all within acceptable limits relative to NZECO's total portfolio, with the largest exposure being 12.5% of NZECO's total risk portfolio.

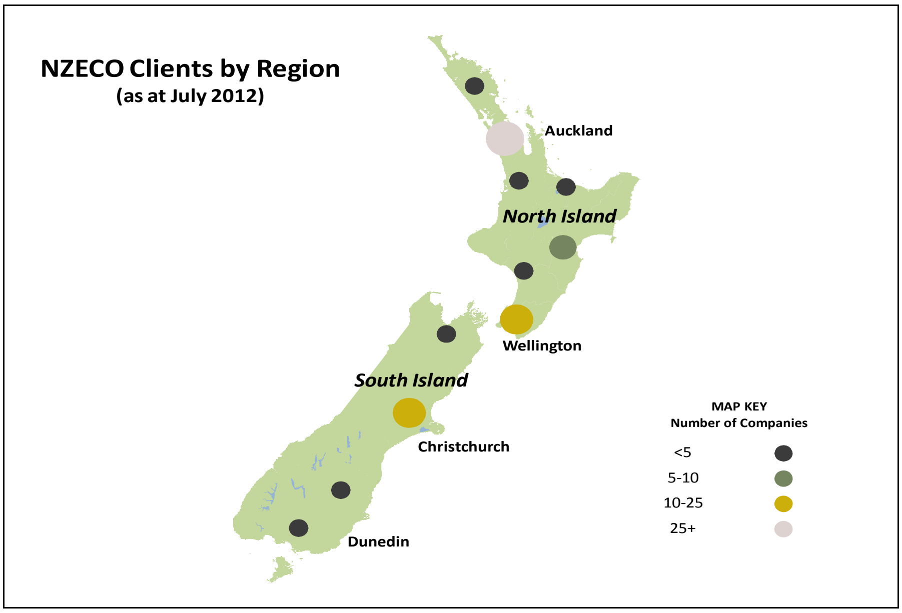
The majority of NZECO's commercial risks are on unrated companies that NZECO has assessed as being equivalent to a B credit rating. NZECO is also underwriting a few foreign country or public authority buyers, namely in Fiji, American Samoa and Cuba. NZECO's total actual exposure is currently spread across 20 countries, with the largest concentration (52%) recorded on New Zealand (reflecting those New Zealand companies whose performance NZECO underwrites). Concentration risk on United States is also relatively high (21%), however the actual risks of adverse country or political risk events occurring are considered to be minimal. The third highest country risk exposure is on Turkey (10%), which is within acceptable limits. Only 5% of NZECO's total portfolio is concentrated in higher risk countries (i.e. Cuba, Fiji and Solomon Islands), and these policies are closely monitored.

NZECO's current exposure to sectors is weighted towards manufacturing. This relates primarily to radio equipment, textile, processed food and automated machinery.

The challenge for NZECO is building a diversified and balanced portfolio without constraining its support for New Zealand firms that have high-value export opportunities which may otherwise result in a high concentration risk - whether by sector, country or transactional - relative to NZECO's total portfolio. NZECO is focusing implementing reinsurance arrangements with other ECAs and private reinsurers as one means of balancing its future risk concentrations.

Priority 3: NZECO is highly engaged to market conditions

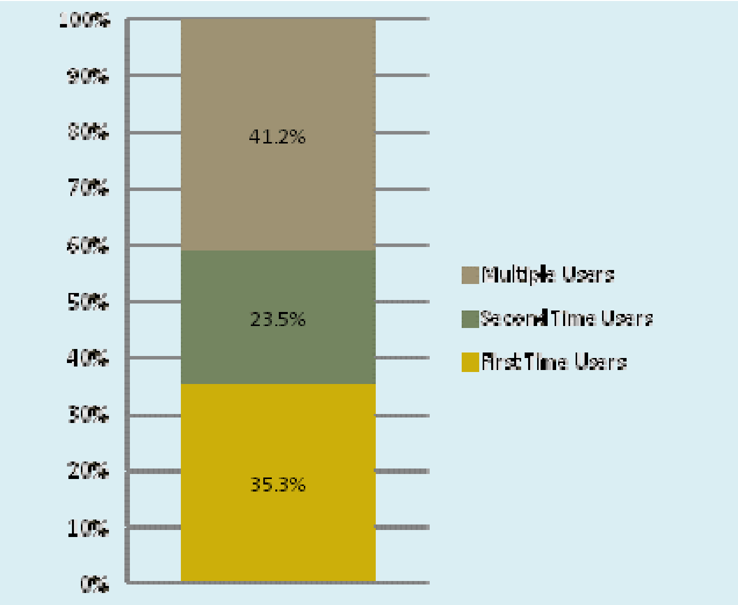
NZECO's ability to be highly engaged to market conditions requires it to be actively communicating with the exporters, banks and exporter-focused agencies. NZECO achieved its busiest year on record with 498 external face-to-face engagements with exporters, banks / financiers and other agencies.



This engagement was nationwide with NZECO staff visiting every region during 2011/12, with the exception of Northland and West Coast.

These regional visits directly contributed to NZECO achieving broad geographical coverage of its support, as demonstrated in the map to the left.

Characteristics of Exporters using NZECO during 2011/12

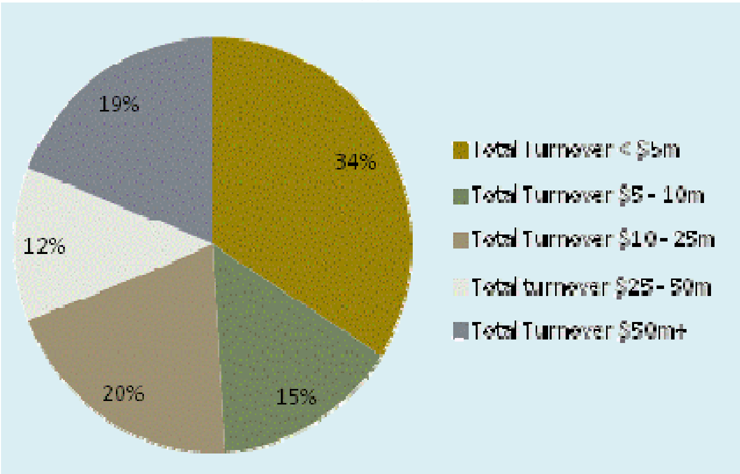


NZECO's external engagement included "first-time" meetings with 79 exporters new to NZECO, which recognises that a critical aspect to NZECO's sustained business growth is identifying and supporting exporters new to NZECO.

Consequently, of the 34 exporting companies that NZECO issued policies to during 2011/12, over one-third of those were exporters that NZECO had never previously supported.

A consequence of New Zealand's small domestic market is that New Zealand businesses with aspirations to grow have to export earlier than they otherwise would if their home market was larger.

Annual turnover of NZECO-supported firms (historical)



Accordingly, as demonstrated in the graph to the right, NZECO's exporter clients to date have been overwhelmingly SME.

However the graph to the right also shows that there is an important market need and economic development role for NZECO in supporting some of New Zealand's largest companies as well.

During this year, in response to market feedback, NZECO obtained the Government's approval to add the Chinese Renminbi (RMB) to its list of approved currencies that it can underwrite its policies in. In addition, NZECO's transactional requirement for a minimum 30% NZ content was substituted for a broader "NZ economic benefit test", in order to better support internationalising NZ companies and their offshore subsidiaries. As with the baggage and material handling systems company, BCS Group, with their first project in Mexico.

The New Zealand banks play a critical contributing role in the success of NZECO in terms of:

- identifying exporter prospects for NZECO and market feedback;
- providing additional funding and bonding to exporters directly covered by NZECO policies; and
- sharing information, risk sharing and supporting recoveries.

For example, 83% of all the policies issued by NZECO during 2011/12 were either subsequently assigned to a bank by the exporter (in order to access additional trade finance), or provided directly to a bank (in order to facilitate the issuance of a contract bond, the confirmation of a letter of credit or provision of additional lending).

In light of increased corporate risks globally, many New Zealand exporters have prudently looked to negotiate more secure forms of payment, such as via letters of credit. NZECO has assisted New Zealand banks to confirm the payment of foreign-issued letters of credit in emerging markets (e.g. Vietnam, Bangladesh) and the Eurozone (e.g. Portugal).

NZECO values the importance of developing relationships with other export credit agencies in order to share current market information, benchmark best practices, and monitor new product developments (particularly for SME exporters). NZECO's membership in the Prague Club (consisting of over 30 export credit agencies) and attendance at its bi-annual meetings continues to be an excellent source of foreign market information, particularly in emerging markets.

Priority 4: Education of exporters (and their agencies) on how to appropriately manage their own risks (relating to trade finance flows)

An important function of NZECO is educating New Zealand exporters (particularly SME firms) about how to appropriately manage their financial risk, as well as highlighting trade finance solutions. During the year, NZECO delivered 46 presentations to external groups, as summarised below:

Objective	2010/11 Actual	2011/12 Actual
Number of NZECO presentations at exporter events	14	21
Number of NZECO presentations to NZ bank staff	11	12
Number of NZECO presentations to export-facing agencies (Govt & Industry)	7	13

NZECO also published case study articles and prepared country-specific risk reports (for Australia, India, Philippines, Singapore, Spain and Turkey) to complement NZTE's country information guides.

The Government's Business Growth Agenda (BGA) is designed to create the conditions that assist businesses connect to international opportunities and grow their exports. In support of this, NZECO increased its engagement with other government agencies (i.e. NZTE, Ministry of Foreign Affairs and Trade, Ministry of Business, Innovation and Employment, and Education NZ) to highlight how NZECO's products may support their agency's sector-specific initiatives or export growth strategies.

Year Ahead: 2012 - 13

One of the Business Growth Agenda work-streams is "Building Export Markets", and the "enhancement of NZECO's products and services" is one of its action points. In response to this action point, NZECO will seek during the first quarter of 2012/13 approval from Cabinet for incremental amendments to NZECO's mandate to enable it to:

a) extend its existing Contract Bond Guarantees to enable NZECO to issue exporter performance guarantees directly to foreign government and public agency buyers; and

b) rename and extend the maximum term of its existing working capital guarantee to enable NZECO to support longer-term loans to SME exporters.

The Government has also set an aspirational goal of achieving a 40% export to GDP target by 2025. NZECO has a part to play in helping achieve that goal, in collaboration with other government agencies.

NZECO plans to finalise Master Guarantee arrangements with Canada's Liberty Mutual (to enable NZECO to support 100% surety bonds in Canada), and with the international financier Northstar Trade Finance (who specialise in funding "small" - i.e. up to USD 10m) - cross-border loans for exporters). New Zealand bond providers and banks find it a challenge to respectively provide Canadian surety bonds and to fund smaller value cross-border loans, and these new arrangements provide alternative solutions to New Zealand exporters looking to be internationally competitive.

NZECO will also focus on negotiating reinsurance arrangements with other export credit agencies and private reinsurers, as one means of balancing NZECO risk concentrations as well as facilitating increased exports. For example, NZECO is in discussions with Indonesia's export credit agency (AESI) and the African Trade Investment Agency. A proposed arrangement would include each agency providing local buyer and market information to assist with NZECO's underwriting, as well as sharing risk on any subsequent trade credit policy.

A new member will be appointed to NZECO's Technical Advisory Committee this coming year, and the current Chair will step down after 11 years of valued contribution. A key priority for TAC and NZECO will be the risk management of the provisioned export credit claim, and implementing a recovery process in a manner that best minimises losses to NZECO.

A combination of growing trade opportunities for New Zealand exporters in emerging markets, and increased corporate and banking risks in the advanced economies, leads NZECO to forecast increasing demand for its products during 2012/13. In response, NZECO will continue to work proactively with New Zealand exporters, banks and insurers to help support export growth.

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