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Review of CCC's Capital Release Options

Report Highlights

STRICTLY PRIVATE AND CONFIDENTIAL

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Christchurch City Council

GLOBAL ALLIANCE PARTNER OF ROTHSCHILD

Report Highlights

Rationale for a capital release programme

- In its Draft CCC 2015 – 2025 LTP, Christchurch City Council (CCC) is proposing to meet a potential $1.2 billion funding shortfall through, among other things, releasing $750 million in capital from some or all of its Council Controlled Trading Enterprises (CCTOs) (Capital Release)

- CCC proposes to meet this funding shortfall by:

1	Opex and capex (service levels and infrastructure)	*"Reviewing the Council's programme of major capital works"* *"Reviewing the Council's operational spending"*
2	Rates, fees, charges etc.	*"Increasing rates by 8.75%, 8.5%, 8.5% and 7.5% over the next four years"*
3	Debt	*"Managing debt prudently"*
4	CCTOs	*"Releasing $750 million in capital from some or all of the companies owned by CCHL"*

This report focuses on Capital Release only

Report Highlights

Capital Release framework

- There are two broad methods by which CCC can potentially release capital from its CCTOs to meet its funding shortfall: Capital Restructure and / or Equity Sale

  1. **Capital Restructure** – where a CCTO makes a distribution of capital to CCC and funds this through an internally driven transaction involving either issuing non-equity capital (debt) and / or selling internal assets

  2. **Equity Sale** – where CCC sells the equity it currently owns in a CCTO and receives the capital directly

- The two capital release options are not mutually exclusive. However, CCC should execute them in the following order:
  - First, optimise the capital structures of its CCTOs. This is largely independent from the decisions relating to equity sale
  - Once the capital restructure options have been completed and the impact on CCC's funding requirements understood, consider its equity sale options

Report Highlights

CCC's Capital Release objectives

- While the primary objective for CCC's capital release programme is to meet its projected funding shortfall across 2015 – 2025, it is clear that CCC has a wider set of objectives. We understand these to be as follows:

    1. Releasing capital to meet CCC's forecast funding shortfall, while minimising the impact on CCC's future dividends and debt capacity
    2. Retaining control over CCTOs deemed to be strategic, namely Orion, LPC and CIAL
    3. Preserving CCC's ability to pursue non-commercial objectives for these strategic CCTOs
    4. Capitalising on opportunities to enhance the value of CCC's strategic assets
    5. Maximising interest from potential investors in CCC's CCTOs

- Our analysis shows that it is possible for CCC to develop a programme from the capital release choices identified which meets these objectives. We address the achievability of each objective below

Report Highlights

Achieving CCC's Capital Release objectives

1. **Releasing capital to meet CCC's forecast funding shortfall, while minimising the impact on CCC's future dividends and debt capacity**
   - The analysis shows that CCC has a range of capital restructure opportunities and capital release options from potential sales of equity among its portfolio of CCTOs
   - These opportunities and options enable CCC to develop a capital release programme that comfortably meets its funding shortfall
   - Some combinations of capital release choices will have less impact on CCC's debt capacity and future dividend flows than others
   - Some equity release options have the ability to materially mitigate the impact on CCC's debt capacity and future dividends through the value enhancement a partner or different ownership structure could bring to the businesses of CCTOs

2. **Retaining control over strategic CCTOs, namely Orion, LPC and CIAL**
   - The capital release choices available enable CCC to develop a programme that meets its funding needs, while retaining control of Orion, LPC and CIAL
   - The market sounding process and our analysis provides confidence that there will be investor interest in minority stakes in these CCTOs
   - A number of these investors have a track record of adding value as an equity partner and are confident they could assist in enhancing the value of CCC's strategic CCTOs
   - Achieving this outcome will require careful contracting around the decision rights such partners are provided with in any partnership with CCC
   - If the Council chooses to proceed to sell minority stakes in its strategic assets, there will be a number of precedents available from overseas jurisdictions on which to model potential equity partnerships. As in the case of CCC, the objectives of these partnerships is to release capital and enhance the value of the business under local authority control. Examples in the UK include Manchester Airport Group, Newcastle International Airport and Birmingham Airport
   - CCC has the option of maintaining a controlling stake in each of Orion and CIAL and undertaking an IPO (Initial Public Offering – ie sale and listing of shares on the New Zealand stock exchange) of shares in these CCTOs, although it is likely this would generate a lower level of proceeds for CCC than an equivalent sale of equity to a partner
   - CCC also has the option of floating non-voting shares in Orion and CIAL to the public. Such IPOs would generate lower level of proceeds than equivalent IPOs of ordinary equity in these CCTOs, but would enable CCC to maintain all its voting shares and interests

Achieving CCC's Capital Release objectives (cont.)

3. Preserving CCC's ability to pursue non-commercial objectives

- The non-commercial objectives which CCC has for its strategic CCTOs does not represent an impediment to a sale of a minority interest in each of Orion, CIAL or LPC
- Any impact on the value of the relevant CCTO and the price paid for a minority interest can be minimised by CCC clearly identifying, defining and codifying its non-commercial objectives and incorporating them into a contractual arrangement between the CCTO (and equity partners)
- The discipline of working with the CCTOs to identify and codify non-commercial objectives in this way, regardless of whether CCC chooses to sell equity stakes, is likely to improve commercial monitoring and measurement of outcomes for CCC in any event.
- Identifying and codifying non-commercial objectives (rather than having implicit objectives) is increasingly seen as best practise and adopted in overseas jurisdictions. A current example of this is the sale process for the Port of Melbourne, which is being sold on a 50 year concession and part of the sale contract includes a cap on overall pricing at the level of inflation for the first 15 years of the concession

4. Capitalising on opportunities to enhance the value of CCC's strategic CCTOs

- Our market sounding and analysis identified a number of potential equity partners for CCC with the ability to enhance the value of CCC's strategic CCTOs through their proprietary knowledge, networks, governance experience and other resources and capabilities. Some might also capture synergies with other investments they own
- As noted above, capitalising on these opportunities through equity partnerships would partially mitigate the impact of any capital release on CCC's debt capacity and future dividends
- Maximising the potential value enhancing impact of an equity partnership will require choosing the right partners and undertaking careful analysis and contracting around the decision rights provided to that equity partner

5. Maximising interest from potential investors in CCC's CCTOs

- Our market sounding and analysis indicates that CCC will be able to conduct competitive processes for the sale of equity interests in all CCTOs reviewed
- Achieving the best outcome will be a function of the discipline applied to the preparation and execution of the sale process, including the ownership form chosen, the timing of the sale and the sale package offered. The sale package will need to address such matters as economic interest to be sold, decision rights, codifying of non-commercial objectives and plan and information provided to potential buyers.

Capital Release decision steps

- CCC's funding requirement will be dynamic and iterative – external events, CCC decisions and capital release initiatives will continually impact the funding requirement. Consequently, decisions regarding capital release will need to be:
  - Dynamic, in order to adjust for an expected change in the budget shortfall due to both internal and external factors
  - Iterative, in order to reflect the impact of earlier capital release decisions

- Our report identifies a series of decision steps for CCC to follow:

  1. Capital restructure – engagement with CCTO board and management team to determine the optimal capital structure. Certain CCTOs are facing significant strategic challenges and competitive pressures and an appropriate capital structure and / or asset base is critical for their competitiveness and long-term profitability
  2. Equity sale – whether or not CCC decides to sell equity in its CCTOs, our report identifies the need for CCC to re-assess the strategic importance of each CCTO, codify any non-commercial objectives it may have in relation to each CCTO and evaluate CCC's ability to achieve its objectives with lower levels of ownership and in ways which minimise the potential impact on the value of the CCTO

- The suggested decision steps are discussed in more detail below

Capital Release decision steps (cont.)

- Ultimately, the Council must make the decisions regarding which (if any) capital release options will best meet its funding requirement. We propose the following decision steps

Capital Restructure

1. Establish appropriate capital structure:

Investigate all capital restructure options within the constraint that the resulting capital structure should be appropriate for both CCC and each CCTO

In this respect it should take into account the views of:

- The CCTO board and management in relation to:
  - The potential impact on the achievement of the business plan
  - The ability to take advantage of strategic opportunities
  - The associated risks (including the risk appetite of the equity- holders)
- Other shareholders

2. Distribute capital to CCC:

Tax efficiency of any distribution from the CCTO to CCC needs to be considered

The implications on the funding requirement needs to be assessed

Equity Sale

1. Establish 'strategic importance' to CCC of each of the CCTOs based on:

An objective assessment of the fundamental importance of the assets to Christchurch and the Canterbury region;

An assessment of ratepayers' wishes

2. Confirm CCC's non-commercial objectives for its strategically important CCTOs:

With lower levels of ownership

And establishing mechanisms for 'codifying' these non-commercial objectives

3. Confirm CCC's preferred equity sale option for each CCTO, including the expected amount and timing addressing the:

The trade-offs between the level of 'control' required to meet the goals of step 1 and 2 above and the price per share that can be achieved

Potential for improving the business plan and enhancing the value of the commercial asset

4. **Match the amount and timing of CCC's funding requirement** to the preferred capital release options across CCC's portfolio of CCTOs

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Capital Release decision steps (cont.)

CCC Funding Requirement

- Dynamic
- Iterative

Capital Release

Capital Restructure

1 Establish appropriate capital structure

- *Issue non-equity capital (e.g. debt; subordinated debt; preference shares)*
- *Sell internal assets*

2 **Capital Release**

Sell Equity

1 Establish ‘strategic’ importance of CCTOs

- *Fundamental importance to regional economy*
- *Political considerations*

2 Confirm CCC non-commercial objectives and ability to meet with lower levels of ownership for strategically important CCTOs

3 Confirm preferred equity sale option for each CCTO

- *Decision rights*
- *Value*
- *Sale structure*

Establish potential amount and preferred timing

4 **Capital Release** - Choose the optimal capital release option(s) to meet CCC Funding Requirement amount and timing

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Capital Release decision steps / programme – indicative options

- Indicative options for Capital Release from each of the CCTOs have been reviewed – these have included capital restructure and/or equity sale options across Orion, CIAL, LPC, City Care and Red Bus
- A hypothetical Capital Release programme developed for the Council indicates it can readily meet the funding shortfall outlined in the LTP
- The Council has yet to decide what the form any Capital Release will take. Ultimately any final Capital Release programme will require judgements to be made by the Council requiring it to work through the decision framework outlined on the previous page

Concluding remarks

Impact of Capital Release on CCC's Funding Requirement

- The capital release options do not have a direct 'one-for-one' impact on CCC's funding requirement. For any CCTO, capital release from either capital restructure and / or equity sale will reduce the dividends received by CCC from the CCTO, in turn reducing CCC's debt capacity. This means that for every dollar of capital raised from either capital restructure and / or equity sale, CCC will have a lower amount of dividends available to apply to its funding shortfall. The impact of the capital release needs to be assessed on a case-by-case basis
- The relationship between the capital released and expected dividend foregone will dictate the <u>immediate</u> impact on CCC's funding requirement, but not necessarily the medium/long run impact. Capital release of equal amounts from either capital restructure or equity sale may have significantly different long term impacts on the value of the CCTO to CCC e.g. there is scope for new equity partners to enhance the performance of the CCTOs and therefore the dividends available overtime

Capital Release Execution

- Regardless of the CCTO chosen for capital release via the sale of equity, in order to maximise interest from potential investors CCC needs to run a credible, professionally managed process that incorporates:
  - A clearly stated sale package and transparent decision making criteria and process - bidders like clear 'ground rules'
  - Acceptable mitigation of completion risks – bidders will be mindful of incurring costs and spending time to participate in a sale process

  In addition, Council has expressed a very clear preference for CCC to have good oversight of the process and to be able to direct and control the capital release programme to achieve its objectives

'Plan B'

- There are many reasons for an equity sale failing to complete, including events that simply 'close' the market (this occurred during the GFC) and a lack of investors prepared to meet a vendor's reserve price and conditions. A failed transaction will have reputational and political consequences, but can be critical if the timing of the capital requirement will not allow another equity sale to be completed. Accordingly, CCC needs to plan for the potential failure of an equity sale by having a back up plan that provides a plan B

Capital Release Preparation

- CCC's potential Capital Release programme will be a complex, time-intensive undertaking and will require significant preparation and stakeholder consultation at the programme level – apart from the preparation and engagement required at the CCTO level to initiate either a capital restructure or equity sale
- Programme complexity, timetable constraints and political considerations suggest that should CCC wish to execute a Capital Release programme, it should do so as soon reasonably practicable

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