ONTRACK
New Zealand Railways Corporation Rere Totika

SENSITIVE: SPECIAL HANDLING REQUIRED

4 December 2007

Hon Dr Michael Cullen
Minister of Finance
Parliament Buildings
WELLINGTON

Dear Minister

RE: TOLL NEW ZEALAND

Attached are discussion notes as background for the meeting with you later this week.

They represent initial advice and are based on a set of assumptions which still require verification. We have not yet had access to detailed information from Toll nor have we undertaken due diligence.

The attendees from ONTRACK will be Cam Moore (Chairman), Murdo Beattie (Cameron Partners Ltd) and I, and we look forward to seeing you then.

Yours sincerely

William Peet
Chief Executive

Attached: Discussion Notes: Toll New Zealand

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DISCUSSION NOTES: TOLL NEW ZEALAND

3 December 2007

CAMERON PARTNERS
investment bankers

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Introduction

This paper discusses an indicative offer for Toll's New Zealand business.

Background

- In August this year the ONTRACK Board provided you with a paper setting out a rationale for the acquisition of Toll's New Zealand operations.

- Cabinet considered this issue in October and you have subsequently mandated ONTRACK to pursue the acquisition.

- ONTRACK has now indicated to Toll that it wishes to purchase its New Zealand operations. This follows the failure of the parties to agree on matters relating to the amendment of provisions in the National Rail Access Agreement (NRAA).

- ONTRACK sought access to detailed business information on Toll's New Zealand business to assist it in making a high quality (but non-binding) offer to Toll for the New Zealand business.

- Toll declined to provide detailed information to ONTRACK. Instead, it proposed a process as follows:
  - Toll will provide ONTRACK with its current business plan which incorporates a four year forecast.
  - ONTRACK will provide Toll with a non-binding offer for Toll's New Zealand business based on its analysis of this information and other information that is in the public domain.
  - Toll will determine whether or not to continue negotiations based on the value of this non-binding offer. Any negotiations on the parts of the business that Toll wishes to keep (e.g. the freight forwarding activities) will only occur after agreement on the non-binding offer.

- ONTRACK has accepted this process. This paper sets out a preliminary valuation of Toll's New Zealand business based on this data provided by Toll.

Strategy

- The indicative offer stage in transactions of this nature inevitably forms part of the negotiation process.

- Key objectives at this stage are:
  - To test the level at which Toll might be willing to enter negotiations, and, if possible to continue those negotiations.
  - To send a signal about ONTRACK's willingness to pay.
  - To avoid unrealistic expectations developing on the part of Toll.

- This paper canvasses some of the options for the indicative offer to Toll.

- As will be seen from the valuation material below, there is a strong tactical element to the indicative offer to Toll.

- This arises because:
  - The future course of NRAA charges has a major impact on the value of the business.
  - The enforceability of key NRAA terms is disputed, particularly regarding service levels as any agreement is likely to reduce Toll's freedom to withdraw or downscale services.
  - Toll are unlikely to believe that the Government / ONTRACK are serious about a full recovery of NRAA charges, unless a strong signal to the contrary is sent by Ministers followed up by actions from ONTRACK.

- Factors that should be considered in pitching an indicative offer are:
  - The extent to which the Government / ONTRACK is willing to pursue full NRAA charges, including a hostile response from Toll in terms of network / service contraction. Toll can be expected to test the Government's resolve in this respect.
  - Concerns about 'overpayment' relative to the value of Toll NZ when facing full NRAA charges.
  - The desire to reach an agreed transaction quickly.
  - The value to the Government of a rapid transition to rail ownership and the ability to pursue more integrated transport sector policies.

    - Any concerns regarding negative perceptions by offshore investors if Toll is seen as having lost heavily in its dealings with the Government.

- Choosing where to pitch an indicative offer to Toll is heavily dependent on the weighting of these factors.

Approach to Valuation

- The valuation approach is straightforward:
    - Discounted cashflow (DCF) analysis.
    - Extrapolating Toll's forecasts but making material adjustments to capex and forecast ONTRACK charges under the NRAA.

- The rationale for this approach is as follows:
    - Encourage Toll to provide further information to 'prove us wrong'.
    - Avoid a substantive debate on Toll's forecasts until we have access to the detailed information necessary to challenge those forecasts.
    - Maintain maximum flexibility to revise the indicative offer following the receipt of further information.

Valuation

- The valuation uses the four year forecasts to June 2011 provided by Toll.
- The Toll forecasts are extrapolated out to 2020 but are otherwise as provided by Toll except for:
  - Significant ferry capex outside Toll's explicit forecast period (2013).
  - Moderately higher IT costs based on our assessment of Toll's systems.
  - Higher NRAA charges reflecting ONTRACK's view of the NRAA.
- We regard the valuation methodology and assumptions as non-controversial.
- Summary cashflow spreadsheets are attached as an appendix to this paper.
- The valuation outcome is dominated by the assumptions relating to charges payable by Toll under the NRAA.

NRAA charges assumed in Toll forecasts

- In the "Toll view" valuation NRAA charges are assumed to be:

All in nominal $NZm p.a.

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
56	57	59	61	62	64	66	68	70	72	75

NRAA charges assumed by ONTRACK

- In the "NRAA view" valuation NRAA charges are assumed to be:

All in nominal $NZm p.a.

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
56	74	83	93	102	112	121	131	141	152	162

- The reason for the large differences in these two scenarios are:
    - The "Toll view" assumes an extension of the current interim agreement.
    - The "NRAA view" assumes that payments will revert to full TAC charges and payments for improvements / renewals.

- The "Toll view" figures produce an equity value for Toll's NZ operations close to $500m.

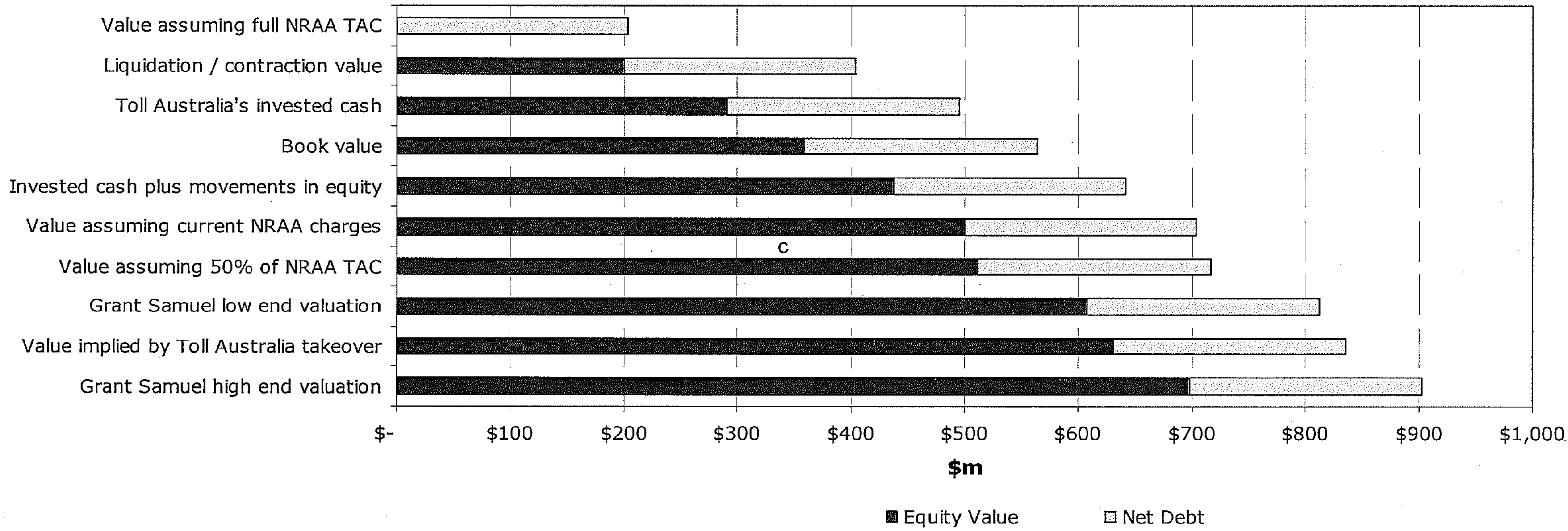
- The "NRAA view" figures produce an equity value close to zero.

- The equity value of zero is not credible. It is likely that Toll could liquidate its New Zealand assets for a figure significantly above this level, possibly around $200m. More work is required on this point.

- These figures compare with an equity value of $631m based on Toll's $3.00 per share offer to the Toll New Zealand minorities in September this year. This value was within the fair value range of $607.8m and $697.8m assessed by Grant Samuel, the independent appraiser in the takeover offer. Not surprisingly, the Grant Samuel view is closest to the value we assess using Toll assumptions for NRAA charges.

- The following chart illustrates a range of Toll NZ valuation considerations:

Toll NZ Valuation Considerations



Source: ONTRACK, PWC, Cameron Partners

- The table below sets out equity values based on different levels of NRAA charges being incurred by Toll. The $500m valuation that reflects our view of their assumptions produces a value similar to that resulting if Toll pays only 50% of ONTRACK's assessed NRAA charges.

Equity value under different levels of NRAA charges

	ENTERPRISE VALUE ($M)	EQUITY VALUE ($M)
100% NRAA TAC	201.8	-2.4
75% NRAA TAC	458.8	254.6
50% NRAA TAC	715.9	511.7
25% NRAA TAC	972.9	768.7
100% Toll TAC	705.3	501.1

- The valuation data can therefore be used to support a very wide range of conclusions. The key issue is future NRAA charges. Two aspects are most important:
  - ONTRACK's attitude to enforcement of the NRAA as opposed to a continuation of concessionary 'interim agreements' or a revised agreement.
  - The extent to which ONTRACK or Toll will 'win' if NRAA charges are enforced / challenged through the legal system.

Indicative Offer

- There are a number of alternative approaches to making an indicative offer to Toll. As outlined in the table below, the real range is around $200m to $650m.

OFFER	BASIS	RATIONALE	COMMENT
Zero	DCF value.	It is the true value with NRAA enforcement.	Not credible. Toll has superior alternatives.
$200m	Liquidation / contraction value.	Toll's best outcome with full NRAA enforcement.	No incentive for Toll to accept.
$250m	Assumes 50:50 win for Toll on NRAA.	Best outcome Toll could expect if Government pursues NRAA.	Will need to be followed up by vigorous pursuit of NRAA before it becomes credible.
$291m	Toll's invested cash.	Gives Toll money back.	Deal has not worked. Designed to keep Toll whole.
$380m	Toll's book value.	Toll's book value.	Deal has not worked. Designed to keep Toll whole.
$437m	Toll's invested cash plus movements in equity.	Gives Toll money back and return on money.	Deal has not worked. Generous offer to make Toll accept quickly.
$500m	Assumes current NRAA charges.	Accepts Toll view on future NRAA charges.	Could make Toll accept more quickly.
$631m	Purchase price for outstanding shares in mid 2007.	Recent market test.	Very generous. Hard to substantiate with normal valuation methodology.

- In considering the above it is important to note that the NRAA charges are real expenditures that are likely to be required by 'the rail business' whether they are funded by Toll, ONTRACK or Crown subsidy. Based on Toll's current business plan, this suggests that the value of the business to be acquired by ONTRACK is close to zero.

- It is also significant that equity analysts appear to view Toll's New Zealand business as being worth more than $500m. It is reasonable to assume that the analyst's views reflect guidance from Toll management. This is important because it will influence Toll management's view of what can be presented to the market as a 'win' for Toll.

- Factors that should be considered in pitching an indicative offer within the range discussed above are:
  - The extent to which the Government / ONTRACK is willing to pursue full NRAA charges, including a hostile response from Toll in terms of network / service contraction. Toll can be expected to test the Government's resolve in this respect.
  - Concerns about 'overpayment' relative to full NRAA charges.
  - The desire to reach an agreed transaction quickly.
  - The value to the Government of a rapid transition to rail ownership and the ability to pursue more integrated transport sector policies.
  - Any concerns regarding negative perceptions by offshore investors if Toll is seen as having lost heavily in its dealings with the Government.

Toll Response

- Toll's response can be expected to be along the lines that the offer (at any level) is unsatisfactory. They can be expected to dispute ONTRACK's NRAA assumptions and most probably decline further sale discussions.

- ONTRACK will need to decide how it responds to this. Options include:
  - Vigorous pursuit of full NRAA charges.
  - Making NRAA implications more visible to the investment community. The objective of this would be to focus Toll shareholders on the realistic value of the New Zealand business if ONTRACK pursues the NRAA. Shareholders could then be expected to pressure Toll management to address the New Zealand business' future.

- Toll may also choose to go public on the deal or on service contraction options to test the Government's resolve in a public dispute.

- ONTRACK will need to be prepared for these responses and develop response strategies.

Appendix

Toll NZ Cashflow Statement assuming Toll forecast of TAC

Toll Financial Model

Input Data

DCF Valuation

$m at year end June		2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Terminal
yearfrac		0.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Revenue		**757.8**	**812.6**	**846.3**	**880.3**	**906.7**	**933.9**	**961.9**	**990.8**	**1,020.5**	**1,051.1**	**1,082.7**	**1,115.1**	**1,148.6**	**1,148.6**
% growth yoy			*7.2%*	*4.1%*	*4.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*0.0%*
Non-TAC Expenses		(576.5)	(608.2)	(622.9)	(644.2)	(663.5)	(683.4)	(703.9)	(725.)	(746.8)	(769.2)	(792.2)	(816.)	(840.5)	(840.5)
TAC	Toll forecast	(55.5)	(57.2)	(58.9)	(60.6)	(62.5)	(64.3)	(66.3)	(68.3)	(70.3)	(72.4)	(74.6)	(76.8)	(79.1)	(79.1)
Total Expenses		**(632.)**	**(665.4)**	**(681.8)**	**(704.8)**	**(725.9)**	**(747.7)**	**(770.2)**	**(793.3)**	**(817.1)**	**(841.6)**	**(866.8)**	**(892.8)**	**(919.6)**	**(919.6)**
EBITDA		**125.8**	**147.2**	**164.5**	**175.5**	**180.8**	**186.2**	**191.8**	**197.5**	**203.5**	**209.6**	**215.8**	**222.3**	**229.0**	**229.0**
% margin		*16.6%*	*18.1%*	*19.4%*	*19.9%*	*19.9%*	*19.9%*	*19.9%*	*19.9%*	*19.9%*	*19.9%*	*19.9%*	*19.9%*	*19.9%*	*19.9%*
Depreciation		(61.7)	(67.7)	(70.5)	(70.8)	(72.9)	(75.1)	(83.4)	(85.9)	(88.4)	(91.1)	(93.8)	(96.6)	(99.5)	(99.5)
EBIT		**64.1**	**79.5**	**94.0**	**104.7**	**107.8**	**111.1**	**108.4**	**111.7**	**115.0**	**118.5**	**122.0**	**125.7**	**129.4**	**129.4**
% margin		*8.5%*	*9.8%*	*11.1%*	*11.9%*	*11.9%*	*11.9%*	*11.3%*	*11.3%*	*11.3%*	*11.3%*	*11.3%*	*11.3%*	*11.3%*	*11.3%*
Tax		(21.2)	(23.9)	(28.2)	(31.4)	(32.4)	(33.3)	(32.5)	(33.5)	(34.5)	(35.5)	(36.6)	(37.7)	(38.8)	(38.8)
NOPAT		42.9	55.7	65.8	73.3	75.5	77.8	75.9	78.2	80.5	82.9	85.4	88.0	90.6	90.6
Add Depreciation		61.7	67.7	70.5	70.8	72.9	75.1	83.4	85.9	88.4	91.1	93.8	96.6	99.5	99.5
Less capex		(80.)	(129.2)	(80.4)	(77.7)	(72.9)	(191.1)	(77.4)	(79.7)	(82.1)	(84.5)	(87.1)	(89.7)	(92.4)	(92.4)
Less change in working cap		(3.)	(3.1)	(3.2)	(3.3)	(3.4)	(3.5)	(3.6)	(3.7)	(3.8)	(3.9)	(4.)	(4.2)	(4.3)	(4.3)
Net Cash Flow		**21.6**	**-8.9**	**52.7**	**63.1**	**72.1**	**-41.7**	**78.3**	**80.7**	**83.1**	**85.6**	**88.1**	**90.8**	**93.5**	**93.5**
Terminal value															**1,219**
Periods to discount		0.25	1.00	2.00	3.00	4.00	5.00	6.00	7.00	8.00	9.00	10.00	11.00	12.00	12.00
Discount factor @	10.9%	0.97	0.90	0.81	0.73	0.66	0.60	0.54	0.48	0.44	0.39	0.36	0.32	0.29	0.29
Present value		11	-8	43	46	48	-25	42	39	36	34	31	29	27	352

Total present value ($millions)	**705.3**
Less Net Debt	(204.2)
Equity value	**501.1**

Valuation parameters

End of financial year	31/6/2008
Valuation date	31/12/2007
Tax rate - 2008	33.0%
Tax rate - 2009 onwards	30.0%
WACC	10.9%
2011 - 2020 Rev / Exp / Depr growth	3.0%
Terminal growth	3.0%
TAC (NRAA=1,Toll=5)	5

Implied Multiples	2008
Implied EV/EBITDA multiple	5.6
Implied EV/EBIT multiple	11.0

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Toll NZ Cashflow Statement assuming Ontrack forecast of TAC under NRAA

Toll Financial Model

Input Data

DCF Valuation	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Terminal
$m at year end June														
yearfrac	0.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Revenue	**757.8**	**812.6**	**846.3**	**880.3**	**906.7**	**933.9**	**961.9**	**990.8**	**1,020.5**	**1,051.1**	**1,082.7**	**1,115.1**	**1,148.6**	**1,148.6**
% growth yoy		*7.2%*	*4.1%*	*4.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*0.0%*
Non-TAC Expenses	(576.5)	(608.2)	(622.9)	(644.2)	(663.5)	(683.4)	(703.9)	(725.)	(746.8)	(769.2)	(792.2)	(816.)	(840.5)	(840.5)
TAC — NRAA	(56.)	(74.3)	(83.5)	(92.7)	(102.2)	(111.7)	(121.5)	(131.3)	(141.3)	(151.5)	(161.9)	(172.4)	(183.)	(183.)
Total Expenses	**(632.5)**	**(682.5)**	**(706.4)**	**(736.9)**	**(765.7)**	**(795.1)**	**(825.3)**	**(856.3)**	**(888.1)**	**(920.7)**	**(954.1)**	**(988.4)**	**(1,023.5)**	**(1,023.5)**
EBITDA	**125.3**	**130.1**	**139.9**	**143.4**	**141.1**	**138.8**	**136.6**	**134.5**	**132.4**	**130.5**	**128.6**	**126.8**	**125.1**	**125.1**
% margin	*16.5%*	*16.0%*	*16.5%*	*16.3%*	*15.6%*	*14.9%*	*14.2%*	*13.6%*	*13.0%*	*12.4%*	*11.9%*	*11.4%*	*10.9%*	*10.9%*
Depreciation	(61.7)	(67.7)	(70.5)	(70.8)	(72.9)	(75.1)	(83.4)	(85.9)	(88.4)	(91.1)	(93.8)	(96.6)	(99.5)	(99.5)
EBIT	**63.6**	**62.4**	**69.4**	**72.6**	**68.1**	**63.7**	**53.2**	**48.6**	**44.0**	**39.4**	**34.7**	**30.1**	**25.5**	**25.5**
% margin	*8.4%*	*7.7%*	*8.2%*	*8.2%*	*7.5%*	*6.8%*	*5.5%*	*4.9%*	*4.3%*	*3.7%*	*3.2%*	*2.7%*	*2.2%*	*2.2%*
Tax	(21.)	(18.7)	(20.8)	(21.8)	(20.4)	(19.1)	(16.)	(14.6)	(13.2)	(11.8)	(10.4)	(9.)	(7.7)	(7.7)
NOPAT	42.6	43.7	48.6	50.8	47.7	44.6	37.3	34.0	30.8	27.6	24.3	21.1	17.9	17.9
Add Depreciation	61.7	67.7	70.5	70.8	72.9	75.1	83.4	85.9	88.4	91.1	93.8	96.6	99.5	99.5
Less capex	(80.)	(129.2)	(80.4)	(77.7)	(72.9)	(191.1)	(77.4)	(79.7)	(82.1)	(84.5)	(87.1)	(89.7)	(92.4)	(92.4)
Less change in working cap	(3.)	(3.1)	(3.2)	(3.3)	(3.4)	(3.5)	(3.6)	(3.7)	(3.8)	(3.9)	(4.)	(4.2)	(4.3)	(4.3)
Net Cash Flow	**21.3**	**-20.9**	**35.5**	**40.6**	**44.3**	**-74.9**	**39.7**	**36.5**	**33.4**	**30.2**	**27.0**	**23.9**	**20.8**	**20.8**
Terminal value														**271**
Periods to discount	0.25	1.00	2.00	3.00	4.00	5.00	6.00	7.00	8.00	9.00	10.00	11.00	12.00	12.00
Discount factor @ 10.9%	0.97	0.90	0.81	0.73	0.66	0.60	0.54	0.48	0.44	0.39	0.36	0.32	0.29	0.29
Present value	10	-19	29	30	29	-45	21	18	15	12	10	8	6	78

Total present value ($millions)	**201.8**
Less Net Debt	**(204.2)**
Equity value	**(2.41)**

Valuation parameters

End of financial year	31/6/2008
Valuation date	31/12/2007
Tax rate - 2008	33.0%
Tax rate - 2009 onwards	30.0%
WACC	10.9%
2011 - 2020 Rev / Exp / Depr growth	3.0%
Terminal growth	3.0%
TAC (NRAA=1,Toll=5)	1

Implied Multiples	**2008**
Implied EV/EBITDA multiple	1.6
Implied EV/EBIT multiple	3.2

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