

Treasury Report: National Rail: Proposal by Mainfreight

Date:	18 February 2003	Treasury Priority:	High
Security Level:	Commercial Sensitive	Report No:	T2003/196

Action Sought

	Action Sought	Deadline
Minister of Finance	Note; and Agree that First NZ Capital respond to Mainfreight's proposal.	Wednesday 19 February 2003

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact

Enclosure: Yes

18 February 2003

SH-8-4

Treasury Report: National Rail: Proposal by Mainfreight

Purpose of Report

1. On Monday 3 February 2003 you were invited to consider a proposal on Tranz Rail put forward by Mainfreight Limited, Tappenden Management Limited and Allco Finance Group Limited.
2. This report provides an overview analysis of that proposal and suggests a path forward on the issue.

Analysis

3. Mainfreight and its consortium put a proposal to you on Monday 3 February that included a vertical separation of the infrastructure from operations, establishment of a track company to operate the track, and a consortium led by Mainfreight holding monopoly rights for rail freight operations.
4. It had been anticipated that such an approach by third parties might be possible and advice on the issues to consider were set out to you in National Rail – Potential Third Party Approach [T2002/1241 refers].
5. We have reviewed the proposal with the assistance of First NZ Capital. The proposal gives rise to three key issues:
 - i. **Financing of the acquisition** - because of Tranz Rail's weak financial position, it is most unlikely that a potential acquirer could finance a substantial amount of debt through dividends from Tranz Rail. The acquisition would therefore need to be funded largely by equity. On the face of it, the consortium referred to above does not have the capacity to provide the amount of equity funding required unless Tappenden contributes most of it, which First New Zealand Capital consider unlikely. A brief description of the financial position of the parties to the consortium is summarised in annex one.
 - ii. **Due diligence** – the consortium's desire for the Crown to facilitate due diligence is unusual. The board of Tranz Rail is likely to consider that it has a fiduciary duty to shareholders to facilitate due diligence by any party with the credentials and willingness to make a serious takeover offer, particularly in view of the recent poor performance of the company. We understand that a number of the major shareholders would welcome an opportunity to exit their shareholdings at a reasonable price. In general, however, a board would need to be satisfied that the potential acquirer could fund the acquisition and will offer a price that means that takeover has a realistic prospect of succeeding. In this case, the Tranz Rail board could need to be convinced that the parties have the financial capacity to make a successful takeover offer.
 - iii. **Establishment of a track company** – the consortium's proposal for the establishment of a largely privately financed track company financed through the issuing of capital indexing bonds does not seem to be likely to succeed given the economics of rail in New Zealand. To achieve the Government's objectives it is

likely that any separate track company would be non-commercial and therefore would need to be in public ownership. This may also simplify any due diligence issues.

6. On the face of it the consortium is probably only likely to be a successful acquirer of Tranz Rail if Tappenden contributes the majority of the equity funding.
7. We recommend that First NZ Capital approach the consortium to establish whether Tappenden is likely to provide this funding prior to any more detailed discussions taking place with the consortium. A letter to Bruce Plested of Mainfreight to this effect, and also indicating that in any transaction the Crown would be prepared to take the network, is attached for your signature should you agree.

Recommendation

8. It is recommended that you **sign** the attached letter to Bruce Plested, Mainfreight Limited.

for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

Annex One: Summary Information on Consortium Partners

In First NZ Capital's view, neither Mainfreight nor Allco Finance has the capacity to contribute significant amounts of equity to an acquisition of Tranz Rail. Brief details on Mainfreight and Allco are as follows:

Mainfreight¹	Market capitalization	\$86 million
	Revenue	\$401 million
	Net profit after tax	\$6.6 million
	Total assets	\$155 million
	Net debt	\$55.5 million
	Ordinary equity	\$52.2 million
	Net debt/total capital	51%
	Interest cover	4.6x
Allco Finance²	Revenue	A\$643,693
	Net profit after tax	A\$9,143
	Total assets	A\$7,723,327
	Net debt	A\$1,689,902
	Ordinary equity	A\$6,033,502
	Net debt/total capital	22%

Allco Finance

Allco Finance is a private Australian company with issued ordinary share capital of A\$6 million. It has three shareholders who are the directors of the company. Its principal activities are described as investing in shares and lending funds for the production of dividend and interest income.

Tappenden

Tappenden Holdings Limited is a private investment company owned by interests associated with Alan Gibbs and Trevor Farmer. It is assumed that Tappenden Management Limited is a wholly owned subsidiary of Tappenden Holdings. Tappenden states that it has investments totalling approximately \$600 million.

Along with Todd Capital, Tappenden is one of the few sizeable New Zealand investment companies. As such, it is regularly approached by parties looking to find New Zealand partners to contribute equity to fund investments in New Zealand. Its general approach is to adopt an "open door" approach to investment opportunities. Hence, it is frequently associated with investment proposals, many of which never proceed. It has a reputation as a rational, astute and "hard-nosed" investor.

¹ For its last financial year ended 31 March 2002.

² Based on the accounts filed with the Australian Securities & Investments Commission, key financial information on the company FY ended 30 June 2002.

Because of Tranz Rail's weak financial position, First NZ Capital are of the view that it is most unlikely that a potential acquirer could arrange a substantial amount of debt to fund an acquisition of Tranz Rail. The acquisition would therefore need to be funded largely by equity. On the face of it, First NZ Capital are of the view that the consortium only has the capacity to provide the amount of equity funding required if Tappenden contributes most of it.

COMMERCIAL SECRET

Bruce Plested
Executive Chairman
Mainfreight Limited
PO Box 14 038
AUCKLAND

Dear Bruce

Thank you for meeting with me on Monday 3 February 2002 and outlining the consortium proposal for the acquisition and refinancing of Tranz Rail.

As I mentioned to you the Government is keen to ensure that rail plays its role as a crucial transport infrastructure. As such, we take rail issues very seriously and have given some thought to your proposal. Obviously in considering the issues your proposal gives rise to, Government needs to be mindful of its wider land transport objectives, its specific rail objectives, and its relationship with Tranz Rail as a key participant in the transport system.

Your proposal gave rise to some issues that need to be followed up from the Government's perspective, and I have asked Treasury to review your proposal for me. I understand that its financial advisors, First New Zealand Capital are likely to approach you to discuss some of these issues in more specific terms and I think this discussion is likely to be helpful in informing my judgement as to whether I will pursue your proposal further with my colleagues.

I should say also that the work we have done to date suggests that a privately owned rail track company is unlikely succeed in New Zealand. We have therefore assumed that any separate rail track company in the future would likely require public ownership.

I trust this is an acceptable path forward.

Yours sincerely

Hon Dr Michael Cullen
Minister of Finance