



Memo

To: John Park, Manager Deposit Guarantee Scheme, The Treasury
From: [Withheld under s9(2)(b)(ii)]
Date: 1 September 2010
Subject: **South Canterbury Finance (“SCF”)**
Offer from [Withheld under s9(2)(b)(ii)]

1. Introduction

Over the past 48 hours we have reviewed various information and documentation that has been provided in respect of an offer that * has made to purchase all SCF’s assets. You have asked us to comment on the risks associated with that offer.

We will not summarise the terms of that offer in this note.

As requested, we are revising our report of 26 August 2010 to cover this offer. In the interest of providing prompt advice to the Treasury, this memo provides an overview of the key issues that will be raised in that report.

2. Restrictions & Scope of Work

This memo is supplemental to and must be read in conjunction with our draft report of 26 August 2010 and the revisions we are currently making to that report. The restrictions and terms and conditions contained in that report apply to this memo.

This memo is based on the information that is listed in Appendix A.

3. Potential Key Risks

We understand that the Treasury is identifying the potential benefits of the * offer. We have been asked to comment on the key potential risks. The report we are preparing will discuss the offer and the risks in detail but in the interests of providing prompt advice to the Treasury we note the key potential risks at a high level below.

a. Process Run by Forsyth Barr

- Forsyth Barr (“ForBar”) has provided a letter to the Treasury (dated 30 August 2010) providing an overview of the recapitalisation process they undertook over the past 12 months or so. The current offer from * emerged from that process.
- ForBar’s letter notes that the recapitalisation has been very public, the implication being that any parties who might have had an interest in participating in a recapitalisation (or some other transaction) would have approached either ForBar or SCF (as it notes some did).
- SCF is now in receivership and the Crown has paid out all creditors (aside from unsecured trade creditors, as is discussed below).
- The current situation is therefore very different to the conditions under which ForBar ran its process. The process letter notes that offers or interest from some parties was discounted because their proposal would have contained very little equity and required

* Information withheld under s9(2)(b)(ii)

the Crown's financial or liquidity support. The Crown has now provided that support and * offer contains very little equity.

- It is possible therefore that other parties may have submitted offers if the current conditions had existed during ForBar's process.
- Accordingly, there can be no certainty that * offer is the best offer that could be obtained. Equally there is no certainty that a better offer could be obtained but it would be possible to find that out if a process (perhaps a very short process) were undertaken by ForBar or SCF's Receivers.

b. Guarantee from Entities Related to *

- * has promoted its offer as including a guarantee for * million of the approx. \$* billion that * will owe the Crown.
- * is procuring ^[Withheld under s9(2)(b)(ii)] , an entity that * controls, to pledge the shares it owns in * as collateral for t* ^[Withheld under s9(2)(b)(ii)]
- We believe there is an issue with the valuation of the collateral and the structure of the guarantee.

Value of Collateral

- Over the past 48 hours we have attempted to form a view on the value of the]*
- ForBar has represented they are worth \$* on the basis of forecasts earnings ^[Withheld under s9(2)(b)(ii)] . We have been provided with information that shows the following historical earnings profile:

Parent Company		NPAT A\$million
FY08	Audited	*
FY09	Audited	*
FY10	Unaudited	* *

- * is a complicated vehicle. ^[Withheld under s9(2)(b)(ii)] ^[Withheld under s9(2)(b)(ii)]
- In the short space of time within which we have reviewed information relating to * we have been unable to confirm whether the shares being pledged as security are worth \$* . Equally we cannot say they are not.
- This needs to be resolved, potentially by obtaining a proper, independent valuation of * especially given the structural issues with the guarantee that are discussed below.

* Information withheld under s9(2)(b)(ii)

Structure of Guarantee

- The contractual matrix around the guarantee is ultimately a legal question but we note our observations below in order that the Treasury can consult with its legal advisers.
- It appears to us that:
 - [redacted] is pledging the [redacted] shares as security and its guarantee is limited to those [redacted]
 - [redacted] is not therefore guaranteeing [redacted] of the Crown's exposure, it is simply agreeing that the [redacted] are collateral to the Crown's exposure.
 - The *Deed of Covenant and Security* ("Deed") provides that [redacted] will, or will procure its shareholder to, provide additional collateral in the event the value of the [redacted] (or any collateral subsequently provided) is less than [redacted]. In essence, the clause is structured to require [redacted] to ensure that the collateral posted as security at any time is worth at least [redacted].
 - In so far as we can see, no party is positively obligated to surrender up this additional or replacement collateral. The lender can only ask [redacted] to attempt to obtain additional collateral. In the event this is not provided, we assume [redacted] would be in default of the Deed and SCF could enforce its security. SCF could not however pursue anyone for any additional collateral.
- This structure increases the risk around the value of the [redacted].
- It would be preferable for a party of substance to:
 - Provide a guarantee for [redacted]; and
 - Be obligated to maintain the collateral at [redacted] or more.

c. Clause 2.2 of the Deed of Covenant

- The effect of this clause is again ultimately a legal question but we note our observations below in order that the Treasury can consult with its legal advisers.
- We are concerned that this clause fetters SCF's rights to enforce the terms of the document, as currently drafted.
- It may be that a strict legal interpretation may provide a different view. We believe it is important to consider this pragmatically. The borrower will rely on this clause to argue that it is not in breach of provisions of the deed or that the lender must consent to changes to the deed.
- This is highly undesirable and creates uncertainty around the manner in which the relationship between the lender and the borrower will be managed. Consequently there will be uncertainty around the way the Company and its assets are managed and ultimately therefore the Crown's recoveries.
- We believe this clause needs to be deleted or significantly caveated to preserve the lender's discretion.

** Information withheld under s9(2)(b)(ii)*

d. Unsecured Creditors to be Paid from Deposit

- The *Agreement for sale and purchase of business assets* provides that * million of the * deposit will be applied in payment of certain unsecured creditors, including substantial sums to *
- The Crown will want to satisfy itself that it is necessary to pay the unsecured creditors, as this is a material amount relative to the deposit.

4. Conclusion

- The process undertaken by ForBar, as detailed in their letter, means it is uncertain whether * offer is the best offer that can be obtained. There is however no certainty that a better offer can be obtained.
- The structure of the guarantee appears to limit it to the value of the * There does not appear to be a positive obligation on any party to ensure the assets posted as collateral at all times remain worth at least *. The value of the l* * needs to be ascertained and it would be preferable for the guarantee to be fixed at *, with a party of substance being obligated to post collateral to that value.
- Clause 2.2 appears to create considerable uncertainty around the enforceability of the rights under the Deed, which in turn creates uncertainty around the Crown's recoveries.
- The Crown will want to satisfy itself that it is necessary to pay unsecured creditors from the deposit.

5. Alternatives

- There are other alternatives available to the Crown, including:
 - Realising the assets through a receivership, in the manner discussed in our July and August reports;
 - The Crown independently implementing a structure similar to that contemplated under the * proposals so that it retains the benefit of any profits or upside (but equally remains exposed to any downside); or
 - Seeking other offers.
- We have not explored these alternatives in detail because they are outside the scope of our instructions.

* Information withheld under s9(2)(b)(ii)