12 March 2018

HAWKE'S BAY REGIONAL COUNCIL

# CAPITAL STRUCTURE REVIEW

## Final Report

**CONFIDENTIAL**

Prepared for:
Hawke's Bay Regional Council
(28 March 2018)

HAWKE'S BAY
REGIONAL COUNCIL

# INTRODUCTION

**PART I OF THIS REPORT, RELEASED IN DECEMBER 2017, PREVIOUSLY IDENTIFIED THE FOLLOWING:**

## COUNCIL FUNDING PRIORITIES

### ENVIRONMENT
PROTECTION & ENHANCEMENT

- DELIVER CORE SERVICES
- ENHANCEMENT INITIATIVES: WATERWAYS, BIODIVERSITY
- Facing increasing cost and investment pressures

### COMMUNITY RESILIENCE

- FLOOD PROTECTION
  COASTAL EROSION
  EARTHQUAKE/ TSUNAMI READINESS
- Facing increasing cost and investment pressures

### ECONOMY

- ENABLE PORT GROWTH
- OTHER INITIATIVES
- Increasing investment requirements

COUNCIL CORE SERVICES ■ COMMERCIAL INVESTMENTS

1

**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) 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 Port requires further large-scale infrastructure investment 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 capital for the environment and community resilience, and find solutions to fund the Port's growth, maintain vital Council income and reduce/ diversify Council's commercial investment risk exposure.

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**As Council faces pressure for more investment across its portfolio, 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 funding to support the Council's priorities, such as borrowing for Council programmes?

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**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 diversifying the current commercial investment portfolio and increase income and capital.**

a) Invest some of the funds currently invested in term deposits into higher yield investments

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

c) bring in a new investment partner 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

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**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 revenue and profit to fund Port development

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

(5) Council invests more capital into HBRIC/Port

(6) Council charges ratepayers a special targeted rate to fund the Port developments

(7) Introduce a minority investment partner 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)

The interim review established that only options (7), (8) and (9) could meet the needs of Council, noting that all options required deeper consideration, with Council feedback required on its appetite to explore these options and public consultation being required as part of the process.

## INTRODUCTION

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**Consequently, Council resolved to leave five key capital structure options on the table for further evaluation:**

(1) Council charges ratepayers a special targeted rate to fund Port development

(2) The Port increases its charges/revenue to fund Port development

(3) A minority share in the Port is sold to another cornerstone investor

(4) The Port is listed on the NZX with HBRIC/Council retaining majority ownership

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

or a combination of the above

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**Additionally, Council requested that the Panel:**

- undertake further review of the above five options
- review Council's balance sheet to identify additional solutions for funding inter-generational Environmental and Resilience Projects (Environmental Projects)
- provide recommendations on the capital structure solutions that will meet Council's long term needs
- recommend options for how to organise and manage Council's commercial investments

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**In considering this brief, the Panel has organised this report under three key headings, with each evaluated against key criteria, as follows**:

a) inter-generational Environment and Resilience Projects (Environmental Projects):

- How to maximise funds to deliver more and faster Environmental Projects for the benefit of current and future generations
- How to sustainably fund these projects which will have low or no direct financial returns

b) Council Investment Portfolio:

- How to design the investment portfolio
  - to permanently protect and grow Council's commercial investment capital and income to deliver a regular release of funds to support the region's current and future environmental, resilience and economic needs
- How to reduce the Council's risk exposure
  - Particularly to its investment in the Port (commercial and natural disaster risks)
- How to manage the investment portfolio

c) Funding Port Development:

- How to fund the port development to ensure regional growth, without injection of Council capital or reduction in Council investment income
- How to maintain adequate Council control of the Port

# SECTION ONE: FUNDING INTER-GENERATIONAL ENVIRONMENT AND RESILIENCE PROJECTS (Environmental Projects)

**Council has indicated a desire to be ambitious with investment in Environmental Projects. At this stage, detailed options and expenditure are to be determined, with some included in the current Long Term Plan (LTP).**

**It is therefore critical that Council gain clarity about the quantum and timing of funds required and the use of those funds to support community engagement and financial planning.**

**Key options to fund Environmental Projects include:**

**1.1 Borrowing**

**1.2 Increased rates**

**1.3 Releasing funds currently tied up in investments (e.g. Port)**

## 1.1 BORROWING

Borrowing is a legitimate and common-place means of funding inter-generational long term investments. Key to this is having a plan to cover interest costs and repay debt over time.

The Panel has reviewed the Group's balance sheet and identified that there is the opportunity to borrow more to invest in activity that provides intergenerational benefits. Historically, Council hasn't tended to borrow for such purposes. In line with Council's ambitions to invest in Environmental Projects, there is an opportunity to leverage the current balance sheet to benefit future generations.

The table below shows a range of debt measurements, compared to Council's current position. Comparable metrics are given for LGFA (Local Government Funding Agency) which provides debt to Local Authorities at reduced interest rates from a market lender. LGFA is deemed a suitable benchmark due to many Councils (currently 52) using LGFA for their borrowing requirements.

The table below illustrates that Council is currently well below policy and LGFA benchmark thresholds. Financial modelling indicates that Council could borrow at significantly higher levels and still be below, or in line with typical thresholds and its own policy. As a guide, current bank debt for HBRC is around $25m (or 4% of its equity). If Council were to borrow up to its current policy limit of 28%, this would mean it could borrow up to approximately $150m (or an additional $125m).

As noted in the draft 2018-28 LTP Council intends to consult on borrowing an additional $70m for a combination of investment in infrastructure assets, Council operating assets, and Environmental Projects.

Servicing of debt will be accommodated in annual operating budgets.

The analysis shows that Council will be able to drawdown such an amount without breaching policy or benchmark thresholds, with additional room to still borrow prudently beyond the current LTP aspirations.

An example of this is commercial forestry, which is not included in the current LTP. The option to invest in a commercial forestry joint venture is currently being contemplated by Council.

In the LTP, Council will consult on the option of using LGFA to obtain access to favourable interest rates and conditions compared to market.

| Measure | HBRC Policy | LGFA Policy | HBRC Actual (2016/17) |
|---|---|---|---|
| Debt / Equity | <28% | <30% | 3.5% |
| Net Interest / Debt | <25% | Not stated | 7.6% |
| Net Interest / Annual Rates Income | Not stated | <25% | 8.1% |

## ENVIRONMENTAL PROJECTS

A key and obvious ongoing challenge to resolve with borrowing is how to pay for the cost of debt and make debt repayments. Two options exist:

- Charge the ratepayer (targeted or general rates)
- Fund the cost of debt and debt repayment from income or capital released from the investment portfolio

### 1.2 Charge the ratepayer

Increasing rates to pay for Environmental Projects is a sensible solution based on the principle of beneficiary pays (aligned with Council's core services and rating role).

A $10m loan over a 10-year period would cost approximately $290,000 per annum in interest costs, or $4 per annum per ratepayer.

**Maintaining the option to charge:**

- targeted rates for specific Environmental Projects with defined beneficiaries and
- general rates for broad regional benefit

**should be pursued as an ongoing means of funding projects as part of core Council business.**

### 1.3 Releasing funds currently tied up in investments

The option to limit the impact on ratepayers by releasing funds from investments, or increasing returns from them, also remains a prudent complimentary contributor to pay for Environmental Projects or fund debt repayment and interest costs associated with them.

It should be noted that investments will likely have variable returns or liquidity constraints for capital release.

Council has one major asset (Napier Port) which could be used to create funds ranging from $50-$350m+.

A key issue with releasing capital from Napier Port is that it provides up to $10m of dividends to Council each year, which are relied upon to support existing services and projects and affordable rates in the region.

Any release of investment funds is likely to result in a reduction of income if the released funds are not re-invested in like for like, or higher returning financial investments.

Releasing investment funds to pay for Environmental Projects (which by their nature have little or no financial return) is therefore only viable if:

- sufficient funds are re-invested
- with adequate returns
- and only surplus capital and income is released for Environmental Projects

Maintaining some pressure on the investment portfolio will ensure that the Council's investment portfolio continues to work hard to support the region's requirements.

Placing all the burden on investments would reduce the scale of Environmental Project investment that can be contemplated and impose constraints on the investment portfolio, which is considered unsustainable.

### ENVIRONMENTAL PROJECTS CONCLUSIONS:

1

Council should model the range of Environmental Projects that it wishes to see advanced in order of priority, cost and urgency.
Once this is complete more detailed analysis of debt repayment and interest costs can be evaluated to determine an appropriate load sharing between:

- Council borrowing
- Rates
- the investment portfolio

2

Ultimately a combination of rates increases and borrowing, supported by investment proceeds (income and occasional capital release), will provide the most balanced and sustainable solution for funding Environmental Projects.

# SECTION TWO: COUNCIL INVESTMENT PORTFOLIO

**Key attributes of the investment portfolio that need consideration:**

**2.1 Portfolio design**

**2.2 Risk profile**

**2.3 How to manage the portfolio**

**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 100% ($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 38% ($4.3m) last 4 years Modest | Medium | Re-evaluate over time - Provides solid cash returns, capital gains and geographic diversity |
| TERM DEPOSIT $50M | NO 3.5% | NO | High | Reconsider investing for higher returns |
| PORT $235M | NO 3-4% | YES 32% ($58m) last 4 years | Low | Consider releasing value for reinvestment at higher returns |

## 2.1 PORTFOLIO DESIGN

Ongoing increases in the cost of supplying services and Environmental Projects mean Council's requirement for investment income is likely to increase. Council has the benefit of approximately $300m of existing commercial investments (as outlined above) which it needs to preserve.

To minimise pressure on rates and borrowing Council needs to maximise returns from its investment portfolio, within the bounds of its Statement of Investment Policies and Objectives (SIPO).

**Council should continue to have a progressive approach to growing its investment fund and income base.**

## COUNCIL INVESTMENT PORTFOLIO

As outlined in the Panel's initial report, to support the development of options, a benchmarking report was commissioned as part of this report to provide an indication of the level of returns that could be expected from a commercial investment portfolio.
The benchmarking report, undertaken by PwC, 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 New Zealand and overseas.

This report 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 possible across a range of infrastructure and property assets across domestic and International markets. Cash returns - i.e. annual income ranges from 3.9%-6.8%.

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 current term deposits and Port investment).

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.

With proper planning the option to re-organise (parts of) the commercial investment portfolio to free up cash could produce further gains.

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

- the term deposit
- the Port

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

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

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

b) Extract funds from the Port and reinvest them at a higher return

By way of example, if the current investments in term deposits ($50m) and Port ($235m) were converted from 3-4% investments to 5% investments, this could create up to an additional $5.5m in annual income.
The table below illustrates the increased returns.

Reinvesting the term deposit is simple to execute. Council simply needs to choose to reinvest some or all the $50m funds currently in term deposits into higher yielding investments. As outlined above, a realignment from 3.5% cash returns to 5%+ returns will generate good annual income gains.

Releasing funds form the Port for reinvestment is covered in more detail in section 3.

## 2.2 INVESTMENT RISK

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 are in one asset, the Port. Representing 77% of Council's commercial investment portfolio, this presents a highly concentrated geographic and commercial risk, as well as exposure to a region wide natural disaster event.

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

If the Council's core services are compromised by a natural event, it is likely that the Port will be negatively affected also. 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.

The Port risk is insured for material damage and business

| | Investment $m | Current annual income $m | If reinvested @ 5% $m | Difference $m |
|---|---|---|---|---|
| **Term deposit** | 50 | 1.8 (~3.5%) | 2.5 | 0.7 |
| **Port** | 235 | 7-10 (~3-4%) | 11.8 | 1.8-4.8 |
| **TOTAL** | **285** | **8.8-11.8** | **14.3** | **2.5-5.5** |

## COUNCIL INVESTMENT PORTFOLIO

interruption; however, insurance costs and deductibles are increasing considerably. The insurance does not cover loss of dividend to Council, or damage to land or shipping channels, leaving material income and investment risks. The Port currently represents a large percentage of Council income (up to $10m p.a) and investments (77%).

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

### 2.3 HOW TO MANAGE THE INVESTMENT PORTFOLIO

Key questions the Panel has focused on include:

- options for management of HBRC commercial/financial investments
- Is there a need for an investment company? If so, should its mandate/objectives change and to what?

### 2.3.1 INVESTMENT COMPANY ORIGINAL PURPOSE

The current investment company was established in 2011:

- To bring expert advice to the table through a board of directors
- To provide consistent and stable investment strategy across the political cycle
- To provide a higher rate of return on investment assets than that being achieved by Council
- To help meet the annual budget shortfall for the cost of HBRC operations
- To quarantine the risk associated with investment assets in a separate company
- To allow those assets to be leveraged by debt to further invest
- To provide a vehicle to pursue strategic commercial initiatives
- To reduce the concentration risk of the HBRC investment assets

Since then:

- Napier Port has been transferred to HBRIC's balance sheet and has operated successfully, with improved dividends and capital value
- Other Council financial assets (cash, commercial property and forestry assets) have not been transferred
- The Ruataniwha Water Storage assets and IP were transferred to HBRIC with a mandate to take the project to financial close. $14m of Council funds were advanced and HBRIC bank debt of $6m obtained. Following suspension of the scheme due to inability to access required land and Council's decision not to invest further, the shareholder advance has been written off by Council
- The original objectives of HBRIC have only been delivered in part

The Panel has discussed and evaluated whether the Council should continue with an investment company structure or bring all investments back within Council.

### 2.3.2 OPTION A: COUNCIL MANAGES ALL INVESTMENTS (NOT PREFERRED BY THE PANEL)

- All investments managed within Council and dissolve the investment company

Pros:

- Would result in fewer lines of communication and more direct control
- Some cost savings (cost of directors)

Cons:

- Any Port transaction will be a material project to manage, with detailed commercial preparation, oversight and negotiation required. This transaction will require a strong commercial skillset
- Any port transaction presents a major distraction for the Council management team from its core regulatory/environmental role
- This option does not provide the ability to quarantine debt and leverage investments (which could generate additional investment funds)
- Does Council over time possess the commercial skillset and resources required?

**The Panel's view is that it is premature to consider the wind down of the investment company prior to detailed evaluation of tax implications and the level of proceeds from any potential Port transaction is considered.**

## COUNCIL INVESTMENT PORTFOLIO

### 2.3.3 OPTION B: RETAIN AN INVESTMENT COMPANY STRUCTURE AND RE-ORGANISE IT TO BE FIT FOR PURPOSE (PREFERRED OPTION)

Pros:

- Provides an independent, commercially oriented structure and resources to manage any port transaction, which will be a significant undertaking requiring strict probity processes
- Allows Council to focus on core regulatory and environmental priorities
- Provides the ability to quarantine investment asset risk in a separate entity (protecting wider Council capital and assets)
- Provides the option to leverage the portfolio of investments (which could generate additional investment funds)
- Provides third parties with a professional commercial entity to engage with
- Provides a potential vehicle for third party investment

Cons:

- One step removed from Council – could be addressed by revised reporting requirements
- Some overhead costs incurred

**The Panel's view is that:**

- there is a need for an investment company structure to provide the long-term discipline and skills required to optimise Council's commercial investments and manage associated risks. It also allows the Council to focus on its core environmental responsibilities/tasks.
- the original objectives remain relevant
- changes are required to the Council SIPO and investment portfolio
    - SIPO changes to define financial, blended(financial/non-financial) and non-financial investments and which balance sheet these should be allocated to, with clear and separate criteria for financial and blended investments
    - Review InvestCo delegations and reporting requirements to support good governance and needs of shareholder
    - Council to reduce its dependence on InvestCo dividends to pay for underlying operational activities, with a graduated reduced dividend profile for this purpose to be agreed
    - To provide a higher rate of return – subject to tax analysis, transfer appropriate Council investment assets to InvestCo and leverage these assets to increase investment funds.
    - Risk and portfolio liquidity profiles developed, alongside ethical investment criteria
    - From this, InvestCo to create a 'Future Fund' to pay for intergenerational Council initiatives through ongoing capital and income distributions, with an agreed **increasing dividend and capital release** profile to be developed as the portfolio grows
    - The Port to be part of the Future Fund, with capital from it to be released for reinvestment and to reduce risk concentration
    - InvestCo should be rebranded, re-organised and repositioned with its revised mandate. Specifically, this should include a reduced number of directors, removal of the councilor directors, and a baseline reset of the skillsets required of the remaining or new director talent.

### 2.3.4 RECOMMENDED PRIORITIES FOR INVESTMENT CO.

1. Port value release (2+ years)
    - Material transaction requiring dedicated resources
    - Determine transaction preparation/advice/due diligence costs and funding arrangements
    - Develop business case
    - Supply materials/information for Consultation Support Package (via Council)
    - EOI, Tender process
2. Build the Future Fund portfolio (2+ years)
    - Re-organise the balance sheet with appropriate Council assets transferred into the portfolio and the assets leveraged through prudent borrowing
    - Invest surplus cash into interim higher yield investments to provide short term dividends to contribute to Council P&L requirements – currently $15m annual income, then decreasing

## COUNCIL INVESTMENT PORTFOLIO

- Develop a longer-term investment strategy and re-organise investments accordingly to provide income and capital as needed by Council for Environmental Projects. This includes a review of Forestry investment.

3. Re-organise InvestCo organisational structure to be efficient and support priorities
4. Review InvestCo delegations, activity and reporting requirements to support good governance, the needs of the shareholder, and improved interaction between the parties.

## COUNCIL INVESTMENT PORTFOLIO CONCLUSIONS:

### Portfolio design:

1. As liquidity (quick access to funds) may be required, it is recommended that Council evaluate as part of its investment policy, a minimum line of credit, or 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 recommended minimum cash holdings/short term debt is $10m.
2. Council should reinvest most of its current term deposits into higher yielding investments, while preserving the required liquidity buffer
3. The Panel recommends that Council sets a hurdle for preserved investment capital and income and then utilises surpluses (capital and income) for reinvestment growth or to support other Council initiatives, ensuring the capital and income of the investment portfolio never drops below the hurdle. These targets can be re-evaluated as part of future LTPs. Minimum $300m capital base + $15m p.a income (inflation and market adjusted)
4. Changes are required to the Council SIPO and investment portfolio

### Investment risk

5. Council should reduce its investment exposure to the Port by extracting funds currently tied up in it
6. To achieve a rebalanced risk profile, it is recommended that at least 33% of current Port holdings be released and reinvested into new investments targeting an average 5% return and with a low-moderate risk profile, with any surpluses used to repay Council debt or interest costs

### Portfolio management

7. Council should retain an investment company structure and re-organise it to be fit for purpose
8. InvestCo should be rebranded, re-organised and repositioned with its revised mandate to reinvest and grow the fund. Specifically this should include a reduced number of directors, removal of the councillor directors, and a baseline reset of the skillsets required of the remaining or new director talent
9. InvestCo to create a ‘Future Fund’ to pay for intergenerational Council initiatives through ongoing capital and income distributions, with an agreed increasing dividend and capital release profile to be developed as the portfolio grows
10. The Port to be part of the Future Fund, with capital from it to be released for reinvestment and to reduce risk concentration.

# SECTION THREE: FUNDING PORT DEVELOPMENT

## 3.1 COUNCIL CHARGES RATEPAYERS A SPECIAL TARGETED RATE TO FUND THE PORT DEVELOPMENTS

The Panel has discounted this option for several reasons:

- 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
- It potentially impedes Council's ability to work with ratepayers on funding other core regional activities including Environmental Projects
- It does not resolve Council's risk exposure to the Port
- The Port is a commercial arms-length operation, with alternative options to fund its capital requirements without placing a burden on the ratepayer

## 3.2 THE PORT INCREASES CHARGES/REVENUE

The Panel views that it is appropriate for the Port to achieve a satisfactory return on capital employed through fair and reasonable pricing to its customers and efficient use of capital. The current returns need improvement, with the shareholder only yielding a 3-4% cash return.

The business case for any development investment must factor in revenue growth. The exact nature of this is best determined by the commercial staff and board at the Port, to establish the prices that its users are willing to pay to preserve and grow the services of the port to meet their import and export requirements versus the high cost alternative of transporting products by land to other ports.

The Panel has discounted this as a complete solution and considers that it should contribute to Port development.

However, it does not address other key issues, such as:

- Council's risk exposure to its investment in the Port
- Sourcing funds for Council Environmental Projects

## 3.3 PORT VALUE RELEASE OPTIONS (MINORITY, IPO, LONG TERM LEASE)

These three options involve some form of release of value currently tied up in the Port.

As an asset linked to the economic growth of central New Zealand, Napier Port will appeal to investors. It offers:

- A stable New Zealand economic and political environment
- A demonstrable track record of growth with strong fundamentals and prospects
- Diversity of trade across cargo types
- A strong cargo catchment area
- The universe of potential investors includes:
- New Zealand infrastructure investors
- International infrastructure investors/investment funds
- Iwi
- Government investment funds (e.g. NZ Super, or overseas funds)
- Infrastructure corporates
- Strategic industry investors

**All three options can fund the Port's development needs. However, each addresses Council's broader objectives differently. See table over page.**

**The following table was provided in Part 1 of the Panel's report in December, which summarises the merits of options associated with funding Port development. It has been updated to reflect the latest available information.**

| Option | Impact on Council income | Provides Council with capital for Environmental Projects | Funds immediate Port develop needs | Supports long term Port growth | Supports Council Strategy/ LTP | Council ability to maintain control of Port | Impact on Council investment portfolio risk profile | Comments |
|---|---|---|---|---|---|---|---|---|
| **1.** Council charges ratepayers a special targeted rate to fund Port developments | Neutral | No | Yes, but with limitations | Yes, but with limitations | No, rates better used for Council services and Environmental Projects | Yes | Unchanged and still high exposure | Impact on ratepayers a key consideration |
| **2.** The Port increases charges/revenue to fund port developments | Neutral | No | Yes, but timing of revenue to capital outlay requires long payback | Yes, but ability to charge based on competitive pressures | Neutral | Yes | Unchanged and still high exposure | Addresses Port capital needs but not Council risk exposure or other Council needs |
| **3.** Minority share in the Port sold to another investor | Positive<br>Up to $100m released to reinvest at higher returns | No | Yes<br>Current Port debt paid off | Yes | Yes | Yes | Reduces risk exposure | Assumed that released funds re-invested in same or higher returns<br>If not then risk of income reduction |
| **4.** The Port is listed on the NZX, with HBRIC/ Council retaining majority ownership | Positive<br>Up to $140m released to reinvest at higher returns | No | Yes<br>Current Port debt paid off | Yes | Yes | Yes - some reduction | Initially reduced. However, note value subject to share market | Assumed that released funds re-invested in same or higher returns<br>If not then risk of income reduction<br>Dividends subject to different drivers under NZX independent board fiduciary duties |
| **5.** The Port is leased to another party (with HBRIC/ Council maintaining ownership of the Port assets) | Approx. $250m+ released to reinvest at higher returns | Approx. $250m+ released to reinvest at higher returns | Yes<br>Current Port debt paid off | 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?<br>Assumed that released funds re-invested in same or higher returns<br>If not then risk of income reduction |

## FUNDING PORT DEVELOPMENT

| | Napier Port | Investment Company/Council | | | | |
|---|---|---|---|---|---|---|
| | Delivers development funding | Retains control | Value released for reinvestment | Maintains Council income | Optimises value release | Considerations |
| **MINORITY SALE**<br>33-49% of Port sold to another party | ✓ | ✓ | Port debt paid off<br><br>$50-100m released for reinvestment | ✓ | ✗ | • Value discount for minority share likely - estimated 20%-30%<br>• Joint decision making (strategy, dividends, management, capital structure)<br>• Council still may need to supply capital |
| **IPO**<br><br>33-49% of Port listed on NZX | ✓ | ✓ | Port debt paid off<br><br>$80-$140m released for reinvestment | ✓ | ✗ | • Permanent sale<br>• Lack of scale for NZX listing<br>• Value uncertain<br>• Makes investment more liquid<br>• Port Board must act in interests of all shareholders<br>• Council still may need to supply capital |
| **Long term Lease**<br><br>Right to operate the Port granted to another party for say 50 years | ✓ | ✓ | Port debt paid off<br><br>$250m+ released for reinvestment<br><br>Up to $100m surplus for Council debt repayment or Environmental Projects | ✓ | ✓ | • Maximum value release<br>• Maximum value for asset<br>• Underlying ownership maintained<br>• Investors fund future capital needs of Port<br>• Control achieved through legal agreements, not day to day control |

## FUNDING PORT DEVELOPMENT

### 3.4 MINORITY SALE

A minority sale would involve the sale of part (e.g. 33%-49%) of Council's current interest in the Port to another party.

Key features of a minority sale are:

- Council maintains majority control of the Port
- As such, a minority investor will likely discount the price of the minority shares (due to lack of control). This could result in a 20-30% reduction in valuation.
- To protect its minority position, the minority shareholder would likely have shareholding protections including veto rights over
  - Port strategic plans
  - Dividend payments
  - Management appointments
  - Refinancing and capital structure
  - Future equity raising
  - Mergers
- It is very important to have alignment of investment objectives with a minority partner to avoid conflict and paralysed decision making. Partner choice would be vital.
- A key question in partner choice is whether the minority party brings additional value to the table for the ongoing success of the Port (i.e. does it bring any skills or industry leverage which will add value to the Port investment or region)
- Under this model, to avoid dilution of its shareholding, Council would be compelled to invest in the future if the Port needs more funds
- If Council sells 49% upfront, it would be compelled to invest in the future to avoid losing its majority shareholding position
- If Council sells beyond 33% it may lose the benefit of tax imputation credits

**The estimated value released of a minority sale is $50-100m after current Port debt (c$86m) has been paid.**

The total value will depend on:

- The amount of shares sold (i.e. 33% to 49%)
- The amount of debt left on the Port balance sheet
- The market's view of the value and risk associated with the asset

A minority sale achieves most of Council's objectives:

- control
- capital for port development
- maintains Council income (on basis sale proceeds are reinvested)
- reduced risk exposure

However, it is unlikely to provide material funds for Council investment in Environmental Projects or for material debt repayment.

It is noted that a minority sale may achieve a lower price than other options, but may also unveil strategic partners with common objectives to Council, which is a valued attribute.

**The Panel considers that a minority sale REMAINS A VIABLE OPTION for Council.**

### 3.5 IPO

An IPO (partial listing) would involve listing some of Council's current interest in the Port (e.g. 33%-49%) on the New Zealand Stock Exchange (NZX).

Key features of a minority sale are:

- Council maintains majority control of the Port
- At 33%, this leaves the Council with the option to release more value later (by listing up to 49% later)
- It increases the governance and regulatory oversight due to NZX listing requirements and as such the Board of the Port would have a fiduciary obligation to act in the interest of all shareholders including minority shareholders
- Under this model, to avoid dilution of its shareholding, Council would be compelled to invest in the future if the Port needs more funds
- If Council lists 49% upfront, it would be compelled to invest in the future to avoid losing its majority shareholding position
- If Council sells beyond 33% it may lose the benefit of tax imputation credits

**The estimated value released of a partial listing is up to $140m after current Port debt (c$86m) has been paid**

**However, it should be noted that at this scale of listing, Napier Port would not feature on the NZX 50 (top 50), and therefore may be subject to a major price risk up-front, if the shares are not perceived as liquid, and then ongoing price risk if not actively traded.**

## FUNDING PORT DEVELOPMENT

A listing of $250m is required to enter the NZX50. By contrast the Port of Tauranga listed market cap is circa $1.3b.

The total value will depend on:

- The amount of shares listed (i.e. 33% to 49%)
- The amount of debt left on the Port balance sheet
- The market's view of the value and risk associated with the asset
- If the listed shares are not actively traded, the value of the shares will be negatively affected

An IPO achieves most of Council's objectives:

- control
- capital for port development
- maintains Council income (on basis sale proceeds are reinvested)

or reduced risk exposure

However, it is unlikely to provide material funds for Council investment in Environmental Projects or for material debt repayment.

It is noted that an IPO may be valued unpredictably at launch and ongoing, posing a major risk.

It is also noted that equity markets (the share market) tend to focus on short term results and outcomes, which may not align with longer term objectives of infrastructure funding.

**For these reasons, the Panel considers that an IPO is currently NOT a viable option for Council.**

**Should the Port grow or become part of a bigger enterprise at a later point in time, this option could be considered then.**

### 3.6 LONG-TERM LEASE

A Long-Term Lease would involve Council retaining control/ownership of all strategic port assets, while granting a long-term lease/right to operate the Port to a third-party investor.

The investor pays up front for the lease/right to operate, or pays an annual lease, or combination of the two.

Key features of a Long-Term Lease are:

- Council can set a minimum level of maintenance obligations and minimum handback conditions
- Council mandates a minimum level of investment by the investor to continue to develop the Port
- Council reserves the right to regulate pricing to protect the local economy
- Council mandates open access for all importers and exporters
- Council can set minimum workforce protections to protect the local community
- Council can set obligations and reporting requirements for the investor to ensure ongoing viability of the Port, including its uses, maintenance requirements, transport access, safety, environment, insurance, natural disaster response
- Council can set minimum consultation requirements for future port development and operations

**The estimated value released from a Long-Term Lease is $350m+ after current Port debt (c$86m) has been paid.**

The total value will depend on:

- The level of controls Council seeks to enforce
- The market's view of the value and risk associated with the asset

A Long-Term Lease achieves ALL of Council's objectives:

- maximum value release
- control (by legal agreement) and ongoing retention of the asset
- capital for port development
- maintains Council income (on basis sale proceeds are reinvested)
- reduced risk exposure
- material funds for Council investment in Environmental Projects or for material debt repayment

These findings have been validated by a tour of Australian Ports using this model (Melbourne, Adelaide, Darwin, Brisbane). The tour was attended by senior officials from Council, HBRIC and Port who interviewed local government, Napier Port operators, investors, customers and unions.

**The Panel considers that a Long-Term Lease REMAINS A VIABLE OPTION for Council.**

**Further, more detailed due diligence should be undertaken in advance of any decision to progress with this option.**

## FUNDING PORT DEVELOPMENT

### PORT DEVELOPMENT CONCLUSIONS:

1

Council should rule out ratepayer funding for Port development (which is better focused on intergenerational environmental projects)

2

Council should support the Port to increase revenue to achieve acceptable return on capital employed (being good business practice)

3

Council should release funds from its port investment for re-investment and then repayment of Council debt

4

Council should rule out an IPO at this time

5

Council should further consider a Minority sale of the Port

6

Council should further consider the Long-Term Lease of the Port

# SECTION FOUR: OVERALL - PREFERRED CAPITAL SOLUTIONS

## RECOMMENDATIONS

1

**Council should better utilise its capacity to borrow to create inter-generational equity for Environmental Projects and then increase rates to a sustainable level to fund interest costs and capital repayments**

- It is recommended that the Council models the range of Environmental Projects that it wishes to see advanced in order of priority, cost and urgency
- Once this is complete more detailed analysis of debt repayment and interest costs can be evaluated to determine an appropriate load sharing between
  - Council borrowing
  - rates and
  - the investment portfolio

  This will also inform the level of capital release and reinvestment requirements associated with the Port.

2

**That Council builds a future investment fund**

- ensuring the capital and income of the investment portfolio never drops below the hurdle of $300m capital base + $15m p.a income (inflation and market adjusted). These targets can be re-evaluated every three years as part of LTP process
- utilising surpluses (capital and income) for reinvestment growth or to support Council debt reduction, interest costs or Environmental Projects
- As liquidity (quick access to funds) may be required, it is recommended that Council evaluate as part of its investment policy, a minimum line of credit, or 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 recommended minimum cash holdings/short term debt is $10m
- Council should reinvest most of its current term deposits into higher yielding investments, while preserving the required liquidity buffer
- Changes are required to the Council SIPO and investment portfolio
- Council should reduce its investment exposure to the Port by extracting funds currently tied up in it
- To achieve a rebalanced risk profile, it is recommended that at least 33% of current Port holdings be released and reinvested into new investments targeting an average 5% return and with a low-moderate risk profile
- with any surpluses used to repay Council debt or interest costs
- Council should retain an investment company and re-organise it to be fit for purpose
- InvestCo should be rebranded, re-organised and repositioned with its revised mandate. Specifically, this should include a reduced number of directors, removal of the councillor directors, and a baseline reset of the skillsets required of the remaining or new director talent.

3

**Rule out ratepayer funding for Port development (which is better focused on Environmental Projects)**

4

**Support the Port's efforts to increase revenue and profits to ensure adequate return on capital (current and future)**

## RECOMMENDATIONS

5

**Consider pursuing a minority sale to fund Port development and reduce Council's current exposure to commercial and natural disaster risk from this asset**

Pursue if Council wishes to:

- achieve modest risk reduction
- achieve a modest release of funds to support a more balanced investment portfolio
- maintain maximum control of the Port through ownership

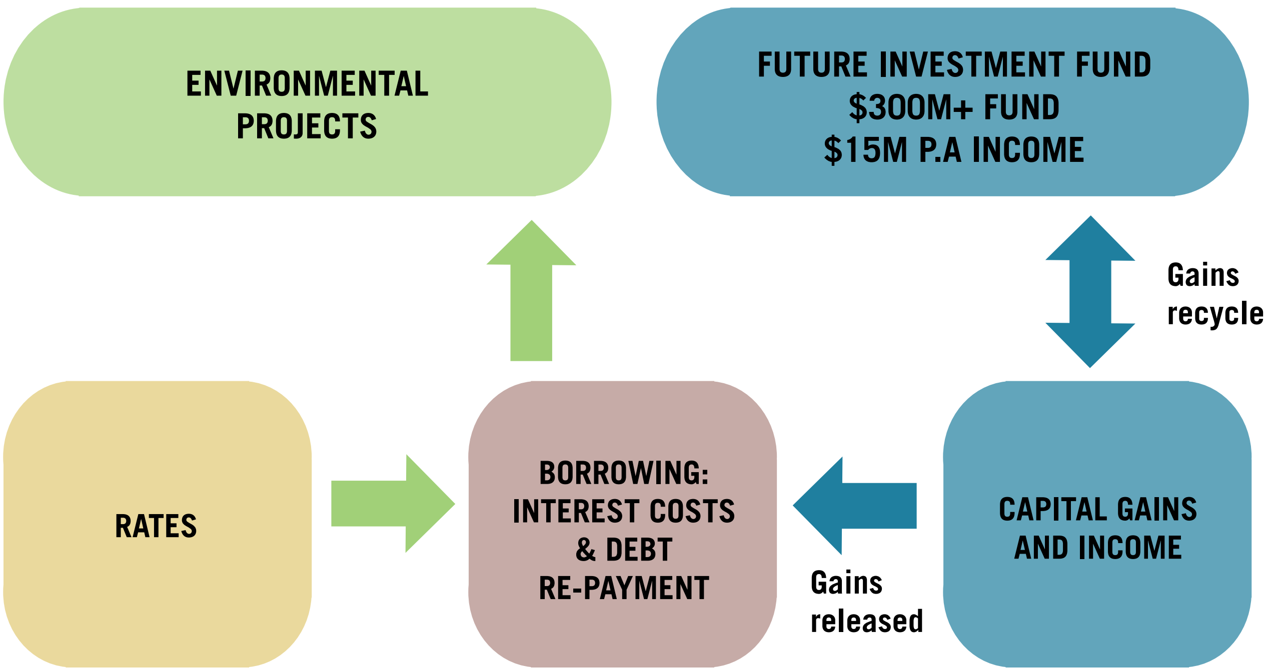
6

**Consider pursuing a Long-Term Lease of the Port to fund Port development and reduce Council's current exposure to commercial and natural disaster risk from this asset**

Pursue if Council wishes to:

- significantly reduce risk investment concentration in the Port
- release maximum funds for re-investment in Council's investment portfolio
- release maximum funds for Environmental Projects
- can accept control through legal agreements rather than ownership
- values underlying ownership of the asset and the option for a handback of the asset and operations in the future

## RECOMMENDED CAPITAL STRUCTURE MODEL



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