Pohutukawa

Manager’s Report: Ross George, Managing Director, Direct Capital Limited

The following was presented at the Pohutukawa Annual Shareholder meetings, Wednesday 19th May 2010.

Thank you for coming to the shareholders meetings for Pohutukawa I and Pohutukawa II. As John McDonald has said on behalf of Direct Capital, the manager of the Pohutukawa Funds, I will report on the investment activity and portfolios for both Pohutukawa 1 and 2. The Manager of both Pohutukawa I and Pohutukawa II is a joint venture between Direct Capital and Craigs Investment Partners.

I would first like to introduce the Direct Capital team

Mark Hutton
Bill Kermode
Tony Batterton
Gavin Lonergan
Simon Plowman
Travis Sydney
Andrew Frankham
Craig Prosser

I am advised that there is an almost 75% overlap in shareholders between the funds. In any event the investment approach and style Direct Capital takes, is the same in both funds.

The slide attached sets out the position of the two funds.

You will see that Pohutukawa I invests together with the institutional fund Direct Capital III and Pohutukawa II in tandem with Direct Capital IV. From here-on I will refer to the funds as Pohutukawa I and Pohutukawa II.

There will be no new investment in Pohutukawa I, but as the annual report outlines, Pohutukawa I may inject additional capital to allow any one of those 8 existing portfolio companies to buy an add on business which complements its existing operations. This enables the portfolio companies to actively consider acquisitions when many other companies are retracting.

By way of example, Stratex, a New Zealand Company acquired an Australian operation in 2008 and Pohutukawa I injected capital into Stratex to enable it to make that acquisition. This same situation is currently under consideration in 3 of the 8 companies as we speak. With all our investments, we have board representation in each company and are involved with those strategic acquisitions.

Pohutukawa II on the other hand, is actively pursuing new companies to invest in. Transaction Services Limited was its first investment and we are actively involved, as we always are, with new prospects and are hoping to make our next investment within the month.

The Pohutukawa Portfolio

Across both funds, the portfolio comprise 14 companies, with only 1 in Pohutukawa II at this stage.

In aggregate, it's a large group with $900m in revenues and 3,000 employees. It has a current value of $775m and debt of $200m (about $15m in each), with a total of 4 different banks.

The average Direct Capital shareholding is 48% with 6 majority and 8 minority stakes. The businesses operate from a total of 204 locations in Australia and New Zealand

I now want to turn to general investment issues which apply to both funds. I will take as read, the annual reports for Pohutukawa I and II.

Current Investment Climate

We would characterise 2010 as a relatively normal investment market.

- Australasian economies are both growing.
- Equity capital is scarce, as it is long term.
- Banks are cautious, but lending again as is the case long term.
- There is a reasonable amount of structural change in the economy leading to corporates buying and selling businesses.
- Further compounding the existing aging demographic, private company owners, age 1 year every 365 days.
- Activity has returned to the private company market towards long term volume or activity levels.

All of this is positive for us and the Pohutukawa funds are well regarded in the private company market, banks are willing to lend to our portfolio companies and we have equity capital to make things happen.

As I said at last years meeting, the period 2005/2007 was in our experience not a normal period and virtually none of the long term market characteristics outlined above were in place. Although it didn't look like it to everybody at the time, risk was exceptionally high. Risk is often inversely correlated to its public image. When it looks the lowest, it is often the highest and vice versa. Investment risk is at very tolerable levels for us at present.

At Direct Capital we spend time on industry studies, to identify sectors to actively pursue investment in for Pohutukawa.
There are currently 4:

- Health
- Education
- Supply and services to the infrastructure industry & property industries, and
- The consumer industry (which we will target towards the end of this year).

We are a reasonably long term investor. It is therefore no use following a short-term trend which may be "flavour of the year" in the listed market.

Consumer obviously falls into this category, it is not currently in favour.

Having identified the industries of interest to us, we are most fortunate in the private company market, to have a large number of private companies to talk to.

We seek to invest in profitable private companies with revenues of $30m - $250m. There are approximately 850 companies fitting this criteria in New Zealand. By way of comparison, there are approximately 70 profitable companies on the NZSX.

You will note I used the word profitable. This is particularly pertinent in today's climate. Many people talk to me socially and say :

> *"it must be easy for you at the moment with all those companies struggling financially"*

I need to reiterate that the rescue market or the financially troubled market is not our target area. We invest in companies that are currently profitable, in good industries with good people. We inject Pohutukawa's capital into those good companies who are already going well to expand their *currently successful* business.

We don't put Pohutukawa's capital into financially troubled businesses to rescue them. That is a different risk profile.

As you will have noticed from the portfolio makeup, the industries that we focus on changes over time, depending on our long term economic views. By way of example, there was an unprecedented consumer boom for 15 years to 2007, and many successful investments were targeted at those consumer cashflows. If we were to look at the major cashflows today, a large number of them in New Zealand and offshore appear to be central Government cashflows and 2 of our current industry focuses on health and infrastructure services aim to target those long term cashflows.

That is a summary of how we at Direct Capital approach investment of Pohutukawa I and Pohutukawa II in the current climate.

POHUTUKAWA I

I would now like to turn specifically to Pohutukawa I. I would like to say at the outset that the Pohutukawa 1 portfolio has performed very well, and we are delighted with it.

To re-cap, investors committed a total of $53m to Pohutukawa I.
Pohutukawa I invests alongside Direct Capital III, which is made up by institutional investors and gives a total investment pool of $130m.

You have committed $1.00 per share to Pohutukawa I.

We have now drawn down $1.00 per share and now hold cash reserves.

You have had a maximum of 57 cents outstanding because some of the assets have been sold and the money returned to you.

The NTA of the remaining 8 portfolio companies, along with cash and BPV investments is 84 cents/share (76c) net.

We understand from Craigs the current share price is 90 cents, which suggests the market believes the remaining 8 assets are worth more than their valuations set out in our annual report.

I will now give you an outline on the individual portfolio companies in Pohutukawa I.

NZ Pharmaceuticals

Industry	Pharmaceuticals
Locations	Palmerston North, Reading

NZ Pharmaceuticals is budgeting for an almost 20% increase in revenues, but EBITDA down by 3%. While this does not sound satisfactory, it reflects primarily exchange rate differences – 96% of NZP's sales are denominated in US$, and the budgeted rate of 70c is considerably higher than last year's actual in the low 60's. A significant part of the revenue growth is due to the newly acquired UK company Dextra Laboratories. The Dextra acquisition and integration have proceeded well, and Dextra's carbohydrate chemistry capability adds a significant bow to NZP's product offering. Its physical presence in the UK – at Reading, an hour out of London – is also proving a positive for NZP in its marketing of its existing products.

Stratex

Industry	Manufacturing
Locations	Auckland and Sydney

Key points:

1. Likely to complete its financial year 7% down in earnings compared to last year, reflecting softer market demand;
2. Has completed the operational merger of its acquired business, Trans Tec, and is developing new products utilising this technology;
3. Is seeking to complete a further acquisition in Australia.

Triton

Industry	Healthcare Services
Locations	Christchurch, Hamilton & Tauranga

- Doubled the number of clinics and nearly doubled revenues since our investment in 2006;
- Current ACC funding pressures but outlook underpinned by strong demographics;
- Currently rounding out existing territories by opening new clinics.

GoBus

Industry	Transport
Location	Waikato, Central North Island

GoBus now operates 600 buses.

1. 2009 a year of significant change at GoBus, with the company commencing the urban services in Tauranga and the Hawke's Bay. Also increased its number of MOE routes 3 fold, from Waikato down to Hawke's Bay. All new services well executed and high levels of customer service maintained;
2. Having bedded down the expansion, the focus has shifted to maintaining operational best practice across all aspects of the business;
3. GoBus is now double the size from when Direct Capital invested in late 2007.

Shears&Mac4

Industry	Manufacturing
Location	Auckland

Key Points:

1. Has grown its revenue more than 30% (earnings 75%) in what has been a tough trading environment, but margins have been reduced. Nonetheless, a very satisfactory turn-around from its prior year;
2. The company has a solid order book with 30% of its revenue ex Australia;
3. The company is completing its operational merger from two sites to one, (Onehunga) and also seeking to complete an acquisition in Australia in order to complete the installation work that the company currently sub-contracts.

Rodd & Gunn

Industry	Retail
Location	Auckland H.O. (Australia/NZ wide)

Market conditions for retail have been quite positive in Australia, NZ still fairly flat;
Rodd & Gunn has continued with its store expansion plan through this period, particularly in Australia, and the group now has 64 stores, of which 43 are in Australia - Rodd & Gunn has grown market share through the recession;
Focus remains on growing the diffusion 'R&G / Duck range aimed at the younger customer, with first stand alone 'Duck' store opened in Newmarket in April.

NZ King Salmon

Industry	Food
Location	Nelson, Picton, Auckland, Sydney & San Francisco

- Government has recently announced plans to streamline the consent process for new aquaculture farms. NZKS view this as a positive development which should ensure production can meet market demand;

- NZKS enjoyed a significant increase in orders in both Asia and Middle East following the impacts of the volcano in Europe, with good follow through on sales in these markets;

- Currently trading ahead of budget and outlook for 2011 year remains positive.

Fishpond

Industry	Online Retail
Location	Auckland

Fishpond's results are ahead of the investment case. The company continues to grow at an impressive rate, sales for example running at close to 100% growth per annum while maintaining impressive profitability. Their product offering has two competitive advantages – in Australia, their largest market, the absence of GST for customers, and in NZ, delivery times for much of their stock of 1 – 2 days compared with rival Amazon's 8 – 12 days. If you didn't take advantage of the voucher you were sent when we invested, you should look at the site, fishpond.co.nz – I'd encourage to still do so and see the range and ease of purchase they provide compared with traditional retail bookshops.

BioPacificVentures

As you will recall Pohutukawa 1 allocated capital to companies in the BioPacific Ventures portfolio. Two of its investments are held in common with Pohutukawa 1, namely New Zealand King Salmon and NZ Pharmaceuticals. I want to highlight one of the other investments, Horizon.

Horizon

horizon science

Horizon Science is one of BioPacificVenture's larger investments. It markets the world's first "slow-burning" or "Low GI" sugar, LoGiCane. It's in both the big supermarket chains here under the Chelsea brand.

This product helps people to control the sugar rush and, more importantly, it controls the overload your body gets trying to handle sugar – which indirectly leads to diabetes.

LoGiCane was first launched in Australia a little over a year ago as a "better for you" sugar, and has now captured 2% of the value of the entire supermarket sugar sector. And that's with just one product offering - a broader range is in development.

But more importantly, talks are underway in several off-shore sugar companies, in the USA, Japan and India to mention a few. Deals with these parties will be the value-driver for Horizon.

POHUTUKAWA II

I would now like to turn to PPE II

To re-cap, investors committed $82.5m to Pohutukawa II.

Pohutukawa II invests alongside Direct Capital IV, which is made up by institutional investors, and gives a total investment pool of $325m.

You have committed $1.00 per share to Pohutukawa II and to date we have drawn down 10 cents per share.

Going forward when Direct Capital IV makes a new investment, Pohutukawa II invests its proportional share in each company alongside those institutional investors in Direct Capital IV.

When you read in the newspaper that Direct Capital IV has made a new investment, Pohutukawa II will always be part of that investment.

The first investment in Pohutukawa II is Transaction Services Limited.

Transaction Services Limited

Industry	Financial Transaction Services
Locations	New Zealand & Australia

Investment completed in January, and traded to expectations since then.

- The company is achieving record customer numbers, as a result of key gym clients adding gyms through acquisition and new openings;
- The company also continues its push into other vertical markets outside gym and sports clubs - talking to telecommunications, child care, storage coys, web hosting coys, security businesses about their using the company cash processing services (anyone processing large volumes of small dollar value transactions by direct debit).

Other

We are currently very close to 2 further investments and will most likely make one of those very shortly. Whilst I would share more details of these investments, I am unable to do so due to standard confidentiality terms associated with the transactions.

I hope that this gives you a good outline of how we are investing your capital, and the companies we have invested in to date.

You are aware of the 4 successful realisations made in the global financial crisis, and hope that this reconfirms in your minds the solid nature of companies Pohutukawa invests in. We spend as much time assessing the down side as we do the up and this has proved to be invaluable in the long term.

The market is back to normal, our investment efforts and approach has not changed from the alarmingly simple trio of

- good industry,
- good business, and
- good people.

This approach has worked for 16 years now for us, and we have no intentions of changing it.

Thank you for your continued support, we fully intend to continue providing you the returns we have made over the last 16 years in the next 16 years.

Presentation concludes.

Portfolio Companies

DIRECT CAPITAL III Pohutukawa I	DIRECT CAPITAL IV Pohutukawa II
New Zealand King Salmon SHEARS & MAC4 EXPERTS IN SHOPFITTING & COMMERCIAL INTERIORS go bus STRATEX PRODUCT PROTECTION fishpond.co.nz RODD & GUNN Triton HEARING CLINICS NEW ZEALAND PHARMACEUTICALS NZP LTD	transactionservices
Total Capital = $130m	Total Capital = $325m

DIRECT CAPITAL