

Pohutukawa



Manager Report: Bill Kermode, Director of Direct Capital

The following was presented at the Annual Shareholders meetings, Thursday 16 May 2013.

Thank you for coming along today to the Annual Shareholders Meeting for Pohutukawa I and Pohutukawa II.

As John has outlined, the 2012 financial year has been another successful one for both Pohutukawa funds, and all investors. The notable investment activities for the year were the successful realisation of the GoBus investment in Pohutukawa I, and five follow-on investments into Pohutukawa II portfolio companies. There were no new investments in Pohutukawa II. And within the two portfolios there was again significant organic activity.

The eighteen companies which the two funds have invested in to date continue to represent a significant New Zealand corporate group. The companies have \$1.3bn in annual revenues, employ around 4,500 people, and derive more than 50% of their revenues from offshore.

Our experience in those companies has been that in general, economic conditions in New Zealand have been improving over the last 6-9 months, and the outlook for the next 12 months is positive. And in Australia, perhaps surprisingly given the newspaper headlines, the portfolio companies' performance over that period has also been positive.

Companies continue to look to repay debt rather than increase it, while the banks have over the last 12 months become increasingly keen to lend to companies. The performance of the listed market is a good illustration of the fact that there is plenty of money around, even at high valuations, for companies that can provide yield to investors or are perceived to have high growth prospects. However our strategy of investing in successful, established, well managed privately owned businesses, alongside good partners, remains unchanged.

Turning to performance in our portfolio companies, starting with Pohutukawa I:

- With the \$53m of capital in Pohutukawa I, we invested, alongside Direct Capital III, in twelve privately owned companies. We have realized 6 of these investments at a weighted average gross money multiple of 2.9x. 6 investments remain, plus the interest in BioPacific Ventures.

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- Trading conditions in the portfolio during the last twelve months have been mixed, reflecting either the specific trading environment of the industry sector the company is exposed to, or specific issues encountered by the portfolio company. For example, NZKS experienced farm production issues, which reduced the volumes of fish produced for harvest. Stratex and Shears & Mac did not achieve expectations during the year due to industry challenges specific to each company, but both companies are implementing robust initiatives to build their respective businesses. Rodd & Gunn's performance has improved this year after a challenging 2011 year (particularly in Australia), and it had a very strong Christmas. Fishpond's sales growth continued, but systems integration issues with its new US and UK subsidiaries affected its bottom line. NZP however had its best ever financial performance, even with the NZD / USD exchange rate at such unattractively high levels.
- The six companies remain focused on their individual game plans and these will continue to develop over the years to come. Inevitably the outcomes will take time and will result in varying degrees of success. The portfolio valuation is now heavily weighted to the two largest investments, NZ Pharmaceuticals and NZ King Salmon, which represent almost 80% of the remaining value (including BPV). The portfolio valuation increase during the 2012 year was centred around NZP's strong uplift in performance. While the outlook for each of the individual companies is solid, we do not expect the 2012 portfolio valuation uplift will be repeated in 2013.
- We also do not expect significant distributions from the Pohutukawa I companies in the 2013 year. The Manager continues to support each company with additional capital if required, and we believe that being patient to execute the game plan strategies in each company will enable the best results to be achieved on your behalf.

To give you an insight into the key aspects of each of those game plans:

- NZ King Salmon has embarked on a strategy to increase marine farm capacity, going through an Environmental Protection Authority process for new salmon farms in the Marlborough Sounds. That process resulted in permission being granted by the EPA for four new farms, albeit that is now subject to appeal. The process has been a long, and very expensive one for NZ King Salmon. However if the appeal is dismissed, the four new farms would double the company's productive capacity. The earliest these farms will be productive is 2015, and the company will require new capital to implement its growth plan.
- NZP has committed to an extensive capital expenditure program to increase its productive capacity. We expect this spend to be funded from internal and bank debt

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sources. The company also has a number of exciting product development initiatives underway but these will take time to produce a sustainable uplift in earnings.

These are the two remaining big value drivers in Pohutukawa I and the remaining four investments combined represent only about 20% of its current value.

- Stratex has invested in new print and lamination capability to more directly target its end customer market. Stratex has secured a number of new contracts as a result.
 - Rodd & Gunn opened two new stores in Australia during the year, and launched its new youth brand “Bing Harris” with a small number of standalone stores and Myer concessions. The company has continued to develop its wholesale business in Australia and the USA which is providing earnings diversification.
 - Shears & Mac has made good progress in diversifying its business from retail to include the hospitality & gaming, and construction sectors, particularly in the Australian market. And, with the Christchurch reconstruction now well underway there is an expectation that margins in the industry will improve over time. Notwithstanding this, it continues to operate in a challenging environment.
 - And Fishpond continues to focus on maintaining its position as the number one online retailer in Australasia other than Amazon, and particularly to grow its non-book categories such as toys, health and beauty, movies and lifestyle.
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- Pohutukawa II’s six portfolio companies traded well during the year, and continue to do so which is very pleasing.
 - No new investments were made in the year. We were as active in evaluating the market last year as ever, but our observations of deal activity in the 2012 year were that:
 - There were a comparable number of opportunities and transactions to previous years.
 - The quality of maintainable earnings in many of those potential investments were not, to our judgment, sustainable.
 - We saw a good number of investments as being completed at unusually high valuations;
 - And also a bigger number than usual of significant opportunities that were not completed - by anybody.

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- I will talk a little later to the fact that our experience so far in 2013 has been more encouraging, and we are currently actively engaged on two interesting new prospects.
- We did however make five follow-on investments in 2012, into three Pohutukawa II companies.
 - Two of these were into Hiway Group and made alongside existing management shareholders. The first investment in July allowed the company to acquire new specialised machinery to assist its Christchurch growth plan. The second follow-on investment was in October, to acquire a similar business to Hiway in Brisbane. This acquisition effectively doubled the size of Hiway's Australian operation, and cemented the Group with a strong Australasian footprint.
 - Your Manager also made two follow-on investments into Scales Corporation. In January Pohutukawa II and other Scales shareholders funded Scales company Mr Apple into acquiring a 10.1% interest in Turners & Growers. This investment was made to build greater industry co-ordination and consolidation, a move which is now "bearing fruit". The second follow-on investment was utilised to fund a number of capital initiatives in the Scales group, with Direct Capital increasing its total shareholding from 80% to 83%;
 - The fifth follow-on investment was into forestry management business PF Olsen, increasing our shareholding from 30% to 40%, an investment made with the benefit of our first 6 months ownership of the business. PF Olsen has an exciting growth plan in Australia.

We are very pleased with the makeup of the Pohutukawa II portfolio to date. It represents a broad cross section of New Zealand industry whilst also having extensive exposure to offshore markets.

60% of the portfolio is in the two largest investments - Transaction Services and Scales - with the remaining 40% reasonably evenly spread among the other four.

- The Scales investment is leveraged to the growing agri and food sectors of the New Zealand economy. The company has completed a very successful year and has met all its internal targets, particularly concerning debt reduction. As a result Scales has declared its first

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dividend during our ownership which is included in the Pohutukawa II distribution payment announced today. The current financial year is also tracking well, with the important apple crop now successfully harvested.

- Transaction Services revenues are generated approximately 80% in Australia and 20% in NZ. DebitSuccess is the largest brand it trades under, hence the logo on the slide. Both Australia and New Zealand showed growth over the prior year's numbers, and Transaction Services continues to pay dividends whilst also paying down its bank debt facility. Debit Success had some notable contract wins in new sectors with companies such as eyecare specialists OPSM, and diet company WeightWatchers.
- Hiway Group is currently heavily involved in remedial works, like those we have just seen, in Christchurch and in Queensland. The company has had a very successful trading year. The game plan to focus on Christchurch and Queensland has been successfully implemented to date. The challenge will be to continue these plans and manage growth in the Australian operation, which now makes up greater than 50% of contribution, from a low base in 2011.
- Bayleys grew revenues and earnings in 2012. The recent surge in Auckland property sale volumes has benefited the company and the real estate market shows little sign of abatement in the short term.
- Cavalier Wool Holdings continues to support the consolidation within the industry and will continue to pursue this strategy if opportunities unfold. Trading this financial year has been strong, with a strong market share of wool volumes being achieved along with higher than budgeted wool grease prices. The company continues to pay frequent imputed dividends to shareholders.
- Since our investment in PF Olsen in late 2011, the company has secured two significant forest management contracts in Australia, which when fully planted, will represent a substantial increase in forestry managed hectares. PF Olsen has increased its number of employees in Australia from 5 to 25 in the short time we have been a shareholder. And in New Zealand, the company continues to endeavour to take a leadership position in all aspects of forestry management, and in particular health and safety in the forestry industry.

Investment outlook

- The Manager's focus for new investments will continue to be on profitable privately owned New Zealand and Australian companies with good management teams who will partner with us.
- We continue to pursue our established investment approach to make sound investments with your funds. We will remain cautious in our approach to new opportunities.

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- As mentioned earlier the Manager is currently in due diligence on two interesting opportunities. It is expected both will take some time to conclude an investment. Both have one of our main investment themes - Succession - at their heart, and in both cases there may well be future follow-on investment opportunities if they grow as they hope to.
- We continue to believe that our existing portfolio companies are well placed to continue to perform well.
- A further distribution in Pohutukawa II is possible before the end of the calendar year.

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.