Bramwell Brown Ltd

INVESTMENT ADVISERS – BROKERS

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Share Buybacks

Mighty River Power and Infratil have been in the news recently regarding share buybacks. What is a share buyback, why do companies do it, and how does it benefit investors? Typically a company will buy its own shares if it has surplus cash, and believes its shares are undervalued. The company would usually issue a statement to the effect that there is no better use for their cash than buying their own (undervalued) shares. When a share buyback occurs the shares are usually cancelled, therefore following the buyback there are less shares on issue. Because the share buyback reduces the number of shares on issue, it increases the earnings per share, and tends to increase the value of the remaining shares. This benefit is realised by those who hold their shares, rather than those who sell into the buyback offer.

Mighty River Power directors were widely criticised for the timing of their share buyback (just weeks before the Meridian Energy listing). Opponents of the Government asset sales programme felt it was a cynical attempt to boost the price of Mighty River Power shares leading up to the Meridian float. However, it is a legitimate practice by a company acting in the best interests of its shareholders. There was a very irate letter to the editor in the Dominion questioning how the Government could allow tax payers money to be used to buy back shares in a company they had just sold! What the writer fails to understand is that the money used in the share buyback does not come from the Government – it comes from the cash held within the company from the profits it generates.

Infratil announced a share buyback at the end of September, citing similar motives to Mighty River Power. Infratil considered their business was worth between $3.08 and $3.69 per share, rather than the $2.45 per share that it was trading at. They offered to buy back 24.8 million shares at $2.60 per share. You could argue that this seems like a poor deal for those selling, however there is no compulsion to sell – investors have a choice. It is also a more tax-efficient method of returning capital to shareholders than paying it out as a dividend. Dividends are taxable in the hands of investors, whereas the sale of shares is not (yet). So if you hold a share in a company that is undertaking a buyback it is generally a good sign for investors. If you don't need to sell your shares you should benefit in the long-run from a company buying its own shares back.

Meridian Energy

Meridian Energy listed on the NZX on Tuesday October 29th at $1.00, and closed the day at $1.08. Proponents of the Government asset sales programme describe it as a success; opponents call it an abject failure. The Labour/Greens coalition claim the Government has sold Meridian too cheaply, and has cost the taxpayer in excess of $1 billion. In my view that cost to the taxpayer lies directly at the feet of the Labour/Greens as a result of their archaic proposal to nationalise the electricity industry. I don't hear them congratulating the Government on achieving such a good price for Mighty River Power (sold for $2.50 – currently valued by the market at $2.20).

For those who invested in Meridian Energy you will find that your application has been scaled. Broker firm allocations were scaled by 10% and general offer applications were scaled as listed below:

How your application will be scaled:	**You will receive:**
First $2,500	The full amount you asked for
From $2,501 to $10,000	90% of what you asked for
From $10,001 to $15,000	85% of what you asked for
From $15,001 to $20,000	75% of what you asked for
From $20,001	55% of what you asked for

Refunds were paid on October 30th – contact the office if this has not occurred.

The Asset Sales Programme

The asset sales programme has hardly been a roaring success for the Government. Already they are admitting they will not reach the $5 billion -$7 billion hoped for. I was not an advocate of the programme from the start – my feeling was that the Government had the ability to borrow money at a much lower rate than the return these assets were generating. Why sell an investment that is returning 7% per annum when you can borrow money at 3%? I also questioned the market's ability to absorb another three electricity companies – how many do investors need in their portfolio? However, once the decision was made to proceed, I saw no reason why New Zealand investors should not participate. I would rather have a stake in these assets than see them being sold offshore. The Labour/Greens coalition has done their utmost to derail the process, and this political risk is the single biggest factor that will affect the performance of these companies. I would advocate anyone investing in the power companies should have an expectation they will hold them for the long-term. Governments will come and go, and with those changes will come volatility. However in my view they will remain good long-term investments that produce regular dividends. Whoever is in power, having the Government as a 51% shareholder should also provide some security to investors.

Contact Energy Capital Bonds

In 2011 Genesis Energy and Contact Energy both issued long-term capital bonds. The Genesis issue had a 2041 maturity date and the Contact issue matured in 2042. Both had varying five-year and ten-year rate reset characteristics. The initial coupon payments were 8.50% and 8.00% for Genesis and Contact respectively. The very long terms of these bonds allowed the companies to consider the borrowings as equity in their balance sheets, rather than debt. This had a positive effect on their credit ratings issued by the ratings agencies. Under certain circumstances the companies were able to repay the bonds early, with one of those sets of circumstances being a "rating agency event." Recently Standard & Poors has downgraded the equity content of both of these securities from high to intermediate, which has an effect on each company's credit rating.

Genesis opted to modify the terms of their bonds rather than repay them, and that bond now carries an interest rate of 6.19% until July 2018. Contact Energy has just announced its intention to redeem their bonds, rather than offer new terms. This is very disappointing for investors who thought they had locked in an 8.00% return until 2017. The bonds will be redeemed on November 15th.

Shares

The New Zealand share market has had a very strong run over the last two years, increasing by almost 50%. This is largely a result of low interest rates, forcing investors to look elsewhere for higher returns. It's unrealistic to expect the NZX to continue climbing at the rate it has, and analysts I speak to suggest the New Zealand market is fully priced. I attended a presentation recently where more than one speaker suggested the Australian market still has gains to be made, and offers better opportunities than New Zealand. The ASX index has increased by only 31% over the last two years, significantly less than New Zealand. If we look back to the Global Financial crisis, Australia was one of a very few countries around the world to avoid recession. It eventually suffered similar problems to other countries, albeit later than most. It too had to go through the process of deleveraging corporate balance sheets and lowering interest rates. It's possible that because those measures were put in place later than most, their recovery is also occurring later than most. We have a close relationship with Baillieu Holst in Melbourne who provide us with research on the main listed Australian companies. Call the office if you would like to discuss opportunities that may suit you.

For those with smaller sums to invest, the Australian Foundation Investment Company (AFI) is a very useful vehicle for diversifying into Australia. It's an investment company listed on the ASX and the NZX and invests in the larger listed companies in Australia. Here is a link to their website:

http://www.afi.com.au/

Fixed Interest

The secondary fixed interest market continues to provide little in the way of risk-adjusted returns. It's a difficult time to be investing in fixed interest, with rates slowly showing signs of improvement. Bank term deposit rates are climbing and there is an expectation rates will rise over the next five years. Investors are reluctant to commit to long-term fixed interest, knowing they are likely to be disappointed in hindsight. The trade-off, of course, is receiving low returns on your money at call, while you wait for those rates to rise. My advice has always been to have a diversified portfolio of fixed interest that has varying maturities over a five to seven-year period. This way you will at times be reinvesting under favourable conditions, and at other times those conditions will not be as favourable.

The recent Wellington Airport bond offer shows the level of demand currently for quality fixed interest offers. Wellington Airport has a bond maturing in mid-November and had offered new terms of 6.25% for eight years. The offer was for $50 million with the ability to accept oversubscriptions of $25 million. The $50 million mark was achieved on the opening day of the offer, and Wellington Airport will now exercise its discretion to refuse applications from new investors. Any existing holders of the bond will have preference over new investors, so for those new investors who have applied it is highly likely your application will be unsuccessful. If this is the case your money will be refunded in full.

It's interesting to note the term of the Wellington Airport bond – eight years. Infratil's last issue was also long-term at nine years. To me this is another indication that interest rates are expected to increase. Infratil and Wellington Airport can see the advantage of offering an attractive headline interest rate (6.85% and 6.25% respectively) in the knowledge that in two or three years time those rates will seem low. This is something investors need to consider when weighing up the various alternatives for their money.

Rabobank

Rabobank interest rates have increased since last month's newsletter. Here are their current rates:

Term	**Rate (annual interest)**
Premium Saver (call account)	4.20%
1 year	4.35%
2 years	4.90%
3 years	5.10%
4 years	5.60%
5 years	5.80%