BELL GULLY

By email
david.ainsworth@comcom.govt.nz /
hamish.forsyth@comcom.govt.nz

Public version

David Ainsworth / Hamish Forsyth
Chief Advisor / Senior Investigator
Commerce Commission

FROM **Phil Taylor / David Blacktop**
DDI 64 9 916 8940 / 64 4 915 6531
MOBILE 64 21 994 216 / 64 21 663 059
EMAIL phil.taylor@bellgully.com
EMAIL david.blacktop@bellgully.com
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Dear David and Hamish

Cavalier Wool Holdings - The Superstore Benefit

This letter provides further explanation of the superstore benefits likely to flow, and the reasons why they will flow only with the acquisition and not without.

1. Background to the concept – the wool supply chain

In Decision 553 (Pyne Gould Guinness/Wrightsons), the Commission explained the wool supply chain. This description provides a useful backdrop for considering the incentives to promote the superstore and the reasons why it would not eventuate in the counterfactual.

As the Commission explained in Decision 553, wool growers have a variety of options to sell their wool including through a broker, merchant, exporter, end-user and/or the internet. The most common forms of sale are through either:

- a wool broker (such as PGW, Elders etc) who sells wool on behalf of a grower through auction or private treaty and charges the grower a commission for selling their wool through auction or arranging a contract with end-users;
- a merchant/exporter who buys the wool directly from the grower or via an auction for on-sale. The Commission found that "[a] grower may consult two or three merchants/exporters, and choose the best offer, or deal with only one merchant on a regular basis" (WSI falls into this grouping, albeit that it also has its scouring interests); or
- a New Zealand based processor including spinners and millers, such as Cavalier Bremworth, Godfrey Hirst, etc.

These various parties compete to acquire wool from growers based on the return they can offer. For their part, growers generally make use of a range of the available sale methods and switch between a range of acquirers.

Once a mode of sale is selected by the grower, based on expected returns, the grower (or the grower's agent) arranges for the wool to be transported in bales into the distributor's wool store facilities or such other wool store facilities as the acquirer/agent directs. Those woolstores are geographically dispersed, regularly not in a straight line to the port and are often in what were historically strong wool growing regions (although they may no longer be strong wool growing regions).

Here, the wool is "handled" in a variety of ways. This transportation cost to the woolstore is generally borne either directly or indirectly by the grower and hence is a factor the grower will consider in deciding the method to be adopted to sell the wool.

2. The commercial opportunity

The Commission also noted in Decision 553 that "most brokers do have their own wool handling facilities and services" and explained that:

> The grower does not pay for these services specifically. It is similar to a supermarket distribution and warehouse centre, which forms part of the supermarket's business, and is not an item specifically charged to the supplier.

Of course, as with supermarkets, naturally those overhead costs form part of the cost structure of the various participants and will influence the costs charged to growers or the price to be offered. CWH believes that currently the cost to a grower associated with each participant running its own woolstore operations is around **[ ]** per bale.

In addition, the grower pays directly for freight to the woolstore and this influences the returns earned for wool sold. To the extent there is an inefficient freight cost incurred, that is an avoidable cost to the grower.

The duplication of these overhead structures and the costs to growers associated with those cost structures mean that returns to growers are lower than they would be if duplicated costs could be removed.

The superstore concept is no more than a centralised distribution and warehouse centre for wool as is the case with supermarket distribution.[1] The commercial opportunity arises in the same way as it does for supermarket distribution and warehouse centres or for a 3rd party logistics/storage provider, in that the superstore will generate significant fixed asset and freight/handling efficiencies. These arise in three primary ways:

- lower per unit costs of production through rationalisation and economies of scale – over time CWH estimates the operating costs of a North Island superstore could be in the order of **[ ]** per bale based on achieving sufficient greasy bales of wool. (It also believes that the costs of establishing the superstore will be **[ ]**;
- creating freight efficiencies by removing reverse cycle freight and rationalising freight more generally; and
- allowing the sale of land and buildings and plant currently utilised in duplicated facilities.

There are significant benefits to "NZ Inc" and the wool industry from making this happen and those benefits will accrue in different ways to different participants.

2.1 *The benefit to CWH*

CWH will be a 3rd party operator of, in essence, a warehousing facility in much the same way as operators like Linfox[2] operate in other industries. In many respects, the commercial

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[1] The superstore would be expected to receive and handle greasy wool directly from the grower into store, provide facilities for wool dumpers to operate as well as the scour lines and then handle and arrange for direct export to the nearest wool port.

[2] We refer to CWH as the operator, however, it is equally possible that CWH will be the promoter/creator of the concept but that in time, once the concept proves its value it may transfer its interest to an independent investor or business. Equally,

model for the superstore is similar to the commercial model for commission wool scouring. The assets involved are long-life assets and the costs of production are largely fixed. The capital required will be incurred up-front when the decision to invest is made.

While the superstore's immediate financial return will be the price that it can charge users for this service facility, it is unlikely to be profitable on day 1 let alone provide the necessary return on capital immediately **[ ]**

It will have significant fixed costs and its ultimate profitability will be driven by CWH's ability to attract sufficient greasy bales to achieve economies of scale so as to drive down per unit costs towards the **[ ]** it believes will be achievable.

[ ]

Over a relatively short period of time, CWH's per unit costs will decline as it attracts volumes and moves toward the **[ ]** cost position it believes is achievable.

2.2 *The benefit to participants – CWH's superstore "customers"*

Conversely the benefit for participants will be derived from the extent to which they are able to reduce their cost base by, in effect, contracting out this aspect of their business to CWH. This will not only arise from reductions in overhead costs, but also through reductions in freight costs through freight efficiencies and by enabling those businesses to sell land and buildings and excess plant currently used by them to provide these wool handling services.

The ability to exit these fixed assets will also result in participants altering their cost structures from fixed to variable, and as a result this will lower their risk profile.

As initial participants achieve cost savings as a result of their participation, they will gain a competitive advantage over their competitors. In turn that will provide an incentive for those competitors to use the superstore (or otherwise drive efficiencies in their businesses) to reduce their own supply costs to make them cost competitive.

These are the financial incentives to participate and the reasons why CWH has every confidence that there will be a significant take-up of superstore capacity.

2.3 *Benefit to growers*

The benefits of a lower industry cost structure will also flow to growers both:

- directly, through improved freight efficiencies; and
- indirectly because a reduced cost base will provide merchants/exporters/brokers more latitude to offer higher prices to growers to secure their volumes.

There is a "win-win" opportunity for all participants.

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once the concept is established an investor may take over and then lease out to the operator the buildings utilised in the superstore.

2.4 ***Summary of the benefits***

At a high level, the wool industry is spending more money – **[ ]** – than it needs to on wool handling. In other words, up to **[ ]** is currently being left on the table.

The opportunity exists for a 3rd party provider to provide a service that enables New Zealand to take this **[ ]** off the table.

How that **[ ]** (once achieved) will be divided between CWH as the 3rd party provider, its customers and growers is difficult to precisely determine. **[**

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It is for these reasons that CWH believes that the superstore concept makes sense.

3. **What prevents this concept from being rolled out today?**

The best evidence that the superstore concept will not arise in the counterfactual is the fact that the concept has not been developed and implemented to date and shows no sign of happening absent this acquisition.

As the Commission is aware **[**

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Certainly, **[**

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3.1 ***Concept relies on an independent 3rd party operator***

As described in our earlier letter, the superstore concept requires an independent 3rd operator to develop and operate the facility.

This is necessary to ensure that there would be no actual or perceived conflict of interest between the superstore owner/operator and its customers. If there was such a perception, the model would not work. **[**
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The reason why an independent operator is required is analogous to the reason why merchants/exporters are either reluctant to, or in the majority of cases refuse to, use WSI as a scourer. The concerns expressed by those parties include not wanting to provide additional revenue to WSI which can be used to subsidise its trading activities against merchants/exporters, and a fear that WSI would extract an advantage from gaining information about other merchants/exporters order book profile (e.g., its customer specifications etc).

Similarly, the potential users of a superstore would be very reluctant to use a superstore operated by one of its competitors or alternatively a superstore promoter may be reluctant to share its superstore with one of its competitors. It is this very dynamic which has led to the duplication of facilities evident in the market place today.

CWH has the established industry and customer connections (it already has **[ ]** of the commission wool scouring in New Zealand), the capital, and the demonstrated business history to make the superstore concept a reality. **[**

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There is no other independent 3rd party operator that could operate this service and have the confidence of its customers in terms of independence.

3.2 ***No financial incentive for CWH to invest in the concept absent WSI acquisition occurring***

As discussed above:

- The superstore concept requires significant investment in the order of **[ ]**.
- **[ ]**
- The only immediate revenue (and return) for CWH is dictated by the profitability of the superstore. In turn, this is a function of:
  - **[ ]**
  - **[ ]**

  [ ]

CWH has yet to further advance this concept to date, and would not do so in the counterfactual. **[ ]**

It has no doubt that there is sufficient revenue available to make superstore a profitable business but only if it can be assured of receiving sufficient volumes and in a sufficiently short time period to make the investment (both capital and initial start up financing) worthwhile.

This investment hurdle is significant, particularly given the declining wool environment which is endemically entrenched in New Zealand. No rational investor would base an investment case on a material *increase* in New Zealand wool volumes. A best case scenario would only see sheep numbers and wool volumes holding steady over the medium to long term.

The uncertainty is created by WSI's existence, market position, and the attitude of other participants to its existence. If CWH was to introduce a superstore today, WSI would have little choice but to respond by constructing its own competing woolstore complex.

If WSI did not respond, then:

- It would find itself at a cost disadvantage to its trading competitors (i.e., merchants/exporters etc) in a declining wool environment. This would place its trading division at risk. If it lost trading volumes, then this would also undermine its scouring volumes (given merchants generally refuse to use WSI for scouring). (This is analogous to the reason why CWH is confident that other participants will participate once the model is implemented.)

- It would find itself at a competitive disadvantage to CWH in relation to the **[ ]** of true commission scouring volumes CWH estimates WSI currently captures from customers willing to use WSI as a scourer. **[**

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While the alternative would be for WSI to use the CWH superstore, there is no real chance of this happening under its current merchant/scourer model. If CWH allowed WSI to use the CWH facility, then CWH's other superstore customers *would be much less likely to use* or support the CWH superstore. The current antagonism to WSI is testament to this. There is therefore a material risk that many of them would rather continue to operate their own facilities than support a facility that assists WSI's trading operations. This would make it more difficult for CWH to attract enough volumes to achieve a profitable per unit cost position.

Moreover, from WSI's perspective, using a CWH superstore would not solve the locational advantage CWH's wool scours would have to capture WSI's limited number of commission scouring customers.

The heightened (actual or perceived) and material risk of significant duplication remaining creates uncertainty because if such retention eventuated, it would reduce the volume of wool going through the superstore. Even if CWH believed it would ultimately attract sufficient volume, the presence of WSI is likely to mean that it will take longer for CWH to achieve this position. Accordingly, there are two effects:

- there is materially heightened uncertainty as to whether a critical mass of volume could ever be achieved; and
- even if it could be achieved, **[**

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Both these factors substantially raise the risk profile of the project and therefore the investment hurdle. For these reasons, CWH would not be able to achieve sufficient certainty to ensure its return would be sufficient to justify the investment.

3.3 *Conclusion*

The superstore concept requires an independent 3rd party to operate the store. CWH is the only plausible and identifiable 3rd party. Absent this 3rd party involvement it will not happen.

With the removal of the barrier created by WSI, there are profit maximising incentives both for CWH to promote and create a superstore in each Island, and for industry participants to support it and gain the benefits of it.

From an investment perspective it is the existence of WSI and its merchant scourer business model coupled with the antagonism towards that model from the industry which undermines the incentive for CWH to invest in the concept.

From an investor's (and financier's) perspective, there are only two plausible scenarios:

- an "all in" scenario where both CWH and WSI operate woolstores – in that scenario the investment case **[ ]**
- an "all out" scenario where neither CWH nor WSI operate woolstores – in that scenario CWH's shareholders can apply **[ ]** to more profitable investment opportunities.

In the counterfactual, CWH cannot be sufficiently certain that WSI would not respond with its own woolstore or that the involvement of WSI would stand in the way of support from other participants.

4. **Steps taken to date to achieve the superstore concept**

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

Yours sincerely

[Sgd: Phil Taylor / David Blacktop]

Phil Taylor / David Blacktop
Partner / Senior Associate