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Goldman Sachs

Economics

Mixed Asset Ownership: Benefits Well Beyond Public Debt Reduction

Economics | New Zealand

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Overview:

- The NZ Government has asked Treasury to advise it on the merits of a mixed ownership structure for State Owned Enterprises Mighty River Power, Meridian, Genesis and Solid Energy. It is also interested in the merits of a reduction in its majority ownership of Air New Zealand (currently 76%). This represents a potential sale value of $8-10 billion.
- The mixed ownership model is common practice in the OECD with governments on average only fully owning 57% of their SOEs. This ownership structure has subsequent implications for stock market composition. For example, over 50% of Norway's market capitalisation is made up of SOEs.
- This process is vastly different to NZ's previous public asset sale experience over the late 1980s and 1990s with: 1) the government set to retain control; 2) wide reaching economic benefits outside of debt reduction; and 3) the public having a much better chance to participate.

Key Benefits:

- Our analysis of major previous privatisation suggests **financial efficiency gains could boost individual company profitability by around 20%** with some 80% of these benefits coming from stronger cost disciplines.
- We believe the **government accounts would be up to 39% better off** compared to the status quo under a mixed ownership model driven by interest savings and efficiency gains lifting dividends and corporate tax paid.
- We see mixed ownership as an **important step in reversing a loss of critical mass in the equity market**. In particular, we believe quality new equity supply will rejuvenate household participation in equities. We estimate that a restoration of NZ household equity ownership to the 1997 proportion of financial assets would imply $5bn of new demand, something that SOE floats will be instrumental in facilitating.
- SOE floats could be a mechanism to help **improve corporate governance standards** in NZ. In particular, these companies could raise the bar for board composition and remuneration practices.
- We believe **improved equity performance in NZ will provide important economic benefits**. The difference in stock market capitalisations between NZ and Australia could potentially explain half of the gap in GDP per capita of the two nations.

Which Companies Should Go First?

- With all five companies proposed for partial sale already subject to appropriate regulatory oversight, we believe the level of NZ demand will be the key factor in determining which company goes first.
- Share ownership of listed peers suggests NZ retail demand will probably be the greatest for SOE electricity companies, which could account for up to 70% of free float.
- Within the SOE electricity companies, we believe the investment prospects for Mighty River Power and Meridian are equally attractive. However we believe Mighty River Power is subject to less medium-term uncertainty and therefore likely represents a lower risk initial prospect for investors.

The Details

A shake up on the policy front

The NZ Government has asked Treasury for advice on the merits of a mixed ownership structure (both public and private ownership) for some of its commercial assets. That is, an ownership structure along the lines of Air New Zealand, where the government has a majority stake and the remainder is listed on the NZX.

Specifically, the government has signalled the possibility of this new mixed ownership structure for State Owned Enterprises (SOEs) Mighty River Power, Meridian, Genesis and Solid Energy. It is also interested in the merits of a reduction in its majority ownership of Air New Zealand (currently 76%). The Prime Minister believes that *"apart from freeing up taxpayers' capital for investing in other assets, the mixed ownership model could broaden the pool of investments for New Zealanders, bring sharper commercial disciplines to the companies and provide them with more capital to grow."*

While this announcement from the PM is "new", the idea is not. The partial sale of some SOEs was one of the key recommendations of the Capital Market Development Taskforce in December 2009. This Taskforce was initiated by the previous government.

But there are some tests to pass

If we put to one side the fact that the government has said it will seek a mandate from the electorate on this issue at this year's general election (November 26). It has also importantly stated that for this idea to proceed, the followed five tests would need to be met:

- The government would have to maintain a majority ownership;
- NZ investors (rather than foreign) would be "at the front of the queue";
- The companies would offer good opportunities for investors;
- The capital freed up would have to be used to fund new public assets and reduce pressure on government borrowing; and
- Any industry-specific regulations adequately protect consumers.

Public Asset Sales: This Time Is Different

NZ was one of the first countries in the OECD to actively embark on public assets sales as a key government policy. Treasury figures show that in total the government received proceeds from asset sales in excess of $19 billion between 1988 and 1999 (a table on the timeline and details of the specific assets sold is shown in the Appendix). This level of proceeds relative to GDP put NZ in the higher echelon of OECD countries between 1990 and 2001 at around 19% of GDP. This was similar to Australia (close to 20% of GDP), but well ahead of the likes of the UK and France, at around 4% and 6% respectively.[1]

But NZ has effectively had a "freeze" on public asset sales since 1999. In fact, you could argue that there has been a move in the opposite direction with the nationalisation of Air New Zealand and KiwiRail, and the starting up of KiwiBank. This freeze on asset sales most likely relates to what we suspect is a widespread level of discontent from the general public about the success of the previous sales.

In our eyes, some criticism is justified. A number of individuals benefited massively from the transactions. New Zealand (as the seller) was arguably naïve in its approach. In addition, the speed at which some transactions occurred meant that appropriate regulation and competition measures were not necessarily in place at the time leading to some difficulties and ongoing problems (Telecom and NZ Rail potentially fit into this category).[2]

But we believe the concept of a mixed ownership structure for some SOEs represents a vastly different approach to the privatisations of the late 1980s and 1990s. This is for the following key reasons (we discuss these in more detail below):

[1] The UK's figure will likely be impacted by the fact that the governments of the time embarked on a period of aggressive asset sales prior to 1990.
[2] For a discussion on these issues refer to the Treasury Report from 21 December 2010 titled *"Privatisation in New Zealand: An assessment of a series of company experiences"*

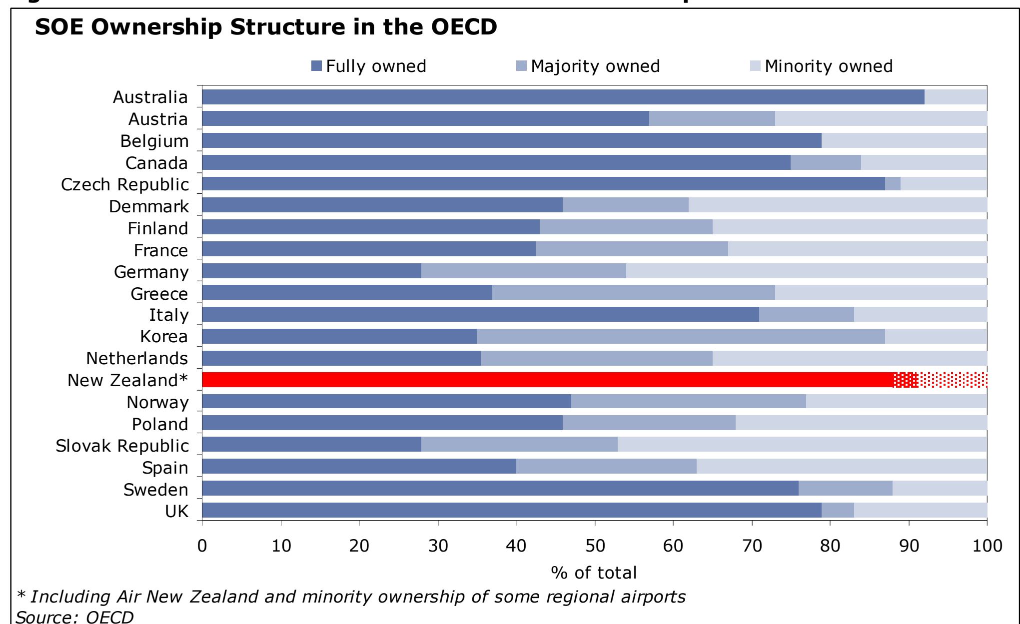
- **The government will maintain majority ownership**
- **Mixed ownership is not predominately about maximising debt reduction**
- **The public will have better opportunities to participate**

The Government will maintain majority ownership

In all previous NZ asset sales, the government disposed of its full shareholding. This time around the government plans to retain majority ownership (at least 51%). This means the government will continue to have effective control over all major strategic decisions including acquisitions, disposals, capital allocation and distributions.

This mixed ownership structure has become increasingly popular, even amongst nations with a tradition of state intervention. Within the OECD, governments on average only fully own 57% of their SOEs. In Germany for example, the state only fully owns around 28% of its SOEs, with a minority ownership (around 46%) the more common method (figure 1).

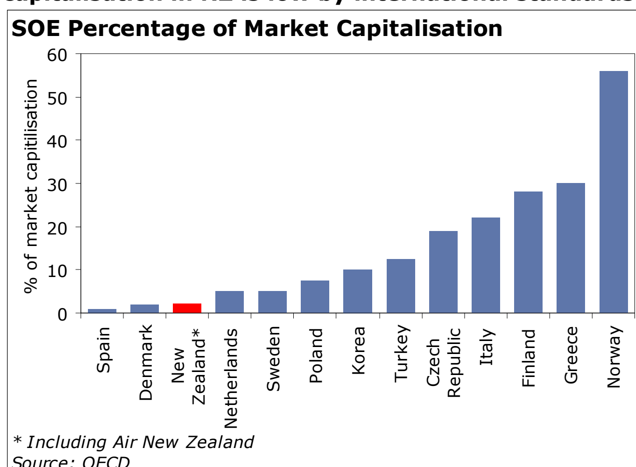
Figure 1: NZ is unusual in the extent of its full ownership of SOEs



** Including Air New Zealand and minority ownership of some regional airports*
Source: OECD

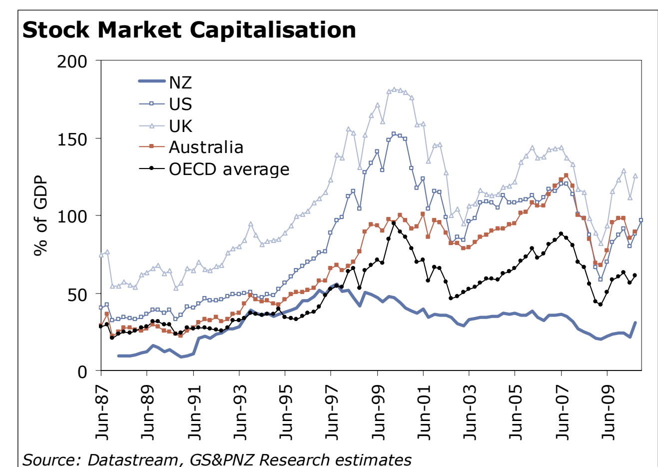
Further to this, a direct result of NZ's choice of ownership structure for its SOEs is that the percentage of SOEs listed on the stock exchange is significantly lower in NZ than in other OECD countries. For example, over 50% of Norway's market capitalisation is made up of SOEs. In NZ, this is around 2% and only because of the government's decision to partly nationalise Air New Zealand in 2001. Given that SOEs are often some of the largest entities in an economy, NZ's past preference for trade sales over public offerings is most likely one reason why NZ's stock market capitalisation relative to GDP is one of the lowest in the OECDs at around 30% (figure 3).

Figure 2: SOE's proportion of total market capitalisation in NZ is low by international standards



** Including Air New Zealand*
Source: OECD

Figure 3: As is our market capitalisation by itself



Source: Datastream, GS&PNZ Research estimates

Mixed ownership is not predominately about maximising debt reduction

The public accounts were in a bad way in the 1980s and 1990s

It can be argued that the prime motivation for the extent of public asset sales in NZ in the late 1980s and 1990s was due to the fragile state of the government accounts. Government net debt peaked at over 50% of GDP in 1992. S&P lowered NZ's foreign currency rating to AA- in January 1991, which is still the lowest credit rating NZ has experienced since it was first rated in 1977. As figure 5 shows, the majority of asset sales occurred when public net debt was near its peak. The proceeds of these sales were used to reduce this debt burden, which troughed at 5.6% of GDP in FY08.

Figure 4: Asset sales spread over the late 1980s and 1990s

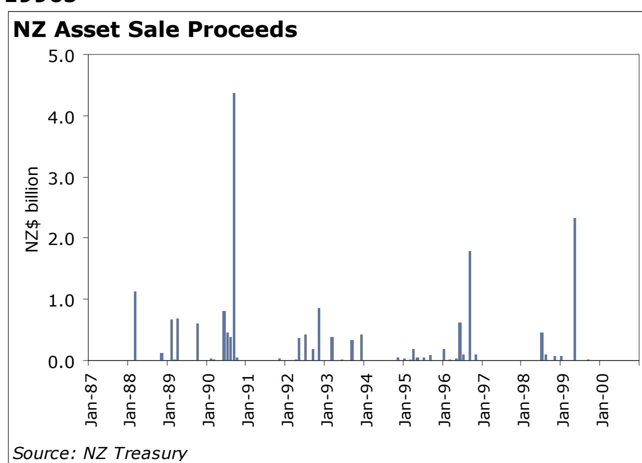
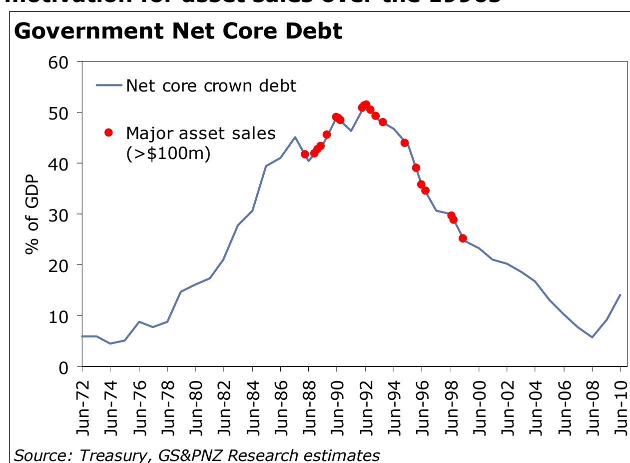


Figure 5: High Government debt was a key motivation for asset sales over the 1990s



The same fiscal pressures do not exist this time

Core crown net debt, at 14% of GDP in FY10, is significantly lower than where it was 15 years prior. Admittedly, economic recession, the recent Canterbury earthquakes and the troubles for the finance company sector have, and will, weigh heavily on the government accounts. They are deteriorating again and S&P has the country's rating on negative outlook (currently AA+). But the starting point is vastly different.

The partial sale of SOEs are for other reasons

As the PM stated, these partial sales are not just about reducing public debt. There are potentially other economic and capital market benefits:

- Improving the efficiency and operating performance of the specific companies';
- Deeping NZ's capital markets, which should have flow on economic benefits;
- Providing another source of capital that these companies can use to grow and invest; and
- Reallocating public capital to other, arguably more important, areas.

The public will have better opportunities to participate

Given the fiscal pressures in the 1990s, we believe it was the government's main priority to maximise the price and speed at which it sold public assets. It is for this reason that trade sales - where the asset is sold to a single or consortium of players - were the preferred method. In fact, NZ was unique in the extent of its preference for trade sales. Between 1988 and 1999, trade sales were used in around 60% of cases (figure 6). This compares with the OECD average of just 20%. Conversely, only 2% of NZ sales were via public floats, versus 62% in the OECD.

Trade sales can typically occur faster than public share offerings and can often achieve a higher price given the purchaser may pay a premium to gain control. But given the size of some of the assets sold, the only natural buyers were foreign. We estimate that around 60% (by value) of NZ's public assets sold between 1988 and 1999 went to international rather than domestic buyers. It is probably for this reason that the public feel as though they were bypassed in a lot of the process.

Figure 6: NZ's preferred method of public asset sales was though trade sales at 60%

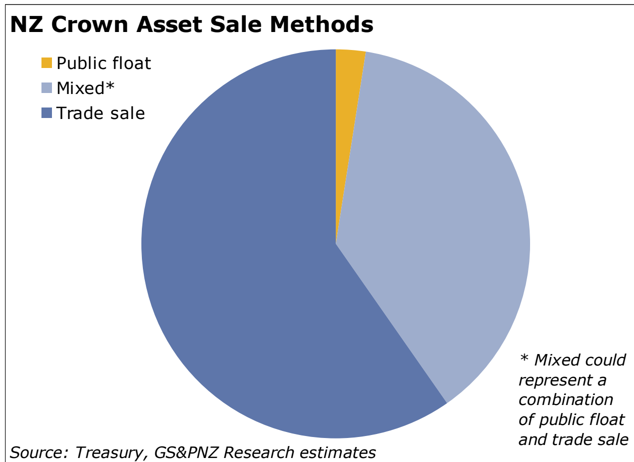
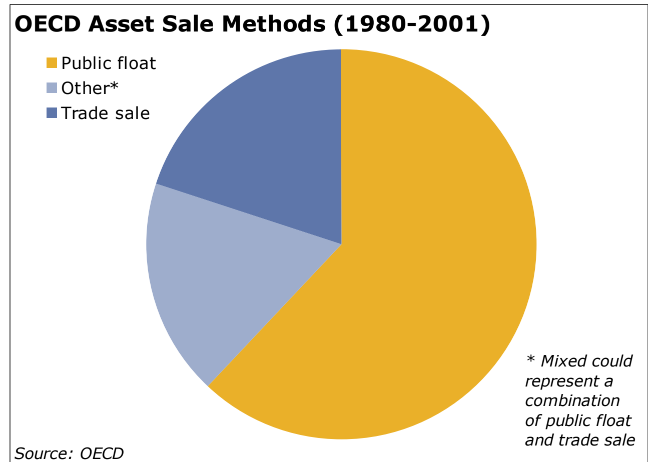


Figure 7: This compares with the OECD average of just 20%



But these concerns are not relevant this time around

Firstly, the method of sale will be through public share offering giving members of the public the opportunity to participate. New Zealanders will be able to directly purchase stakes in these SOEs or indirectly through their own KiwiSaver accounts or other managed funds. Second, the government has specifically said that NZ residents will be given priority over foreigners in these offerings.

We shouldn't also forget that if concerns over foreign ownership do exist, then the government has the ability to legislate to ensure that no one entity (excluding the government) could hold a certain portion of shares. This is something that Australia has done in the past, with its "Four Pillars" legislation of its major banks the best example.

But beyond this argument, we would add that foreign ownership is not necessarily "bad". While of course foreign investors expect a return on any investments (profits/dividend), they often bring with them knowledge and capital that would not have been available otherwise.

There is a common misconception in NZ that the major reason for the country's large current account deficit and stock of international liabilities is due to the extent of foreign ownership of its assets. This couldn't be further from the truth. NZ's net equity liabilities only represent a tiny proportion of NZ's stock of net foreign liabilities (4%). The majority is instead debt (96%) as a result of households borrowing (through banks) to fund consumption and housing investment (figure 8). Furthermore, a reasonable portion of the income earned by foreign companies in NZ is actually reinvested (figure 9).

Figure 8: The majority of NZ's overseas liabilities are debt not equity…

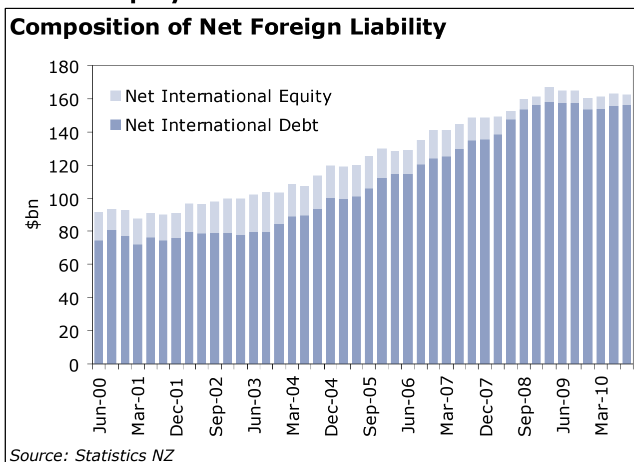
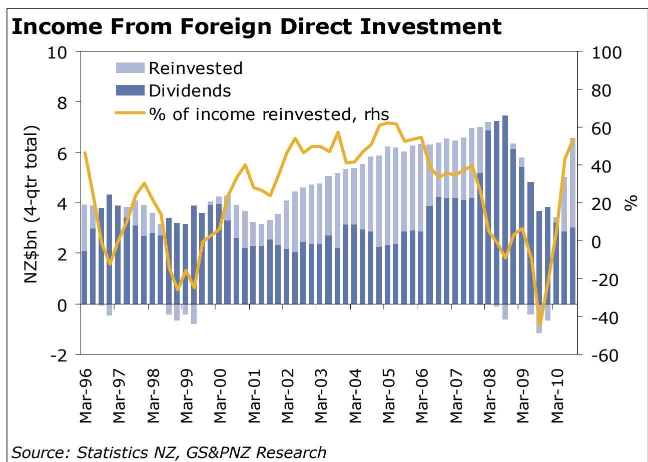


Figure 9: … and a reasonable proportion of income earned from FDI is reinvested



Potential Financial Efficiency Gains at the Company Level

International studies point to material efficiency gains

We believe external oversight by the capital markets should lead to better corporate governance, including sharper commercial disciplines, better board structures, greater financial integrity, improved risk management and more appropriate managerial remuneration. This in turn should result in improved financial performance for shareholders.

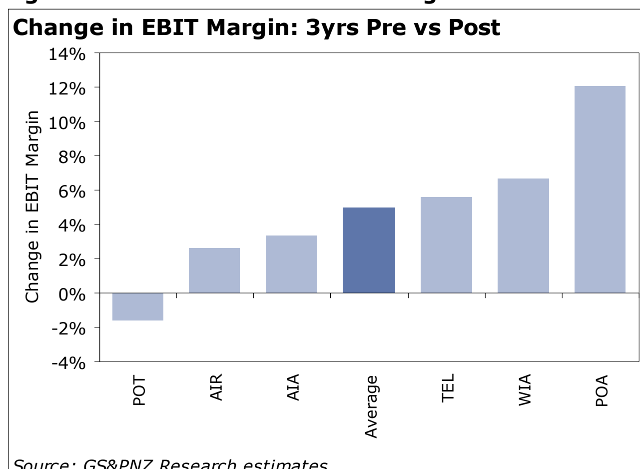
This is not a new concept with reports by the OECD and World Bank previously highlighting the overwhelming empirical evidence that privatisation around the world has resulted in significant increases in company profitability, real output and efficiency. In particular, a study into financial benefits from privatisation in the 1990s within 28 industrialized countries found statistically significant increases in both margins (+3%) and returns on assets (+1%). These reports also highlight financial benefits from partial privatisation, but at a lower magnitude to full privatisation.

Positive experience in NZ

We have conducted a similar study into financial benefits from privatisation in NZ. This analysis incorporates the sale of NZ government shareholdings in Air New Zealand (AIR), Auckland International Airport (AIA), Telecom (TEL) and Wellington International Airport (WIA) plus the sale of local government shareholdings in Port of Tauranga (POT) and Ports of Auckland (POA). Contact Energy and Vector have been excluded from this analysis due to distortions from major acquisitions.

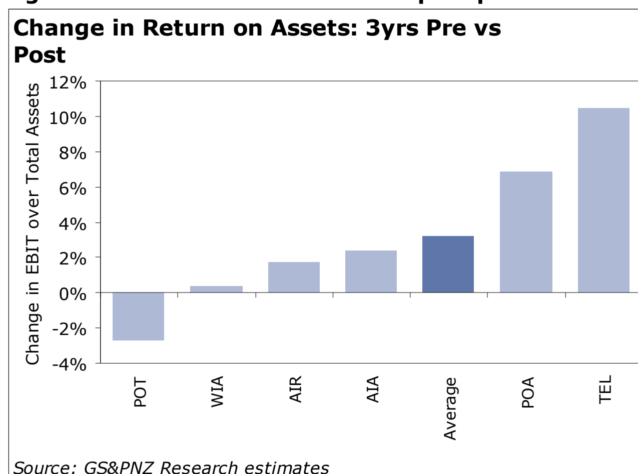
Comparing the average financial performance for each company 3-years pre-privatisation and 3-years post-privatisation reveals an average increase in EBIT margins after divestiture of 5%, from 31% to 36%. Moreover, five out of six companies experienced expanding margins after privatisation. Interestingly, average margin improvement from mixed ownership companies (AIA, POT and POA) was similar to trade sales at 5%. In addition, return on assets increased on average by 3% to 12%, including +2% for mixed ownership companies.

Figure 10: Material increase in margins …



Source: GS&PNZ Research estimates

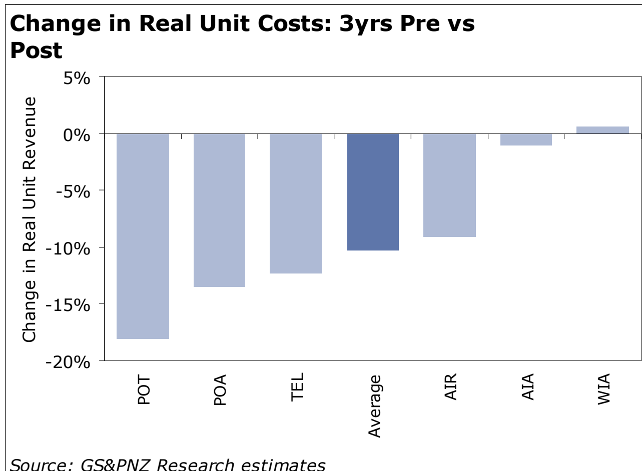
Figure 11: … and return on assets post privatisation



Source: GS&PNZ Research estimates

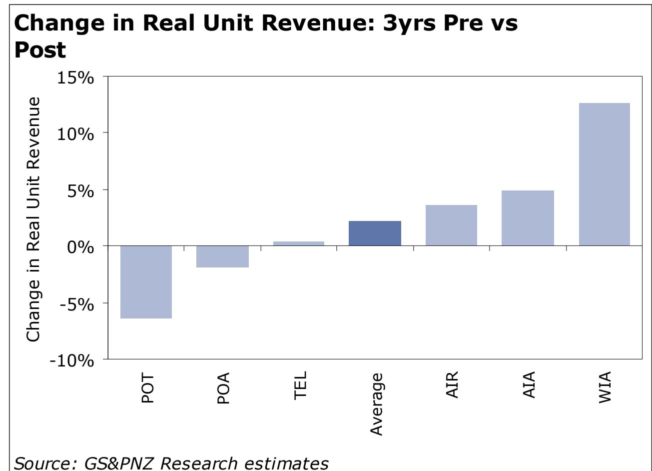
Further analysis suggests these material improvements in EBIT margin and return on assets has been driven by principally lower unit costs, and to a lesser degree, higher unit revenues. In particular, real unit costs (adjusted for inflation) after divestiture declined on average by 9%. Real unit costs fell at 5 out of 6 companies indicating wide spread cost saving benefits. The average fall in real unit costs at mixed ownership companies was even higher at 11%. Real unit revenue after divestiture also increased on average by 2% mainly driven stronger retail spend rates following terminal building expansions at WIA and AIA.

Figure 12: Financial efficiencies driven by a large fall in real unit costs …



Source: GS&PNZ Research estimates

Figure 13: … and to a lesser degree, a modest increase in real unit revenues



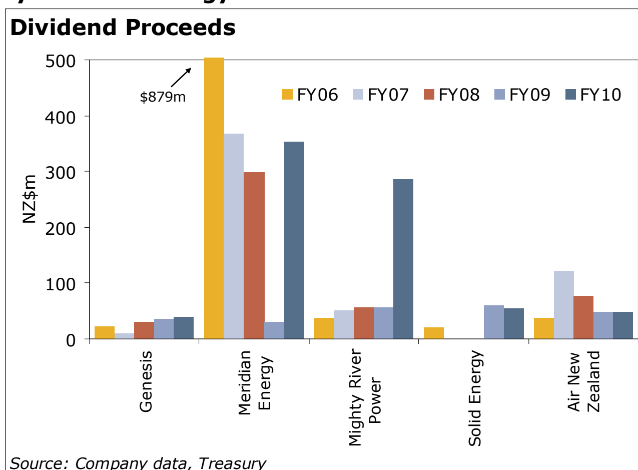
Source: GS&PNZ Research estimates

Based on our analysis, NZ experience suggests financial efficiency gains from privatisation could boost a company's EBIT by around 15%. After allowing for financial gearing, we believe financial efficiency gains would boost NPAT by 20%. Over 80% of these benefits would most likely stem from stronger cost disciplines. We would expect a similar magnitude of financial efficiency gains for short-listed SOEs under a mixed ownership model. In particular, we believe the collective starting point for these companies is not dissimilar to previous privatisation within our analysis. This would flow through to boost corporate tax payments and dividends.

Net Impact on the Government's Accounts Is Positive

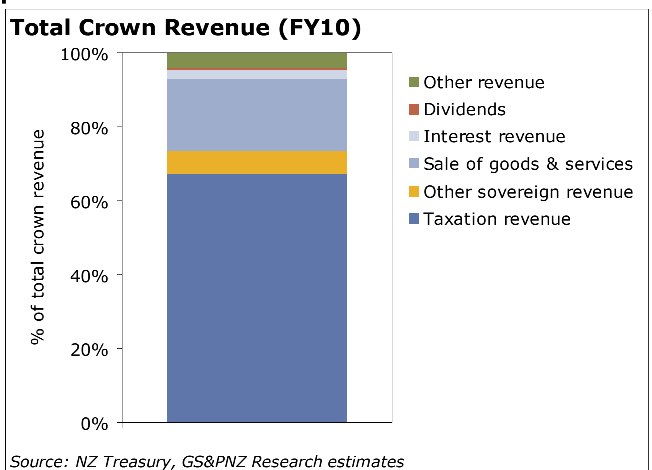
In FY10, the government received a total dividend payment of $782 million from the four aforementioned SOEs and Air New Zealand. But between years and entities, large disparities in the size of dividend paid do exist, with special dividends often distorting the results. Over the past five years Meridian Energy has paid an average dividend of $386 million per year compared with dividends from Genesis and Solid Energy averaging only $27 million per year. The median dividend payment over the past five years has totalled closer to $500 million. To put that in perspective, this represents only around 1% of total Crown revenue.

Figure 14: Dividend payments have been dominated by Meridian Energy



Source: Company data, Treasury

Figure 15: SOE dividends only represent a small portion of total Crown revenue



Source: NZ Treasury, GS&PNZ Research estimates

Corporate tax paid by these entities in FY10 totalled $273 million, and is more stable. The median corporate tax paid over the past five years is $287 million.

A partial sell-down would obviously reduce dividend receipts

Assuming the government decide to sell down it stakes in these assets to 51% and dividend flows remain near the median over the past five years, then dividends received could subsequently drop from $507 million to around $267 million. In other words, a loss in Crown revenue of around $240 million.

Table 1: Dividends from these SOEs have average $600m over the past five years

Dividends from SOEs and Air New Zealand ($m)	2010	2009	2008	2007	2006	**5-year median**	*with 51% ownership*
Genesis	39	36	29	10	23	**29**	*15*
Meridian Energy	354	30	298	368	879	**354**	*180*
Mighty River Power	286	56	56	50	36	**56**	*28*
Solid Energy	54	60	0	0	20	**20**	*10*
Air New Zealand	49	48	76	122	36	**49**	*33*
Total	**782**	**229**	**459**	**550**	**995**	**507**	*267*

Source: Company Data, GS&PNZ Research estimates

But a reduction in debt servicing would offset

In FY10, gross sovereign issued debt (less RBNZ settlement cash) sat at around $54 billion. A sell down in the assets of $8-10 billion could obviously put somewhat of a dent in this, although we acknowledge that it would likely occur over a number of years. The proceeds could also be used to reduce operating deficits (at least in a headline sense) and see the accounts return to surplus than otherwise would be the case.

But beyond the initial payment received from sale, there are likely to be additional financial benefits to the government. These surround servicing costs. Using a government bond yield of 6%, the government could potential save $540 million per year if the proceeds from sales (say, $9 billion) were used to repay debt. This exceeds the loss in dividend payment, largely due to the fact that the average dividend yield that these entities pay the government is below the government's borrowing rate.

We also need to take into account potential efficiency gains

As described above, we believe efficiency gains from a mixed ownership structure of these SOEs could boost NPAT by 20%. This will flow through to the government's accounts two fold. First, one would expect dividend payments from these entities to be 20% higher (after accounting for pro-rata ownership). And second, higher profits correspond to higher corporate tax, which should also be 20% higher.

A modest drop in tax from investment income could occur

The final thing to take into account is any potential loss of tax revenue if the proceeds from these sales were sourced from other investments. For example, if we assume that the sale proceeds will come from bank deposits, the government would lose withholding tax income, all else being equal. The same could be said if households choose to consume less in order to participate in this process, GST tax revenue would be lower.

For simplicity, if we assume that the split between domestic and foreign participation is 70/30 and all the domestic funding is from bank deposits (with the highest RWT rate of 33%), then the loss in government revenue could be $104 million.

In total, the Government stands to be around 39% better off from these sales

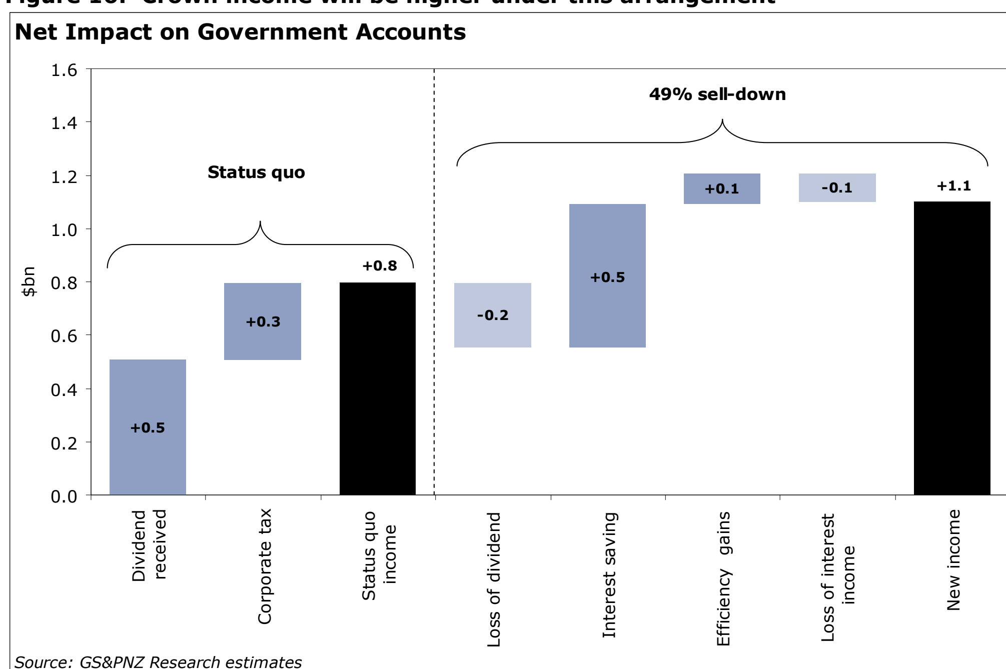
Summing these benefits and costs together, we conclude that the government stands to benefit to the tune of $306 million (table 2). In other words, the government would be 39% better off financially than the status quo. While this is just a static analysis and does not take into account any growth in dividends going forward, we believe the size of the net benefit to the government should more that outweigh any financial considerations of that nature.

Table 2: The Government will be 39% better off after the partial sell-down

Net Impact on Government Accounts					
Status quo (5-year median)		NZ$m			
Dividend received		507			
Corporate tax		287			
Total income		794			
49% sell-down		NZ$m		**Key assumptions**	
Dividend lost		(241)			
Interest saving		540		Government bond rate	6.0%
Efficiency gains		111		Deposit rate on saving	5.0%
Dividend	*53*			Sale price ($m)	9,000
Tax	*57*			Domestic ownership	70%
Loss of interest income		(104)		Top RWT rate	33%
				Efficiency gains	20%
Total net benefit		**306**	**39%**		

Source: Company data, GS&PNZ Research estimates

Figure 16: Crown income will be higher under this arrangement



Source: GS&PNZ Research estimates

Capital Market Impact: A Significant Positive

We see the decision around mixed ownership of government assets as inextricably entwined with the future of the capital markets in New Zealand, and in particular, the equity market.

To be clear, SOE floats alone are unlikely to reverse the secular decline of the NZ equity markets. But without SOE participation the equity market's role in the NZ economy will, in our view, continue to lose relevance. Accordingly we see the decision on mixed ownership as part of a broader public policy question of the role for sovereign capital markets. We also believe SOE floats can be used to further advance corporate governance standards in NZ.

NZ Equity Market in danger of losing critical mass

The decision on mixed ownership comes against the backdrop of a local equity market that is losing critical mass. There are many manifestations of this trend: loss of Private Wealth investor interest, a decline in analytical depth and coverage, minimal new float activity and increasing migration of institutional funds across the Tasman. These developments are encapsulated in two top down perspectives:

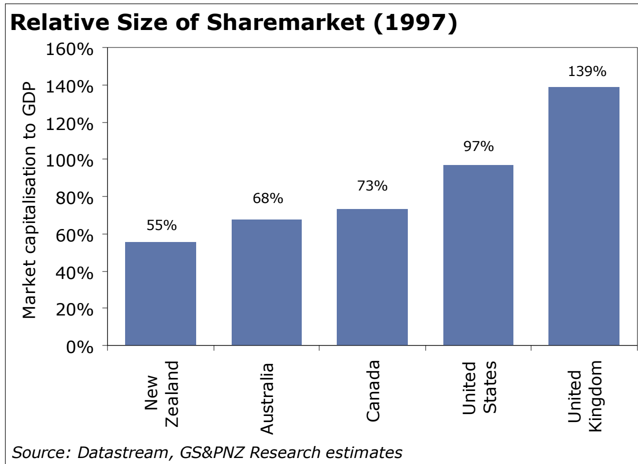
Participation in the economy

The NZ equity market's low and declining share in the economy is indicative of a reduced role in the provision of risk capital. As little as 15 years ago the NZ equity market’s share of GDP was within range of our advanced economy peers, and close to Australia (56% versus 68%).

NZ's share has dropped to 29%, while our advanced economy peer group has grown. Two types of economies tend to have an equity share of GDP at around the 25%-50% level: emerging economies (eg Colombia, Turkey); or advanced economies in a downward spiral (eg Ireland, Greece).

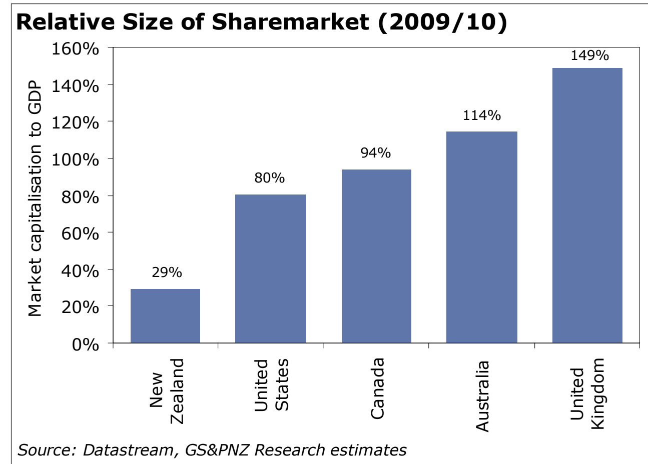
This reduced role means businesses seeking capital expansion or vendor exit are increasingly seeking capital via (typically offshore) trade buyers. In short, the most useful characteristic of an equity market: price discovery of risk capital, is becoming impaired.

Figure 17: In 1997, NZ's sharemarket's role in the economy was closer to its peers...



Source: Datastream, GS&PNZ Research estimates

Figure 18: ... than it is now



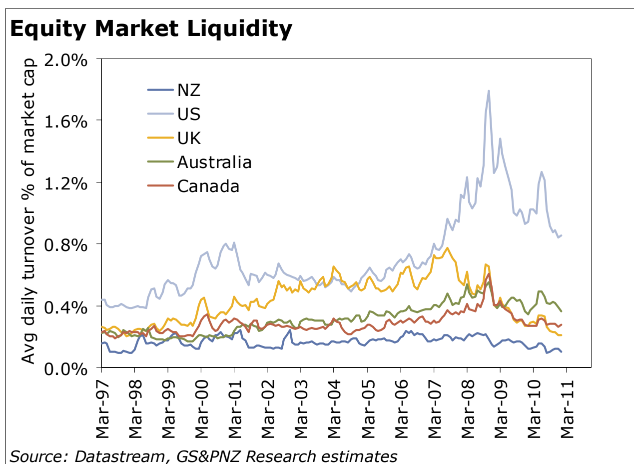
Source: Datastream, GS&PNZ Research estimates

Deteriorating liquidity

A declining role in the economy has meant market liquidity has suffered. Again, relative to developed market peers, NZ's liquidity looks poor (figure 19). However, daily trading volumes provide the best illustration of the tenuous state of institutional investing in NZ. Average daily turnover has oscillated around a flat trend for 15 years, and at current levels ($60m/day) is the same as in 1997. By contrast, daily trading in Australia has risen from an average of $1bn/day in 1997 to $5bn/day currently (figure 20).

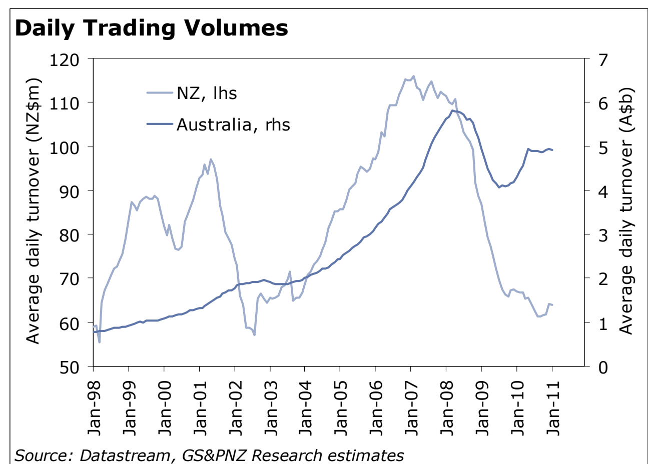
Flat nominal trading activity against a backdrop of poor inflows and declining commission structures has seen some predictable consequences. This includes sell-side retrenchment, particularly of research analysts and reduced coverage of NZ from the buyside, with a concomitant increase in institutional focus on Australian equities as a proxy for domestic investment.

Figure 19: NZ's market liquidity is low by international standards...



Source: Datastream, GS&PNZ Research estimates

Figure 20: ... and is getting worse



Source: Datastream, GS&PNZ Research estimates

Likely impact of mixed ownership on equity market sustainability

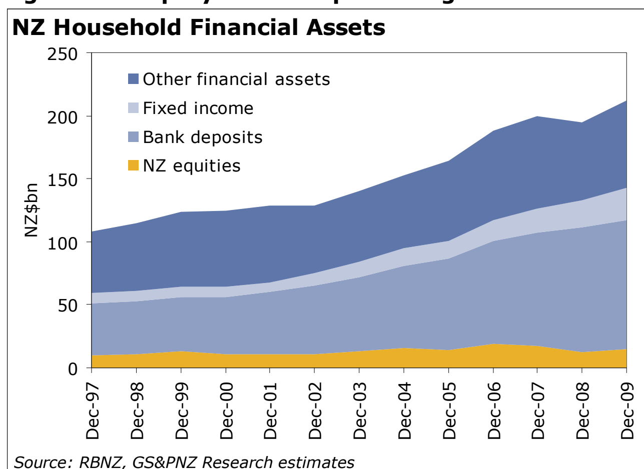
With the local equity market in structural decline, mixed ownership has the potential to be a significant positive catalyst. The nature, speed and size of any sell-downs are important considerations for the local equity market.

Will there be sufficient demand?

The declining role of the equity market in the economy outlined above means that demand for government assets cannot be taken for granted. As a rule of thumb, new equity supply of >$1bn in any one year will be a significant bulge of equity supply for investors to absorb. That said, the significant advantage the Crown has is that it has the luxury of selling down only as much as the market can absorb. This will be important, for while "demand" is essentially a question of liquidity (which we know is poor), a more structural perspective indicates New Zealanders are underinvested in equities, suggesting latent demand will be released as supply improves:

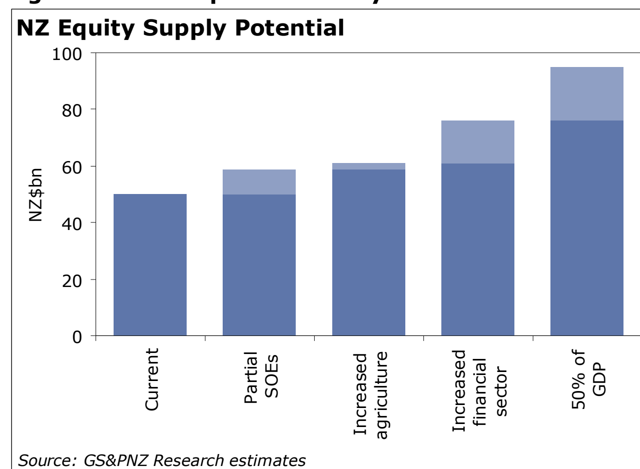
- RBNZ data shows ownership of local equities has languished while other financial assets, notably bank deposits and bonds, have grown strongly (CAGR of 20% and 27% versus equities of 12.5%, figure 21). A restoration of NZ equity ownership to the 1997 proportion of financial assets would imply $5bn of new demand.
- Public policy changes in recent years: Kiwisaver, the NZ Super Fund and a less distortionary tax system have gone some way to improving equity market participation. We would expect the NZ Super fund would be a significant participant in SOE flotations.
- Both Institutional funds and private wealth have tended to use Australia as a proxy for domestic investment. New equity supply would encourage these funds to migrate back to the domestic market.

Figure 21: Equity ownership has languished



Source: RBNZ, GS&PNZ Research estimates

Figure 22: Some positive catalysts are needed



Source: GS&PNZ Research estimates

How will mixed ownership impact supply?

Notwithstanding improving demand conditions, there is a genuine issue with the nature of the assets the Crown will bring to market. In particular, the NZ Equity market is already well represented by utilities. With electricity generators likely to part of any offering, the Crown will have to be careful to ensure demand within any particular sector is not saturated. However, we do not see this as a deal breaker with sector concentration being higher in other peer markets. For example banks account for ~30% of ASX200. Moreover, as figure 22 shows, the small size of the NZ market means sector diversity can be boosted relatively quickly with one or two major floats. The most plausible of these outside SOEs is from the agriculture and financial sectors.

The mix of ownership will also be critical in maximising the positive impact on equity market liquidity. In particular, we see the following as important:

- The crown remains a cornerstone holder in any asset. As well as satisfying policy objectives, this prevents assets being fully acquired by trade buyers.
- Access to a broad local investor base is facilitated, possibly structured to enhance affordability.
- Supply is balanced to ensure demand tension from local institutions, including the New Zealand Super Fund.

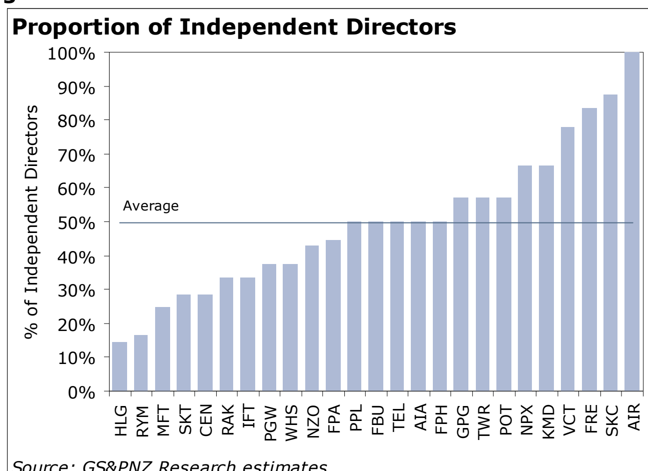
Improving NZ corporate governance standards

We recently undertook a comprehensive review of corporate governance practices by major NZ listed companies. The analysis focused on the key price-sensitive areas being board, audit and remuneration. We believe the current performance leaves room for improvement with an

average score a relatively modest 56 out of 100. All NZ companies have at least one red flag (being a score of 50 or less on board, audit and remuneration) and 52% with two red flags.

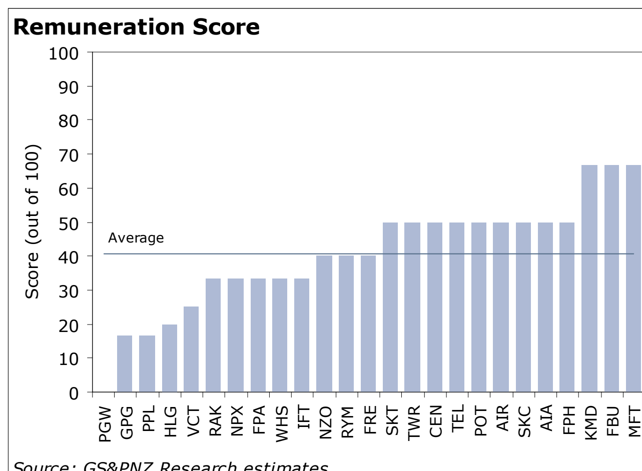
We believe SOE floats could be used as a role model to all other listed NZ companies in selected areas of corporate governance. In particular, the government should ensure that the board consistent of a majority of truly independent directors with a wide range of experience and qualifications. AIR is an excellent example. SOE floats should also look to raise the bar of remuneration transparency and appropriateness. In our view, best practice would see appropriate disclosure around incentive hurdles, limits on compensation and incentives clearly linked to both specified performance targets and aligned with shareholder interest.

Figure 23: SOE Floats could help set higher corporate governance standards …



Source: GS&PNZ Research estimates

Figure 24: … for Director Selection and Remuneration Practices



Source: GS&PNZ Research estimates

The Economic Benefits Could Be Large

Economic growth implications of stronger capital markets

As we highlight above, we believe one of the government's main objectives with this new mixed ownership model for SOEs is about capital market development rather than just maximising debt reduction. It is the former where we believe the greatest positive spin-offs to the wider economy could exist.

As the Capital Market Development Taskforce highlighted, capital markets play an important role in an economy. Well developed capital markets help to efficiently allocate savings to the most productive investments, facilitating capital formation, which in turn should generate economic growth. Leahy et al (2001) state four key functions that capital markets (or financial systems) play in an economy. They 1) mobilise savings; 2) diversify risk; 3) allocate savings to new projects; and 4) monitor the allocations of managers.

There is a growing international literature looking at the links between capital market development and economic growth. Admittedly, there still appears to be a lack of settled consensus on the issue. Some of the debate surrounds the direction of causality and also whether capital market development reaches a point where it becomes detrimental to growth. That is, excess volatility leads to a lack of investment. However, we would add that a number of recent empirical studies find positive links between the two, particularly for underdeveloped markets, such as in emerging economies. We would argue that NZ's capital markets are also underdeveloped.

In a cross country study of OECD countries, Leahy et al (2001) find that financial market development, proxied by either stock market capitalisation, private sector credit or liquid liabilities has an important relationship with fixed asset investment and hence economic growth. In fact, they find that differences in stock market capitalisation of 10 percentage points yield differences in GDP per capita of 3.3%.

Other studies to also find positive links with stock market size or liquidity and economic growth include Bassanini et al (2001), Levine & Zervos (1995 & 1998), Beck & Levine (2004) among others.

Capital market development and economic growth in NZ

We repeat the analysis by Leahy et al (2001) for NZ looking at financial market development and its impact on private non-residential investment (business investment). The model, apart from looking at a sole country, is the same. That is, business investment is modelled as a function of real GDP, real long-term interest rates (adjusted for a user cost of capital) and a variable for financial development. Our proxies for the latter are stock market capitalisation as a percentage of GDP and the stock market turnover ratio. The results are shown in Table 3.

For NZ, we find that stock market capitalisation has a positive relationship with private non-residential investment and is significant to the 1% level. Furthermore, a 10% lift in stock market capitalisation relative to GDP is found to correspond to around an 8% lift in business investment. Interestingly, the turnover ratio is found to have negative, but insignificant impact on investment. We do not offer a strong reason for why this may be the case, but it perhaps could be due to the fact that NZ's stock market turnover is depressed, which actually does highlight some constraints in the process of firms being able to raise capital and invest and also efficiently withdraw their interest once the project is completed.

Table 3: Market capitalisation has a significant impact on business investment

Long-run coefficient estimates from regression of private sector non-residential GFCF

	Stock market capitalisation	**Turnover ratio**
Estimators		
Financial development	0.078	-0.045
	(0.019)**	(0.041)
GDP	1.626	1.680
	(0.076)**	(0.107)**
Adjusted real interest rate	-1.992	-3.651
	(0.906)*	(1.263)*

*Standard errors in brackets; ** corresponds to 1% significance; * corresponds to 5% significance*

Source: GS&PNZ Research estimates

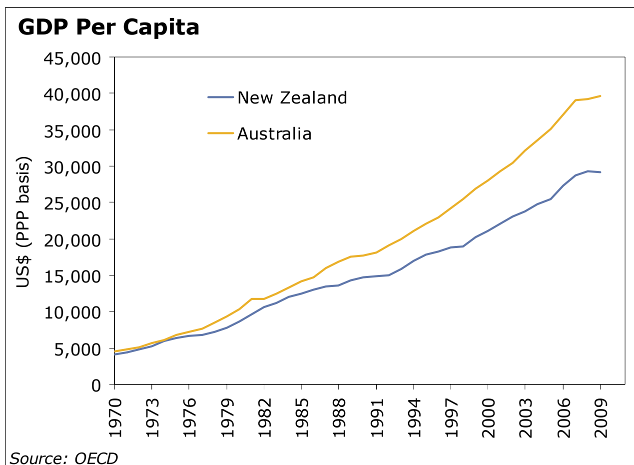
Capital market development may also help explain NZ's underperformance compared to Australia

NZ's GDP per capita on a PPP basis is currently around 73% that of Australia's. Moreover, Australia is ranked 6th in the OECD in terms of economic performance compared with NZ's rank of 22. While a number of factors may explain the underperformance of NZ relative to Australia, we believe capital market development (or the lack there of in NZ) has played an important role.

If we again use stock market capitalisation to GDP as a proxy for capital market development, a very simple regression analysis supports this hypothesis. That is, we find that the relative differences in stock market capitalisation between the two nations explain some of the differences in GDP per capita. We estimate that if NZ's stock market capitalisation to GDP was the same as Australia's, that is, around 90% rather than 29% of GDP, then the gap in GDP per capita between the two countries would be around 15 percentage points narrower. In other words (and all else being equal) the gap between NZ and Australia's GDP per capita would be closer by around half.

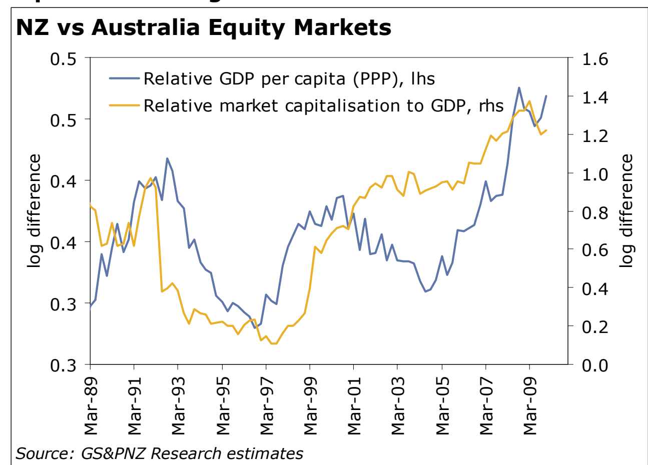
Of course, this does not approach the question of causality, and as mentioned, there are bound to be a number of other factors that explain the difference in relative economic performance. Hence, this result should only probably be used for illustrative purposes only. Nevertheless, we believe it is still interesting and warrants further initiatives to support NZ capital market development.

Figure 25: NZ has underperformed relative to Australia since 1970



Source: OECD

Figure 26: Capital market development may partly explain the divergence



Source: GS&PNZ Research estimates

Implications for national saving of partial asset sales

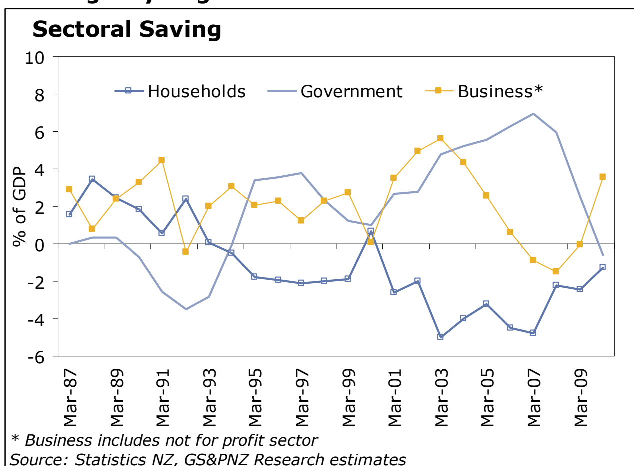
At first glance it is unclear how this mixed asset structure and partial sell down of public assets will impact on the outright level of national saving. It will definitely not be a silver bullet by itself. Of course, if the government uses the proceeds to pay down debt and reduce servicing costs, this could see the fiscal accounts return to surplus earlier and improve government saving. All else being equal, this could lower the risk premium on our international borrowing, and hence interest rates, and potentially take some pressure off the NZ$ to appreciate. However, it depends on where the proceeds come from.

Where we believe the main long-term saving benefits could arise is in the type of saving NZ does, particularly for households. One reason given for NZ's poor household saving record is the lack of quality assets to invest in. This is reflected in household balance sheets, which show that three quarters of household assets are tied up in housing. Direct equity ownership on the other hand sits at just 3% (figure 28).

While housing plays an important role in sheltering the population, it provides little in the way of flow-on benefits for the economy with regard to productivity and growth. Increased participation in equities (or financial investments more generally) would provide a number of businesses with much needed capital to employ and invest.

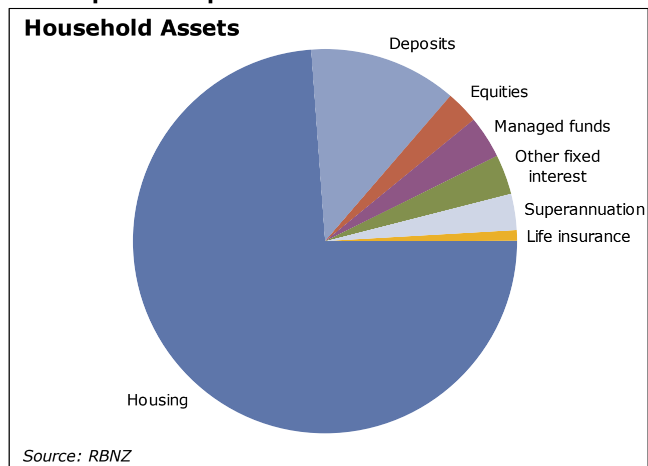
Furthermore, with households in NZ having such a large exposure to housing, at times when the housing market is weak (like at the present time) this results in widespread caution from households and is a tough environment for retailers. Likewise when the housing market is strong, this can lead to exuberance and often difficulty in the RBNZ attempting to moderate the business cycle. A more diversified household investment portfolio could arguable lessen these cycles. It is part of a wider economic rebalancing the NZ economy needs to pursue.

Figure 27: Household saving has improved, but there is a long way to go



** Business includes not for profit sector*
Source: Statistics NZ, GS&PNZ Research estimates

Figure 28: Financial assets, particularly equities, only make up a small portion of total household assets



Source: RBNZ

Capital can be used in other areas

Is fully owning three electricity generators, a coal producer and the majority of an airline the best use of the government's capital? To put it another way; if the government tomorrow was to start with a clean sheet and had $8-10 billion to invest, would it choose to own these assets? We believe it would be highly unlikely. The fact the government has found itself owning these assets is more an accident of history rather than anything more strategic.

As the first Investment Statement of Government released in December stated *"The composition of the [Crown] portfolio reflects the residual of broader policy choices rather than a deliberate choice to meet specified commercial investment goals"*. The current state of the government's holdings of commercial assets has largely occurred "by accident". Therefore to the doubters on the merits of asset sales we would ask; if it is better to have government ownership, then why does the government not own more commercial assets?

The partial sell-down of these assets could free up capital for the government to use for its core functions. That is, investing in schools, hospitals and other infrastructure. The PM himself stated this as a key reason. However, we feel the argument goes even beyond this. All else being equal, it frees up capital that could be used to invest in more "strategic assets". For example, the government could have had spare capital to invest in distressed dairy farms. The possibility of foreign ownership of land may not have even been a headline grabber if this was the case. There are also other natural assets such as forestry or mineral assets that the government could strategically own, or more infrastructure such as ports.

The idea that the government "must" own these assets because it already does seems an overly simple and redundant argument in our minds.

Which Companies Should Go First?

Company specific tests

Government has established five tests to be met for it to proceed with partial privatisation of the SOEs. The three company-specific tests are:

- The government is confident of widespread and substantial NZ share ownership.
- The companies involved present good opportunities for investors.
- The government is satisfied that industry-specific regulations adequately protect NZ consumers.

In our view the third question is largely redundant. All four SOEs proposed for partial sale operate in industries that currently include privately owned companies. Each industry is already subject to a high level of competitive and environmental regulation which is mutually exclusive from ownership. We view the key questions therefore being 1) what is likely to be NZ investor appetite for investing in each of the SOEs and 2) do the companies represent an attractive investment proposition.

Potential for widespread and substantial NZ share ownership

As discussed earlier, we believe on a simple top down analysis of household balance sheets that there is up to $5bn of potential demand for domestic equities. In addition to this, there are three additional sources of domestic demand that were absent during prior state sell-downs:

- The NZ Superfund is a significant strategic investor ($19bn fum) that has a policy objective to allocate investments to the domestic economy.
- Iwi are now collectively a significant source of potential demand. Moreover the nature of Iwi investment (domestic strategic assets) tends to be aligned with the assets the Crown will likely bring to market.
- Kiwisaver ($7bn fum) has structurally improved inflow into the managed funds industry. Accordingly we expect domestic institutions will be an improved source of demand.

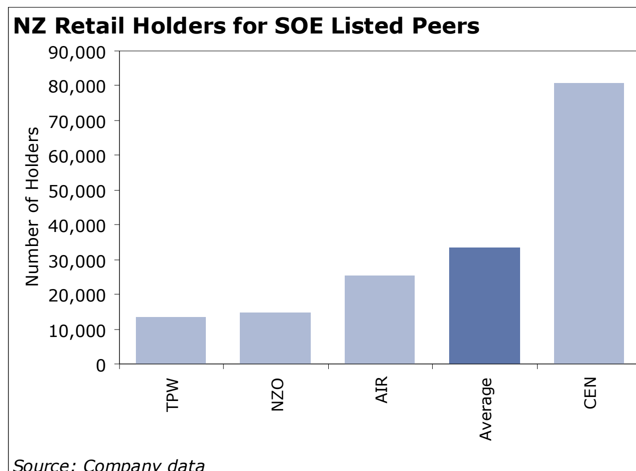
In addition, our analysis of NZ listed peers suggests all potential privatisation candidates should attract solid interest from NZ retail investors. Based on the share ownership of Contact Energy and Trustpower suggests the strongest level of NZ retail demand would be for SOE electricity companies. In particular, our analysis suggests NZ retail demand for SOE

electricity companies could account between 30% and 70% of the free float from up 100,000 individual investors.

Figure 29: Electricity companies have largest NZ retail ownership ...

Source: Company data

Figure 30: ... as % of free float and number of individual holders



Source: Company data

Prospects for investors: Electricity Companies

We see a high hurdle for the SOE electricity companies to meet the criterion of presenting a 'good opportunity for investors' given 1) the NZ investment community's depth of knowledge on the industry's prospects and risks, and 2) existing high quality investment options in the sector.

In our view the principal long-term driver of value of an electricity generator (both its existing assets and development options) is the future electricity price path (theoretically defined by the long-run marginal cost of new generation) relative to cost base. In NZ the generally accepted base case scenario is that electricity prices need to materially increase over the long-term to reflect the higher cost of generation investment. The likelihood of higher gas and carbon costs support this outlook.

The high weighting of zero marginal cost renewable assets and development options within Meridian and Mighty River Power (MRP) mean both companies provide positive exposure to this long-term theme. Conversely the considerable uncertainty over future costs and utilisation of Genesis's thermal dominated portfolio represents a significant risk in any valuation of and investment in the company (including the future of its major asset, the Huntly power station).

At this thematic level we believe Meridian and MRP currently meet the criterion of presenting a 'good opportunity for investors' whereas Genesis does not. In the near-term we do not believe this is likely a surmountable issue for partially privatising Genesis and therefore view any initial selection choice between Mighty River Power and Meridian.

Mighty River Power vs Meridian

In our view at a thematic level the investor prospects of MRP and Meridian are similar with both potentially representing attractive investment propositions through:

- **Exposure to higher long-term electricity prices** through Meridian's 2760MW (100% of production, hydro and wind) and MRP's 1427MW ((~92% of production, hydro and geothermal) of renewable generation.
- **A pipeline of NZ generation development options** including for Meridian (wind hydro and irrigation totalling up to $4.5b over the next decade) and MRP (consented projects 110MW Ngatamariki geothermal station ~180MW Turitea wind farm).
- **Leverage of its expertise into international markets.**
  - MRP is one of the largest companies globally in the niche geothermal sector. It has targeted its international investments as having the "potential for significant growth and return enhancement". Currently it has plans to invest US$250m through the GGE Fund. The fund's investments include a 50MW geothermal power station in California and survey and exploration programmes in Nevada, Chile and Germany.

- Meridian has wind investment in Australia including the 70MW Mt Millar wind farm in South Australia it acquired in May 2010 for A$191m and its JV with AGL to build the ~A$1b 420MW Macarthur wind farm in Victoria. Meridian has also invested ~US$30m in solar in the US.

Risks

In our view the ongoing risks/earnings volatility in both Meridian and MRP due to wholesale price and hydro output fluctuations are not materially different from the NZX listed electricity generators Contact Energy and TrustPower and therefore generally well understood by the NZ investment community and not an impediment to investibility.

We do see some short-term issues that may promote investor risk aversion that would ideally be rectified or concluded before any partial sale including:

- **Ministerial Review changes:** Initiatives currently being enacted following the 2009 Ministerial Review include 1) the 'sale' of Tekapo to Genesis from Meridian, 2) 'virtual asset swaps' between Meridian and MRP (up to 700GWh) and Meridian and Genesis (450GWh), 3) the introduction of a 'customer compensation scheme' whereby retailers make payments to consumers and 'scarcity pricing' or a minimum wholesale price in the event of a public conservation campaign, and 4) the abolishment of the Reserve Energy Scheme. These changes have resulted in short-term market uncertainty and instability including:
  - **Waitaki system operating efficiency uncertainty:** The split of the Waitaki system between Meridian (Pukaki) and Genesis (Tekapo) may reduce the efficiency of this system. We believe it is likely Meridian will need to operate the assets more conservatively to manage the uncertainty of inflows and lower storage capacity to meet its South Island load.
  - **Wholesale market dynamics:** A number of the Ministerial Review initiatives are targeted at improving security of supply by lifting the dry year cost to hydro generators. We believe these initiatives have contributed to a change in pricing policy from generators which could alter medium-term dynamics/outcomes in the wholesale market.
  - **Retail competition:** The asset sale and swaps have necessitated a rebalancing of SOEs customer load and therefore a significant escalation in retail competition. Retail competition will likely ease over the medium-term as generation-load balances are re-established.
- **Iwi claims/concerns** with the privatisation of sensitive assets including water and geothermal rights.
- **Defining the balance between domestic and international growth aspirations and short-term returns including distributions to shareholders.** Long-term, growth investments generally have a higher risk profile than existing operations and can consume a significant amount of short-term cash flow, eg, Meridian's subsidiaries (including international wind and solar, smart meters, dam engineering, housing efficiency businesses) lost EBITDAF $30m in FY10.
- **Water rights:** Defining future water rights over hydro power station waterways.
- **Meridian specific:**
  - **HVDC link upgrade:** The current constraints on the HVDC which limits the electricity able to be exported north to south likely promotes a more conservative use of Meridian's stored water to manage potential dry year risk. We expect an upgrade of the link to be commissioned at the end of 2012.
  - **HVDC pricing:** Currently the HVDC link is paid for by South Island generators, with Meridian meeting ~80% of the cost. A long-dated review is being undertaken into pricing policy of the link. Any change could result in a material cost reduction for Meridian.
  - **'Fit for purpose' review:** Meridian itself has acknowledged its historic commercial underperformance and is implementing a review targeting cost savings and a greater commercial focus. A deferred sale may allow government to capture a greater portion of the value from these initiatives.

Prospects for investors: Solid Energy

The listing of Solid Energy on the NZX would add a sizeable resources company to the domestic market. The resources sector is currently thinly represented and we believe the addition of a quality and sizeable operator would be a welcome addition for NZ investors. In our view Solid Energy would provide investors exposure to:

- **Emerging market growth/industrialisation** and the resulting demand for energy and construction (steel) resources.
- **Solid Energy's substantial growth objectives** including expansion and green field coal mining, renewable businesses wood pellets and biodiesel, coal seam gas, underground coal gasification and South Island lignite conversion into high energy briquettes, urea and transport fuel. The capital cost of the lignite conversion projects is potentially substantial at ~$1.5-3b and ~$5b for the urea and transport fuel projects respectively.

We see a key question to be addressed before any partial privatisation of Solid Energy as **defining the balance between growth aspirations and short-term returns.** In its Statement of Corporate Intent Solid Energy stated that it will use the strong cash flow from its coal business to pursue future growth opportunities. It is forecasting a nominal dividend of $20m pa. Traditionally NZ retail investors have shown a preference for dividend yielding investments.

Risks

In our view Solid Energy as a resources company has a higher inherent risk profile than the electricity companies and previously privatised SOEs. Education will be important to mitigate the risk of a negative investor reaction should downside earnings scenarios eventuate.

- **Earnings volatility:** As a resources company Solid Energy is exposed to significant volatility in prices, which coupled with variability in production, result in considerable earnings uncertainty and volatility.
- **Reinvestment risk:** Solid Energy's investment aspirations are coupled with the risk that the projects fail to deliver expected returns due to a underachievement of pricing, demand or production.
- **Industrial relations:** Unions have a strong presence in the mining sector and Solid Energy has a history of disruptions from industrial disputes.
- **Environmental risk**, including pricing of greenhouse gas emissions and the rehabilitation of previous mine sites.

Prospects for investors: Air New Zealand

The investment case for AIR has strengthened significantly over the last few years on the back of nimble management of day-to-day operations coupled with major product innovation and cost saving initiatives. Superior management of operations, especially route selection and aircraft capacity, and limited pressure on profitability from the swine flu and the global financial crisis, has seen AIR significantly outperform its regional peers during this period.

Key product innovations on the Tasman and long-haul sectors were only released in the last few months. We expect financial benefits from these changes should be significant, however unlikely to be fully captured in AIR earnings base until 2012. In particular, AIR launched its new long-haul seats with the arrival of its new Boeing 777-300ER in December. Key innovations include industry-first lie-flat seat in economy class (Skycoach) and new premium-economy seats which we expect to lift long-haul revenue by 8%. The new long-haul seats should be available on most routes by end of 2012.

In addition to strong cost management, AIR should also see material cost savings from its recent decision to move to a single aircraft type for short-haul and long-haul operations. AIR is replacing its Boeing 737 short-haul fleet with Airbus 320s over the next 5 years. At this same time, AIR will replace the majority of Boeing 747 long-haul fleet with Boeing 777 aircraft. We expect this to result in average cost savings per seat of between 5% and 10%.

Collectively product innovation and cost saving initiatives coupled with alliance with Virgin Blue on the Tasman should significantly lift margins and returns over the next 3 years. Our forecasts suggest AIR's return on equity should reach 10% by FY14 despite headwinds from higher fuel prices. This may prove conservative with AIR's internal modelling suggesting a return on equity in the high-teens being possible.

Risks

At a listed company, we believe the NZ investment community generally appreciates the above average earnings volatility with AIR due to competitive nature of the airline industry. In particular, Adjusted NPAT has ranged between $92m and $214m over the last 5 years mainly reflecting the inability of industry players to handle periods of relatively sharp changes in demand levels, jet fuel prices and currency levels.

We believe the gradual improvement in AIR underlying profitability through product innovation and cost saving initiatives should somewhat reduce medium-term earnings volatility. Notwithstanding this, significant effort will need to be directed towards ensuring first time NZ retail investors into AIR fully understand the magnitude of short-term earnings risk surrounding the airline industry.

Appendix

Table 4: History of NZ's public asset sales

NZ Government Major Asset Sale History				
Asset	Year	Sale price (NZ$)	Type of sale	Details
Air New Zealand	1989	660	Mixed	As a condition of sale, Brierley Investments was required to sell down 30% of its initial shareholding (65%) to the NZ public, institutions and Air NZ staff
Auckland International Airport	1998	460	Public float	AIAL was listed on 28 July, with the Crown receiving a price of $1.80 per share
Bank of New Zealand	1992	850	Trade sale	
Contact Energy	1999	2,331	Mixed	$1,208m was sold to a cornerstone investor. The remainder was a public float
Forestry Corporation of New Zealand	1996	1,600	Trade sale	
Forestry cutting rights	1990	1,027	Trade sale	
Housing Corporation mortgages	From 1991	2,414	Trade sale	
Maui Gas	1990	254	Trade sale	
New Zealand Rail	1993	328	Trade sale	
New Zealand Steel	1988	327	Trade sale	
NZ Timberlands	1992	366	Trade sale	
Petrocorp	1988	801	Trade sale	
Post Office Bank	1989	678	Trade sale	
Rural Bank	1989	688	Trade sale	
State Insurance Office	1990	735	Trade sale	
Taranaki Petroleum mining licences	From 1992	121	Trade sale	
Telecom	1990	4,250	Mixed	The sale was on the basis that the shareholding of any single foreign shareholder or consortium would be limited to 49.9%, the Government would retain a Kiwi share and at least $500m worth of shares be made available via public offering on the NZ market
The Radio Company	1996	89	Trade sale	
Wellington International Airport	1998	96	Trade sale	
Works and Development Services	1996	108	Trade sale	
Other	-	938	Trade sales	
Total	**-**	**$19,122**	**-**	

Source: NZ Treasury, GS&PNZ Research estimates

Table 5: NZ stock recommendations

Element						
Company	AIA	AIR	CEN	POT	TEL	VCT
Price ($)	2.20	1.32	6.15	7.85	2.13	2.44
12 Month Target Price ($)	2.35	1.25	6.60	8.50	2.00	2.50
Recommendation	Hold	Sell	Hold	Buy	Sell	Hold

Source: GS&PNZ Research estimates

I, Philip Borkin, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to specific recommendations or views expressed in this report.

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New Zealand - Research Recommendation Definitions

Sell (S)	Stock is expected to underperform the NZSX 50 Index for 12 months
Hold (H)	Stock is expected to perform in line with the NZSX 50 Index for 12 months
Buy (B)	Stock is expected to outperform the NZSX 50 Index for 12 months

Other Definitions

NR	Not Rated. The investment rating has been suspended temporarily. Such suspension is in compliance with applicable regulations and/or Goldman Sachs & Partners New Zealand Limited ("GS&PNZ") policies in circumstances when GS&PNZ and/or, our affiliate, Goldman Sachs & Partners Australia Pty Ltd ("GS&PA") is acting in an advisory capacity in a merger or strategic transaction involving the company and in certain other situations.
CS	Coverage Suspended. GS&PNZ has suspended coverage of this company.
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Target Price

Analysts set share price targets for individual companies based on a 12 month horizon. These share price targets are subject to a range of company specific and market risks. Target prices are based on a methodology chosen by the analyst as the best predictor of the share price over the 12 month horizon.

Research Criteria Definitions

The above recommendations are primarily determined with reference to the recommendation criteria outlined below. Analysts can introduce other factors when determining their recommendation, with any material factors stated in the written research where appropriate. Each criterion is clearly defined for the research team to ensure consistent consideration of the relevant criteria in an appropriate manner.

Industry Structure:	Based on GS&PNZ industry structure ranking. All industries relevant to the New Zealand equity market are ranked, based on a combination of Porter's Five Forces of industry structure as well as an industry's growth potential, relevant regulatory risk and probable technological risk. A company's specific ranking is based on the proportion of funds employed in particular industry segments, aggregated to determine an overall company rating, adjusted to reflect a view of the quality of a company's management team.
EVA™ Trend: [1]	EVA™ trend forecast for coming 2 years. Designed to reflect "turnaround stories" or to highlight companies GS&PNZ analysts believe will allocate capital poorly in the estimated timeframe.
Earnings Momentum:	The percentage change in the current consensus EPS estimate for the stock (year 1) over the consensus EPS estimate for the stock 3 months ago. Stocks are rated according to their relative rank, effectively making it a market relative measure.
Catalysts:	A qualitative and quantitative assessment of a company's long term catalysts that the analyst believes should be considered and possibly recognised by the market.
Price/Valuation:	The premium or discount to base case DCF valuation at which the stock is trading relative to the average premium or discount across the market.

For Insurers

ROE Trend: [1]	ROE is used as a proxy for EVA™. Rating takes into account the expected level and trend of ROE over the next 2 years.
Balance Sheet:	Analyst's assessment of the quality and strength of the insurer's balance sheet, including conservatism of provisioning, sufficiency of capital, and quality of capital.

For REITs

Strategy:	Used instead of industry structure as many REIT investors are intra rather than inter sector focussed.
EPU Growth:	Ranking of Earnings Per Unit growth relative to other listed Real Estate Investment Trusts. Used instead of EVA™ Trend.
Yield:	Yield relative to the REIT sector average. Used instead of Earnings Momentum.

For Australian Companies

Relevant Index:	If a research report is published by GS&PA, the recommendation of a company or trust is based on their performance relative to S&P/ASX 200 Index (Gross) and not the NZSX 50 Index.

[1] *EVA™ is a registered trademark of the U.S. consultancy firm Stern Stewart*

Distribution of Recommendations – as at 31 December 2010

Recommendation	Overall	Corporate relationship* in last 12 months
Sell	8%	6%
Hold	53%	50%
Buy	39%	44%

* No direct linkage with overall distribution as the latter relates to the full GS&PA/GS&PNZ coverage (>250 companies). The above table combines the corporate relationships and recommendations of both GS&PA and GS&PNZ.

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