



# Memorandum

**Re:** Summary of changes to incentive fees in the Management Agreement<sup>A</sup>

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## 1. Summary

Infratil and Morrison have agreed amendments to the incentive fee provisions in the Management Agreement. The amendments provide for:

- annual 'offsetting' of over and under performance between the three categories of incentive fees for international assets<sup>B</sup>;
- carrying forward the impact of underperformance for unrealised assets (and in limited circumstances for realised assets); and
- replacing the binary nature of the deferred tranche payments with a more proportionate approach.

No changes have been made to the base management fees or how the underlying incentive fee calculations are performed. Incentive fees can still only be earned on international assets, and the hurdle for triggering payment of an incentive fee remains at a fixed 12% p.a. with any fee calculated as 20% of outperformance above that hurdle.

## 2. Overview of the Incentive Fees

There are three categories of incentive fees that may be payable on international assets:

### Initial Incentive Fee

The initial incentive fee is based on the 31 March fair market value of any international asset that Infratil has held continuously for between two and three years. These international assets are grouped together and the fee is calculated at 20% of the outperformance of those assets against a benchmark of 12% p.a. after tax, compounding.

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<sup>A</sup> **Important notice:** This explanatory memorandum is provided for information purposes only. It is necessarily high-level and does not encompass full details of the amendments made to the Management Agreement. Readers are strongly advised to refer to the relevant provisions of the Management Agreement – and in particular clauses 9.3 and 9.4 – for full details of the how incentive fees are now calculated and paid. No person should rely on the contents of this memorandum as a complete and accurate summary, and any reliance on this memorandum is at the reader's own discretion and risk. Nothing in this memorandum constitutes financial, legal, tax or other advice. Infratil does not have any obligation to update or revise this memorandum. Infratil excludes, to the maximum extent allowable at law, its liability for any person relying on this memorandum and none of Infratil or its associated parties or advisers will be liable for any inaccuracies, errors, or omissions in this memorandum or for any actions taken in reliance on its content.

<sup>B</sup> For these purposes, international assets are portfolio entities that have at least 50% of their assets domiciled outside New Zealand.

After applying the new offset mechanism, any initial incentive fee is paid after it is calculated at the end of the financial year.

#### Annual Incentive Fee

The annual incentive fee is based on the 31 March fair market value of any international assets held continuously for at least three years. These international assets are grouped together and the fee is calculated on the same basis as the initial incentive fee.

After applying the new offset mechanism, the annual incentive fee is paid in three annual instalments. The first is paid after it is calculated at the end of the financial year. The second and third instalments are paid in the second and third years after they were earned, subject to any adjustment under a new proportionate adjustment mechanism.

#### Realised Incentive Fee

The realised incentive fee is calculated on the realised gains from the sale of international assets (grouped together) at 20% of the outperformance (since the last valuation date) against a benchmark of 12% p.a. after tax, relative to the most recent 31 March valuation.

After applying the new offset mechanism, any realised incentive fee is paid after it is calculated at the end of the financial year.

### **3. Changes to the Management Agreement**

#### Offsetting and carrying forward

Separate initial, annual and realised incentive fees have been retained, including the deferred tranche payment structure for the annual fee, but negative performance in one fee category is now offset against the others before incentive fees are paid.

To the extent that the aggregate incentive fees earned in a year do not fully extinguish the negative performance drag in the initial or annual fees, the negative balance is carried forward and offset against future years' performance.

These amendments have the effect of creating a modified high-water mark, meaning Morrison won't receive incentive fees from one fee category without adjusting for any negative balances in other fee categories and does not earn incentive fees on the recovery of any underperformance of a fee category.

Realised incentive fee outcomes (whether positive or negative) are also included in the offsetting mechanism in the current year. Recognising that these fees are directed at incentivising well-managed portfolio composition, the default position is that any residual deficits relating to the realised asset are then written off and are not carried forward into the following year's calculation (as such residual deficits would have been treated under the previous approach). However, where a

realised asset has generated a negative realised fee, but a net positive fee in the two prior financial years, a 'wash-up' applies, essentially to recover the lower of those amounts adjusted for offsets that have already reduced amounts paid to the Manager.

#### The Wash-up

In respect of each realised asset that meets the test (i.e. it has generated a negative realised fee, but a net positive fee in the two prior financial years; referred to as a 'qualifying asset'), a negative amount may be carried forward to the following year, calculated as follows:

- (a) the lower (on an absolute basis) of (i) the net positive initial and/or annual fee generated by that qualifying asset in the prior two years and (ii) the negative realised fee generated by that qualifying asset, *less*
- (b) a proportionate amount (where the proportion is calculated based on that qualifying asset's proportionate contribution to the total negative realised incentive fees in that year) of amounts that have already been applied as an offset against the negative realised fees (being positive initial, annual or realised fees or tranche losses, as described below) under the offsetting referred to above, and therefore not paid to Morrison.

Any remaining negative amount relating to realised assets that is not carried forward under the 'wash-up' is written off (previously all of the negative amount would have been written off).

#### Replacing the hair trigger with proportional loss

Given that negative performance is now carried forward, a proportionate approach is appropriate with respect to the separate calculation of whether the deferred annual fee tranches (for previous years' annual fees) remain payable in the event of subsequent lower valuations.

Previously, 100% of a deferred tranche of any annual fee generated in a year would have been forfeited by Morrison if the valuation of the relevant assets was less than the valuation when the fee was generated, even by \$1 (the 'hair trigger'). As part of the offset and carry forward mechanisms, Infratil has agreed that only a proportionate amount of a deferred tranche will be forfeited.

Specifically, if the total valuation of the relevant assets for an accrued annual fee falls in year two, tranche two of that deferred annual fee is reduced by the proportion of that decrease, relative to the valuation increase that gave rise to the annual incentive fee. The same approach would then be taken for tranche three of the relevant annual incentive fee, measured at the time that tranche would be payable. The proportionate loss test is a separate calculation to the calculation of the following year's annual incentive fee; it is a test for whether an accrued fee tranche is payable.

For example, if the valuation increase that gave rise to the annual incentive fee was NZ\$30 million and, in the following year, the total valuation of the relevant assets is NZ\$10 million lower, then tranche two would be reduced by 33% (\$10m/\$30m). The same calculation is repeated for tranche three the following year, measured at the time that tranche would be payable.

In situations where the proportionate loss mechanism applies, the changes to permit offsetting between fee categories and carrying forward of losses described above are also likely to apply. Any proportionate reduction from the proportionate loss mechanism is offset against any applicable negative amounts carried forward from the period, so that there is no double counting.

*Application of the changes and termination*

The changes apply for fees relating to FY23 and ongoing. The new proportionate loss mechanism is applied progressively from FY24 when the first test of the FY23 fees occurs.

Infratil also has the option to terminate the changes and revert back to the previous arrangement at a later date (approximately 5 years).