The Treasury

Project Korimako - Release of advice

December 2022

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[23] 9(2)(a) - to protect the privacy of natural persons, including deceased people

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[26] 9(2)(ba)(i) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment

[36] 9(2)(h) - to maintain legal professional privilege

[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

Where information has been withheld, a numbered reference to the applicable section of the Act has been made, as listed above. For example, a [23] appearing where information has been withheld in a release document refers to section 9(2)(a).

TE TAI ŌHANGA
THE TREASURY

Treasury Report: New Zealand Post Limited: Special Dividend

Date:	14 June 2022	Report No:	T2022/1078
		File Number:	SE-2-12-1

Action sought

	Action sought	Deadline
Acting Minister for State Owned Enterprises (Hon Dr Megan Woods)	**Note** the contents of this report **Sign and send** attached letter to the Chair of New Zealand Post Limited	22 June 2022
Acting Minister of Finance (Hon Dr David Clark)	**Note** the contents of this report **Agree** for the Acting Minister for State Owned Enterprises to sign and send letter to the Chair of New Zealand Post Limited	22 June 2022

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Alice Courtney	Senior Analyst, Commercial and Institutional Performance	[39]	N/A (mob)	✓
Andrew McLoughlin	Principal Advisor, Commercial and Institutional Performance	N/A (wk)	[35]	

Minister's Office actions (if required)

Acting Minister for State Owned Enterprises Office: Sign and send the attached letter. **All offices: Return** the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: Yes (attached)

Treasury Report: New Zealand Post Limited: Special Dividend

Executive Summary

This report sets out New Zealand Post Limited's (NZ Post's) position on a proposed special dividend that would be paid from the proceeds of a proposed sale of its 53% shareholding in Kiwi Group Holdings Limited (KGH).

This report also sets out the Treasury's analysis of an optimal capital structure for NZ Post based on the information we currently have available and our various engagements with NZ Post and other parties. In light of these activities we recommend a pathway forward.

Given the potential size of the transaction for NZ Post, it is likely to be a major transaction under section 129 of the Companies Act 1993, thereby requiring shareholder approval. Advice will be provided separately on this matter once agreement has been reached on the proposed transaction (at this stage, anticipated to occur in July 2022).

[25], [26], [38]

[25]

NZ Post has stated that this level of retention will support NZ Post's significant planned capital investment programme, ongoing transformation of the mail business into one that is commercially sustainable, and ensure that NZ Post's credit rating is not downgraded below BBB post sale of KGH.

We note that in the event a transaction does not go ahead, NZ Post is expected to seek to maximise its financial return from KGH to ensure the core business is able to fund its transformation and strategic objectives. We also note KGH does not fit within NZ Post's core business or strategic objectives.

The Treasury has approached the matter from a perspective of determining what an optimal capital structure would be for NZ Post following a sale of its KGH stake (i.e. a structure that achieves a BBB credit rating, consistent with Owner's Expectations). [25]

Post due to differences in key assumptions and some matters that are yet to materialise. In particular, NZ Post needs to engage with rating agencies, auditors and lenders to understand how the company's operating business and financial structuring profile (including its leasing arrangements) is viewed following the divestment of KGH.

[25]

On that basis, we recommend that Ministers acknowledge NZ Post's proposed [25], [26], [38] retention and set out expectations of NZ Post in relation to its commitments to demonstrate the shareholder value created through the proposed retention and review its capital needs every six-months. The Treasury will continue working with NZ Post to operationalise these commitments and we recommend that you indicate in the letter that you look forward to receiving an update on this alongside the major transaction proposal.

Recommended Action

We recommend that you:

a **note** that the Board of New Zealand Post Limited (NZ Post) proposes to retain an amount of [25], [26], [38] from the sale proceeds arising from the planned divestment of Kiwi Group Holdings Limited (KGH) and pay a special dividend to the Crown comprising the balance of the KGH sale proceeds.

b **note** that based on the information available and assumptions made, [25] and that Treasury will continue to work with NZ Post to review and assess its optimal capital structure.

c **agree** to sign and send the attached letter to the Chair of NZ Post, in response to the Board's proposed special dividend if a sale of its shares in KGH goes ahead.

Agree/disagree.	*Agree/disagree.*
Acting Minister for State Owned Enterprises	Acting Minister of Finance

Andrew McLoughlin
Principal Advisor, Commercial and Institutional Performance

Hon Dr Megan Woods
Acting Minister for State Owned Enterprises

Hon Dr David Clark
Acting Minister of Finance

Treasury Report: NZ Post Special Dividend

Purpose of Report

1. This report sets out New Zealand Post Limited's (NZ Post's) position on providing a special dividend to the Crown from the proceeds of a sale of its 53% shareholding in Kiwi Group Holdings Limited (KGH). It also sets out the Treasury's analysis of an optimal capital structure for NZ Post based on the information currently available and our various engagements with NZ Post and advisors. Considering NZ Post's proposal and Treasury's analysis, we recommend a pathway forward.

Background

2. KGH is a holding company which wholly owns Kiwibank Limited (Kiwibank) and other adjacent subsidiaries. KGH is currently owned by NZ Post (53%), New Zealand Superannuation Fund (25%) and Accident Compensation Corporation (22%). Kiwibank is undergoing a multi-year bank-wide transformation to enhance its future competitive growth prospects. However, [25], [26] for Kiwibank is likely to be difficult to achieve under KGH's current shareholding arrangements given rising Reserve Bank of New Zealand regulatory capital requirements. Therefore, the Crown is now moving to acquire shares in KGH from those shareholders seeking to exit [33], [37] NZ Post is one shareholder seeking to exit, having expressed its desire to exit for the past few years.

3. Cabinet has agreed to the Minister of Finance and Associate Minister of Finance (Hon David Parker) (the Negotiating Ministers) negotiating to purchase KGH shares, subject to Cabinet agreement to the relevant capital appropriations now that the Budget 2022 moratorium has expired.

4. The Treasury has been conducting a phased negotiation with KGH shareholders on behalf of Negotiating Ministers. [25], [37]

5. Negotiations are still in progress, but we are now approaching the time when the Crown may make an offer to purchase KGH shares. Given the Budget moratorium has expired, the Minister of Finance is considering seeking an appropriation to fund the possible purchase of KGH shares.

6. Alongside negotiations, a confirmatory due diligence process is being undertaken and following completion, an offer will be put to those shareholders seeking to exit. The due diligence process provides additional information on the risks inherent in investing in KGH. Following initial discussions with the shareholders, due diligence is now underway.

NZ Post shareholder conflicts of interest

7. Treasury has sought advice from the Cabinet Office about possible portfolio conflicts of interest that arise as a result of the Project Korimako transaction. One such conflict arises for the Minister of Finance who has a role in negotiating the purchase of KGH shares on behalf of the Crown, as well as being one of the two Crown shareholders in NZ Post. Given the potential size of the transaction for NZ Post, it is likely to be a major

transaction under section 129 of the Companies Act 1993, thereby requiring shareholder approval.

8. This would mean that the Minister of Finance would have active roles on both the sale and purchase sides of the transaction, which results in a conflict of interest between those roles. A temporary transfer of Hon Robertson's decision-making responsibilities as a shareholder in NZ Post (that is, his role on the vendor side of the transaction) to the Minister for State Owned Enterprises has been made to resolve this conflict.

9. Responsibilities for NZ Post as Minister for State Owned Enterprises were transferred to Hon Dr Woods in 2021. The Cabinet Office advises that this transfer was made for unrelated reasons and would not affect this further transfer – that transfer concerned a conflict between work in the Digital Economy and Communications portfolio, regarding the pricing and market structure of the postal services market, and the Minister for State Owned Enterprises' shareholder responsibilities to NZ Post.

10. Under this transfer shareholding Ministers will be asked to approve the major transaction (currently anticipated to occur in July) and to engage on NZ Post's proposed capital retention.

Return of value to the Crown by NZ Post

11. For both the Board of NZ Post, and shareholding Ministers, the question of how much NZ Post returns to the Crown by way of special dividend is an important consideration. The amount of capital NZ Post retains impacts its ability to support its operations and invest in the business, which ultimately impacts the resilience and long-term value proposition of the company and therefore value for shareholding Ministers and the Crown. For Ministers and the Crown, a special dividend represents funds to the Crown that can be redeployed to other government priorities.

12. Ordinarily, a decision as to whether to declare a dividend, and for how much, is a question for the board of a company. The board can only declare a dividend if it is satisfied on reasonable grounds that the company will, immediately after the distribution, satisfy the solvency test (pursuant to the Companies Act 1993).

13. However, shareholding Ministers have a range of levers available to them, including setting expectations of companies through a letter of expectations, commenting on the statement of corporate intent, being consulted on significant investment decisions, and approving major transactions (under the Companies Act 1993). Section 13(1)(b) of the State-Owned Enterprises Act 1986 (the Act) also provides that shareholding Ministers can determine the amount of dividend payable by a State-owned Enterprise (SOE) in respect of any financial year or years.[1] However, directional powers under the Act have been exercised rarely and the board would still need to be satisfied that the solvency test would be met under the Companies Act 1993 after paying any special dividend.

Should the transaction not proceed

14. In the event the sale of KGH does not proceed for any reason and NZ Post retains its shareholding in KGH, NZ Post will continue to derive a stream of income from KGH's operating activities (principally through Kiwibank). Currently this equates to around $12 million per annum in dividends from NZ Post's redeemable preference shares held in KGH.

15. [25], [26]

[1] After it has had regard to Part 1 of the Act and consulted the board.

[25], [26]

16. We also note that KGH's business activities are not part of NZ Post's core business, which is principally a mail and parcels business, and can therefore distract from NZ Post's key focus. Further, KGH is constrained in its growth prospects as NZ Post is unlikely to be able to provide sufficient capital to invest in growing that business. A sale to other owners will provide the possibility for KGH to realise its growth potential through sufficient investment and through a better alignment of strategic interests.

Capital Structure Analysis

17. Capital management is an important lever for ensuring the performance of Crown companies. Effective capital management can assist in promoting better commercial disciplines on entities over which the government has a majority shareholding interest, and result in the government being able to reallocate funds to invest in other priorities.

Capital structure best practice

18. It is best practice to set dividends at a level that achieves a company's optimal capital structure. This is because dividends remove cash and retained earnings from a company's balance sheet, affecting the mix of equity and debt financing. Therefore, dividends and capital structure are inextricably linked.

19. Following asset divestment, setting the amount of any special dividend to that which achieves optimal capital structure is common practice. An optimal capital structure strikes an appropriate balance between debt and equity, ensuring a company can deliver on its strategic objectives and shareholders' ownership objectives and expectations while minimising financial risk:

    a **Equity:** The company has sufficient financial resources to deliver on its business plan; even under a downside scenario. [25], [26]

    b **Debt:** Utilising debt lowers a company's overall cost of capital. It can also strengthen governance; debt introduces additional monitoring and oversight from lenders and rating agencies. This is important in the Crown ownership context where external oversight is limited to the Treasury and there is a high degree of separation between shareholding and management (meaning agency costs are higher). In an optimal capital structure, debt is set at a level that incentivises efficient performance but is sustainable if a plausible downside scenario eventuates.

Approach – target a scenario that achieves a BBB credit profile [25], [26]

20. Both NZ Post and the Treasury have used an approach to assess an appropriate special dividend to achieve a BBB (investment grade) stand-alone credit profile (SACP)[2] [25], [26] A BBB credit rating is consistent with the Owner's Expectations.[3] It is also commonly used as a proxy for optimal capital structure as finance costs

[2] Stand-alone meaning the credit profile a company could achieve without a favourable upgrade for implicit government support.

[3] The Owner's Expectations set out that the Government expects that SOEs will have a capital structure consistent with a BBB (flat) credit rating as a minimum, unless the SOE can demonstrate good reasons otherwise. This is to ensure that all SOEs have appropriate financial disciplines to manage capital efficiently at similar risk levels.

significantly increase below BBB. As such, a BBB rating balances the need to maintain investment-grade ratings with the benefits provided from debt.

21. The Treasury used credit metrics from BBB-rated comparable companies to determine what metrics NZ Post would need to achieve to have a BBB SACP.

22. [25], [26]

23. [25], [26] Given credit ratings are a forward-looking opinion, it is not appropriate to base today's assessment of what is an optimal capital structure on performance of NZ Post during this period, [25], [26]

24. This is consistent with the approach Standard and Poors (S&P) take to credit ratings (including in its latest report on NZ Post, dated 15 February 2022) and we would expect this to hold when NZ Post engages with S&P following any divestment of KGH.

25. Additionally, we note that other incumbent postal companies are either undertaking, or have completed, similar periods of transformation.[4] For those with listed debt, they have maintained BBB or above credit ratings although they are not meeting the metrics for investment grade during the transition period, focusing on the expected long-term financial performance and position of these companies.

The Board's Proposal for the Proceeds from KGH

26. NZ Post's Board proposes paying a special dividend of the KGH transaction proceeds less [25], [26], [38] . NZ Post has stated that this level of retention will ensure that the enterprise value of NZ Post increases (though this is yet to be demonstrated). It states that this enables it to return to being a dividend-paying SOE and/or ultimately will provide the owners options as to how they will crystalise that increased value.

NZ Post is in a transition period and there are a number of risks

27. The Board's rationale for retention at this level in the near term includes the imperative of supporting the financing of NZ Post's transformation programme and ensuring that NZ Post's credit rating is not downgraded below BBB.

28. [25], [26] Key risks the business is facing over the coming years include the following[5]:

a [25]

[4] Examples of such companies are included in our selected peers (Royal Mail Group, Post NL, Singapore Post, etc.)

[5] The Treasury recently provided advice on NZ Post's business plan and statement of corporate intent (*T2022/1240 refers*) and provided commentary on some of these key risks over the planning period.

b [25], [26]

c Current Crown funding for NZ Post's mail business will end in FY23. Over the planning period, NZ Post will be continuing with significant changes in the mail business, with associated costs. A sustainable end-state for the mail business is still being worked through, and there is execution risk to this.

d There is current economic uncertainty, with factors such as inflation and rising interest rates creating pressures and risks on both costs (for example, through wage inflation) and revenue (if consumer demand dampens due to less favourable economic conditions).

A range of costs and investments form the basis of NZ Post's proposed [25], [26], [38] **retention**

29. [25], [26] These form the basis of its position to retain [25], [26], [38] of the KGH sale proceeds. These are listed below in Table 1. Highlighted rows indicate items that are not in NZ Post's FY23-FY25 Business Plan.

[25], [26]

30. [25], [26]

31. Considering the above, NZ Post has stated that it needs to retain [25], [26], [38] of the proceeds of a KGH sale to maintain its investment grade rating. Underlying this proposal is a set of assumptions, which can be found in Annex 1.

32. [25], [26]

The Treasury's Assumptions and Outputs

33. The Treasury has undertaken its own independent analysis of NZ Post's optimal capital structure to support this advice. Our analysis is based on figures provided by NZ Post, incorporating the business plan and the additional investments proposed by NZ Post (outlined in Table 1).

34. Underlying this approach are several key assumptions, the most significant of which is the Treasury's approach [25], [26]

More detail on this assumption can be found in Annex 1.

35. [25], [26]

36.

37. We understand that engagements with rating agencies on the revised forecasts are yet to take place (we note S&P's most recent research update was in February 2022). This, along with engagement with other parties such as auditors and lenders would provide additional insights as to how the risk of the business is viewed and whether that would have any impact on our analysis.

[6] This represents the investments included in the FY23-FY25 Business Plan, we note that this is an estimate and is likely to change as NZ Post continues working through its investment programme.

38. An additional factor to materialise is how the business is viewed following a transaction of KGH. NZ Post notes it is yet to enter conversations with S&P regarding the potential sale of KGH and any impact on how it views NZ Post's credit profile. In its current rating from S&P, NZ Post currently receives a one-notch benefit today to reflect the "significant source of financial flexibility provided by the holding of KGH". We note S&P also assesses a high probability of government support which is reflected in a four-notch benefit to NZ Post's credit rating.

[25], [26]

39. Based on our assumptions, the available information, and adjusting [25], [26] to align with industry comparators, we note that a capital retention of up to [25], [26], [38] could be sufficient to achieve a stronger-than BBB SACP [25], [26] .[7] Our assessment includes the investments listed in Table 1 at the mid-point of the expected cost range.

Conclusions and Recommendations

40. NZ Post has proposed to pay a special dividend of the proceeds of any sale of KGH less [25], [26], [38] and states that this level of retention will ensure that the enterprise value of NZ Post increases. This retention amount is based on investments it considers important to achieving its strategic direction and returning to being a dividend-paying SOE. [25], [26]

41. The Treasury has approached the matter from a perspective of determining what an optimal capital structure would be. Based on the assumptions we have made and the available information, our analysis suggests [25], [26] However, there are key assumptions that differ between our approach and NZ Post's.

There are matters that need to be worked through and materialise before we can provide a definitive recommendation on an optimal capital structure

42. [25], [26] NZ Post's engagements with rating agencies, auditors and lenders will provide important insights as to how the risk of the business is viewed. This is important to forming a robust view on an optimal capital structure.

NZ Post has committed to demonstrating the shareholder value that is created

43. In its proposal to retain [25], [26], [38] from the sale proceeds of its KGH stake, the NZ Post board has made a commitment to continuing to work with the Treasury to assess the matter of an optimal capital structure.

44. NZ Post has signalled there are [25], [26]

[7] We note the stronger than BBB SACP translates to around [25], [26]

45. We are continuing to engage with NZ Post as to what this will look like in practice and how it proposes to demonstrate and communicate this value. NZ Post has set out it is committed to continuing to consult on investments in accordance with its SCI obligations and continue with its "no surprises" approach. It notes that all the items on the [25], [26] will be incorporated into the business plan in due course as they progress through the business case process and receive Board approval.

46. We recommend Ministers emphasise the need for prudent capital expenditure, clearly demonstrating the value and return on investments, and continuing to engage with Treasury on its capital investment intentions.

[25] and [26]

47. [25] and [26]

48.

49.

50.

51.

Next Steps

52. We invite you to send a letter to the Chair of NZ Post, setting out that you welcome the Board's proposed special dividend and your expectations in relation to the proposed special dividend.

53. Treasury officials will continue to work with NZ Post to clearly articulate the capital structure review and engagement processes and associated timeframes and we will update you alongside our advice on the approval of the proposed major transaction in July 2022.

Annex 1 – Key assumptions

Key assumptions in NZ Post's analysis

54. NZ Post has taken an approach to model its capital structure to the period to [25], [26] . It compares interest cover, leverage ratio and gearing ratio to a BBB range.

55. The key assumptions in NZ Post's base case for a [25], [26], [38] retention are:

    a [25], [26]

    b

    c

56. [25], [26]

Key assumptions in Treasury's analysis

57. A key difference in our approach to that taken by NZ Post is in relation to [25], [26]

58. [25], [26]

59.

60. At this time, we consider it reasonable to adjust [25], [26] to a level comparable with industry peers. For the purposes of our analysis we adjust [25], [26]

61. Other key differences in our assumptions are that we assume:

    a [25], [26]

    b

    c

62. Based on these factors, we note that [25], [26]

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[8] For example, [25], [26]

[9] Under IFRS 16 a company can value [25], [26]

[10] We note the [25], [26]