1 September 2010

Mr Gabriel Makhlouf
Deputy Chief Executive
The Treasury
1 The Terrace
PO Box 3724
Wellington

Dear Mr Makhlouf

Proposal Relating to South Canterbury Finance Ltd

I have been asked by the Treasury to provide an opinion on the proposal from *[*]* (*[*]*) to acquire the assets of South Canterbury Finance Ltd (SCF), which was placed into receivership on 31 August 2010. This letter summarises my views on the financial and non-financial aspects of the proposal.

Information
I have been provided with the legal documents relating to the proposal and recent reports on SCF prepared by Korda Mentha for the Treasury. I have also received a briefing from the relevant personnel in the Treasury.

Financial Analysis
[*] is proposing to acquire all of the assets of SCF, including the shares in Scales Corporation and Dairy Holdings Ltd (DHL). The purchase of the shares in those two businesses is dependent on OIO approval and other conditions. For the purpose of my analysis, I have assumed that *[*]* will acquire the shares for the purchase prices stated in the legal documents of *[*]* illion and *[*]* illion respectively.

[*] proposes to pay for the assets by way of a deposit of *[*]* million and the balance by instalments over *[*]* The deposit is to be used to meet certain specified charges (such as unsecured creditors) with the residual to be transferred to SCF as working capital. Hence, the deposit would not be received by the Crown so the amounts it would receive are the instalment payments shown in the table below.

[Withheld under s.9(2)(b)(ii)]

These payments would be secured over the assets of SCF. In addition, *[*]* would provide additional security for the purchase price in the form of *[*]* having a value of at least *[*]* illion, or alternative security of the same value.

* *[Withheld under s.9(2)(b)(ii)]*

The main alternative for the Crown is to have the receivers manage a wind-down and disposal of the assets of SCF over time. Korda Mentha has estimated the potential recoveries to the Crown under receivership in its report dated 26 August 2010. The following table summarises the net cash flows projected by Korda Mentha.

[Withheld under s.9(2)(b)(ii)]

Korda Mentha stresses that there is considerable uncertainty over the amount and timing of realisations. While more disaggregated (e.g. monthly) cash flows may be available, the uncertainty over them is such that in my opinion they would not add much to the analysis.

The present value of the projected cash flows under each scenario can be compared using appropriate discount rates. In the time available, I have not undertaken a careful analysis of the discount rate. On the face of it, the cash flows the Crown would receive under the *[*]* proposal are more certain than those under the receivership scenario. However, *[*]* is not undertaking to introduce new capital to SCF, or to secure new funding lines, etc. It is open to *[*]* to fund the instalments due to the Crown from the sale of SCF assets and the cash, if any, generated from ongoing parts of the business. In that case, the risks inherent in the cash flows to be received by the Crown are similar to those achievable under a receiver-managed process in that both are ultimately dependent on asset sales and any other cash that can be derived from SCF's existing business.

My estimates of the present value of the cash flows in each case using a range of discount rates are shown in the table below.

[Withheld under s.9(2)(b)(ii)]

Because of the uncertainty over the cash flows likely in a receiver-managed process, the receivership scenario numbers should be seen as indicative only.

As might be expected, across a range of discount rates the present value of the cash flows to the Crown under the *[*]* proposal is somewhat less the present value of the realisations projected by Korda Mentha under a receiver-managed process. This reflects the commercial drivers of the transaction from *[*]* perspective. In return for contractually committing to a payment schedule, *[*]* could not be expected to deliver higher cash flows to the Crown than are likely in a receiver-managed process.

As noted above, a case can be made for using a lower discount rate to value the *[*]* cash flows since arguably they are more certain than the cash flows projected from a receiver. However, a much lower discount rate would need to be used to value the *[*]* cash flows (say 7% for *[*]* versus 12% for receivership) before the ranking of the two cases would be reversed.

** [Withheld under s.9(2)(b)(ii)]*

The present value of the [*] cash flows would fall further behind the present value of the projected cash flows in the receivership alternative if tax were taken into account. The sale and purchase agreement states that the purchase price includes interest, the deductibility of which means that the Crown's net position would be reduced by the tax benefit to [*]. Assuming an interest rate of 8% and a 28% company tax rate, I estimate that the present value of the tax benefit is in the order of* million over the five year period.

In a receiver-managed process, SCF would have minimal borrowings so would not have any significant interest expense deductions.

Taking into account the tax revenue loss relating to interest deductibility, the value derived by the Crown under the [*] proposal would be in the order of [*] million less than it might expect to receive under a receiver-managed process.

In my view, these results highlight the significance of the additional security to be provided by [*]. This provides some downside protection to the Crown in the event that the cash flows generated by SCF are insufficient to fund the instalment payments. In my opinion, it would be important for the Crown to obtain further assurances on the value of the [*] or alternative security to be provided under the proposal.

I note that if [*] is unable to purchase the shares in Scales and DHL, those would revert to the Crown, in which case the Crown would be exposed to any loss in value relative to the proposed purchase prices.
[Withheld under s.9(2)(b)(ii)]

In the receivership scenario, the Crown would benefit from any upside in asset values, e.g. if the property market improves, whereas under the [*] proposal, the Crown would not share in any upside.
[Withheld under s.9(2)(b)(ii)]

Non-financial Considerations

In my view, there are a number of non-financial considerations that are relevant in considering the [*] proposal, including:

- *[Withheld under s.9(2)(b)(ii)]*

- a perception that in entertaining a deal with [*] at this early stage of receivership the Crown may have undermined SCF's ability to raise new capital. The counter to this is that SCF undertook an extensive process without result; that in any outcome, the existing shareholders in SCF would realise no value for their shares; and the Crown is obliged to consider valid proposals that might reduce the net cost to the taxpayer of SCF's receivership;
- an argument that the Crown should explore all of the options now available to it, rather than quickly concluding a deal with [*]. In particular, it is uncertain whether the [*] proposal is the best one available to the Crown.
[Withheld under s.9(2)(a)]

- the risk of [*] defaulting on the payment schedule. As noted earlier, [*] is not undertaking to introduce new capital to SCF or to arrange new funding lines, so its ability to make the instalment payments required may depend on its success in generating cash from the business. If it defaults, the Crown can terminate the agreement and take back any remaining assets (and would gain the benefit of the additional security provided by [*]). However, it is probable that the Crown would be left with the least liquid and lowest quality assets, requiring a complex or extended process for realisation and adverse publicity for the Crown and SCF;
- the [*] proposal greatly simplifies the Crown's involvement with the SCF receivership. It would not need to be involved day to day, or to make judgments about optimal realisation strategies, etc;

* *[Withheld under s.9(2)(b)(ii)]*

- the [*] proposal removes control of the asset realisation process from the Crown. Ministers have stated that they want to minimise disruption to the economy from SCF's receivership and that Crown control may lead to lower pressure on borrowers to meet their loan obligations. The Crown would not be in control of the business under the [*] proposal. Nevertheless, the proposal involves an extended payment schedule over [*] and so can be said to not put undue pressure on [*] to realise assets;
- [*] may have a better opportunity than the Crown or a receiver to secure the services of key personnel required to run SCF, such as the CEO. Departure of key people at this stage could seriously affect the business.

[Withheld under s.9(2)(b)(ii)]

- [*] may be able to introduce people to the business with the skills and expertise not normally available to a receiver, possibly from [*] That might in turn lead to a better outcome for the business and hence a better outcome for the Crown than a receiver-managed process;
- although [*]'s plans are unknown, the proposal probably increases the probability of SCF continuing in business in some form in the long term. [*] can arrange funding to enable "Good Bank" or other parts of SCF to remain in business. While a sale of Good Bank as a going concern would be possible under the receivership scenario, the Crown would have to arrange the funding required and take whatever other steps are necessary.

Of the above considerations, in my opinion the most important one is that the Crown cannot be sure that it is getting the best available deal. If it were to accept the proposal, in my opinion the Crown would need to be reasonably satisfied that it is impractical to run a more extended process inviting offers from other parties.

[Withheld under s.9(2)(b)(ii)]

Limitations

This letter has been prepared in a short time frame. While I have read all of the material provided to me, I may not have correctly understood all aspects of the [*] proposal. My analysis has necessarily been limited by the time I have had available.

Conclusion

In my view, while acknowledging that there is a great deal of uncertainty over recoveries to the Crown in a receiver-managed process, it is likely that the Crown's net financial position would be materially worse under the [*] proposal when loss of tax revenue is taken into account.

In my opinion, the main attraction of the [*] proposal is the additional security to be provided by way of [*] with a value of at least [*] million, or alternative security of the same value. This would provide some protection for the Crown against a further decline in SCF's asset values. In addition, the proposal provides greater certainty over the cash flows the Crown would recover from SCF.

The proposal would simplify considerably the Crown's role in the receivership and free it from the day-to-day decisions that need to be made in managing the business and the asset realisation process. Government processes are not well suited to that level of involvement and type of decision-making.

In my opinion, the financial analysis and non-financial considerations outlined above do not lead to a strong conclusion in favour of either scenario. On the one hand, the [*] proposal has practical benefits to the Crown and provides greater certainty over its net recoveries from SCF. On the other hand, the proposal may result in a lower level of recoveries and would reduce the Crown's tax revenues relative to a receiver-managed process.

Accordingly, in my opinion, the Crown would need to be satisfied that the practical benefits and greater certainty offered by the [*] proposal outweigh the potential value loss. If so, it would be reasonable for the

** [Withheld under s.9(2)(b)(ii)]*

Crown to accept the *[*]* proposal, provided it is also reasonably satisfied with the quality of the additional security to be provided.

Yours faithfully ** [Withheld under s.9(2)(b)(ii)]*

[Withheld under s.9(2)(a)]

Director