DIRECT CAPITAL

By email

Mya Nguyen
Commerce Commission
Wellington

Dear Mya

Response to request for follow-up information 12 June 2015
"Information on and examples of the rate of return rate for different investor types"

Background

Following the public conference held on the 10th of June you have requested follow-up information on, and examples of, the rate of return expectations for different investor types.

Credentials

Direct Capital is New Zealand's largest and oldest private equity firm operating in New Zealand. It was established in 1994 and since that time has raised more than NZ$800 million for investment into more than 70 private companies. Direct Capital's investors (Limited Partners) include long term pension funds, insurance funds, community trusts, endowment funds, educational trusts, Iwi and Kiwisaver providers.

I am an investment director with Direct Capital and have been with the firm for 18 years. I am also former chairman of the New Zealand Private Equity and Venture Capital Association.

Investment in private companies, and overseeing the project investments that they make, is all that Direct Capital does. Discussion around capital allocation, risk and required investment return, is, for Direct Capital, a common and practical application of corporate finance theory.

Rate of Return

Weighted Average Cost of Capital (WACC) is a defined corporate finance term and has common meaning. "Hurdle Rate", "Required Rate of Return", "Cost of Capital", "Minimum Rate of Return" and other variations are more subjective in their common use. These terms may simply be interchangeable with WACC or they may refer to WACC with some form of premium attached to it. That premium may represent a gating mechanism, a tool to compensate for inherent forecast error, an adjustment for risk not otherwise contained in the WACC calculation, a genuine hurdle over WACC to be achieved, or some other adjustment factor.

Professor Guthrie's Submission

Regarding the threat of new entry, the submission from Professor Guthrie focused specifically on concluding a single rate of return applicable for new entry in the scouring industry. It assumes all investor types are the same.

The focus on a single rate of return that would apply to a new entrant decision for establishing a new scour operation is both narrow and overstated in its importance and relevance.

- Each investment will have its own WACC
- Each investor has its own hurdle rate, which may be tied to the investment's WACC or it may vary from this
- Each investor will have its own set of projected cash flows
- A financial investor will only have the stand alone cash flows and limited other reasons to invest
- A strategic investor may have different cash flows comprising synergies or more informed views on how it can achieve returns, along with strategic reasons to invest in addition to the cash flows

Corporate finance theory tends to seek to reduce all investment decision-making to objective and measurable components, including such things as required rates of return. In practice, while investment decisions may include formulaic components, these components are often simply used as 'gating' measures, used to validate and sense-check an investment, rather than direct or lead an investment decision.

For example, irrespective of an assessed rate of return on an investment, Direct Capital will not complete an investment where:

- The domicile of the platform investment is outside of New Zealand or Australia
- It fails to meet obligations under the United Nation's Principles of Responsible Investment
- The platform investment is in real estate
- The platform investment is in a start-up operation.

These investments may be permissible to other financial investors and as a 'type' these financial investors may have similar rate of return requirements. But in the case of Direct Capital, this will be irrelevant. No rate of return level will change the decision to not invest.

This is just one example where a rate of return requirement is relegated to irrelevance, even amongst similar types of investors.

Between different types of investors, the factors driving what is an appropriate return rate becomes much more varied and dispersed.

Investment decisions, as often as not, will include other factors that take precedence over return rate. These other factors will include:

- strategic benefits (both financial and non-financial),
- available synergy benefits (or costs avoided), and
- other non-financial considerations.

In fact, all things being equal, strategic benefits will typically be the ultimate determinant in the approval of an investment decision. While there will generally be a requirement that an investment meets a prescribed rate of return (whether a premium to WACC or WACC itself), as

we will highlight, strategic and non-financial factors may well reduce this premium to zero, and in the case of an investment being made to protect an existing business, may even negate the requirement to achieve the investment's required WACC.

Regarding identifiable synergy benefits, or costs avoided, these would amend the cash flows assessed as between a financial investor and strategic investor, increasing the investment's NPV. We note that the new entry model submitted in the application is on a stand-alone basis only.

This is particularly relevant for a new entrant to the New Zealand scouring industry where the most likely new entrant will be a merchant, or group of merchants, acting to protect their business against a perceived or actual threat of price increase with significant consequences to their core business.

Rate of Return between different Investor Types

Professor Guthrie's paper appears to present all investor types as being homogenous, having the same return requirements. While the literature on this may be conceptually supportable, in practice this is demonstrably not the case.

For the purpose of this discussion we break "investor types" into three groups:

- Financial Investors
- Strategic Investors with an existing operation in the industry, investing for growth
- Strategic Investors with an existing operation in the industry, investing to protect

As commented, each investor type will have different motivations, available financial and non-financial strategic benefits, available synergy benefits (or costs avoided) and other non-financial considerations.

Financial Investors: The financial investor is able to benefit by the cash-flows of the investment only. In contrast to strategic investors, it will have imperfect knowledge of the industry and the specific investment risk. It will have imperfect knowledge of the agency risk of a new relationship with management and less ability to react to agency risk with its own personnel.

In theory and practice the financial investor has the highest rate of return requirement of the three investor types.

Strategic Investors investing for growth: In addition to the cash-flows available to the financial investor, the strategic investor will have available the benefit of:

- Existing knowledge of the industry and risks
- Ability to vertically integrate the investment into its existing business (and in the case of a new entrant, underpin the scour with its existing wool volumes)
- Synergy values including management overhead, financial reporting, corporate costs savings such as insurance and utility volume discounts
- The ability to leverage existing relationships (both suppliers and end customers)

- Enhance strategic value through building a broader market presence and providing more components of the supply chain
- Enhanced market perception and branding
- Ability to attract/retain staff (larger operation, more opportunity etc)

Strategic Investors investing for protection: In addition to the benefits of the financial investor, and the strategic, synergy and other benefits of the strategic investor highlighted above, the strategic investor investing to protect their business will have available the benefit of:

- Avoiding negative revenue or cost implications such as the threat of scour price increases. In this instance, an investment in a scour line may even be made at a return rate below the "required" rate, if the investment protects their core business.
- Remove a perceived strategic weakness

There will be a number of other benefits arising to strategic investors compared to financial investors. The above simply highlight some of the more obvious ones.

These strategic factors almost always act as an override or an increment to the return arising from the standalone[1] asset itself. Professor Guthrie's paper ignores this entirely and it's a critical factor when looking at the issue of a new entrant in this particular market.

When Direct Capital acquired its shareholding in CWH, it did so on the basis that over a twenty year period the industry had right-sized itself to match declining wool volumes. Direct Capital's expectation was that this would continue.

There was no consideration given to increasing capacity in a market that already had excess capacity. It is unlikely that there is any hurdle rate that would attract investment by a financial investor to increase capacity in the industry (with the possible exception where the risk is fully underwritten by the customers).

However, for a merchant, or group of merchants, the situation is quite different.

For a merchant or group of merchants acting together, who between them control sufficient volume to justify the capacity introduced (i.e. their own volume) and where all industry losses arising from that additional capacity fall to the incumbent(s), then clearly the hurdle rate will be materially lower than that of a financial investor.

That underwriting of volume is simply not available to a financial investor (or if it is, it would obviously come at an additional cost of contracting and include counter-party risk).

In fact, with merchant ownership, a plant could operate at breakeven if financial and non-financial strategic goals, synergy benefits and other non-financial benefits are being achieved - in particular protecting a key input cost of a merchant's existing business, being the cost of scouring.

[1] Standalone – the asset operating in its current form with no regard to any other considerations.

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Evidence of Actual Return Rates

Professor Guthrie's submission relies on various pieces of academic literature to conclude a generic rate of return (20%) as an "entirely plausible"[2] measure to apply to a new entrant.

Direct Capital has the benefit of pointing to actual examples, and in this case the specific required rates of return applied in this investment. We can point to several data points that support a return rate of 15% or lower.

ACC's acquisition of 25% shareholding in 2009

The following is an extract from ACC's investment paper of August 2009 in respect of its acquisition of a 25% shareholding in CWH held by NZWL (David Ferrier). This highlights ACC's WACC at the time of 10%.

Discounted Cashflow (DCF)

We have also completed a DCF valuation of the forecast performance set out in section 6.1. In addition to those forecasts, other key assumptions are:

- WACC of 10%
- Terminal growth rate of 2%
- Capital expenditure increased in the terminal calculation to 1.25 times depreciation
- Tax rate of 30%

Agreement between ACC and NZWL (D Ferrier)

In respect of the same transaction, the following is an extract from the agreement between ACC and NZWL, referring [redacted]

[redacted]

[2] Page 2 of Professor Guthrie's 8 May 2015 report.

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Direct Capital's acquisition of 25% shareholding in 2010

In 2010 when Direct Capital acquired its shares in CWH from Mr Ferrier, it applied a post-tax WACC of 13.84% in a sense-check of its purchase price. Its WACC calculation included an investor specific Market Risk Premium, over and above the common use MRP of listed equities.

WACC Calculation

WACC Calcualtion - Capital Asset Pricing Model Build-Up

	Input	Calculation	Source / Commentary
Long term target E/EV	65.0%		
Long term target D/EV	35.0%		
Implied D/E		54%	
		TRUE	
Market Risk Premium (MRP)	15.00%		< Investor specific (FNZC 7.25% for general NZ listed market)
Risk Free Rate (RFR)	5.30%		< Yield on 10 year NZ Government Bond at 5 November 2010
Asset Beta (B_a)	0.70		< Lower than average in cyclicality
Equity Beta (B_e)		0.97	
Cost of Equity (R_e)		18.4%	
Debt Premium	2.75%		< Market rate (market at January 2010)
5 Year SWAP	4.75%		< 5 year SWAP rate at 5 November
Pre tax Cost of Debt		7.5%	
Tax Rate (T_c)	28%		
Adjusted Cost of Debt (D_a)		5.4%	
Weighted Cost of Equity (D)		12.0%	
Weighted Cost of Debt (E)		1.9%	
WACC		13.84%	

Option Agreement between ACC, Direct Capital and Lempriere

The Option Agreement, contained in the Shareholders' Agreement, a copy of which the Commission has, while theoretical in nature (given it is 'out of the money', has a strike price that increases over time and requires authorisation to exercise), includes an annual 15% price escalation reflecting a proxy for ACC and Direct Capital's rate of required return expectation.

9.2 **Price**

(a) The price payable by Lempriere for the Shares on exercise of the Original Option will be the highest of:

(i) the price per Share derived from eight times the forward normalised EBITDA of the Company for the then next 12 month forecast period, as derived from the most recent Budget and forecast approved by the Board; or

(ii) subject to adjustment under clause 9.2(c), NZ$14.00 per Share; or

(iii) if the Company is proceeding with an initial public offering at the time at which the Original Option is exercised, the price per Share expected to be received by Direct Capital and ACC for the Shares to be sold by them under the initial public offering; or

(iv) if either Direct Capital or ACC has, at the date of the Option Notice, received a current bona fide third party offer for their Shares, the price per Share offered by that third party.

(b) The price payable by Lempriere in accordance with this clause 9.2 will be adjusted to address any change to the capital structure of the Company (including a Share split or consolidation) on a basis which preserves, so far as is possible, the intended economic outcome of this clause 9.2.

(c) If the Original Option is not exercised within 12 months of the Agreement Date, the price specified under clause 9.2(a)(ii) will be increased by 15% on each anniversary of the Agreement Date. For clarity, each 15% increase will apply on a compounding basis in relation to any previous price increase under this clause 9.2(c) (meaning, for example, that the revised price at the first anniversary of the Agreement Date would be $16.10 and at the second anniversary of the Agreement Date would be $18.52).

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The above data points are specific to the various shareholder transactions applicable to Cavalier Wool Holdings. There are a number of other relevant reference points. For example:

Forsyth Barr (Share broker / Investment Bank)
April 2015 DCF Valuation Parameters for 65 researched NZSX listed companies. The WACC calculations range between **7.4% and 14% and average 9.7%**, with the wide range evidencing the high variance of risk among the companies. (In this regard we would posit that a tolling operation of a scour is relatively low risk - refer the asset beta used in the DCP historical WACC computation above).

DCF Valuation Parameters

Code	Company	Asset Beta	Target Gearing Debt:Mkt Cap	D/(D+MC)	Debt Prem	Kd	Equity Beta	Div Tax Adjustment	Ke	WACC	Terminal Growth
ABA	Abano Healthcare Group	0.85	60.0%	37.5%	2.2%	6.7%	1.36	0.1%	13.4%	10.2%	2.0%
AIA	Auckland Airport	0.53	30.0%	23.1%	1.0%	5.2%	0.69	0.1%	8.4%	7.5%	2.0%
AIR	Air New Zealand	1.11	20.0%	16.7%	2.2%	6.5%	1.33	0.2%	13.2%	11.8%	2.0%
ARG	Argosy Property	0.53	50.0%	33.3%	1.1%	5.6%	0.79	0.0%	9.1%	7.4%	2.0%
ARV	Arvida Group Limited	0.68	40.0%	28.6%	1.7%	6.2%	0.95	0.1%	10.4%	8.7%	2.0%
ATM	The a2 Milk Company	0.75	0.0%	0.0%	1.1%	5.6%	0.75	0.0%	8.9%	8.9%	2.0%
AUG	Augusta Capital	0.58	50.0%	33.3%	1.4%	5.9%	0.86	0.0%	9.6%	7.8%	2.0%
BGR	Briscoe Group	1.00	15.0%	13.0%	2.1%	6.6%	1.15	0.2%	11.9%	11.0%	2.0%
CAV	Cavalier Corporation	0.95	15.0%	13.0%	2.0%	6.5%	1.09	0.0%	11.3%	10.5%	2.0%
CEN	Contact Energy	0.60	40.0%	28.6%	1.4%	5.9%	0.84	0.1%	9.6%	8.1%	2.0%
CNU	Chorus	0.56	60.0%	37.5%	1.7%	6.2%	0.90	0.1%	10.0%	7.9%	2.0%
DGL	Delegat Group	0.85	50.0%	33.3%	2.1%	6.6%	1.28	0.1%	12.6%	10.1%	2.0%
DIL	Diligent	1.04	0.0%	0.0%	2.0%	5.5%	1.04	0.0%	11.0%	11.0%	2.0%
DNZ	DNZ Property Fund	0.55	50.0%	33.3%	1.2%	5.7%	0.83	0.0%	9.3%	7.6%	2.0%
EBO	EBOS Group	0.80	25.0%	20.0%	1.7%	6.2%	1.00	0.9%	11.6%	10.2%	2.0%
EVO	Evolve Education	1.00	20.0%	16.7%	1.8%	6.3%	1.20	0.0%	12.3%	11.0%	2.0%
FBU	Fletcher Building	0.85	35.0%	25.9%	1.5%	6.0%	1.15	0.7%	12.5%	10.4%	2.0%
FPH	FSP Healthcare	0.90	15.0%	13.0%	1.7%	6.2%	1.04	0.1%	11.0%	10.1%	2.0%
FRE	Freightways	0.71	25.0%	20.0%	1.5%	5.9%	0.89	0.1%	9.8%	8.7%	2.0%
FSF	Fonterra	0.57	50.0%	33.3%	1.2%	5.7%	0.86	1.4%	11.0%	8.7%	2.0%
GMT	Goodman Property Trust	0.53	50.0%	33.3%	1.1%	5.6%	0.79	0.0%	9.1%	7.4%	2.0%
GNE	Genesis Energy	0.60	40.0%	28.6%	1.4%	5.9%	0.84	0.5%	9.9%	8.3%	2.0%
HBY	Hallaby Holdings	0.95	68.0%	40.5%	1.8%	6.3%	1.60	0.2%	15.3%	11.0%	2.0%
HLG	Hellenstein Glasson	1.00	15.0%	13.0%	2.1%	6.6%	1.15	0.2%	12.0%	11.1%	2.0%
IKE	IkeGPS	1.44	0.0%	0.0%	0.0%	4.5%	1.44	0.0%	14.0%	14.0%	2.5%
KPG	Kiwi Property Group	0.53	50.0%	33.3%	1.1%	5.6%	0.79	0.0%	9.1%	7.4%	2.0%
KMD	Kathmandu Holdings	1.00	15.0%	13.0%	2.1%	6.5%	1.15	0.6%	12.5%	11.3%	2.0%
MELCA	Meridian Energy	0.60	35.0%	25.9%	1.3%	5.8%	0.81	0.4%	9.5%	8.1%	2.0%
MET	Metlifecare	0.68	40.0%	28.6%	1.7%	6.2%	0.95	0.3%	10.5%	8.8%	2.0%
MFT	Mainfreight	0.80	25.0%	20.0%	0.8%	5.3%	1.00	0.1%	10.7%	9.3%	2.0%
MHI	Michael Hill Intl	1.00	15.0%	13.0%	1.9%	6.4%	1.15	1.7%	13.5%	12.4%	2.0%
MPG	Metro Performance Glass	0.90	40.0%	28.6%	2.0%	6.5%	1.26	0.1%	12.7%	10.4%	2.0%
MRP	Mighty River Power	0.60	40.0%	28.6%	1.4%	5.9%	0.84	0.1%	9.6%	8.0%	2.0%
MVN	Meltwen	0.95	15.0%	13.0%	1.8%	6.3%	1.09	0.4%	12.0%	11.0%	2.0%
NPT	NPT	0.59	50.0%	33.3%	1.3%	5.8%	0.89	0.0%	9.8%	7.9%	2.0%
NPX	Nuplex Industries	0.85	53.0%	34.6%	1.8%	6.1%	1.45	2.0%	16.0%	12.0%	2.0%
NZO	New Zealand Oil & Gas	0.80	20.0%	16.7%	1.9%	6.4%	0.96	0.0%	10.4%	9.4%	2.0%
NZR	Refining NZ	0.73	17.6%	15.0%	1.7%	6.2%	0.85	0.1%	9.5%	8.8%	1.5%
NZX	NZX	1.00	0.0%	0.0%	1.6%	6.1%	1.00	0.2%	10.8%	10.8%	2.0%
OIC	Opus Intl Consultants	1.00	30.0%	23.1%	1.9%	6.4%	1.30	0.3%	13.1%	11.1%	2.0%
PCT	Precinct Properties NZ	0.53	50.0%	33.3%	1.1%	5.6%	0.79	0.0%	9.1%	7.4%	2.0%
PEB	Pacific Edge	1.30	0.0%	0.0%	2.1%	6.6%	1.30	0.0%	12.9%	12.9%	2.0%
PFI	Property For Industry	0.56	50.0%	33.3%	1.1%	5.6%	0.84	0.0%	9.5%	7.7%	2.0%
PGW	PGG Wrightson	1.05	17.1%	14.6%	2.0%	6.5%	1.23	0.3%	12.5%	11.5%	2.0%
POT	Port of Tauranga	0.56	30.0%	23.1%	1.5%	6.0%	0.73	0.1%	8.4%	7.5%	2.0%
PPL	Pumpkin Patch	1.00	15.0%	13.0%	3.7%	8.2%	1.15	0.0%	11.8%	11.0%	2.0%
RBD	Restaurant Brands NZ	0.85	21.5%	17.7%	1.6%	6.1%	1.03	0.1%	11.0%	9.9%	2.0%
RYM	Ryman Healthcare	0.60	26.6%	21.0%	1.4%	5.9%	0.76	0.5%	9.4%	8.3%	2.0%
SAN	Sanford	0.85	15.0%	13.0%	1.8%	6.3%	0.98	0.1%	10.8%	9.8%	2.0%
SKC	SKYCITY	0.75	32.5%	24.5%	1.2%	5.7%	0.99	0.5%	11.2%	9.5%	2.0%
SKL	Skellerup Holdings	0.90	15.8%	13.6%	1.7%	6.2%	1.04	0.2%	11.1%	10.2%	2.0%
SKT	Sky TV	0.70	17.7%	15.0%	1.4%	5.9%	0.82	0.1%	9.5%	8.7%	2.0%
SLI	S.L.I. Systems	1.30	0.0%	0.0%	0.0%	4.5%	1.30	0.0%	12.9%	12.9%	2.5%
SPK	Spark NZ	0.85	40.0%	28.6%	1.6%	6.1%	1.19	0.2%	12.3%	10.1%	2.0%
STU	Steel & Tube Holdings	0.95	40.0%	28.6%	2.2%	6.7%	1.33	0.2%	13.3%	10.9%	2.0%
SUM	Summerset Group	0.68	25.0%	20.0%	1.6%	6.1%	0.83	0.5%	9.7%	8.6%	2.0%
TME	Trade Me Group	0.70	17.3%	14.7%	1.5%	6.0%	0.82	0.1%	9.4%	8.7%	2.0%
TPW	Trustpower	0.60	40.0%	28.6%	1.5%	6.0%	0.84	0.5%	9.5%	8.3%	2.0%
TTK	TeamTalk	0.85	25.0%	20.0%	2.1%	6.6%	1.05	0.3%	10.4%	10.1%	2.0%
VCT	Vector	0.53	50.0%	37.5%	1.2%	5.7%	0.84	0.1%	9.6%	7.5%	2.0%
VHP	Vital Healthcare	0.55	50.0%	33.3%	1.1%	5.6%	0.83	0.0%	9.3%	7.6%	2.0%
WHS	The Warehouse Group	0.85	18.0%	15.3%	1.8%	6.3%	1.00	0.2%	10.9%	9.9%	2.0%
WYN	Wynyard Group	1.30	0.0%	0.0%	0.0%	4.5%	1.30	0.0%	12.9%	13.9%	2.5%
XRO	Xero	1.30	0.0%	0.0%	2.5%	7.0%	1.30	0.0%	12.9%	12.9%	2.0%
ZEL	Z Energy	0.68	25.0%	20.0%	1.7%	6.2%	0.84	0.2%	9.7%	8.6%	1.5%

Notes: Risk Free Rate (Rf): 4.50% Market Risk Premium (MRP): 7.50%

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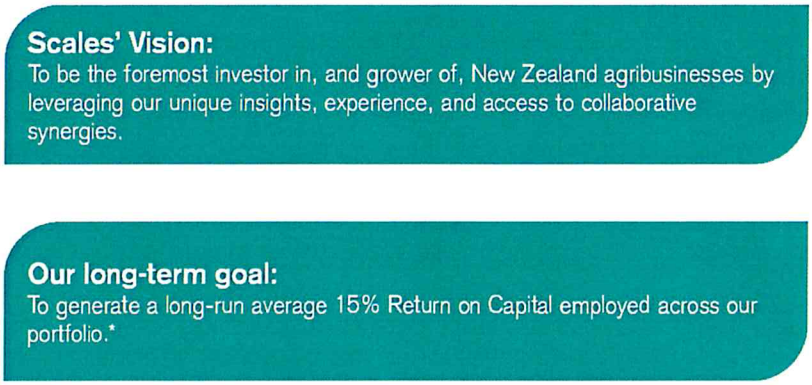
Scales Corporation

Extract from its 2015 AGM Presentation referencing its long-run required return of 15%



Summary

For the reasons discussed, financial investors such as ACC and Direct Capital will have significantly higher return requirements than strategic investors in such operating assets as wool scours.

Strategic investors, including merchants with a vested interest in the industry gain the benefit of the financial returns of the investment, but also strategic, synergy and non-financial benefits.

Strategic benefits are likely to be the prime investment determinant and act as an override or an increment to the return arising from the standalone asset itself.

Protecting against supplier pricing is a very strategic consideration for merchants. Protecting their core businesses, with an investment in a scour line, even if operated at breakeven, will be a straightforward proposition in the event CWH, post authorisation threatens to raise prices.

Should merchants act on a proposal to establish a new entrant, their hurdle rate will be significantly below the rates that ACC and Direct Capital applied to their investments – namely a range of 10%-15%. Other industry and financial market data highlight return rates no greater than 14%.

Accordingly, we do not believe there is any basis for assuming the return rate of 20% contained in Professor Guthrie's submission.

Regards,

Gavin Lonergan
Investment Director
Direct Capital Limited