

RE-ENGINEERING

THE FINANCE COMPANY SECTOR IS UNDERGOING ASTONISHING CHANGE. CHALLENGES AND OPPORTUNITIES ARE EMERGING FROM EVERYWHERE. WHICH COMPANIES WILL COME OUT ON TOP?



NEW ZEALAND FINANCE COMPANIES REPORT 2008

FOR EVERY BORROWER THERE IS AN INVESTOR. THIS REPORT PROVIDES THE ESSENTIAL TOOLS TO ASSIST INVESTORS IN CHOOSING A QUALITY FINANCE COMPANY.

CONTENTS

1	EXECUTIVE SUMMARY
10	THE PAIN OF 2008
16	NEW ZEALAND FINANCE INDUSTRY
22	NEW ZEALAND FINANCE COMPANY SECTOR REVIEW
37	REGULATION
41	NEW ZEALAND FINANCE COMPANY SECTOR OUTLOOK
45	COMPANY PROFILES & PERFORMANCE
55	STATISTICAL SUMMARY
62	THE COMPANIES
85	DISCLAIMER & DISCLOSURE

1 DECEMBER 2008

Finance Companies

ADVERSITY? PLENTY. OPPORTUNITY? ABSOLUTELY.

If 2007 was a year to forget for the finance company sector, until October, 2008 had been one to erase permanently from the hard drive.

Regrettably, the consolidation phase we first foreshadowed in our 2004 report has unfolded largely as we had feared. In fact, to be fair, what has taken place over the last 12 months is considerably worse than what we had imagined. On top of the failure of at least a dozen low quality companies, more recent defaults have marked an ominous new phase, and with it, the capitulation of the domestic mezzanine property finance sector.

This year there are just 11 finance companies unaffected by receivership, moratoria or restructure that meet our inclusion criteria. Last year the number was 29. In 2006 it was 38.

Amongst the angst however there is genuine reason for optimism. In particular, the Government guaranteeing of retail deposits has turned the entire finance industry on its head, and is the shot in the arm that the finance company sector desperately needed. Prior to 12 October, debenture products looked destined to fade for all but the strongest companies. That view is now well out of date. With funding alternatives in short supply for all but the strongest, we expect finance companies to re-target the retail market over the next 12 months.

With deposit rates in steep decline, and with theoretically and practically the same risk of financial loss on offer across both the bank and finance company sectors, we expect many finance companies to realise a substantial surge in fund flows. In fact, this is already happening. However, with the great majority of new funds likely to be 12 or 18 month money, companies lacking alternative funding lines will need to manage their matching very carefully.

The squeeze in funding availability that has accompanied the collapse of the mezzanine property finance segment and the pending withdrawal of major non-deposit taking finance companies from specific markets is providing a stark reminder on how important, but under-appreciated the finance company sector is to the NZ economy. This \$22 billion industry financed many of the projects and assets that contributed to the boom decade leading into 2007. Yes, there were a number of bad apples in the bunch, but the role of the sector is arguably more important today than it's ever been in financing assets that banks cannot, or do not want to in a syndicated form.

The downturn in credit availability means there are serious opportunities on offer for those with the money and the will to move.

This will be our last report specifically on the NZ finance company sector. Such is the gravity of recent events that next year we intend broadening the report's coverage to cover all classes of non-bank lender. For better or worse, the local sector is becoming increasingly compact, and deserves to be treated as such.

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EXECUTIVE SUMMARY

WHAT A YEAR

So much has happened in the finance company sector in the year since our last report.

Unfortunately, the consolidation phase we have warned of since 2004 has unfolded largely as we had feared. In the past 12 months, at least a further 16 at-scale finance companies have either failed or entered repayment moratoriums.

Our view back then, that unsustainable credit growth in the residential sector would eventually expose those companies with dubious lending practices and poor balance sheet management, has very much panned out. Without naming them, the demise of at least a dozen such companies came as little surprise to us.

But what we and others who know the sector well did not foresee was just how far the cleanout would stretch. We're brave enough to concede that we did not expect to see happen a number of the more recent failures.

We acknowledge two key underestimations.

Firstly, what we and most other commentators around the world did not fully appreciate was the full extent of the unfolding financial crisis and the effect it was to have on market liquidity and sentiment. Instead of being the once-a-decade event that most observers expected this time last year, subprime has since exploded to a full-blown once-a-lifetime crisis that has undermined the entire global financial system.

The second factor we underestimated was the strength of the downturn in the local property sector and its implications for deteriorating asset quality. St Laurence, Strategic, Dominion, North South, Hanover, United and Dorchester all lent heavily into the property space. While their exposures are each yet to fully play out, what is clear is that each has suffered a rapid and substantial deterioration in loan book quality.

THE GLOBAL MARKET MELTDOWN

The impact of the turmoil that has reigned in global investment markets over the past 12 months cannot be understated. The numbers are simply staggering, and serve to convey the depth of the collapse in investor sentiment globally.

Prices across all asset classes have been severely impacted. Global stock market indices in particular have been massacred, down between 35% and more than 70% (Russia) from a year ago. House prices are in reverse across most OECD nations. As investors have exited riskier positions in favour of cash, bond yields have tanked. On 17 September, following the collapse of Lehman Brothers, yields on 3 month US treasury bills closed at 0.03%, the lowest since the Great Depression.

Figure 1: Global Share Indices, 1 Year Performance

COUNTRY	INDEX	12 MTH RETURN
Australia	ASX 200	-43.1%
Canada	TSX	-37.3%
Germany	DAX	-40.2%
Hong Kong	HANG SENG	-51.1%
Japan	NIKKEI	-43.9%
NZ	NZX 50	-35.3%
Russia	RTS	-71.0%
UK	FTSE 250	-45.0%
US	S&P 500	-40.9%

Source: IRESS, 28 November 2008

Although US subprime is usually fingered for most of the blame for what's since unfolded, in reality subprime was only the masthead for what was a western nation trend of leveraged consumer excess. The progressive easing of credit criteria to accommodate what appeared to be a bottomless supply of cheap, easy money was the same across most of the world, NZ included. Property speculation blossomed on the back of this dynamic, creating a classic asset pricing bubble.

AFTER THE PARTY: THE HANGOVER

The decade-long 'Buy Now, Borrow Now, Pay Later' consumer party that we described last year is well and truly over, and we are now firmly into the correction stage of the cycle: global deleveraging. The result has been a dramatic ebb in liquidity and confidence as investors across the world have taken flight.

Unlike past recent crises (the dotcom and Asian crises in particular) where the global banks were largely observers to the chaos, this time the banks and financial institutions are donkey deep in it. Global powerhouse names like Bear Sterns, Lehman Brothers, Merrill Lynch, AIG, ING, Barclays, RBS, HBOS and Citigroup have all been badly affected, some to the point where they have folded completely.

The IMF estimates that losses on US-based loans and securities are likely to reach US\$1.4 trillion. With only 40% of that amount written off by banks to date, there looks to be considerably more pain yet to come. As the downturn works its way through other countries' macroeconomies, further write-downs in other territories appear very likely.

The ensuing collapse in trust between counterparties has led to severe credit dislocation, impacting the mobility of capital locally and internationally. From mid-September into October, the US wholesale market was virtually shut for business. While indicators in November have been more positive, volumes remain very weak. The market is desperately seeking the return of some sense of order.

THE REAL ECONOMY: NOT LOOKING REAL GOOD

The spillover effects of the crisis formerly known as subprime now represent a full-blown threat to the health of the global economy, the likes of which hasn't been seen since the 1930s.

This was always the risk; that banks' holdings of toxic subprime securities would result in impaired credit intermediation, lower economic growth and, ultimately, further deterioration in credit holdings.

Indicators of household and business activity and confidence are very weak across most western economies. Spooked businesses and households are voting with their wallets, increasing the likelihood of a truly global recession. Despite showing strong early defiance, employment indices across most nations are now weakening fast.

New Zealand was an early mover into recession, having now been there for all of 2008. Other geographies have since followed suit. Japan, the world's second-largest economy, is formally now into recession, as is the 15-nation Eurozone. The US is almost certainly next, and there is increasing speculation that even Australia will follow.

There are also clear signs that the previously meteoric growth paths of developing nations are also levelling off. For those nations, largely reliant on the strength of the manufactured export trade, the stories are increasingly similar. Although the starting points are much higher (GDP growth in China in 2007 was 11.4%), easing demand for exports is working its way through to domestic demand.

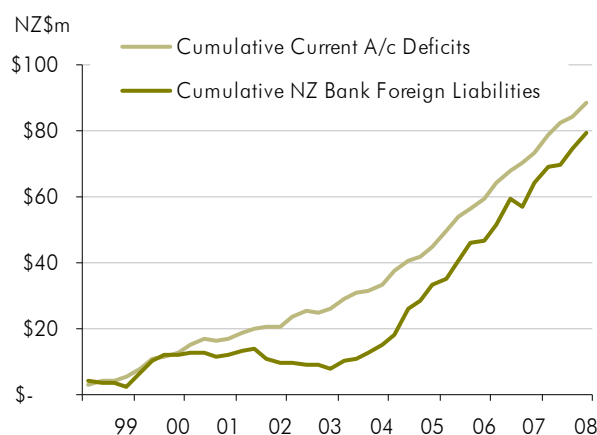
THE NZ CONTEXT: CAUSE FOR BOTH OPTIMISM AND CONCERN

The events of the past 12 months have highlighted areas of both stability and fragility in the NZ economy. Areas of strength are largely microeconomic in nature, while areas of concern are centred on the macroeconomy.

Looking firstly to the positives, confidence can clearly be taken from the underlying health of the local banking and business sectors. Local banks run extremely simple models by global standards, typified by strong capitalisation and light securitisation. Whereas many of the prime banks elsewhere, and particularly in the US and Europe, are deep in the complex derivatives that have now claimed so many, local banks clearly are not. NZ Banks all have comparatively high credit ratings and are overseen by a competent and conservative regulator.

Similarly, and contrary to what was the case leading into the 1987 share market crash, the balance sheets of NZ corporates are in generally good order and are not over-gearred.

Figure 2: Cumulative Balance of Payments Deficits & Foreign Borrowing, 10 Years



Source: RBNZ data

The main area of concern lies with the external sector. Long-term excess domestic demand has drawn more than three decades of current account deficits. Poor domestic savings rates have resulted in a heavy reliance on offshore funding to meet demand.

The effect has been exacerbated over the last decade by the loose availability of cheap credit, which Kiwis have devoured to fund their homes and lifestyles.

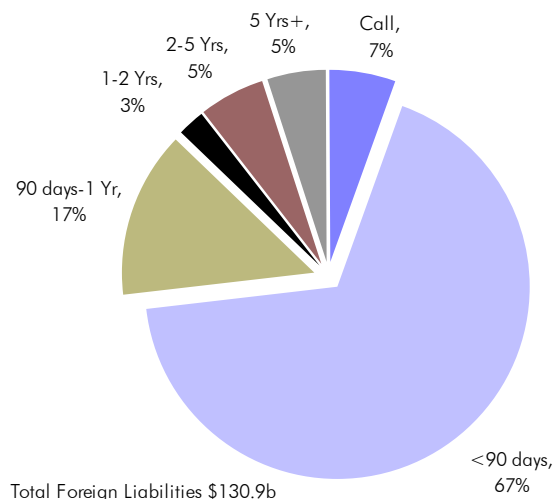
The contractionary policy path the RBNZ ran during this period brought high real interest rates intended to reign in the inflationary pressure brought about by excess demand. Much to the RBNZ's ongoing and vocal frustration, high policy rates did not have the suppressive effect on household borrowing it had hoped for.

New Zealanders' external debt now exceeds \$160b, approaching 100% of GDP and over \$100,000 for every NZ household. The average household mortgage is around \$250,000.

Arguably the strongest impact realised from the RBNZ's contractionary path was to the NZ\$. The massive inflow of foreign money seeking yield contributed to a NZ\$ grossly overvalued on fundamentals, suppressing exports and balance of payments. The result was a further deterioration of an already sick external account.

Compounding the funding issue is that of maturity. More than 70% of foreign liabilities are due to be rolled within 90 days. Should international money markets remain as illiquid as they have been for the past few months, NZ banks will find it difficult to secure the rollover funding they require, regardless of whether they can offer a Crown guarantee.

Figure 3: Maturities of NZ Bank Foreign Liabilities



Source: RBNZ SSR data at 31 Oct 2008, McDouall Stuart Research

Offsetting this risk is the clear willingness by the central bank to offer its balance sheet to the cause. Steps the RBNZ has taken recently to encourage liquidity give significant reason for confidence, should access to rollover funding continue be an issue.

Ironically, that all NZ's major banks are offshore-owned may also provide some insulation by dispersing the problem of how to ensure continuity of funding to NZ subsidiaries beyond just this jurisdiction. Countering this is the funding pressure that parents are themselves feeling at home.

The indirect impacts of severe credit dislocation on small, open and consumption-heavy economies like NZ which are heavily reliant on foreign capital, is profound.

ANNUS HORRIBILIS FOR MOST NON-BANK DEPOSIT TAKERS

Global events have formed only part of the NZ finance company sector's challenge set. In fact, it is difficult to imagine a more unfavourable set of market and economic circumstances than those that most companies have faced over the past 12-18 months.

The initial collapse of the weakest finance companies during 2006/07 was the much needed wakeup call for investors to look harder at the sector. Many of those that did were spooked at what they found and decided not to place or leave money in the sector.

The early failures were gathered around the top end of the most recent economic cycle. At that time, economic growth remained robust, employment high and asset price growth strong.

The ensuing domestic economic downturn meshed with the full arrival of subprime to NZ shores in late 2007. The slow march of failures that followed through late 2007 and early 2008 were largely the result of investor flight exposing weak liquidity in generally already low quality companies that were not able to manage book matching exposures.

The start of the property market downturn in late 2007 was the next crucial turning point. Until then, the funding side of the balance sheet was the main source of finance company pressure, although still a manageable one for those many companies that held sufficient flexibility. The property downturn that was to follow brought pressure to the other end of the property financier model, that of asset quality.

NZ PROPERTY MARKET DOWNTURN = NZ PROPERTY FINANCIER DOWNTURN

Anyone credible foresaw the Kiwi property party coming to its end. Again, what we and others underestimated was the speed and depth with which the market would correct.

For those even remotely connected to the property space, financiers certainly included, the situation has turned sharply negative. Speculators operating at the riskier end of the property model have experienced the sharpest impact. The dynamic at play for them is simple: developers that have not managed to sell or pre-sell enough of their developments have not been able to service or repay loans made to them by lenders.

Holders of second or subsequent mortgages in this situation, typically finance companies, were the first security holders to take a haircut on sale. The breakdown in relations between first and subsequent mortgage holders is a notable feature of the current market. The lack of current cooperation is of a scale not seen since 1988/89.

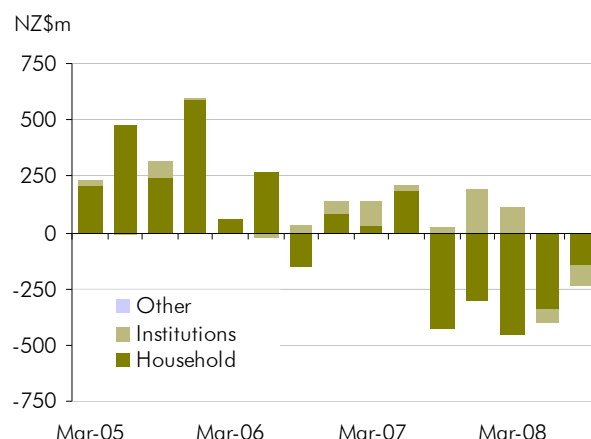
With the ebbing of debenture inflows leaving the funding sides of finance company balance sheets under already intense pressure, the further squeeze to liquidity that accompanied the deferring of loan servicing and repayments was enough to push some companies over the edge.

This is precisely the crunch that has claimed most of the more recent finance company defaults: Dominion, North South, St Laurence, Dorchester, Hanover, United and Strategic. All were intensive property financiers and collectively had loan books at the time of their defaults of \$1.6 billion. Of the \$3.8b of debenture funds now at risk in defaulting finance companies to date, almost \$3b lies with property financiers.

FINANCE COMPANY FUNDING A STORY OF HAVES AND HAVE NOTS

The downturn in retail debenture funding is clearly evident in official statistics. While bigger companies have enjoyed more resilience with rollover and new money rates, the easing of flows has been felt to varying extents across the entire industry. More than \$1.5b left the sector in the 15 months to September 2008, destined primarily to the prime banks.

Figure 4: Finance Company Funding Flow, Quarterly



Source: RBNZ, McDouall Stuart Research

The past 12 months has exposed groupings of funding haves and have-nots among finance companies. Only the strongest companies have been able to raise new non-debenture funding. South Canterbury Finance and Marac have each successfully raised substantial tranches of new, long-dated non-debenture money from the capital markets. Tier-2 companies have also enjoyed success, albeit on a significantly smaller scale.

Larger companies, simply because of the scale of their funding requirements, face a numerically more challenging task to find new money to replace old. In money markets which are currently highly evasive of risk, this has proved extremely challenging. Despite this, the major finance companies have successfully raised more than \$1.5b in bank, institutional and listed debt in the past year.

NON-DEPOSIT TAKING FINANCE COMPANIES ALSO IN RETREAT

Non-deposit taking finance companies are also very important, but very under-appreciated members of the NZ lending market. With assets totalling more than \$11b, the non-deposit taking sector is as big as its deposit taking counterpart.

By value, the majority of the non-deposit taking sector is accounted for by local subsidiaries of global multinationals. A worrying trend over the past few months has been that of non-deposit taking financiers severely scaling back their NZ operations, particularly in the vehicle financing space. Parent companies to have recently taken this decision include GE and General Motors.

Although unsurprising that parents themselves under pressure at home are opting to consolidate, that parents of the calibre GE, a AAA credit rated company, are also doing so is indicative of the pressure that even the highest credit quality companies are now facing. As a distant and small satellite office, pulling back from offering credit in the likes of NZ is an easy decision to comprehend.

The potential compound impact of these decisions on specific sectors of the domestic economy is very significant. GE Money and GMAC finance probably close to half the vehicle forecourts in NZ, a market both are currently in the process of withdrawing from. Although other finance companies do already offer into the forecourt space, it is doubtful they will be either willing or able to pick up the full slack. We estimate that some \$200m of replacement financing is required by Christmas to plug the gap.

In Australia, where GE Money and GMAC also dominate the vehicle finance market and have taken the same decision to withdraw, such is the level of concern that the Federal Government has become directly involved in looking at ways to plug the A\$2b gap estimated to be left by their departures.

We consider there to be reason to be seriously concerned about the potential impact on the local vehicle dealership industry.

MORTGAGE FUNDS: FLAWED FROM THE START

Possibly the most direct local victim of the surge in demand for capital return over the past year have been the local mortgage funds. At least 13 such funds, and close to \$2.4b of investor funds, are currently frozen by their managers. Since the first fund called a redemption halt in March, the aggregate of investor money since frozen by mortgage funds well exceeds the \$1.7b of newly-frozen finance company debenture money over the same period.

These funds, which are generally offered and operated under the banner of very highly reputed and professional fund managers, fell victim to their own outdated investment models. Simply put, mortgage funds are fair-weather structures not designed to cope with a capital flight contagion. Borrowing very short (often on call) and lending very long (often five years or more), and with little if any capital or liquidity, mortgage funds were always going to struggle if a run on them unfolded.

We find it intriguing that the turmoil of the last 18 months has seen mortgage funds largely escape or deflect criticism, while the finance company model has been so deeply maligned.

Our view is that the mortgage fund model is already at least two decades out of date, and we expect to see it eventually disappear in its current form.

FOCUS SHIFTING TO 'WHAT HAPPENS NEXT?' FOR DEFAULT COMPANIES

With 60,000 debenture holders affected by the defaults of the seven big property financiers, focus has naturally shifted to 'what's next' for each company. St Laurence, Hanover, United, North South and Dorchester have since tabled restructure proposals. Later we discuss the key features of each.

Whether or not to support a particular proposal is a judgement for each investor to make based on their individual circumstances, their appetite for risk and the degree of confidence they have in the people proposing to lead the company through the process, and we do not intend here to issue a blanket recommendation one way or the other.

We do, however, wish to make three generic points.

Firstly, security holders are faced with an unenviable, but critically important decision between one of two options: Receivership or "whatever else it is you're offering". A morbid fear of the 'R' word by most Kiwi investors means that whatever the 'whatever else' is will likely gain its required support. We believe the question of whether the 'whatever else' options presented of late have truly been the best that first-ranked security holders could have hoped for, is an open one. In some cases, bottom-ranked equity holders appear to have as much if not more to gain from restructure proposals than first-ranking security holders.

Secondly, we consider the stigmatising of the receivership process as expensive, inefficient and likely to result in fire sale outcomes has been overdone. Receivers have a legal obligation to act in the best interests of creditors. Yes, receivership is costly, and we certainly agree there is a need for greater disclosure, transparency and accountability around the true costs of the process. But very expensive also is the cost structure of a distressed finance company that has a going concern mandate to operate under the control of an existing board and management.

Finally, the explanatory material which has recently been circulated to investors is so overly-complex to make it virtually meaningless to many voters. This is why the role of the Trustee is so important – to decipher and simplify security holders' interests. As the Geneva and MFS/OPI situations have already shown, however, Trustees must also be vigilant in ensuring that restructure proposals are viable and based on an accurate set of starting facts.

OVERSIGHT: TRUST THE TRUSTEES?

From our discussions with industry, there is clearly concern at the role and performance of Trustees. Criticism appears to be centred on two fronts, and is not just confined to those companies that have had the doors closed on them.

Firstly, there is a view that many easy years of sufficiently light-handed oversight may have drawn Trustees into a false complacency. Many in the industry openly question their capability and resource, and whether lack thereof may be putting investors' best interests at risk.

Secondly, the issue of Trustee independence is a commonly expressed area of concern, and one deserving of greater scrutiny going forward. There are a number of specific examples of potential conflict in the sector.

There is a clearly a challenge ahead for Trustees to win the confidence required of the sector. A requirement of the RBNZ to undertake a review of NBDT regulations within five years will provide another opportunity to look at the role and performance of Trustees.

REGULATION A MIX OF THE EXPECTED, AND THE VERY UNEXPECTED

A further issue for finance companies to contend with is a tightening of the regulatory and oversight environment they now face. The passing of the RBNZ Amendment Act in September extended the central bank's responsibility to that of prudential regulator of NBDTs. Once fully implemented, Trustees will report directly to the Reserve Bank.

Among other obligations, the new regulations will require, by March 2010, finance companies to obtain a credit rating from an agency approved by the RBNZ.

Our view is that companies eager to achieve the necessary scale and book diversity likely necessary to achieve an investment grade credit rating significantly lifts the scope for M&A activity over the next 18 months. With only a small number of firms operating in this middle space, some jockeying may emerge.

A separate piece of fresh legislation, the Financial Adviser Act, will make the advisory sector also the subject of greater scrutiny. This is both entirely appropriate and well overdue. Distribution has been an important contributor to the rise of low quality finance companies, and the events of the past 2-3 years have reflected very poorly on the financial advisory sector. A lack of investment in research into a sector that has more than \$11b has been a failure that contributed to poor advice by many advisors. While mandatory ratings will continue to improve disclosure, one hopes that commission-led advisers who previously directed clients into what presented as very poor quality finance companies will invest in robust research and focus on their clients' best interests in the future.

THE DEPOSIT GUARANTEE LIFELINE

On 12 October, the NZ fixed interest market was turned on its head by the Government's decision to guarantee approved bank and non-bank retail deposits.

Figure 5: Finance Companies Accepted into Retail Deposit Guarantee Scheme as at 28 November 2008

	FY08 LOAN BOOK
Allied Nationwide	\$158m
Asset Finance	\$20m
Avanti	\$33m
Broadlands	\$32m
Finance Direct	\$5m
Fisher & Paykel	\$361m
MARAC	\$1,303m
Medical Securities	\$198m
Mutual Credit	\$17m
Mutual	\$9m
NZF Money	\$68m
Oxford	\$52m
PGG Wrightson	\$505m
Priority	\$4m
Savings & Loans	\$3m
South Canterbury	\$1,379m
UDC	\$1,966m

Source: The Treasury, Companies Office

At time of writing, 17 NBDT finance companies had applied for and been accepted into the scheme. That list includes eight companies not large enough to make our inclusion criteria. Having those names on the 'approved' list indicates that policymakers are serious with their intent that all criteria-meeting companies will be included.

The irony is that the guarantee scheme is set to act as the lifeline the finance company sector desperately needed to draw investors back to it, but will provide serious challenges and uncertain outcomes if it is not either extended or gently unwound on current expiry in October 2010.

PERVERSE INCENTIVES = PREDICTABLE OUTCOMES

A risk with introducing any new regulation is that of creating unintended incentives and outcomes.

In respect of the retail guarantee scheme, the implicit separating out of default risk (the risk of a company defaulting on its payments) and loss-of-money risk (the risk that investors will actually lose money following a default event) is probably the scheme's most striking feature. The effect is that investors do not need to worry about losing their money if they invest in a guaranteed retail deposit taker.

At the funding end of the model, the distortion created by disconnecting risk and return in this way goes against the most basic principle of investment.

We are already aware of substantially increased funding inflows to finance companies. With the guarantee currently due to expire in October 2010, unsurprisingly the majority of new fund flow is as 12 or 18 month money.

Watching pricing outcomes over the next two years will be particularly interesting. We think there is the potential for significant distortions to emerge in the pricing of fixed interest products. Again, there is evidence that such distortions are already emerging.

Deposit inflows to finance companies are already resulting in significant falls in deposit rates. We can see the potential for spreads between bank and guaranteed finance company fixed interest deposit rates to fall to very low levels. This is not a healthy market outcome, particularly given the collectively bad judgement that investors around the world have shown in the last decade towards the pricing of risk.

We also consider there to be significant scope to work the new system to the benefit of both companies and their investors. There are a number of ways in which this could potentially happen, with the most obvious, the explicit structuring of products around the guarantee period, already on the market.

The quest for innovation will need to be balanced against a regulator who will have its eyes wide open to the array of possibilities that could emerge. Coverage under the scheme is a privilege, not a right, and the scheme affords the Crown powerful discretion.

At the lending end of the model, the main risk is one of indirect moral hazard. Although companies themselves are not insulated from the financial losses stemming from default, the potential fund inflow from investors which are covered may see companies laden with funds excess to their immediate lending needs, and which they may therefore lend more loosely than they otherwise would have.

We do not consider this potential exposure to be as much of an issue, partly because most of the lower-quality, higher-risk lenders have already left the industry, but also because there should be confidence that officials monitoring the scheme will be acutely aware of this particular risk.

For all its drawbacks, and all its potential for producing sub-optimal outcomes, the perilous nature of the financial system into which this and other policy interventions going on around the world have been introduced must be recognised. Frankly, the guarantee is policy intended entirely to deal with an externally irrational set of unprecedented market circumstances. For all its flaws, the investment community must regard it as such.

FINALLY, SOME GROWTH-LED CONSOLIDATION

Since the first signs of stress in mid-2007, industry consolidation has largely failure-led. Receiverships and moratoriums have dominated the landscape, interrupted only occasionally by the odd loan book sale or managed wind-down.

Amongst the angst however, there are encouraging recent signs that some growth-led consolidation is starting to emerge. In particular, the acquisition by Allied Nationwide Finance of Speirs Finance is representative of the type of opportunities that are

Figure 6: Key Outlook Themes

Funding	<ul style="list-style-type: none"> ▶ debenture market to be retargeted, with Government guaranteed capital a key selling point ▶ pricing distortions to intensify as investors take advantage of risk arbitrage ▶ liquidity to improve, but matching to remain a key focus, particularly 12-18 months out ▶ innovative capital raisings likely, as are new funding models
Lending	<ul style="list-style-type: none"> ▶ credit availability to remain tight as focus remains on liquidity and book quality ▶ sizeable and vacant market segments on offer, particularly in property & vehicle financing ▶ more structure and formality in arrangements between security holders
Corporate Performance & Activity	<ul style="list-style-type: none"> ▶ earnings to stagnate, with higher margins offset by lower volumes and higher bad debts ▶ renewed scope for M&A, particularly for companies seeking additional scale & diversity ▶ some consolidation still yet to come, primarily through the exit of smaller, non-guaranteed companies ▶ internal organisational tuning to continue in preparedness for new NBDT regulatory regime ▶ capable companies to increasingly consider banking upgrade option
Regulatory	<ul style="list-style-type: none"> ▶ RBNZ to move quickly to implement NBDT oversight regime ▶ Trustees to remain under scrutiny

Source: McDouall Stuart Research

emerging. The key attraction of the deal from Allied Nationwide's perspective is the gaining of access to Speirs' existing \$250m securitisation programme. Prior to the deal, Allied Nationwide did not have any non-debenture funding lines of significance in place, nor were its chances high of securing a green field prime bank facility.

Other than the Speirs deal, there has been a distinct lack of transaction activity in the sector. The reasons why are fairly clear. The distress being felt further down the sector means that those bigger companies that are otherwise positioned to acquire are instead finding no shortage of opportunities to grow their lending bases organically. In other words, at present, strong finance companies that already have scale do not need to acquire to achieve their growth aspirations.

Managing the pressures of finding new money and uncertainty towards the underlying quality of target loan books are likely to be other factors weighing on M&A.

NZ FINANCE INDUSTRY: CHALLENGES AND OPPORTUNITIES EVERYWHERE

Until the guarantee scheme was announced, we did not see a recovery to the debenture downturn being faced by most of the sector anytime soon. Trust in the sector had been damaged to the point that, for many companies, debenture products were at risk of becoming uneconomic to continue offering. With alternative funding largely unavailable, the business models of vanilla, debenture-exclusive companies were at serious risk.

The deposit guarantee scheme now makes that view outdated, and we are considerably more optimistic in our view towards the sector's prospects.

We expect the debenture market to re-blossom over the next 12 months. This may happen in various forms:

- ▶ Existing debenture-issuing companies extending their efforts and/or introducing new debt products
- ▶ Companies which have previously decided to withdraw from the retail fundraising market revisiting their decisions
- ▶ Companies which have not previously taken deposits entering the retail market.

We also expect to see more companies moving towards taking the steps necessary to upgrade their status to that of a registered bank. The pending arrival of new NBDT regulations from 2010 means that some of the bigger and better quality finance companies may need only invest modest additional capital and/or effort to realise substantial further benefits. We note that SBS's funds flow has lifted substantially since registering as a bank in October.

Related to this, we also see significantly greater scope for transaction activity over the next 12-18 months. The primary driver that we consider will underpin that activity is the migration towards the new regulatory framework. In particular, mid-size companies that would otherwise lack the scale and book diversity to attract an investment grade credit rating may increasingly look towards acquisition as a means of achieving exactly that.

With the RBNZ now head-long into what is an increasingly steep easing cycle, fixed interest yields on finance company debentures will quickly become more attractive, particularly with the wrapping of a capital guarantee.

That said, finance companies need only offer what's required to meet their lending needs. With focus likely to remain on liquidity and book quality, we expect credit availability to remain tight. Spreads over bank rates may well shrink, and shrink significantly, if post-guarantee money flow is as strong to finance companies as some are suggesting it might be. Again, we are already seeing evidence of this.

Liquidity will continue to remain a core focus. Although funding inflows will boost short-term cash positions, the challenge is one of close loan book management to ensure that, 12-18 months out, any exodus of maturing money does not leave balance sheets and cash positions exposed. Companies with overweight debenture books and little in the way of alternative lines will need to watch this very closely. In the short-term, capital adequacy may be stretched as debenture inflows are accommodated onto balance sheets.

Profitability across the sector is likely to remain relatively stagnant as companies continue to focus on liquidity and higher lending margins are offset by lower lending volumes and higher bad debts. Important also is recognition of the cost of membership under the guarantee scheme.

For unrated or lowly-credit rated companies that take on significant inflows, the 300 basis point coverage cost on new money will bite.

As a final note of caution, we see the pending withdrawal of GE, GMAC and potentially others from the vehicle financing business as a serious issue for the industry to manage. Although there are clearly opportunities for incumbents to take up some of the slack, there is not enough capacity in the market to cover the full shortfall. Already suffering, the motor vehicle dealership industry faces a further hollowing-out if nothing further is done.