Deals Insights New Zealand

Winter 2017

pwc

Highlights

Winter 2017

Avg WACC
9.0%
For NZX listed companies
+60 bps vs. 31 December 2014

Risk free rate
4.5%
+50 bps vs. March 2015

NZ Deals
182
Deals completed in 2016
+5.5% vs. 2015

Avg. EV / EBITDA
11.4x
For NZX-listed companies
11.9x at 31 December 2014

New Zealand Macroeconomic Indicators

3.1%

GDP growth

New Zealand GDP grew at an average annual rate of 3.1% over 2016

2.2%

Inflation

Headline inflation has returned to within the RBNZ's mandated range

0.70
NZD/USD

Exchange rate

The New Zealand dollar found stability against the USD over 2016 and now resides at ~0.70 NZD/USD

4.9%

Unemployment rate

New Zealand's unemployment rate decreased from 5.2% to 4.9% over Q1 2017

6.7%
YoY

Retail sales

Latest figures released for the March quarter showed 6.7% YoY growth in retail sales

Source: Reserve Bank of New Zealand & Statistics New Zealand

Introduction

Welcome to PwC's Deals Insights for Winter 2017

Murray Schnuriger

Managing Partner – Deals

T: +64 9 355 8461

E: murray.p.schnuriger@nz.pwc.com

In our Winter 2017 edition of PwC's Deals Insights, we reflect on 2016 for New Zealand in terms of its macroeconomic performance, deal activity and listed company valuations.

Over 2016, New Zealand's economy continued to show resilience in the face of shocks to the global economy brought about by a number of events including bouts of Chinese share market volatility, Brexit, and the election of President Trump.

M&A activity in New Zealand was strong, with deal volumes up 5.5% on 2015. Global deal activity was also resilient, with 2016 deal volumes only 2.2% down on the record 2015 year.

Domestic deals comprised around 50% of total New Zealand deals in 2016. With a number of New Zealand private equity firms having recently raised funds, we expect there will continue to be strong local interest in quality New Zealand assets.

Offshore interest was also high, particularly in the primary sector. The NZD has weakened slightly from highs in late 2014/early 2015, and New Zealand continues to be ranked as one of the easiest countries in the world in which to do business, ensuring we remain an attractive investment destination.

The primary sector, a traditional strength of New Zealand, saw significant deal activity, while consumer products (including food and beverage), real estate and tourism assets also demonstrated increased deal volume.

In addition to topical articles, we have also included a new cost of capital analysis for New Zealand listed companies, which reflects an upward reassessment of the risk-free rate to 4.5%, reflecting recent increases in New Zealand government bond rates.

Please contact any of our Deals team with feedback or questions.

New Zealand macroeconomic overview[1]

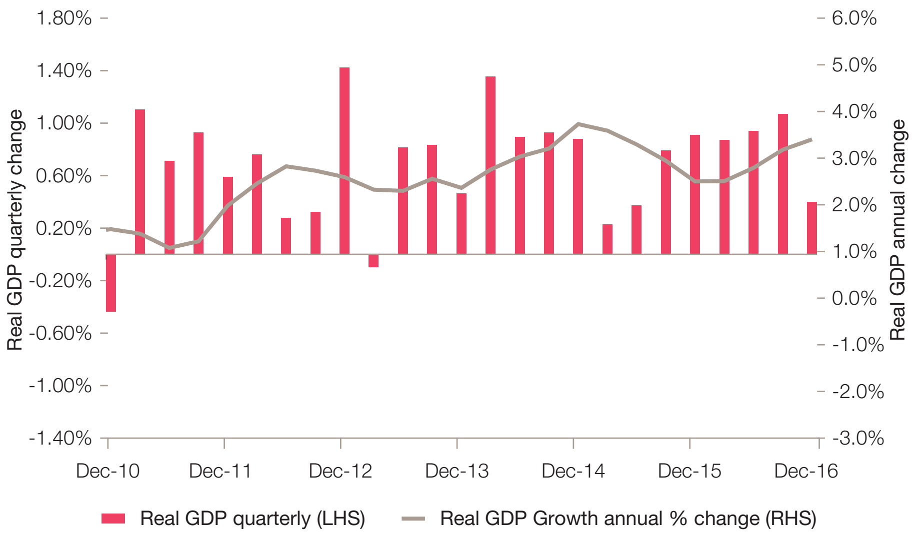
Over the last year the New Zealand economy has continued to show resilience when faced with global volatility

First came the Chinese stock market crash and plummeting oil prices in early 2016, followed by 'Brexit' chaos in June and lastly culminating with the election of President Donald J Trump in the United States in November. As overseas economies felt the brunt of such volatility, New Zealand continued to grow strongly (albeit with a slight dip in Gross Domestic Product (GDP) in the December quarter due to adverse climatic conditions). Importantly, expectations for sustained and robust growth remains positive. The impressive resilience begs the question, what has been driving, more so protecting, New Zealand's economy?

New Zealand continues to exhibit strong economic growth

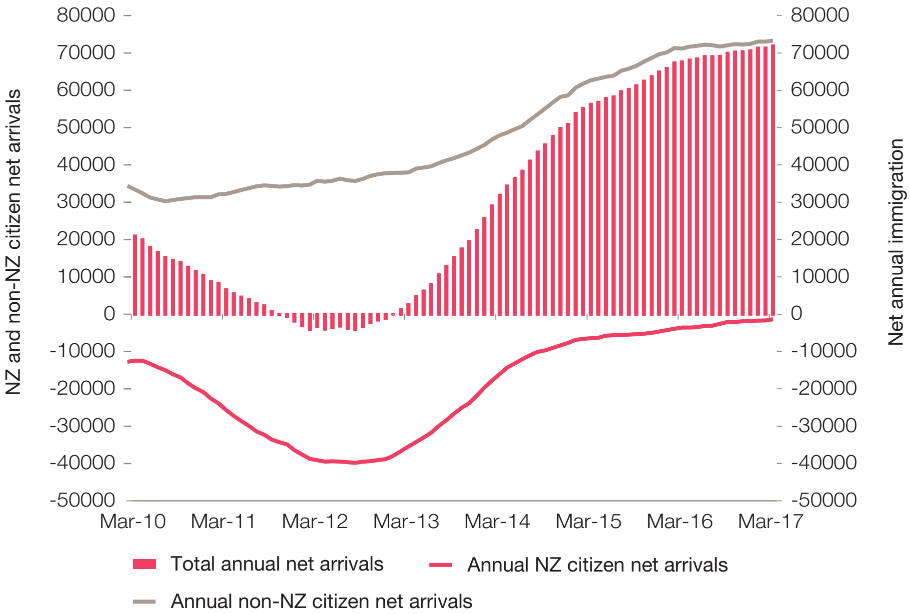
An indicator that clearly stands out is record net high immigration (resulting in sustained population growth). New Zealand's stable political climate, attractive lifestyle, and the strong labour market due to businesses demanding skilled workers acts as the driving forces behind the increasing migration numbers. With this trend not expected to decrease anytime soon (subject to election outcomes), net migration inflows will continue to provide a solid foundation for New Zealand's economic growth.

New Zealand Real GDP Growth (seasonally adjusted)



[1] Content finalised 15 May 2017

New Zealand citizen net arrivals and non-NZ citizen net arrivals

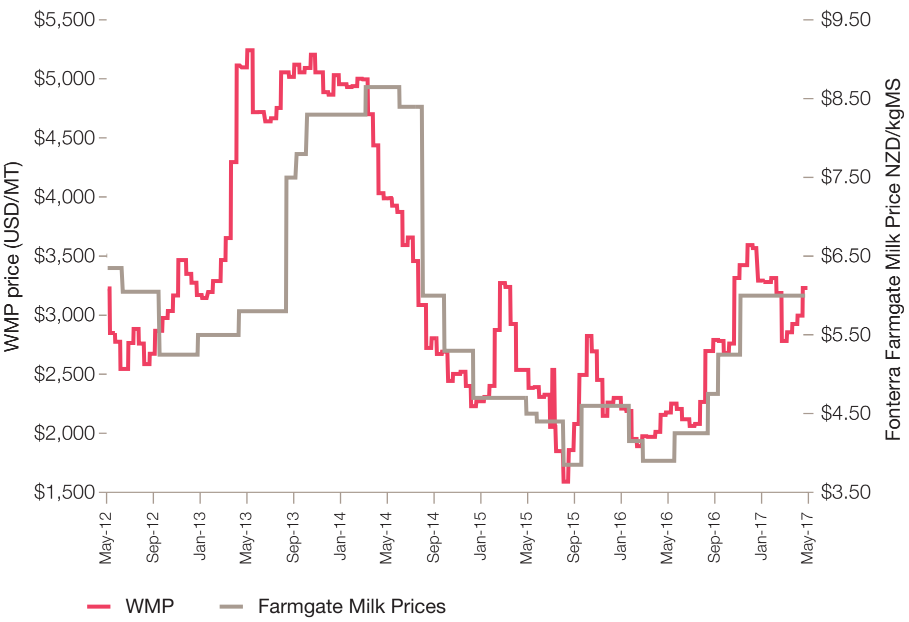


PwC view

We expect strong construction and tourism to continue supporting GDP growth above 3.0% throughout the next 12 months

On similar lines, the New Zealand economy has continued to be underpinned by strong construction and tourism sector performance. These sectors have been supported by both the manufacturing and services sectors. Larger infrastructure projects across the country, to cater for our growing population, and greater focus from the Government on developing and promoting New Zealand tourism, has also contributed to strong New Zealand economic performance. Lower jet fuel prices means more airlines are flying into New Zealand, thus the cost/distance for foreign tourists is not as prohibitive as it once was. We expect these forces to continue supporting GDP growth above 3.0% throughout the next 12 months

GlobalDairyTrade WMP and Fonterra Farmgate milk payout prices



Uncertainty surrounding dairy prices hopefully in the past

However, downside risks are present to the growth outlook. Our largest sector, dairy, remains vulnerable to offshore demand patterns and has seen a number of significant fluctuations in price over recent years. The strengthening of other sectors during 2016 essentially countered any negative impact the dairy sector had on the economy as a whole.

Following the surge in Whole Milk Powder (WMP) commodity prices from US2,000/MT to US3,500mt in the second half of 2016, price action was soft to begin 2017, slumping back down to US2,700/MT. Most recently however, the GlobalDairyTrade auction platform has seen a recovery in WMP prices, supporting expectations that there is little risk of moving below the US2,500/MT mark. As we near the end of the 'crunch' period for dairy prices, we assess the direction of dairy prices moving largely across the page until season end.

Reserve Bank of New Zealand (RBNZ) not convinced that higher inflation is sustainable

The RBNZ left the Official Cash Rate (OCR) unchanged at 1.75% in their May Monetary Policy Statement (MPS). While this was expected by financial markets, more surprisingly, Governor Wheeler maintained the February MPS forecasts that the OCR will remain on hold until the second half of 2019.

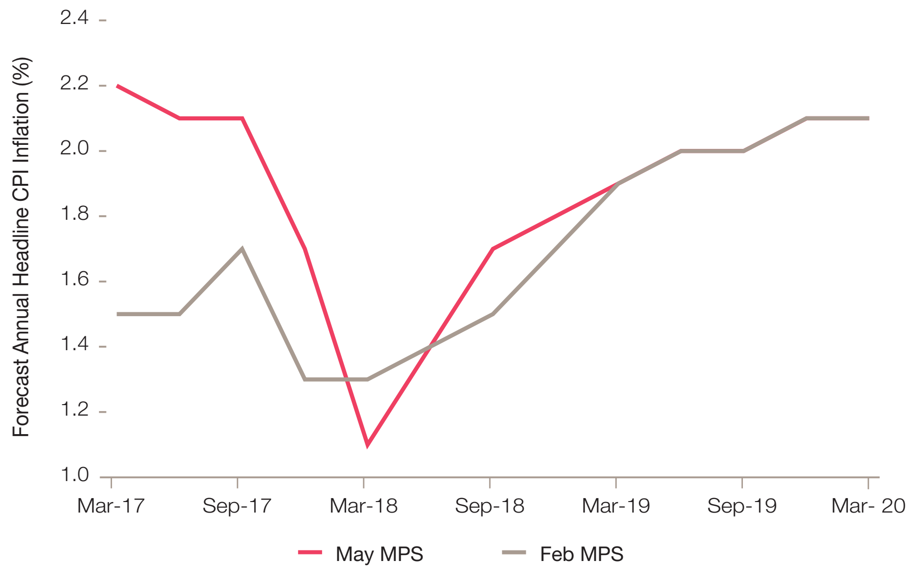
The announcement was at odds with financial market sentiment, where many expected the forecast for an increase in OCR pulled back in time as New Zealand continues to be blessed with a relatively strong growth and thus inflation environment. The Q1 Consumer Price Index signalled headline inflation resting at 2.2%, above the midpoint of the RBNZ's mandated target band of 1-3%.

These dovish comments by the RBNZ were based on the view that the recent spike in inflation was due to movements in oil and food prices, believed to be transitory. RBNZ forecasts suggest that once these temporary factors unwind we would see inflation levels dropping as low as 1.1% (March 2018).

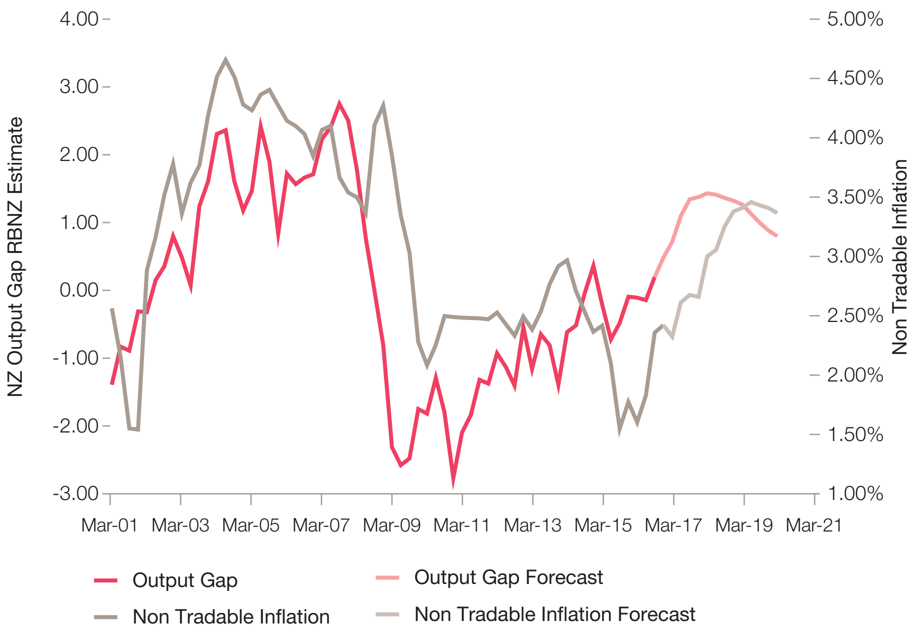
Many financial market commentators (including ourselves) have taken this view to be 'aggressively neutral', considering the economy has seen upside inflation across the last three quarters, supported by stronger commodity prices and labour market data.

Furthermore, the New Zealand Output Gap (actual GDP growth vs estimated potential GDP growth) has returned to positive territory, and is expected to continue in this trend, suggesting higher levels of non-tradable inflation (domestic prices unrelated to import and exports) will also be seen in the next few years.

RBNZ MPS Feb and May Annual Headline CPI forecasts



NZ Output Gap vs NZ Non tradable inflation



PwC view

We expect short term New Zealand interest rates to gradually increase over the medium term as the RBNZ ultimately incorporate these inflation pressures into their OCR projections

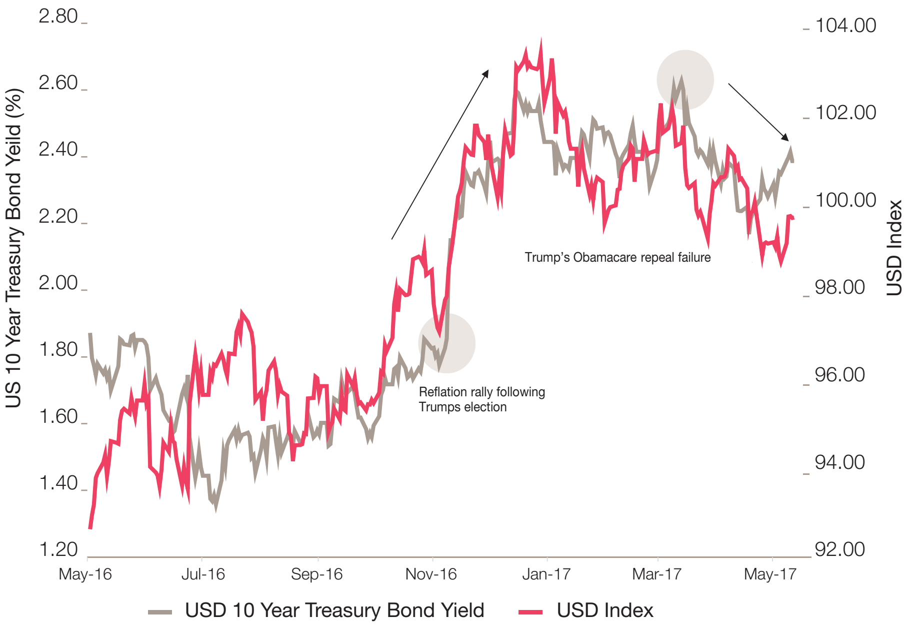
What does this signal for New Zealand's future?

In contrast to the comments made by the RBNZ, domestic capacity pressures and increased New Zealand commodity prices suggest that the higher inflation levels may be sustained moving towards 2018. We expect short term New Zealand interest rates to gradually increase over the medium term as the RBNZ ultimately incorporate these inflation pressures into their OCR projections.

Although New Zealand has fared well in terms of the volatility caused by recent world events, long-term interest rates are still exposed to global interest rate movements. In particular, the changes in The Federal Reserve and their monetary policy will have a direct effect on the long end of the New Zealand interest rate yield curve (five years plus). Following the March hike of 25 basis points in the Fed Funds Rate to 0.75%, two further hikes are expected in 2017 as the United States economy continues to perform well. US long term interest rates (which our long-term rates closely track) are expected to increase by another 0.50% to near 3.00% as their short-term rates are pushed up this year.

The New Zealand dollar was recently sold down on its own account when President Trump moved to impose tariffs on Canadian timber imports into the US. As Trump also mentioned potential protectionist tariffs for imports of dairy and aluminium products, the implications for the trade dependent New Zealand economy were seen as particularly negative. Therefore, we have experienced an earlier than expected taste of potential global trade protectionist policies that are outright negative for us in New Zealand.

US 10 Year Treasury Bond Yield v USD Index



Despite the RBNZ remaining firmly on hold regarding future monetary policy, we expect the New Zealand economy and subsequently the New Zealand dollar currency value to remain reasonably stable over the next 12 months, well supported due to a combination of:

- Solid domestic economic growth
- Increasing inflationary pressures
- Stable dairy prices
- Political stability relative to the rest of the world

The only potential risk to the stable New Zealand dollar outlook is foreign disinvestment if the Labour/Greens political coalition starts to close in on the ruling National Government.

We see short term fair value in the NZD/USD exchange rate around 0.7000 and slightly higher.

PwC view

We see short term fair value in the NZD/USD exchange rate around 0.7000 and slightly higher

James Butler

Senior Analyst — Corporate Treasury

T: +64 9 355 8265

E: james.p.butler@nz.pwc.com

Roger Kerr

Corporate Treasury

T +64 9 355 8181

E: roger.j.kerr@nz.pwc.com

M&A Deals update

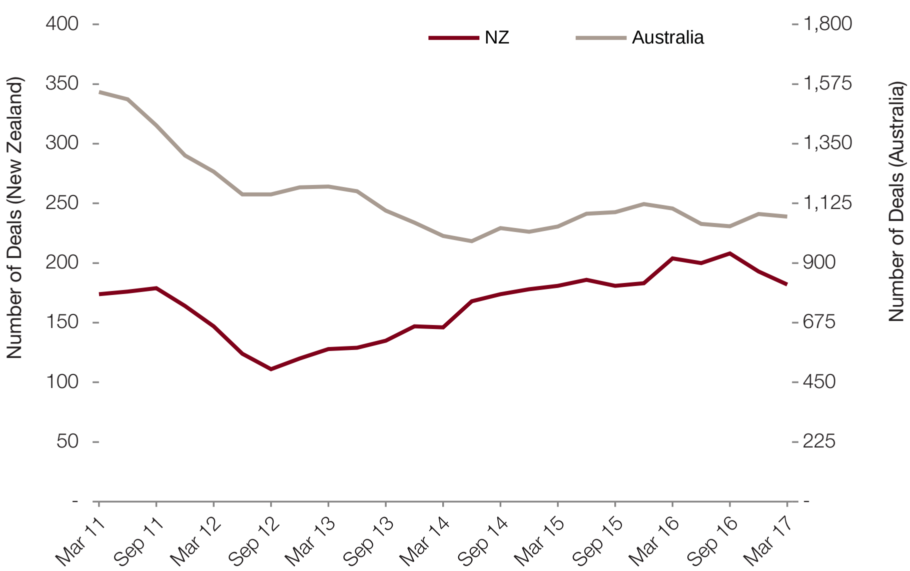
New Zealand deal volumes increased by 5.5% over 2016, while global deal volumes were robust, down only 2.2% on record-level volumes in 2015

New Zealand

New Zealand deal activity continued its upward trend across 2016, with deal volumes increasing 5.5% on 2015 (based on Thomson Reuters and CapitalIQ data). The increase in deal volumes was supported by favourable local M&A conditions including low funding costs, strong equity market returns, and an increase in the number of quality local assets following a prolonged period of economic growth.

Over 2016, New Zealand investors capitalised on local M&A opportunities with domestic transactions (involving both New Zealand buyers and target companies) comprising 50% of all deals. Solid inbound deal numbers suggest that overseas investors continue to see New Zealand as an attractive investment destination.

Rolling Last Twelve Months Deal Activity



Source: Thomson Reuters and Capital IQ data based on unconditional date of announced deals

The previous chart could suggest a slow start to 2017 for New Zealand M&A activity, but our expectation is that this is more due to seasonal factors and under-reporting of deals rather than any downward trend.

PwC view

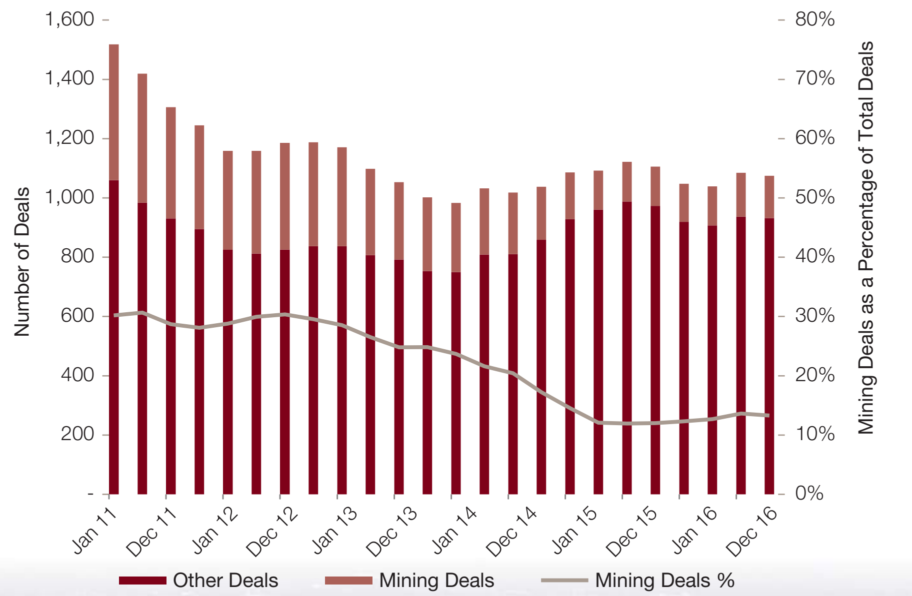
We have seen strong activity in New Zealand M&A markets in the beginning of 2017

Australia

In Australia, the 3-year decline in mining related deals subsided over 2016 (see graph below), following the recovery of prices of a number of resource-based commodities.

Despite a plateau in the decline of mining-related deal numbers, overall Australian deal volumes decreased by 3.3% over 2016. Assuming the wider Australian economy picks up on the back of a stronger resource sector, the large amount of funds available to invest, particularly within private equity, should see M&A volumes increase in 2017.

Australian Last Twelve Month Deal Data



Source: Thomson Reuters and Capital IQ data based on unconditional date of announced deals

NZ activity by deal type

Deals undertaken by New Zealand domestic entities increased from 108 (59% of deals) to 128 (67% of deals) between 2015 and 2016. This included both New Zealand (domestic) and foreign (outbound) entities as target companies. This puts the percentage of deals including New Zealand buyers near the 10 year average of 65%.

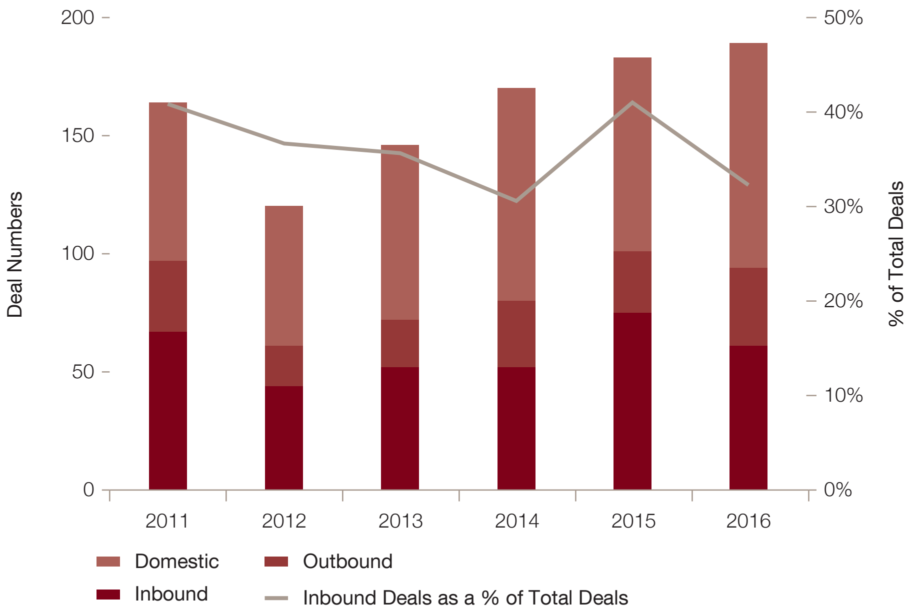
There were 61 inbound deals over 2016, slightly down from the post-GFC high of 75 reported in 2015, but largely in-line with the 3-year historical average.

Australia remained New Zealand's largest source of inbound investment with deal volumes from Australia up 27% in 2016 relative to 2015. The largest of these deals was First State Fund Managers NZ$950m purchase of Vector Gas Ltd's gas transmission system and gas distribution assets outside of Auckland.

Inbound deals from the US during 2016 were among the highest in terms of value. High-value deals included Insight Venture Partners LLC purchase of NZX-listed software company Diligent Corporation for NZ$943m and New Zealand manufacturer Sistema Plastics sale to US consumer goods company Newell Brands for NZ$660m in December 2016.

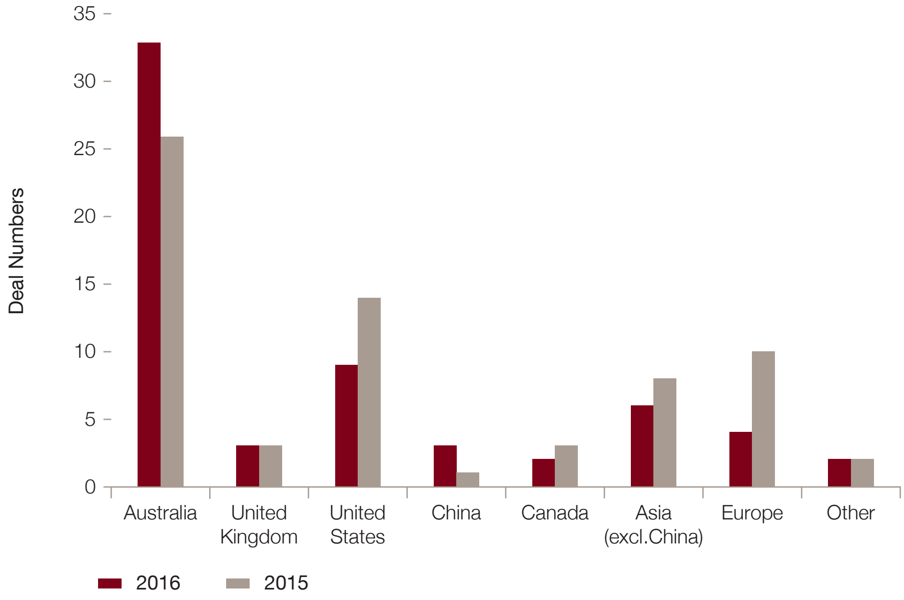
Asia continued to remain an important source of inbound investment into New Zealand over 2016 with a number of high profile transactions involving investors from this region. Inbound deals of note from this region include the 50% sale of meat processor Silver Ferns Farm to Shanghai Maling for NZ$261m.

New Zealand deal type activity by year



Source: Thomson Reuters and Capital IQ data (excluding deals with an undisclosed acquirer)

Inbound Investment Activity



Source: Thomson Reuters and Capital IQ data (excluding deals with an undisclosed acquirer)

Private equity was highly acquisitive in New Zealand during 2016 coinciding with a period of strong fund-raising activity

Private equity

Private equity firms were highly acquisitive during 2016 coinciding with a period of strong fund-raising activity. Notable private equity deals during 2016 included the sale of My Food Bag to Waterman Capital, the purchase of Jetts Fitness by Quadrant Private Equity, and the sale of outdoor apparel and equipment company Macpac to Champ Ventures.

Pencarrow Private Equity was busy during 2016, having acquired a 50% shareholding in New Zealand fund administrator MMC Limited while it also sold its shareholding in BrewGroup (formerly Bell Tea) to global coffee and tea company Jacobs Douwe Egberts.

Australian-based Pacific Equity Partners (PEP) had an active year in New Zealand, completing the acquisition of Auckland-based Academic Colleges Group in April. Additionally, PEP investee companies Manuka Health and Patties Foods respectively acquired Natures Country Gold and New Zealand food manufacturer Food Partners.

Local private equity firms Waterman, Direct Capital, Pencarrow, Oriens, Milford, and Pioneer Capital have all recently raised funds. These new funds, combined with the existing pool of funds held by local private equity firms, is expected to drive activity in the New Zealand M&A market in the coming year. Strong interest in New Zealand companies is also expected to continue from Australian private equity firms holding investment mandates which include both Australia and New Zealand.

PwC view

Private equity firms are expected to remain very active in 2017 given the significant new fund raising in 2016

The consumer products and services, real estate, and energy and power segments all recorded increased deal volumes in 2016 compared to 2015

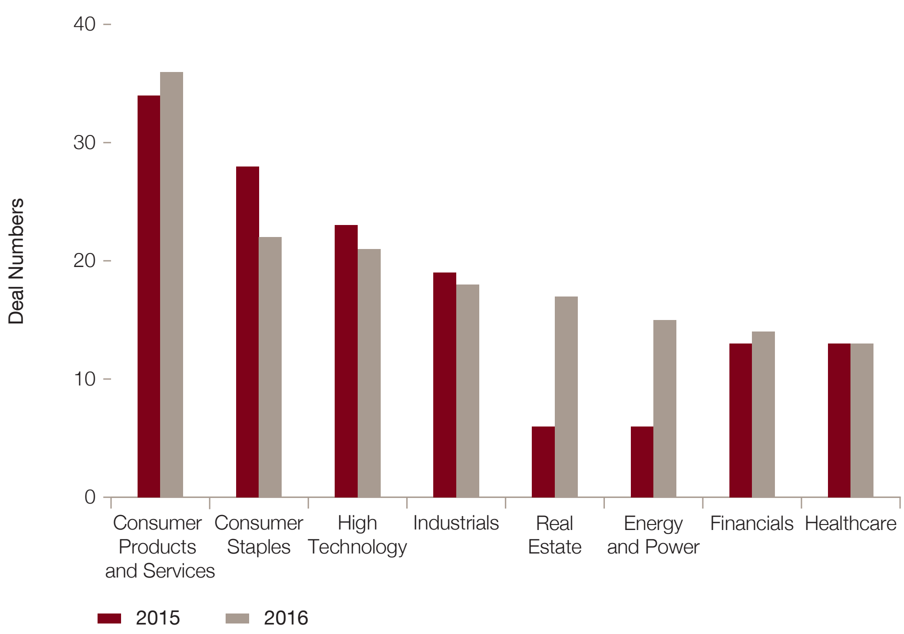
NZ deal activity by sector

The consumer product and services sector, comprising household goods and other discretionary consumer items, continues to attract strong investment interest as has the consumer staples sector which primarily comprises of food and beverage companies[1]. These sectors have been favourably impacted by strong consumer spending, positive net migration, and the household wealth effect resulting from the increase in New Zealand property prices.

The continued strength of New Zealand's tourism industry has seen a number of tourism-related deals in 2016. Australian firm Webjet purchased travel booking firm Online Republic for NZ$85m and TradeMe sold its accommodation website Travelbug and online booking engine BookIt to Hamilton-based company, Travel Booking Services. Additionally, South Island-based Ngai Tahu acquired Glacier Southern Lakes Helicopters and entered into a joint venture with Earth and Sky for construction of an International Astronomy Centre at Lake Tekapo.

The real-estate segment experienced the greatest increase in deal numbers accounting for 9% of the total deal volume in 2016 compared to just 3% in 2015. The largest real-estate transaction was Canada's Public Sector Pension Investment Board selling 50% of their New Zealand portfolio to the Canada Pension Plan Investment Board for NZ$580m.

Sector Analysis



Source: Thomson Reuters and Capital IQ data based on target company sector

[1] The consumer products and services sector covers industries such as tourism, education, health and nutrition, and animal care.

Transaction Services insights

The PwC Transaction Services team continue to see strong deal activity with a weighting to the food and beverage, infrastructure, financial services, and healthcare sectors. A key driver of the food and beverage sector activity has been continued growth in Asian market consumer demand that has driven prices and profits upward for New Zealand companies.

Healthcare activity continues to be strong with high levels of interest from offshore private equity firms. While activity in the retirement village and aged care sectors continues, the number of large 'platform assets' remaining in private ownership is diminishing, hence the volume of these transactions may moderate going forward.

Equity capital market listings have been slow in New Zealand over the past two years, however, the listings that have occurred over this period have been consistent with the interest in the aforementioned sectors (i.e. Tegel, New Zealand King Salmon, and Oceania Healthcare). We are proud of our reputation at PwC as market leaders in the provision of Independent Adviser's Reports for most of these IPOs.

PwC view

While the general outlook for capital market listings appears subdued, we still expect at least another couple of listings this year

Ian McLoughlin

Partner — Transaction Services

T: +64 9 355 8167

E: ian.mcloughlin@nz.pwc.com

Gareth Galloway

Partner — Transaction Services

T: +64 9 355 8513

E: gareth.a.galloway@nz.pwc.com

Given the significant amount of New Zealand and Australian private equity funding available, strong M&A activity among listed companies, and New Zealand's stable economy, we expect 2017 to be an active year for M&A markets

Q1 2017

Initial reporting of transactions in the first quarter of 2017 was weaker than Q4 2016; however, this is partly due to the March quarter containing the holiday season and a number of completed deals yet to be reported.

Listed companies have been active in M&A markets over the start of 2017, with a number of companies undertaking unsolicited takeovers. Earlier this year, Bapcor completed its takeover of Hellaby Holdings while Zhejiang RIFA completed its partial acquisition of Airwork Holdings. Other unsolicited transactions in 2017 include Spark's now cancelled offer to acquire TeamTalk for $22.7m, the rival bids from Fairfax Financial Holdings and Suncorp to acquire Tower Limited, and Augusta Capital's bid to create a combined $500m property portfolio with NPT.

Outlook

Given the significant amount of New Zealand and Australian private equity funding available, strong M&A activity among listed companies, and New Zealand's stable economy, we expect 2017 to be an active year for M&A markets. Anecdotally, it appears that private M&A markets have experienced an uplift in pricing which may see companies that otherwise might have listed be sold privately instead.

Important factors for New Zealand M&A in 2017 include:

- Strong economic growth continuing
- Significant available funds for investment
- Stable credit availability
- Owners of high quality businesses looking to trade.

Risk Factors include:

- New Zealand election delaying OIO and Commerce Commission decision making
- Commerce Commission being more active in the 'Fair Trading' space
- Geopolitical risk — Brexit, issues between the US, Russia, Syria, North Korea, and protectionism
- Capital controls in China.

Harriet Lambert

Analyst — Corporate Finance

T: +64 9 355 8741

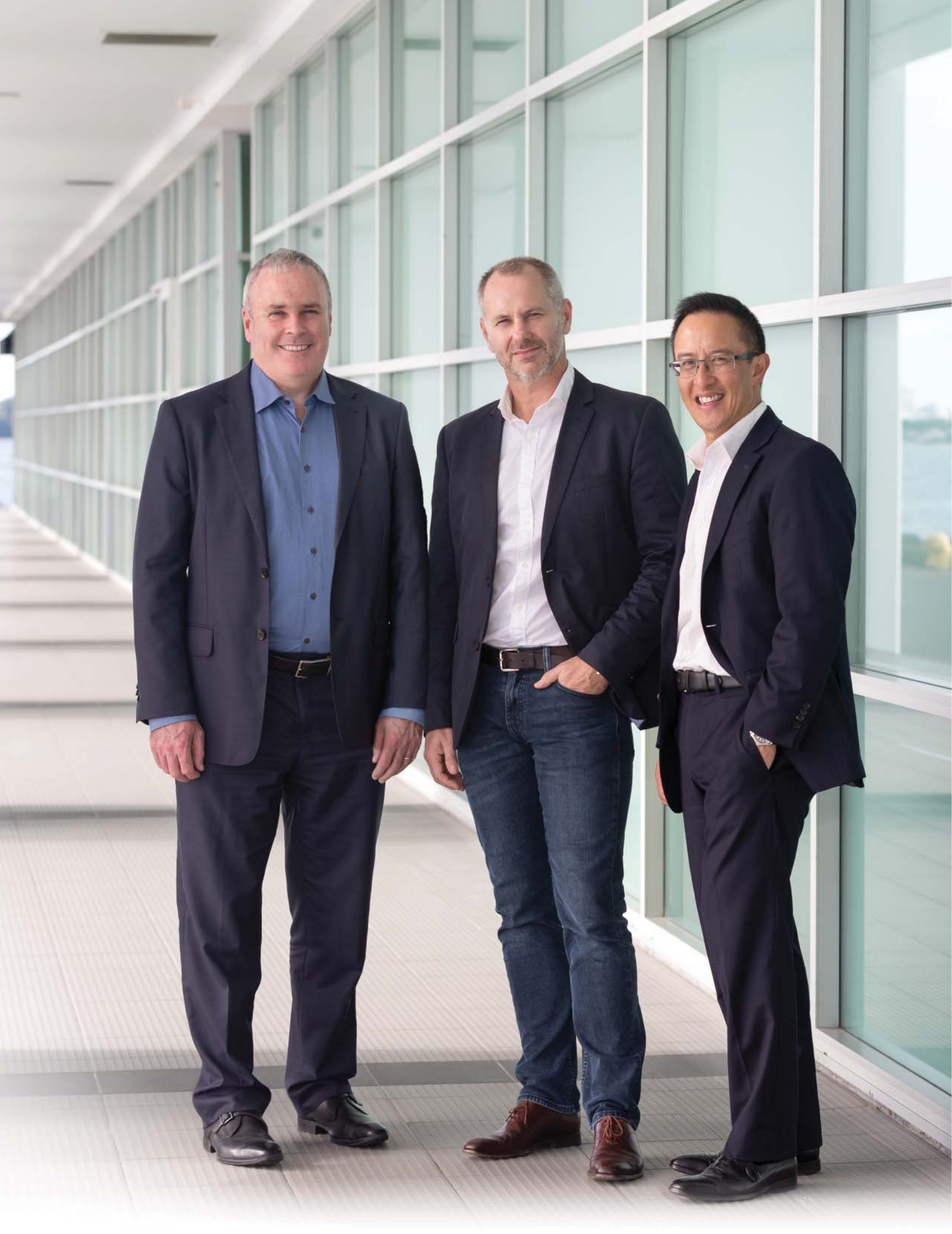
E: harriet.a.lambert@nz.pwc.com

Warrick Jackson

Director — Corporate Finance

T: +64 9 355 8082

E: warrick.d.jackson@nz.pwc.com



Left to right: Robert Cameron, John Schellekens and Richard Chung, PwC Real Estate Advisory

Real Estate advisory insights

When does it make sense to sell operational real estate assets?

The common reason for exiting operational real estate assets is to release capital, or restructure your balance sheet. These are rational decision drivers, but what are the potential consequences, and how do you maximise the outcome from such a strategy?

At one extreme, a specialised asset which is fundamental to business success and for which control is required (Core assets) should, all else equal, be owned. In contrast, assets that are generic, in ready supply and which are not essential to your business could be leased (Non-core assets).

It is not a binary choice, however, and there are multiple ways of structuring real estate occupancy, as illustrated in the diagram below:

Some of the key decisions that need to be taken into account before embarking on a sale and lease back strategy include:

- ***Importance of control:*** Ultimate control rests with ownership. While an element of control can be retained via the lease, depending on how the lease is structured, you may not be able to expand (or contract) your real estate requirement to match your business requirement with the same level of flexibility.

Understanding the implications of control requires reference to the core business strategy. For example, if an asset is a critical part of a supply chain network and loss of control would materially adversely impact operations, ownership will commonly be preferred.

(Continued on next page).

The importance of real estate assets to a business can be considered on a continuum

Non-core assets ⟷ ***Core assets***

Short –medium term Lease	***Middle ground, including long-term and structured leases***	***Ownership***
Typically applies to: • Generic assets located in areas where replication is easy • Non-core or non-strategic assets • Attractive for entities with a high cost of capital.	• Lease mechanisms that replicate (mostly) the level of control associated with ownership (long term leases with rights of renewal and potential call options to re-purchase) • Such lease structures, however are imply associated costs as a long term liability and potentially crosses the line from an operating to a financial lease (albeit operating leases can also 'consume' balance sheet) • Short-to-medium term leases are generally 'more expensive', as the owner of the occupied real estate is exposed to greater risk.	• Strategically important assets, expected to remain so for the medium-long term • Specialised assets for which there is no or limited market appetite (either as a result of the built nature or the location) • Requires long-term capital (cost should reflect weighted cost of capital, not marginal cost of debt) – challenging if capital constrained • Favoured if high marginal tax rate (given depreciation benefits).

If selling a real estate asset, an entity needs to consider the best approach to staging and packaging prior to sale in order to maximise value

- ***Capital efficiency:*** Flexibility and risk are the key capital considerations. Your business may or may not be the best entity to own a particular asset noting maintenance, capital expenditure and funding requirements. Linked to this is the impact on financial ratios and bank covenants – real estate offers strong collateral and leverage potential but it also ties up considerable capital that might be better applied to investment in other forms of business growth initiatives.
- ***Shareholder objectives:*** Some shareholders may be focused on releasing capital and maximising the value of a lease covenant to drive returns from real estate, while others may be focused on control and see real estate assets as a key supporter of future business growth.
- ***Marketability:*** Assets that are relatively generic (a standard industrial facility for example) are highly liquid and a strong lease covenant will maximise demand and pricing. Specialised assets can be more challenging to exit (efficiently), and where this is the case and an exit is planned, lease structuring becomes paramount.
- ***Tax and structuring:*** shareholder arrangements and tax / depreciation consequences also need to be considered.

Where it is deemed appropriate to consider selling an asset, or asset classes, an entity needs to consider the best approach to staging and packaging prior to sale in order to maximise value.

The options include:

- An operational lease (sale and lease back), which is popular at present given low real estate yields
- A hybrid 'finance' lease (sale and lease back) to establish a level of control more consistent with ownership
- A capital market event (public or private listing) involving transferring the asset(s) into a separate vehicle and introducing new capital.

The choice of exit option will typically depend on your relative interest in either:

- Maximising funds received on exit
- Maintaining future operational flexibility (as an occupier); or
- Retaining a reversionary interest (via a call option to re-acquire the asset, for example).

PwC view

Real estate is a key element of almost all businesses – the decision to own or lease, and the form of ownership / lease, requires some careful thinking. A clear strategy can deliver strong returns either by delivering capital growth through ownership or underpinning your business strategy

John Schellekens

Partner– Real Estate Advisory

T: +64 9 355 8681

E: john.b.schellekens@nz.pwc.com

Richard Chung

Partner– Real Estate Advisory

T: +64 4 462 7610

E: richard.h.chung@nz.pwc.com

Rob Cameron

Partner– Real Estate Advisory

T: +64 9 355 8907

E: robert.j.cameron@nz.pwc.com

Transaction insights

Completion mechanisms in the SPA: understanding values and reducing risk

The time between signing and completing an M&A transaction presents a challenge for both sellers and buyers. Economic events and operational decisions by the seller in this period mean that the value of the target company at completion can be different from the price agreed at signing. As a result, completion mechanisms are an important component of any Sale and Purchase Agreement (SPA) that can prove key to ensuring the transaction is successful for both parties.

Two of the most common completion mechanisms employed in M&A transactions are: 1) completion accounts; and 2) locked box. In this article, we outline some of the basic features of completion accounts and locked boxed mechanisms and consider the pros and cons from the perspective of buyers and sellers.

1. Completion Accounts

To capture the difference in the value of a target company between signing and completion dates, price adjustment mechanisms are often employed to adjust the initial signing price to a final purchase price. Typically, the SPA will outline 'normal' levels for certain financial items (i.e. working capital and net debt) that are expected to prevail at the completion date. At completion, these 'normal' levels are compared against the actual figures presented in the completion accounts, with any differences serving as the basis for the purchase price adjustment.

Working capital and net debt are two items that are often focal points in SPAs and completion accounts. A simplified example involving these items and completion account adjustments is set out below:

Completion accounts worked example

All figures $m	*Example figures*	*Example figures*		
Purchase price (Enterprise value)		10.0	Initial valuation	*Determined pre-deal*
Non-negotiable adjustments	(1.0)		e.g. Pension deficit, environmental exposure	*Determined pre-deal*
Debt/cash free price		9.0	Starting point for price in SPA	*Determined pre-deal*
Less: normal working capital	(1.5)		Agreed in the SPA	*Determined pre-deal*
Plus: $ for $ working capital	2.0		Completion accounts	*Determined post-deal*
Working capital adjustment		0.5		*Determined post-deal*
Plus: $ for $ cash	1.0		Completion accounts	*Determined post-deal*
Less: $ for $ debt	(3.0)		Completion accounts	*Determined post-deal*
Net debt adjustment		(2.0)		*Determined post-deal*
Total purchase price (equity value at closing)		7.5	Price actually paid to the seller	*Determined post-deal*

Completion accounts can have a significant impact on the price actually paid to the seller, and may not be finalised and agreed for some time after completion

The SPA should adequately dictate the methodology, definitions and timeline for the preparation of the completion accounts. Below are common questions to think about when considering the completion accounts section of a SPA.

Common Questions

- Does the SPA adequately define working capital, cash and debt?
- Who prepares the completion accounts and what accounting policy will be used?
- Does working capital have large intra-month changes and how is this dealt with?
- Are there areas of material judgment, e.g. contract accounting, and how is this dealt with in the SPA?
- Is the business rapidly growing and could this distort working capital?
- Has 'trapped cash' been considered, e.g. rent deposits, cash held for regulatory purposes, overseas cash subject to taxes if repatriated?
- How broad or narrow is the definition of debt? Some items to consider include finance leases, break fees on hedging, accrued interest.

PwC view

Completion accounts are a very common completion mechanism. They can be time consuming and complex to both prepare and review. As with the unique nature of every business, it is important to ensure the SPA is tailored to the transaction. A well-drafted SPA will enable the completion accounts process to proceed as smoothly as possible

2. Locked Box

An alternative to completion accounts is to agree a fixed equity value in the SPA prior to the completion date, also known as a 'locked box' approach. In essence, the economic risk and benefits of the business pass to the buyer from the locked box date, which precedes the completion date.

A successful locked box mechanism ensures the box is locked, i.e. no value leaks to the seller between locked box and completion that is not otherwise agreed. This approach may involve a payment to the seller, to recompense them for the opportunity cost, or cash profits accumulated, for the duration between the locked box date and completing the transaction.

A worked example involving a locked box calculation is provided on the following page combined with a discussion of the pros and cons of locked box vs. completion accounts to both the seller and buyer:

PwC view

Locked box mechanisms can be attractive, especially for sellers seeking certainty of price. However experience shows that they are not necessarily appropriate for all deals, and can result in complexities which impact deal value

Locked Box worked example

$M	*Example figures*	*Example figures*	
Debt/cash free price		9.0	Valuation at the locked box date
Net debt and working capital adjustments	(2.0)		As per the balance sheet on the locked box date
Equity value at locked box date		7.0	Price agreed in SPA
Interest charged on equity value / cash profits after locked box date	0.5		Can be payable to seller to recompense for period between locked box and completion
Total purchase price (equity value at closing)		7.5	Price actually paid to Seller

Determined pre-deal

Seller Pros:

- Gives certainty of price and control over the process, resulting in ability to use proceeds quickly
- Hardwires consistency with previous accounting policies so there is no debate over completion accounts policies

Seller Cons:

- Potential for loss if the deal is delayed and the mechanism to recompense is set too low
- Difficult to apply where there is no anchored balance sheet (e.g. carve-out)

Buyer Pros:

- Management time not tied up in preparing and debating completion accounts, and instead focused on the acquired business
- Gives certainty of price

Buyer Cons:

- Risk of business deteriorating between locked box date and completion
- Need to debate debt, working capital etc. earlier, potentially with less detailed knowledge
- May need to place additional reliance on warranties

PwC view

Every M&A transaction is unique and the choice of completion mechanism should take the specifics of the deal in to account. We have outlined the principles of completion accounts and locked box as the two most common mechanisms for calculating the final equity value, which can differ significantly from the headline business valuation. There can be many potential complexities and areas of negotiation when either mechanism is used

Andrew Keenan

Manager — Corporate Finance

T: +64 9 355 8432

E: andrew.j.keenan@nz.pwc.com

David Urlich

Director — Transaction Services

T: +64 9 355 8387

E: david.t.urlich@nz.pwc.com

Risk free rate update

Global bond yields have moved higher since bottoming in July 2016, however they remain in a historically low range

Global interest rates

Despite the views of many economists that global bond yields were unlikely to drop below levels seen in 2014/15, yields fell to record-lows (negative in Europe and Japan) during 2016. New Zealand Government bond yields were no exception.

While bond yields have moved higher in the last six months, they still remain at low levels (refer to chart).

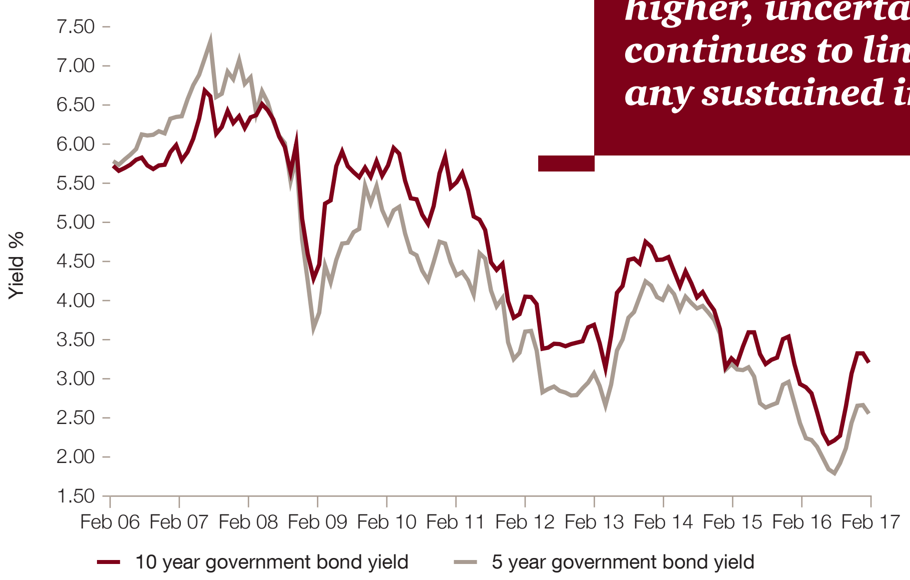
A combination of factors in the last three years have caused yields to trade in a lower range:

- quantitative easing/negative interest rate policies by global central banks
- significant event/market risk such as the collapse of Chinese equities in early 2016 and the UK's decision to leave the European Union
- a significant movement lower in oil prices (from a trading range above US$100/barrel to US$40-60/barrel)
- doubts about Chinese growth
- poor states of banks in Southern Europe

Since late 2016 global inflationary pressures have re-emerged after a long absence. An improving US economy and expectations for Federal Reserve policy actions have set the tone for cautiously higher interest rates, with these expectations further buoyed by President Trump who is promising (but yet to deliver) strong fiscal stimulus.

The US Federal Reserve raised interest rates in December and March, increasing the base Federal Funds rate from 0.50% to 1.00% during this time. Federal Reserve officials have indicated further increases are likely this year.

New Zealand Government bond yields



Source: Reserve Bank of New Zealand

While bond yields have moved higher, uncertainty in markets continues to linger, putting a cap on any sustained increase in yields.

Global developments have set the tone for New Zealand interest rates, however domestic factors remain influential

New Zealand interest rates

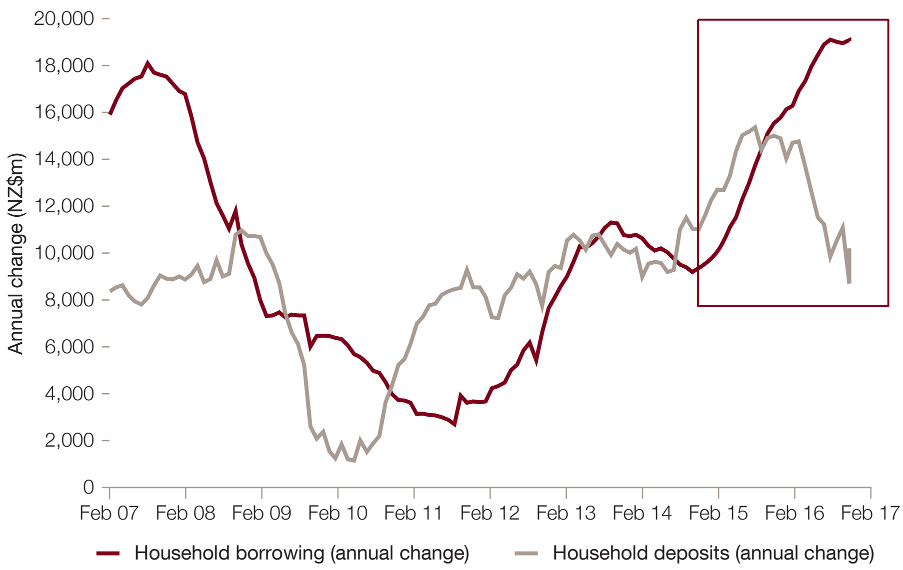
Uncertainty in the New Zealand dairy sector as well as negative tradable inflation saw the Reserve Bank reduce the Official Cash Rate (OCR) from 2.00% to 1.75% in November 2016. The RBNZ has since moved to a firm neutral stance, suggesting recently that monetary policy will remain accommodative for a considerable period.

Despite monetary policy remaining on hold, mortgage rates in New Zealand have risen within the last six months, reflecting a number of factors:

- higher global interest rates
- a disconnect between retail deposits and lending among New Zealand banks, forcing banks to look abroad for funding (and borrowing at higher rates)
- a stricter regulatory environment requiring banks to hold more capital against borrowing
- banks looking to reduce their exposure to the housing market

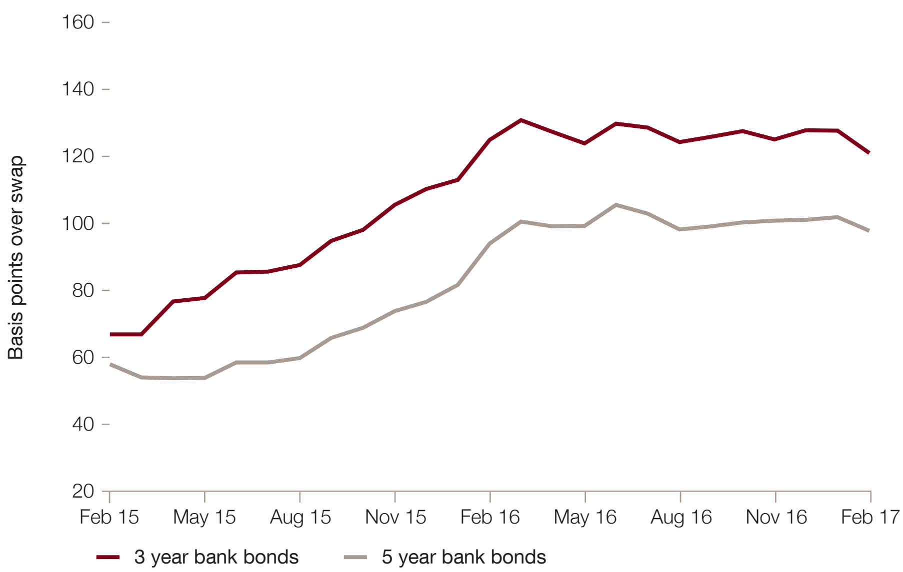
As the previous charts demonstrate, increased bank lending to New Zealand households has occurred as retail deposits have fallen, forcing banks to borrow more funds abroad. Alongside this disconnect is rising credit spreads on bonds issued by New Zealand banks (a proxy for bank borrowing costs), which have risen by ~50 basis points since 2015 – indicating banks funding costs have been increasing.

New Zealand bank lending to households and retail desposits



Source: Reserve Bank of New Zealand

New Zealand AA – rated bank bond spreads (basis points over swap)



Source: PwC Analysis, Thomson Reuters

Risk free rate

The interest rate environment that has prevailed in the last five years has many practitioners reconsidering views on a single risk free rate to use in calculating weighted average costs of capital. The Treasury (who publish discount rates for valuation purposes[1]) in June 2016 revised downward their long-term risk free rate assumption from 5.50% to 4.75% reflective of a lower interest rate environment in the last five years.

Our current view is to use the interpolated forward rates for each cash flow when discounting. For the purpose of deciding a 'single' risk free rate to apply to all cash flows, PwC considers 4.5% appropriate. This view is based on:

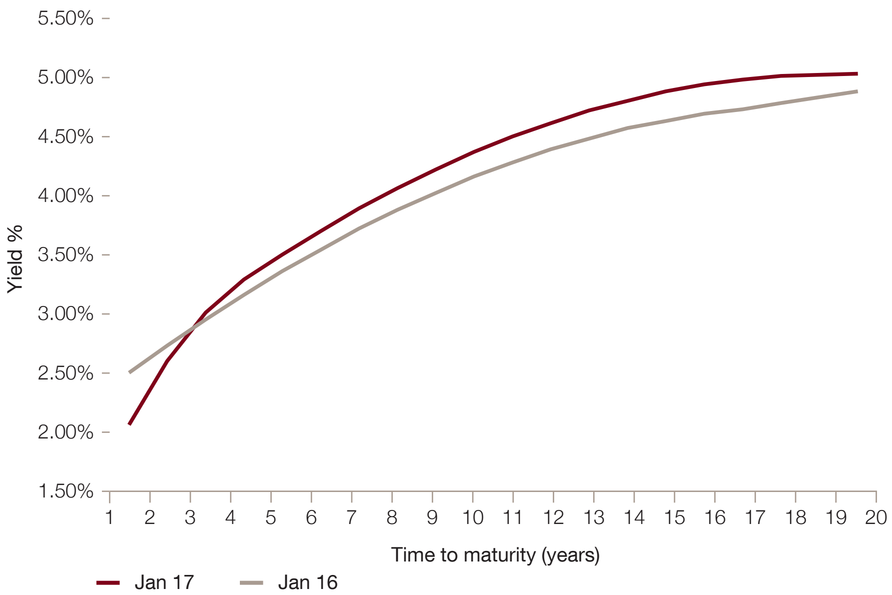
- the long-term average of current interpolated forward yields being close to 4.5%
- longer dated interpolated yields (beyond year 8) in the range of 4.0% to 5.0%.

PwC view

For the purpose of deciding a 'single' risk free rate to apply to all cash flows, PwC considers 4.5% appropriate.

With uncertainty surrounding global economic conditions, and an election occurring later this year this may prompt further movements in the risk free rate

Interpolated New Zealand Government Bond Forward rate curve (Jan 16 and Jan 17)



Source: The New Zealand Treasury

Mark Paterson

Director — Corporate Finance

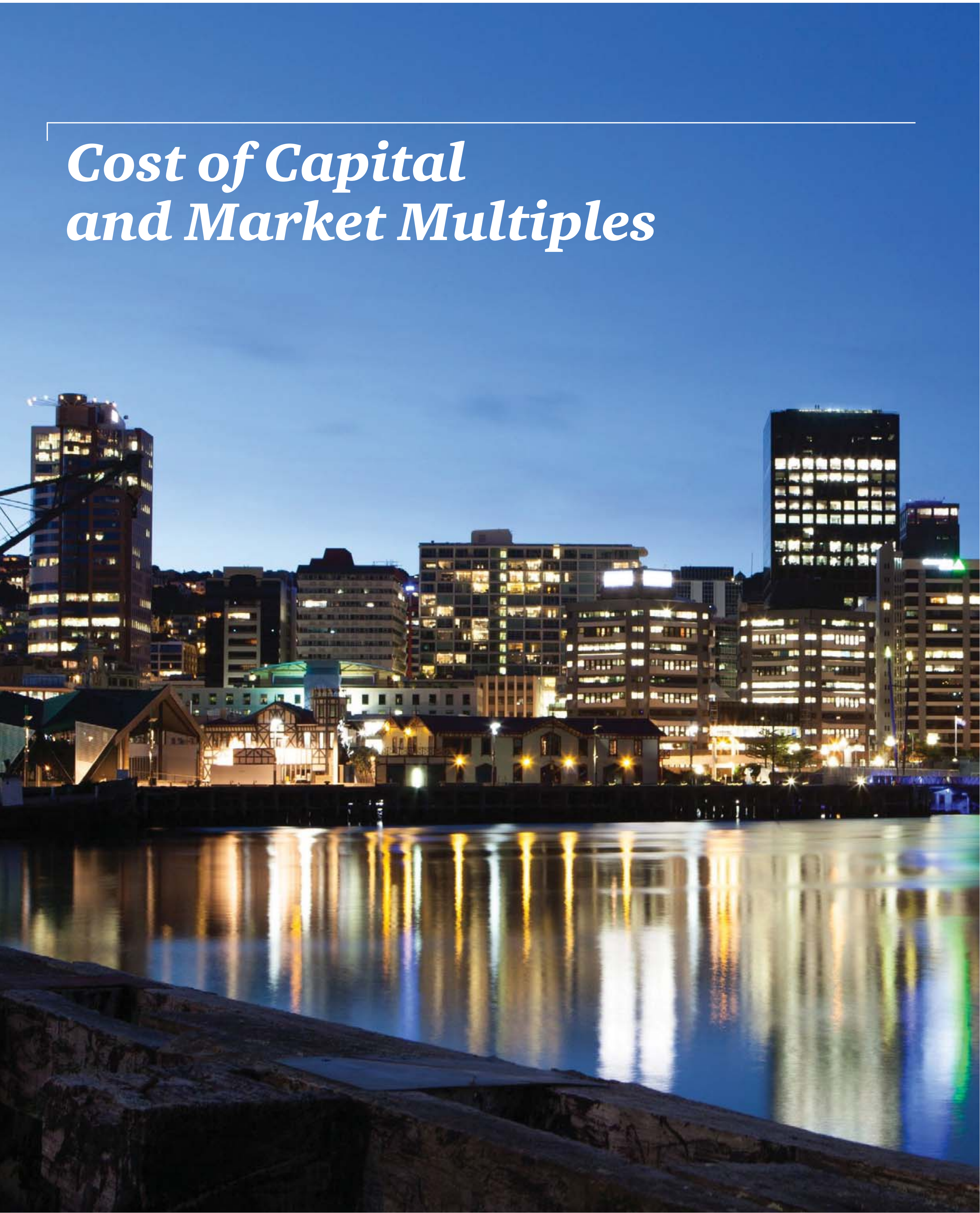
T: +64 9 355 8225

E: mark.n.paterson@nz.pwc.com

Our current view is that 4.5% is an appropriate estimate of the long-term risk free rate

[1] www.treasury.govt.nz/publications/guidance/reporting/accounting/discountrates/

Cost of Capital and Market Multiples



Following are observed Market Multiples and estimated Cost of Capital as at 31 December 2016 for selected New Zealand listed companies

This supplements our full analysis of the Cost of Capital in New Zealand which can be found on our website ***pwc.co.nz***.

As noted in this publication's article on the risk-free rate, we have used the long-term risk-free rate interpolated from the yield on New Zealand government bonds.

Where a multiple is negative or greater than 50x we have recorded this as not meaningful (NM).

Where a company has been listed for less than three years we have included that company's multiples although have not included the estimated WACC as there is insufficient trading history for calculation of Beta used in the calculation of WACC.

Charlotte Yee

Senior Analyst — Corporate Finance

T: +64 4 462 7356

E: charlotte.l.yee@nz.pwc.com

Justin Liddell

Partner — Corporate Finance

T: +64 9 355 8330

E: justin.g.liddell@nz.pwc.com

As at 31 December 2016

Input assumptions:

Market Risk Premium	7.5%	Risk Free Rate Of Return	4.5%
Marginal Tax Rate On Debt	28.0%	Investor Tax Rate On Equity	28.0%

Company	EBITDA Multiple	EBIT Multiple	NPAT Multiple	Equity Beta	D / (D+E) Ratio	WACC
Agriculture & Fishing						
The a2 Milk Company Limited	29.1	29.8	NM	1.4	-	13.7%
Fonterra Shareholders' Fund	NM	NM	NM	0.5	-	6.8%
PGG Wrightson Limited	8.0	9.0	9.6	1.4	26%	11.4%
Sanford Limited	10.9	13.8	18.2	0.4	22%	6.2%
Seeka Kiwifruit Industries Limited	8.1	12.2	10.0	0.7	51%	6.8%
Synlait Milk Limited	9.1	12.3	16.2	1.0	28%	8.9%
T&G Global Limited	9.5	13.2	13.7	0.6	39%	6.5%
						9.5%
Building Materials & Construction						
Fletcher Building Limited	10.0	12.8	15.8	1.3	19%	11.6%
Metro Performance Glass Limited	11.2	14.0	16.8	NM	22%	NM
Steel & Tube Holdings Limited	7.2	8.4	8.2	0.9	32%	8.7%
Tenon Limited	NM	NM	NM	0.5	27%	6.3%
						11.4%
Consumer						
Cavalier Corporation Limited	7.5	10.4	17.2	1.0	41%	8.3%
Comvita Limited	14.3	17.2	22.7	0.4	20%	6.2%
Delegat Group Limited	9.1	10.4	10.9	0.5	34%	6.4%
Moa Group Ltd	NM	NM	NM	1.4	-	13.9%
Promisia Integrative Limited	NM	NM	NM	1.1	4%	11.0%
Scales Corporation Limited	8.1	9.5	12.1	NM	11%	NM
SeaDragon Limited	NM	NM	NM	2.2	11%	18.0%
Trilogy International Limited	14.7	15.2	22.5	0.4	9%	6.0%
						6.9%
Financial						
Heartland Bank Limited	17.1	18.7	13.2	0.9	48%	7.4%
NZX Limited	16.8	19.6	29.7	0.4	7%	6.0%
Turners Limited	18.8	19.9	15.6	1.3	43%	9.4%
Tower Limited	NM	NM	NM	1.0	1%	11.0%
						7.8%
Health & Aged Care						
Abano Healthcare Group Limited	5.5	6.8	5.8	0.6	36%	6.7%
Arvida Group Limited	10.2	11.0	11.7	NM	7%	NM
BLIS Technologies Limited	NM	NM	NM	1.5	-	14.6%
Ebos Group Limited	13.0	14.5	20.0	0.9	13%	9.3%
Fisher & Paykel Healthcare Corporation Limited	18.2	21.1	30.3	0.7	1%	8.3%
Metlifecare Limited	5.2	5.2	5.2	1.5	6%	13.7%
Pacific Edge Limited	NM	NM	NM	2.8	-	24.1%
Ryman Healthcare Limited	12.1	12.6	11.2	1.2	15%	11.0%
Summerset Group Holdings Limited	11.7	12.0	10.3	1.4	21%	12.0%
						10.2%

As at 31 December 2016 contd.

Company	EBITDA Multiple	EBIT Multiple	NPAT Multiple	Equity Beta	D / (D+E) Ratio	WACC
Industrial Products						
EROAD Limited	20.8	NM	NM	NM	6%	NM
Future Mobility Solutions Limited	15.7	29.6	29.9	1.0	-	10.4%
ikeGPS Group Limited	NM	NM	NM	NM	-	NM
Mercer Group Limited	NM	NM	NM	1.7	33%	12.6%
Methven Limited	8.8	11.6	13.8	0.7	20%	7.8%
Scott Technology Limited	12.3	14.2	21.5	0.5	0%	7.2%
Skellerup Holdings Limited	9.2	11.3	14.3	0.6	11%	7.5%
Wellington Drive Technologies Limited	NM	NM	NM	0.5	13%	6.7%
						7.7%
Information Technology						
Gentrack Group Limited	17.9	19.5	26.3	NM	-	NM
Orion Health Group Limited	NM	NM	NM	NM	0%	NM
Plexure Group Limited	NM	NM	NM	1.9	-	17.5%
Pushpay Holdings Limited	NM	NM	NM	NM	0%	NM
Rakon Limited	NM	NM	NM	1.1	36%	9.3%
Serko Limited	NM	NM	NM	NM	3%	NM
SLI Systems Limited	NM	NM	NM	2.5	-	21.8%
Smartpay Limited	8.5	27.5	49.6	1.0	48%	8.2%
Trade Me Group Limited	18.2	18.7	26.6	1.1	6%	10.9%
Vista Group International Limited	39.1	40.6	NM	NM	1%	NM
Xero Limited	NM	NM	NM	2.2	-	19.9%
						15.5%
Investment						
Allied Farmers Limited	6.9	8.6	16.6	2.6	30%	17.8%
Barramundi Limited	13.7	13.7	17.3	0.4	-	6.6%
Hellaby Holdings Limited	11.5	16.4	17.6	0.4	22%	6.2%
Infratil Limited	12.1	20.0	48.5	0.9	51%	7.3%
Kingfish Limited	4.3	4.3	4.3	0.5	-	6.9%
Marlin Global Limited	NM	NM	NM	0.4	-	6.3%
Rubicon Limited	NM	NM	NM	0.8	38%	7.5%
Veritas Investments Limited	NM	NM	NM	1.7	79%	7.8%
						7.3%
Leisure & Tourism						
Millennium & Copthorne Hotels New Zealand Limited	7.8	8.6	11.6	0.4	14%	6.1%
SKYCITY Entertainment Group Limited	9.6	13.2	17.7	1.3	15%	11.8%
Tourism Holdings Limited	6.9	12.7	17.6	0.6	17%	7.1%
						10.5%

As at 31 December 2016 contd.

Company	EBITDA Multiple	EBIT Multiple	NPAT Multiple	Equity Beta	D / (D+E) Ratio	WACC
Media & Telecommunications						
Chorus Limited	6.7	13.7	17.8	1.2	56%	8.0%
Sky Network Television Limited	6.8	9.4	12.1	0.8	16%	8.3%
Spark New Zealand Limited	8.6	13.2	16.9	1.0	12%	10.0%
TeamTalk Limited	4.9	NM	NM	1.3	74%	7.6%
						9.1%
Mining						
New Talisman Gold Mines Limited	NM	NM	NM	0.4	-	5.9%
New Zealand Oil and Gas Limited	7.4	NM	NM	0.5	1%	6.9%
						6.8%
Ports						
Auckland International Airport Limited	19.1	22.5	28.4	1.0	21%	9.2%
Marsden Maritime Holdings Limited	12.4	12.6	12.3	0.6	3%	7.4%
Port of Tauranga Limited	20.8	24.8	33.9	0.6	11%	7.4%
South Port New Zealand Limited	9.8	12.1	16.6	0.4	7%	6.0%
						8.7%
Property						
Argosy Property Limited	9.6	9.6	9.3	0.6	40%	6.4%
Augusta Capital Limited	7.8	8.0	7.5	0.5	35%	6.5%
CDL Investments New Zealand Limited	5.9	5.9	8.0	0.4	-	6.0%
Goodman Property Trust	8.6	8.6	6.2	0.6	36%	6.7%
Kiwi Property Group Limited	8.4	8.4	6.9	0.7	36%	6.9%
NPT Limited	16.3	16.5	17.7	0.5	36%	6.5%
Precinct Properties New Zealand Limited	10.0	10.0	10.5	0.5	16%	6.7%
Property for Industry Limited	12.2	12.2	12.1	0.5	33%	6.3%
Vital Healthcare Property Trust	6.9	6.9	7.1	0.6	24%	6.9%
						6.7%
Retail						
Briscoe Group Limited	11.3	12.0	16.4	0.6	-	7.8%
The Colonial Motor Company Limited	8.2	9.1	10.7	1.0	28%	9.1%
Green Cross Health Limited	10.9	12.6	18.1	0.4	16%	6.1%
Hallenstein Glasson Holdings Limited	6.9	9.6	13.2	0.7	-	8.7%
Kathmandu Holdings Limited	7.3	8.8	11.7	1.5	10%	13.7%
Restaurant Brands New Zealand Limited	12.3	19.4	25.8	0.9	10%	9.8%
Smiths City Group Limited	17.9	23.3	8.2	0.9	59%	7.1%
The Warehouse Group Limited	7.5	10.8	12.5	0.7	27%	7.6%
						8.6%

As at 31 December 2016 contd.

Company	EBITDA Multiple	EBIT Multiple	NPAT Multiple	Equity Beta	D / (D+E) Ratio	WACC
Services						
AWF Madison Group Limited	8.7	11.0	14.7	0.7	20%	7.7%
Evolve Education Group Limited	8.2	9.0	11.1	NM	16%	NM
Intueri Education Group Limited	NM	NM	NM	NM	96%	NM
Opus International Consultants Limited	NM	NM	NM	0.6	45%	6.7%
						7.0%
Transport						
Air New Zealand Limited	4.5	7.3	5.3	1.1	51%	8.0%
Airwork Holdings Limited	6.1	11.1	10.3	0.6	39%	6.5%
Fliway Group Limited	5.9	7.4	8.7	NM	17%	NM
Freightways Limited	13.5	15.4	21.0	0.8	14%	8.5%
Mainfreight Limited	13.4	16.6	21.6	0.4	13%	6.0%
						7.5%
Utilities						
Contact Energy Limited	29.8	NM	NM	0.8	34%	7.6%
Genesis Energy Limited	7.0	9.7	11.4	NM	30%	NM
Mercury NZ Limited	11.0	16.8	24.6	1.1	26%	9.6%
Meridian Energy Limited	12.8	19.7	36.0	NM	16%	NM
NZ Windfarms Limited	NM	NM	NM	0.5	28%	6.6%
The New Zealand Refining Company Limited	5.0	7.8	8.4	0.5	27%	6.2%
Vector Limited	8.1	11.3	11.9	0.6	41%	6.7%
Z Energy Limited	19.2	25.0	36.8	0.9	28%	8.6%
						8.0%
Market Weighted Average						**9.0%**

Note all multiples are trailing.

Disclaimer: The Cost of Capital and Market Multiples is intended as an overview of WACC and Market Multiples as at 31 December 2016. Advisors may form a different view on key assumptions, beta, based on the perceived systematic risk of a company and its comparables. Readers are advised that before acting on any matter arising in this report, they should consult the PwC Deals team.

Contact us

	Corporate Finance	Transaction Services	Corporate Treasury & Debt Advisory
Auckland	*Murray Schnuriger* murray.p.schnuriger@nz.pwc.com	*Ian McLoughlin* ian.mcloughlin@nz.pwc.com	*Stuart Henderson* stuart.r.henderson@nz.pwc.com
	Justin Liddell justin.g.liddell@nz.pwc.com	*Colum Rice* colum.rice@nz.pwc.com	*Roger Kerr* roger.j.kerr@nz.pwc.com
	Eric Lucas eric.lucas@nz.pwc.com	*Gareth Galloway* gareth.a.galloway@nz.pwc.com	
	Karl Dwight karl.r.dwight@nz.pwc.com	*Russell Windsor* russell.l.windsor@nz.pwc.com	
	Regan Hoult regan.b.hoult@nz.pwc.com		
	Amy Ellis amy.e.ellis@nz.pwc.com		
	Mark Averill mark.averill@nz.pwc.com		
Hamilton	*Wayne Tainui* wayne.n.tainui@nz.pwc.com		
Wellington	*Richard Longman* richard.longman@nz.pwc.com		*Brett Johanson* brett.a.johanson@nz.pwc.com
Christchurch	*Craig Armitage* craig.armitage@nz.pwc.com		
	Wayne Munn wayne.r.munn@nz.pwc.com		

	Real Estate Advisory	Business Recovery Services
Auckland	*Rob Cameron* robert.j.cameron@nz.pwc.com	*David Bridgman* david.bridgman@nz.pwc.com
	John Schellekens john.b.schellekens@nz.pwc.com	*Kate Dekker* kate.e.dekker@nz.pwc.com
Wellington	*Richard Chung* richard.h.chung@nz.pwc.com	*John Fisk* john.fisk@nz.pwc.com
Christchurch		*Maurice Noone* maurice.noone@nz.pwc.com
		Malcolm Hollis malcolm.g.hollis@nz.pwc.com

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