

December 2016 Update

Pencarrow Newsletter

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Annex to Fund IV of \$80m Raised

Since our last newsletter of June 2016 Pencarrow has concluded the investment period of Fund IV and raised in effect an annex to that fund called the Bridge Fund. This has allowed us to extend the size of committed capital from \$124m to in excess of \$200m while we prepare for launching Fund V later in 2017. When counting co-investments in BrewGroup and Icebreaker this has provided us capital commitments of in excess of \$225m. The Bridge Fund is designed to be a highly concentrated portfolio of only two to four investments but will ultimately allow us to build a portfolio of 8-10 investments across both funds to add to the six investments in Fund IV.

Having opened and closed the Bridge Fund at the hard cap of \$80m on 30 November 2016, we have already concluded the first investment for the Fund being a 50% investment alongside management in MMC, New Zealand's leading fund administration outsourcing business. We discuss MMC in more detail later in this newsletter.

In addition to the investment in MMC, the other key activity for Pencarrow in the past six months has been concluding the first sale of a portfolio investment from Fund IV after receiving an unsolicited offer for BrewGroup (previously Bell Tea & Coffee) from global hot beverage leader, Jacobs Douwe Egberts (JDE). Netherlands-based JDE has been highly acquisitive globally and was attracted to BrewGroup by its number one position in both tea and fresh coffee in New Zealand, a position built under Pencarrow's three-year ownership through organic growth and acquisition. The sale of BrewGroup settled on 30 November 2016 and was a very successful outcome for the fund generating in excess of 2.7 times money and gross IRR of 35%.

About Pencarrow

Pencarrow was formed in 1993 and is New Zealand's longest established private equity manager.

In December 2012 we closed our fourth fund, the Pencarrow IV Investment Fund, with committed capital of NZ \$123.7 million. In November 2016 Pencarrow closed an

extension of that fund at the hard cap of \$80 million. The combination of Fund IV and the Bridge Fund plus co-investment capital extends Fund IV to in excess of NZ\$225 million of commitments and will allow a portfolio of 8-10 companies.

To assist with the investment of Fund IV we took the opportunity to boost our investment team and since raising the fund we have added four professionals with great complementarity in their skill sets. More information on Pencarrow and the team can be found at www.pencarrowpe.co.nz.

Fund IV continues our long established focus on MBOs, expansion capital and replacement capital investments in businesses with enterprise values typically in the range of NZ\$20 million to NZ\$100 million that have strong management teams, attractive positions in their markets and the opportunity to create significant value.



Pencarrow Lighthouses: Representing the combination of our insight with your vision to create a strategy for future success

Portfolio Investments

The investment period for Fund IV concluded in September 2016, with a portfolio of six investments (since reduced to five with the sale of BrewGroup). In November 2016 we closed the Bridge Fund at its \$80m hard cap and the first investment for that fund, MMC, has been concluded.



BrewGroup is an iconic New Zealand business well positioned for future growth

BrewGroup (previously named Bell Tea & Coffee Company)

In October 2013, Pencarrow partnered with the management team of BrewGroup to acquire the business from Foodstuffs (New Zealand's leading grocery supermarket chain) who had owned it for the prior 50 years. BrewGroup is a market leader in the New Zealand hot beverage industry with key brands including Bell Tea, Twinings (under licence), Gravity, Jed's Coffee and Burtons. BrewGroup sells to and services every major channel in New Zealand including retail grocery, food service and workplace. BrewGroup also owns a business called Coffee Solutions which provides coffee machines, coffee and tea supplies, barista training and kitchen consumables to workplace, food service and corporate customers.

The core elements of the investment thesis included continued expansion of distribution into traditional supermarket and food service channels, introduction of further new products, selective offshore expansion (particularly Australia) and bolt-on acquisitions.

BrewGroup achieved consistent growth in EBITDA over the three years of Pencarrow's ownership driven by a strong performances in its grocery channel (including expansion into Australia), acquisitions and strong growth in its non-grocery channel, primarily hospitality and corporate/workplaces.

Of particular note in the last six months was the acquisition by BrewGroup of Hummingbird Coffee, a premium coffee business in both grocery and hospitality channels. Hummingbird's leading brand status arises from its strong resonance with customers as an organic and Fairtrade brand. Following the acquisition, BrewGroup became the clear number one company in roast and ground coffee in New Zealand to complement its leading market position in tea.

It was this strong position in tea and coffee executed under Pencarrow's ownership which attracted an unsolicited offer from the world's second largest coffee company, JDE, which BrewGroup shareholders accepted in August and settled on 30 November leading to a strong realised return for Fund IV investors.

BeGroup

BeGroup provides affordable and modern retirement villages with an emphasis on helping residents enjoy life to the fullest extent possible

BeGroup

In May 2014, Fund IV acquired a platform asset, The Falls Estate retirement village, located in Whangarei as the foundation for a larger opportunity in the rapidly growing retirement village and aged care industry. A holding company, BeGroup, was formed to own this seed asset and it aims to develop a network of modern retirement villages providing a full range of care ranging from independent living to hospital level care. The intention is to ultimately create a business with between six and eight sites.

Guy Eady, a highly respected and experienced retirement industry executive, was recruited to lead the rollout and he has subsequently hired a CFO and development manager.

BeGroup has made strong progress against its ambition of achieving a portfolio of aged care sites at various stages of development with three sites now in the portfolio. The first site of The Falls in Whangarei is now close to 100% occupied and the further development of new villas is now well progressed with Stage 1 expected to be completed this month (and the majority pre-sold) and Stage 2 due for completion in July 2017. A resource consent to build a 50-bed care facility on an adjacent site has been lodged.

The second site at Rawhiti in one of Auckland's wealthiest suburbs has had construction commence for 27 apartments, a 20-bed dementia facility and a 48 care bed facility.

In regard to a third site in Halfmoon Bay in eastern Auckland acquired in May 2016 BeGroup is in the process of applying for resource consent for a facility for 200 villas and 80 care beds.

SOLARCITY

solarcity plans to revolutionise the way energy is delivered by giving customers a cleaner, more affordable alternative to their monthly utility bill

solarcity

In June 2014, Fund IV provided expansion capital in two instalments to solarcity, New Zealand's leading solar power company, resulting in it becoming the largest shareholder with a 37% stake. The expansion capital was primarily to assist solarcity to roll out a new rooftop solar offering, SolarZero, to residential customers. SolarZero is a solar-as-a-service offering requiring no upfront payment by the household with payments made monthly alongside the retail electricity bill over a 20-year contract period. The company is creating an attractive 20-year receivables book of residential installations and has a target of 15,000 residences within 5 years. Early progress has been strong and solarcity has significantly exceeded its targets.

There are strong economic and industry drivers for growth in distributed solar installations in New Zealand, as the cost of solar generated electricity is now below the generation cost from the grid without subsidies.

Solarcity has recently begun installing some of its photovoltaic solar systems with batteries supplied by its key alliance partner, Panasonic. While batteries are not yet fully economic to install with solar systems Panasonic is keen to subsidise batteries to solarcity as its exclusive New Zealand distributor and use New Zealand as a global experimental testbed in anticipation of the time when combined battery/solar systems are competitive with grid electricity.



ARANZ Geo is well placed to leverage its global sales footprint to capitalise on its investment in product development and innovation

ARANZ Geo

In July 2014, Fund IV made a significant minority investment in ARANZ Geo (AGL) providing mainly expansion capital to become the largest single shareholder. AGL is a leading global provider of 3D geological modelling software for mining and exploration geologists. The flagship product is Leapfrog, which uses sophisticated mathematical functions to rapidly analyse scattered data for surface interpolation, enabling the creation of 3D images of ore bodies much more quickly and efficiently than other software.

AGL has a global client base encompassing over 50 countries and over 400 mining and exploration companies, including most of the majors. The business has strong recurring licence revenue and has performed strongly despite the significant downturn in the mining sector.

Pencarrow's investment was made to assist the company to enhance its product suite and provide capital for potential complementary acquisitions, two of which have been completed this year. Further acquisitions are being contemplated to augment the accelerated software development programme, which will enable AGL to expand further along the mining chain and into other industry verticals such as civil engineering and oil & gas.

ARANZ Geo has performed strongly since Fund IV's investment with revenues up around 100% in the past two years. Its software licensing is primarily subscription-based revenue and renewal rates are around 87% despite the woes of the mining sector providing a very high quality revenue stream.



Umbrellar is the leading domestic domain name and SME focused cloud hosting company in New Zealand

Umbrellar (previously named Digiweb)

In September 2014, Pencarrow partnered with the management team of Umbrellar to acquire the business from its founder. Simultaneously, Umbrellar acquired Webdrive, another domain name and web hosting business, and Arrenway, a small underutilised data centre. Both acquisitions offer significant cost synergies with Umbrellar and an early part of the investment thesis is to execute and realise these synergies.

The combination of these three businesses represents the first part of a consolidation strategy in the domain names and web hosting industry in New Zealand. Umbrellar is now New Zealand's leading domestic domain name company and has a strong position in the web hosting sector. The business has historically demonstrated high recurring annuity-style revenues and low customer churn.

In September 2015, Umbrellar undertook further consolidation of the industry via the acquisition of Freeparking. The Freeparking business is based in New Plymouth and provides web hosting, e-commerce, domain registration and hosting and other supplementary services under two brands, WebFarm and Freeparking. Since 1997, Freeparking has grown to become one of New Zealand's largest web hosting and domain name registrars. This growth has been achieved organically and through the acquisition of 2Day.com in 2005.

The combination of Umbrellar and Freeparking represents an imminent opportunity to further consolidate the New Zealand domain name and web hosting sectors, mirroring similar consolidations in the United States, Australia, Canada and the UK. Freeparking is one of the few remaining acquisition targets of scale. The combined business will have a ~36% share of the domestic domain name market and around 30% of the domestic hosting market, further entrenching Umbrellar's position as the leading tier two player. Leading industry consolidation was one of the core elements of our original investment thesis for Umbrellar when we acquired the business in September 2014.



Icebreaker is a leading designer and marketer of outdoor apparel

Icebreaker

In November 2015, Fund IV took a significant minority stake in Icebreaker, a leading designer and marketer of outdoor apparel focused on merino wool. Icebreaker offers a diverse set of products using natural and sustainable fibres including next-to-skin products and outer and mid-layers. It employs a multi-channel distribution model incorporating wholesale, e-commerce and company-owned stores to service primary markets in Europe, Canada, United States, New Zealand and Australia.

The company has a very high quality management team led by ex-CEO of Air New Zealand, Rob Fyfe, and a management team comprising executives from many of the world's leading apparel companies. Many of this management team have been hired very recently as Icebreaker seeks to improve its profit margins and accelerate its overseas growth.

Icebreaker is one of New Zealand's most iconic brands and fits well into Pencarrow's strategy of investing in New Zealand-based emerging global champions.

Since our investment, management have undertaken a number of key initiatives to improve gross margin across the business including expanding its supplier base, assessing moving to a finished goods model for some core products, undertaking a freight tender, reducing discounting, assessing in-market pricing positioning and improving product engineering to reduce manufacturing costs. Management are also strongly focused on inventory reduction and efficient inventory management.



MMC is the leading NZ outsourced fund and investment administration service provider

MMC

In November 2016, the Bridge Fund acquired a 50% stake in MMC, a leading New Zealand outsourced fund and investment administration business with over \$25 billion of clients' funds under administration. MMC is well positioned for strong growth by increasing economies of scale through organic growth, capturing a significant part of the funds management value chain and introducing adjacent services to new and existing clients.

MMC has a history of strong revenue growth and is forecast to increase revenue through a number of strategic growth initiatives which include:

- Securing additional clients in the core fund accounting and unit pricing service primarily those in a rapidly growing Kiwisaver market;
- Providing additional services to both existing and new clients;
- Transitioning further in-house providers to an outsource arrangement driven by an increasingly complex administrative and compliance burden.

Local merger and acquisitions markets remain relatively strong in volatile global market

Market Environment

New Zealand has one of the strongest performing economies in the western world with current year-on-year GDP growth of 3.6% driven by particularly strong growth in construction and tourism along with strong inbound migration.

Growth is expected to continue to be robust in the immediate future and some commentators believe it may even accelerate to above 4% growth. In the meantime, despite this high growth, inflation remains remarkably subdued and continues to be below the 1% to 3% range mandated for the Reserve Bank. As a consequence while most western countries are at the limit of monetary policy easing (and in the case of the United States may look to raise central bank rates soon), New Zealand is in the enviable position of being likely to reduce rather than raise interest rates in the near future in order to assist getting inflation back up into the 1% to 3% band. The very low interest rate environment combined with robust growth is assisting the strength of asset prices as investors seek yields and returns above those available from bank deposits. How long this environment will last and whether we are entering a possible bubble phase for at least some asset types is an open question.

When compared to the wider global environment we believe New Zealand is relatively positively placed. This has been reflected in the New Zealand sharemarket performance which has been one of the strongest and most robust in the western world over the past year or two. Looking forward there are potential risks on the horizon that could trigger a possible downturn in global markets following the long extended lift in asset prices since the nadir of the global financial crisis. How these trigger events might impact New Zealand companies and asset prices is open to question.

We had a recent demonstration of this with the decision of the British electorate in a plebiscite to exit from the European Union (the so-called Brexit) which initially caused a very negative market reaction followed by a quick recovery. The Brexit implementation is yet to play out and could result in further lurches in markets. The result of the US presidential election with the election of Donald Trump also initially took investors by surprise but markets rebounded very quickly following the news.

Barring unforeseen downturns out of the control of New Zealand, we see an ongoing attractive environment in New Zealand for the Fund IV portfolio to continue to build value. While many of the obvious add-on acquisitions have been successfully completed by the portfolio companies we will continue to look for selective opportunities to add value, not just through organic growth, but also through acquisitions where that makes sense. With 95% of committed capital called we have only a small amount of capacity to fund further expansion via equity if needed. The focus is now on deploying the Bridge Fund and with a strong deal pipeline in front of us we expect further new platform investments in the next few months.

Our Team

The Pencarrow team



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