

The Cost of Capital Report

As at 30 September 2004

Interest Rate Movements

Interest rates are a major news item. The house price boom and the steam rolling economy have made interest rate movements big news. Perhaps not front page news but they certainly rank higher than the all-to-frequent reports of yet another dismal performance of our test cricketers in Australia. It is rather sad to think interest rates should be of more interest that sport, but the thought of another spanking at the hands of the Australians is too much to bear.

New Zealanders have a substantial amount of their wealth invested in property. The weighting of property has grown with the rapid rise in property prices in recent years. Changes in mortgage rates impact directly on home owners' cash flow and on their perceptions of financial well being.

The other major impact of interest rates on the average New Zealander is through the relationship between interest rates and exchange rates. The factors that are providing strength to the New Zealand dollar at present are complex and global in their scope. However, there is no doubt that relative interest rates, and in particular the high level of our real rates, are helping to propel the dollar upwards.

While rising interest rates mean higher mortgage rates, the average New Zealander will have benefited from the strong New Zealand dollar. For example, the dollar's rise will have moderated to some extent the impact of rising oil prices on petrol prices. Also, for people buying imported consumer products, the strong dollar has been a boon.

For business, and particularly the export sector, the interrelationship between interest rates and exchange rates is well publicised. The recent period of rising short term interest rates and the strengthening NZ dollar has been a challenge for exporters. To some extent we have been lucky that the rising dollar has coincided with strong international prices for some of our key export products. This has allowed some sectors to weather the rising dollar. However, for others, for example fishing, forestry and some horticulture exports, times have been tough.



Person taking off in hang-glider photographed by Kevin Fleming

The relationship between interest rates and exchange rates is important, however it is the direct impact on cost of capital that will be most obvious to business. The cost of borrowing is an important explicit cost of doing business. Of course, it also has a significant influence on the cost of equity capital.

With the rise in interest rates in recent times it is reasonable to expect that the weighted average cost of capital is increasing. This is indeed what has been happening, although, as we demonstrate below, the increase is more subdued than has been the case for short term rates. In particular, while the OCR has been moving up and down over the last four years, our market average cost of capital has moved within a somewhat narrow band.

The volatility in short term interest rates over recent years is not necessarily unusual. For example, Australia has experienced similar volatility, although less so during the past year. More important for cost of capital are changes in longer term rates, which tend to be more moderate than swings in short term rates.

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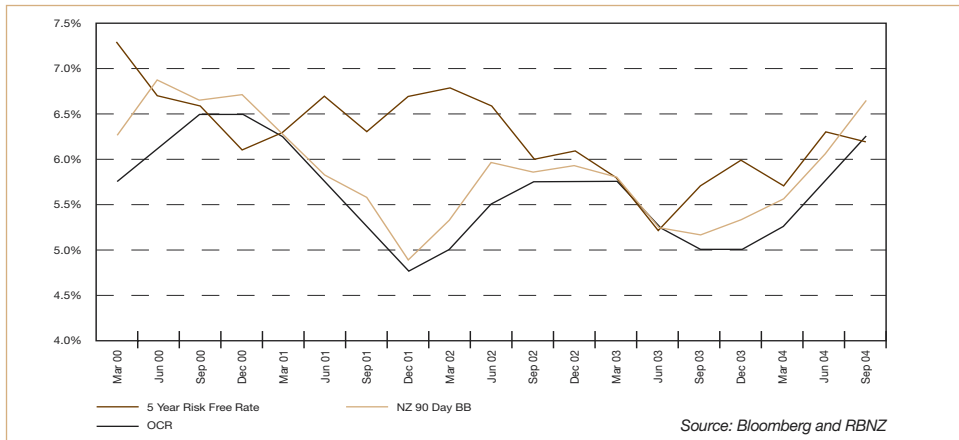
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Input Assumptions:			
Market Risk Premium	7.5%	Marginal Tax Rate On Debt	33.0%
Risk Free Rate Of Return	6.2%	Investor Tax Rate On Equity	28.0%

Company	NZX Code	EBIT Multiple	NPAT Multiple	Equity Beta	D/(D+E) Ratio	WACC
Agriculture						
Affco Holdings Ltd	AFF	15.2	16.1	0.54	15%	8.2%
Pyne Gould Guinness Ltd	PGG	12.1	13.8	0.61	49%	7.6%
Sanford Ltd	SAN	5.9	8.8	0.36	6%	7.1%
Williams & Kettle Ltd	WKL	7.9	10.9	0.36	18%	7.1%
Wrightson Ltd	WRI	8.3	11.0	0.74	6%	9.8%
						7.9%
Building Materials & Construction						
Fletcher Building Ltd	FBU	11.1	15.8	0.97	28%	9.9%
Nuplex Industries Ltd	NPX	11.0	16.3	0.80	37%	8.4%
Steel & Tube Holdings Ltd	STU	12.9	19.4	1.05	6%	12.0%
						9.9%
Consumer						
Briscoe Group Ltd	BGR	8.2	12.5	0.72	1%	9.9%
The Colonial Motor Co Ltd	CMO	6.9	9.4	0.38	22%	7.1%
Hallenstein Glasson Holdings Ltd	HLG	12.6	19.0	0.60	1%	9.0%
Kirkcaldie & Stains Ltd	KRK	14.5	17.2	0.57	48%	7.7%
Michael Hill International Ltd	MHI	16.7	24.1	0.48	13%	7.8%
Pacific Retail Group Ltd	PRG	38.7	-5.5	1.39	78%	9.8%
Restaurant Brands New Zealand Ltd	RBD	10.5	15.6	1.07	18%	11.4%
Turners Auctions Ltd	TUA	14.6	21.9	0.75	0%	10.1%
Vending Technologies Ltd	VTL	15.2	11.2	2.17	54%	13.5%
Wakefield Hospital Ltd	WFD	10.4	12.0	0.40	25%	7.2%
The Warehouse Group Ltd	WHS	12.0	17.1	0.71	17%	9.1%
						9.2%
Energy						
Contact Energy Limited	CEN	19.1	29.5	0.54	26%	7.6%
Horizon Energy Distribution Ltd	HED	10.9	15.8	0.48	22%	7.6%
Infratil Ltd	IFT	19.4	32.8	0.90	30%	9.5%
NGC Holdings Ltd	NGC	5.7	9.3	0.90	0%	11.2%
The New Zealand Refining Co Ltd	NZR	8.6	13.9	0.49	0%	8.2%
Powerco Ltd	PWC	14.4	24.1	0.80	62%	7.1%
Trustpower Ltd	TPW	16.6	25.4	0.85	19%	9.8%
						8.5%
Food & Beverages						
DB Breweries Ltd	DBB	13.6	19.1	0.40	5%	7.5%
						7.5%
Forestry & Forest Products						
Carter Holt Harvey Ltd	CAH	-6.8	-4.5	1.26	28%	11.4%
Evergreen Forests Ltd	EVF	-6.5	-1.5	0.77	61%	8.0%
Tenon Ltd	TEN	-0.9	-0.8	1.57	39%	12.5%
						11.4%
Intermediate & Durables						
EBOS Group Ltd	EBO	15.4	19.6	0.71	14%	9.3%
Fisher & Paykel Appliances Holdings Ltd	FPA	12.2	14.4	0.83	20%	9.6%
Fisher & Paykel Healthcare Corporation Ltd	FPH	19.3	28.4	0.71	1%	9.8%
Provenco Group Ltd	PVO	-12.1	-8.6	2.43	16%	20.4%
Scott Technology Ltd	SCT	9.8	14.8	0.96	0%	11.7%
						10.0%
Investment						
Genesis Research & Development Corp Ltd	GEN	-1.2	-1.2	1.10	2%	12.6%
Hellaby Holdings Ltd	HBV	16.0	13.6	0.79	13%	9.9%
Sealegs Corporation	SLG	-4.5	-4.5	2.41	2%	22.3%
						10.4%

Company	NZX Code	EBIT Multiple	NPAT Multiple	Equity Beta	D/(D+E) Ratio	WACC
Leisure & Tourism						
CDL Hotels New Zealand Ltd	CDL	9.7	16.4	0.99	24%	10.5%
Sky City Entertainment Ltd	SKC	12.3	18.0	0.71	24%	8.7%
Tourism Holdings Ltd	THL	11.5	22.1	1.28	18%	12.7%
						9.2%
Media & Telecommunications						
GDC Communications Ltd	GDC	39.9	-45.0	1.43	33%	12.7%
Independent Newspapers Ltd	INL	5.0	4.8	1.28	16%	12.7%
Sky Network Television Ltd	SKY	89.3	3123.3	1.21	15%	12.3%
Telecom Corp of New Zealand Ltd	TEL	10.8	16.1	1.58	30%	12.8%
						12.7%
Mining						
New Zealand Oil & Gas Ltd	NOG	-152.3	-141.2	0.68	0%	9.6%
						9.6%
Ports						
Auckland International Airport Ltd	AIA	17.9	26.1	0.80	20%	9.3%
Lytelton Port Co Ltd	LPC	11.6	15.8	0.64	17%	8.7%
Northland Port Corporation (NZ) Ltd	NTH	24.9	33.2	0.39	0%	7.4%
Ports of Auckland Ltd	POA	10.8	15.0	0.70	18%	8.8%
Port of Tauranga Ltd	POT	16.2	24.3	0.37	19%	6.8%
South Port New Zealand Ltd	SPN	8.6	12.5	0.32	7%	6.9%
						8.7%
Property						
AMP NZ Office Trust	APT	7.7	6.8	0.39	24%	7.0%
CDL Investments New Zealand Ltd	CDI	5.8	8.8	0.80	0%	10.5%
Calan Healthcare Properties Trust	CHP	13.8	16.5	0.51	28%	7.7%
Capital Properties New Zealand Ltd	CNZ	17.3	15.1	0.57	47%	7.2%
Kiwi Income Property Trust	KIP	16.3	17.2	0.41	26%	6.9%
Macquarie Goodman Property Trust	MGP	10.6	13.6	0.44	32%	7.2%
The National Property Trust	NAP	21.2	17.7	0.67	55%	7.8%
Property for Industry Ltd	PFI	10.2	10.5	0.40	25%	7.1%
Trans Tasman Properties Ltd	TTP	10.1	9.7	0.76	57%	8.2%
						7.4%
Finance & Other Services						
Abano Healthcare Group Ltd	ABA	14.1	14.9	1.78	58%	11.7%
Metlifecare Ltd	MET	16.7	16.2	0.75	16%	9.4%
Ryman Healthcare Ltd	RYM	18.0	17.4	0.57	11%	8.4%
Taylors Group Ltd	TAY	9.1	13.4	0.50	8%	8.1%
Waste Management NZ Ltd	WAM	17.7	29.1	0.94	13%	10.8%
						9.8%
Textiles & Apparel						
Cavalier Corporation Ltd	CAV	11.7	17.7	0.60	9%	8.7%
Pod Ltd	POD	11.7	14.8	1.06	18%	11.4%
						9.1%
Transport						
Air New Zealand Ltd	AIR	9.8	6.2	1.73	60%	10.8%
Mainfreight Ltd	MFT	19.7	42.4	1.05	29%	10.5%
Owens Group Ltd	OWN	13.4	-103.0	0.48	28%	7.6%
Toll NZ Ltd	TRH	26.8	-440.7	1.37	38%	11.3%
						10.9%
Overseas						
Guinness Peat Group Plc	GPG	18.7	29.4	0.49	10%	7.9%
BIL International Ltd	BRY	-157.0	-20.1	1.43	61%	9.5%
Lion Nathan Ltd	LNN	14.9	23.5	0.40	26%	6.8%
						7.8%
Market Weighted Average						10.0%

Figure 1: New Zealand Interest Rates

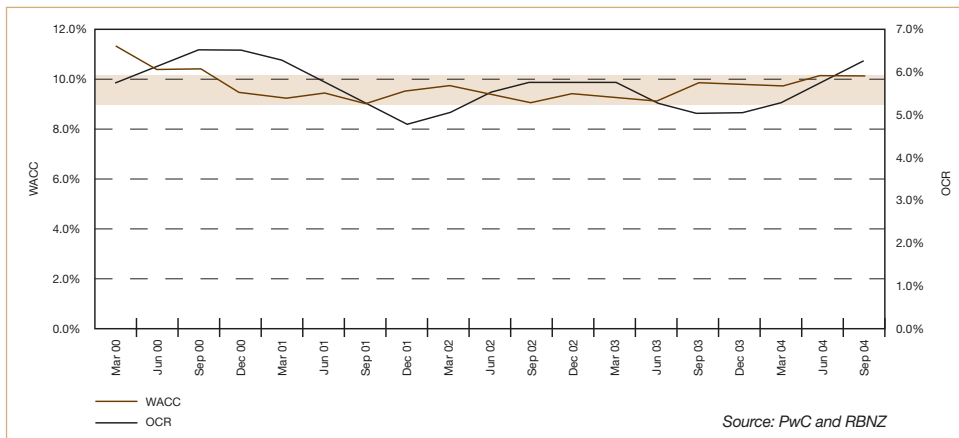


Source: Bloomberg and RBNZ

The 5 year risk free rate is based on 5 year government stock rates. This is the rate that is used in our cost of capital calculation. The measured volatility of the 5 year risk free rate is a lot less than that for the OCR and shorter term rates, as represented in Figure 1 by the 90 day bank bill rate.

By definition, if the volatility of the 5 year risk free rate is lower than the short term rates then our WACC should also exhibit less volatility. This is best demonstrated by comparison of our market average weighted average cost of capital to the OCR:

Figure 2: Market Average WACC and OCR



Source: PwC and RBNZ

This comparison indicates that our market average WACC has exhibited some stability compared to the OCR. Over the period December 2000 to September 2004, our market average WACC has fluctuated in a band 9.0% to 10.1%.

Although WACC has exhibited lower volatility than the OCR, we don't want to belittle the increase in WACC that has occurred over the last four quarters. A 1% change in WACC can be significant, particularly in the context of NPV analysis.

The upward trend in WACC over the last four quarters has important implications for businesses, as it means that the cost of servicing capital and importantly attracting new capital is increasing. For those businesses servicing the export sector this means a double whammy. Not only are New Zealand dollar revenues depressed because of the high dollar, but it will be increasingly difficult to compete for capital as the alternative investment opportunities, such as fixed interest investments, become increasingly competitive.

Some short term respite in the interest rate rises was provided by the Governor of the Reserve Bank, when he signalled a pause in interest rate rises. However, this looks like it will be short lived. In his most recent announcement he signalled that inflation is at worrying levels and further rate rises might be necessary.

We are predicting that our cost of capital estimates may dip slightly in the December 2004 quarter. However, if recent trends are an indicator, we expect that our market average cost of capital will rise further during the first half of next year. This suggests that there will be no immediate let up for exporters and the competition for capital will be intensify.

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Disclaimer: The Cost of Capital Report is intended as an overview of WACC as at 30 September 2004. Readers are advised that before acting on any matter arising in this report, they should consult PricewaterhouseCoopers Corporate Finance.

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