

# Pohutukawa



---

Manager Report: Bill Kermode, Director of Direct Capital Limited

---

The following was presented at the Annual Shareholders meetings, Wednesday 21 May 2012.

Thank you for coming to the shareholders meetings for PI and PII.

The 2012 financial year has been one of solid progress for both Pohutukawa funds. The highlights have been:

- Firstly, a significant milestone in Pohutukawa I with the achievement of the return of your total capital investment amount. This was primarily on the back of the realisation of the GoBus investment, at a significant uplift over the purchase price, and the resulting 32c distribution to shareholders being paid in the last week. This included a number of fully imputed dividends;
- And secondly, three new investments in Pohutukawa II – into new portfolio companies Scales, PF Olsen and Hiway Group. In the case of the PF Olsen and Hiway, these were mainstream Direct Capital investments – straightforward shareholdings in successful, privately owned, well managed New Zealand businesses. The individual businesses in Scales fitted the Pohutukawa mould too, but the Scales holding company structure that owns those businesses brought with it some additional elements – the company had more than 500 shareholders at the time of our initial investment, making investment and related activity subject to the Takeovers Code; the 80% total stake that Direct Capital acquired was from the receiver of South Canterbury Finance; and it was too large for Direct Capital to do on its own and NZ Super and ACC funds were brought in as Co-Investors.

The companies included in the two funds continue to represent a significant group. With GoBus included, the 13 companies in the portfolios have \$840m in annual revenues, around 3,900 employees, and operate from more than 130 locations in New Zealand and Australia, and one in the UK.

I will now turn to an outline of the individual portfolio companies, firstly in Pohutukawa I.

# Pohutukawa



## Pohutukawa I highlights

- A distribution of 31.75 cents per share was made to shareholders this month. This distribution reflected:
  - GoBus and Innovair realisation proceeds; and
  - Dividends from NZKS and Fishpond;
  - There were no direct investments made in Pohutukawa I companies in 2011 although there were some small follow-on investments made in three BPV companies.
- Total gross distributions for Pohutukawa I to date are \$1.08 per \$1.00 invested.

## Pohutukawa I distributions

- The directors' assessment of the net asset value of the investments remaining in the portfolio is 49c, implying a gross return multiple before an Earnout provision of 1.57x.

## Pohutukawa I portfolio composition

- 6 investments have now been realised at a weighted average money multiple of 2.9x;
- 6 investments remain in portfolio, plus the interest in BPV, with valuations heavily weighted to the largest two, NZ King Salmon and NZP, which represent over 60% of the portfolio value;
- Up to \$7.5m is available for follow-on investment, enabling portfolio companies to consider acquisitions or value adding expansion initiatives.

## GoBus investment observations

- GoBus more than doubled in size during Direct Capital's involvement
  - Bus numbers increased from 410 to more than 750;
  - Employee numbers increased from 460 to more than 800;
  - New contracts were added in Hawkes Bay and Bay of Plenty;
  - Canterbury Bus Services in Chch was acquired;
  - There were substantial increases in the school bus business;
  - Direct Capital underwrote all rights issues to fund the growth, lead arrangement of associated bank financing, and executed the CBS acquisition
- It was also instrumental in key executive appointments, including new CEO Calum Haslop shortly after investment.

# Pohutukawa



## Observations of Pohutukawa portfolio performance

- The portfolio is heavily weighted towards its two largest investments, NZKS (food) and NZP (pharmaceutical manufacture);
- Current trading conditions across the portfolio during the last twelve months have been challenging, reflecting the general state of international and local economic conditions;
- The Manager remains focused on creating operational value with all portfolio companies during this period;
- Debt levels within the portfolio remain relatively low:
  - Portfolio company Debt/EBITDA multiples are generally in the range of 1 - 3x;
  - Ongoing dividends from portfolio companies are expected; and
  - The respective banks continue to support each portfolio company.

## Pohutukawa II highlights

- Pohutukawa II has now completed six investments;
- Shareholder calls now total 47 cents per dollar share, post the 10 cent call paid in April 2012 which covered funding for the follow-on investments in Scales Corporation and PF Olsen, and capital for the next investment;
- Pohutukawa II's maiden distribution of 2 cents was paid in September 2011, reflecting fully imputed dividends received from Transaction Services and Bayleys, and a return of capital from Transaction Services;
- We are hopeful of another distribution of dividends before the end of the calendar year.

## Pohutukawa II portfolio composition

The portfolio composition highlights that 60% of the portfolio is in the two largest investments Transaction Services and Scales, and the remaining 40% reasonably evenly spread among the other four.

## Hiway Group

- Pohutukawa II invested \$3.6m for a 14.3% shareholding in December 2011. Combined with Direct Capital, the total shareholding is 60%;
- Hiway is a specialist roading and infrastructure contractor in NZ and Australia:
  - Hiway Stabilizers provides horizontal stabilising, primarily for road construction and maintenance;

## Pohutukawa



- Hiway GeoTechnical provides vertical stabilising and environmental remediation
- The investment is highly consistent with the Pohutukawa II mandate:
  - It is a succession transaction, passing ownership from one generation of the founding family to another while retaining all the executive shareholders, plus one new one;
  - It is leveraging off increased levels of spending on infrastructure by national and state governments;
  - And it has a strong Trans-Tasman growth focus.

### PF Olsen

- Pohutukawa II invested \$2.4m for a 9.5% shareholding. Combined with Direct Capital, the total shareholding is now 40% (an initial 30% in September 2011 and a further 10% in April 2012);
- PF Olsen is an independent provider of forestry services, primarily forestry and harvest management;
- Again, the investment is consistent with the Pohutukawa II mandate:
  - PF Olsen is the leading independent player in an important and large industry.
  - It has strong growth prospects, significantly based on trans-Tasman expansion, and
  - It is a medium term succession investment.

### Scales

- Pohutukawa II invested \$7.3m for a 9.0% shareholding including a convertible loan advanced to the company of \$2.3m. Combined with Direct Capital, the total shareholding is 80% (with co-investors NZ Super and ACC).
- Scales main divisions are:
  - Mr Apple, the largest grower, packer and exporter of apples in NZ;
  - Storage and Logistics involving the Polarcold and Whakatu coldstores, Liqueo and Scales Logistics;
  - Meateor, a pet food ingredient supplier; and
  - Property holdings, which are mainly two industrial parks and other commercial property.
- The various Scales businesses are highly consistent with the Pohutukawa II mandate, being:
  - Mid market primary sector buyouts;
  - Scales corporate is a public unlisted structure.

# Pohutukawa



## Cavalier Wool Holdings

- Pohutukawa II has invested \$3.4m for a 6.0% shareholding. Combined with Direct Capital, the total shareholding is 25%.
- Cavalier Wool Holdings is one of two, and the largest, wool scouring companies in New Zealand, processing 60-70% of the national greasy wool clip each year:
  - It has operations in Napier and Timaru and is the only full wool scouring processing commission-only operation in the country;
  - Wool grease is extracted as a by-product and used for refining into lanolin for use in the cosmetic and pharmaceutical markets.
- The company last year received Commerce Commission authority to acquire the scouring assets of Wool Services International, subject to agreement of the shareholders, and continues to negotiate with WSI to effect the transaction.
- Trading this financial year has been sound, with lower than budget wool volumes being compensated by higher than budget wool grease prices.

## Bayleys

- Pohutukawa II has invested \$3.6m for a 7.5% shareholding. Combined with Direct Capital, the total shareholding is 32%;
- Bayleys is the leading national real estate services business, with a well regarded brand. The business includes real estate agency (in the Residential, Commercial & Industrial and Rural categories) and Property Services;
- Bayleys has grown revenues and earnings over the last year despite the continued weak property market.

## Transaction Services

- Pohutukawa II has invested \$5.7m for an 11.4% shareholding. Combined with Direct Capital, the total shareholding is 49%;
- As an outsourcing payment processor, the business incorporates (1) billing services (2) call centre customer management (3) debt collection and (4) club management operating software, initially in the gym and sports club markets, but now expanding into sectors as diverse as educational residential, direct TV sales, storage, and optical retail;

## Pohutukawa



- TSL revenues are generated roughly 80% in Australia, 20% in NZ. Both countries continue to grow compared with last year's numbers;
- TSL returned \$1.4m, 24% of the original Direct Capital investment, in September 2011, while continuing to pay normal dividends.

### Investment outlook

- The Manager's focus for new investments will continue to be on privately owned companies with strong track records, good people who will partner with us, and industry dynamics which are favourable for financial investment;
- We've seen as many new investment prospects so far this year as we usually do, but none is yet well progressed, which is slower than usual. We believe this is a consequence of the cautious and uncertain macroeconomic outlook. We continue to pursue our established investment approach to make sound investments with your funds;
- Economic conditions remain challenging and we believe will continue to be so for some time. So we remain cautious in our approach to new opportunities, and particularly so with respect to Australia where performance and macroeconomic indicators have been markedly downbeat over the last 9 months;
- However we continue to believe that our existing portfolio companies are well placed to continue to perform well, and the funds ultimately continue distributions.
- Thank you for your continued support and we look forward to continuing to provide you with the financial returns you have come to expect from Pohutukawa.