Commentary on NPT Proposals

11 April 2017

A Special meeting of NPT shareholders will be held at the offices of Link Market Services, Level 11, Deloitte Centre, 80 Queen Street, Auckland at 11am on Friday 21 April

We have delayed making comment on the matters being brought to the NPT Special Meeting until now as the situation has been continually evolving. Further manoeuvres may impact on what we say, and for that reason we have limited ourselves to the bigger picture view. We have held discussions with NPT, Kiwi Property, Augusta, Salt Asset Management and ANZ Equity who are the principal parties involved.

There are two distinct, but related matters that shareholders have to consider.

A. The Kiwi Property Group (KPG) proposal.

The current NPT board is supporting a proposal that will see the following occur:

- KPG will sell two Wellington properties (the Majestic Centre office building in the CBD and the North City Shopping Centre in Porirua) to NPT for $230m. This is a $6.5m (2.8%) discount to the independent valuation.
- The purchase will be funded by additional bank debt of $87m and a roughly 1 for 1 entitlement offer to all shareholders seeking to raise $94m. The share issue price for this is still to be decided. This will depend on the NPT share price at the time and will be done by way of a rights offer with some potential for a small payment to those who don't take it up, depending on the final book build price.
- KPG will be issued with sufficient new shares to give it a 19.9% holding in NPT. The price for these is an agreed formula related to the 10 day weighted average share price prior to the entitlement offer adjusted for any discount applied to the entitlement offer.
- KPG will pay NPT $6m to buy the management rights for the expanded NPT portfolio. This will result in an overall reduction in NPT's management costs from 1.3% to 0.7% per annum.
- The transaction will occur as soon as various conditions are satisfied with the expectation that this will be by 31 May unless extended.

Positives:

- The transaction will result in NPT finally having real scale. The larger number of shares on issue will also increase liquidity. NPT has historically traded at an average 12% discount to net tangible assets. Higher liquidity would normally be expected to reduce this gap.
- The deal is expected to result in a 6.8% increase in distributable profit and dividends.
- Importantly (and uniquely), the deal has a provision that any time after 5 years NPT can dismiss KPG as manager without cause – albeit at a cost of $10m. KPG could also leave and receive the $10m, but they cannot sell the contract to anyone else without NPT having first rights. We are not aware of any other management contract with these dismissal provisions. While the numbers seem large it is worth remembering Property for Industry is proposing to buy their external management contract for $40m.

- Gearing will remain reasonable at less than 35%.

- KPG has the skills and resources to manage the properties to a high standard. NZSA is comfortable that the two properties adequately meet seismic requirements, are insurable (this would be done as part of KPG's overall portfolio management) and that there are sufficient safeguards in place regarding completion of some work at North City. We are also satisfied that possible conflicts of interest issues with KPG are properly addressed.

Negatives:

- The share entitlement price remains unknown. This is significant because as it reduces the positive accretions to NPT diminishes. Salt Asset Management has calculated that at a share price of 58c, KPG would be buying into NPT at a discount of almost 20%. Matthew Goodson of Salt complains that buying assets at a 2.8% discount and paying part of the cost with shares at a 19.9% discount does not make sense. Craig Tyson from ANZ Equity argues that while this is not ideal, the shares have always had a large discount to NTA and in the longer term the deal potentially unlocks value by fixing the scale issue. Northington Partners have also produced an analysis that shows that if the KPG assets were bought at full valuation instead of the 2.8% discount and KPG bought shares at NPT's NTA, the net dollar effect is actually slightly more negative.
- The entitlement offer will require underwriting to ensure success and this remains undetermined. This is also significant as the underwrite fee and discount required could materially change the financial outcome for NPT shareholders.
- NZSA is generally philosophically opposed to externalised management contracts, but in this case, the small scale of NPT makes this a very costly option and externalising makes sense. We also think the KPG shareholding does give strong alignment between the company and manager.
- Transaction costs are relatively high, although not dissimilar to other transactions of this type.

Alternatives that have been proposed:

- NPT could do nothing. It remains solvent and pays a decent dividend yield. However it is very limited in its ability to grow and will likely remain illiquid with a discount to NTA.
- NPT could externalise its management to reduce costs. This income combined with selling a smaller asset such as the Watties Building in Hastings would free up cash to enable future leveraged purchases as these become available. This option is potentially value accretive to NPT shareholders, but does not address the scale issue.
- NPT could be broken up and the assets sold. This may give a greater return than the value of the current share price given the discount to NTA.

B. Changes to the board

There are 5 resolutions proposed by Augusta (who hold nearly 20%). They seek to remove two NPT directors (James Sherwin and recently appointed chairman, Tony Sewell) and replace them with three of their own nominees.

- Paul Duffy is the chairman of Augusta and is not an independent.
- Bruce Cotterill has director experience back to 1998, but not in property. He was a director of Pumpkin Patch for two years. He is an independent.
- Allen Bollard (**NOT** the former RBNZ governor) has an audit and tax background and extensive building and property development experience. He is an independent.

The problem we have with changing the board is that shareholders have no idea of what actions it may take. We think it is unlikely that the status quo would prevail.

It is worth remembering that if a new board decides to externalise the management contract this can be done without reference to shareholders, and on whatever terms the board decides. This could be at a lower price than the KPG offer, and may not have the buy-back provisions for example.

Despite our best attempts, we have not been able to get a clear commitment about what Augusta (the largest shareholder) might propose going forward.

So what to do:

We think this is pretty simple. It comes down to certainty with some known negatives, versus significant uncertainty about NPT's future direction.

1. For long term investors who want to continue receiving a similar level of dividend with the potential for asset and share price growth over time, the Kiwi Property proposal brings a strong level of certainty. There is undoubtedly some short term cost, and it is not ideal to be bringing in a new major shareholder (KPG) at a significant discount. However scale and liquidity may be very positive in time.

   If you favour the KPG proposal, you should also vote against all the resolutions about directors to ensure the deal can be completed in a timely fashion.

2. If you don't like the KPG proposal, you should vote against it remembering that no-one knows what NPT might look like going forward.

   You will then need to decide what to do about the directors. Assuming you want a complete shake-up, it would make sense to vote in favour of removing the incumbents and installing new faces. We don't see much likelihood of a blended board of old and new working together constructively.

NZSA Discretionary Proxy Voting Intentions

We believe most retail shareholders invest in property companies for steady income without too many surprises.

For that reason we will vote discretionary proxies **IN FAVOUR** of the Kiwi property proposal.

We will vote **AGAINST** all resolutions relating to the election of directors.

As always, we recommend you carefully read the very detailed Notice of Meeting and accompanying documentation, and if necessary consult your financial advisor.

Note that proxies must be received by Link market services no later than 11am on Wednesday 19 April. You can vote online at https://investorcentre.linkmarketservices.co.nz/voting/NPT

If you have already voted and wish to change your mind, simply vote again. The most recent vote (including in person at the meeting if you decide to attend) is always the one that counts.

The Team at NZSA