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FIRST NZ CAPITAL

COMMERCIAL SECRET

Memorandum

To	The Treasury
From	First NZ Capital
Date	14 October 2002
Re	**Consortium Process**

1. Introduction

The Crown wishes to explore whether it is feasible to establish a consortium to acquire and subsequently restructure Tranz Rail, with the Crown taking over ownership of the rail infrastructure. This memorandum summarises our recommendations on the process for discussion of this proposal with potential consortium partners.

2. Consortium Proposal

As discussed, we believe that the Crown would need to put forward a specific proposal for discussion. This is outlined in Treasury's memo entitled "Crown Proposition".

To anticipate other substantive issues that might be raised by other parties in the initial discussion, we suggest the following items be added to the Crown Proposition:

Funding

- other parties are likely to perceive the Crown as the best source of funding;
- normally, a consortium would arrange funding pre offer and minimise partners' equity contributions by maximising debt funding. In this case, it is unlikely that banks would give a pre-offer commitment to funding secured over Tranz Rail's assets because of the uncertainties surrounding Tranz Rail. Banks would, of course, be prepared to lend if the loan were guaranteed by the Crown;
- in the absence of bank funding for the consortium, each party would need to arrange funding for its equity contribution. Equity contributions would be set pro rata to the provisional value of the assets each party would acquire post offer relative to the total value of Tranz Rail;
- provisional asset values would be agreed pre offer based on information available to the consortium, including information obtained during any due diligence process;

Due diligence

- it is likely that the other party/ies would want to undertake due diligence on Tranz Rail before any offer is made. Tranz Rail has previously facilitated extensive due diligence by parties interested in acquiring the company. NZSE approval is required and the parties must sign an NZSE approved confidentiality and "standstill" agreement;
- for the reason's previously discussed, it would be preferable for the Crown itself not to be directly involved in due diligence. However, we suggest that the Crown's advisors should be involved, ostensibly as advisors to the other party/ies. There should be full sharing of due diligence information among the parties;

Decision making

- to protect all parties, all key decisions, such as determining the offer price, would have to be agreed unanimously. If a party cannot agree, its only option would be to withdraw from the consortium;
- joint responsibility for the offer price decision would assist in protecting the Crown from leverage from Tranz Raiol shareholders seeking to increase the offer price;

Exclusivity

- the heads of agreement would normally include a commitment by the parties to act exclusively with one another. This would be an issue for the Crown, since it would want to be free to act with other partners if it could not reach agreement with the initial parties;

Post offer agreements

- if, following a successful takeover, the parties are unable to agree the material terms of the restructuring, we suggest the Crown would have to offer to buy out the other party/ies at cost. The definition of cost would have to be agreed, but is likely to include the initial outlay plus interest.

3. Potential Partners

We suggest that potential partners are:

- Toll Holdings
- Stagecoach
- Ports of Auckland
- Mainfreight
- RailAmerica
- Patrick Corporation

The attachment provides a brief profile of these companies.

4. Selection Criteria

From the Crown's perspective, we suggest that the following criteria will be important in selecting a partner, or deciding to proceed with a partner:

- consistency of strategy and objectives with the Crown's;
- track record as a rail operator;
- financial capacity; and
- reputation in the financial community.

5. Recommended Approach

To assist in preserving confidentiality, we suggest that the general strategy should be to approach parties sequentially. We propose that the initial approach should be as follows:

- approach Stagecoach to clarify its interest. In its letter of 19 September 2002 to the Minister of Finance, Stagecoach states that:
  - it would acquire Wellington Tranz Metro in a joint venture with Wellington Regional Council. In addition, it would need a ten-year funding agreement with Transfund and a sole supplier contract with Wellington Regional Council;
  - to acquire Auckland Tranz Metro, Stagecoach would need a ten-year funding agreement with Transfund and a 15-year management contract with the Crown, Auckland Regional Council and the Auckland local bodies;
  - Tranz Scenic (now only 50% owned by Tranz Rail and signalled for divestment) should be restructured;
  - under "certain circumstances", Stagecoach would be interested in owning the ferry operations, or at least the passenger side of the ferry operations;
  - the rail passenger operations should attract a "relatively low price".

It is understandable that Stagecoach would need to agree funding with Transfund, etc, but it would not be possible to resolve any of the above matters in the context of a takeover offer. Discussions with Stagecoach should focus on the level of commitment it is prepared to make in the absence of these agreements. It is possible that any arrangement with Stagecoach could only be pursued following completion of a takeover offer;

- then approach Toll Holdings. We understand that Toll is not interested in the rail passenger operations, so a subsequent divestment of the operations to Stagecoach should be consistent with its objectives; and
- we would also approach Rail America to clarify its level of interest. In our view, RailAmerica lacks the financial capacity to acquire the rail freight business in its own right.

Depending on the responses to these approaches, in conjunction with Treasury we would decide whether to approach other parties.

Note that Patrick Corporation is a partner with Toll in National Rail and FreightCorp. Hence, Toll may wish to involve Patrick in any transaction involving Tranz Rail.

Both Ports of Auckland and Mainfreight would have competition issues to address in pursuing Tranz Rail. In particular, ownership of Tranz Rail's freight operations by Ports of Auckland would cause major concerns for other port companies, who would fear that Ports of Auckland would use its control of rail freight to direct export and import volumes through Auckland and away from other ports.

If Mainfreight were involved, other freight companies would be concerned about Mainfreight obtaining favourable terms for access to rail services and freight.

If parties have any interest, they are likely to request that the proposal be put in writing. We expect that they would then need a period of a few days to a week to confirm their interest. Following feedback from the parties, we should be in a position to advise Treasury on whether or not there is sufficient interest to proceed to detailed discussions.

If there is, the timetable going forward will depend in part on the availability of the key decision makers. Assuming they are available, detailed discussions to determine whether agreement in principle can be reached are likely to require 3-4 weeks.

At the end of the period, we expect the other parties would wish to undertake some form of due diligence on Tranz Rail. The process and timetable for due diligence would then need to be agreed with Tranz Rail and the NZSE.

6. Conclusion

We look forward to discussing this memorandum with Treasury.

Summary Information

Company	Brief Description	Financial Information		Recent News/Comments
Toll Holdings (TOL)	TOL provides express freight transport by road, rail and sea throughout Australia and provides integrated logistics and distribution systems, including specialised warehousing, port operations, etc.	All A$m Market Capitalisation: Net Debt (06/02): Debt/Debt + Equity Revenue (2002) S&P Credit Rating	 1,746 329 16% 2,038 Not Rated	TOL has a conservative balance sheet with plenty of capacity for further acquisitions. In May 2002 Toll acquired BHP Stevedoring and BHP Transport and Logistics (NZ) from BHP Billiton and a majority equity position in Southern Distribution Centre – all in NZ. TOL has publicly stated that it is interested in expanding in NZ. In February, TOL combined with Patrick Corp. to acquire National Rail and FreightCorp for $1.2 billion.
Stagecoach (SGC)	SGC provides and operates public transport services in the UK, USA, HK, Australia and NZ. SGC supplies bus services throughout all of these regions and passenger rail services in the UK.	All £m Market Capitalisation: Net Debt (04/02): Debt/Debt + Equity Revenue (2002) S&P Credit Rating	 287 817 74% 1,848 BBB	SGC's share price has fallen by 71% in 2002. There has been a lot of concern about the poor performance of Coach USA which generates about one third of SGC's revenue. SGC is on negative credit watch with S&P and its gearing has blown out to 74%. At its recent AGM, the acting chairman stated that SGC's strategy remains focused on core bus and rail opportunities in selected geographic markets.
Ports of Auckland (POA)	POA operates in a variety of port-related commercial activities such as providing ship and cargo facilities, cargo handling, container terminal operations, etc. POA is NZ's largest general port, handling (by value) 66% of imports and 25% of exports.	All NZ$m Market Capitalisation: Net Debt (06/02): Debt/Debt + Equity Revenue (2002) S&P Credit Rating	 636 162 20% 157 A	POA returned $132m of surplus capital in May 2002. The company still has a strong balance sheet with an A rating from S&P and gearing of 20%. POA has been interested in Tranz Rail in the past but may wish to team up with a rail operator.
Mainfreight (MFT)	MFT provides and supplies freight, warehousing and logistics services throughout NZ and Australia. The Company provides freight forwarding services by road, rail, sea and air.	All NZ$m Market Capitalisation: Net Debt (03/02): Debt/Debt + Equity Revenue (2002) S&P Credit Rating	 87 49 36% 401 Not Rated	MFT is relatively conservatively geared. However, the small size of the company means that, in the absence of new equity, it is unlikely to be able to commit much capital as part of a consortium to acquire Tranz Rail. MFT has been interested in Tranz Rail in the past and is one of Tranz Rail's biggest customers.

Company	Brief Description	Financial Information		Recent News/Comments
RailAmerica (RAM)	RAM owns and operates short line freight railroads in North America and regional freight railroads in Australia and Chile. The company owns, operates, or has an equity interest in a diversified portfolio of railroads located in the US, Australia, Canada, Chile and Argentina.	All US$m Market Capitalisation: Net Debt (06/02): Debt/Debt + Equity Revenue (2001) S&P Credit Rating	 239 387 62% 370 BB-	Despite S&P raising RAM's credit rating from B+ to BB- in April this year, the company remains fairly highly geared. RAM's share price has fallen 48.6% in 2002. RAM remains interested in further acquisitions and has been interested in Tranz Rail in the past. RAM would be a credible partner as a rail freight operator but may struggle to commit any significant amount of capital.
Patrick Corporation (PRK)	PRK has operations in freight and transport logistics sector with activities in rail and seaborne trade movements. It hauls freight by rail along with operating container and general stevedoring facilities and terminals at designated ports. PRK also has a 50% interest in Virgin Blue Airlines.	All A$m Market Capitalisation: Net Debt (09/01): Debt/Debt + Equity Revenue (2001) S&P Credit Rating	 2,349 -15 n/a 688 Not Rated	PRK has no net debt on its balance sheet and a high market capitalisation. However, it generates all its revenue in Australia and hasn't appeared to have any interest in the NZ market to date. In February, PRK combined with Toll Holdings to acquire National Rail and FreightCorp for $1.2 billion.

Source: Bloomberg, FNZC Research