2006 Value Creators Report – New Zealand Supplement

Strong Returns and Low Volatility

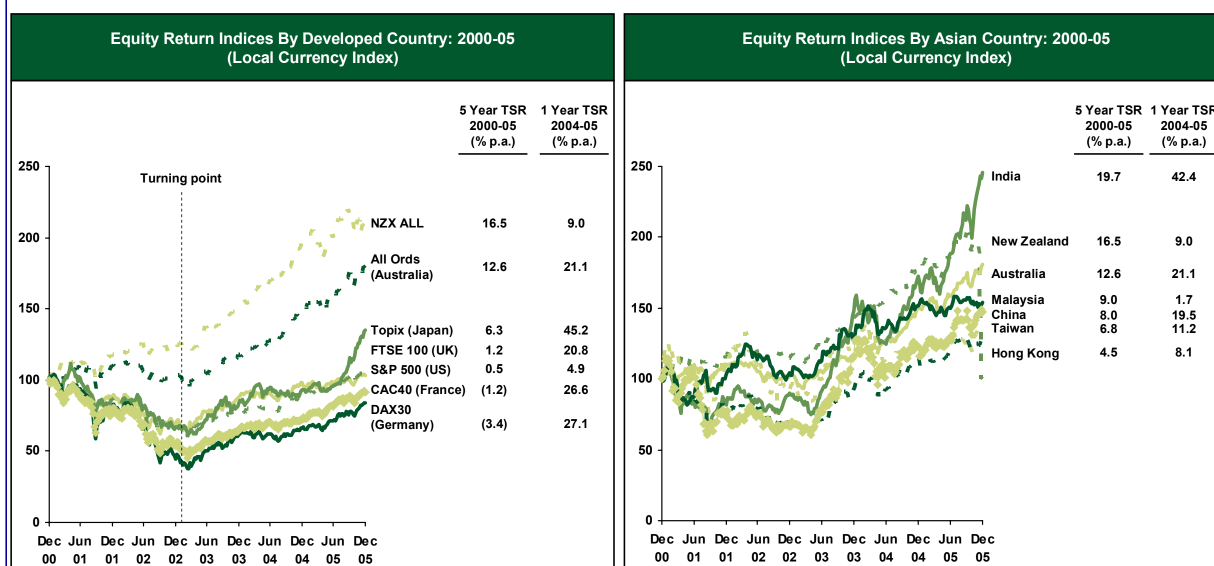
Over the past five years, New Zealand companies outshone the world's major equity markets and their peers in the Asian region, India notwithstanding. Boasting a five-year Total Shareholder Return (TSR) of 17 percent per annum, the New Zealand market achieved 4 percentage points above its closest neighbour, Australia (Exhibit 1), despite Australia's recent resources boom.

However, single year performance was less impressive, with a lower one-year TSR (of 9%) in 2005 relative to many other indices, partially caused by declining economic growth expectations.

In general, the New Zealand economy has been enjoying a prolonged period of expansion, with a growth rate of around 3.5 percent per year over the last five years. This compares favourably against the OECD average of around 2 percent for the corresponding period. Profits have risen through the combination of strong business investment—growing at 10 percent per year in the three years to 2004— and a higher return on capital stock.

Like Australia, New Zealand's superior five-year returns have been achieved at relatively low levels of volatility, due in part to both countries having minimal exposure to the boom and bust of the dot-com economy. New Zealand also managed to escape the worst effects of the global downturn in 2001 and 2002 (Exhibit 2)[1].

EXHIBIT 1
NEW ZEALAND HAS OUTPERFORMED MOST MAJOR WORLD AND REGIONAL MARKETS

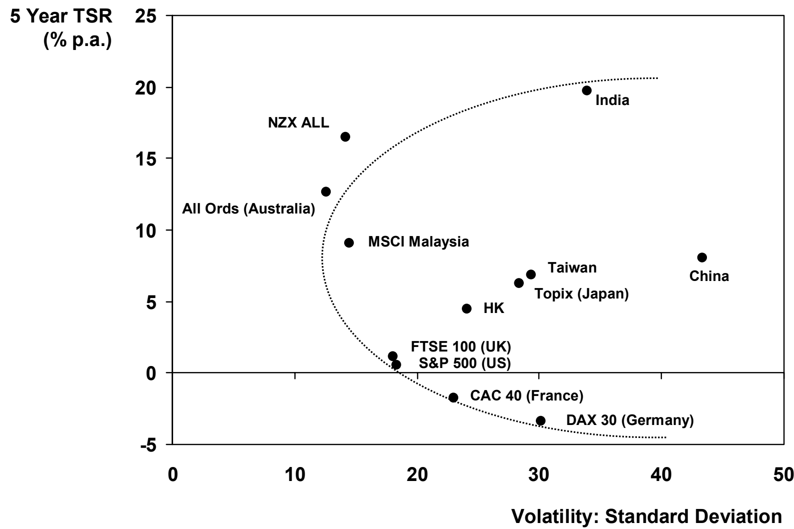


Note: All non-ANZ indices calculated using MSCI country indices
Sources: Thomson Financial Datastream; BCG analysis

[1] Estimation of the long term average return is subject to sampling error, which decreases as the time period increases. However, the choice of a longer sample will inevitably cover many structural changes in the economies and markets – e.g. the floating of currencies and the opening up of markets to foreign investors. Past performance is not an indicator of future returns.

EXHIBIT 2
NEW ZEALAND HAS ACHIEVED SUPERIOR RETURNS AT A LOWER LEVEL OF VOLATILITY

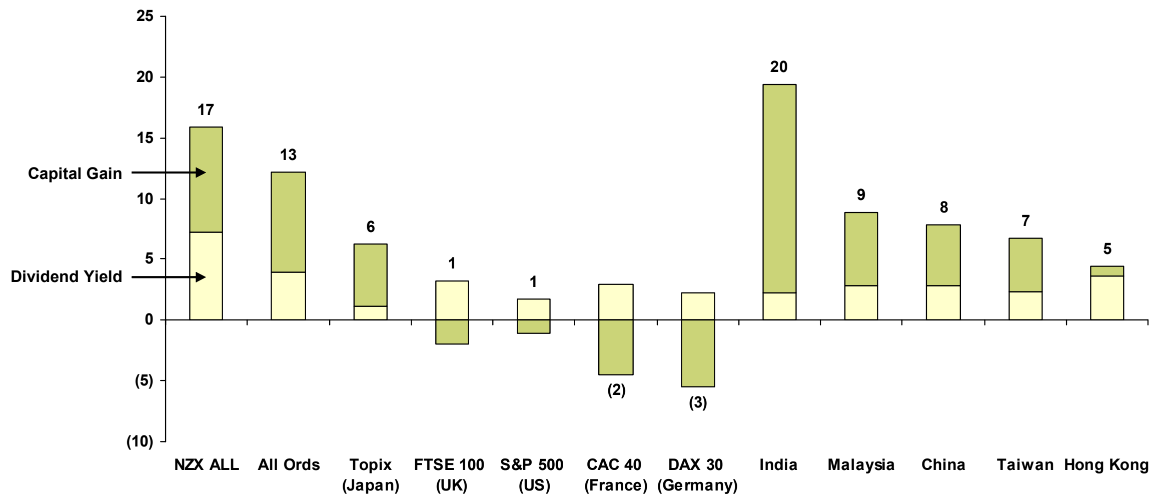
Selected Indices: 5 Year Returns Versus Annual Volatility (2000-05)



Sources: Thomson Financial Datastream; BCG analysis

EXHIBIT 3
NEW ZEALAND HAS A HIGHER DIVIDEND YIELD THAN MOST OTHER COUNTRIES

Dividend Yield and Capital Gain NZ and Other Regions: 2000-05
(% p.a.)



Sources: Thomson Financial Datastream, BCG analysis

A distinguishing feature of the New Zealand market is its relatively high dividend yield of 8 percent, compared with 4 percent in Australia and only 2 percent in the United States (Exhibit 3). This in itself may have contributed to lower volatility because paying profits out as dividends means they are not put at risk as they would be if they were reinvested in the business.

Three possible explanations can account for the high dividend yield:

- New Zealand companies are paying out high dividends to satisfy income-seeking investors who would otherwise be attracted by high-yielding domestic bonds;
- New Zealand companies may see fewer profitable growth opportunities, which makes paying out dividends an effective use of capital;
- New Zealand's system of dividend imputation. However, unlike Australia, New Zealand's zero capital gains tax may make capital gains a more attractive option for investors than imputation.

Improving Fundamentals and Steady Expectations

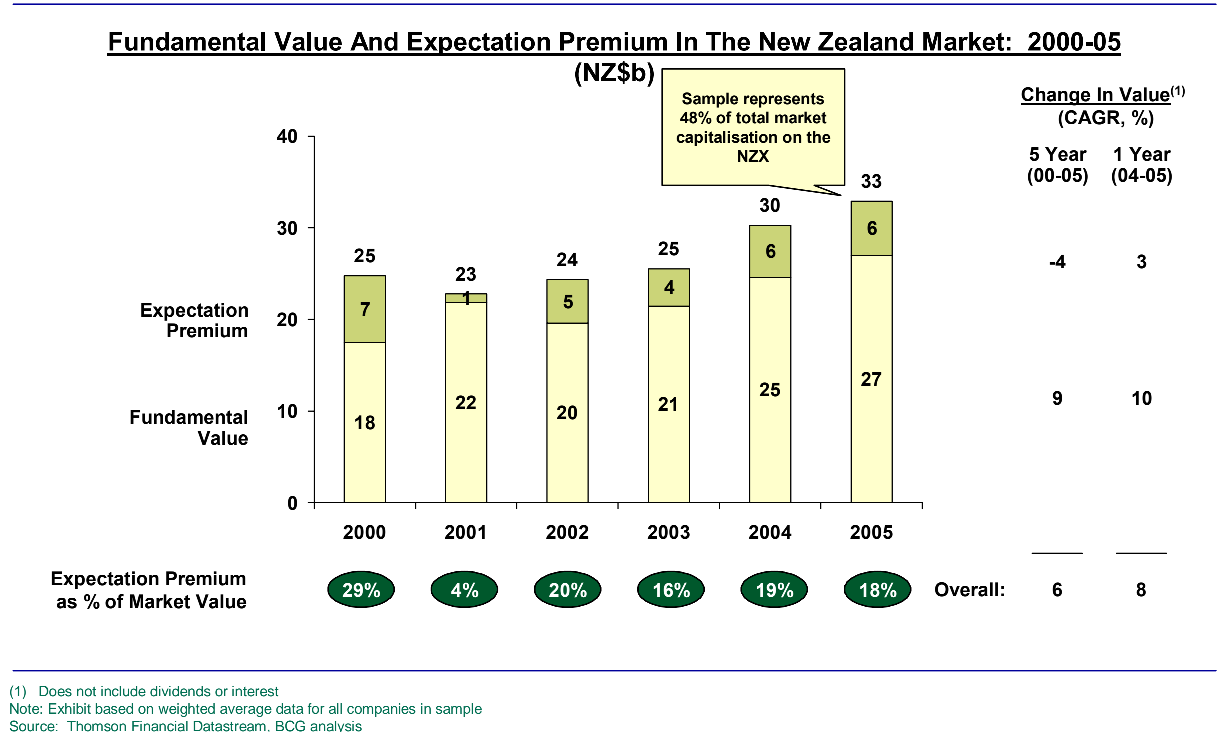
BCG uses a proprietary methodology to disaggregate the market value of companies into what we call Fundamental Value, which is the present value of the future cash flows of a business, and Expectation Premium, which reflects the market's outlook on future profitability and growth.

To understand the underlying drivers of New Zealand's recent record of value creation, we used this methodology to analyse the five-year performance of twelve of the country's largest listed companies.[2]

We found that companies in this sample delivered strong fundamental growth at a rate of 9 percent per annum in the past five years, compared with 12 percent per annum for Australia and 7 percent for companies in our global sample over the same period (Exhibit 4). While Fundamental Value growth was lower in the New Zealand market than the Australian, New Zealand companies achieved a higher TSR by paying out more dividends and decreasing leverage.

EXHIBIT 4

NEW ZEALAND'S TSR PERFORMANCE DRIVEN BY STRONG GROWTH IN FUNDAMENTALS

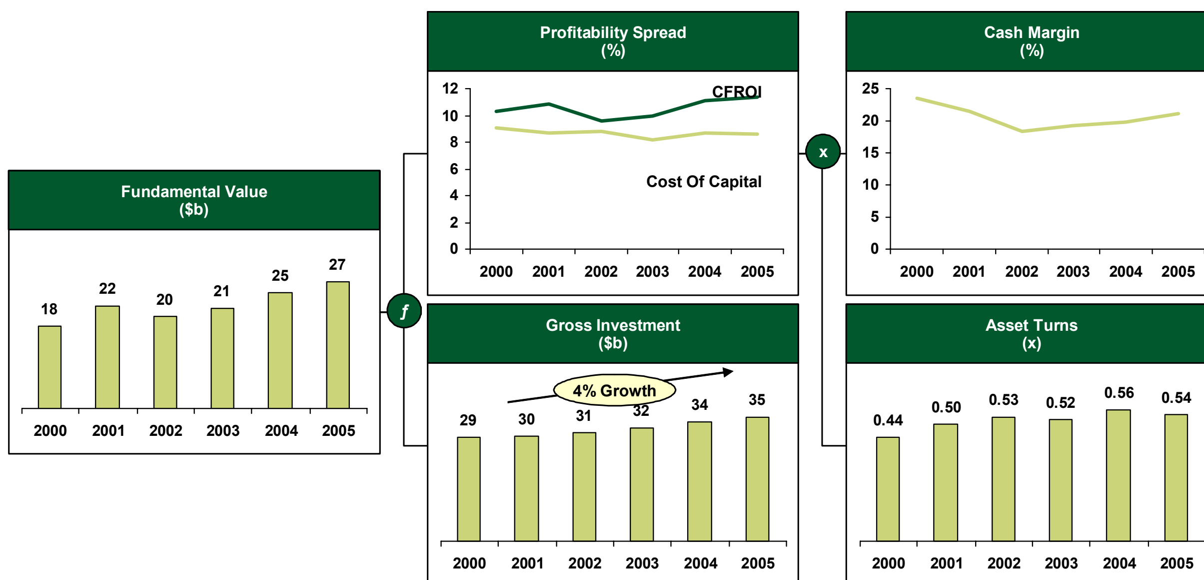


(1) Does not include dividends or interest
Note: Exhibit based on weighted average data for all companies in sample
Source: Thomson Financial Datastream, BCG analysis

[2] See the Methodology and Sample section for further definitions.

EXHIBIT 5
GROWTH IN FUNDAMENTAL VALUE THE RESULT OF ASSET PRODUCTIVITY GAINS AND INVESTMENT

Decomposition Of Fundamental Value In The New Zealand Market: 2000-05



Note: Exhibit based on weighted average data for all companies in sample
Source: BCG New Zealand Market Database

The main driver of this growth was high asset productivity, which contributed $8 billion to Fundamental Value. Managers utilised a growing asset base of 4 percent per annum to achieve increases in revenue in excess of 8 percent per annum (Exhibit 5). This growth in gross investment added $6 billion in Fundamental Value, with a lower cost of capital contributing another $2 billion. However, as cash margins also fell over the period, the net increase was $9 billion.

Overall, these results suggest that New Zealand managers have done a great job of delivering revenue growth, while keeping market expectations in check. Expectation Premiums have been relatively steady since 2002 and are currently at a similar level to global and Australian benchmarks.

Drivers of Value

As explained in our global report, BCG disaggregates TSR into six common financial drivers which fall within three broad categories – Changes in Fundamental Value, Changes in a Company's Valuation Multiple[3] and Changes in Free Cash Flow Distribution (Exhibit 6).

Key contributors to the great performance of New Zealand companies in our sample were revenue growth, dividends and the change in net debt (Exhibit 7). In particular, strong free cash flows differentiated New Zealand from Australia, and these were used to pay higher dividends and reduce reliance on debt and fund expansion. As a result, New Zealand companies outperformed our sample of Australia's largest companies by 2 percentage points.

New Zealand's top performers concentrated on growing revenue without sacrificing excessive margin. Some used acquisitions to increase their revenue. What makes the revenue growth more impressive is that it has been achieved without increased leverage and while paying generous dividends. Despite achieving profitable growth, the change in these companies' multiples did not significantly add to TSR.

The star performer in our sample is Fletcher Building, which created shareholder value primarily through improved fundamentals. Fletcher Building's revenue growth was driven by buoyant New Zealand and Australian construction markets and a series of acquisitions in local and overseas businesses performed according to strict criteria.

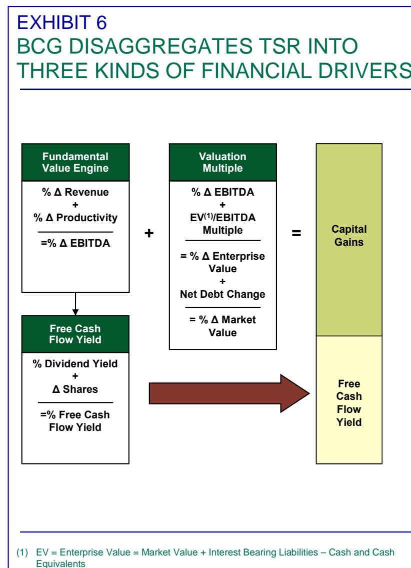
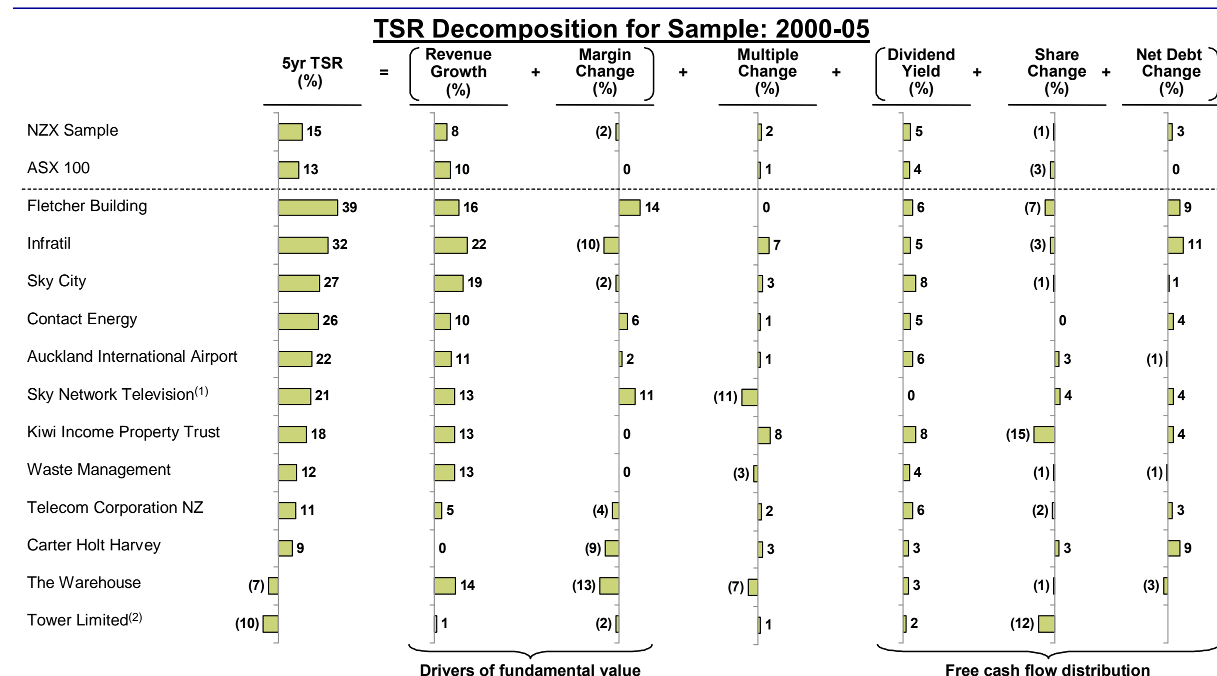


EXHIBIT 7
TOP PERFORMERS PERFORMED WELL AS A RESULT OF PROFITABLE GROWTH



(1) Company financials were sourced from annual reports 2000-2005, based on data period to the merger of Sky TV and INL.
(2) Net Debt Change does not apply to Financial Institutions
Source: BCG Australia and New Zealand Market Database

[3] The Valuation Multiple is a proxy for the Expectation Premium.

At the other end of the spectrum, the bottom four performers failed to grow profitably. Some attempted aggressive expansion, sacrificing margin, whilst others simply did not grow at all. Even within this small group, the market rewarded companies that returned more cash to shareholders through higher dividends, fewer share issues and reduced leverage.

This demonstrates one of the foundational principles of capital management—returning cash to shareholders is the best strategy when profitable investments are lacking. However, BCG's global research shows that over the long term, revenue growth, not dividends, is the largest single driver of TSR.

In general, we found that high performance was not limited to one industry. The TSR performance of New Zealand companies is all the more remarkable, given that Australia's best performing industries—resources and banks—are notably absent from the sample.

Where to from Here?

New Zealand companies have performed well in both absolute and relative terms over the past five years. Businesses have made strong progress in terms of revenue growth, productivity and asset utilisation, and they have managed this whilst keeping expectation premiums in check.

However, recent performance has been less spectacular, with the average 2005 one-year TSR of New Zealand companies lagging behind most major world indices. So far 2006 has delivered poor results with annualised TSR of only 2%. As the New Zealand economy slows, managers must address the challenge of continuing to create value in a less favourable economic climate. Key questions they should ask include:

- What is the right target for shareholder value creation? Is Australasian top-quartile TSR performance appropriate?
- Will efficiency gains and high dividend yields be sufficient to achieve the TSR target? BCG research suggests that for most companies this will not be the case.
- Should companies focus on growth opportunities within New Zealand, winning share in existing and adjacent markets? Will this be feasible for the top 15 companies that already occupy leading positions in their respective markets?
- Is overseas expansion an attractive path to dampen the effects of the local economic cycle on earnings and the limited growth opportunities in a small economy?

On the last point, companies considering overseas expansion must evaluate the extent to which their current competitive advantages will apply in new markets. Expanding into larger economies means that they can no longer rely on facing limited competition, a status many incumbents in our sample currently enjoy.

Although growth outside traditional core markets is often challenging, this is an issue that many New Zealand business leaders must confront. In small economies such as this, successful companies often generate significant free cash flow while finding their domestic investment options limited. Using this cash to increase dividends or reduce leverage can create shareholder value in the short-term, but over the longer term it is hard to sustain top quartile TSR performance without consistent revenue growth.

Although the appropriate responses to these challenges are far from obvious, by understanding how past operating, investing and financing decisions have driven TSR, managers can assess the likely effects of future decisions, whether they relate to enhancing growth, improving profitability, or more effectively deploying free cash flows. In so doing, managers can chart a course to value creation that integrates their financial strategy with their business strategy.

Methodology and Sample

What Is Meant by ‘Fundamentals’?

The two basic drivers of value creation are profitability and growth. Profitability is measured by the difference between cash flow returns on investment (CFROI) and the weighted average cost of capital (WACC); this is referred to as the economic spread. Growth is measured in terms of total gross investment.

These two drivers of value come together in the form of cash value added (CVA), a form of economic profit. The change in CVA is a measure of internal value creation over the long term, and is more highly correlated with TSR than other accounting-based measures such as EPS growth.

In the 2004 edition of the Value Creators Report, BCG introduced a new framework to help understand the dynamics of shareholder value creation. This TSR decomposition framework recognises that, in addition to these measures of internal value creation, it is important to understand how the market is valuing what the company is doing.

The linkage is the multiple; understanding what drives it is often a subject of debate and conjecture. BCG’s research indicates that there is, in fact, a science behind multiples and they can be much better understood and explicitly managed than was previously thought.

What Is ‘Fundamental Value’?

BCG calculates the fundamental value of a company based on its current performance and a sustainable growth rate. The calculation is a capitalisation of the estimated future economic profits, similar to a Discounted Cash Flow analysis (DCF), except that BCG’s method does not rely on a terminal value.

Instead, BCG uses a ‘double fade’ methodology that is founded on the notion that, over time, the profitability and growth rates of companies fade towards long-run industry averages. The concept of fade is empirically supported and is consistent with the workings of an efficient competitive market in which outperformance is competed away by rivals and underperformance is forced up by capital market pressures.

What Is the ‘Expectation Premium’?

The expectation premium is simply the difference between the market capitalisation and the fundamental value. It gets its name from the fact that a difference between these two values implies the market has a different expectation regarding profitability and/or growth fade rates compared to that used in estimating the base case intrinsic value.

What Sample Was Used in the Analysis?

Exhibit 8 shows the 12 companies in our sample. The sample was based on companies in the NZX15 for whom five-year returns were available at 31st December 2005 (i.e. companies who were listed as at 31st December 2000). Collectively, our sample represents 48 percent of the market capitalisation of all stocks on the New Zealand Stock Exchange. Carter Holt Harvey (CHH) was included as part of the NZX15 despite its delisting in December 2005, and so Vector Limited, which replaced CHH, was excluded from our analysis. Three companies were excluded due to lack of five-year return data (i.e. they were not listed in their current form as at 31st December 2000). These are: Fisher and Paykel Appliances Holdings Limited, Fisher and Paykel Healthcare Corporation Limited and Freightways Limited.

EXHIBIT 8
PERFORMANCE OF NZX SAMPLE

Rank	Company	Industry	5-year TSR 2000-05 (%pa)	Market Value (NZ$m, 31 Dec 05)	1-year TSR 2005 (%pa)	TSR in 2006[1] Jan-Sep (%pa)
1	Fletcher Building	Industrial / Materials	39	3,522	22	26
2	Infratil	Real Estate / Infrastructure	32	823	16	20
3	Sky City	Media / Entertainment	27	1,965	-8	21
4	Contact Energy	Telco / Utilities	26	3,823	7	7
5	Auckland International Airport	Telco / Utilities	22	2,420	10	0
6	Sky Network Television	Media / Entertainment	21	2,452	28	-16
7	Kiwi Income Property Trust	Property Trusts	18	900	23	21
8	Waste Management	Industrial / Materials	12	615	15	N/A
9	Telecom Corporation of New Zealand	Telco / Utilities	11	11,783	7	-36
10	Carter Holt Harvey	Industrial / Materials	9	3,272	26	N/A
11	The Warehouse	Consumer	-7	1,084	2	68
12	Tower	Diversified Financials	-10	748	-2	88

(1) Annualised TSR for eight months to September
Sources: Thomson Financial Datastream; BCG analysis

About this Supplement

Since its founding more than 40 years ago, The Boston Consulting Group (BCG) has analysed the drivers of value creation for clients across industries. In recent years, we have published annual studies that analyse the world's top-performing companies in order to build an understanding of why leading players are successful. The 2006 Value Creators Report – Spotlight on Growth, which is our eighth annual study of the world's top-performing companies, analyses shareholder value creation in 14 major industry sectors across the globe. This document is a supplement to the global report and presents our analysis of how leading New Zealand companies have performed in the past five years.

About the Authors

David Pitman is a Vice President and Director in BCG's Sydney office and leads the firm's Corporate Development practice in the Asia Pacific Region. David Tapper is a Vice President and Director in BCG's Auckland office and Paul Newfield is a Project Leader in that office. We would like to thank a number of people who were involved in preparing this Supplement. In particular, the authors would like to thank Michael Chu, Nicolas Rohrlach, Ben Mayson and Chris Kutarna. Editorial assistance was provided by Marita Shevland.

About BCG's Corporate Development Practice Area

BCG's Corporate Development practice area combines BCG's traditional expertise in corporate strategy with extensive experience in mergers and acquisitions and post-merger integration. It also comprises a proprietary value-management methodology, and new analytic approaches for understanding and responding to the ways that capital markets value a company. In the practice area, we work closely with BCG's industry experts to help clients design and execute their corporate strategies, reengineer their portfolios, and screen potential acquisition targets. Post acquisition, we also help integrate the two entities, and make sure that corporate processes are aligned with the goals of the company's value-creation strategy.

For Further Information

For further information on the Supplement and to learn more about BCG's value-management capabilities, please contact:

David Pitman
Vice President and Director
BCG Sydney
+61 2 9323 5600
pitman.david@bcg.com

David Tapper
Vice President and Director
BCG Auckland
+64 9 377 2297
tapper.david@bcg.com

Paul Newfield
Project Leader
BCG Auckland
+64 9 377 2297
newfield.paul@bcg.com

Disclaimer

The Boston Consulting Group is a general management consulting firm that is a global leader in business strategy. Founded in 1963, the firm now operates 61 offices in 36 countries. Although BCG has a substantial value-management consulting business, this report is not intended to provide investment advice to any party. It is important to acknowledge, as always, that past stock market performance may not be an indicator of future performance. Any investment decision should be made only after independent review and analysis. For further information, please visit our web site at www.bcg.com.