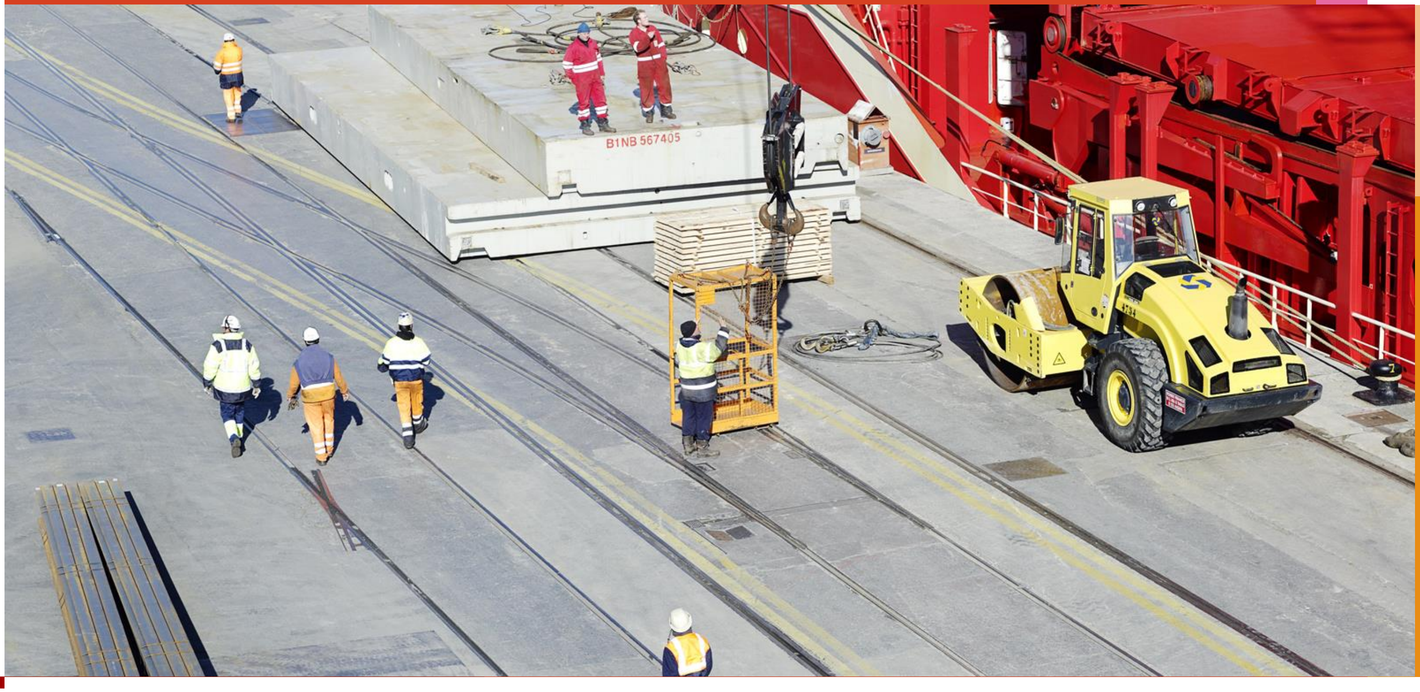
Corporate Finance

Hawke's Bay Regional Council

Napier Port: Summary review of capital structure options



1 October 2018

1 October 2018

In accordance with your instruction as confirmed in our letter of engagement dated 14 August 2018 (the Contract), we present a summary of the valuations adopted by Hawke's Bay Regional Council (HBRC) and Hawke's Bay Regional Investment Company Limited (HBRIC) in its consultation document dated October 2018 (the Consultation Document), including our views on the reasonableness of these valuations (the Summary Report), as HBRIC consider its ongoing ownership of the Port of Napier Limited (Napier Port or the Company).

This Summary Report should be considered only in its entirety.

This report was prepared solely to assist HBRC and HBRIC in assessing the merits of the capital structure options considered and is not to be relied upon for any other purpose. We consent to your providing copies of this Summary Report to third parties only in its entirety and on the basis that, to the fullest extent permitted by Law, we accept no duty of care to any such party in connection with the provision of this Summary Report and/or any related information or explanation (together the Information). Accordingly, regardless of the form of action, whether in contract, tort (including without limitation negligence or otherwise) and to the extent permitted by applicable Law, we accept no liability to any third party and disclaim all responsibility for the consequences of any third party acting or refraining to act in reliance on the information.

Notwithstanding the above, our consent to your distributing this Summary Report to third parties is given solely on the basis that you agree that, in the event such release leads to our incurring any costs or obligations to such third parties, we will rely on the indemnities which you have provided to us.

In preparing this Summary Report we obtained information from a variety of sources. While we have analysed financial information, we have not undertaken an audit or verified this information, and will not accept any responsibility for any errors contained in the information provided. Accordingly, we accept no responsibility and make no representations with respect to the accuracy of or completeness of any information provided to us, except where otherwise stated and no assurance is given. Further detail on our key terms of business are provided at Appendix 1 of this Summary Report.

Yours faithfully

Price Waterhouse Coopers

PricewaterhouseCoopers

PricewaterhouseCoopers, 188 Quay Street, Private Bag 92162, Auckland 1142
Telephone: + 64 (9) 355 8000, Facsimile: +64 (9) 355 8001

Contents

Introduction

Background

- Through HBRIC, HBRC owns Napier Port. Based on current forecasts Napier Port is expected to experience significant growth in cargo volumes and needs to invest in further infrastructure to support this growth. A new wharf (Wharf 6), estimated to cost around $142m, is the first step in a 10 year investment programme estimated to cost ~$320m to $350m.
- We take at face value Napier Port's view that Wharf 6 capital expenditure (capex) is required to sustain growth. Expansion capex is a necessary requirement to support growth; failure to spend that capex is likely to have adverse impacts to regional growth and hence HBRC's rating base.
- Consideration of options to fund the Napier Port infrastructure has prompted HBRC to review its ongoing ownership interest in the Company.

Scope

- The scope of our services is to carry out a review of the reasonableness of the valuations adopted by HBRC in the Consultation Document, including:
  - The valuation approaches adopted;
  - Key assumptions;
  - Sense checking of outputs; and
  - Views on the pros and cons of the approaches.

Capital structure options

- As instructed, we have first considered Napier Port's and HBRC's capacity to fund the expansion capex through debt. Our analysis is provided on the following pages 5 and 6.
- In addition, in this Summary Report we also consider the reasonableness of the valuations adopted by HBRC with regard to other funding options, specifically:
  - An Initial Public Offering (IPO) model;
  - A Concession/lease model; and
  - A Minority Share Sale.
- We provide a comparison of these options on pages 7 and 8. Each option is also discussed in separate sections of this Summary Report.

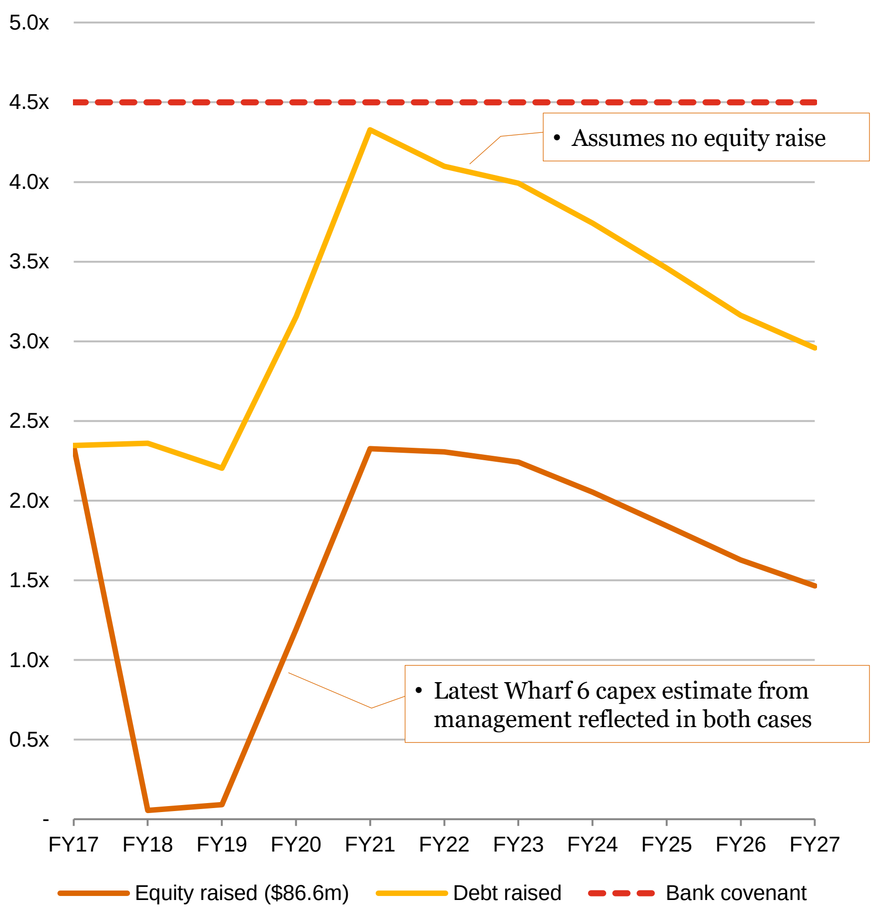
Other considerations

- The views contained in this report are as at the date of this report. Market conditions can change which may impact the conclusions contained.
- Transaction costs can vary, particularly as transaction costs can be linked to proceeds.
- The proceeds presented in this document are net of initial income tax estimates. We have provided this tax advice based on various assumptions for the purpose of presenting financial information for consultation net of income tax considerations. Once a decision has been made at the conclusion of this consultation process, further detailed tax advice on the preferred approach will need to be provided to confirm the position.

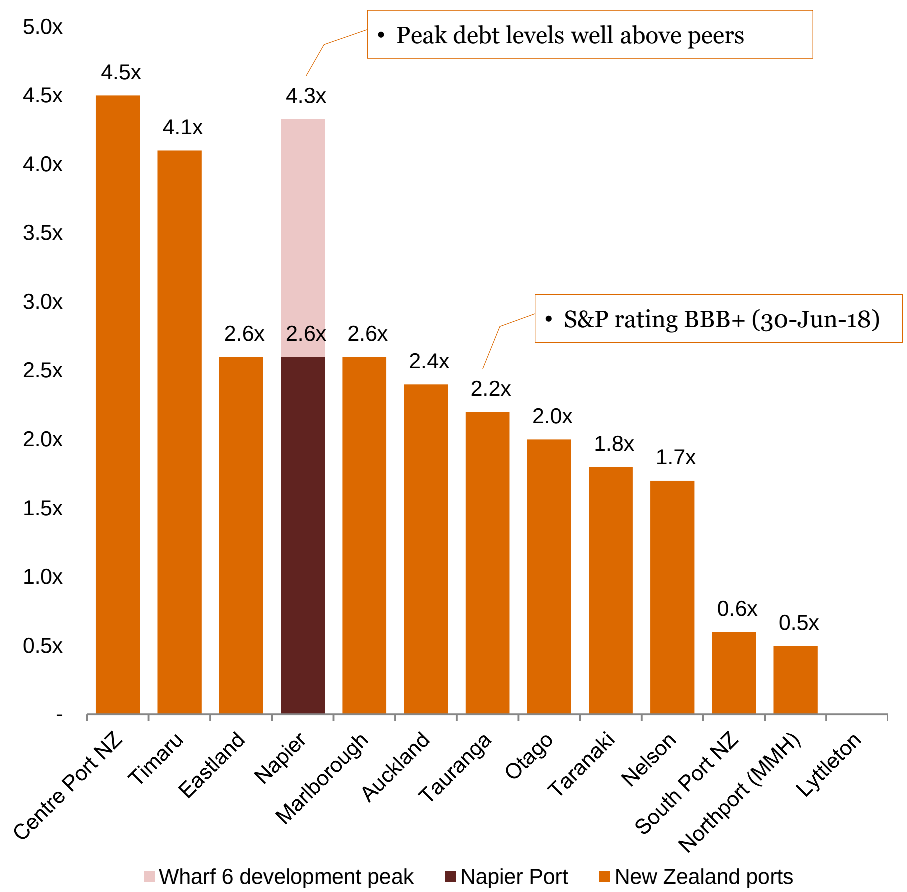
Debt Funding Option: Napier Port debt capacity

Based on analysis of current debt levels, Napier Port has limited capacity to debt finance the Wharf 6 port expansion in addition to its ongoing maintenance capex requirements

Net debt / EBITDA



FY16 Net debt / EBITDA peer comparison

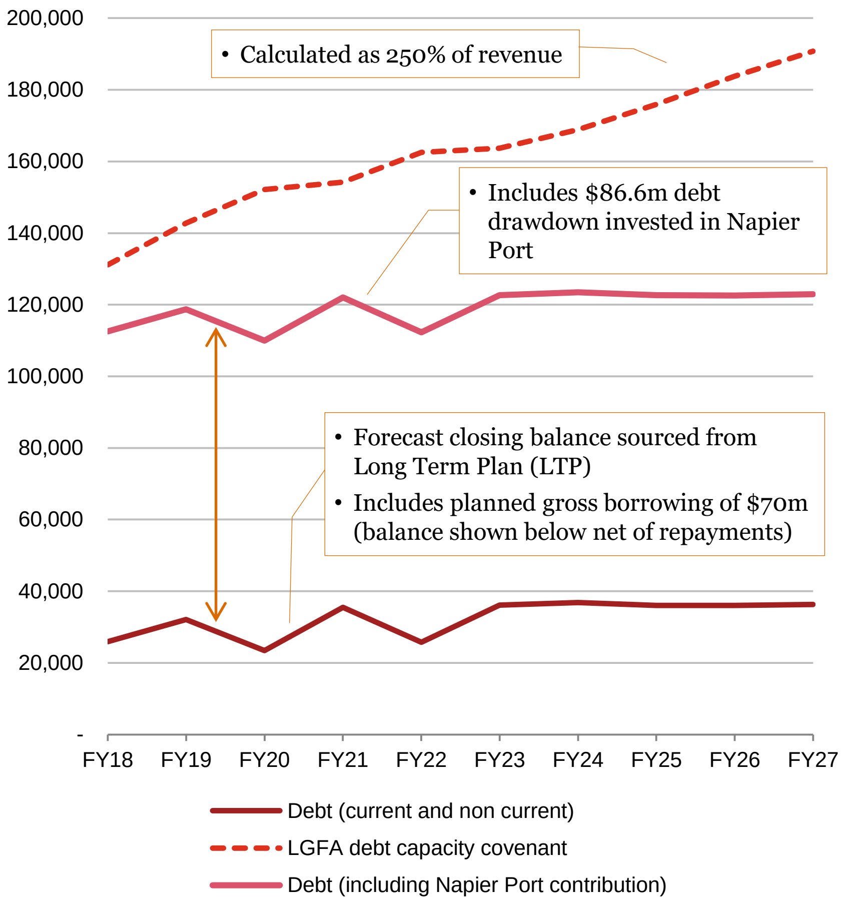


Source: HBRC, PwC Analysis

Debt Funding Option: HBRC debt capacity

We have also reviewed the debt finance option associated with HBRC using its own resources to finance Napier Port expansion. HBRC would also have limited capacity to increase debt levels

Forecast debt capacity



Comments

- As set out on the previous page, Napier Port does not have the capacity to fund the expansion on its own balance sheet given current debt levels. The only option to achieve this would be for HBRIC to inject capital of $86.6m to retire Napier Port debt, which may have implications for future dividends from Napier Port, which is consistent with the advice previously received by HBRIC.
- To execute the above, HBRC would have to borrow the $86.6m of new capital to be invested in Napier Port increasing net debt to $112.5m, leaving only $18.7m of headroom under LGFA guidelines (on the basis of maximum debt at 250% of revenue) and reducing flexibility to respond to future unexpected events. In addition HBRC may require a credit rating to receive such an increase in debt levels. We estimate that the cost of new debt to be in the range of $3m to $4m which would need to be funded by rates increases. The alternative of Napier Port not paying dividends will also likely have a rates impact.
- We note also that the above analysis has been undertaken on the debt balance net of repayments. Credit rating agencies may take into account gross borrowings.

Source: HBRC, PwC Analysis

Indicative valuation comparison summary

Comparison of transaction structure options

$m	IPO – 45% sold Low	IPO Mid	IPO High	Concession / lease Low	Concession / lease Mid	Concession / lease High	Minority share sale – 45% sold Low	Minority share sale Mid	Minority share sale High
Indicative valuation comparison									
Napier Port enterprise value	410	**435**	460	397	**466**	534	410	**435**	460
Less: Napier Port debt		(87)			(87)			(87)	
Equity value (100% of shares)	323	**348**	373	310	**379**	447	323	**348**	373
Indicative proceeds comparison									
Gross proceeds to HBRIC[1]	89	**94**	100	310	**379**	447	43	**60**	79
Additional equity raised[2]		87			n/a			87	
Total equity raised (incl new equity)	175	**181**	186	n/a	**n/a**	n/a	129	**147**	166
Indicative transaction costs		(11)			(13)			(8)	
Indicative retained equity comparison									
Value of retained equity	226	**239**	253	40	**49**	58	226	**239**	253

1. HBRIC sale of 45% of its existing equity shareholding.
2. Equity raised by Napier Port from new investors to pay down all outstanding debt.

Valuation comparison

- Improved operational efficiencies are expected to drive a higher valuation under the Concession/lease transaction structure.
- Based on comparable company trading and transaction multiples, the concluded value ranges appear reasonable.

Proceeds comparison

- A 45% share sale has been assumed under the IPO and Minority Share Sale structures (including new equity raised to pay down existing debt).
- Discounts have been applied to the IPO and Minority Share sale options consistent with those often observed in the New Zealand market.

Retained equity value comparison

- 55% equity retained by HBRIC under the IPO and Minority Share sale structures.
- Equity retained under the Concession/lease structure but lease runs for 50 years.

Qualitative comparison summary

Key
✓ Advantage
– Neutral
✗ Disadvantage

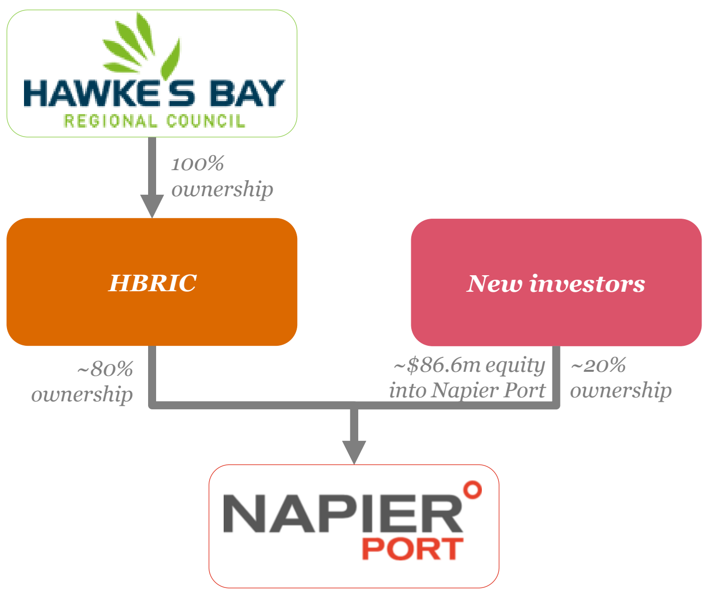
	Concession	IPO	Minority ordinary share sale
Structuring simplicity	✗	✓	✓
HBRIC future direct influence	✗	–✓	–✓
Future efficiency of port	✓✓	✓	–✓
Gross valuation of Napier Port	✓✓	✓	✓
Tax considerations regarding proceeds	–✗	✓	✓
OIO considerations	✗	✓	–
Complexity of future port consolidation	✗	✓	–
Transaction achievable by 1 July 2019	✗	✓✓	✓

IPO Option

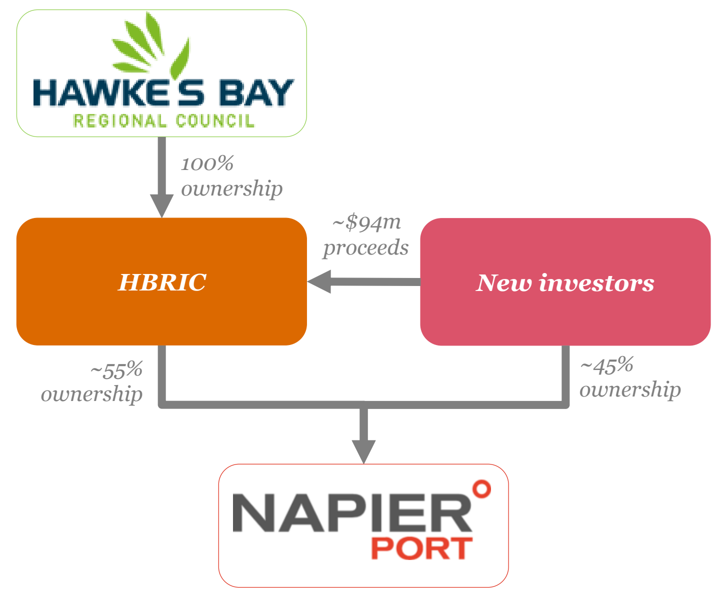
IPO Option:
Proposed transaction structure

The IPO transaction structure considered by HBRC/HBRIC is presented below. Total raising $181m of equity (based on the midpoint valuation) consisting of $86.6m new equity and a $94m sale of existing equity by HBRIC is being considered. Upon completion of the IPO, HBRIC would have a 55% shareholding in Napier Port

IPO structure – Primary equity



IPO structure – Secondary equity



At listing, the following would occur simultaneously:

1 **Primary Equity**

IPO investors would subscribe for $86.6m of new shares in Napier Port, the proceeds will be used to reduce debt to nil.

2 **Secondary Equity**

HBRIC would divest its shares, reducing its shareholding to 55% and raising ~$94m of proceeds (based on the midpoint valuation).

IPO Option: Indicative EV range

The IPO option valuation concluded on a range of $410m to $460m. Based upon analysis of comparable company trading multiples, the concluded value range appears reasonable

	IPO		
	45% sold		
$m	Low	Mid	High
Indicative valuation comparison			
Napier Port enterprise value	410	**435**	460
Less: Napier Port debt		(87)	
Equity value (100% of shares)	323	**348**	373
Indicative proceeds comparison			
Gross proceeds to HBRIC[1]	89	**94**	100
Additional equity raised[2]		87	
Total equity raised (incl new equity)	175	**181**	186
Indicative transaction costs		(11)	
Indicative retained equity comparison			
Value of retained equity	226	**239**	253

Commentary

- As a cross-check to the concluded value range of $410m to $460m, trading multiples of comparable companies that are publicly traded were considered.
- We note that:
  - The comparable companies considered consisted of three listed New Zealand ports, listed Australasian infrastructure companies and listed overseas ports, logistics and stevedore companies;
  - Port of Tauranga Ltd (PoT) is the most comparable New Zealand listed port to Napier in terms of operations however it is much larger, has stronger growth prospects and therefore attracts a premium multiple; and
  - South Port is comparable in terms of scale to Napier Port, however it has less than half Napier Port's TEU throughput and EBITDA and lower growth prospects.

1. HBRIC sale of 45% of its existing equity shareholding.
2. Equity raised by Napier Port from new investors to pay down all outstanding debt.

IPO Option: Qualitative observations

Upfront proceeds are relatively lower than the Concession/lease model given only 45% is sold. However, the option has precedents in New Zealand and HBRC would retain shareholding in a strong dividend yielding asset - proceeds and remaining shareholding should be considered together

Not as structurally complex as the Concession as new and existing shares are sold and there is a clear precedent of mixed ownership in New Zealand.

HBRIC will retain influence through majority shareholding but Napier Port must act commercially and be governed by an independent commercial board representing all shareholders. If new equity is required, HBRIC would need to participate to retain its majority shareholding.

An IPO should lead to **increased efficiency** (albeit less efficiency than under a Concession model), with historical government IPOs demonstrating this phenomena.

No material tax issues with an IPO, **valuation likely to be lower** than a gross concession valuation, influenced by future business prospects and investor views on the boards ability to act commercially (may need to consider board make up). IPO values are typically priced at a slight discount to expected trading value. Value to HBRC/HBRIC is in the form of upfront proceeds and remaining shares in Napier Port, which will continue to receive dividends.

Investors will be New Zealand retail, New Zealand institutional and off shore institutional; likely to need OIO exemption but hurdle is lower than for a concession.

Does not rule out future participation in port consolidation.

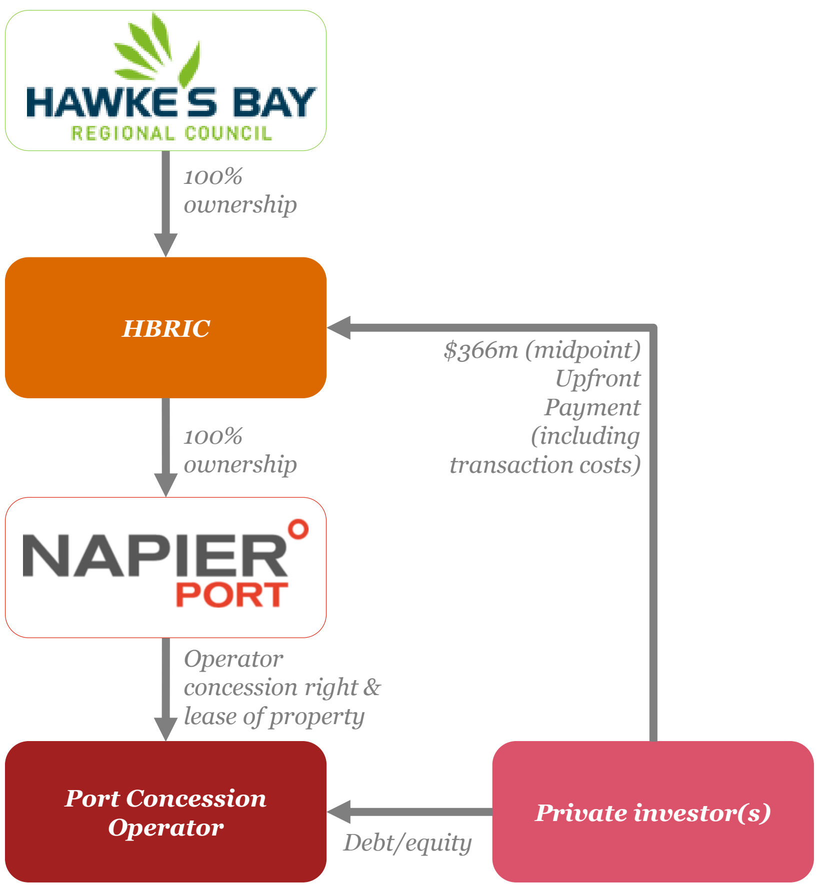
Timetable achievable by 1 July 2019 as advised.

Concession/lease Option

Concession/lease Option: Proposed transaction structure

The Concession/lease structure is effectively a finance lease of the existing Napier Port assets for a fixed concession term (50 years has been proposed)

Concession/lease structure



Commentary

- The operator concession model is new to New Zealand but there are a number of examples in Australia (refer to following page).
- HBRIC offers the right to a port concession operator to operate Napier Port under a fixed term concession, say 50 years. This involves the transfer of Napier Port assets, together with employees, key contracts (including supply agreements), liabilities (eg employee leave balances) and goodwill via a lease agreement.
- Consideration is received upfront by HBRIC.
- A lease agreement with relevant safeguards is required to ensure HBRIC and broader stakeholders' interests are protected. Some key aspects to be considered in the lease agreement include:
  - Transaction structure to ensure HBRIC influence;
  - Minimum investment requirements;
  - Share in future economic upside eg dividends (will reduce upfront payment);
  - Step in rights based on performance; and
  - Asset condition on handback.
- The concession will require property company (PropCo) and operating company (OpCo) separation whereby HBRIC will continue to own the assets leased to the 3rd party lessee/operator.
- The tangible and intangible assets will need to be valued as part of the transaction in order to ascertain total income tax payable resulting from the transaction. As a finance lease, income is taxable to the extent depreciation is recovered as part of the lease. Proceeds which exceed the asset cost are not taxable.
- In order to provide HBRIC and 3rd party operators with greater certainty regarding tax treatment, it would be prudent to seek binding tax rulings from the Inland Revenue Department prior to agreement signing.

Concession/lease Option: Indicative EV range

Australian Concession/lease transactions have transacted at EBITDA (LTM) multiples of between 17x and 28x

	Concession / lease		
$m	Low	Mid	High
Indicative valuation comparison			
Napier Port enterprise value	397	**466**	534
Less: Napier Port debt		(87)	
Equity value (100% of shares)	310	**379**	447
Indicative proceeds comparison			
Gross proceeds to HBRIC	310	**379**	447
Additional equity raised		n/a	
Total equity raised (incl new equity)	n/a	**n/a**	n/a
Indicative transaction costs		(13)	
Indicative retained equity comparison			
Value of retained equity	40	**49**	58

Commentary

- Since 2010, there have been a number of port Concession/lease transactions in Australia, in particular:
  - Port of Brisbane (2010);
  - Port Botany/Kembla (2013);
  - Port of Brisbane (secondary sale) (2013);
  - Port of Newcastle (2014);
  - Port of Darwin (2015); and
  - Port of Melbourne (2016).
- These Australian ports are ports of significant scale and with the exception of Port of Darwin are all at least double Napier Port in size.
- In addition, each port has significant geographic monopolies.
- Given these factors (among others) the concluded value range, which applies a substantial discount to these multiples, appears reasonable.

Concession/lease Option: Qualitative Observations

Whilst likely to result in the best economic outcome of the options, there are a number of control and completion risks that need to be considered

The most structurally complex option, with operations separated from land and operations subject to a 50 year lease. Complexity likely to result in increased advisory fees, such as accounting, tax and legal. There are no existing New Zealand precedents which may impact timing (eg tax rulings).

HBRIC has no influence over operations for 50 years, except through enforcement of the lease agreement, but then operations are returned in 50 years.

Concession model likely to create a **highly efficient port**, although toward the end of the concession, the operator will have **less incentive to invest**. However, asset handback provisions are typically included in lease agreements and are designed to ensure an agreed level of asset quality at handover.

Subject to the consideration of tax, **likely to result in highest proceeds to HBRIC**.

Difficult to see how the 'public' could participate in OpCo alongside the leasee, and adds complexity to Napier Port participation in any future port consolidation.

Larger New Zealand parties typically do not participate in competitive processes. Likely to attract significant overseas interest and this may add **OIO complexity** and cause completion delays. We note, however that other New Zealand port operators (eg Port of Auckland Ltd and PoT) may also be interested in a concession.

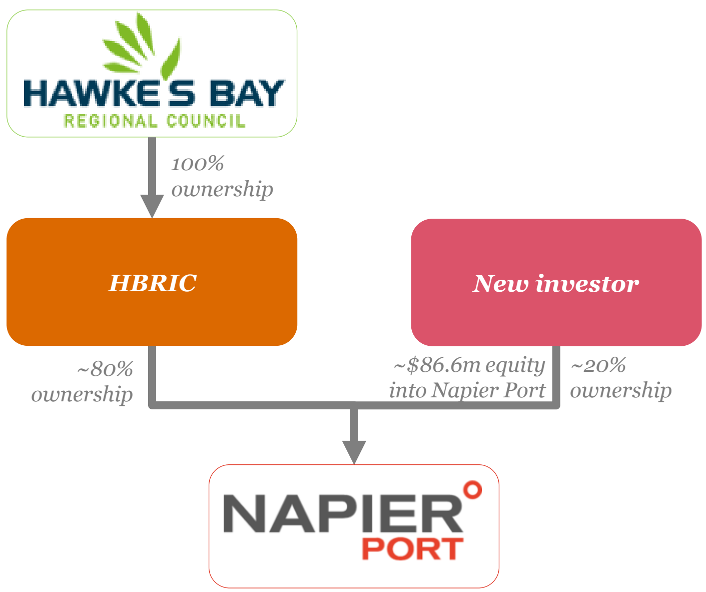
Greatest timetable risk, difficult to see how proceeds could be received by 1 July 2019, particularly given the complexity and OIO considerations above.

Minority Share Sale Option

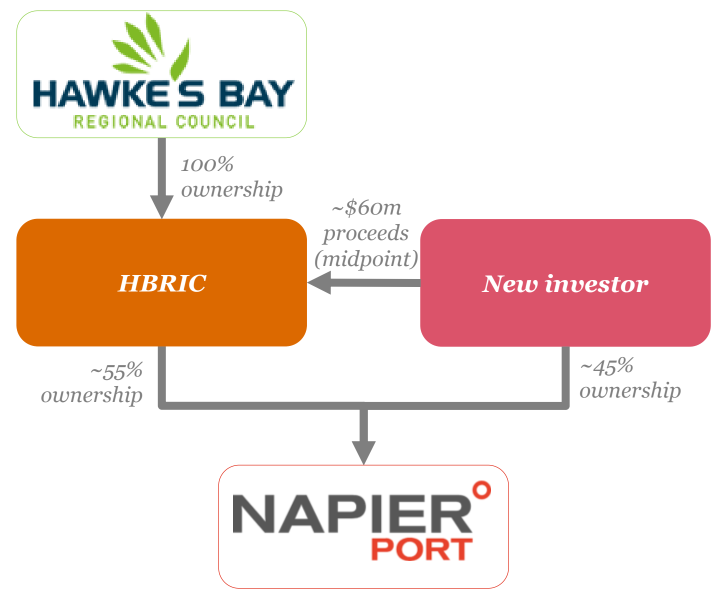
Minority Share Sale Option: Proposed transaction structure

The Minority Share Sale transaction structure considered by HBRC/HBRIC is presented below. Total raising $147m of equity (based on the midpoint valuation) consisting of $86.6m new equity and a $60m sale of existing equity by HBRIC (pre transaction costs) is being considered. Upon completion of the transaction, HBRIC would have a 55% shareholding in Napier Port

Minority Share Sale structure – Primary equity



Minority Share Sale structure – Secondary equity



Suggest both would occur simultaneously:

1 **Primary Equity**

The investor would subscribe for $86.6m of new shares in Napier Port, the proceeds will be used to reduce debt to nil.

2 **Secondary Equity**

HBRIC would divest its shares, reducing its shareholding to 55% and raising ~$60m of proceeds (based on the midpoint valuation).

Minority Share Sale Option: Observations

With regard to a minority ordinary share sale to a trade party, a strong shareholders' agreement should result in a similar value to that achieved through an IPO, however the more control HBRC seek to retain the lower likely minority valuation

- The value range adopted by HBRC suggests a minority ordinary share sale would transact at a discount of 20% to 30% of the 100% equity value.
- A minority ordinary share sale may achieve a similar valuation to an IPO, however to achieve this the shareholders' agreement would need to specify shared control of key matters with the minority shareholder.
- Therefore prudently, we have adopted a lens reflecting a weaker shareholders' agreement which should see value reduce along the lines outlined including a limitation of buyer audience. Shareholders' agreement considerations include:
  - Director appointments, capex agreements and the ability to influence the Company's strategic direction; and
  - Exit provisions.
- After adjustment to allow for like for like comparison with the other options, the upfront proceeds expected from this option are $43m to $79m with a midpoint of $60m (pre transaction costs), and retained equity of ~$239m (based on a 45% sale).

Similar complexity to an IPO.

HBRIC will retain influence through majority shareholding; but shareholders' agreement will limit influence, likely retain the ability for future liquidity and require commercial action.

Introducing a minority partner should **increase efficiency** but would depend on the investing party.

No material tax issues with a minority sale. **Valuation is likely to be strongly influenced by a 'quality' shareholders' agreement** – with a quality shareholders' agreement, value is likely to be similar to an IPO.

Investors could be New Zealand based but more likely to be offshore, creating similar OIO considerations to a Concession/lease model.

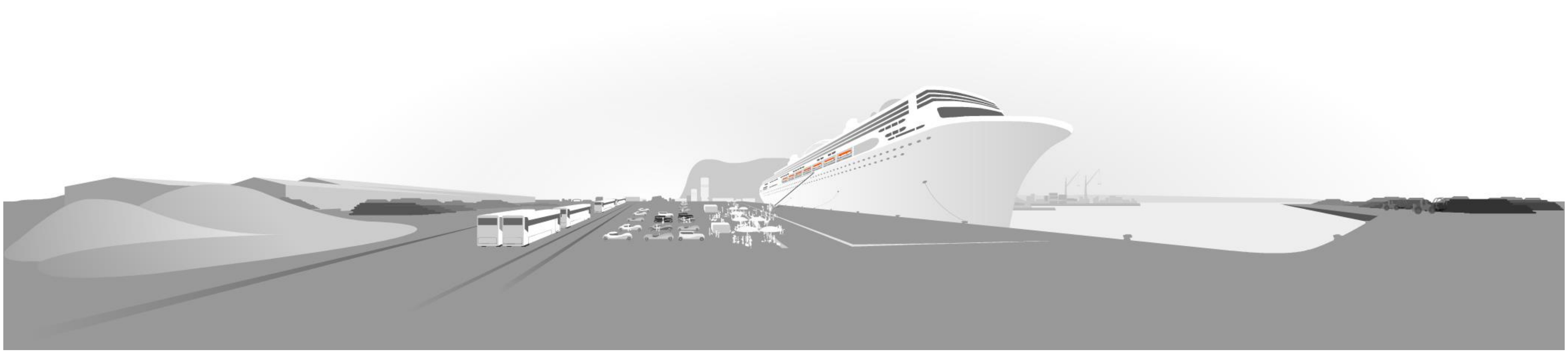
Flexibility to participate in future port consolidation, however more complex than an IPO.

Sale achievable, subject to OIO, by 1 July 2019.

Conclusion

Overall assessment

1. Napier Port is not in a position to fund Wharf 6 capex with debt given maintenance capex and dividend requirements, and based on our review of HBRC's debt capacity, if HBRC were to increase it's debt by $86.6m to provide as capital to Napier Port (to eliminate Napier Port's current debt) HBRC would be left with little debt capacity to cater for future unforeseen circumstances.
2. Therefore provision of external capital into Napier Port (such as through the three options considered) is an alternative to facilitate growth at Napier Port, and throughout the region.
3. At a high level, pre transaction costs and tax the valuations adopted by HBRC in the Consultation Document appear reasonable.
4. We note also that valuations are a best estimate, subject to market movements and market conditions on the day.



Appendices

Key terms of business and restrictions

- This Report has been prepared solely for the purposes stated herein and should not be relied upon for any other purpose.
- To the fullest extent permitted by law, PwC accepts no duty of care to any third party in connection with the provision of this Report and/or any related information or explanation (together, the "Information"). Accordingly, regardless of the form of action, whether in contract, tort (including without limitation, negligence) or otherwise, and to the extent permitted by applicable law, PwC accepts no liability of any kind to any third party and disclaims all responsibility for the consequences of any third party acting or refraining to act in reliance on the Information.
- We have not independently verified the accuracy of information provided to us, and have not conducted any form of audit in respect of the Company. Accordingly, we express no opinion on the reliability, accuracy, or completeness of the information provided to us and upon which we have relied.
- The statements and opinions expressed herein have been made in good faith, and on the basis that all information relied upon is true and accurate in all material respects, and not misleading by reason of omission or otherwise.
- The statements and opinions expressed in this report are based on information available as at the date of the report.
- We reserve the right, but will be under no obligation, to review or amend our Report, if any additional information, which was in existence on the date of this report was not brought to our attention, or subsequently comes to light.
- We have relied on forecasts and assumptions prepared by the Company about future events which, by their nature, are not able to be independently verified. Inevitably, some assumptions may not materialise and unanticipated events and circumstances are likely to occur. Therefore, actual results in the future will vary from the forecasts upon which we have relied. These variations may be material.
- This Summary Report is issued pursuant to the terms and conditions set out in our engagement letter and the Terms of Business attached thereto.
- In addition the following should be noted:
  - Certain numbers included in tables throughout this report have been rounded and therefore may not add exactly.
  - Reproduction of any information, data or material, including ratings (Content) in any form is prohibited except with the prior written permission of the relevant Content Provider. Such party, its affiliates and suppliers (Content Providers) do not guarantee the accuracy, adequacy, completeness, timeliness or availability of any Content and are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, or for the results obtained from the use of such Content. In no event shall Content Providers be liable for any damages, costs, expenses, legal fees, or losses (including lost income or lost profit and opportunity costs) in connection with any use of the Content. A reference to a particular investment or security, a rating or any observation concerning an investment that is part of the Content is not a recommendation to buy, sell or hold such investment or security, does not address the suitability of an investment or security and should not be relied on as investment advice. Credit ratings are statements of opinions and are not statements of fact.

Glossary

Term	Definition/Meaning
Capex	Capital expenditure
Company	Port of Napier Limited
EBIT	Earnings before interest and tax
EBITDA	Earnings before interest, tax, depreciation and amortisation
EV	Enterprise value
FY17	Financial year ending 30 September 2017
HBRC	Hawke's Bay Regional Council
HBRIC	Hawke's Bay Regional Investment Company Limited
IPO	Initial Public Offering
LTM	Last twelve months
LTP	Long Term Plan
Napier Port	Port of Napier Limited
NZ Ports	Port operations based in New Zealand
OIO	Overseas Investment Office
OpCo	Operating Company
PoA	Ports of Auckland Limited
PoT	Port of Tauranga Limited
PropCo	Property Company
S&P	Standard & Poor's
TEU	The twenty-foot equivalent unit