

Optimality in Capital Management

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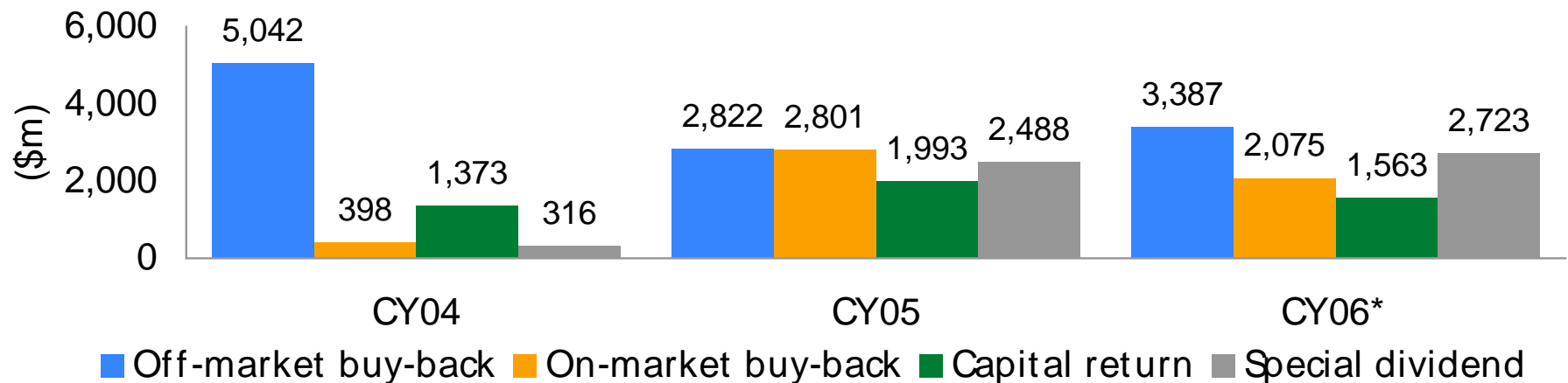
Outline of presentation

- ◆ Current trends in capital management
- ◆ The great buy-back debate
 - optimal use of franking credits
 - but is it fair?
 - share price performance
 - special dividend alternative
 - valid concerns
- ◆ Key tips
- ◆ Questions

Current trends in capital management

- ◆ Off-market buy-backs have become an increasingly popular mechanism to return capital to shareholders
- ◆ Greater focus on dividend payouts
 - use of DRPs as a flexible capital management tool
- ◆ More efficient and aggressive balance sheet management

Total capital returned to shareholders by S&P / ASX 200 companies



Notes: * As at 19 October 2006

1. On-market buy-back totals calculated as the value of shares actually repurchased in each calendar year
2. Special dividends and capital returns declared but not paid are not included in 2006 figures

Share buy-backs—the great debate

The criticisms ...

- ◆ “The main purpose of buy-backs is to prop the stock price”
 - some on-market buy-backs perhaps ...
 - not applicable when buy-back price at large discount to market
- ◆ “The company can’t think of anything better to do with shareholders’ cash”
 - growth initiatives and capital management are not mutually exclusive
 - balance between reinvestment for growth and distributing capital to shareholders
 - imposes additional rigour on capital allocation
- ◆ “Management undertake buy-backs to increase the value of their shares / options”
 - 16 out of the Top 20 ASX-listed companies use Total Shareholder Return (TSR) as a key performance hurdle under senior executive incentive schemes
 - value of ordinary and special dividends paid is always included in the calculation of TSR
 - buy-backs are generally only reflected to the extent of any share price appreciation

Off-market buy-backs—value for franking credits

Dispelling the criticisms

- ◆ ‘Buy-backs are an inequitable way of distributing franking credits’
 - these credits are surplus, if not distributed their value erodes over time
 - no impact on ability to fully frank ordinary dividends, most companies actually increase ordinary dividends in conjunction with implementing an off-market buy-back
 - allow companies to maximise the value of franking credits
 - tender structure ensures the franking credits must be bid for
 - shareholders receive credits in return for accepting a lower buy-back price
 - 14% discount to market price is common
 - maximises EPS enhancement and long term value creation

**Off-market buy-backs maximise
the value of franking credits for all shareholders**

Off-market buy-backs—no impact on ordinary dividends

- ◆ On average, companies that had undertaken an off-market buy-back increased their ordinary dividends both with and after the off-market buy-back
 - 24% increase with announcement of the buy-back
 - 18% increase following the buy-back

Dividend movement at profit results announcement

| (cps) | Buy-back announced | Profit results with buy-back announcement | | | Profit results subsequent to buy-back completion | | |
|----------------|--------------------|---|------|-----------|--|--------|-----------|
| | | Previous DPS | DPS | % mvmt | Previous DPS | Div. 2 | % mvmt |
| CML 2006 | 23-May-06 | – | – | – | 17.0 | 22.5 | 32 |
| SGB 2006 | 16-Dec-05 | – | – | – | 67.0 | 74.0 | 10 |
| BHP 2006 | 15-Feb-06 | 17.1 | 23.7 | 39 | 19.2 | 24.2 | 26 |
| WBC 2005 | 2-Nov-05 | 44.0 | 51.0 | 16 | 49.0 | 56.0 | 14 |
| CML 2005 | 17-Mar-05 | 14.0 | 16.3 | 16 | 15.0 | 17.0 | 13 |
| RIO 2005 | 11-Mar-05 | – | – | – | 45.5 | 50.6 | 11 |
| Average | | | | 24 | | | 18 |

Note: The % movement represents the movement from interim to interim dividend or final to final dividend at each respective profit results announcement. Special dividends are not included.

Discounts achieved in recent buy-back tenders

| Buy-back | Size of buy-back (\$m) | % issued shares bought back | % scale back | Dividend component as % of the buy-back price | Final buy-back price (\$) | Prem/(disc) to close on last day of buy-back (%) |
|--------------------------|------------------------|-----------------------------|--------------|---|---------------------------|--|
| CBA–Mar 04 | 532 | 1.5 | – | 60 | 27.50 | (17.2) |
| BHP Billiton Ltd–Apr 06 | 2,250 | 2.7 | 63.5 | 91 | 23.45 | (16.3) |
| Westpac–Jun 04 | 559 | 2.1 | – | 72 | 14.50 | (16.1) |
| Rio Tinto Ltd–May 05 | 1,003 | 8.7 | – | 89 | 36.70 | (15.6) |
| Westpac–Dec 05 | 1,000 | 2.8 | 53.8 | 79 | 19.13 | (14.6) |
| St. George–Feb 06 | 300 | 2.2 | 70.8 | 75 | 25.69 | (14.5) |
| Coles Myer–Jul 06 | 837 | 6.4 | – | 71 | 10.23 | (14.0) |
| Telstra–Nov 04 | 750 | 3.0 ¹ | 11.3 | 63 | 4.05 | (14.0) |
| BHP Billiton Ltd–Nov 04 | 2,271 | 4.8 | – | 83 | 12.57 | (13.0) |
| IAG–Jun 04 | 414 | 5.6 | – | 60 | 4.40 | (12.2) |
| BlueScope Steel–Apr 05 | 200 | 3.5 | – | 60 | 7.75 | (11.7) |
| Corporate Express–Apr 05 | 35 | 2.8 | – | 95 | 5.60 | (11.1) |
| Coles Myer–May 05 | 585 | 5.7 | – | 64 | 8.30 | (9.2) |
| AVERAGE | | | | | | (13.8) |

Notes:

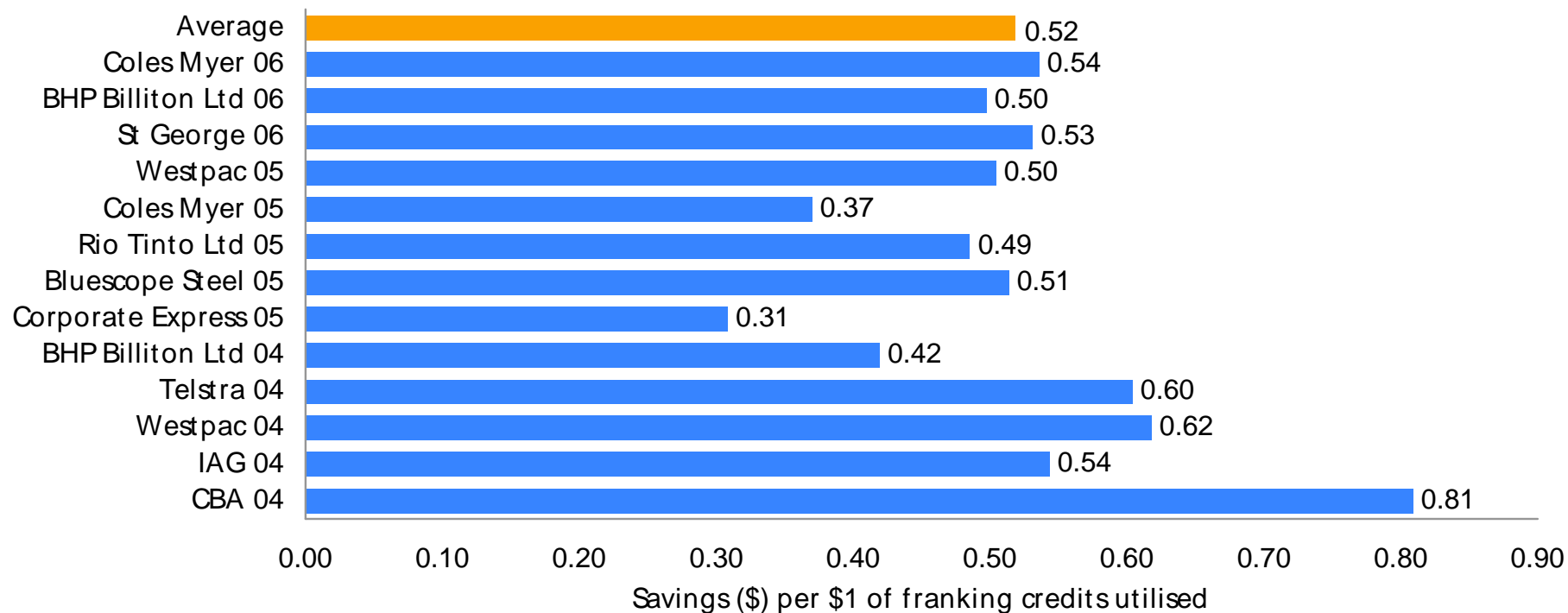
1 Excluding shares held by the Commonwealth government

■ UBS advised on the buy-back

Off-market buy-backs—value for franking credits

- ◆ Value attributed to undistributed franking credits
 - no real consensus
 - attributing 100% value is unrealistic, particularly where share register includes foreign shareholders
 - discount for time it takes to distribute franking credits to shareholders

Savings per \$1 of franking credits distributed under the buy-back

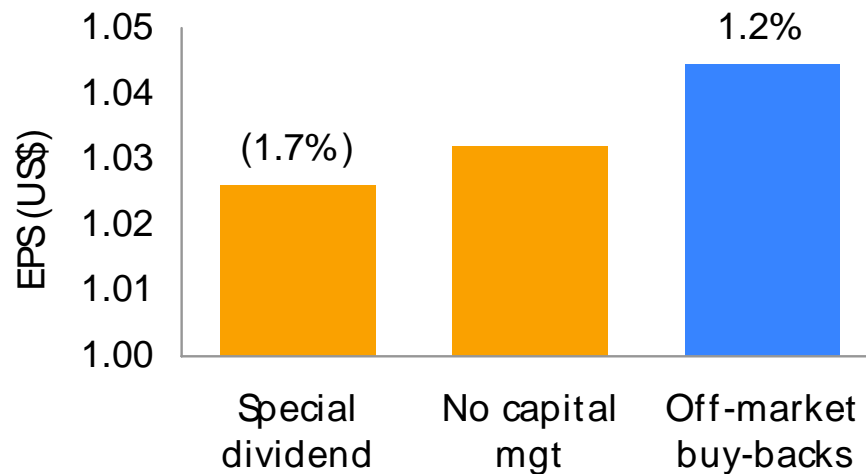


Off-market buy-backs—EPS impact

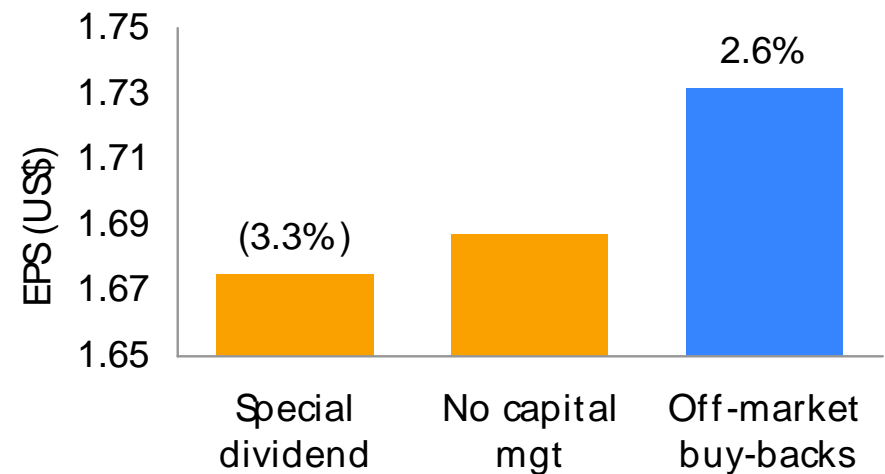
EPS impact of off-market buy-back versus special dividend

- ◆ BHP Billiton Ltd completed \$2.27bn off-market buy-back in Nov 2004 and \$2.25bn off-market buy-back in April 2006
- ◆ Reduction in share count following these buy-backs resulted in EPS accretion of 1.2% in FY05 and 2.6% in FY06
- ◆ Payment of a special dividend would have diluted EPS by 1.7% in FY05 and 3.3% in FY06

FY05



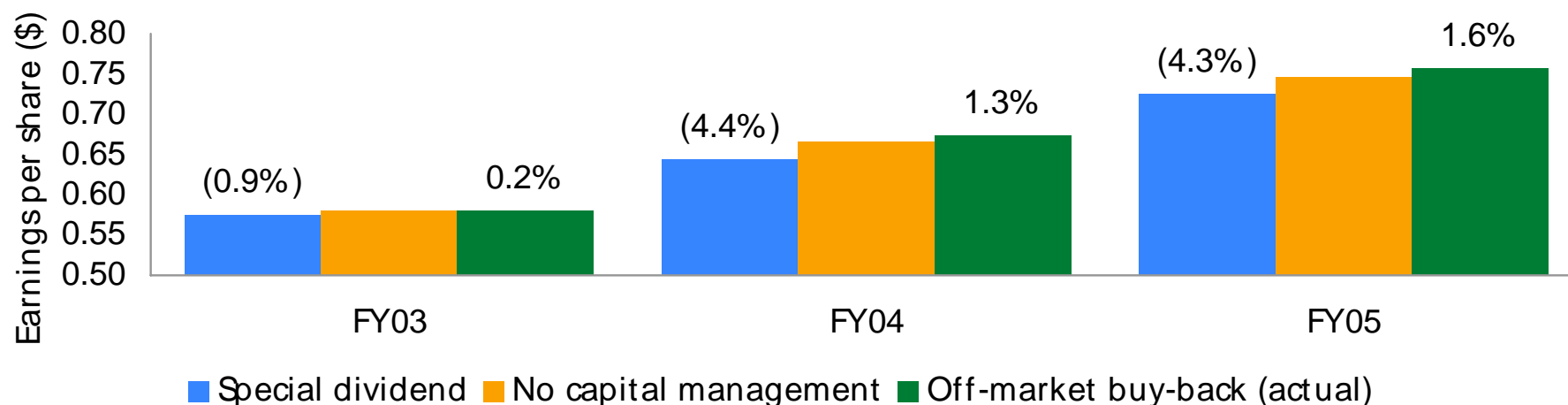
FY06



Source: UBS estimates
Notes: Assumes a funding cost of 5%

Off-market buy-backs—EPS impact

- ◆ In April 2003, Woolworths completed an off-market buy-back of \$532m of ordinary shares
- ◆ Reduction in share count following the buy-back resulted in EPS accretion of 1.3% in FY04 and 1.6% in FY05
- ◆ Payment of a special dividend would have diluted EPS by 4.4% in FY04 and 4.3% in FY05



Source: UBS estimates
Notes: Assumes a funding cost of 6%

Off-market buy-backs maximise EPS enhancement

Off-market buy-backs—equality and fairness

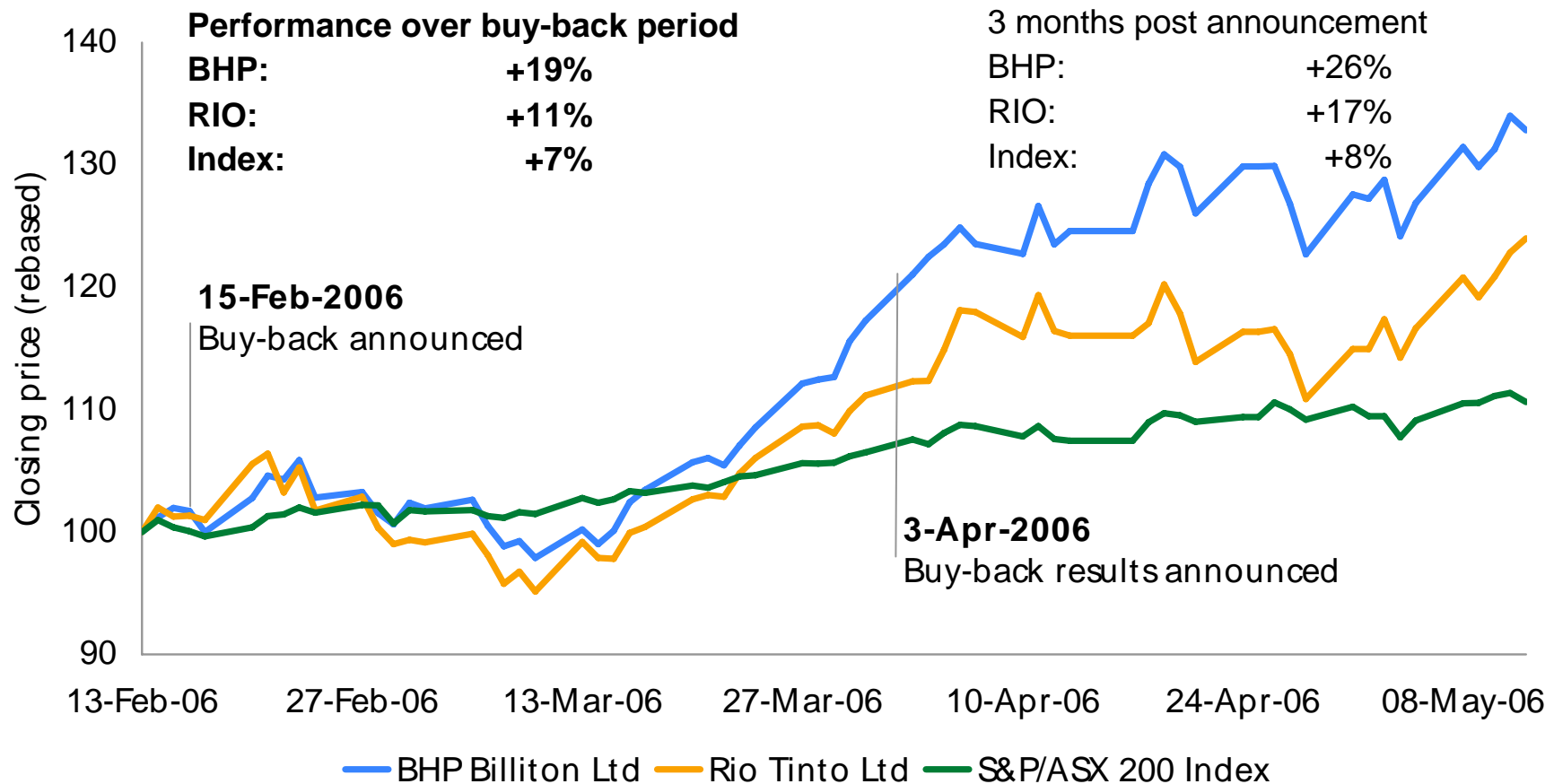
These buy-backs are criticised as favouring shareholders on low tax rates

- ◆ Value of franking credits is dependent on individual's tax position
 - marginal tax system itself discriminates between taxpayers
 - payment of a fully franked special dividend would have exactly the same effect
- ◆ All shareholders have the opportunity to sell their shares into the buy-back and if an Australian resident, receive a fully franked deemed dividend
- ◆ Non-participating shareholders benefit from increased EPS as a result of the reduced number of shares on issue
- ◆ Share prices generally trade higher after announcement and completion of off-market buy-backs

Both participating and non-participating shareholders benefit from these buy-backs

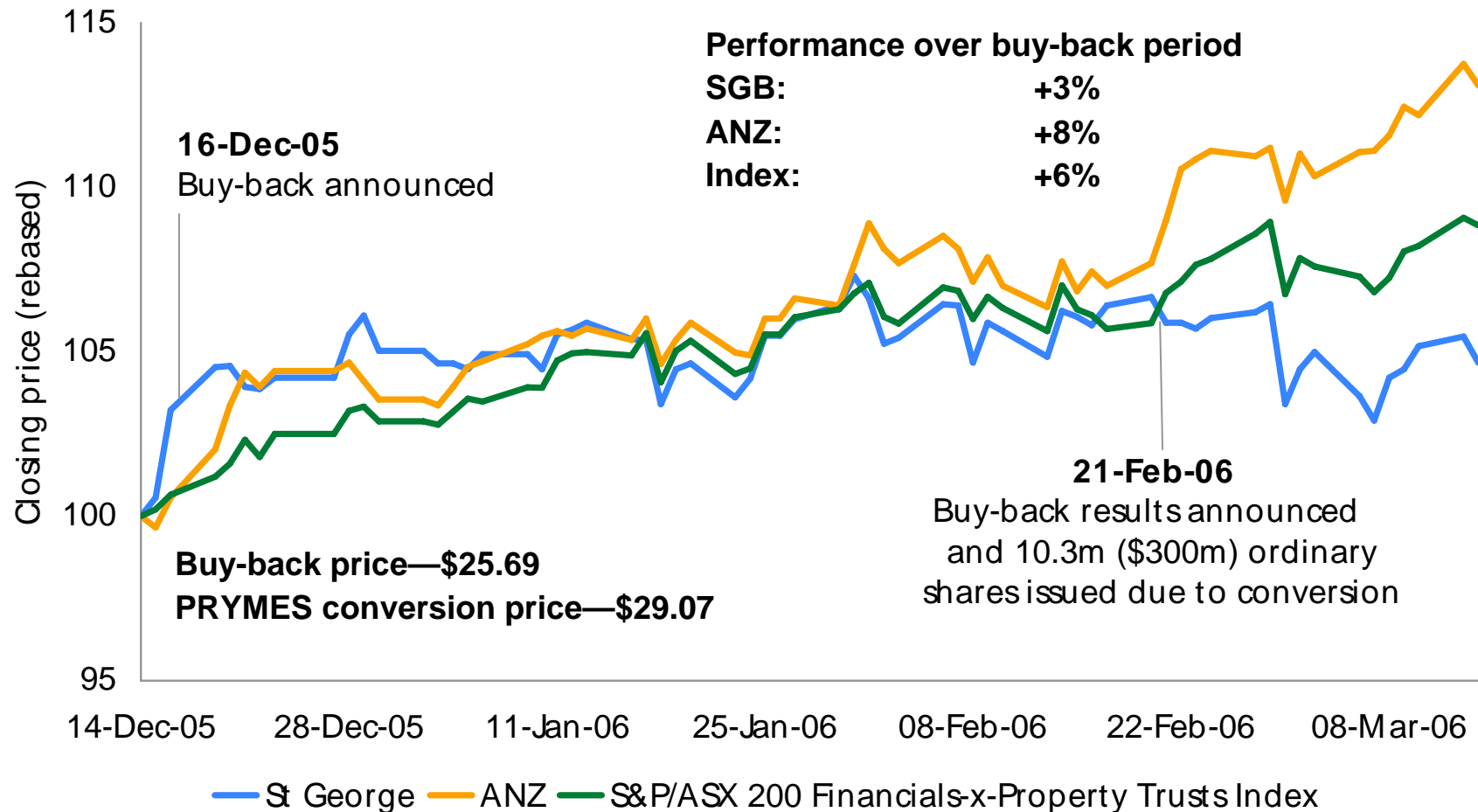
Share price performance around off-market buy-backs

BHP Billiton Ltd (2006)



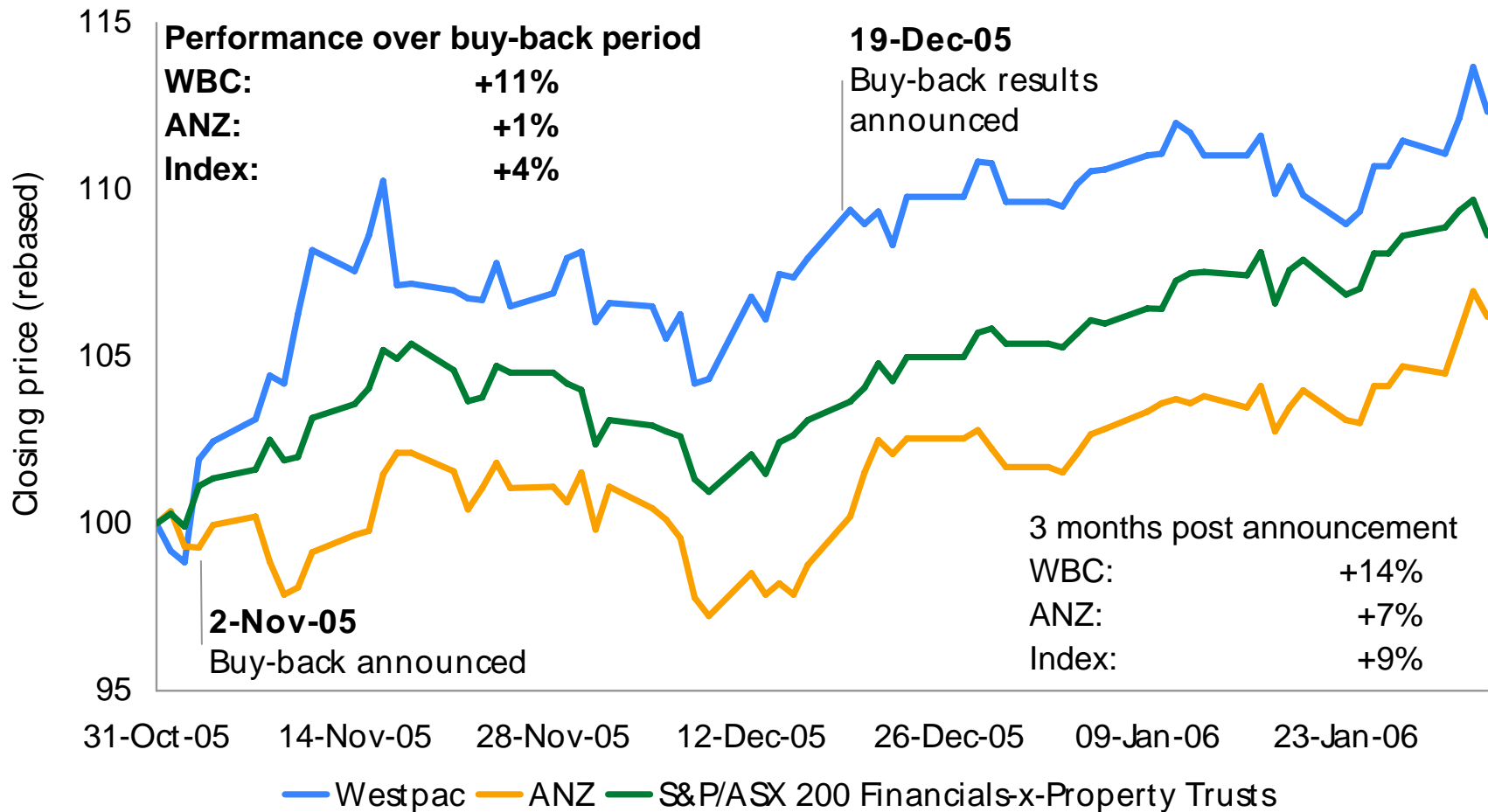
Off-setting dilution from hybrid conversion

St George Bank (2006)



Share price performance around off-market buy-backs

Westpac Banking Corporation (2005)



Special dividend alternative

- ◆ Special dividends are typically paid by companies where buy-backs are problematic:
 - a major shareholder, low free float (e.g. Lion Nathan)
 - a very high PE multiple (e.g. Perpetual)
 - size of return is not sufficient to justify implementation costs of off-market buy-back (e.g. Watty)
 - foreign ownership restrictions

Advantages

- ◆ Simple to implement
- ◆ Easily understood and liked by retail shareholders

Disadvantages

- ◆ No choice in participation so value of franking cannot be maximised
- ◆ EPS dilutive
- ◆ One-off initiative generating no long term benefits for the company

Off-market buy-backs—regulation

- ◆ ‘Off-market buy-backs breach s.254W of Corporations Act’
 - only a “deemed” dividend for Australian tax purposes
 - ASIC and top law firms all agree off-market buy-backs don’t breach the law
- ◆ ASIC Media Release (March 2005) responded to buy-back debate
 - greater disclosure on why a buy-back is appropriate
 - Directors must be satisfied buy-back is in best interests of company as a whole
- ◆ Board of Taxation review
 - whether tax treatment of off-market buy-backs should be changed
 - aim to increase certainty for businesses and reduce compliance costs
 - report in second half of 2007

Share buy-backs—valid concerns

- ◆ Market price relative to fair value and buy-back price
 - don't buy at the top of the cycle
 - management should have confidence future earnings are increasing
- ◆ Avoid “lack of growth opportunities” perception
 - balance between reinvestment for growth and distributing capital to shareholders
- ◆ Impact on market capitalisation
 - equity market capitalisation will reduce if no re-rating
 - reduces free float
- ◆ Delay the buy-back if there is a risk of earnings downgrade or surprise write-off
- ◆ Avoid pricing periods and periods overlapping sensitive corporate actions
- ◆ Insider trading prohibition—no material, confidential, price sensitive matters

Key tips in conclusion ...

- ◆ Beware of using high dividend payouts to compensate for lack of earnings growth
- ◆ Capital management initiatives will not overcome the negative impact of poor earnings performance or a disappointing earnings outlook
- ◆ Ensure the capital management initiative is tax efficient for shareholders
- ◆ Buy-back shares at the lowest possible price
- ◆ Avoid perception company has a lack of growth opportunities

... clearly demonstrate the company has balance sheet flexibility to make acquisitions and invest in growth initiatives in conjunction with returning capital to shareholders

Any questions?