

The Untimely Demise of MFS Pacific Finance Limited

Amongst the numerous investment funds and financial institutions falling victim to the global credit crunch, one that surely need not and should not have succumbed was New Zealand-based MFS Pacific Finance Limited.

Starting life in New Zealand in 1999 as a subsidiary of ASX-listed MFS Limited (now known as Octaviar Limited), an early venture saw the Company take over the name and management of several underperforming Waltus property funds, later followed by an offer of Debenture Stock and Unsecured Notes to the New Zealand public through a registered prospectus. From the outset the Company made clear that funds raised were primarily destined for lending in the broadly diversified Australian property market, with the same interest rates offered in either AUD or NZD reflecting a significant proportion of second or even third mortgage lending. Figures to 30 September 2007 show one third of such lending as lying behind first mortgage advances from MFS Limited's own flagship Premium Income Fund, indicating a common interest between mortgagees. Cash raised in NZD but lent as AUD was hedged back to the New Zealand currency.

Over the next few years, MFS Pacific worked diligently to establish itself within the mainstream New Zealand finance company sector with restructuring in early 2007 placing MFS Pacific Finance under NZX listed MFS New Zealand Limited (38% owned by Australian MFS Limited) the listed entity espousing an aim to become a "substantial player in the New Zealand Financial Services Sector". Such growth was to be achieved largely through paralleling the path of acquisition in the funds management, property and tourism sectors which, by mid 2007, had propelled the ultimate parent, MFS Limited, into an ASX Top-200 position with market capitalisation of over A\$2.8 billion and shareholders' funds around A\$1.6 billion. With funds under management of A\$5.4 Billion, an ambitious target of A\$10 Billion was set for June 2008. During 2007 various leading Australian brokerage research houses valued the MFS Limited ordinary shares from A\$6 to over A\$8 with Macquarie Research estimating a 12 month target of A\$7.15 as late as October 2007.

Put Option

First contained in MFS Pacific's 2005 Prospectus was notice that MFS Limited had entered into an agreement to stand behind the loan investments made by MFS Pacific Finance – the now famous "Put Option". Under terms outlined in the 2005 Investment Statement, MFS Pacific Finance could require the Parent Company to take assignment of any loan or other asset of the Company where any amount due under a loan had been in arrears for three months or more or the current market value of any asset owned by the Company had fallen below the cost paid by the Company for that asset. In summary, if MFS Pacific was to suffer any loss from any loan made by it or asset purchased by it, the Put Option could be exercised and that loss recovered from the Parent. The Put Option was amended in July 2006 to enable any MFS Pacific asset to be assigned at full carrying value. With the NZ Company now paying 1% of total assets as a fee in exchange, the Put Option became commercially as well as legally based.

This formal agreement effectively gave MFS Pacific Finance investors legal recourse to the full financial resources of MFS Limited, in support of both Secured Debenture Stock and Unsecured Notes. By mid 2007 the level of parent MFS Limited shareholder funds had reached a massive A\$1.5 billion. No wonder the relatively generous fixed interest rates on offer of 9.25% secured to over 11% unsecured, attracted widespread support.

MFS Pacific Finance became a significant partner and supporter of financial events around New Zealand, being on hand at major seminars and conferences. Company briefings were open and frank, personnel appeared well informed and competent.

The company seemed to take constructive criticisms on board – such as early disposal of the maligned Waltus name. Details of security type, missing from early communications, were added to later prospectuses. Early attempts to evaluate the Company's liquidity were originally answered by production of a complicated combined line and bar chart purporting to show an excess of assets over liabilities spread over time but, which to this observer at least, seemed to indicate the opposite. However, later financial statements displayed the assets and liabilities maturity profile in the standard tabular format common in New Zealand registered prospectuses with an overall receivables excess over liabilities of about 2.6% claimed for the period ending 30 September 2007. "Past Due" loans were not itemised in prospectuses but said to be included in the 0-6 months assets because the Company could require MFS Limited to acquire these loans at face value if required, under terms of the Put Option. MFS Pacific Finance presented an investment in its debenture stock as, effectively, an investment in MFS Limited with investors and analysts being invited to "look through" the local Company's accounts to the underlying strength of MFS Limited in Australia.

That all changed dramatically in mid January 2008.

So what went wrong?

Casual observers were quick to point the finger at MFS Limited debt levels as being the trigger for its share price crash in January 2008, but such comment fails to recognise that MFS Limited debt was already well documented, even if reaching uncomfortable levels to achieve the gigantic Stella tourism group acquisitions during 2006 and 2007. Indecision over sale or retention of this major asset in view of the global credit crunch may well have contributed to share price decline of about 14% from October 2007 to A\$4 in early January 2008 but this was generally in line with the broad ASX losses over the same interval, so little justification for the ensuing rout can be found here. Markets don't just suddenly react savagely to news that has already been widely known for months.

Further confusion seems to have been generated by suitor City Pacific first showing interest in merging with or acquiring certain financial assets from MFS Limited, then withdrawing, then showing renewed interest, only to withdraw again. City Pacific appears to have problems of its own.

Also, and although flagged in general terms earlier, a Board proposal in early January to address debt by raising A\$550 million from shareholders while splitting the company in two must have contributed to dissatisfaction, it does not fully explain the sudden share price collapse.

No, what really hit out of left field in mid January - vital information unknown previously to the market – was that large shareholders, including Directors, were facing margin calls on shares effectively purchased on deposit, margin calls they were unable to meet. This news appears to have unnerved other substantial holders who quickly joined a rush for the exits. As every highly leveraged property owner knows, a modest fall in the market can wipe out ones equity. Margin traders of shares face the same fate but here the financier, or margin lender, usually demands immediate payment to make good any of the finance provider's losses. Failure to meet such demand may result in immediate sale or confiscation of the leveraged security to limit losses, this being the norm rather than the exception. The decline of MFS Limited shares over several months, in line with market sentiment, was obviously sufficient to trigger margin calls. Dumping of huge volumes on the market, including notifiable directors' holdings, did the rest.

CEO Michael King's conference call on 18 January, following two days of trading halt, was intended to present the separation and cash raising issues but instead oversaw a massive volume of trades, approaching 120 million shares compared to normal volumes between one and five million, and a 69% price collapse to 99 cents where it flat lined into suspension again. See Chart 1 for daily movements. Under questioning, Michael King stated he would not be a "voluntary seller" of MFS shares, leaving open the possibility of being an "involuntary seller" as were directors Michael Hiscock and Paul Manka according to ASX notices. That weekend saw Michael King resign as CEO and the capital raising proposal effectively abandoned. Rapid restructuring in conjunction with asset sales to reduce debt seemed the only and obvious choice for MFS Limited. Three days later, margin financier Tricom Equities, also active in margin trading crisis-hit Allco Finance Group shares, failed to settle for trades with the Australian Stock Exchange and was lucky to be allowed to continue trading.

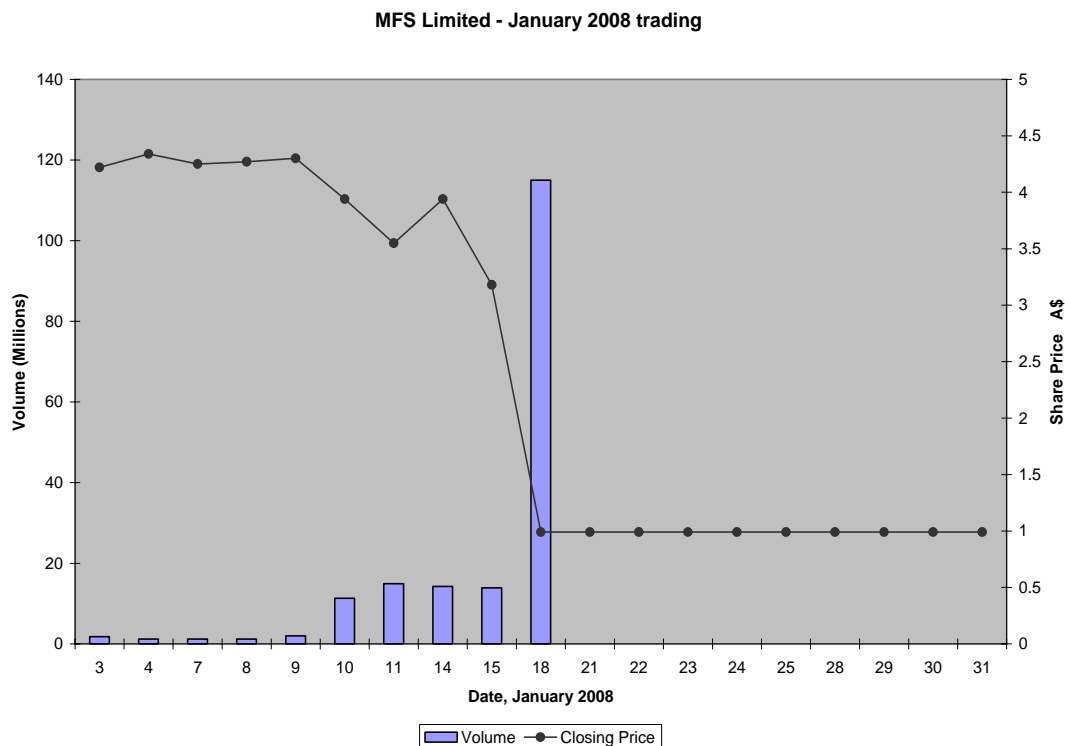


Chart 1. MFS Limited January 2008 trading on ASX

In New Zealand, unnerved debenture holders, the great majority reportedly from MFS’s own advisory group, deserted MFS Pacific Finance en bloc, causing an impossible redemption situation once the request to honour a recent promise of liquidity from MFS Limited went unfulfilled.

In default of repayments due on 31 January 2008, MFS Pacific Finance had no choice but to withdraw its Prospectus, eliminating the right to accept further investments. A moratorium on repayments was proposed to allow an orderly realisation of assets and repayments to investors over time and the dream of becoming a “substantial player in the New Zealand Financial Services Sector” was unnecessarily and prematurely over.

A few deficiencies in the MFS Pacific operation such as initial low capitalisation and a failure to itemise the significant level of past due loans can be identified. The latter was eventually redressed in the September 2007 half year accounts released during January 2008 while the former would need to have been addressed in any case under proposed New Zealand finance company legislation becoming effective over the next two years. Properly handled, neither of these items should have proven problematic in light of the Put Option existence, but both paled in comparison to the margin trading shenanigans in Australia.

Where to from here?

Parent MFS Limited remains suspended from ASX trading while restructuring occurs. In spite of asset sales and the imminent striking of an arrangement to meet obligations to MFS Pacific Finance investors in New Zealand, theoretically at least, assets of the Parent Company remain substantial. Inevitable write downs in the delayed half year accounts to 31 December 2007 should give an indication of the size of the resultant entity (now renamed “Octaviar”) but the 65% sale of Stella Group for A\$1.3 billion equivalent, effectively values that arm at just over \$2 billion, compared to A\$2.5 billion evaluated by analysts earlier. Hence total shareholders’ funds could take a half billion dollar hit from that one item alone. Nevertheless and even if remaining assets were all to be written down by 50%, Octaviar should still manage a theoretical A\$2 –A\$3 per share asset backing in lieu of any new equity injections, compared to the last traded price of 99 cents.

Octaviar shareholders and MFS Pacific Finance investors alike will have been most surprised to learn that major shareholder, Mr. Chris Scott, invited to join the Octaviar Board after threatening to call an Extraordinary General Meeting, holds his own large shareholding subject to a margin loan. Direction of the Octaviar share price, once trading resumes, could well be determined by the fate of Mr. Scott’s large holding. At least he has a powerful incentive to work in the best interests of the Company.

For MFS Pacific Finance investors then, faith in the Put Option deserves to be rewarded. Short term debt within MFS Limited is now largely resolved through application of some of the Stella sale proceeds. In retrospect, pre-emptive exercise of the Put Option would probably have done little except force both companies into receivership. However, the *potential* for exercise places an inescapable obligation on the Parent to support, as required, full repayment to MFS Pacific Finance investors from loans and assets being realised in an orderly fashion under the proposed moratorium. This has got to be an infinitely better arrangement than casting the Company to the receivers.

Perhaps an encouraging pointer can be found in smaller related finance company MFS Boston investors opting for a moratorium on 14 March 2008. Although not having the benefit of a Put Option, MFS Boston intends making quarterly repayments of all capital plus 9% p.a. interest to debenture holders over the next 20 months.

Lessons

Unfortunately MFS Pacific Finance is beyond rescue as an operating unit in its original form and its passing is a genuine loss to the New Zealand finance company sector. In addition to offering investors currency diversification, MFS Pacific carried the potential to set a new benchmark of financial support for finance company borrowings through the “Put Option”. To date no other parent/subsidiary relationship of companies listed on the New Zealand Debentures Exchange has instigated a similar enforceable guarantee. Perhaps the new “Global Credit Crunch” reality will empower investors to demand just that.

In addition, as more intricate trading mechanisms such as margin trading, stock borrowing and short selling evolve, it becomes clear that disclosure of such potentially dangerous practices must become a mandatory requirement imposed by stock exchanges or legislation if markets are to be open and informed. Private investors have quite enough risks to contend with, without the secret avarice of their own company's directors and executives exposing them to even more.

But while the mandatory objective may prove an optimistic goal in the short term, ordinary shareholders and fixed interest investors alike can take their own action immediately, wasting no time in sending the "totally unacceptable" message loud and clear to directors and executives where margin trading is concerned.

Alan King
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