The Treasury

South Canterbury Finance Limited Information Release

Release Document

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

From: Douglas Widdowson [Douglas.Widdowson@rbnz.govt.nz]
Sent: Thursday, 16 July 2009 11:42 a.m.
To: John Park
Subject: [SEEMAIL] [SENSITIVE] Comments on Expert report SCF (Autosaved).doc
Attachments: Comments on Expert report SCF (Autosaved).doc

John

I attach a copy of a review conducted internally of the SCF share purchase of Dairy Farms limited. This was done by the Bank to assess the possible impact of the sale on the capital ratios of SCF under the new NBDT methodology.

We conclude that:

1. The sale price was [3]
2. The transaction transferred cash from SCF, and moved assets into the company that were readily realisable for supporting the company, and in some instances would leave the company more vulnerable to additional calls for funds.
3. The transaction led the company to technically breach some of its bank lending covenants.
4. The transaction would probably leave SCF worse off from a capital ratio point of view, and would require the injection of additional capital to ensure that the entity's capital ratio remained the same.

Given the criteria the specialist applied for determining whether the transaction is at arm's length, we wonder, based upon the above outcomes, whether a different conclusion could be reached as to the transaction's impact on SCF and its status as an arms length transaction.

Regards

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[1]

Comments on the valuation of DHL shares for sale to SCF.

1. This note comments on the price for the purchase by SCF of shares in Dairy Holdings limited. It briefly sets out and assesses both the DHL and the expert report (ER) pricing methodologies. While these use different approaches they come to the same conclusion on the fair market value of the shares. In my view both [3] I have done an alternative calculation that is based on a 22.5 percent fall in the price of dairy farms, [3]
[3]

2. The effect of using my pricing methodology is to reduce the capital injection from the stated [3] million to [3] million. The impact on SCF's capital ratio under the new NBDT regime will be negative because the shares (at their true value of [3] million) will be risk weighted at 600%.

3. The fair market value price is sensitive to the assumption in the extent of the fall in dairy farm prices. The following table set out outcomes for range of price assumptions.

Table one value/farm price sensitivity

Farm price fall assumption	**10%**	**15%**	**25%**	**30%**
Share value $'000	[3]			

4. The following sets out the DHL and ER methodologies and my alternative valuations. The relevant balance sheet data is set out in table two. Column 1 is DHL's actual May 2008 balance sheet. Column 2 is the data the purchase price was based on. Column 5 is the ER fair market valuation and column 6 is mine.

5. All of the methodologies are based on net asset values. The current assets, livestock and investment (mostly dairy company shares) can be ascertained reasonably objectively. Plant is a relatively and the DHL and ER valuations can be accepted.

6. The key issue is the valuation of land and buildings. In my view the ER [3]

7. On the liability side there may be an issue with ER current liability figure. This is only [3] million compared with the [3] million of a year earlier. P&O state that they were provided with a schedule of debt as at 31 May 2009 prepared by management and that they have used that figure. The figure looks low for a company that is extreme financial pressure and which presumably would be trying to make maximum use of trade and other miscellaneous sources of finance. For the purpose of this exercise, however, the [3] million figure has been accepted.

DHL pricing methodology

8. Take the May 2008 balance sheet.

Step 1
Update land and buildings, investment and livestock asset values to May 31 2009

The farm and buildings value is down [3]

Step 2
Deduct provision for disposal costs [3]

Step 3
Deduct 2009 (pre-depreciation) loss of [3]

The increase in debt liabilities in the 2009 year of [3] million is ignored as are the fall in current assets and the net increase in fixed assets.

The value of the business is [3] million and the value of the shares is [3] million.

ER methodology

9. **Step 1**
Update all assets and liabilities to May 2009.

The change in land and buildings is a fall of [3]
Over the 2008-9 year DHL capital expenditure on dairy farms was [3] million. P&O makes no allowance for this in their asset valuation. Their per cent value change is based purely on their assessment of the farm price change over the year.

Step 2
Deduct disposal costs

The value of the business is [3] million and the value of the shares is [3] million

Calculation of land and building values in step one

10. Take the 19 dairy farm sales transactions that occurred in the areas where DHL had their farms over the period October 2008 – May 2009 and calculate the per hectare median price.

11. Take the lower quartile per hectare price (where the difference between the observed median and the lower quartile was calculated from earlier data periods where there were more sales).

12. Multiply the per hectare price from 2. by DHL's total land holdings. Note that for the West Coast farms the price per kg. of production rather than the per hectare price was used. This gives the total value of land and buildings.

Problems with the methodology

13. The methodology was not tested to see if matched the actual valuations at May 2008. If there is a difference, which is likely, then this will be inappropriately interpreted as a change in the value of DHL's assets.

14. It is well know that when property markets crash the number of transactions first falls sharply and the initially observed transactions are not an unbiased estimate (they are above) of the true market clearing price.

15. The analysis is based on all transactions over the November 2008-May 2009 period and at best can be interpreted as the average price centred around January/February. Subsequent to that there has been very bad news on the milkfat payout price and this has been rapidly translated into price expectations.

IH Fair Market Value Methodology

16. **Step 1**
Take the ER pro-forma balance sheet as at 31 May 2009 as the starting point.

Step 2
Assume a [3] percent fall in farm prices. Informed opinion is working on a [3] [3] percent in prices (on an orderly sale basis) from the mid 2008 peak.

Step 3
Add [3] million in net capital additions (expenditure of [3] million less depreciation).

Step 4
Deduct disposal costs.

The value of the business is [3] million and the value of the DHL shares is [3] million.

Balance of document deleted: [3]