

31 March 2009

Mr Steve Dunn,
Chief Executive
NSW Maritime
Locked Bag 5100
Camperdown NSW 1450

Dear Mr Dunn,

NSW Maritime Net Present Value Template Commercial Wetland Lease Proposal Evaluations

1. Introduction

1.1 In accordance with your instructions, I have undertaken a review of recent correspondence from various stakeholders in relation to the Net Present Value Template ("NPV Template") adopted by NSW Maritime. That template is used by NSW Maritime to assist in the assessment and evaluation of:

- (a) proposals from potential new tenants for commercial wetland leases;
- (b) proposals from existing tenants for the renewal of existing commercial wetland leases;
- (c) proposals from existing tenants for the renegotiation of lease terms where the tenant proposes to carry out significant capital works.

1.2 The correspondence I have reviewed consists of:

- (a) Pitcher Partners report dated 4 September 2008 to the Boating Industry Association of NSW ("BIA");
- (b) email dated 5 November 2008 from the BIA to NSW Maritime;
- (c) email dated 18 February 2009 from the BIA to NSW Maritime;
- (d) letter dated 10 March 2009 from Pitcher Partners to NSW Maritime;
- (e) letter dated 11 March 2009 from the BIA to NSW Maritime;

- 1.3 The purpose of this report is to identify and summarise all remaining significant issues of concern in relation to the use of the NPV Template in the context of the introduction of revenue-based wetland lease rentals for marina operators.

2. Summary of the NPV Template

- 2.1 In very general terms, the NPV Template was developed by NSW Maritime as a tool for evaluating competing commercial wetland lease proposals. In particular, it was developed in the context of a broad proposal to establish a rental for leases and an appropriate lease term when putting new leases out to public tender. The purpose of the NPV Template was to enable NSW Maritime to identify circumstances in which a lease proposal would result in an unreasonably high rate of return to the lessee and, therefore, an unreasonably low rate of return to the people of NSW for the commercial use of the public wetland asset.
- 2.2 The NPV Template is a cash flow model based on ungeared and pretax cash flows, which means that the net present value of the cash flows from the lease proposal are independent of the financial and tax structure adopted by the proponent.
- 2.3 NSW Maritime uses the NPV Template to assess the implicit Net Present Value of the cash flows expected to arise from a lease proposal. These cash flows are discounted at a reasonable rate of return (reasonable weighted average cost of capital). In general terms, a positive NPV would mean that the proposed rent is too low or the proposed lease term is too long, and NSW Maritime would normally expect to renegotiate the proposed lease terms. Of course, it is always open to NSW Maritime to grant a lease which provides a positive NPV where, for example, there are valid public purpose reasons for doing so.
- 2.4 Since its development, the NPV Template has been used by NSW Maritime not only to assess proposals for new leases, but also to assess proposals for renegotiated lease terms.
- 2.5 The parameters of the NPV Template include the adoption of a “reasonable rate of return”, which is able to vary as economic circumstances vary and which depends upon the following inputs:
- (a) the risk-free rate (adopted as the 10-year bond rate);
 - (b) the market premium (adopted as 6% in the most recent version of the NPV Template)
 - (c) a beta which reflects the general level of risk in commercial maritime activities (adopted as 1.2 in the most recent version of the NPV Template);
 - (d) a reasonable premium of the cost of debt over the risk-free rate (adopted as 3% in the most recent version of the NPV Template);

- (e) the company tax rate (currently 30%)
 - (f) a reasonable debt:equity ratio for commercial maritime activities (adopted as 50:50 in the most recent version of the NPV Template).
- 2.6 Lessees, their representatives and their consultants appear to be generally supportive of the concept of the NPV template and the way in which that template can be used to assist in the investment decisions of both existing and prospective lessees wishing to undertake maritime-related business activities. They also appear to be generally supportive of the concept that rentals for commercial wetland leases should be determined as a percentage of turnover.

3. Issues of Concern

- 3.1 While NSW Maritime is charged with responsibility for ensuring that the people of NSW receive a reasonable rental for the commercial use of public assets, lessees have their own commercial interests at heart and can be expected to seek to minimise the rental paid to NSW Maritime.
- 3.2 Where the NPV Template is used in rental negotiations, lessees and their representatives and consultants have raised a number of issues in which they seek to argue that:
- (a) the reasonable rate of return adopted by NSW Maritime is too low, because:
 - (i) the debt to equity ratio is too high (i.e. commercial marina businesses have a greater reliance on equity than they do on debt);
 - (ii) the cost of equity and the cost of debt are too low (i.e. commercial marina businesses are very risky and a high return is required by investors and lenders in such businesses in order to compensate for the high level of risk).
 - (b) the cash flows included in the model do not take into account all relevant cash flows, because:
 - (i) the cash flows do not include assets already existing as a result of past marina operations, including amounts associated with past property development applications;
 - (ii) the cash flows do not properly recognise the contribution of assets not owned by NSW Maritime (e.g. freehold land on which the business may be partly located);

4. Reasonable Debt to Equity Ratio

- 4.1 For the purposes of the most recent NPV template, NSW Maritime has adopted a debt to equity ratio of 100% (i.e. 50% debt and 50% equity). This ratio was adopted following a review of the average debt to equity ratios for listed Australian companies in the Consumer Discretionary Sector and the Marine Services sub-sector of the ASX. The ratio has recently been reviewed on the basis of the 2008 financial results of 72 listed companies which revealed an average debt to equity ratio of 106.27%.
- 4.2 A more meaningful listed company debt to equity ratio could be based on the market value of debt and the market capitalisation of equity, rather than on book values of those variables. Based on the 2008 results for 72 listed Australian companies in the Consumer Discretionary Sector and the Marine Services sub-sector of the ASX, the market debt to equity ratio would be 92%.
- 4.3 It should be remembered that the NPV Template has been designed to be applicable to all commercial lease proposals. That is, the discount rate in the Template does not take into account the specific risk or specific financing structure of any particular proposal. Rather, it is the rate of return which NSW Maritime considers to be a reasonable market rate of return regardless of the identity or financial structure of any particular proponent.
- 4.4 As the NPV Template has been designed to be generally relevant, it may be necessary to modify the discount rate and/or the cash flows to allow for the specific circumstances of a particular lease proposal. The Template is sufficiently flexible to be modified in this manner should circumstances warrant it.
- 4.5 As to whether a 50/50 debt to equity structure is an appropriate generally relevant starting point, I note that:
- (a) the market-based debt to equity ratio and the book value debt to equity ratio derived from a sample of Australian listed companies in a comparable industry group is consistent with a debt and equity ratio of 50:50;
 - (b) In their report dated 4 September 2008, Pitcher Partners referred to information provided by the operators of five marinas. The debt:equity ratio in those five examples varied from 50:50 to 69:31;
 - (c) In their letter dated 10 March 2009, Pitcher Partners adopted a 50:50 debt to equity ratio;
 - (d) the lessees and their advisors have not provided any evidence which would suggest that a debt:equity ratio of 50:50 is materially incorrect as a generally relevant starting point.

5. Cost of Equity and Cost of Debt

- 5.1 Using current data, the NPV Template would have a pre-tax cost of equity of approximately 16% - 17% and a pre-tax cost of debt of approximately 7% - 8%, which results in an acceptable pre-tax rate of return (i.e. a discount rate) of between 11.5% and 12.5%.
- 5.2 In their letter dated 10 March 2009, Pitcher Partners referred to a cost of equity of between 17% - 20% and assumed a cost of debt of between 10% - 12%. Both of these rates were derived in about September 2008, at which time the NPV Template would have shown a cost of equity of approximately 17.5% - 18.5% and a cost of debt of between 8% - 9%. The Pitcher Partner rates are therefore somewhat higher than the rates adopted in the NPV Template.
- 5.3 There are a number of difficulties with the Pitcher Partners rates:
- (a) the cost of equity has apparently been derived by an analysis of achieved rates of return in the “marina industry and other infrastructure projects”. However, it could be argued that the return achieved by the marina industry in the past has been affected by lower than market rental rates charged by NSW Maritime. Thus, the returns may have been higher than could be expected given the risk of that industry;
 - (b) the information on which the Pitcher Partners modelling is based is unaudited and was provided by the operators of the marina businesses concerned. It is therefore possible that no adjustment has been made for owner’s remuneration which is higher than market rates, or for remuneration included as expenses of the business;
 - (c) actual transactions in the marina industry suggest capitalisation rates significantly lower than the rates assumed by Pitcher Partners. For example, recent marina valuations by two independent property valuers have adopted pre-tax capitalisation rates of 9.5% to 10%. Assuming growth of 3% per annum, this is the equivalent of a cash flow discount rate of 12.5% - 13%.
 - (d) Past transactions involving the purchase of marina businesses have reflected similar capitalisation rates. For example, Macquarie Leisure Trust advised investors to expect a yield of around 13% per annum from its marina investments. This suggests that the risk associated with marina businesses has been perceived in the past to be rather lower than is implied by the Pitcher Partners analysis;
 - (e) In their letter dated 10 March 2009, Pitcher Partners assert that “the long-term interest rate applicable to [marina] borrowings is between 10% - 12%”, and state that they “do not consider that the recent interest rate reductions in other sectors will flow through to this sector to any substantial extent, given the long term nature of the debt”. Neither of these assertions is supported by any evidence, and it seems counter intuitive to

assume that a widespread and significant general reduction in interest rates would not flow through to a particular sector. Even long-term borrowings can have variable interest rates, and reductions in variable rates are passed on to all borrowers;

- (f) In their modelling based on actual information provided by marina operators, Pitcher Partners adopted an interest rate of 10%. Since the date of that model (September 2008), interest rates have fallen substantially;
- (g) Pitcher Partners assert that high interest rates are applied in the marina industry because marinas are “leasehold investments with no termination value”. Although strictly true, NSW Maritime’s experience is that Marina businesses sell for significant sums, even where the lease term has expired or is about to expire. The commercial reality of this industry is that such businesses do in fact appear to have a “terminal value”, even though no such terminal value is taken into account in the cash flows used in the NPV Template.

6. Existing Assets

- 6.1 The NPV Template takes into account expected future cash flows. If there is an existing asset which is used in the marina business to generate future cash flows, the value of that existing asset is taken into account either as notional initial costs (equal to the fair market value of the asset concerned) or as a notional rental to be paid in the future (equal to the fair market rental for the asset concerned).
- 6.2 Where an existing lessee wishes to undertake an additional investment, and the rental or lease term are to be renegotiated, the NPV template will be prepared as if the existing lease is to be terminated and a new lease entered into.
- 6.3 The NPV template is quite capable of dealing appropriately with the incremental cash flows arising from a proposed new capital investment.
- 6.4 It is important that the cash flows included in the NPV Template do not include any component of past sunk costs or past trading losses. For example, costs incurred in unsuccessfully pursuing a Development Application would not be reflected in the future cash flows. It is no part of NSW Maritime’s obligation to effectively reimburse lessees (through reduced rentals or extended lease terms) for unsuccessful ventures or poor commercial decisions.

7. Joint Cash Flows

- 7.1 Joint cash flows arise where the cash flows associated with a marina business are partly generated from the use of on-shore assets.

- 7.2 In some cases, this contribution will be recognised because the proponent is obliged to pay a rental for those on-shore assets, and the contribution will therefore be recognised as a rental cash outflow.
- 7.3 In other cases, this contribution will be recognised because the proponent is required to construct the on-shore facilities, and the contribution will therefore be recognised as a capital cash outflow.
- 7.4 In cases where a proponent owns the on-shore land, NSW Maritime has adopted the procedure of apportioning cash flows between on-shore and off-shore assets on the basis of on-shore and off-shore land area, and capital cash flows are apportioned on the basis of the location (i.e. on-shore or off-shore) of the asset being constructed. Thus, no part of the capital cost associated with freehold land used in the marina business is included in the NPV Template.

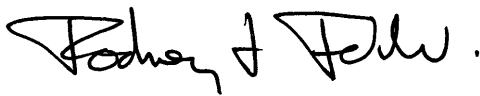
8. Other Matters

- 8.1 The Pitcher Partners letter dated 10 March 2009 is concerned primarily with sustainable rental rates, rather than with the NPV Template as such. In that letter they state that:
- (a) it has been agreed that an appropriate reasonable rate of return (discount rate or weighted average cost of capital) to apply to the marina industry would be 15%; and
 - (b) their modelling indicates sustainable rental rates of 6% - 8% of turnover, although they expressed the view that 6% was the maximum sustainable rate.
- 8.2 I have not been advised that NSW Maritime has agreed to adopt a reasonable rate of return of 15% rather than the rate derived within the NPV Template. However, I note that the NPV Template is able to incorporate any agreed discount rate.
- 8.3 NSW Maritime has adopted different turnover rates for different revenue sources. For example, in October 2005 we prepared a report for NSW Maritime which concluded that a benchmark typical marina operation offering moorings could sustain a rent equal to 11% of moorings turnover plus a fixed fee of \$260 per mooring per annum. This was based on an acceptable pre-tax rate of return of 13% per annum.
- 8.4 In our 2005 report into mooring pricing, we indicated that the average revenue from a mooring in Sydney Harbour was \$3,685 per annum, and NSW Maritime charged a fixed fee of \$395 per mooring per annum. If Pitcher Partners were correct that a rental of 6% of revenue is the maximum sustainable rental rate, then the maximum sustainable rental for a commercial mooring would be approximately \$220 per annum. This seems to imply that marina businesses offering moorings were never viable at a fixed mooring fee of \$395 per annum, and would require a reduction of nearly 45% (to \$220) in order to become

sustainable. This appears to be contrary to the fact that marina businesses have survived for a number of years.

- 8.5 Whether a particular rental rate is sustainable or not depends upon the particular circumstances of each marina business and the adopted reasonable rate of return. The difference between the Pitcher Partners rate of 6% - 8% of turnover and the rate previously recommended by us of 11% (in relation to moorings) is influenced by the difference in reasonable rate of return of 13% adopted by us and the rate of 17% - 20% apparently adopted by Pitcher Partners in their modelling.

Yours sincerely,
Ferriers, Corporate and Forensic Accountants



Dr Rodney J Ferrier

NOT GOVERNMENT POLICY