BELL GULLY

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Public version

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Dear Hamish

Impact of removal of WSI through the acquisition

CWH understands that the merchants/exporters have informed the Commission that CWH's acquisition of WSI will increase New Zealand's export receipts for wool by breaking up the existing vertical integration between WSI's trading and scouring division that results in the world price for New Zealand wool being reduced.

This view is endorsed by the submission of Roger Buchanan of 23 February 2011, a submitter with extensive experience in the wool industry, including as a director of an unrelated wool scouring business and as CEO of the Wool Board before its disestablishment in 2003. Mr Buchanan has no ties to merchants, scours or to CWH or WSI.

The evidence from exporters is that WSI is in fact underselling the New Zealand wool price. This has a contagion effect on the buyer's price expectations in relation to New Zealand wool.

The Commission has asked CWH to comment on the merchants' claims that the removal of the vertical integration between WSI's trading and scouring divisions would give rise to a substantial public benefit. It does so below.

1. **Exporters have expressed concerns since 2003**

Since at least 2003, exporters have expressed concern that WSI has been using earnings from its wool scouring operations to fund its wool trading operations with the result being that WSI is and has for some time been trading wool at prices which suppress the New Zealand price of wool.

Exporters voiced this concern to the Commission at the time of Decision 666 and said it was a reason why they would be reluctant to use WSI as a commission scourer.

The facts as reported by the Commission in Decision 666 imply that WSI was at that time cross-subsidising its scouring operations at this time:

- The Commission recorded at paragraph 124 that while WSI had revenues of $180 million its trading division made a loss of $(0.47) million and that the reported profit of $2.5 million was "only as a result of its scouring activities".

- In contrast, the Commission found that exporters had positive (albeit low) margins of at or below 7 cents per kilogram.

Exporters explained the reason why they would be reluctant to use WSI as a commission scourer was because, by providing additional scouring volumes to WSI, they would assist WSI to lower its per unit scouring costs, thereby increasing its scouring returns and providing additional latitude for WSI's reduced wool trading prices.

2. The WSI business model

The reason why WSI has this price latitude lies in its merchant scouring model and the differing marginal costs WSI has compared to other exporters.

Economic theory predicts that a firm will be willing to price at a level where marginal revenue equals marginal costs. The marginal costs facing WSI differ from those facing other exporters:

- An exporter's key marginal costs are the cost at which it acquires wool and the scouring costs it pays to CWH. This scouring cost in turn reflects CWH's costs and a return on capital.

- In contrast, WSI's key marginal costs reflect the price at which it acquires wool and the marginal costs to it of its scouring operations. Since most of the costs are fixed, WSI's marginal scouring costs are very low.

Consistent with economic theory, *all else being equal*, WSI would be willing to sell wool at a lower price than other exporters. This is because *any* revenue WSI earns above its marginal costs contributes towards its fixed costs. It is true that WSI would ideally like to recover its fixed costs if possible, but the key point is that given the very low marginal costs of scouring, practically any sale at a price above the cost of greasy wool will provide a contribution to fixed costs. If the margin on scouring above variable costs is **[ ]** cents, then WSI may be willing to trade at a price which sacrifices some of this margin.

Similarly, the large proportion of fixed costs associated with scouring provides an incentive for WSI to pursue volume. This is because the more sales it makes above marginal costs, the lower the per sale contribution needed to cover its fixed costs. This drive for volume was recognised by the Commission in Decision 666 in its finding that WSI would have an incentive to seek additional commission scouring customers.

However, experience since Decision 666 has shown that other exporters have not tended to materially use WSI as a commission scourer, and this fact compounds WSI's drive to secure volumes to provide a contribution towards the fixed scouring costs.

In combination WSI has an incentive to make sales at practically any price above its greasy wool procurement, and an incentive to put as much volume as possible through the scour so as to reduce the per unit fixed contribution required to provide a return on capital.

CWH understands this drive for volume has seen WSI regularly procuring wool before having committed sales presumably realising that any sale above its procurement costs will provide some contribution to its fixed costs.

3. Evidence illustrates that WSI has reduced New Zealand's wool price

As highlighted above, WSI management have professed that they do have a significant depressing effect on the price of New Zealand wools and market place evidence supports this.

Figure 1 below shows the history of New Zealand clean wool prices over the last three decades. The period during which exporters have expressed the most concern with WSI coincides with WSI listing on the NZAX in 2003/2004 and its investment in replacing the Whakatu scour line with a new 3.0m scour line in 2005. Figure 1 shows that strong wool prices have consistently declined over this period, a period in which WSI has had a greater need to recover the fixed costs of its Whakatu investment.

Figure 1

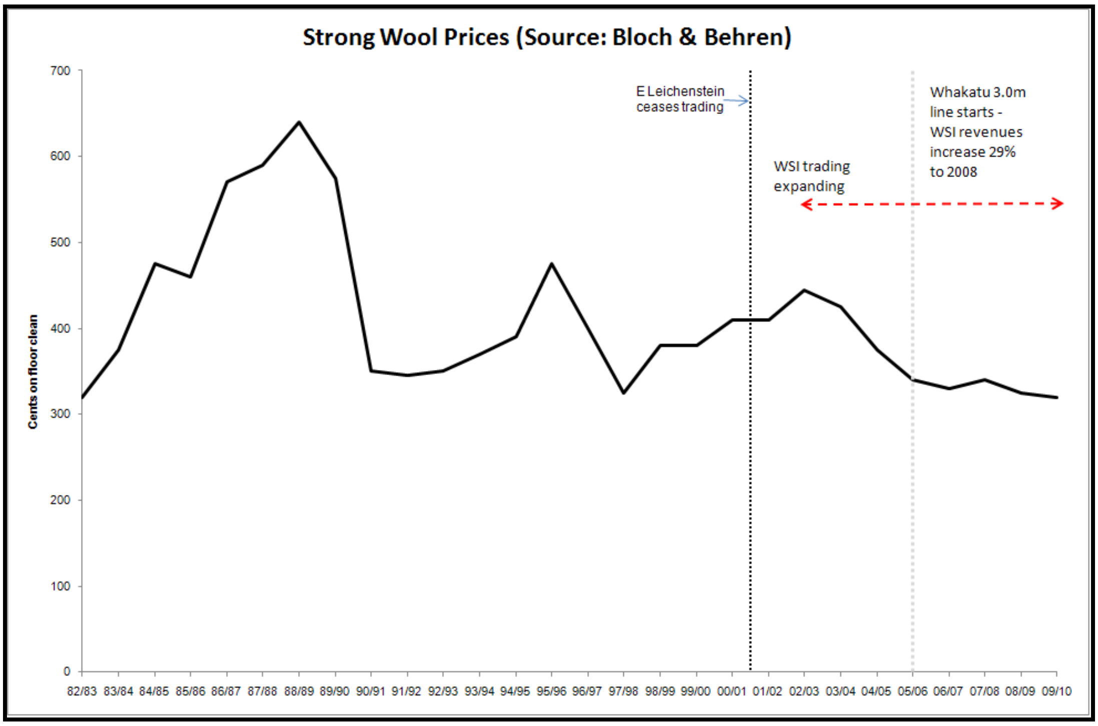


Figure 1 is illustrative although CWH acknowledges that there are many factors that may influence wool prices and underpin the trends shown. However, an examination of other evidence suggests that WSI has been a key contributor.

The commercial reality is that while there is an ostensible “world price”, sale and purchase agreements in the world market do not take place in some form of perfect auction market. Rather, the actual contract price struck between an exporter and a customer for each consignment reflects the prevailing market price and the particular bargaining strength of the exporter and the customer at the time the contract is negotiated.

From a bargaining strength position, customers are well aware that WSI has more latitude to sustainably reduce their prices than other exporters, and also that it needs to maintain a substantial volume of sales to provide an adequate return to cover its fixed costs. This informs the customer’s bargaining position. From WSI’s perspective, it would rather make that sale than risk losing the sale to another party so as to generate cash-flows.

Furthermore, where WSI procures greasy wool ahead of concluded sales it will be placed in a position of having to sell the clean wool blends so as to generate a cash-flow. Customers will know this because, in the usual course, customers specify in advance the blends they want. Where it has uncommitted clean wool blends, WSI has to create a demand for the blends they have rather than simply supplying in accordance with existing demand. In such a scenario, there is a significant shift in bargaining power to the customer as WSI is seeking to sell volumes above a customer’s budgeted requirement.

While Figure 1 provides an aggregate picture of New Zealand wool prices, evidence of New Zealand wool prices in offshore markets in which WSI has a significant presence compared to offshore markets where it does not have such a presence suggests that WSI’s trading operations have been a significant factor in suppressing New Zealand wool prices.

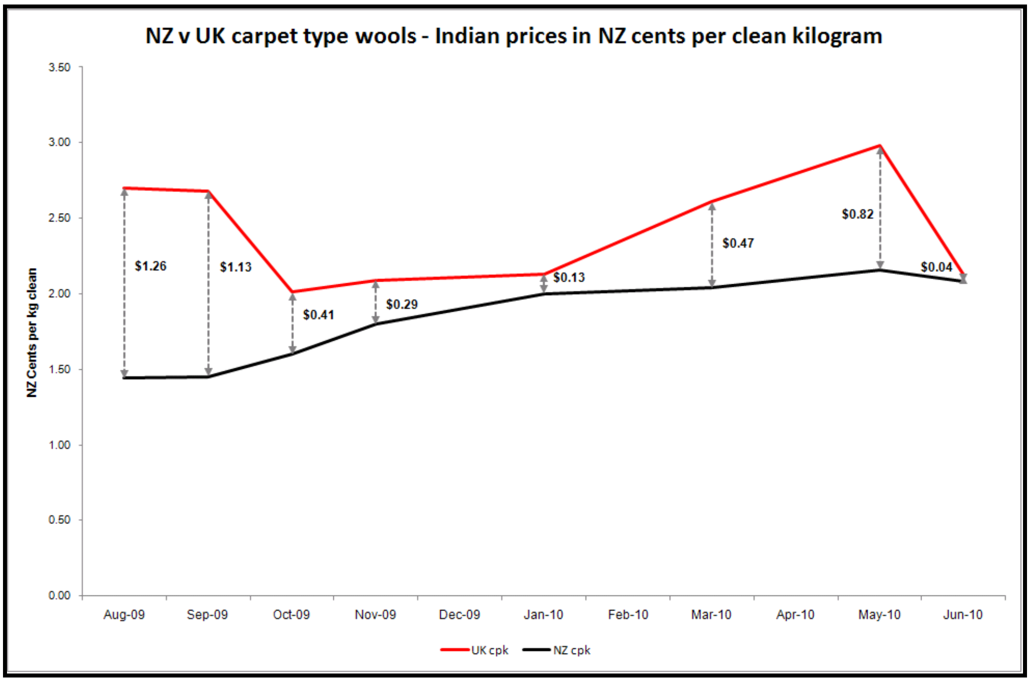
A good example of this is price positioning of New Zealand wool in the Indian market as compared to similar coarse wools from the United Kingdom.

New Zealand wool generally enjoys a price premium compared to similar wool types from the UK. This is because New Zealand wool does not have the black and coloured fibres and kemps which are endemic in UK wools. The absence of these features means that spinners are willing to pay a higher price than is the case for UK wools. This premium is generally around 10 cents per kg and is most prevalent in markets where WSI is not represented. Wool exporters will be able to confirm this for the Commission.

The price positioning of New Zealand wools in India is quite different. New Zealand wool sales into India are dominated by WSI. WSI has stated it enjoys a 65-70% share of New Zealand sales into India. CWH's analysis of export sales to India shows that the New Zealand wool price is significantly below the level it is selling for in other markets where WSI is not present.

This is shown in Figure 2 below which shows the selling price of similar type UK and NZ wools over a 12 month period. This shows that not only are New Zealand wools not achieving the usual premium over UK wools, they are in fact selling **below** UK wools.

Figure 2



The only significant difference between India and other countries in terms of New Zealand wool is WSI's very substantial share of Indian wool sales.

The results are likely to be replicated in other markets where WSI is operating with a significant market share, the most notable of which is China and certainly this is the feedback which CWH has from its merchant customers. **[**

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4. **WSI's financial performance shows WSI is continuing to cross-subsidise its trading operation**

As discussed above, the Commission's findings in Decision 666 imply that WSI's trading operations are substantially underperforming other stand-alone trading operations. This reinforces the conclusion that WSI is selling wool at a level below what New Zealand wool would be expected to obtain.

In Decision 666, the Commission concluded that WSI had lost $(47,000) dollars on its trading division while other exporters were operating profitably. This was based on the 2008 financial year. An analysis of WSI's audited accounts for the 2009 and 2010 financial years indicates that the wool trading division is still underperforming stand-alone trading operations.

- In the 12 months to 30 June 2009, WSI reported a NPAT of $(4.38) million. Its scouring division reported a loss of $(0.11) million and its trading division a loss of $(4.27) million on trading turnover of $158 million.

  However, this masks the fact that a subvention payment of $4.157 million was recorded in the accounts as flowing from the scouring division to the trading division. The impact of this is that in fact the scouring division earned a profit in the order of $4 million while the trading division actually lost closer to $(8) million for the year.

  Having said that, the accounts also include a one-off impairment charge representing its contribution to the rationalisation of the scouring industry following the CWH/Godfrey Hirst transaction. If that is removed due to its one-off nature, while the scouring division earned a profit in the order of $4 million while the trading division is recorded as losing closer to $(3.8) million for the year.

  To put this figure in context, the two comparably large exporters (Masurel and Fuhrmann) reported NPATs of $2.874 million in the case of Masurel (on turnover of $139.5 million) and $0.67 million (on turnover of $49.89 million) in the case of Fuhrmann.

- In the 12 months to 30 June 2010, WSI reported a NPAT of $1.147 million. Its scouring division reported a loss of $(2.756) million and its trading division a profit of $3.903 million on trading turnover of $144 million. However, these figures also mask a subvention payment of $11.27 million recorded in the accounts as flowing from the scouring division. The impact of this is that in fact the scouring division earned a profit in the order of $8 million while the trading division actually lost approximately $(7) million for the year.

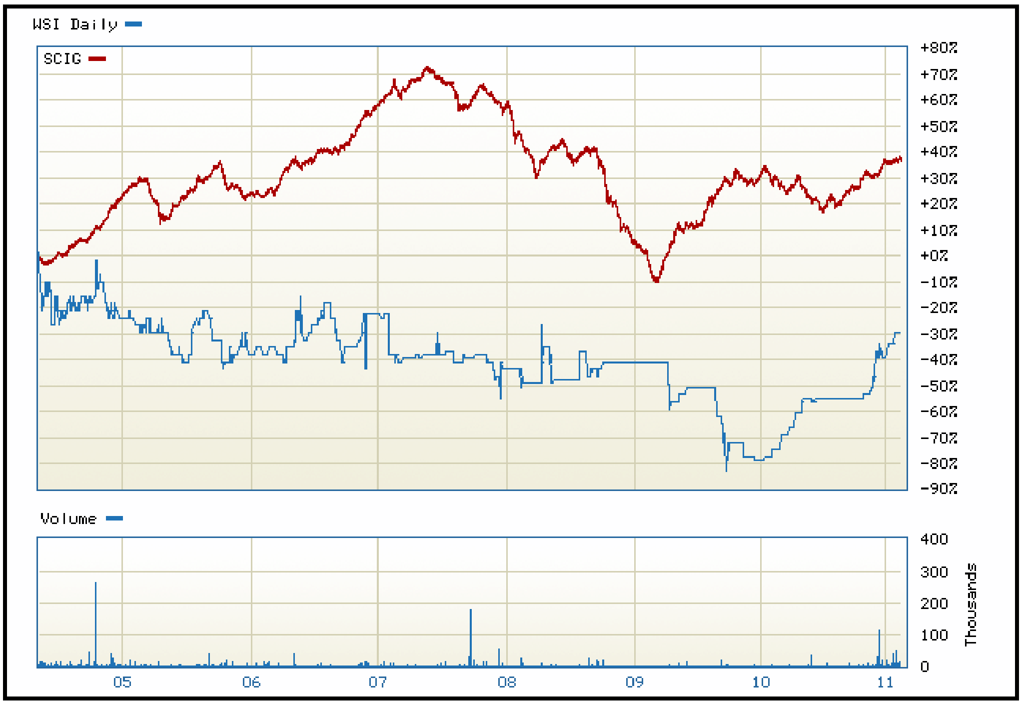
This is not a trend that can be isolated solely to the past few years. Since 2002:

- WSI's revenues have grown 12%, although its EBIT margins have declined from 5.1% to 3.4%. (Inflation over this corresponding period has been 26%.)

- WSI's reported return on equity averages only 5.7% from FY2002 to FY2010. This is well below a workable and sustainable return on capital and indicates that WSI has not been earning sufficient revenue to cover its fixed costs including providing a return on capital employed.

- WSI's dividend payout has averaged only 1.8c per annum, representing a dividend yield of 3.6%. This represents a poor return for shareholders.

- WSI's share price has declined by around 20 cents per share since its listing in 2004. WSI has also underperformed when compared to the NZX "Small Cap" Index. Over the comparative period (since listing), the Small Cap index has appreciated 40% while WSI has deteriorated 30%.



5. **Cavalier's experience with the merchant scouring model**

WSI is the only remaining merchant scouring model in New Zealand. All other merchant scourers have exited from their scouring operations. This includes Cavalier Group, which made the decision in July 2000 to close E. Lichtenstein & Co which at that time operated on a similar model to that employed by WSI today, i.e., it procured, scoured and traded wool. Cavalier ceased trading wool and restructured the scouring operations into a stand-alone commission scouring business, the forerunner of CWH today.

In the Annual Report of 2000, the Board explained the rationale for its decision as follows:

> [The model] involved the company in entering into future sales contracts for scoured wool with overseas customers and local exporters. To meet these contracts, it would acquire greasy wool at auction or, increasingly, directly from the wool grower through its subsidiary Elco Direct Limited. Greasy wool stocks would then be blended and scoured to meet the contract specifications. A very high level of funds are, of necessity, employed in this operation given the requirement by overseas customers to secure fixed price supply commitments into the future and the unwillingness of woolgrowers to make a corresponding commitment. The inherent volatility of commodity prices and the New Zealand dollar and the Company's aversion to risk have necessitated our carrying a high level of inventory, and there has been insufficient margin in wool trading to provide an adequate return on this capital.
>
> The decision to withdraw from wool trading means that E Lichtenstein and Company Limited will no longer operate as an exporter in its own right. However, we have extremely efficient wool handling and scouring operations, and we will continue to be involved in the acquisition and processing of wool for our carpet business. At the same time, we will be seeking other opportunities as a service provider to the export wool industry while working through the restructuring occasioned by the decision to exit wool trading.
>
> ....
>
> ...the Company expects the earnings from the wool operation to be not all that different from where they have been in the recent past. However, the freeing up of an estimated $40 million used in that operation will transform the return on much-reduced funds employed. This

translates to net cash inflows of some $22 million, after the repayment of loans associated with the wool operation.

In the few months after Cavalier made this decision to exit, Cavalier's share price rose by 35% or between $1 and $1.50 per share.

CWH understands that the Commission has been told that New Zealand wool prices increased after E Lichtenstein and Company Limited ceased to trade. Figure 1 above shows that wool prices did in fact increase at this time, although it is difficult to isolate the exact influence of the closure decision on this trend.

6. Removal of WSI will result in a public benefit

Exporters' view that CWH's acquisition of WSI will increase New Zealand's export receipts for wool is supported by the evidence which suggests that, for whatever reason, WSI is selling New Zealand wool at a price below the price which would be obtained if that wool were being sold by other exporters. The impact of this is not only on WSI volumes – the price expectations create a contagion effect for all other exporters of New Zealand wool.

While it is difficult to precisely isolate the extent to which this is the case, however:

- WSI's dismal financial performance suggests that WSI's prices are clearly below market levels;
- recent sales data from India suggests that New Zealand wool prices in the market are between 20 and 130 cents per kg lower than would be expected based on sales in other markets; and
- as stated previously, even if the benefit of New Zealand were only 10 cents per kilogram, a 10 cent per kg price differential across New Zealand's wool exports of approximately 169,000 tonnes (excluding domestically processed wool products) implies a benefit to New Zealand of $16.9 million per year.

Please let us know if you have any questions in relation to this letter.

Yours sincerely

[Sgd: Phil Taylor / David Blacktop]

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