

In the circumstances it is only human to look for the downside – when will we enter the downward phase of the economic cycle? Again, it makes good headlines – “Warning of hard landing for the economy”, “Australia and New Zealand housing boom over”.

Undertaking business valuations in the current part of the economic cycle has some particular challenges. Valuing businesses at any time is an art. It requires commercial judgement and careful analysis. We are currently being asked to value businesses with very strong recent profit trends. One of the key judgements we are having to make is whether current earnings trends are sustainable and can be taken as a guide to future earnings.

There are a number of tensions around this judgement. On the one hand it is appropriate to put a high weighting on the relevance of recent performance. On the other hand, it does pay to have a healthy degree of scepticism when confronted with assertions that recent profit growth will continue unabated for the foreseeable future. Unfortunately, life is not that simple. The existence of business and economic cycles and the ebb and flow of consumer preferences means that revenue and profit growth is rarely linear. It does pay to remember that what goes up often comes down.

This doesn't mean that we deny the current strength of the economy. But equally we cannot ignore history. It is not that long ago, the late 1990's, when there were predictions about an economic “paradigm” shift and a new economy built on technology and information where old concepts of economic value, profits and cash flow would not be so relevant. However, the “paradigm” didn't shift but there was a crash. Economic reality set in and the old concepts of supply and demand and cash flow were reinstated.

That is not to say that the current strength of the economy has any similarities to the technology bubble of the late 1990's. However, what it does suggest is that it pays not to ignore history and history tells us that, unfortunately, profits or at least profit growth can go down as well as up. This emphasises the need to be particularly vigilant about the sustainability of profit forecasts underpinning valuations in the current environment. It is a brave decision to prepare a valuation on the basis of a decline in profits in the face of recent growth trends but that can be economic reality.

It is a fundamental principle of cost of capital theory that future profits, or more correctly, expected returns will go up and down. A cash flow in a valuation should represent a probability weighted expectation of all future cash flows. It should take into account all possible outcomes, with a weighting placed on each related to the probability of the outcome occurring. Actual outcomes might then be either above or below the probability weighted expected outcome. Cost of capital compensates the investor for the volatility of returns around the probability weighted expected return.

We often find in debating valuation issues that cost of capital can be a focus of attention, perhaps too much attention. Valuations can be sensitive to relatively small changes in cost of capital but it can be easy to lose sight of the importance of establishing a robust set of cash flow forecasts that adequately reflect a balance of all reasonably probable outcomes.

The need to focus on future prospects is important in most business valuations at any time. This is not new, but the current economic conditions serve to emphasise the need to be careful in making judgements about future growth prospects and not to let current prosperity cloud the need to apply sound economic principles. Learning from history never goes amiss.

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Disclaimer: The Cost of Capital Report is intended as an overview of WACC as at 31 December 2004. Readers are advised that before acting on any matter arising in this report, they should consult PricewaterhouseCoopers Corporate Finance.

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# The Cost of Capital Report

As at 31 December 2004

Input Assumptions:			
Market Risk Premium	7.5%	Marginal Tax Rate On Debt	33.0%
Risk Free Rate Of Return	6.1%	Investor Tax Rate On Equity	28.0%

Company	NZX Code	EBIT Multiple	NPAT Multiple	Equity Beta	D/(D+E) Ratio	WACC
<b>Agriculture</b>						
Affco Holdings Ltd	AFF	13.8	14.4	0.48	16%	7.7%
Pyne Gould Guinness Ltd	PGG	11.1	11.8	0.58	48%	7.3%
Sanford Ltd	SAN	6.1	9.1	0.39	6%	7.2%
Williams & Kettle Ltd	WKL	11.0	16.1	0.39	13%	7.2%
Wrightson Ltd	WRI	19.6	28.2	0.73	7%	9.6%
						7.8%
<b>Building Materials &amp; Construction</b>						
Fletcher Building Ltd	FBU	8.9	12.4	0.98	27%	9.9%
Nuplex Industries Ltd	NPX	11.5	16.4	0.71	29%	8.3%
Steel & Tube Holdings Ltd	STU	9.8	14.7	1.01	7%	11.5%
						9.9%
<b>Consumer</b>						
Briscoe Group Ltd	BGR	6.7	10.2	0.65	1%	9.2%
The Colonial Motor Co Ltd	CMO	6.0	7.9	0.37	18%	6.9%
Hallenstein Glasson Holdings Ltd	HLG	8.9	12.9	0.63	1%	9.1%
Kirkcaldie & Stains Ltd	KRK	14.0	16.0	0.59	49%	7.7%
Michael Hill International Ltd	MHI	14.3	21.0	0.50	11%	7.8%
Pacific Retail Group Ltd	PRG	39.3	-5.9	1.31	77%	9.4%
Restaurant Brands New Zealand Ltd	RBD	10.4	15.5	0.97	18%	10.7%
Turners Auctions Ltd	TUA	13.7	20.6	0.65	0%	9.2%
Vending Technologies Ltd	VTL	16.4	17.3	2.09	70%	11.1%
Wakefield Hospital Ltd	WFD	11.7	13.9	0.39	22%	7.1%
The Warehouse Group Ltd	WHS	10.6	14.7	0.58	19%	8.0%
						8.6%
<b>Energy</b>						
Contact Energy Limited	CEN	19.9	31.2	0.57	25%	7.7%
Horizon Energy Distribution Ltd	HED	11.3	16.6	0.53	21%	7.8%
Infratil Ltd	IFT	20.3	35.0	0.96	28%	9.8%
NGC Holdings Ltd	NGC	13.2	16.4	0.87	25%	9.4%
The New Zealand Refining Co Ltd	NZR	12.8	20.7	0.54	0%	8.4%
Trustpower Ltd	TPW	18.5	29.0	0.98	17%	10.6%
						8.8%
<b>Forestry &amp; Forest Products</b>						
Carter Holt Harvey Ltd	CAH	-6.5	-4.1	1.30	30%	11.3%
Evergreen Forests Ltd	EVF	-6.4	-1.4	0.79	62%	7.9%
Tenon Ltd	TEN	5.8	-5.5	1.57	13%	15.0%
						11.5%
<b>Intermediate &amp; Durables</b>						
EBOS Group Ltd	EBO	11.8	15.0	0.60	14%	8.5%
Fisher & Paykel Appliances Holdings Ltd	FPA	12.9	13.3	0.79	32%	8.7%
Fisher & Paykel Healthcare Corporation Ltd	FPH	20.4	30.1	0.70	1%	9.6%
Provenco Group Ltd	PVO	13.0	16.7	2.27	13%	19.6%
Scott Technology Ltd	SCT	9.5	14.4	0.91	0%	11.2%
						9.4%
<b>Investment</b>						
Genesis Research & Development Corp Ltd	GEN	-1.0	-0.9	1.07	3%	12.3%
Hellaby Holdings Ltd	HBV	13.0	15.7	0.75	12%	9.5%
Sealegs Corporation	SLG	-6.3	-6.3	2.37	1%	21.9%
						10.2%