FIRST NZ CAPITAL

COMMERCIAL SECRET

Memorandum

To	The Treasury
From	First NZ Capital
Date	20 August 2002
Re	**Takeover Issues**

1. Introduction

This memorandum outlines First NZ Capital's views on a number of key issues relating to a Crown takeover of Tranz Rail. A separate memo outlines the takeover process and timetable required under the Takeovers Code.

2. Due Diligence

An offer under the Takeovers Code cannot be conditional on due diligence, so any due diligence undertaken by the Crown on Tranz Rail would need to be completed before any offer is made.

The Crown would employ advisers to undertake due diligence, but the identity of the Crown as the principal would need to be disclosed at least to the board (and probably the chief executive) of Tranz Rail and the New Zealand Stock Exchange. Other employees in these organisations are likely to find out about the Crown's involvement.

Because of this, we consider that there would be a high risk of someone disclosing the Crown's interest in Tranz Rail. This would lead to a sharp rise in Tranz Rail's share price and therefore push up the price the Crown would need to offer in a subsequent takeover offer.

In our view, the risk of leakage and the detrimental effect it would cause far outweigh the benefits to the Crown of undertaking due diligence, particularly since the Crown would be making a takeover offer for public policy, rather than investment, reasons.

3. Offer Pricing

The offer price would be critical to the success of the offer. The price should be:

- high enough for it to be credible for the Crown to say that it is a final price;
- not so high as to suggest that the Crown is willing to pay an excessive price; and
- preserve scope for the Crown to increase the offer price once by 10-20 cents if necessary. Investors will expect that the Crown is able to increase its offer price. Depending on the circumstances, a single small increase in the offer price might satisfy this expectation and remove the expectation of any further increase.

In our memo dated 13 August 2002, we suggested that the Crown would need to make an offer in the range of $2.80 to $3.20 based on a Tranz Rail share price of $2.00 (i.e. the offer price would be at a 40-60% premium to the pre-offer price).

A final decision on the offer price would need to be made shortly before the takeover notice is given to the company, taking into account the importance the Crown places on achieving a successful offer.

4. Dealing With "Hold Out"

Because the Crown will be perceived as having no funding constraints and a need to acquire Tranz Rail for public policy reasons, there is a serious risk that investors hold out for a higher offer price, irrespective of what the Crown says about its price.

In addition, a takeover offer is likely to attract opportunistic buying in Tranz Rail shares by parties such as Guinness Peat Group (GPG). The objective of these parties would be to acquire at least 10% of Tranz Rail to block the Crown's ability to reach the 90% threshold required for compulsory acquisition. They would then hold out for a higher price from the Crown.

We consider that the probability of such behaviour is high, so the risk of the Crown being thwarted or forced to pay an excessive price is also high.

Possible strategies for dealing with this risk include the following:

1) Communication of the Crown's position (see also section 5 below):

- the Crown has a credible alternative to the takeover – it could negotiate directly with Tranz Rail to acquire the rail infrastructure
- there are constraints on the price the Crown can pay – it cannot be seen to be paying an excessive price to shareholders, especially to "profiteers"
- the Crown's offer price is fair and reasonable and will not be increased
- the Crown's adviser would market the offer to Tranz Rail shareholders and endeavour to convince large holders of these messages

2) Offer conditions:

- The offer cannot be conditional on matters under the control or discretion of the offeror. However, the Crown could make the offer conditional on there being no change in shareholdings in Tranz Rail requiring the issuing of a substantial security holder notice. Such notices need to be given when a party acquires 5% or more of a listed company and when the shareholding of an existing substantial security holder changes by 1% or more (of the total shares on issue).
- The effect of this condition would be to impose a shareholding "standstill" on existing large shareholders (i.e. those holding 5% or more of Tranz Rail) and inhibit any other person from acquiring 5% or more of the company.
- The rationale would be that the Crown wishes to be fair to existing shareholders in Tranz Rail, but not provide an opportunity for others to profit at the Crown's expense.
- The Crown could waive this condition if it appeared that it would in any event reach the 90% threshold. It may be possible to waive the condition on a case by case basis.

3) Arrange for a third party to acquire Tranz Rail, with an agreement for the Crown to acquire the rail infrastructure post acquisition. For example, Toll Holdings may be interested in doing this:

- The arrangement would be along the following lines. The Crown would agree to acquire the rail infrastructure for a specified amount, such as $200 million. The acquirer would pay the balance needed to acquire 100% of Tranz Rail. Following the takeover, the Crown and the acquirer would agree the access and other financial arrangements relating to use, maintenance and upgrade of the infrastructure. If the parties could not agree, the Crown would agree to acquire 100% of Tranz Rail from the acquirer at the price (including transaction costs) paid by the acquirer. Hence, the Crown would need to agree the price offered by the acquirer.

- Neither the Crown nor the acquirer would have the information needed to agree the access and other financial arrangements in advance of the offer.

- It is likely that the potential acquirer would want to undertake due diligence on Tranz Rail before making any offer. This means that this option could not be implemented immediately – some 4-6 weeks would be needed to enable the acquirer to complete due diligence and its internal analysis and approvals.

- This option would remove the need for the Crown to own the non-infrastructure assets of Tranz Rail.

4) Acquire shares on market to make it more difficult for any other party to accumulate a block.

- As noted in our memo on the Takeover Code process, an offeror can acquire no more than 20% of the target outside of the offer provided the offer is for cash. The Crown could therefore acquire shares on the NZSE.

- The disadvantage of doing this is that the Crown would be left with a shareholding of up to 20% if the offer fails. The shares would be acquired at prices that reflect the Crown's offer price and, if disposed of following an unsuccessful offer, would be sold at prices that reflect the failure of the offer.

- Hence, in our view this strategy is relevant only if the Crown is determined to see the full offer succeed.

5) Acquire Tranz Rail through an amalgamation or scheme of arrangement. These options were discussed in detail in previous memos, particularly our memo of 29 May 2002.

- The advantage of these options is that a takeover can be approved by a special resolution of shareholders who vote in person or by proxy. This is a much lower threshold than the 90% acceptance threshold in a takeover offer.

- However, these options would require the Crown to obtain an exemption from the Takeovers Code from the Takeovers Panel. It may be difficult to obtain such an exemption.

5. Offer Management and Communication

The cost of an offer to the Crown, and the ultimate success or otherwise of the offer, would depend in part on the Crown's ability to convince investors of the Crown's position on the offer price and the alternatives available to the Crown.

To avoid giving investors conflicting or incorrect signals, it would be very desirable that there is a single person who is authorised to speak on behalf of the Crown. No other person in the Government should make any public comment on the offer.

We suggest the following themes should be included in communications by the Crown:

- The Crown's objective is to ensure that the rail network is used to its full potential for the benefit of the economy as a whole.
- The Crown believes that the best way for it to achieve this objective is for the Crown to own the rail infrastructure and develop the rail network in the same way that it owns and develops the roading network.
- However, the Crown recognises that a sale by Tranz Rail of the rail infrastructure to the Crown would be a fundamental change in the nature of Tranz Rail's business. Accordingly, to be fair to existing shareholders, the Crown is making the takeover offer.
- If sufficient shareholders do not want to accept the offer, or the offer fails for other reasons, the Crown will enter into direct negotiations with Tranz Rail to acquire the rail infrastructure.
- If those negotiations are unsuccessful, the Crown will explore other options, such as subsidy arrangements, for meeting its objectives.

6. Risk of Other Offers

We understand that a number of parties have given serious consideration to acquiring Tranz Rail over the last 12-24 months. To date, no party has proceeded with an offer. Over the last few months, the company's share price has fallen markedly and its operating performance has failed to meet investor expectations. In addition, it has been placed on negative credit watch by the rating agencies, faces the likelihood of having to refinance its Aratere lease and needs to renegotiate its bank facility by mid October. In these circumstances, it is most unlikely that any private sector party would make a takeover offer for the company without undertaking a full due diligence exercise.

In addition, there has been considerable media comment over recent months about the Crown's interest in acquiring the rail network. Given the importance of the network to Tranz Rail's operations, it is most unlikely that any party would make an offer for the company without first approaching the Government to understand its position on the rail network.

For these reasons, we believe there is little likelihood of a surprise offer by third party.

7. Conclusion

The biggest risk to the Crown in making a takeover offer for Tranz Rail is the risk of hold out behaviour from existing shareholders in Tranz Rail or new shareholders seeking to profit from the offer. This has the potential to substantially increase the cost of the offer to the Crown and could frustrate an offer.

We suggest that further work should be done on this matter in conjunction with Treasury's legal advisers.