

# New Zealand

*Despite record high exchange rates and rising interest rates, M&A activity remains strong*

## Current Environment

The economy has grown steadily, with GDP growth posted at 2.8 percent from a low point of 1.4 percent in the year to September 2006. The government's original growth forecast called for relatively subdued levels in the short term, with an expectation for households to go through a period of consolidation before an export-led recovery would lead to growth increasing to historical levels of around 3 percent in 2009 or 2010. The latest figures appear to indicate that this recovery has arrived ahead of schedule.

Citing continuing buoyancy in the housing market, a tight labour market, increased government spending and strong growth in dairy prices, the Reserve Bank increased the Official Cash Rate three times between March and June 2007. It is now at 8.0 percent, the highest it has been since the New Zealand dollar was floated. This makes New Zealand's interest rates the highest in the developed world, with the exception of South Africa. As can be imagined, the interest rate situation is frustrating businesses and homeowners alike.

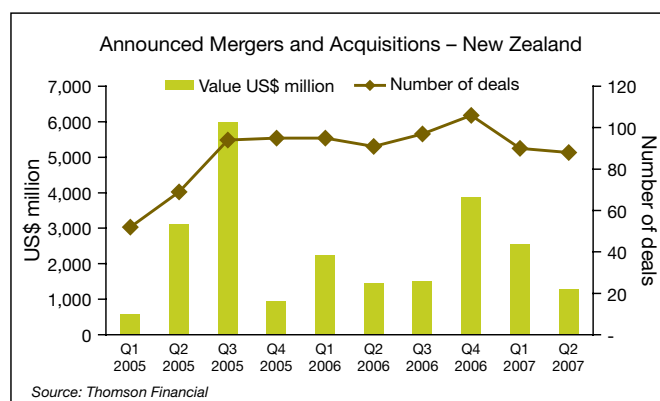
The high interest rate has supported the New Zealand dollar, which has reached .80 US Dollars, also a post-float record. In addition to the US, the New Zealand dollar has also been strong against other trading partners as evidenced by the high level of the Trade Weighted Index. Similarly, the terms of trade (ratio of merchandise export prices to merchandise import prices) are well above average, primarily due to high global dairy prices.

A surprise in the foreign exchange markets was the intervention of the Reserve Bank. On 11 June, the Bank sold New Zealand dollars in an attempt to reduce their value. The Bank then publicly confirmed this intervention. The foreign exchange market has suspected other interventions on later occasions, but these have not been confirmed. This event marks a new policy stance for the Bank as it is the first time that the central bank has intervened in the foreign currency market since the New Zealand dollar was floated. Although the Bank did succeed in reducing the New Zealand dollar on 11 June, it has since traded higher than this level. Market commentators have mixed views about whether the central bank's new intervention policy can materially influence foreign exchange rates, and whether it should be intervening at all, given that a lower dollar contributes to inflation.

Petrol prices increased by 8 percent in the June quarter; this was the largest single contributor to the 1 percent rise in the overall Consumer Price Index over the same period. Annualised inflation to June 2007 was 2 percent, at the mid-point of the 1-3 percent central bank target. The high dollar has been keeping tradable inflation in check; however inflation pressures in the non-tradable sector have been persistent.

The major party of the left-wing coalition government, Labour, continues to trail in the opinion polls behind its main right-wing rival, National. The National party has climbed in the polls following the appointment of a new leader, Mr John Key, a former foreign exchange trader. The next election will take place in 2008.

## Deal Activity



M&A activity in the first half of 2007, with a total value of US\$3.8 billion, was in line with the same period in the prior year. Likewise, transaction volume held steady with 178 deals compared with 186 in the first half of 2006. Of note within these figures is the impact of larger deals on the overall total.

Noteworthy amongst those deals was the NZ\$2.2 billion (US\$1.8 billion) acquisition of Yellow Pages Group (YPG), New Zealand's only nationwide print and online business advertising and telephone directory publisher. New Zealand's largest telephone company, Telecom New Zealand, sold YPG to CCMP Capital Asia and Teacher's Private Capital. The deal was financed with a large proportion of debt syndicated from 21 banks; making the deal New Zealand's largest-ever leveraged buyout transaction. Following the transaction, Telecom New Zealand has proposed a capital return of NZ\$1.1 billion (US\$0.9 billion) to shareholders.

In the media sector, Television and Radio network company MediaWorks has been purchased by private equity firm Ironbridge Capital. Ironbridge was required to make a second offer in order to persuade major institutional shareholder Brook Asset Management to sell. The second offer makes Ironbridge's total investment approximately NZ\$740 million (US\$590 million).

The leading New Zealand sharemarket index, the NZX50, gained 18 percent in the twelve months to June 2007. The strong performance from the sharemarket can be partially explained by continued buoyant M&A activity. Quality assets continued to attract strong interest from both trade



purchasers and private equity firms. The biggest potential deal of the year is the recently announced proposal from Dubai Aerospace Enterprise (DAE) to acquire 50 to 60 percent of Auckland International Airport Limited (AIAL) for an investment of NZ\$2.6 billion (US\$2.1 billion). The proposal offers current shareholders a mixture of cash, new shares, and loan notes. Several other parties, including Canada Pension Plan Investment Board, Macquarie Bank and Spanish firm Ferrovial, have also expressed interest in the airport. It is possible that one or more of these parties may launch an alternative proposal; therefore, it is not guaranteed that DAE will emerge as the successful buyer at this point in time. For example, the DAE proposal has already run into political opposition from a local government body that owns approximately 10 percent of AIAL.

With the inclusion of the AIAL deal (not yet in the Thomson figures), the value of transactions announced this year would reach US\$5.9 billion, with the YPG and AIAL deals collectively accounting for approximately 66 percent of the total.

In deals with New Zealand purchasers, Rank Group, controlled by billionaire Mr Graeme Hart, completed its US\$2.8 billion takeover of Swiss drink carton manufacturer SIG. Rank had to raise its offer to see off a competing bid from Norway's Elopak. Additionally, Fletcher Building Ltd announced their intended acquisition of laminates maker, Formica Corp. of the U.S. from its private equity owners Cerberus Capital Management and Oaktree Capital Management in a deal valued at US\$700 million.

## Outlook

After the recent interest rate rises, the Reserve Bank may hold off further rises in the third quarter in order to see if they have any affect on the housing market and consumer spending. The rate rises, together with the sustained strength in the New Zealand dollar, have clearly had some impact on exporters. Several major manufacturers have shifted production offshore. If the New Zealand dollar remains at these high levels, more of these production transfers and the ensuing job losses can be expected. Furthermore, net migration levels have declined. These factors point to a slowing economy.

Nevertheless, the economy has retained significant momentum and there are a number of significant positive influences. Retail sales are tracking at 8 percent more than this time last year. Agricultural income has increased dramatically due to the boom in world dairy prices. The Purchasing Managers' Index indicates that manufacturing is expanding. Furthermore, International visitor numbers are up 4 percent over last year. Both factors indicate that the economy is surviving the high New Zealand dollar remarkably well. Government spending can also be expected to increase in the lead-up to the 2008 election. Expectations are for the economy to grow between 2.5 to 3.1 percent in the year to March 2008.

A much talked-about transaction for the second half of 2007 is the potential take-over of the largest general merchandise store group, The Warehouse. Although a takeover has not been announced, the two major grocery supermarket groups (Foodstuffs and Woolworths) have both applied to New Zealand's competition regulatory agency (the Commerce Commission) for permission to purchase The Warehouse Group. The Commerce Commission has declined both applications on the grounds that The Warehouse has the potential to become a successful competitor in the grocery retailing market, and that a takeover by either Foodstuffs or Woolworths would eliminate the benefit of this competition to consumers. The Commission cited the example of Wal-Mart in the United States, which, after a slow start, eventually became a successful grocery retailer. The Warehouse is currently at a very early stage in its development of a grocery business, with only two stores offering groceries. Both Foodstuffs and Woolworths have appealed the Commission's decision to the High Court. If the appeals fail, there will be a higher probability that The Warehouse's current majority shareholder, Stephen Tindall, will revive his plan to privatise the company with a joint offer in conjunction with private equity firm Pacific Equity Partners.

The market consensus is that M&A activity will remain strong for the remainder of the year. While private equity activity will remain strong, the size of private equity transactions may not be of the same scale that it has been recently, due to the emergence of trade buyers for large value assets. Rather, the smaller end of the market is expected to come under renewed interest from private equity firms.

