KordaMentha

South Canterbury Finance

Preliminary Report to Treasury

17 July 2009

Table of Contents

Contents	Page
1. Introduction	1
2. Funding Overview	2
3. Key Trust Deed Covenants	3
4. Key Funding Covenants	4
5. Implications of a Ratings Downgrade	6
6. Overview of SCF Payment Processes	8
7. SCF Exposure by Market Segment	10

Appendices	
Appendix A – Restrictions	12

1. Introduction

This report, which has been prepared for the Treasury, has been undertaken pursuant to the scope of work that is contained in the Agreement for Inspection & Related Services entered into between KordaMentha and the Crown.

Pursuant to the scope of work set out in the Agreement for Inspection & Related Services and detailed in our scoping letter of 1 July 2009, this report covers the following preliminary matters in relation to our investigation:

- Schedule of key trust deed covenants and current compliance;
- Schedule of key funding covenants and current compliance;
- High-level commentary on potential impact of a rating downgrade, with particular reference to funding and trust deed issues;
- High-level commentary around SCF's payment processes; and
- High level commentary on the potential economic implications if SCF was to cease to be an active lender into the key market segments to which it has significant exposure.

We note that SCF has provided us with a relatively limited set of information to date. We have submitted a number of questions to SCF in relation to the contents of this report. SCF has been unable to answer a number of these questions within the required timeframe. As a consequence the information on which this report is based is incomplete. These omissions will be addressed in subsequent reports.

This report has been prepared pursuant to the terms and conditions that are contained in the Agreement for Inspection & Related Services and those that are set out at Appendix A.

All references to $ in this report are to New Zealand dollars.

Abbreviations

$	New Zealand dollars
S&P	Standard & Poors
SCF or the Company	South Canterbury Finance Limited
BNZ	Bank of New Zealand Limited
CBA	Commonwealth Bank of Australia Limited
EBIT	Earnings before Interest & Tax
NAB	National Australia Bank Limited

2. Funding Overview

Funding Book

The make-up of SCF's funding book as at 8 July 2009 is summarised below:

- Secured Bonds NZ$350 million
- Secured Debenture Stock NZ$1,549 million
- Unsecured Deposits NZ$30 million
- US Private Placement US$100 million

The secured bonds have been issued in three tranches as follows:

- $125m maturing June 2011
- $125m maturing December 2012
- $100m maturing October 2010

The October 2010 series matures inside the Government Guarantee period, whilst the other bonds mature outside that period.

Liquidity Position

SCF's liquidity position as at 26 June 2009 is summarised below:

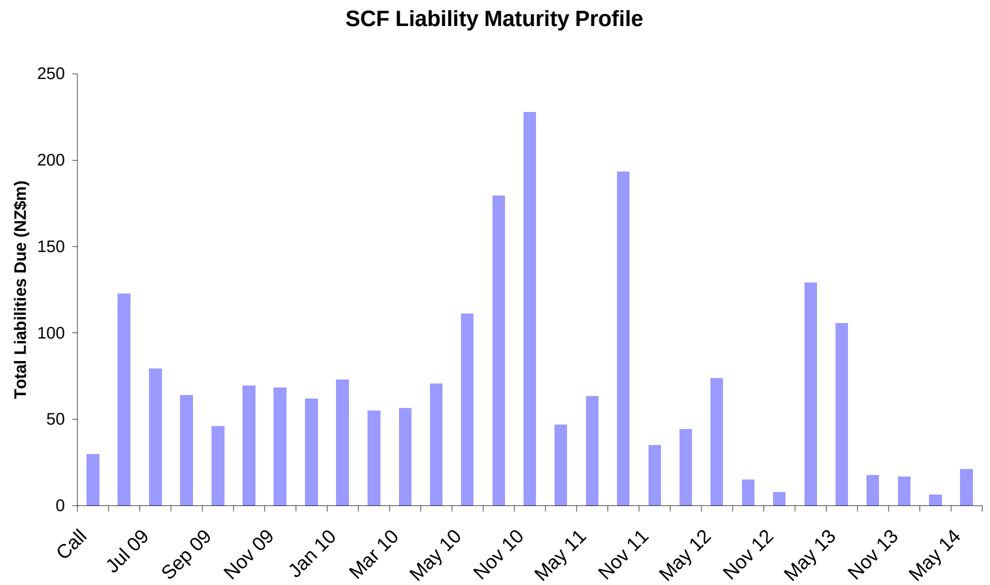
- Term Deposits $110 million
- At Call $59 million

The $50 million 364 day syndicated facility (BNZ & CBA) has expired (in November 2008) and is no longer available.

The BNZ, as Syndicate Agent, believes that a Potential Event of Default has occurred in respect of the $100 million syndicated facility (also BNZ & CBA), which is currently draw-stopped (we understand that BNZ advised SCF of this in April 2009). CBA has advised SCF that it no longer wants to be a part of this facility.

Maturity Profile

SCF has advised that the term of investments has shortened since the Government Guarantee was introduced. The maturity profile of the SCF book illustrates the concentration of maturities that now exists immediately prior to the expiration of the guarantee, which, at face value, may put liquidity under pressure.



3. Key Trust Deed Covenants

Overview

The Bonds, Debenture Stock and the US Private Placement are first ranking, secured debt obligations of SCF that are constituted by, and issued pursuant to, the SCF Trust Deed. The Trustee is Trustees Executors Ltd.

Key Covenants

SCF is required to report the following covenants to the Trustee within 60 days of the end of the financial year and half year. SCF is currently finalising its accounts for the year ending 30 June 2009. The most recent covenant compliance data is therefore for the 6 months ending 31 December 2008, which are shown below with actual compliance in blue.

- Prior Charges shall not exceed 7.5% of Total Tangible Assets.

  As at 31 December 2008, Prior Charges were 0.6% of Tangible Assets, giving headroom of $149m

- Aggregate book value of equity securities held not to exceed 100% of Shareholders' Funds.

  As at 31 December 2008, book value of equity securities was 54% of Shareholders' Funds, giving headroom of $114m.

- Total Liabilities (excluding Total Contingent Liabilities) will not exceed 12x Shareholders' Funds.

  As at 31 December 2008, Total Liabilities were 7.6x Shareholders' Funds, giving headroom of $1,089m

- Exposure to any single group (excluding banks) shall not exceed 35% of Shareholders' Funds

  The only exposure exceeding 20% of Shareholders' Funds as at 31 December 2008 was the loan of $81.9m to Southbury, which represented 32.7% of Shareholders' Funds.

- The aggregate of: First Ranking Stock; Second Ranking Stock; Total Contingent Liabilities secured by First Ranking Security Stock; and Prior Charges

  $1,859m as at 31 December 2008

  will not exceed

- The aggregate of: 98% of Total Readily Realisable Investments; 92% of Total Secured Receivables; 85% of Total Unsecured Receivables; 70% of Total Real Property; and 70% of Total Other Tangible Assets.

  $1,949m as at 31 December 2008 - i.e. headroom of $90m

- Total Contingent Liabilities shall not exceed 150% of shareholders funds.

  As at 31 December 2008 Total Contingent Liabilities were 7.9% of Shareholders' Funds, giving headroom of $356m.

At this stage we have simply reported, without verification, the covenant compliance figures produced by SCF. We will be verifying compliance as at 31 December 2008 and 30 June 2009 as part of our full review.

4. Key Funding Covenants

US Private Placement

SCF raised US$100 million in April 2008 via a US private placement using NAB as its agent. The terms and conditions of the Notes issued under the private placement are set out in the Note Purchase Agreement dated 2 April 2008. The Notes constitute a first ranking, secured debt obligation of SCF under the Trust Deed.

Key Covenants

Negative covenants include restrictions on related party transactions (must be in the ordinary course of business and at arm's length), mergers and sale of assets.

Financial covenants for the end of the half and full year are set out below:

- Liens not to exceed 7.5% of Consolidated Total Assets (similar to the Trust Deed).
- Consolidated Equity must be greater than 4% of Consolidated Total Assets.
- Non-Performing Assets must be less than 7% of Consolidated Total Financial Assets.
- Consolidated Equity + Loan Loss Reserves must be greater than 300% of Non-Performing Assets.
- Loan Loss Reserves must be less than 2% of Consolidated Total Assets.
- Capital Adequacy Ratio must be greater than 9%.

Each quarter, the Renewal Rate Ratio must be greater than 85%. This is the ratio of the Liquidity Amount divided by outstanding Secured Debenture Stock. The Liquidity Amount in any period is defined as:

- The amount of outstanding Secured Debenture Stock at the beginning of that period; *less*
- Secured Debenture Stock maturing in that period; *plus*
- Secured Debenture Stock inflows during the period; *plus*
- The aggregate amount of other borrowings received by SCF over the period.

Most Favoured Lender Status

If at any time SCF incurs debt obligations with more restrictive covenants than those of the private placement, it must advise Note holders accordingly and those covenants are deemed to be included in the private placement agreement.

Repayment Upon Ratings Downgrade

A Ratings Downgrade Prepayment Event is triggered 90 days after SCF fails to maintain an investment grade credit rating. If this occurs, SCF is required to advise Note holders within 5 days and offer to repay the entire unpaid principal outstanding, together with accrued interest, within 15 days.

This is now a particular risk, given that S&P placed the Company on negative rating watch on 7 July 2009. This status means that within the next 90 days S&P will either maintain or downgrade the Company's rating. Any rating downgrade will trigger this prepayment obligation. We deal further with this issue in Section 5. Our full report will analyse the resulting impact on the Company's liquidity.

Syndicated Facility Agreement

In November 2007, SCF executed a syndicated facility agreement comprised of:

- 364 day facility with a limit of $50 million (now expired); and
- 3 year facility with a limit of $100 million (currently draw-stopped).

The syndicate comprises BNZ and CBA. SCF has not drawn on either facility. The facilities are revolving, so that any amount repaid may be reborrowed.

Covenants

Negative Covenants:

- Amalgamations, Major Transactions, return of capital to shareholders, and related party transactions require prior written consent from the Banks.

4. Key Funding Covenants

Financial Covenants:

- EBIT must be greater than 1.2x Interest & Financing Costs for any 12 month period

  We understand EBIT Interest Cover was 1.20x as at 31 December 2008 and is expected to be 1.22x as at 30 June 2009[1].

- For each quarter, Total Liquidity will not be less than the greater of (i) 8% of Gross Receivables; and (ii) 75% of Retail Debenture Stock due to mature in the next 3 months less Gross Receivables due to be paid over the same period.

  SCF had a liquidity buffer of $430m as at 31 December 2008, which is expected to reduce to $224m as at 30 June 2009.

We understand that the Potential Event of Default under this facility relates to the October 2008 amalgamation with Southland Finance Ltd, which was not wholly within the Guaranteeing Group, and for which the Banks' prior written consent was not obtained. Even if SCF is able to remedy this default by obtaining a waiver from the banks, it appears that compliance with the EBIT Interest Cover covenant is border-line at best.

Future Availability of the $100m 3 year Facility

We understand that CBA has advised the Company that it wishes to exit the facility but it cannot do so without BNZ's consent. We understand that BNZ has advised the Company that it will consider its willingness to continue providing its $50 million share of the facility after it has reviewed our full report.

It seems likely that, at best, the facility will reduce to $50 million.

Disclosure

We note that SCF's current (October 2008) Debenture Stock prospectus refers to an undrawn cash facility of $150 million in several places, including in the first paragraph of the Chairman's letter on page 2 of the prospectus

On 5 May 2009 the Company filed its 31 December 2008 financial accounts with a prospectus extension certificate. Under note 20(b) to those accounts the Company correctly refers to the $100 million facility (which is technically still available, but cannot currently be drawn upon).

Under note 19(b) however the accounts refer to the facility as being a "$150 million bank facility". We are advised that this misstatement arose due to a clerical error and that the Company will ensure that it is corrected in its 30 June 2009 financial accounts.

.

[1] *MorganWallace report on Dairy Holdings Transaction, June 2009, page 21. We have requested, but not yet received, this from SCF.*

5. Implications of a Ratings Downgrade

CreditWatch Negative

SCF has maintained a BBB- credit rating from S&P for some time. BBB- is the lowest investment grade credit rating. On 7 July 2009 S&P placed SCF on "CreditWatch Negative", which according to S&P implies a 50% likelihood of a downgrade in the next three months.

S&P has attributed its decision, amongst other factors, to:

- An increased risk of non-performing assets translating into lending losses;
- SCF's decision to shift its holdings of liquid assets from cash to higher risk and high-yield investments which had increased the risk profile of the company and weakened its liquidity; and
- An increase in related-party exposures, which have moderated SCF's capitalisation, and which S&P deems a weakness at the BBB- rating level.

Repayment of US Private Placement

If SCF is downgraded, it will no longer be an investment grade credit. If the downgrade is not reversed within 90 days, SCF has a further 5 days in which to advise the private placement Note holders and offer to repay the entire unpaid principal. For those Note holders that so elect, payment is to follow 15 days later.

We are unsure as to the current costs associated with repayment of the private placement and have requested this information from the Company. In the meantime, we note the following:

- SCF currently records the private placement liability as NZ$125 million.
- It is possible that the SCF will be liable for Make Good payments, to compensate investors for interest foregone as a result of early repayment.
- The Company has entered into swaps to hedge the currency exposure associated with the private placement. There is likely to be a cost associated with closing out these swaps early. We do not know the current mark to market value of the swaps.

It is SCF's current intention to visit Note holders in the US prior to any downgrade occurring in order to seek a waiver or removal of the Ratings Downgrade clause. We suspect it is unlikely that investors will agree to waive this clause. We do not know how likely it is that a waiver would be granted. If it is, the associated fees and increased interest costs are likely to be significant. We are waiting on advice from SCF's private placement agent (NAB Capital) about likely outcomes.

Assuming that S&P downgrades SCF at the end of the three month creditwatch period, SCF would not have to offer to repay private placement Note holders until the end of calendar year 2009.

Liquidity

Assuming the current outstanding principal of the private placement of NZ$125 million was repaid at the end of June 2009, SCF's liquidity would fall from $169 million to $44 million.

- This should not result in any immediate issues with covenant breaches under the Trust Deed.
- However taking SCF's existing liquidity profile at face value, liquidity would become critical around October 2010.
- In reality a downgrade and immediate repayment of the private placement is likely to impact reinvestment rates and place more immediate liquidity pressure on SCF.

Government Guarantee

Under the Crown Deed of Guarantee, each deposit taker pays a fee in proportion to the Guaranteed Amount. For deposit takers with Guaranteed Amounts less than $5 billion, the fee percentage varies according to credit rating:

- As an investment grade lender, SCF currently pays a fee of 0.5%.
- If SCF's ratings falls to between BB and BBB-, the fee doubles to 1.0%
- For a rating lower than BB or for companies with no rating, the fee is 3%

5. Implications of a Ratings Downgrade

The Guarantee Fee is only levied on the amount by which SCF's guaranteed indebtedness increases relative to when the guarantee was entered into in October 2008.

- SCF's qualifying indebtedness was $1.50 billion in October 2008;
- This had risen to $1.84 billion by 30 June 2009.

The current guarantee fee is around $82,000 per month, which is equivalent to an annualised fee of $980,000.

- If SCF's ratings falls to between BB and BBB-, the fee will increase by around $980,000 per annum relative to current annualised levels
- If SCF's rating falls below BB, the fee will increase by around $4.9m per annum relative to current annualised levels

Other

A credit downgrade, and the subsequent liquidity issues, would most likely have a significant impact on SCF investor confidence, and therefore re-investment rates and investment term (our assumption being that investors may then be even less likely to invest for any term that is outside the guarantee period). It would most likely also impact on the BNZ's decision as to whether to renew its portion of the $100 million Syndicated Facility.

We consider the potential repercussions of this in our full report. In particular, we will analyse SCF's potential future liquidity based on various reinvestment rates and investment terms.

6. Overview of SCF Payment Processes

We assume that the Government Guarantee covers all investor products other than the preference shares, provided they mature within the guarantee period or one of the specified defaults occurs within the guarantee period.

On that basis, using information that the Company provided , we estimate that up to 38,096 individual investors who are owed $1,877 million may be covered by the Crown Guarantee, although it is not possible to conclusively determine eligibility (refer comments below).

Product ($ million at 8 July 2009)	No of Investments	No of Individual Investors	Gross Investment
Secured Debenture Stock	45,838	30,908	1,549
Unsecured Deposits	1,178	1,017	30
2010 Bonds		`	100
2011 Bonds		3,031	125
2012 Bonds		3,140	125
less Investments >$1m			(52)
less Non-Resident Deposits			(33)
less Related Party Deposits			(3)
Total Potential Crown Gtee Exposure		38,096	1,841

SCF has identified individual investors that hold multiple accounts within the secured and unsecured debenture stock but it cannot be certain whether those same investors also hold bonds. The Company believes therefore that the number of investors covered by the Guarantee is likely to be less than 38,096. Ultimately the actual number could be determined by a data matching exercise.

Identification of Guaranteed Amounts

The Company's investor records do not contain sufficient information to conclusively determine whether individual clients are covered by the Guarantee scheme. Specifically, the Company's records do not capture information on:

- Residency or Citizenship (i.e. if investors are New Zealand citizens or residents, whether they live in New Zealand or not).
- Trust Relationships:
- If the investor of record is acting as a trustee or in any other capacity for any other person. This may include financial institutions offering custodial services.
- Whether the beneficiaries of any declared trust are eligible to be covered by the guarantee.

We assume that The Treasury would have specific documentary requirements that investors would have to meet to confirm eligibility before any payments would flow.

In our experience, it is also prudent to seek confirmation of other key matters before making payment, including:

- The amount owing to each investor; and
- Investors' bank account details.

This would involve a large volume of paperwork, which would be of a very different nature to that which the company ordinarily handles.

Payment Processes

SCF uses two registry services:

- In-house for the Secured Debenture Stock and Unsecured Deposits; and
- Computershare for the Bonds.

6. Overview of SCF Payment Processes

Computershare

In our experience, Computershare has systems and processes that will enable it to make a large volume of payments and process a large volume of documentation.

In-house Registry Service

The largest volume of clients are dealt with via the in-house registry system.

We understand that Sovereign, on which the investor database is maintained, contains contact details for each investor and transaction records for each investment.

We also understand that SCF has IT expertise in-house to run queries against the system and set-up template documentation that could be produced for each investor. In our experience, bulk mail houses are most efficient at printing and posting documentation.

The key limitation is likely to be around the physical processing of the paperwork returned by investors and the related payment. There are 39,000 investors so it is realistic to expect this will be a time consuming and labour intensive process that will not result in all clients being paid on the same day.

We have previously undertaken a very similar exercise, which involved writing to over 10,000 people to seek confirmation of the amount they were owed, processing detailed paperwork that they returned and then making payments accordingly. With the cooperation of the bank, we were able to pay up to 700 people each day. Clearly we can resource for more payments per day. The ability to process payments comes down to the decision making rules (processes in place and bottlenecks in that process).

In finance company distributions with which we have been involved, we have been able to pay upwards of 4,000 people in one day.

It appears that the Company holds the information necessary to seek confirmation from investors of the amounts owing and that it will be possible to establish a process to deal with any payout under the Crown Guarantee. It must be recognised however that the sheer volume of clients means that this will require significant planning.

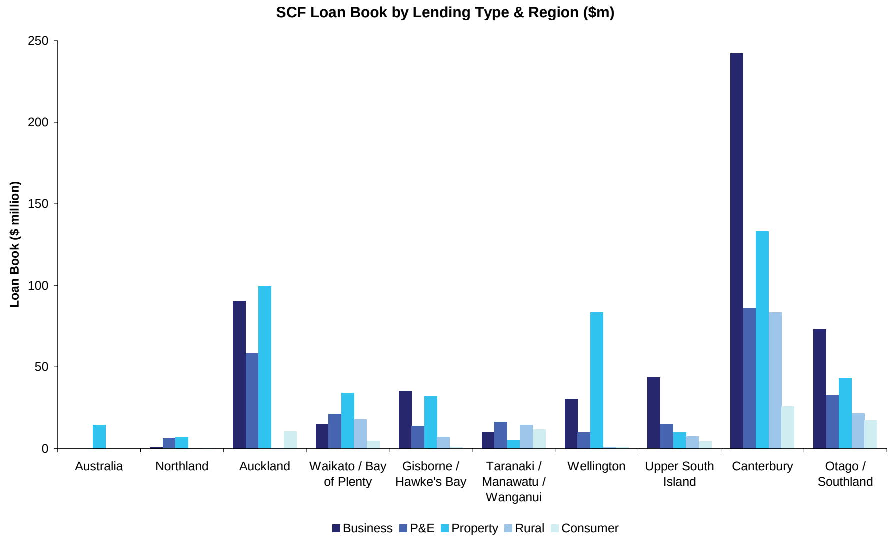
7. SCF Exposure by Market Segment

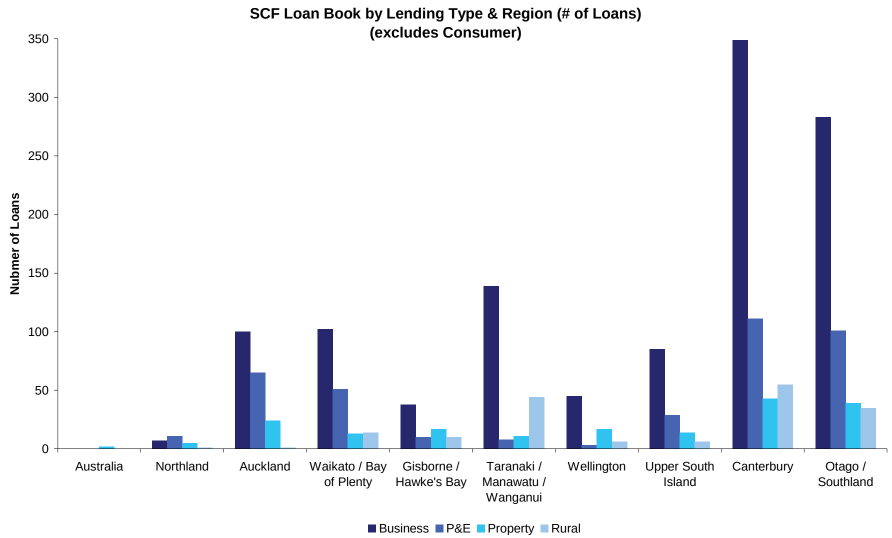
The loan book provided to us by SCF lists almost 11,000 loans totalling $1,493 million as at July 2009, broken down according to the following sectors:

	Loan Value ($m)	Number of Loans	Average Size ($)
Business	542	1,149	471,772
Plant & Equipm	260	389	667,852
Property	462	185	2,494,787
Rural	153	172	892,190
Consumer	76	8,974	8,487
Total	**1,493**	**10,869**	**137,365**

The graphs at right show the breakdown of the loan book by lending type and region by loan value and by number of loans:

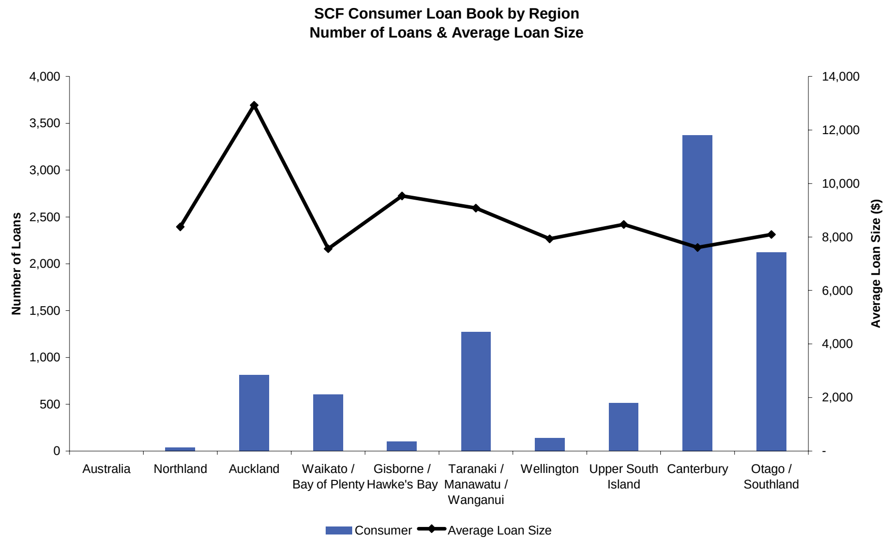
- SCF has a higher exposure (in terms of both loan value and loan numbers) to Canterbury than any other region. Lending in Canterbury totals $571 million or 38% of the book by value.
- The next largest exposures by region are to Auckland ($259 million) and Otago/Southland ($187 million).
- Significant “Property” exposures in Canterbury, Auckland and Wellington
- “Rural” exposure is concentrated in Canterbury ($83 million or 54% of the Rural book) with 14% in Otago/Southland.
- The second graph shows that of the 1,149 business loans, 632 (55% by number) are located in Canterbury/Otago/Southland.
- Of 390 loans for plant & equipment, 212 (55% by number) are located in Canterbury/Otago/Southland.

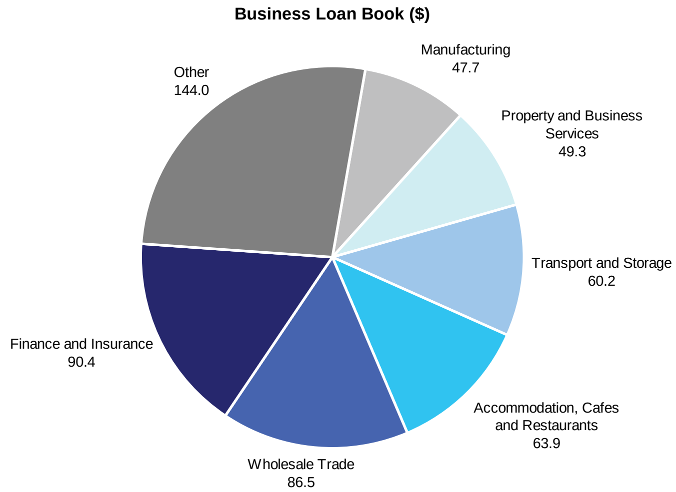


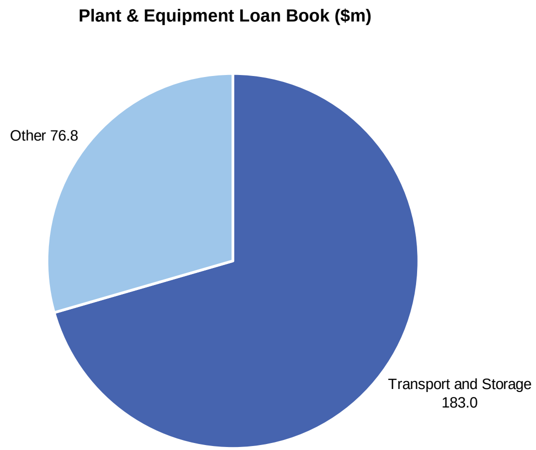


7. SCF Exposure by Market Segment

The graph below shows SCF's consumer lending by region.







Key features of the consumer loan book include:

- Almost 9,000 loans with an average size of around $8,500
- 61% of the borrowers (by number) are from Canterbury/Otago/Southland
- The average loan size in Auckland is the largest, at $12,900.

The graphs at right show the breakdown of the Business and Plant & Equipment loan books by business type.

- Business loans are spread over a wide range of sectors, the largest being Finance/Insurance at $90 million, wholesale trade at $87 million, hotels/cafes/restaurants at $64 million, and transport at $60 million.
- The transport industry is also the biggest beneficiary of the plant & equipment loan book, at $183 million or 70% of the total P&E book.

Appendix A: Restrictions

- This report, which has been prepared for the Treasury, has been undertaken pursuant to the scope of work that is contained in the Agreement for Inspection & Related Services entered into between KordaMentha and the Crown.
- This report is not intended for general circulation, nor is it to be reproduced or used for any purpose other than that outlined above without our written permission in each specific instance. We do not assume any responsibility or liability for any losses occasioned to any party as a result of the circulation, publication, reproduction or use of this report contrary to the provisions of this paragraph.
- In preparing this report we have relied on information provided to us by the Company. We have not carried out any form of due diligence or audit on that information. The information provided to us included forecasts of future revenues and expenditures, profits and cash flow that were prepared by the Company. Forecasts by their very nature are uncertain, and some assumptions inevitably will not materialise. Therefore the actual results achieved may vary significantly from those in the forecasts.
- We reserve the right (but will be under no obligation) to review this report and if we consider it necessary to revise the report in light of any information existing at the date of this report which becomes known to us after that date.