NZX grain exchange retains carrying value after review

18 July 2011 - The Audit and Financial Risk Committee ("Audit Committee") of the NZX Board, with external review from KPMG has, over the the course of the last ten days, completed a thorough financial, operational and strategic review of NZX's Clear Grain Exchange ("CGX") and its carrying value on the NZX Group Balance Sheet. KPMG have reported to the Audit Committee that in their view there are no factors indicating that there is an impairment issue that should be signalled in NZX's accounts.

The Board confirms that the carrying value of the CGX asset on the NZX Group Balance Sheet remains unchanged. Whilst CGX remains in an early stage, and subject to significant volatility - including that driven by trading volumes that follow grain prices in the Australian market - the NZX Board has accepted the recommendation of the Audit Committee, and determined that the amount held for CGX on the NZX Group Balance Sheet should not be impaired.

Given the level of interest in this matter, in addition to confirming to the market the carrying value of CGX, NZX has elected to provide further detail as to the review and related matters.

1. The investment review process

The Audit Committee has considered the carrying value of the CGX asset in the NZX accounts at each financial reporting period (half and full year) since NZX acquired CGX in late 2009. As part of the preparation and review of NZX's financial statements for the six months ended 30 June 2011, the Audit Committee was, as is usual, to consider the carrying value of the CGX asset. As a result of recent speculation, NZX decided to expedite this process. The NZX Board instructed NZX Limited's auditors, KPMG, to undertake a review of the CGX asset ahead of the review of NZX's half year financial statements.

During the period 8 to 17 July 2011, the Audit Committee has overseen a comprehensive and detailed process designed to assess the value of the CGX asset.

The process has involved a number of Audit Committee and Board meetings over the review period. Detailed analysis was conducted on matters including, but not limited to: trading volumes, relevant market catchment area, likely harvest size, discount rate, customer connectivity, market relationships, technology platform, expenses, capital expenditure, terminal value and other matters.

To assess the appropriateness of the carrying value, significant emphasis was placed, in particular, on the long-run assumptions. Sensitivity analyses, stress testing and various market scenarios have been undertaken and assessed. These demonstrate that, to sustain the current CGX carrying value on the NZX Group Balance Sheet, the CGX business needs to achieve market share in relevant market segments (i.e. not the entire Australian grain market) at or around 7% by 2015, which is not materially above current market share levels. CGX is currently estimated at around 4% of the relevant market. Similar outcomes were obtained using detailed bottom-up analysis, as well as top-down estimates using higher than usual discount rates, combined with conservative business assumptions.

KPMG have been fully involved in reviewing the various draft papers, valuation models and assumptions, as well as the broader market analysis presented by management to the Audit Committee. In addition, KPMG have been given unrestricted access to NZX staff, including a site visit to the Melbourne office where CGX is based.

The Audit Committee also sought comment from KPMG on the appropriateness of: the forecasts for costs, the discount rate applied to the NPV calculations, the terminal value, whether provision for capital expenditure was sufficient, and whether the various grain volumes and tonnage projections were reasonable, as well as the valuation outcomes.

The NZX Board has resolved that the carrying value of the CGX asset remain unchanged.

2. NZX Group and CGX performance

The NZX Group is an integrated organisation with a series of business lines. NZX provides detailed monthly operating metrics, from which the revenue for most of NZX's businesses can be determined. As disclosed in those monthly metrics, the CGX business has recently underperformed in traded volumes, which tracks to the revenue side. However, much larger business lines, such as clearing, cash market trading and agri sales, have delivered stronger than expected performance metrics. Equally, strategically important business lines such as derivatives are also growing well.

CGX represented 1.7% of NZX Group revenues in 2010, and the CGX carrying value represents less than 3% of NZX's current market capitalisation. Today CGX revenues are at close to 3% of annualised revenues. As such, CGX is not yet a major business within the NZX Group portfolio.

CGX revenues relate to grain tonnes traded. As described above, there has been a recent sharp decline in grain market pricing conditions. As grain prices have declined markedly, some growers have retained a portion of their grain (a durable commodity that can be carried across seasons) in warehousing pending a price recovery. This has resulted in a decline in CGX's transactions - which has been disclosed in NZX's monthly operating metrics. Despite this decline, CGX is tracking well ahead of the previous year.

At NZX's 7 March 2011 Investor Day, various ranges and estimates were provided for CGX. Grain trading volumes to the end of February 2011 were tracking at four times the 2010 harvest levels. Based on these volumes, the expectation for full year 2011 was between 650,000 and 850,000 tonnes traded. The base case for tonnes traded now stands at circa 500,000 tonnes.

The cost base outlook for CGX was for costs to reduce as against previous levels by circa $800,000. As a consequence of structural integration with NZX's Grain Intelligence Unit, and the provision of critical support functions more efficiently by other divisions of NZX, CGX's cost performance is ahead of the outlook provided.

At NZX's March Investor Day, NZX indicated that its outlook was for an annualised turnaround in CGX's profitability to be at $2.0 to $2.5 million. Based on current information, NZX expects to be within $300,000 to $500,000 of the lower end of that range. As noted above, larger revenue lines are, on the basis of disclosed operating metrics, tracking above the March Investor Day outlook.

As previously advised to the market on 17 June, NZX's half year financial results will be released on Monday 15 August 2011. On that date, NZX will provide the market with an outlook for the second half of 2011, including for CGX, in the normal way.

3. May 2011 court proceedings in Victoria, and comments relating to CGX

Whilst not part of the carrying value review, NZX considers that it is appropriate to clarify statements made by the NZX CEO in his evidence during the court proceedings in the State of Victoria. Selective and isolated extracts of those court proceedings have been reported in the media.

The reported reference to a "substantial economic loss" for the CGX business was intended, in context, to refer to the periods ending 31 December 2009 and 31 December 2010. The comments were also directed at the context of CGX - not the NZX Group. Those amounts had already been included in the NZX 2009 and 2010 full year financial accounts.

NZX reports its Australian business in two parts: trading and data. As with the rest of NZX's business lines, those line items are reported by function, not by location.

Therefore Mr Weldon's comments, in addition to being specific to two previous calendar years and limited to the CGX business alone, were both historically accurate and not material in the context of the NZX Group as a whole. They were not intended to refer, as has been implied, to either the current or prospective performance of CGX, or the NZX Group.

4. NZX Group's disclosure related to legal matters

As both an operator of New Zealand's capital markets, and a listed company on those markets, NZX takes its continuous disclosure obligations extremely seriously.

NZX confirms that specific reference to the employment-related litigation with Grant Thomas was disclosed as a contingent liability in Note 23 of the 2010 NZX Group financial statements. For reasons of privacy, NZX did not name Mr Thomas in this disclosure. The amount of the dispute was not, and is not, considered material, consistent with the treatment of similar amounts in this business line, and others, over previous financial periods.

In addition, certain media comment has referred to additional potential payments relating to the CGX Sale and Purchase Agreement. The earn-out provisions contained in that agreement have been itemised as contingent liabilities in both the NZX full year 2009 and 2010 financial statements (see notes 26 and 23 respectively).

5. Share trading

The Board wishes to confirm that the NZX CEO sought and obtained approved consent for the sale of NZX shares, as disclosed to the market.

The Board confirms, including based on the information in this release, that NZX has been and remains in compliance with its continuous disclosure obligations, including at the time Mr Weldon received consent to trade and placed an order to sell shares in NZX Limited.

6. Conclusion

NZX will continue to keep the market informed as its integrated information, markets and infrastructure business develops and grows.

ENDS