Hawke's Bay Regional Council

Capital Structure Review

Interim Report

5 December 2017

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Prepared for:	Capital Review Panel
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The views expressed in this report are those of the Capital Structure Review Panel and not Katalyzer. Katalyzer has provided editorial and presentation services to the Panel.

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Part I - INTRODUCTION

Need for this Report

1. Hawkes Bay Regional Council (Council) is preparing to enter the consultation phase for its 2018-2028 Long Term Plan (LTP). The LTP sets out its priorities over the medium to long term and must include information on activities, goods or services provided by Council, and specific funding and financial management policies and information.

2. In preparing for the LTP, Council has determined that it needs to:

   a) Tackle increasing demands to protect and enhance the region's environment and improve resilience to natural events. Understanding the upcoming costs of providing services (existing and new) and how these will be funded is vital to Council's planning. Significant cost pressures are anticipated.

   b) Explore options to optimise and reshape how it applies capital across its operational and investment portfolios to deliver more income and ensure it has enough capital to support Council's long term objectives for core services and enhancement initiatives.

   c) Identify key risks to Council's income sources and capital base, including risks associated with its large investment in Napier Port.

3. This interim report includes options to modify Council's current approach to commercial investment and borrowing to achieve improved returns and release funds to support Council's long term objectives. The final version of this report will make recommendations about these options, prior to the formal commencement of the LTP consultation process.

Parties to the Report

4. The parties to this Report and entities subject to this capital review are the Hawke's Bay Regional Council (Council), the Hawkes Bay Regional Investment Company Ltd (HBRIC) and Napier Port (the Port). HBRIC is a wholly owned, limited liability, subsidiary of Council. Napier Port is a wholly owned subsidiary of HBRIC.

5. It is acknowledged that each of these parties has its own Council or Board charged with the conduct of their business. This report does not seek to evaluate or assume the responsibilities of those Boards. Views from each entity have been captured as input to this review.

6. To objectively integrate and evaluate the options, each of the parties agreed to the appointment of a tripartite Review Panel, represented by the Chairs of each entity and supported by the addition of independent committee members.

7. It was also agreed that an independent writer would be commissioned to collate the output and synthesise the materials/information presented to and the views of the Panel. The views expressed in this report are those of the Capital Structure Review Panel and not the writer.

Review Panel

8. Council, on 29 March 2017, resolved that it forms a *Capital Structure Review Panel*.

9. The Review Panel members, appointed by Council, were chosen because they had direct or related knowledge of the investment activities of Council, and/or collectively provided the required experience and skills to undertake the review.

10. The members of the Panel are:

    Chris Tremain (Capital Review Panel Chair). Chair of HBRIC Ltd, Chair of Bank of China (NZ). Previous CE of Tremain's Real Estate. Previous MP and Cabinet Minister.

    Rex Graham. Council Chair, Director and Trustee of several private companies and trusts involved in horticulture, intellectual property and community interests. (**Rick Barker** as designated alternate as required).

    Neil Kirton. Councillor, Chair of Council Corporate and Strategic Committee, Chair of Council Finance, Audit and Risk Sub-committee. Current Business and Marketing Manager of Hohepa Homes Trust Board. Previous MP and Cabinet Minister.

    Alasdair MacLeod. Chair of Port of Napier Ltd. Also serves as Chair for other commercial enterprises. Retired Partner of Deloitte.

    Jim Scotland. Director, HBRIC. Former Chairman of Port of Napier Ltd, with extensive national and local commercial governance experience.

    David Shand. Previous directorships/chairs including Director of Meridian Energy Ltd. Has also worked as a Financial Management Advisor and Acting Director for The World Bank in Washington DC.

    The Panel is supported by the Chief Executives of Council (James Palmer), HBRIC (Blair O'Keeffe) and the Port (Garth Cowie). Management resources from all three parties are also supporting the review.

    The Terms of Reference for this review as adopted by Council resolution is included as Appendix One.

Report Structure

11. This report is presented in seven parts.

    Part I – Introduction - outlines the need for the report.

    Part II - Executive Summary

    Part III - Current Situation - summarises the current commercial investment portfolio's role in supporting Council's financial and strategic objectives.

    Part IV – Options and Next Steps - to meet Council's income needs and the capital needs of Council, HBRIC and the Port.

    Part V - Investment Policy - will review Council's existing investment policy with recommended changes (to be completed by March 2018).

    Part VI – Investment structure - will consider options for how to organise and manage council investments, including the role of HBRIC (to be completed by March 2018).

    Part VII – Final recommendations (to be completed by March 2018).

Abbreviations

The following abbreviations are used in this Report.

Abbreviation	Meaning
Council	Hawkes Bay Regional Council
HBRIC	Hawkes Bay Regional Investment Company Limited
LGA	The Local Government Act 2002 and its subsequent amendments
Panel	The Review Panel (also known as the *Capital Structure Review Panel*) appointed by Council to produce this report.
The Port	Port of Napier Ltd (trading as Napier Port)
SIPO	Statement of Investment Policy Objectives

PART II - EXECUTIVE SUMMARY

12. Council faces four key challenges which are placing increasing demands on funding.

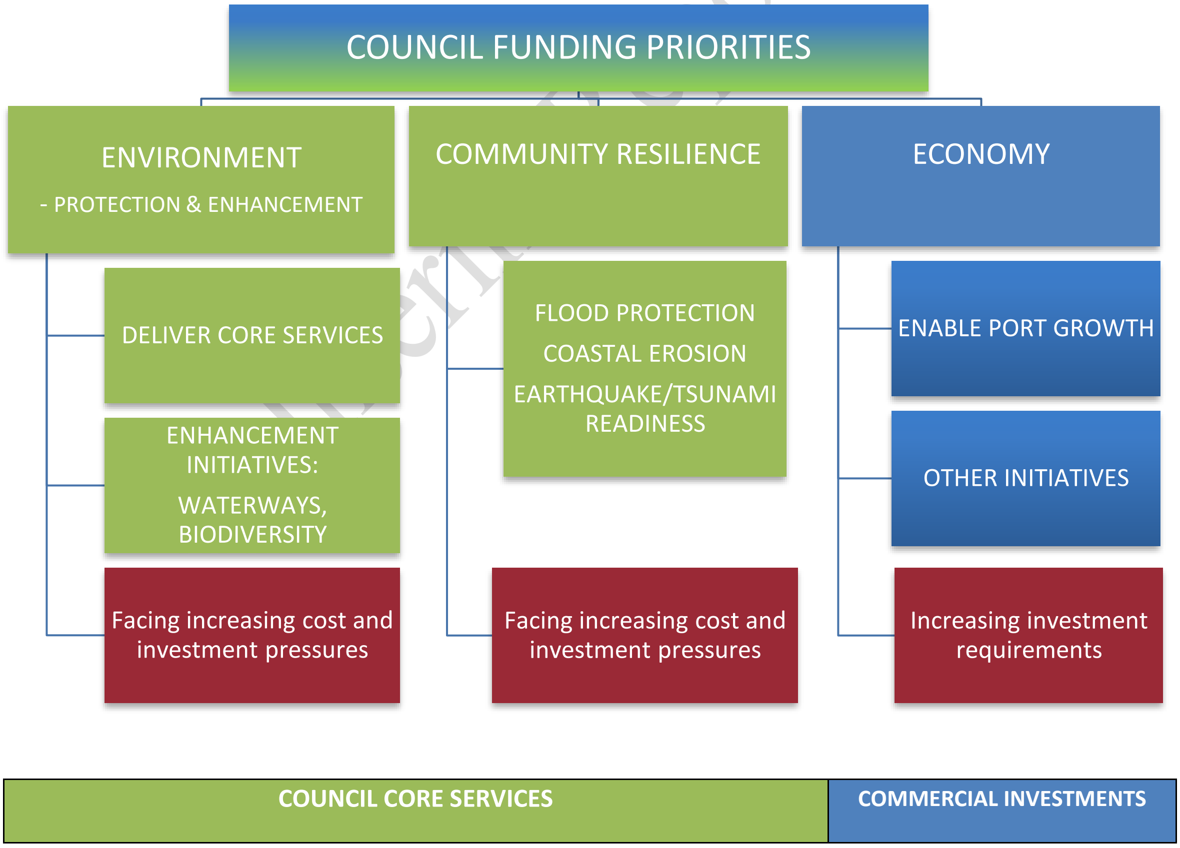
    a) Increasing demand for better protection and inter-generational enhancement of the region's environment.

    b) The need to enhance regional resilience to natural events such as flooding, coastal erosion and earthquakes.

    c) Council's commercial investment portfolio, which contributes heavily to cover the cost of Council core services to ratepayers, needs to work harder to meet growing demands for income and capital.

    d) The requirement for further large-scale infrastructure investment in the Port, placing pressure on the dividends it can pay HBRIC/Council unless it can source more capital. The Port, Council's largest commercial investment, also represents a high concentration of income and capital risk.

    Council needs to find sustainable sources of income and sufficient capital to enhance environmental and community resilience, find solutions to fund the Port's growth, maintain Council income and reduce/diversify Council's commercial investment risk exposure.



13. As Council faces pressure for more expenditure across its portfolio, it is faced with difficult choices:

    a) Can Council deliver its core services more efficiently or reduce service levels?

    b) Should Council increase rates to be more aligned with the true cost of services provided?

    c) Should Council explore new sources of funding to support the Council's priorities, such as borrowing for Council programmes?

14. To date, this review has evaluated a series of options associated with Council's commercial investments with the goal of finding ways to make Council's current investments work harder. The following options have been identified for Council to consider in order to diversify the current commercial investment portfolio and increase income and capital.

    a) invest some of the $60m currently invested in term deposits into higher yield investments.

    b) reduce heavy reliance on, and risk exposure to the Port.

    c) bring in external investment to support the growth of the Port, whilst maintaining Council control of this essential regional asset.

    d) re-invest some Port investment funds for higher cash returns or to fund Council needs.

15. This review considered a series of ways to achieve the Port-related outcomes. These include:

    (1) The Port does not invest, so it can keep paying dividends (do nothing).
    (2) The Port increases its debt levels to fund Port development needs (e.g. bank debt, shareholder loan or issuing a bond).
    (3) The Port increases its prices or introduces a levy on Port users to fund Port development.
    (4) HBRIC/the Port receives dividend relief for a defined period.
    (5) Council invests more capital into HBRIC/the Port.
    (6) Council charges ratepayers a special levy to fund the Port developments.
    (7) Introduce a minority external investment to the Port.
    (8) The Port is listed on the NZX, with the Council retaining majority ownership.
    (9) The Port is leased to another party (with Council/HBRIC maintaining ownership of the Port assets).

All options require deeper consideration, with Council feedback required on its appetite to explore these options and public consultation being required as part of the process.

PART III – Current Situation

Funding challenges

16. Council faces four key challenges which are placing increasing demands on funding.

    a) **Increasing demand for better protection and inter-generational enhancement of the region's environment**

    e.g. aquifer, rivers, lakes, climate change, marine responsibilities, strengthened biodiversity.

    b) **Regional resilience**

    The region faces ongoing pressures to natural events such as flooding, coastal erosion and earthquakes.

    To support (a) and (b) <u>Council needs to find sustainable sources of income and sufficient capital</u>.

    c) **Council's commercial investment portfolio needs to work harder**

    To date, Council has been able to deliver its core services with the support of income generated from commercial investments (Napier Port, cash deposits, other commercial investments). To meet growing demands for income and capital, the commercial investment portfolio needs to work harder as it is currently only producing 3-4% cash returns.

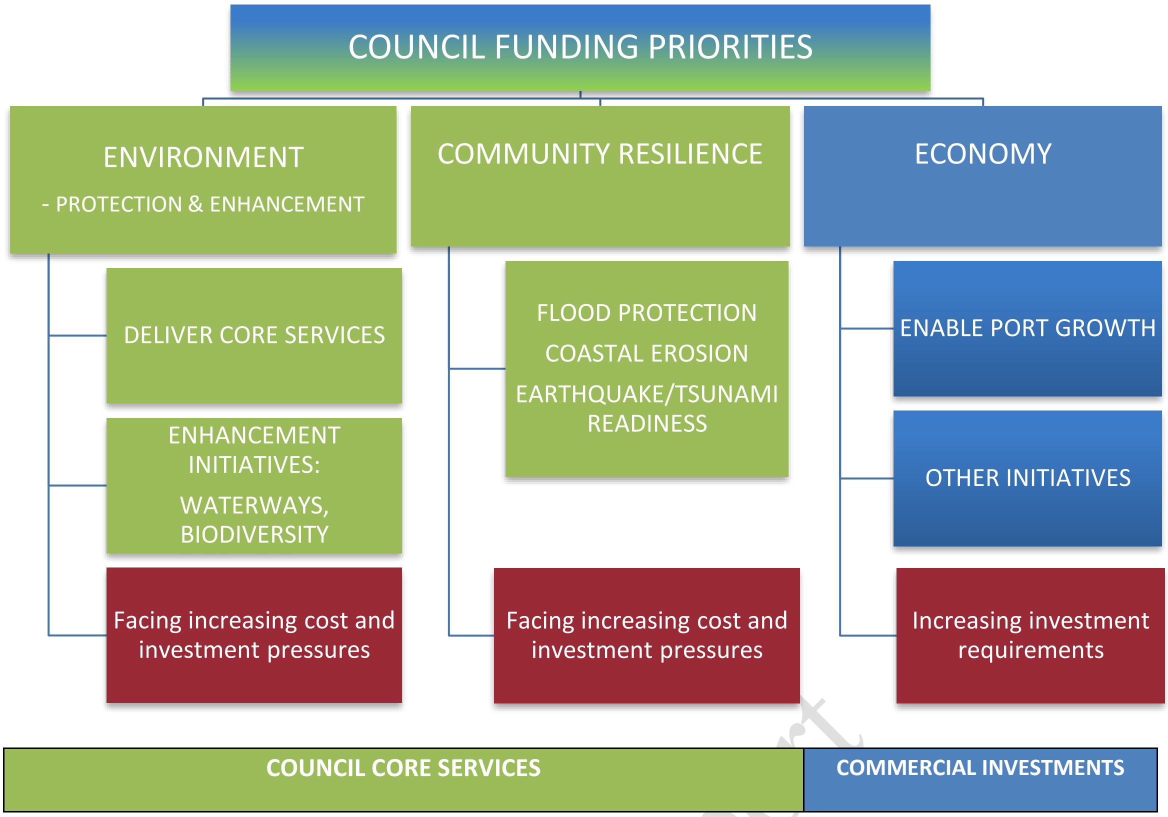
    d) **The Port requires further large-scale infrastructure investment**

    The Port requires further large-scale infrastructure investment to meet the needs of the region's importers and exporters, who, with the Port, underpin the Hawke's Bay economy, placing pressure of the dividends it can pay. This exacerbates the pressure on the overall investment portfolio return identified in c) above.

    The Port already makes up 74% of the Council's commercial investment portfolio representing a high concentration of income and capital risk in one asset. This investment asset is also based in the same location as most of Council's core assets, representing a very high geographic concentration of assets and exposure to region wide natural disaster events.

    <u>How to fund the Port's growth, maintain vital Council income and reduce/diversify Council's commercial investment risk exposure is a key challenge.</u>

In summary, and as represented in the following diagram, Council needs more income and capital to fund increasing demands across its portfolio and it needs to reduce/diversify its commercial investment risk exposure.



17. Cost pressures from statutorily required functions are increasing generally along with Council and public demand for improved environmental outcomes. These include areas such as freshwater and associated land management reforms driven by Central Government, which are placing additional requirements on councils for more scientific monitoring and analysis, greater catchment-based planning effort and support for community collaborative processes, as well as necessitating more resource consents, compliance and legal enforcement.

18. There is also additional work required to control the region's biosecurity risks and pests.

19. Collectively this additional work is likely to cost up to an additional $5m each year after recoveries. Approximately one third of this is needed to cover the legislative requirements listed above, with the remainder required to fund discretionary but desired programmes (such as major afforestation). These programmes are being worked through as part of the LTP process.

20. Council also faces extensive capital commitments, particularly in relation to its various infrastructure assets, which include stop banks, dams, drainage networks, and pump-stations. Collectively, 25 flood control and drainage schemes throughout the region form a large portion of Council's asset base. The purpose of these schemes is to protect communities to agreed levels. Council achieves this through detailed service standards which are based on various legislative requirements.

21. The cost of operating these assets to meet minimum standards is currently around $7.5m per annum, plus additional annual capital requirements of around $2m. These costs are currently majority funded (around 80%) by targeted rates while around 20% of costs are recouped through general funding. Service levels are currently being reviewed to determine if standards should be increased further to ensure additional future proofing, thus increasing cost pressures.

22. The LTP process will also consider further environmental enhancement initiatives.

Funding sources

23. Council's three key sources of funds to address the cost of its core services are:
    - rates and charges.
    - Council borrowing.
    - commercial investment income.

    All three areas present opportunities for change which could help enhance the environment, resilience and prosperity of the region.

24. Currently, the cost of providing core ratepayer services exceeds the income from rates and charges by approximately $14m. This means the users of the services are not paying the true cost of the services provided. To date, Council has been able to deliver its core services with the support of income generated from commercial investments (Napier Port, cash deposits, other commercial investments).

25. However, moving forward Council faces an income gap in funding its LTP, in part resulting from the Ruataniwha Water Storage Scheme not proceeding. The scheme was forecast to produce some of the required additional income to offset the funding shortfall. Increasing cost pressures mean that the shortfall is likely to increase, requiring a combination of increased rates, borrowing, and investment income or programme cuts.

26. The current shortfall has been addressed in the short-term by the Port (through HBRIC) increasing dividends to Council by approximately 25%.

27. The sustainability of this short-term solution depends on the success and demands of the commercial investment portfolio, particularly the Port. As the Port has capital demands of its own the reliability of Port dividends as Council income is being challenged.

28. This Table summarises Council's funding situation for 2017-18:

		$m
Council revenue		**19**
Targeted rates	14.8	
General rates	4.2	
Cost of core services		**33.2**
Net funding requirement		**14.2**
Investment Income		**10.1**
HBRIC/The Port	7.0	
Interest earned	2.1	
Other	1.0	
Underlying funding requirement		**4.1m**
HBRIC/Port interim dividend increases		**3.0m**
Current funding requirement		**1.1m**

29. This table summarises the current leverage applied to Council's core assets.

Debt to equity ratios	Net Assets/Equity $m	Debt $m	Debt to Equity Ratio
Council	**544**	**20**	**4%**
HBRIC	**235**	**5.4**	**2%**
Port	**180**	**86**	**48%**

This table indicates that debt could be used as a source of funds across the Council Group (Council, HBRIC, Port), with a debt to equity ratio of 7% considered an industry average for local government agencies (LGNZ). Analysis has been completed on several other regional Councils specifically, and the majority sit around or below this ratio, with the exception of Greater Wellington Regional Council with debt levels at around 35% of total equity. Local Government is obliged to balance their budget so debt is not used to fund operational expenditure. This ratio may differ for commercial operations.

The current LTP process has established a need for greater leveraging of Council's balance sheet and increased debt levels are expected. It is noted that Council's current policy specifies that the debt to equity ratio does not exceed 28%.

Borrowing for the Port is discussed further later in this Report.

Commercial investment portfolio

30. The current commercial investment portfolio for Council is managed across Council and HBRIC. It includes the following assets.

- Napier Port (HBRIC).
- Term deposits (Council).
- Wellington Commercial Property (Council).
- Forestry investments (Council).

The following analyses use pre-tax numbers unless specifically indicated.

Napier Port

31. Napier Port is the single largest commercial investment in the Council portfolio, representing around 74% of Council's investment funds (as valued in Council's balance sheet). It is owned and managed on behalf of Council by HBRIC.

32. The Port is a catalyst for regional development, with over 27,000 jobs and 51% of Hawkes Bay's Gross Regional Product (GRP) related directly or indirectly to the Port.

33. The Port is primarily an export port, shipping out containers, logs, and other general cargo sourced from the Hawke's Bay hinterland and further afield. For many of the region's exporters the Port represents the lowest cost logistics solution to access international markets.

34. The Port produces modest cash returns to its shareholder with recent dividends around $7m p.a, with the current year increased to $10m. This represents a shareholder return of around 3-4% p.a ($7-10m dividend/$235m shareholder equity). This is broadly comparable to a term deposit, but with much more commercial risk. The Port's ability to produce dividends is limited by the prices it

charges for its services and the capital it needs to re-invest to meet the needs of its customers and maintain its competitive relevance. The Port faces numerous commercial challenges in a highly competitive logistics sector.

35. Although cash returns are modest, the Port's capital value has increased materially with a $58m increase in shareholder value over the last four years.

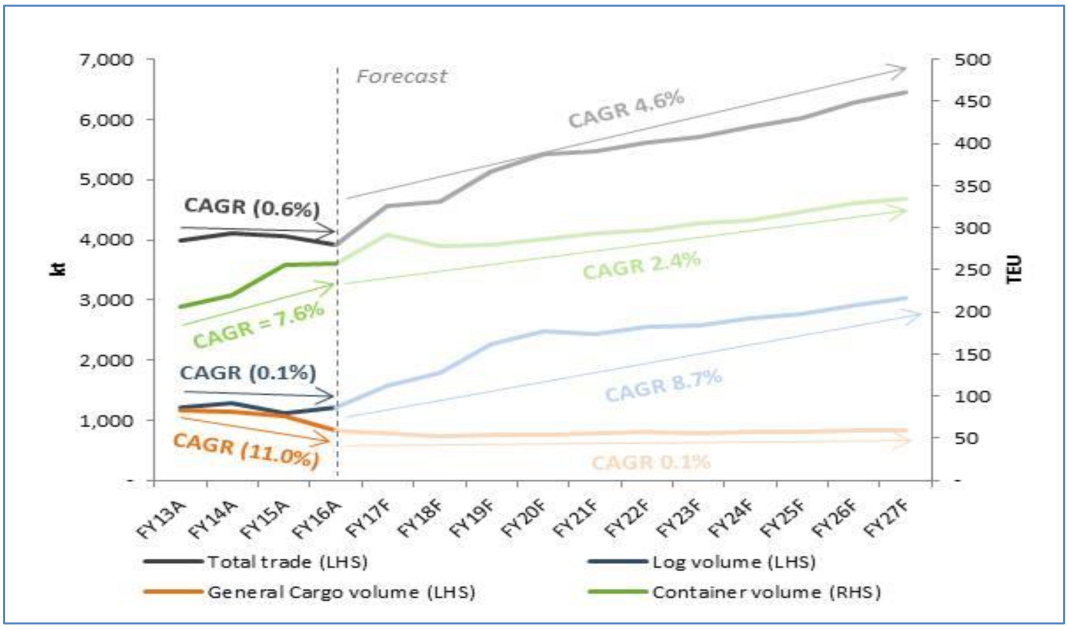
36. The challenge for Council is that the capital gains are of limited value unless it uses the increased capital value to create cash by borrowing more, or by inviting other investors to inject their capital.

37. Napier Port is facing large demands of its own:

    a) The Port is forecast to experience overall trade growth of almost 5% per annum over the next decade, with a projected 49% increase in cargo, wood volumes to double by 2020, 31% growth in containerised cargo by 2026, and 84% growth in bulk cargo.

    b) Cruise shipping is projected to increase by 33% by 2026 as well as growth in vessel size.

    The following graph shows the Port trade forecasts:



CAGR = Compound Annual Growth Rate. Table will be refreshed in final Report.

Forecast capital requirements and debt headroom

38. The Port has made $95m of capital investment over the last five years, principally to cater for peak season container cargos. In addition, the estimated capital spend for 2017 is around $21m.

39. This has resulted in increased borrowing by the Port, with its debt now approximately $86m.

40. Capital expenditure requirements over the next decade are heavy (average $28m p.a.), up on historical spend levels.

41. To meet capacity requirements, maintain strategic relevance of the Port, cater for larger container vessels, and reduce the risk of shipping line service bypass, the Port has identified the need to develop a new 350m wharf, berth, with associated dredging (this is referred to as the Wharf 6 Development and is Wave 1 of major strategic investment for the Port over the next 10 years). Initial cost estimates for Wave 1 are approximately $125m which is forecast to commence in the next five years.

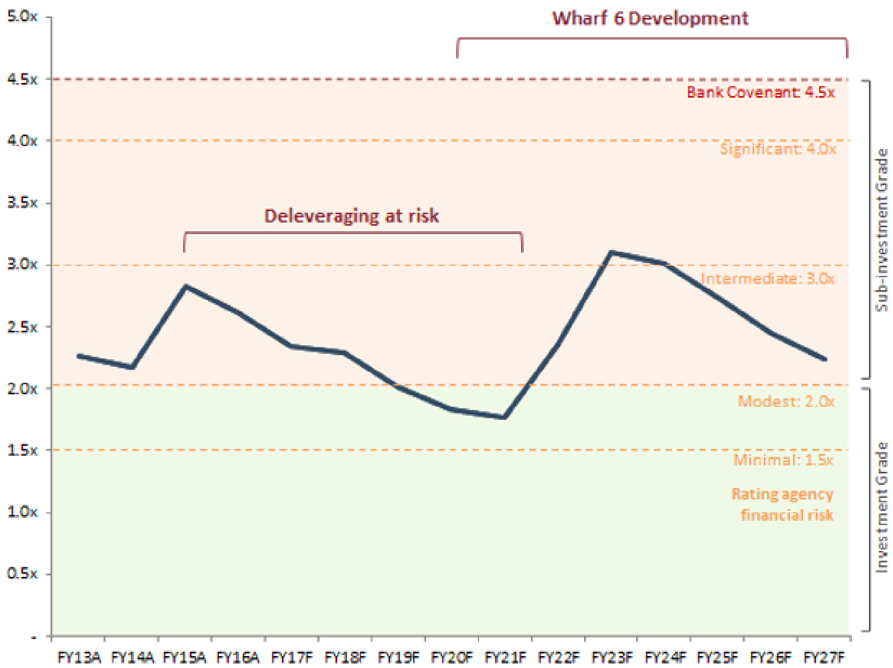
42. Wave 2 investment includes further dredging and upgrades to landside equipment and infrastructure (e.g. gantry cranes, straddle carriers), which requires an additional up to $150m. This investment is forecast to commence in the next 5-10 years.

43. Given the investment required under the Port's strategic plan, the Port's debt levels are forecast to increase significantly. The ability to repay loans is dependent on delivery of trade volume growth, the introduction of new pricing tariffs and the ability to retain earnings currently paid out to its shareholder as dividends.

44. To prudently manage its finances in the lead up to the required investments, the Port needs to plan for paying down current debt and/or finding a new source of capital.

The below chart illustrates the Port Net Debt / EBITDA profile over the Wharf 6 development capex cycle.

<u>PORT Net Debt / EBITDA</u>



45. The table shows unless it lowers its debt prior to Wave 1, the Port would be a sub-investment grade asset, with an "intermediate" risk of financial default. Any increase in the cost of investment, reduction in income or economic shocks could have the potential to put banking covenants at risk. The Review Panel considers that as a Council owned asset of significant economic relevance to the region, it is appropriate for the Port to target leverage consistent with an investment grade rating - i.e. to target a modest financial profile of Net Debt <2x EBITDA across the capital investment cycle.

46. Assuming the $125m Wave 1 Wharf 6 investment and achievement of financial forecasts (pricing and volume), this leverage target would require $40m to be funded by Port borrowings, leaving a need to source another $85m of capital/equity. Should the wave 1 capital cost exceed $125m, further equity would be required, to meet the additional capital cost.

47. Accordingly, the Port Board has formed the view that it is not financially prudent to fund the Port's strategic plan with debt alone, and is exploring options to inject additional equity into the Port.

48. With up to $275m potentially required to fund wharf development and equipment upgrades over the next 10 years, it is considered unlikely that HBRIC or Council can support this level of investment without the Port retaining most of its earnings and significantly reducing dividends, or increasing its borrowing to unacceptable levels.

Term deposits

49. Council currently has $60m of cash in term deposits. These funds were set aside for investment in the Ruataniwha Water Storage Scheme. Following ongoing delays, the Council has decided to withdraw investment support from the scheme and allocate the funds to other investments.

50. Whilst invested in term deposits the $60m is delivering low, but safe returns, and is readily available if needed. These funds could be put to work to generate more value.

Commercial Property

51. Council owns $15m of commercial property in Wellington. These assets provide good cash returns (5.4%) and provide the Council with investment diversification outside Hawke's Bay, albeit in another New Zealand location with identified seismic risk.

Forestry

52. Council also owns 531 ha of commercial forests around Hawke's Bay, valued at $5.4m.

Comparison of Returns

53. The following table compares returns across Council's investment portfolio:

Commercial Investment assets	Current investment value $m	% of Council Commercial Investment funds allocated	Annual cash return %	Annual Cash return $m	Capital gains last 4 years $m	Increase of Capital gains last 4 years %
Napier Port (current valuation)	235	74	3.0	7-10	58	33%
Term deposits	60	19	3.5	2.1	0	0
Commercial property – Wellington	15.6	5	5.4	0.8	4.2	37%
Forestry	5.4	2	4.0	0.2	2.8	108%
TOTAL	**316**	**100**		**10.1-13.1**	**65**	
Net Funding Requirement (net of rate income)				**14.2**		
Underlying Funding Requirement				**1.1-4.1**		

Risk

54. The substantial portion of Council's core services assets and commercial investments currently reside in Hawke's Bay and most of Council's commercial investment eggs are in one basket, the Port. Representing 74% of Council's commercial investment portfolio, this presents a highly concentrated geographic risk and exposure to a region wide natural disaster event.

    The 2012 Christchurch and 2016 Kaikoura earthquakes with resulting damage to Lyttelton Port and CentrePort (Wellington) have highlighted the risk involved with ownership in Port assets.

55. If Council's core services are compromised by a natural event, it is likely that the Port will be also be negatively affected. This means that it is possible that the commercial investment portfolio will create a drag on Council's finances at the same time it needs income to support recoveries across its core services assets.

56. The Port risk is insured to support any required rebuild, however insurance costs and deductibles have increased considerably. For a short period during the current financial year, the insurance market was not prepared to provide full cover of the Port's value. The insurance does not cover loss of dividend to Council, leaving it with a material income risk. As noted earlier, the Port represents a large percentage of Council income.

57. In addition to the risk of natural events, the Port is a dynamic commercial asset operating in a competitive, capital intensive and changeable market. It is a capital hungry investment which delivers modest cash returns (3-4% per annum) which are under increasing pressure. Capital gains are good, but without releasing capital from the investment, Council's capital risk concentration continues to increase as the Port grows.

58. The converse of the risk associated with the Port is the large amount of Council capital invested in term deposits, which are earning a low return. This review will consider options to rebalance the commercial investment portfolio risk profile.

Key areas of focus identified for this review

59. This review will provide recommendations on how the Council could organise its commercial investment and debt funded capital to support the Long-Term Plan. This review, therefore, is focused on:

    A. Council's commercial investment income needs

    - how to generate increased income and capital from the current commercial investment portfolio to support the delivery of Council's objectives.

    B. Council's risk exposure to its commercial investments

    - exploring options to diversify the commercial investment portfolio to achieve greater returns across a wider range of investments with a reduced geographic and sector risk profile.

    C. Port capital requirements

    - The Port is a vital regional asset which the Council wishes to maintain control over and see prosper for the benefit of the region.
    - This review will consider options to fund the Port's short and long-term capital requirements, whilst maintaining Council control of the asset.

D. Council borrowing

- Identify opportunities for Council to leverage its capital base more by prudently borrowing to fund Council initiatives.

E. Council investment Policy

- This review will consider if Council's current investment policy is fit for purpose and provides clear guidance on how to manage its commercial investments. The current Council investment policy has not been reviewed for some time, so it is timely to address this as part of the Capital review.
- Key policy questions to be considered include:
  - i. Investing for social/economic/environmental vs financial returns?
  - ii. Investing for income vs capital gains?.
  - iii. Preferred investment categories/types?
  - iv. Where to invest (local vs not local)?

F. How to manage the investment portfolio

- Council's investment assets are currently spread across Council and HBRIC's balance sheets. This review will consider options to shape the way commercial investments are organised and managed, including the future role of HBRIC.

Items A-C are covered in this interim report, with Items D- F to be covered in the final report in March 2018

PART IV - Options Analysis and Next Steps

60. To support the development of options, a benchmarking report was commissioned to provide an indication of the level of returns that could be expected from a commercial investment portfolio. The benchmarking report, undertaken by PwC (see Appendix Three), provides an overview of returns for core infrastructure and property investments in Hawke's Bay, nationally and internationally. It also includes benchmarking against listed companies in NZ and overseas.

61. This provides a benchmark for the minimum level of returns that might be expected if Council were to re-organise its portfolio of commercial investments. The PwC research indicates total shareholder returns (income + capital gains) ranging from 6- 24% are being achieved across a range of infrastructure and property assets across NZ and International markets. Cash returns (i.e annual income) ranges from 3.9-6.8%.

62. Using a conservative benchmark, this report has applied the assumption that any funds released from the current commercial investment portfolio and reinvested elsewhere could reasonably be expected to achieve a 5% (pre-tax) cash return on investment (i.e. more than the current term deposits and Port investments).

63. As capital gains are less reliable in terms of how and when they can be converted to cash, this report notes that capital gains are achievable, but has only accounted for cash returns to support the assessment of options which support Council's annual income requirements.

64. It is noted that with proper planning the option to sell down (parts of) the commercial investment portfolio to free up cash remains an option that could produce further gains.

65. By way of example, if the current investments in term deposits ($60m) and the Port ($235m) were converted from 3-4% investments to 5% investments, this could create up to an additional $6m in annual income. This would address the current Council shortfall and provide surplus funds for Council priorities or re-investment. The following Table illustrates the increased returns:

	Investment $m	**Current annual income $m**	**If re-invested @ 5% $m**	**Difference $m**
Term deposit	60	2.3 (~3.5%)	3.0	0.7
Port	235	7-10 (~3-4%)	11.8	1.8-4.8
TOTAL	**295**	**9-12.3**	**14.8**	**2.5-5.8**

66. Each existing commercial investment asset has been evaluated.

Investment	Meets 5% return benchmark	Potential for capital gains	Liquidity (Ability to convert to cash quickly)	Option
Forestry $5.4m	**No** **4.0%** **Varies with harvest**	**Yes** **108% ($2.8m) last 4 years** But volatile with downside risk	Low	Re-evaluate over time Small holding
Wellington commercial property $15.6m	**Yes** **5.4%**	**Yes** **37% ($4.3m) last 4 years** Modest	Medium	Re-evaluate over time Provides solid cash returns, capital gains and geographic diversity
Term deposit $60m	**No** **3.5%**	**No**	High	Reconsider investing differently Large quantum earning low returns
Port $235m	**No** **3-4%**	**Yes** **33% ($58m) last 4 years**	Low	Reconsider investing differently Large quantum earning low cash returns + high single concentration of risk

67. Due to materiality, this review has elected to focus the options analysis on:

- the term deposit
- the Port

as both of them currently do not meet the 5% cash returns benchmark yet represent 93% of the current investment portfolio by value.

Opportunities to re-organise the commercial investment portfolio

68. There are two key opportunities available, which are not mutually exclusive:

    a) Reinvest all/part of the term deposit in higher yielding investments.

    b) Re-organise the funding arrangements for the Port to support Council and Port objectives.

Reinvest all/part of the term deposit

69. Opportunity a) is a simple option to execute. Council simply needs to choose to re-invest some or all the $60m funds currently in term deposits into higher yielding investments.

70. As outlined above, a re-alignment from 3.5% cash returns to 5%+ returns will generate good annual income gains. As liquidity (quick access to funds) may be required, it is recommended that Council evaluate as part of its investment policy, a minimum quantum of investments to be held in cash or short term loans to meet short term (1-2 year) needs. Once this minimum amount is established the balance of the funds can be put to better use, in a low-medium risk investment earning better returns. The final version of this report will include a recommendation for the minimum cash holdings/short term debt.

Re-organise the funding arrangements for the Port

71. There are numerous options to re-arrange the funding arrangements for the Port. To support this stream of work the Port has commissioned Flagstaff Partners from Australia to develop funding solutions to support the Port's growth requirements and meet the needs of its shareholder. These options have been combined with options identified by the Capital Structure Review Panel and are discussed below.

    See Appendix Four for a profile of Flagstaff Partners.

Rearranged Port Funding Options

72. Each option is explained further below in terms of its core attributes.

    1) The Port does not invest, so it can keep paying dividends (do nothing)

    - This 'do nothing' option involves the Port continuing to pay dividends of up to $10m p.a., with insufficient limited retained earnings to fund Wave 1 capital development needs.
    - The decision to invest in a new wharf and dredging are deferred for the foreseeable future. If the Port grows as planned, it will become short of on-port space, with the risk of increased costs of operations and reduced service levels. The Port would also not be able to receive larger ships if there is a change in the size of ships calling at New Zealand ports.
    - Although not guaranteed, this option could result in reduced dividends over time if the Port's and Hawkes Bay's relevance in the New Zealand supply chain diminishes.

    2) The Port increases its debt levels to fund Port development needs (e.g. bank debt, shareholder loan or issuing a bond)

    - This would involve the Port borrowing up to $125m to fund major development needs. $40m of this debt is considered within prudent levels of borrowing as outlined in para 47. Borrowing $85m would be above the level considered prudent, with the Port having very high levels of debt and considered a sub investment grade asset.

- Interest costs would reduce Port profits and the dividend it is able to pay.
- Borrowing could take the form of a bank loan or a shareholder loan.
- A bond issue is another form of loan. A bond would have the same effect on the Port's financial position, and usually has a higher interest cost.
- The Port, HBRIC and Council have expressed concern about this option.

3) The Port increases its prices or introduces a levy on Port users to fund Port development

- Under this scenario, the Port would apply a special price or levy over (for example) a five/ten year period, to pay for the cost of the Port capital and any interest charges it may incur.
- This option would be a pure user pays solution but doesn't quantify the commercial risks of such an approach.
- This option presents the Port with the ability to source funds and for Council/HBRIC to maintain full ownership control of the Port.

4) HBRIC/the Port receives dividend relief for a defined period

- Under this scenario the Council would grant HBRIC/the Port a dividend holiday until the Port could retain sufficient earnings to fund its development needs. This option would meet the Port's needs but create a hole of around $10m p.a. in Council's current income. Very quickly, this would either eat into Council's cash reserves, require major cost and service cutting or large increases in rates.
- Council has informally indicated that this option is not viable.

5) Council invests more capital into HBRIC/Port

- Further Council investment in the Port would substantially increase the Council's risk concentration in this asset, which already dominates the Council's commercial investment portfolio, producing modest cash returns.
- Under this scenario Council would invest a further $85m of equity into the Port (via HBRIC), with the Port borrowing the remaining $40m required for the upcoming major developments.
- Council could either borrow the $85m required (by bank loan or issuing a Council community bond for example), or invest its $60m of cash reserves and either borrow the balance or sell other commercial investments.
- Borrowing the full $85m would increase Council's costs by around $3m per annum. Using cash reserves and selling other assets would reduce Council income by $3m+. These values would decline over time as the Port investment produces a payback. However, the Port investments are 25+ year investments.

6) Council charges ratepayers a special levy to fund the Port developments

- Under this scenario, Council would apply a special rate over a ten year period (for example), to pay for the cost of the Port capital and any interest charges it may occur if the Council borrows up front to fund the development.
- This would result in an additional cost to each ratepayer of circa $1,700 over 10 years. ($85m+ c.$35m interest costs spread over 70,344 ratepayers). This represents an approximately 63% average rates increase each year.
- This option presents the Council with the ability to source funds and maintain full ownership control of the Port.

7) Introduce a minority external investment to the Port

- Under this scenario, Council/HBRIC invites another investor to buy shares in the Port. This could range from 25% to 49% of the shares.

- Council via HBRIC remains the majority owner of the Port, with effective control.
- Dividends would reduce in proportion to the percentage sold.
- Flagstaff estimates that this option could fund the Port's $85m capital requirements and release up to $50m+ for Council to re-invest elsewhere or allocate to Council requirements.
- Council's risk profile is improved significantly through diversification of the commercial investment portfolio if proceeds are reinvested elsewhere.

8) The Port is listed on the NZX, with the Council retaining majority ownership

- Under this scenario, the Port issues new shares and HBRIC/Council partially sells down shares to facilitate a listing on the NZX. Council (via HBRIC) retains 51-75% of the shares.
- Council (via HBRIC) remains the majority owner of the Port, with effective control, however is subject to the disciplines of the stock exchange.
- Dividends would reduce in proportion to the percentage sold.
- The option enables public investment.
- Flagstaff estimates that this option could fund the Port's $85m capital requirements and release further upside to option (6) for the Council to re-invest elsewhere or allocate to Council requirements.
- There is a question about whether the size of the market listing would be material enough to promote ongoing trading of shares, which may support the share price over time.

9) The Port is leased to another party (with Council/HBRIC maintaining ownership of the Port assets)

- Under this scenario, the Port is leased to another party for a period of 30-50 years with HBRIC/Council retaining ownership of the Port infrastructure, and a third party taking over the day to day operations of the Port. Full port operations control reverts back to HBRIC/Council at the end of the lease.
- This is a model that has been adopted at several ports in Australia, with significant value gains realised by local Government owners.
- Council can retain important control rights through the lease including pricing controls, service standards and investment requirements.
- Flagstaff estimate that this option could fund the Port's capital requirements and release the most capital of all the options, with Council via HBRIC maintaining base ownership of the Port assets and good control rights. Stringent monitoring arrangements would be required. The more demanding the control rights, the lower the price expectation.
- Council's risk profile is improved significantly through diversification of the commercial investment portfolio if proceeds are reinvested elsewhere.
- There are numerous variants that can be applied to this model including Council retaining some ownership in the operating company and upfront vs ongoing payments.

Option Evaluation

73. In the following Table, each option has been evaluated against the following assessment criteria:

- Are Council funding needs addressed?
    - Additional income generated.
    - Capital released for reinvestment or Council priorities.
- Does the option support Council's LTP strategic plans for the regional economy and environment?
- Are Port funding needs addressed?
    - Supports next wave of investment.
    - Provides a sustainable business model for long term growth.
    - Maintains Hawke's Bay access to international markets.
    - Council ability to maintain sufficient control of the asset.
- What is the impact on the commercial investment portfolio risk profile?

Option	Provides council income	Provides council with capital	Funds Port develop.	Supports long term Port growth	Supports Council Strategy/LTP	Council ability to maintain control	Impact on portfolio risk profile	Comments
1. The Port delays investment, so it can keep paying dividends	Status quo, may reduce over time	No	No	No	No	Yes	Increased risk	Is Council prepared to put Port growth at risk?
2. The Port increases its debt levels to fund Port development needs (e.g. bank debt, shareholder loan, or issuing a bond)	Interest costs reduce Port profits and dividends in short-medium term	No	Yes	No	No	Yes	High risk Port outside acceptable debt levels	
3. The Port charges its users a special price or levy	Status quo	No	Yes	Yes	Yes	Yes	Unchanged and still high exposure	Addresses port capital needs but not Council risk expsoure
4. Council provides dividend relief to the Port for a defined period	No Major loss of income	No	Yes	Yes	No	Yes	Council faces annual losses and large rates increases	Creates major income issue for Council
5. Council invests more capital into the Port	Loss of income for short-medium as council loses investment income or incurs interest costs + reduced Port returns	No Reduces Council capital for other items	Yes	Yes	No	Yes	Increases Council risk exposure to one asset	
6. Council charges ratepayers a special levy to fund the Port developments	Yes	No	Yes	Yes	No	Yes		Impact on ratepayers a key consideration

7. Minority share in the Port sold to another investor	Neutral if released funds re-invested (Lose 25% of dividends, gain back if re-invested)	Yes Approx ~$50m+	Yes	Yes	Yes	Yes	Reduces risk exposure	
8. The Port is listed on the NZX, with HBRIC/Council retaining majority ownership	Higher price frees up more funds to invest at higher returns Approx + ~$2m p.a	Potentially – subject to price Approx ~$50m++	Yes	Yes	Yes	Yes	Initially reduced, However, value subject to share market movements	
9. The Port is leased to another party (with HBRIC/Coucil maintaining ownership of the Port assets)	Yes Options reinvest at higher levels Approx + ~$5-15m	Yes, if upfront lease payment Approx ~$50m+++	Yes	Yes	Yes	Largely, but through contractual agreement with leasee	Heavily reduced exposure to Port	Does the Council need to be the operator of the Port?

Summary of key challenges and choices

74. As Council faces pressure for more investment across its core services it is faced with difficult choices:

    a) Can the Council deliver its core services more efficiently or reduce service levels?

    b) Should the Council increase rates to be more aligned with the true cost of services provided?

    c) Should Council explore new sources of capital to support the Council's priorities, such as borrowing for Council programmes?

    Items (a) and (b) are not considered within the scope of this review, but are noted for Council consideration as part of the upcoming LTP process.

    Options to support item (c) will be explored in the final report due in March 2018.

75. With regards to the commercial investment portfolio:

    Council's income requirements from its commercial investments establish an important financial objective for the commercial investment portfolio. By way of example:

    - if Council's income needs from the commercial investment portfolio reduce, less change to the current commercial investment portfolio will be required.
    - if the income needs from the commercial investment portfolio increase, a more assertive approach to the current portfolio and its returns will be required.
    - if both rates/user pays recoveries increase and commercial investment returns increase, more funds are freed up to deliver more core services and enhancement initiatives to the region.

76. Key commercial investment choices emerging for the Council are:

    a) Will Council support the commercial investment portfolio being re-organised to deliver more income or capital to reduce pressure on rates, fund initiatives and reduce its risk profile?

    Specifically, with regards to the Port:

    b) Should Council 'do nothing' to support Port growth investment? Is Council prepared to take the risk that the regional economy could suffer if the Port cannot meet growth demands?

    c) Should HBRIC/Council support the Port to borrow at levels considered imprudent?

    d) Will Council accept reduced dividends from HBRIC/the Port to fund the Port's investment requirements? This would result in the Council making losses each year unless it increases rates significantly. Is Council prepared to consider such rates increases? The requirement imposed by s100 of the Local Government Act 2002 is that "A local authority must ensure that each year's projected operating revenues are set at a level sufficient to meet that year's projected operating expenses".

    e) Should Council invest more capital into HBRIC/the Port? This will increase the Council's risk exposure to one large commercial asset, use up all available funds that could otherwise be deployed into higher yielding investments or core services programmes and lower Council's already modest 3-4% cash returns from the Port in the short-medium term.

f) Contemplate the introduction of a new structure for the Port which could support the delivery of core Council services and new initiatives (through increased commercial investment income or capital released) at the same time as supporting the growth of the Port utilising third party capital.

g) Should Council source third party investment into the Port, whilst maintaining control of this essential regional asset?

Next steps

77. It is recommended that Council review this interim report and provide feedback on their preferences, noting that the final report is due February 2018.

Appendix One – Review Panel Terms of Reference

Capital Structure Review Panel

Terms of Reference

Proposed Scope Framework (per Council Recommendations)

A. Setting the Scene

a) A summary list of Council's commercial investments and activities – incorporation of any material information arising from the Council's own review of the RWSS.

b) A synopsis of the investment and activities contribution to the Council's purpose and strategy – in particular contributions to environmental and economic prosperity and resilience.

c) Commentary on the risks and opportunities associated with the Council's investments and activities.

d) Clarification on the role and control of HBRIC and its wider role as the manager of HBRC's regional economic development-focussed investments.

B. Establishing Requirements

a) Commentary on the strategy and purpose of the Council and how this is and/or could be framed in a conceptual sense to enable adequate integration between the Council, its strategy and the implementation of that strategy by wholly owned entities such as HBRIC Ltd and ultimately subsidiary or associate companies including ensuring that investments fit the Council purpose.

b) Commentary on the balance between building balance sheet and triple bottom line value versus delivering yield / Commentary on the balance between financial returns and wider benefits of investments to the environment and economy including foregoing financial returns. Observations of any potential impacts on taxation to be acknowledged.

c) Commentary on appropriate and differing levels of return on equity (RoE) for long run infrastructure assets (e.g. HBRIC Ltd has asked Council to re-consider its requirement for HBRIC Ltd to increase distributions to provide a guaranteed 6% on its investment in the RWSS).

d) Commentary on the skills and competencies required to govern and manage those investments and activities.

e) Consideration of how HBRC's overall strategy supports the Regional Economic Development Strategy, "Matariki".

C. Future Scenarios

a) Commentary on future possible commercial investment activities and or expansion.

b) The Port – broad assessment of financing options for additional infrastructure, risks to the investment and options for risk mitigation including alliances.

c) Examination of the arguments for and against retaining ownership of Napier Port in HBRIC Ltd or moving to direct ownership by Council, with such arguments to include but not be limited to tax considerations.

d) Recommendations from review are to inform (but not direct) the 2018-2028 Long Term Plan.

Hawke's Bay Regional Council

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Appendix Two – Overview of parties to this report

Council

Purpose and role

78. Hawke's Bay Regional Council's (Council's) current Strategic Plan states that the organisation's purpose is to 'work with our community to protect and manage the region's precious taonga of rivers, lakes, soils, air coast and biodiversity for health, wellbeing and connectivity'.

79. Council's values are working in partnership and collaboration, holding itself accountable, reporting transparently and striving for a standard of excellence. It plans to achieve this through inspiring, collaborating, identifying and prioritising core business. Council plans to monitor, learn and adapt, and to innovate through technology. Finally, Council also plans to invest, specifically to drive environmentally sound and sustainable regional growth to leverage Hawkes Bay's comparative advantages and values.

Statutory Responsibilities

80. The Resource Management Act (1991) requires that Council establishes, implements and reviews objectives, policies, and methods to achieve integrated management of the natural and physical resources of the region. Council must control the use of its regions land for:

    - Soil conservation
    - Maintenance and enhancement of water quality and ecosystems
    - Maintenance of water quantity
    - Avoidance or mitigation of natural hazards
    - Prevention or mitigation of adverse effects from hazardous substances

81. Council is also governed by statute in other resource management areas such as the coastal marine space, maintenance of indigenous biodiversity, strategic integration of infrastructure with land use and the control of discharges of contaminants to air, land and water.

82. The Local Government Act (2002) requires that local Government meet the current and future needs of communities for good-quality local infrastructure, local public services, and performance of regulatory functions in a way that is most cost-effective for households and businesses. Services must be efficient, effective, and appropriate to present and anticipated future circumstances. The principles of this Act are vast and include that Council should ensure prudent stewardship and the efficient and effective use of its resources in the interests of its district or region, including planning effectively for the future management of its assets. In taking a sustainable development approach, Council should take into account:

    - the social, economic, and cultural interest of people and communities
    - the need to maintain and enhance the quality of the environment
    - the reasonable foreseeable needs of future generations

83. In addition to the above, the Act dictates that any commercial transactions Council makes are to be in accordance with sound business practices. It should periodically assess the expected returns from investing in and undertaking such commercial activities and satisfy itself that the expected returns are likely to outweigh the risks inherent in the investment or activity.

HBRIC Ltd

Purpose and role

84. In 2009 Council reviewed its mix of its investments, which largely reflected the assets transferred to Council at the time of Local Government reform in 1989. Council decided to pursue a more active investment policy to improve financial and economic returns from its investment portfolio. HBRIC was established as a council-controlled trading organisation (CCTO) on 1 February 2012 to manage existing corporate investment of its shareholding in the Port and new investments made in companies in the future.

85. The initial brief for HBRIC was to target potential investments in water (storage), land (improved land use/technology), infrastructure (commercial property) and logistics (Napier Port).

86. HBRIC's mission is to optimise the financial and strategic returns to Council from its allocated investment portfolio to assist Council achieve its vision of "a region with a vibrant community, a prosperous economy, a clean and healthy environment, now and for future generations". Today, HBRIC's core role is to become the leader of regional investment for Hawkes Bay by:

- managing and developing a portfolio of Hawkes Bay regional assets to create increased ROI (income & capital) for HBRIC's shareholders over the medium to long term
- spreading investment risk for Council
- creating a vehicle to source capital from third parties for investment
- being environmentally and socially responsible with its investment activities

87. Key objectives which feature in HBRIC's 20176/18 Statement of Intent include - to:

- actively manage its allocated investment portfolio and any new investments it makes, including its shareholding in the Port of Napier Limited (Napier Port), to ensure:
  - growth of shareholder value
  - increased financial and strategic returns
  - investments are secure and sustainable over the long term
- assist Council, in certain major investments such as the RWSS, to achieve key environmental objectives of the Council's strategy
- identify on behalf of Council, and in conjunction with relevant parties, present and future regional infrastructural needs, and to support the establishment and maintenance of resilient infrastructure in the Hawkes Bay region that has the potential to enhance the economic well-being of the region, and provide an adequate return
- build the financial strength of HBRIC through appropriately directed commercial investment (not constrained to infrastructure), in a manner consistent with the approach set out in the Acquisition/Divestment policy (s 10) and through efficient financial practices

88. In order to balance these objectives, HBRIC may, in appropriate circumstances, recommend to Council that HBRIC accepts a lower return or slower route to profitability. In addition, HBRIC's SOI states that it will:

- own and manage the investment assets and liabilities transferred to it by Council from time to time
- encourage and facilitate subsidiary and associated companies to increase shareholder value and regional prosperity through growth, investment and dividend payments
- make new investments and dispose of current investments in pursuit of its objectives in accordance with its Acquisition/Divestment Policy
- advise Council on strategic issues relating to its investments including, but not limited to, ownership structures, capital structures and rates of return

- perform financial, custodial and other functions required by Council which may include:
  - grouping together Council's ownership of its subsidiary companies
  - separation of the subsidiary companies from the ordinary operations of Council
  - smoothing the cash flows to Council from its subsidiary companies
  - enabling diversification of the Region's income streams for the benefit of ratepayers
  - enhancing Council's capability to manage an active investment policy
- invest in, and manage, a range of financial and physical assets in accordance with Council's Investment Policy detailed in its Long Term Plan (LTP) 2015-2025
- raise funds for investment and/or working capital by issuing bonds, mortgages, preference shares and other debt instruments (with the approval of Council for any sum greater than 5% of the value of HBRIC) or by reducing its holdings in equity investments in its subsidiary or associated companies
- comply with the LGA provisions requiring a special consultative process, and with Council policies, in regard to any disposal or part-disposal of shares in any Strategic Asset, for example by way of part sales of shares in Napier Port

Activity to date

89. The primary investment activity of HBRIC since its inception has been:
    - to monitor Port and source dividends to pass through to Council
    - to promote and develop the RWSS on behalf of Council

    The size and scale of RWSS has absorbed all HBRIC's focus with limited other investment activity pursued. As a result, HBRIC has not achieved the wider objects of its Statement of Intent to date.

Port

90. Council beneficially owns 100% of the shares in Napier Port through HBRIC. Council's stated strategic objective is for HBRIC to continue to beneficially hold the shares of Napier Port as a key means of assisting economic development of the region. The investment is expected (via dividends) to be a significant source of non-rate revenue for Council and has long-term prospects of growth and development.
91. In further developing its investment strategy, including the potential to fund investment in a Ngaruroro Water Storage Scheme, HBRIC will evaluate the risks and benefits of continuing to own 100% of Napier Port and will report to Council on this evaluation. HBRIC and Council will be bound by the provisions of the Port Companies Act 1988 in respect of the shareholding in Napier Port.

RWSS

92. The RWSS proposal is for a 93 million m^3 storage reservoir in the upper Makaroro river; part of a wider programme to better manage water resources in the Tukituki Catchment as part of a long-term, sustainable water supply solution for Central Hawkes Bay.
93. The RWSS was put forward as a transformational project aimed at delivering multiple objectives which align with HBRIC's SOI - including growth of the regional economy, and environmental and financial benefits. The wide-ranging objectives for the RWSS have been the source of much debate, with multiple views held within Council and the community about the economic, environmental and financial benefits and the relative importance of each in the business case.
94. The project was required to produce superior returns from day one, while delivering strong immediate environmental benefits and clear evidence of increased jobs within the region, while respecting the shareholder's limited appetite for risk.

95. Alongside a complicated land matter, which ultimately suspended progress on the RWSS, the mixed objectives for the investment have made it difficult to meet all the investment objectives, especially given that the project is ratepayer funded, which brings additional sensitivity around its application.

96. In late 2017 the Council decided to step away from the RWSS investment and to sell the rights to the RWSS to a third party. A reserve fund tagged to the RWSS will be allocated to other investments or Council priorities. In addition, a write-down of the funds invested in the RWSS to date has been incurred within the balance sheets of Council and HBRIC. The recoverable value from the RWSS investment may be influenced by the recent change of government, which may alter the policy settings for irrigation and environment. Council can no longer rely on the projected revenue from this source.

97. The RWSS has demonstrated that the intersection between local Government leadership, public opinion and the commercial operating environment is complex and often contains competing or contradictory objectives.

98. The pending review of how to address the capital needs of Napier Port may need to consider the risk of similar challenges. This highlights the challenges of managing/developing local investments and the need for a very clear mandate for commercial and 'social' investment activity as an output from this review.

Current Financial Position

Income statement (Y/E June 30, 2017)

	2017 Group (IHBRIC + Napier Port) $m	2017 Parent (HBRIC) $m	2016 Group (IHBRIC + Napier Port) $m	2016 Parent (HBRIC) $m	2015 Group (HBRIC + Napier Port) $m	2015 Parent (HBRIC) $m
Income	82	0	71.4		67	
Dividends		10.7		7.9		7.4
Operating expenditure	(57)	(0.6)	(50)	(0.5)	(48.4)	(0.5)
Operating profit before financing costs	25	10	21.3	7.4	19	6.9
Net finance costs	(4.1)		(4.3)		(3.8)	
Operating Profit after net financing costs	20.9	10	17		15.3	6.9
Impairments		(11.7)				
Profit before tax	9.1	(1.7)	17	7.4		
Tax	(5.8)	0.2	(4.8)	0.1	(4.1)	0.1
Profit after tax	**3.3**	**(1.5)**	**12.2**	**7.5**	**11.1**	**7.0**

Statement of Financial Position (as at June 30, 2017)

	2017 Group (HBRIC + Napier Port) $m	2017 Parent (HBRIC) $m	2016 Group (HBRIC + Napier Port) $m	2016 Parent (HBRIC) $m	2015 Group (HBRIC+ Napier Port) $m	2015 Parent (HBRIC) $m
Equity	185	227	187	239	184	239
Total Liabilities	131	20	134	16.5	122	12
TOTAL EQUITY AND LIABILITIES	316	247	322	255	306	251
ASSETS	316	247	322	255	306	251

- Note no cash assets held

The Port

Purpose and Role

99. The Port's vision is to be central New Zealand's leading provider of port logistics services. It also considers itself to be a catalyst for regional development, with over 27,000 jobs and 51% of Hawkes Bay's Gross Regional Product (GRP) related directly or indirectly to the Port.

100. The Port is primarily an export port shipping out containers, logs, and other general cargo sourced from the Hawkes Bay hinterland. Servicing approximately 600 vessel calls annually, the Port is New Zealand's 6th largest port in overall tonnage (~4Mt), projecting approximately 5% annual total trade volume growth over the next decade.

101. The Port benefits from diversified trade drivers, including being the 4th largest container port in New Zealand (c. 260,000 TEUs) projecting 2.4% p.a. container volume growth over the next decade. Trade growth is linked to Hawkes Bay development with the region experiencing economic growth of 50% above the national average.

Challenges

102. The Port faces a number of challenges, some associated with the pressures of growth, some in terms of competitor response, and some of a commercial nature. These challenges include the following:

<u>Competitor activities</u>

103. Trade in the Port catchment area has multiple logistical options. The Port competes with other North Island ports and hence operating risk is increased to the extent that competitors' operating behaviour can influence volume at the Port. Competing port strategies to attract volume away from the Port include:

    a) Aggressive targeting of key Port customers by other ports.
    b) Inland logistical networks being established to drive trade into alternate catchment areas (eg Kotahi and Fonterra).

<u>Infrastructure and maintenance</u>

104. The Port operation is dependent on one primary container berth which is around 55-years-old. Significant future investment is required to maintain and grow capacity and service levels, and to invest in technology and equipment to ensure competitiveness and strategic relevance in the future. Critical investment needs include the development of a new wharf, berth and dredging requirement to increase port capacity and cater for increasing container vessel sizes.

<u>Insurance</u>

105. Located in an area of seismic activity, the Port (and therefore the combined value of the Port and other Council assets) is exposed to the geo-physical risk of earthquake and tsunami. Recent earthquake events have led to a tightening in the NZ port insurance markets affecting the availability, cost, and terms of insurance cover available to the Port.

Container shipping lines

106. Global container shipping lines provide more than 50% of Napier Port revenue and provide the frequency and choice of services to Port customers that enables the Port to remain an attractive shipping port. The container shipping industry is currently experiencing a glut of capacity and poor financial returns which is leading to consolidation activity amongst industry participants. Such industry changes are likely to result in increasing prices to trade over the medium term, and potentially reduced service offerings and reduced pricing leverage for Napier Port, threatening both Port attractiveness and financial returns.

Biosecurity

107. Biosecurity breaches can have major impact on the Port and industry and the economy locally. Recent bio-incursions have demonstrated that the risks and management costs of protecting the country's productive economy are increasing.

Increased financial risk

108. As more debt funded investment is undertaken by the Port to cater for growth, it increases the indebtedness of the Port, increasing the financial risk to HBRIC as shareholder, which is ultimately borne by Council.

Financial performance

109. The Port is experiencing strong financial performance in the current financial year (2017) in part due to the benefit of increased container volumes from CentrePort (due to interruption from the Kaikoura earthquake) and an increase in logging volumes. Improvement in volume based revenue streams has led to an increase in operating margin.

110. In the nine months to June 2017, containerised cargo volume has increased by 13%, bulk cargo tonnage by 23%, and log tonnage by 36%, meaning that overall cargo tonnage has increased by 22%. In that same period, revenue was up by 21%, expenditure up by 11%, resulting in net profit after tax (NPAT) being 52% up on the previous period.

111. Next financial year could be significantly different, with CentrePort advising of a re-commissioning of their gantry cranes in early September 2017. Consequently the Port does not anticipate retention of all of the Centerport volume.

112. The historical earnings performance of the Port is set out below:

y.e. 30-Sep, $M	**2014**	**2015**	**2016**
Revenue	**67.0**	**72.1**	**72.7**
Container	36.5	41.2	40.9
Logs	6.9	6.4	7.3
General cargo	5.4	5.4	4.9
Other	18.3	19.0	19.5
EBITDA	**28.8**	**29.7**	**30.3**
EBITDA margin	43%	41%	42%
NPAT	**13.4**	**12.9**	**11.5**
Capex	**17.9**	**35.1**	**10.2**
Dividends	**7.0**	**7.4**	**7.9**
Total equity	183.6	186.9	188.2
ROE (post-tax)	7.3%	6.9%	6.1%
Debt	**62.5**	**84.0**	**79.7**
Debt / Debt + Equity	25.4%	31.0%	29.7%
Debt/EBITDA	2.2x	2.8x	2.6x

113.

FY2017 net debt (debt net of cash) is expected to be $86M.

Appendix Three – PwC Modelling

The most relevant sections from the PwC report which has been used to inform this Report are included in this Appendix. The full PwC report is available as a separate document upon request.

Introduction

Hawke's Bay Regional Council (HBRC) is seeking to establish benchmarks for commercial investment returns (particularly infrastructure and commercial property). Examples include:

- Airports – owners and or operators.
- Ports – owners and or operators.
- Energy – owners and or operators of electricity and gas distribution businesses. These include both local distribution and transmission.
- Energy – owners and or operators of generation assets and energy retail businesses ("gentailers").
- Telecommunication infrastructure networks owners and or operators.
- Commercial property owners.

Benchmarking is to include:

- Hawke's Bay (local).
- New Zealand.
- International.

The paper contains estimated returns for the investment subsectors by region. Three categories of returns are presented:

- Total shareholder returns – dividends distributed and share price changes (increases and decreases).
- Actual historical rates of return – profit as a percentage of equity and of total capital employed and also dividends as a percentage of shareholders' funds.
- Required rates of return – cost of equity and weighted average cost of capital.

The measures are described in more detail in the next section, which also includes a description of the calculation methodologies.

The investment returns are presented in tables and in figures. The tables include compound annual growth rates for five share market indices for the five years ending 30 June 2017. These indices are:

- S&P/NZX All (New Zealand).
- ASX All Ordinaries (Australia).
- FTSE All-Share (United Kingdom).
- Dow Jones U.S. Completion Total Stock (USA).
- MSCI World index (Developed markets) (global).

The indices have been selected to provide a guide to the rates of return that could have been earned over the five years from investment in a market-wide portfolio of shares in different countries. We caution that the indices are not directly comparable to all of the types of rates of returns included in this report. However, they will enable a very broad comparison of the investment performance of the subsectors and the performance of shares markets.

Information

We have calculated the rates of return in this report using financial information extracted from company annual reports or from Standards and Poors Capital IQ (Capital IQ). Capital IQ is a financial information data base we subscribe to. We draw your attention to the Capital IQ disclaimer included in **Error! Reference source not found.**.

We have relied on and not verified or audited the information extracted from the annual reports and from Capital IQ.

Currency, financial years and roundings

Rates of return for New Zealand resident companies have been calculated using New Zealand dollar financial information. Rates of return for companies resident in overseas countries have been calculated using financial information expressed in each companies' local reporting currency.

All monetary amounts in this report are exclusive of Goods and Services Tax ("GST"), unless stated otherwise.

Generally, any references to "year" should be taken as referring to financial years. For example, "2017" is the 2017 financial year.

Certain numbers included in tables in this report have been rounded and so the tables might not add exactly.

Methodology

Introduction

Three groups of rates of return on investment measures are presented in this paper. Two are measures of actual historical returns – returns that companies have actually achieved for their shareholders. These two groups of measures are:

- Total shareholder returns (TSR).
- Historical rates of return:
    - Return on equity (ROE), being profit divided by shareholders' funds
    - Return on capital employed (ROCE), being profit before interest but after tax divided by total capital employed. Total capital employed is shareholders' funds and interest bearing debt.
    - Dividends divided by shareholders' funds.

The third group of measures is required rates of return. This is an estimate of the rate of return that a company is expected to earn given its risk profile. This group contains two measures, similar to the historical rate of return measures: return on equity (the required return on shareholders' funds) and weighted average cost of capital (WACC), which is the required return on total capital employed (again, shareholders' funds plus interest bearing debt).

Each group of rates of return provides a slightly different perspective on the returns that companies have generated or are expected to generate for their shareholders and debt providers[1].

TSR (total shareholder return) directly measures the financial benefits that a company has produced for its shareholders. The financial benefits are dividends distributed to shareholders and the change (increase or decrease) in share price over a specified period.

The historical rates of return are reasonably conventional measures that show how profitable a company has been relative to the book value of capital invested in the company. This does not show the actual cash return to shareholders because profit is rarely all distributed – an amount is almost always retained for reinvestment.

The required rates of return measure the return that investors expect a company to generate given its risk profile relative to other investment opportunities. The "other investment opportunities" are represented by a diversified share market portfolio. It is unlikely that a company will achieve the required rate of return each and every year but the expectation is that, over time and on average, it should achieve the required return. If it doesn't, investors will not be willing or at least should not be willing to provide capital to the company.

We set out below the methods used to calculate each of the three groups of returns.

Total shareholder return (TSR)

A TSR has been calculated for companies with five years of historical share price information only (2012 to 2017). The five year TSR has been annualised to produce a return figure comparable to the other annualised measures used in this report.

The TSR formula is:

Equation 1

$$TSR = \frac{Closing\ share\ price - opening\ share\ price + dividends\ paid}{Opening\ share\ price}$$

We have also calculated a shareholder return using dividends distributed only i.e. excluding the change in share price. The formula for this measure is:

[1] Shareholders and debt providers (lenders) provide the capital for a company that it then invests in operating assets, which in turn generate the profit and cash flow that provide the returns to the shareholders and debt providers.

Equation 2

$$TSR\ (excluding\ capital\ gain) = \frac{Dividends\ paid}{Opening\ share\ price}$$

Actual rates of return

The following steps have been undertaken to calculate historical rates of return:

- Identify samples of companies, by region, for each subsector. The companies have been selected on the basis that their primary business activity is consistent with the subsector definitions.

  Some of the samples are relatively small. This certainly the case with local companies – the local companies included in the analysis are Napier Airport, Port of Napier, Unison Networks and Centralines. Also, there is only one listed telecommunications infrastructure network owner/operator in New Zealand (Chorus Limited).

  Section **Error! Reference source not found.** contains the latest available information on the b ook value of shareholders' funds for Napier Airport, Port of Napier, Unison Networks and Centralines to provide guidance on the scale of these companies from an investment perspective.
- Compile historical financial information (profit, shareholders' funds (equity), interest bearing debt, share prices and dividends) for each company. This information has been extracted from annual reports and/or from Capital IQ.
- Use the financial information to calculate total shareholder return (TSR), return on equity (ROE) and return on capital employed (ROCE) for the 2013 to 2017 financial years.

Return on equity (ROE)

ROE is a measure of returns to shareholders. We have calculated the return on equity using both equity at the start of each financial year and the average of equity at the start and end of each financial year.

The formulas for these two measures are:

Equation 3

$$ROE = \frac{Net\ profit\ after\ tax}{Opening\ equity}$$

Equation 4

$$ROE = \frac{Net\ profit\ after\ tax}{Average\ equity}$$

Return on capital employed (ROCE)

ROCE is a measure of the after tax return on total capital employed – the combined return to the providers of both equity and interest bearing debt.

As for ROE, returns on both opening capital employed and average capital employed have been calculated. The formulas for these two measures are:

Equation 5

$$ROCE = \frac{Net\ profit\ after\ tax + Interest\ expense \times (1 - tax\ rate)}{Opening\ equity + Opening\ interest\ bearing\ debt}$$

Equation 6

$$ROCE = \frac{Net\ profit\ after\ tax + Interest\ expense \times (1 - tax\ rate)}{Average\ equity + Average\ interest\ bearing\ debt}$$

A company tax rate of 28% is used to make the adjustment to remove tax adjusted interest expense from net profit after tax. This is a simplifying assumption. It assumes that the tax shield provided by interest is taxed at the marginal company tax rate.

Where information was available, five years of historical ROCE's (and ROEs) have been calculated for each company in the dataset. These have then been used to calculate a five year average ROCE and ROE (using both opening and average equity/interest bearing debt) for each sector and each location.

Some rates of return have been deemed to be outliers and removed from the sample.

Dividends divided by shareholders funds

This measure has been included to provide guidance on the cash return to shareholders as a percentage of the book value of equity. As noted above, not all profit is distributed in any year so this measure provides a guide to the actual cash return received by shareholders.

The return has been calculated using opening capital only.

Required rates of return

Required rates of return have been estimated for the subsectors. These are rates of return that investors require from each of the subsectors such that they will be indifferent to investing in the subsector or a market portfolio of investments.

A key feature of the required rates of return is that they take into account the relative risk of each of the subsectors. The relative risk is the primary driver of the differences between the subsector required rates of return.

Risk in this context is the potential that the actual cash flow a company will generate in the future will vary (either up or down) from the cash flows that it is expected to generate. If there is no potential for variability because the cash flow can be forecast with certainty then the asset will be riskless.

Relative risk included in the required rates of return is quantified by reference to a diversified portfolio of shares. The rate of return for a company whose cash flows are likely to vary from expected cash flows by a lesser proportion than the variability of cash flows for the diversified portfolio will have a relatively low rate of return. Conversely, a company with the potential for higher cash flow volatility should generate a relatively high rate of return to compensate investors for bearing higher risk of cash flow volatility.

We present two forms of required rates of return – a weighted average cost of capital (WACC) and a return on equity. WACC is the required rate of return on total capital invested – the combined return to the providers of interest bearing debt and equity. The return on equity or the cost of equity is the required rate of return for the providers of equity (shareholders) only.

We have used the following conventional WACC formula:

Equation 7

$$WACC = \frac{D}{V} \times R_d \times (1 - T_c) + \frac{E}{V} \times R_e$$

Where D = debt value, E = equity value, V = D + E, R_d = cost of debt, T_c = corporate tax rate and R_e = cost of equity. The cost of equity (R_e) has been estimated using a variant of the Brennan-Lally capital asset pricing model (CAPM).

The inputs to the WACC formula fall in to one of two categories:

- Constant inputs: These are not company or subsector specific and are the same for each company.
- Company or subsector specific inputs. These are the inputs into the formula that reflect the relative risk of each company or subsector and so are the drivers of the differences in WACC (and cost of equity) between companies and between subsectors. These inputs are asset betas, gearing (relative levels of debt and equity) and debt margins.

Asset betas are the input to the WACC formula that provide the measure of relative risk described above. Asset betas are derived from equity betas. Equity betas can be calculated for companies with observable share prices only. Consequently, the WACC and cost of equity estimates for each subsector have been derived using:

- Information for the share market listed companies in our sample.
- Publicly available information on WACC and cost of equity inputs. The primary source of this information is the WACC and cost of equity inputs estimated by the Commerce Commission for the industries it regulates.

Constant inputs

Inputs used for the WACC and cost of equity estimates of all subsectors are:

Table 1: Constant WACC inputs

Input	Value
Risk free rate – one year NZ government bond yield in ten years	3.65%
Market risk premium (PwC view)	7.50%
Investor tax rate	28.00%
Corporate tax rate	28.00%

Sector specific inputs

The following inputs are sector specific:

Table 2: Sector specific inputs

New Zealand sector inputs	Airports	Ports	Energy distribution	Energy "gentailers"	Commercial property	Telecommunications infrastructure
Asset Beta	0.60	0.45	0.39	0.60	0.40	0.50
D / (D+E)[2]	19%	20%	44%	30%	28%	50%
Debt margin	1.31%	2.00%	1.65%	1.73%	2.20%	1.80%

The only input changed for the calculation of international sector WACCs is the asset beta.

Table 3: International asset betas

International sector inputs	Airports	Ports	Energy distribution	Energy "gentailers"	Commercial property	Telecommunications infrastructure
Asset Beta	0.4	0.6	0.35	0.40	0.45	0.60

Tax

The dividends used in the TSR calculation are taken from Capital IQ.

We have not sought to determine the implications for HBRIC of dividend imputation credits attached to dividends from NZ resident companies or the tax treatment of dividends from overseas companies. These tax issues would require further analysis and consideration that is outside the scope of this report.

[2] D / (D + E) is the ratio of debt to funding.

Total shareholder returns

The table and figures in this section contain the historical total shareholder return outputs, both including and excluding capital gain. Asset betas have been included to provide guidance on the relative investment risk for each subsector.

The higher the asset beta the higher the relative risk of earnings volatility. A benchmark for assessing the betas is that the asset beta for the market as a whole is approximately 0.70. So a beta below 0.70 implies less than market risk.

Not surprisingly, all of the subsectors have lower than market risk. Infrastructure businesses generally are expected to have relatively low earnings volatility. Moreover, a number of the subsectors are subject to economic regulation, both in New Zealand and in overseas jurisdictions as the companies with the subsectors own and operate monopoly assets. These companies will have some of the lowest observable betas as their earnings are very stable.

The subsectors subject to forms of economic regulation in New Zealand are international airports, energy distribution (both electricity distribution businesses and gas pipeline businesses) and telecommunications infrastructure businesses (essentially Chorus). Electricity distribution businesses have the lowest risk.

In theory, those subsectors with higher asset betas should over time generate higher TSRs than those with lower betas to compensate investors for bearing higher risk. The information in the table and the following figures suggest this is not the case. There could be a range of reasons for this, including that five years is a relative short investment time frame for infrastructure businesses and also that the number of subsectors, particularly the New Zealand subsectors include a small number of companies – probably too few to be truly representative samples.

Table 4: Historical total shareholder return and risk proxy

Sector	Location	TSR	TSR (excl capital gain)	Asset beta
Airports	NZ	17.9%	5.2%	0.60
	International	24.2%	5.0%	0.40
Ports	NZ	17.1%	5.4%	0.45
	International	13.5%	4.9%	0.60
Energy - Distribution	NZ	9.0%	5.2%	0.39
	International	11.4%	4.6%	0.35
Energy - Gentailers	NZ	6.0%	4.8%	0.60
	International	9.1%	3.9%	0.40
Commercial property	NZ	12.7%	5.7%	0.40
	International	7.6%	6.8%	0.45
Telecommunications infrastructure	NZ	11.0%	3.9%	0.50
	International	8.7%	6.0%	0.60
Share market indices:				
S&P/NZX All		12.9%		
ASX All Ordinaries		6.9%		
FTSE All-Share		6.7%		
Dow Jones U.S. Completion Total Stock		12.5%		
MSCI World index (Developed markets)		11.4%		

Figure 1: TSR against asset beta by sector and location

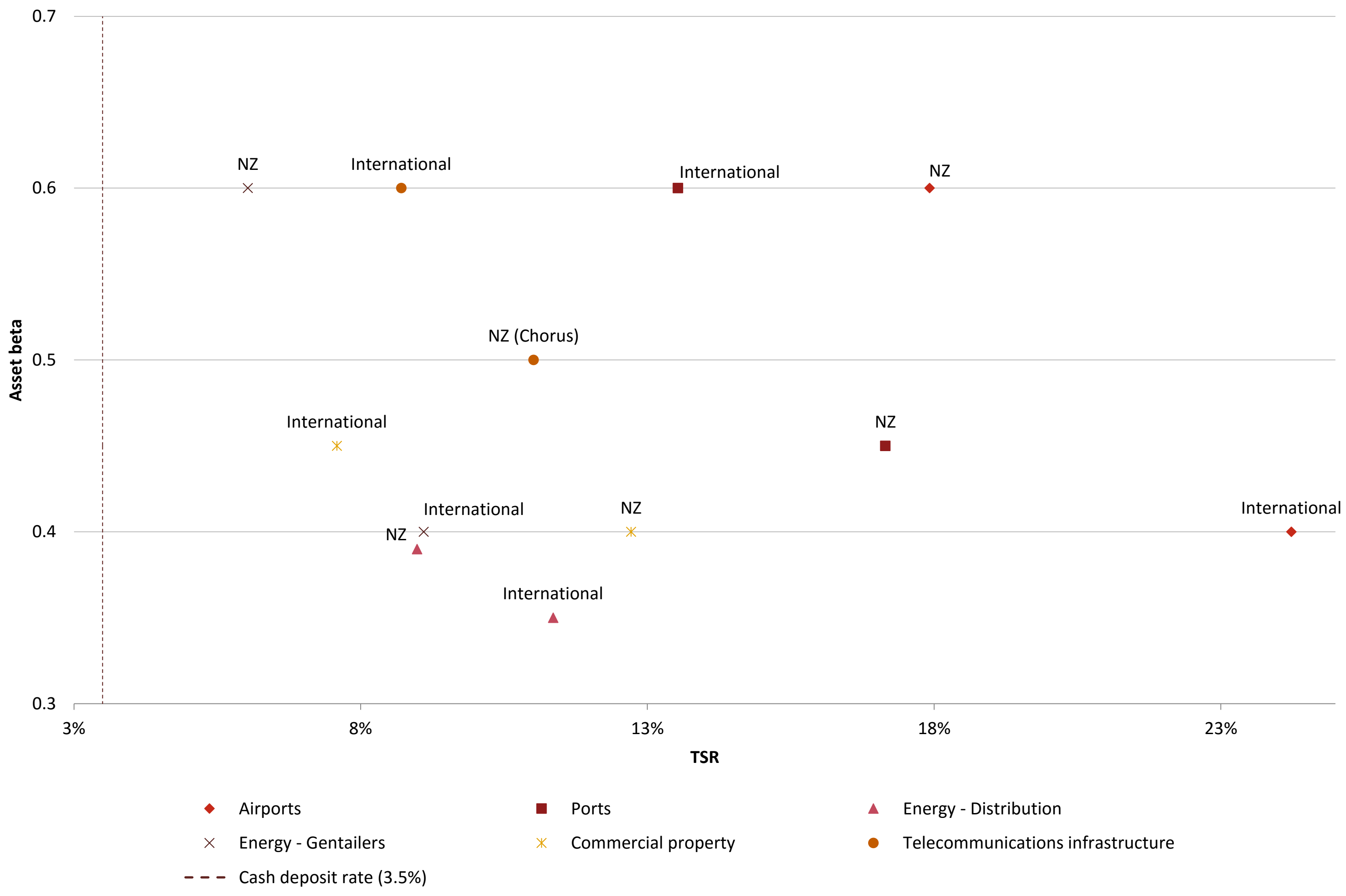
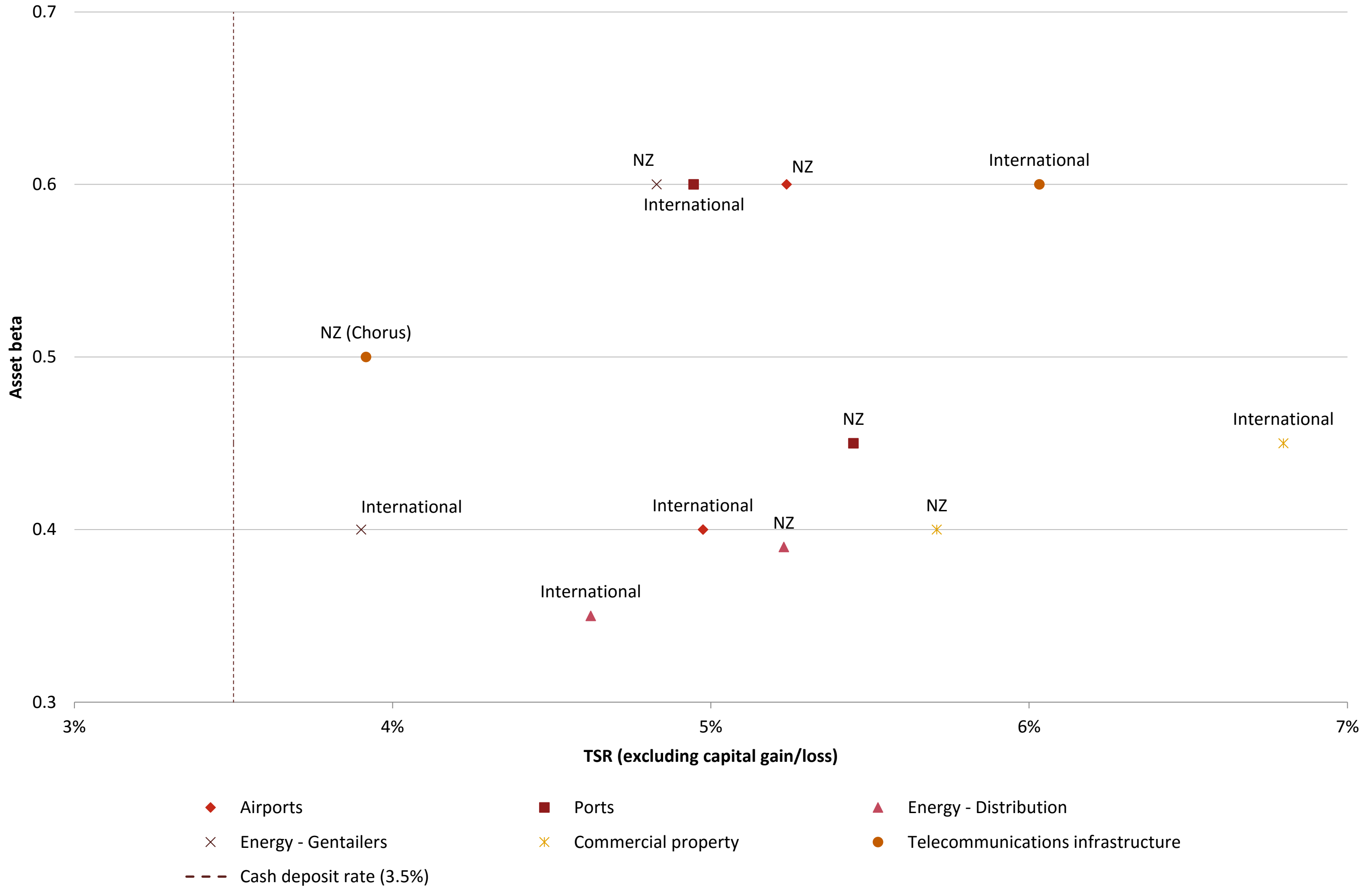


Figure 2: TSR (excluding capital gain) against asset beta by sector and location



Appendix Four – Flagstaff profile