Michael Hill International Limited

Appraisal Report

In Respect of the Issue of Options to Michael Parsell

October 2010

Index

Section **Page**

1. Introduction

1.1 Background

Michael Hill International Limited (**MHI** or the **Company**) owns the brand *Michael Hill* and operates a retail jewellery chain of stores in Australia, New Zealand, Canada and the United States.

The Company had its origins in 1979 when Michael Hill and Christine Hill opened their first store in Whangarei. MHI grew steadily, expanding to 10 stores by 1987 and now has 53 stores in New Zealand.

MHI expanded into Australia in 1987, opening 4 stores in 4 weeks. It now has 141 stores throughout Australia in Western Australia, South Australia, Victoria, Australian Capital Territory, New South Wales and Queensland.

In 2002, the Company expanded into Canada, opening its first stores in Vancouver. It now has a presence right across Canada in British Columbia, Alberta, Manitoba and Ontario.

In 2008, the Company entered the United States market by acquiring 17 stores in Illinois and Missouri. The Company decided in 2010 to consolidate to a smaller platform of 9 stores in the Chicago area.

As at 30 June 2010, MHI had a total of 232 stores - 53 in New Zealand, 141 in Australia, 29 in Canada and 9 in the United States. The Company employs over 2,000 permanent staff in retail sales, manufacturing and administration.

MHI shares were listed on the main equities security market (**NZSX**) operated by NZX Limited (**NZX**) in 1987. The Company had a market capitalisation of $272 million as at 14 October 2010 and audited equity of $160 million as at 30 June 2010.

1.2 Director Options

MHI proposes to issue a total of 2,000,000 options to its executive director and chief executive officer (**CEO**) Michael Parsell (the **Director Options**), subject to shareholder approval. The Director Options are in 5 tranches and vest over a 3 year period.

Director Options

Tranche	No. of Options	Vesting Date	Expiry Date	Exercise Price
1	400,000	Nov 2010	30 Sep 2019	$0.94
2	400,000	Nov 2010	30 Sep 2020	$0.88
3	400,000	Sep 2011	30 Sep 2021	VWAP + 30%
4	400,000	Sep 2012	30 Sep 2022	VWAP + 30%
5	400,000	Sep 2013	30 Sep 2023	VWAP + 30%
	2,000,000			

VWAP: Volume weighted average share price

The terms of the Director Options are set out in an Option Agreement between MHI and Mr Parsell dated 18 December 2009 (the **Director Options Agreement**). The key terms of the Director Options are:

- the Director Options are granted in consideration for the performance of Mr Parsell's duties as CEO of the Company
- each tranche of the Director Options shall vest in Mr Parsell on the respective vesting date, provided Mr Parsell is employed by the Company on such date and that he has, in the opinion of the Company, duly and faithfully carried out his duties and obligations to the Company
- the exercise price for each tranche of the Director Options is calculated at 30% above the VWAP in the 20 business days following the announcement of the Company's annual results (usually in August) for the year in which the options vest (other than tranche 1 which was based on the announcement of the 2009 financial results). The exercise price for tranche 1 is $0.94 and $0.88 for tranche 2
- the exercise period for each tranche of the Director Options is approximately 5 years, commencing approximately 5 years after the options vest (as set out in the following table)
- the expiry date for each tranche of the Director Options is approximately 10 years after the options vest (as set out in the following table)
- each option entitles Mr Parsell to subscribe for 1 ordinary share in the Company
- a minimum of 50,000 options may be exercised at any one time and any exercise must be in multiples of 50,000 options
- the exercise price or the number of shares issued (as appropriate) will be adjusted if the Company undertakes any capital reconstruction such as a rights issue, bonus issue, amalgamation, consolidation, subdivision, reduction or return of capital
- Mr Parsell may immediately exercise any vested options if there is a transaction involving a change in the control of more than 50% of MHI's shares such as an amalgamation, merger or acquisition of the Company or an issue of shares or a sale of the whole or a substantial part of MHI's business
- in the event of a takeover offer or amalgamation proposal, the Company's directors, with the agreement of Mr Parsell, may vary any of the terms of the Director Options so as to facilitate Mr Parsell's participation in the proposal
- if Mr Parsell's employment is terminated for any reason other than fraud or dishonesty, Mr Parsell may exercise any vested Director Options within 3 months of the termination date, irrespective of whether the options are entitled to be exercised
- the Director Options are not transferable without the Company's prior written consent
- the Director Options lapse if they are not exercised by the respective expiry dates for each tranche
- the issue of the Director Options is conditional on shareholder approval.

The vesting dates, exercise periods and expiry dates for the 5 tranches of the Director Options are set out below.

Exercise Periods and Expiry Dates			
Tranche	**Vesting Date**	**Exercise Period**	**Expiry Date**
1	Nov 2010	Between the date that the Company's annual results for the year ending 30 June 2014 are announced and 30 September 2019	30 Sep 2019
2	Nov 2010	Between the date that the Company's annual results for the year ending 30 June 2015 are announced and 30 September 2020	30 Sep 2020
3	Sep 2011	Between the date that the Company's annual results for the year ending 30 June 2016 are announced and 30 September 2021	30 Sep 2021
4	Sep 2012	Between the date that the Company's annual results for the year ending 30 June 2017 are announced and 30 September 2022	30 Sep 2022
5	Sep 2013	Between the date that the Company's annual results for the year ending 30 June 2018 are announced and 30 September 2023	30 Sep 2023

1.3 Regulatory Requirements

Listing Rule 7.3.1 of the NZSX Listing Rules states that no Issuer shall issue any Equity Securities unless the precise terms and conditions of the specific proposal to issue those Equity Securities have been approved by separate resolutions (passed by a simple majority of votes) of holders of each Class of Quoted Equity Securities of the Issuer whose rights or entitlements could be affected by that issue.

Listing Rule 6.2.2(b) requires an Appraisal Report to be prepared where a meeting will consider a resolution where more than 50% of the securities to be issued will be acquired by directors of the Issuer.

Shareholders will vote on an ordinary resolution in respect of the Director Options at MHI's annual meeting on 5 November 2010 (resolution 4). Only the Company's shareholders not associated with Mr Parsell (the **Non-associated Shareholders**) may vote on the resolution.

1.4 Purpose of the Report

The directors of MHI not associated with Mr Parsell (the **Independent Directors**) have engaged Simmons Corporate Finance Limited (**Simmons Corporate Finance**) to prepare an Appraisal Report on the fairness of the Director Options in accordance with Listing Rule 6.2.2(b).

Simmons Corporate Finance was approved by NZX on 12 July 2010 to prepare the Appraisal Report.

Simmons Corporate Finance issues this Appraisal Report to the Independent Directors for the benefit of the Non-associated Shareholders to assist them in forming their own opinion on whether to vote for or against the resolution in respect of the Director Options.

We note that each shareholder's circumstances and objectives are unique. Accordingly, it is not possible to report on the fairness of the Director Options in relation to each shareholder. This report on the fairness of the Director Options is therefore necessarily general in nature.

The Appraisal Report is not to be used for any other purpose without our prior written consent.

2. Evaluation of the Fairness of the Director Options

2.1 Basis of Evaluation

Listing Rule 1.7.2 requires an Appraisal Report to consider whether the consideration and the terms and conditions of the Director Options are fair to the Non-associated Shareholders.

There is no legal definition of the term *fair* in New Zealand in either the NZSX Listing Rules or in any statute dealing with securities or commercial law.

In our opinion, the Director Options will be fair to the Non-associated Shareholders if:

- the options granted to Mr Parsell under the Director Options represent a fair level of remuneration to Mr Parsell
- the terms and conditions of the Director Options are fair.

We have evaluated the fairness of the Director Options by reference to:

- the rationale for the Director Options
- the terms and conditions of the Director Options
- the value of the Director Options to Mr Parsell
- the impact of the Director Options on shareholding levels
- the impact of the Director Options on MHI's share price.

Our opinion should be considered as a whole. Selecting portions of the evaluation without considering all the factors and analyses together could create a misleading view of the process underlying the opinion.

2.2 Opinion on the Fairness of the Director Options

In our opinion, after having regard to all relevant factors, the consideration and the terms and conditions of the Director Options are fair to the Non-associated Shareholders.

The basis for our opinion is set out in detail in sections 2.3 to 2.10. In summary, the key factors leading to our opinion are:

- the rationale for the Director Options is sound as it seeks to provide a long-term incentive to Mr Parsell that aligns his interests with the Non-associated Shareholders
- the options are issued *out of the money* (ie the exercise price is higher than the current share price). The Director Options will only have value to Mr Parsell if the Company's share price is at least 30% higher at the exercise date than when the options were granted
- the options vest in 5 tranches over a 3 year period to September 2013. Each tranche can only be exercised in the period commencing approximately 5 years after their vesting date and ending approximately 10 years after they vest, thus aiding in the retention of Mr Parsell

- the overall remuneration level for Mr Parsell is reasonable, albeit it is at the upper end of the range of market remuneration for the role when the value of the Director Options is taken into account
- the dilutionary impact of the Director Options on Non-associated Shareholders is negligible at approximately 0.5%
- the Director Options are unlikely to have any material impact on MHI's share price or the liquidity of its shares.

2.3 Background to the Director Options

Mr Parsell commenced employment with MHI in 1981. He was appointed to the board of directors in 1989, made joint managing director in 1995 and CEO in 2000.

His employment terms are recorded in an individual employment agreement dated 30 September 2005 (the **CEO Employment Agreement**).

Mr Parsell receives a base salary, superannuation contributions and an annual bonus based on performance. In addition, he is entitled to long-term incentive remuneration in the form of the Director Options.

The 2,000,000 Director Options will be in addition to 2,000,000 options that Mr Parsell currently holds, which were granted to him on 7 November 2007 following shareholder approval.

2.4 Rationale for the Director Options

MHI has from time to time granted options to its senior executives, including Mr Parsell, as set out in section 2.8.

The Independent Directors resolved on 5 November 2009 to grant the Director Options to Mr Parsell, subject to shareholder approval. The Independent Directors are of the view that a part of Mr Parsell's remuneration should be linked to the value he creates for the Company's shareholders through increases in share price. The Independent Directors consider that the issue of the Director Options helps to achieve this objective as the options will only have value to Mr Parsell if the Company's share price increases by at least 30% between when the options are granted and when they are exercised.

In general terms, companies provide equity-based long-term executive incentive remuneration to tie executives' remuneration to the annual and long-term financial performance of the company and to align the interests of the executives with shareholders. Key benefits to the company include:

- equity-based long-term executive incentive remuneration helps to attract and retain top executives
- it enables executives to build equity ownership in the company
- executives' interests are more closely aligned with shareholders' interests.

There has been growing criticism in New Zealand and abroad in respect of the equity-based incentive remuneration. The criticisms centre around:

- the lack of performance hurdles and/or inadequate explanation of performance hurdles
- the length of term for the equity-based incentive remuneration being too short and hence not aligning with shareholder interests
- already generous remuneration for executives.

In our view, the rationale for the Director Options as a component of Mr Parsell's remuneration package is sound:

- it aims to provide a long-term incentive - spanning up to potentially 13 years (based on the expiry date of tranche 5), thus aiding in the retention of Mr Parsell
- it is designed to align the interests of Mr Parsell with those of the Company's shareholders by issuing the options *out of the money*.

However, we note that Mr Parsell already has a strong alignment of interests with the Non-associated Shareholders as he is the 9th largest shareholder in the Company, holding 1.53% of the Company's shares. Therefore it is questionable as to whether the Director Options provide any significant incremental incentive to Mr Parsell to enhance the value of the Company.

2.5 Terms of the Director Options

Positive Features

We consider the following terms of the Director Options are positive features of the Director Options:

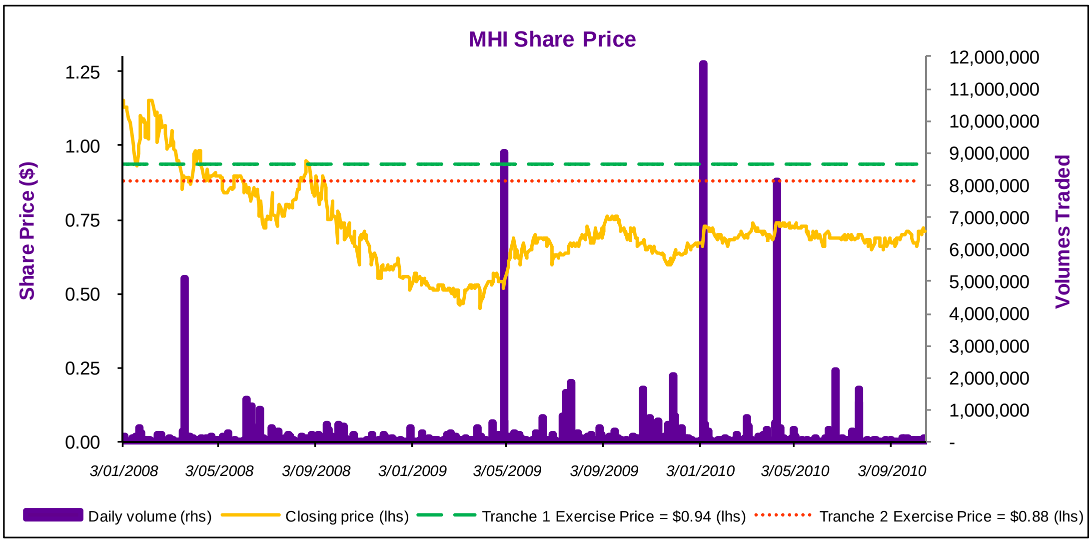
- the options being issued *out of the money*
- the options vest over 3 years
- the exercise period of the options is over a 5 year period between approximately 5 and 10 years after they vest
- the options are not transferable.

Options are out of the Money

The options granted to MHI's senior executives in the past 3 years have been issued with an exercise price set at 30% above the VWAP in the 20 business days following the announcement of the Company's annual results for the year in which the options vest. The exercise price for the Director Options is calculated on the same basis.

Accordingly, the Director Options will be granted *out of the money*. In order for Mr Parsell to derive value from the Director Options, the Company's share price will need to appreciate by at least 30% by the time he exercises the options, in which case all current shareholders in the Company will benefit from an appreciation in the value of their investments in MHI.

The graph below shows that MHI's share price steadily decreased from $1.13 on 4 January 2008 to a low of $0.45 on 31 March 2009. Since then, MHI shares have increased to its current price of $0.71 and the shares have traded at a VWAP of $0.67 in the past year and $0.70 in the past month.



Based on recent prices, tranches 1 and 2 of the Director Options, which will vest in November 2010, continue to be *out of the money*.

3 Year Vesting Period

The Director Options vest in 5 tranches over a 3 year period between November 2010 and September 2013. The vesting of the options in tranches over a 3 year period is likely to provide a stronger retention mechanism than if the options all vested at once.

4 to 13 Year Exercise Period

Each tranche of the Director Options can be exercised between approximately the 5th and the 10th anniversaries of their grant date (other than tranche 1 which can be exercised between approximately the 4th and the 9th anniversaries of its grant date). The earliest the tranche 1 options can be exercised is August 2014 and the latest that the tranche 5 options can be exercised is 30 September 2023.

Therefore the benefits to be derived by Mr Parsell will not begin to accrue until, at the earliest, approximately 4 years from now and will possibly accrue over a further 9 year period to September 2023. This provides a long-term incentive to Mr Parsell and may also aid in his retention.

Non Transferability

The Director Options cannot be freely transferred by Mr Parsell. Therefore he cannot readily realise value for the options in the near term. Furthermore, if Mr Parsell ceases to be an employee of the Company, the options will lapse if they are not exercised within 3 months of his ceasing to be an employee.

Both these terms serve to provide a long-term incentive to Mr Parsell and potentially aid in his retention as an employee of the Company over the term of the Director Options.

Negative Features

When viewed overall, we do not consider any of the terms of the Director Options to be negative from the perspective of the Non-associated Shareholders.

We are of the view that additional terms could have been considered by the Independent Directors in devising the Director Options to further meet their objectives of providing a long-term incentive, aiding in the retention of Mr Parsell and more closely aligning his interests with those of the Non-associated Shareholders.

Such additional terms could have included setting annual performance targets that had to be met before the options vested. Such performance targets could have been referenced to annual increases in total shareholder return, share price or earnings per share. However, given that the Director Options are issued *out of the money*, they have a de facto performance target in the form of the exercise price being 30% above current share price when the options vest.

While additional terms such as vesting conditions could more closely align with the objectives of the Independent Directors, they would have negative value implications to Mr Parsell. Therefore, in the context of his negotiations with the MHI board of directors' remuneration sub-committee (which comprises all of the Company's directors other than Mr Parsell, who attends in an advisory capacity) (the **Remuneration Sub-committee**), other (compensating) terms may have been negotiated - such as an increased number of options and/or a lower exercise price. This may have resulted in minimal changes in the overall value of the Director Options to Mr Parsell or their cost to the Company.

2.6 Value of the Director Options

Our assessment of the value of the Director Options is set out in section 3.

We assess the fair market value of the Director Options to be in the vicinity of $213,000, which averages to approximately $71,000 per annum over the 3 year vesting period of the options.

It is important to bear in mind that while we have assessed the current value of the Director Options to be in the vicinity of $213,000, the actual benefit received by Mr Parsell may be anywhere from nil (if no Director Options are exercised) to potentially considerably more than $213,000 (depending on the actual prices of MHI shares).

MHI will be required to recognise the fair value of the Director Options as an expense in its statement of comprehensive income in accordance with *NZ IFRS-2 Share-based Payment* (**NZ IFRS-2**). NZ IFRS-2 has specific requirements on valuation measurement and reporting of the Director Options that are not specifically covered in this report. These requirements may result in different values being recorded in MHI's financial statements.

2.7 Mr Parsell's Remuneration Package

Although the focus of our evaluation is primarily on the Director Options, consideration needs to be given to the overall level of remuneration for Mr Parsell.

Mr Parsell's employment terms are set out in the CEO Employment Agreement. The key components of Mr Parsell's remuneration are:

- a base salary
- contributions to a superannuation scheme
- a performance-related annual bonus scheme whereby the amount of the bonus paid is based on a percentage of the Company's net profit after tax (**NPAT**) in excess of a hurdle percentage return on capital employed in the Company
- a long-term incentive in the form of the Director Options.

Mr Parsell's remuneration package is reviewed annually by the Remuneration Sub-committee. In doing so, the Remuneration Sub-committee considers the remuneration levels for CEOs of similar sized organisations.

Mr Parsell's total remuneration is disclosed each year in MHI's annual report. His total remuneration for the 2008, 2009 and 2010 financial years are set out below. We have reviewed but not disclosed the components of his annual remuneration as these amounts are confidential to the Company and Mr Parsell.

Mr Parsell's Annual Remuneration

	Year Ended 30 June			
	2008	**2009**	**2010**	**Average**
A\$000	898	541	1,427	955
NZ\$1 = A\$	*0.85*	*0.82*	*0.81*	
NZ\$000	1,056	660	1,762	1,159

Source: MHI annual reports

The variability in Mr Parsell's remuneration is due to the nature of his performance related annual bonus scheme which is based on NPAT and return on capital employed. The annual bonus is paid shortly after the announcement of the Company's annual results.

A summary of market remuneration levels for CEOs of New Zealand companies with similar market capitalisation levels to MHI as surveyed by Moyle Consulting Limited (**Moyle**) in the Moyle CEO Survey 2010 is set out below. The survey results do not include remuneration attributable to share options schemes.

Summary of Market Remuneration

	Total Remuneration [1]			
	25%ile NZ$000	**50%ile NZ$000**	**75%ile NZ$000**	**Average NZ$000**
Listed New Zealand companies with a market capitalisation between \$200m and \$500m (*n = 19*)	465	750	1,155	953

1 Base salary, bonus payments and benefits

Source: Moyle CEO Survey 2010

The market data shows that Mr Parsell's average remuneration over the past 3 years of NZ\$1,159,000 is in line with the 75th percentile of the total remuneration paid to CEOs in companies with a similar market capitalisation.

We note that the Moyle CEO Survey 2010 found that only 1% of the CEOs surveyed participated in a share option scheme. A further 5% participated in a share ownership scheme. The lack of data means it is difficult to make comparisons of market levels of options packages. The only definitive conclusion that can be drawn from the market data is that option packages similar to the Director Options are not common amongst the CEOs surveyed. Notwithstanding this, the addition of approximately \$71,000 per annum in respect of the Director Options places the overall remuneration of Mr Parsell at the top quartile of the remuneration levels for CEOs of comparable organisations.

Based on the results of the Moyle CEO Survey 2010, we are of the view that the overall level of remuneration for Mr Parsell is reasonable, noting that it is at the upper end of market remuneration levels when the value of the Director Options is taken into account. However, the structure of Mr Parsell's performance related annual bonus scheme means that his remuneration may vary significantly from year to year, as evidenced in the past 2 years when his remuneration decreased by 40% in the 2009 financial year and increased by 164% in 2010.

2.8 Impact on Shareholding Levels

Share Capital and Shareholders

MHI currently has 383,053,190 fully paid ordinary shares on issue, held by 3,725 shareholders.

The names, number of shares and percentage holding of the 10 largest shareholders as at 1 October 2010 are set out below.

MHI's 10 Largest Shareholders		
Shareholder	**No. of Shares Held**	**%**
Trustees of the Quinten Trust	98,059,900	25.60%
Trustees of the Michael Hill International Share Trust	80,916,220	21.12%
Accident Compensation Corporation	19,571,144	5.11%
Bond Street Custodians Limited	16,568,400	4.33%
Citibank Nominees (New Zealand) Limited	11,882,485	3.10%
T.E.A. Custodians Limited	11,636,671	3.04%
Peters MacGregor Investments Limited	7,444,600	1.94%
Peters MacGregor Pty Limited	7,367,000	1.92%
Mike Parsell	5,859,890	1.53%
Peters MacGregor Holdings Pty Limited	4,633,000	1.21%
Subtotal	263,939,310	68.90%
Others (3,715 shareholders)	119,113,880	31.10%
Total	383,053,190	100.00%

Source: NZX Data

Mr Parsell holds 5,859,890 shares, representing 1.53% of the total shares on issue.

Interests associated with the Hill family (the **Hill Family Interests**) collectively hold 183,957,770 shares, representing 48.02% of the total shares on issue.

Options

MHI has granted options from time to time to its senior executives. The options have been granted for a 10 year period. Details of the options granted by the Company are set out below.

Options Granted			
Grant Date	**Expiry Date**	**Exercise Price**	**No. Outstanding**
7 Nov 2007	30 Sep 2017	$1.253	4,250,000
24 Aug 2009	30 Sep 2019	$0.94	200,000
5 Nov 2009	30 Sep 2019	$0.94	150,000
17 Sep 2010	30 Sep 2020	$0.88	350,000
		$1.205 [1]	4,950,000

1 Weighted average exercise price

Mr Parsell holds 2,000,000 of the options granted on 7 November 2007. The grant of the options to Mr Parsell was approved by the Company's shareholders by way of an ordinary resolution at the Company's annual meeting on 8 November 2007.

Shareholding Control

Assuming the 2,000,000 Director Options are issued and exercised, the 4,950,000 options currently on issue are exercised and no other shares are issued, there will be 390,003,190 shares on issue. Mr Parsell will hold 9,859,890 shares, representing 2.53% of the shares on issue.

In our view, the increase in Mr Parsell's shareholding from 1.53% to a maximum of 2.53% is unlikely to have an impact on his ability to exercise control over the affairs of the Company, especially given that the Hill Family Interests currently hold 48.02% of the shares in the Company and have 3 representatives on the Company's Board (out of 7 directors).

Dilutionary Impact

Assuming the 2,000,000 Director Options are issued and exercised, this will result in the Non-associated Shareholders' proportionate shareholdings in the Company being diluted by, at most, approximately 0.5%.

We do not consider this level of dilution to be of significance to highlight it as a negative aspect of the Director Options.

2.9 Impact on Share Price and Liquidity

Share Price

The market first became aware of the Director Options on 21 December 2009. The Company's closing share price on 18 December 2009 was $0.67. Since then, its shares have traded between $0.65 and $0.74 at a VWAP of $0.68.

In our view, the movements in the Company's share price are unlikely to have been driven by the announcement of the Director Options. The share price movements are more likely to have been influenced by general movements in the equities markets and various announcements by the Company regarding its operations.

We consider the existence of the Director Options is unlikely to have a material effect (either positive or negative) on the Company's share price as the exercise price is higher than the current share price and the dilutionary impact of the Director Options is not significant.

Liquidity

The average volume of shares traded each month since 3 January 2008 has been approximately 1% of the shares on issue.

The size of the pool of shares held by the Non-associated Shareholders will not change as a result of the allotment of shares upon the exercise of the Director Options.

In our view, the allotment of shares upon the exercise of the Director Options in itself is unlikely to have a positive or negative effect on the liquidity of MHI shares.

2.10 Implications of the Resolution not being Approved

In the event that resolution 4 in respect of the Director Options is not approved, the Director Option Agreement will be terminated.

The Independent Directors will need to re-enter into remuneration negotiations with Mr Parsell. Re-entering into remuneration negotiations is unlikely to be a desirable situation for the Company as it gives rise to a number of risks:

- the potential distraction and lack of focus on Company operations as further negotiations are entered into
- additional costs to the Company if the alternative remuneration package requires shareholder approval
- in the extreme case, the possibility of Mr Parsell resigning from his position if a suitable alternative long-term incentive scheme cannot be negotiated or approved by the Non-associated Shareholders.

2.11 Voting For or Against the Resolution in Respect of the Director Options

Voting for or against resolution 4 in respect of the Director Options is a matter for individual shareholders based on their own views as to value and future market conditions, risk profile and other factors. Shareholders will need to consider these consequences and consult their own professional adviser if appropriate.

3. Valuation of the Director Options

3.1 Methodology and Valuation Approach

Each tranche of the Director Options can be exercised in the period that commences approximately 5 years after the options vest and ends approximately 10 years after they vest. Therefore the options are American options (as opposed to European options which can only be exercised on one particular day).

The Binomial option-valuation model (**Binomial Model**) and the Black-Scholes option-valuation formula (**Black-Scholes Formula**) are commonly used in commercial practice to value options. The Binomial Model is more appropriate for the valuation of American options and options over shares which are expected to pay dividends during the exercise period, although variants of the Black-Scholes Formula exist to handle the valuation of such options.

The key variables in determining the value of an American Option are:

- the exercise price of the option
- the risk free rate
- the current spot price or market value of the underlying instrument
- the volatility of the returns on the underlying instrument
- the time to expiry
- the expected distributions to be made on the underlying instrument.

The values derived from the Binomial Model and Black-Scholes Formula represent the value of options over existing shares. The Director Options are in effect warrants and hence MHI will issue new shares whenever the options are exercised. Accordingly, an adjustment must be made to the values derived from the Binomial Model and Black-Scholes Formula to take into account the dilutionary effect of the Director Options.

Furthermore, the values derived from the Binomial Model and Black-Scholes Formula represent the value of options which are freely tradable. Given that the Director Options are not able to be traded, we have further adjusted the values derived from the Binomial Model and Black-Scholes Formula to allow for the lack of marketability of the Director Options.

3.2 Valuation Assessment – Tranche 1

Valuation Parameters

The key variables applied in our assessment of the value of tranche 1 of the Director Options are:

- number of options – 400,000
- valuation date – 5 November 2010, being the date of the Company's annual meeting. If approved by the Non-associated Shareholders, tranche 1 of the Director Options will be granted to Mr Parsell on or soon after the date of that approval
- exercise price - $0.94 per share
- the risk free rate – 5.1% based on the current yield on New Zealand Government 10 year bonds
- the current market value of MHI's shares - $0.70, being the 1 month VWAP up to 14 October 2010
- volatility - 30% (based on the observed volatility levels of movements in MHI's share price and for comparable companies)
- the time to expiry – 30 September 2019, being the last day that Mr Parsell may exercise tranche 1 of the Director Options
- expected distributions – assumed to equate to a dividend yield of 5.0%.

Dilutionary Effect

The Binomial Model and Black-Scholes Formula assume that the options are over existing shares. However, the Director Options are akin to warrants. MHI will need to issue new shares when the options are exercised and therefore the new shares will have a dilutionary effect. This is taken into account in our valuation.

We have assumed that the number of shares on issue prior to the exercise of tranche 1 of the Director Options is 387,653,190, being the 383,053,190 shares currently on issue plus the 4,600,000 options currently on issue which expire on 30 September 2017 and 30 September 2019.

Discount for Restrictive Terms

The Binomial Model and Black-Scholes Formula assume that the options being valued can be sold on a secondary market. The terms of the Director Options forbid the trading of the options. There is also an argument that, due to management risk aversion, senior executives often exercise options early and in some instances sub-optimally. Accordingly, a discount to the values derived from the Binomial Model and Black-Scholes Formula is required to reflect the restrictive terms and the potential early exercise of the options. We have applied a discount of 20% to the values assessed under the Binomial Model and Black-Scholes Formula (adjusted for dilution).

Valuation Conclusion

Based on the above, we assess the fair market value of each tranche 1 Director Option to be in the vicinity of $0.099 and the fair market value of the 400,000 tranche 1 Director Options to be in the vicinity of $39,600 as at 5 November 2010.

3.3 Valuation Assessment – Tranche 2

Valuation Parameters

The key variables applied in our assessment of the value of tranche 2 of the Director Options are:

- number of options – 400,000
- valuation date – 5 November 2010. If approved by the Non-associated Shareholders, tranche 2 of the Director Options will be granted to Mr Parsell on or soon after the annual meeting
- exercise price - $0.88 per share
- the risk free rate – 5.1%
- the current market value of MHI's shares - $0.70
- volatility - 30%
- the time to expiry – 30 September 2020, being the last day that Mr Parsell may exercise tranche 2 of the Director Options
- expected distributions – assumed to equate to a dividend yield of 5.0%
- dilutionary effect – assumed number of shares on issue prior to the exercise of tranche 2 of the Director Options is 388,403,190, being the 383,053,190 shares currently on issue, the 4,950,000 options currently on issue which expire on 30 September 2017, 30 September 2019 and 30 September 2020 and the 400,000 tranche 1 Director Options which expire on 30 September 2019
- discount for restrictive terms – 20%.

Valuation Conclusion

Based on the above, we assess the fair market value of each tranche 2 Director Option to be in the vicinity of $0.110 and the fair market value of the 400,000 tranche 2 Director Options to be in the vicinity of $44,000 as at 5 November 2010.

3.4 Valuation Assessment – Tranches 3, 4 and 5

Tranches 3, 4 and 5 of the Director Options will not vest until September 2011, September 2012 and September 2013 respectively. The exercise price (based on VWAP + 30%) will not be known until shortly before the options vest. Similarly, the market values of MHI's shares at the grant dates are not known at present. In the absence of these 2 key valuation parameters, we have assessed the indicative value of the tranche 3, 4 and 5 options using market values and exercise prices based on MHI's current share price.

Valuation Parameters

The key variables applied in our assessment of the value of the Director Options are:

- number of options – 400,000 tranche 3, 400,000 tranche 4 and 400,000 tranche 5
- valuation date – 1 September 2011 for tranche 3, 1 September 2012 for tranche 4 and 1 September 2013 for tranche 5
- exercise price - $0.91 per share, being 30% above the 20 business day VWAP to 14 October 2010
- the risk free rate – 5.1%
- the current market value of MHI's shares - $0.70
- volatility - 30%
- the time to expiry – 30 September 2021 for tranche 3, 30 September 2022 for tranche 4 and 30 September 2023 for tranche 5, being the last days that Mr Parsell may exercise the 3 tranches of the Director Options
- expected distributions – assumed to equate to a dividend yield of 5.0%
- dilutionary effect – it is assumed that all previous tranches of the Director Options have been exercised
- discount for restrictive terms – 20%.

Valuation Conclusion

Based on the above, we assess the indicative fair market value of each tranche 3, tranche 4 and tranche 5 Director Option to be in the vicinity of $0.108 and the indicative fair market value of each parcel of 400,000 Director Options to be in the vicinity of $43,200 at their respective grant details.

3.5 Valuation Conclusion

We assess the fair market value of the Director Options to be in the vicinity of $213,000.

Value of Director Options

Tranche	No. of Options	Vesting Date	Expiry Date	Value per Option ($)	Value per Tranche ($)
1	400,000	Nov 2010	30 Sep 2019	0.099	39,600
2	400,000	Nov 2010	30 Sep 2020	0.110	44,000
3	400,000	Sep 2011	30 Sep 2021	0.108 [1]	43,200 [1]
4	400,000	Sep 2012	30 Sep 2022	0.108 [1]	43,200 [1]
5	400,000	Sep 2013	30 Sep 2023	0.108 [1]	43,200 [1]
	2,000,000				213,200

1 Indicative value based on current share price

4. Sources of Information, Reliance on Information, Disclaimer and Indemnity

4.1 Sources of Information

The statements and opinions expressed in this report are based on the following main sources of information:

- the draft MHI notice of annual general meeting
- the MHI 2009 and 2010 annual reports
- the CEO Employment Agreement
- the Director Options Agreement
- share price data and shareholder data from NZX Data
- the Moyle CEO Survey 2010.

During the course of preparing this report, we have had discussions with and/or received information from the Independent Directors and executive management of MHI and MHI's legal advisers.

The Independent Directors have confirmed that we have been provided for the purpose of this Appraisal Report with all information relevant to the Director Options that is known to them and that all the information is true and accurate in all material aspects and is not misleading by reason of omission or otherwise.

Including this confirmation, we have obtained all the information that we believe is necessary for the purpose of preparing this Appraisal Report.

In our opinion, the information set out in this Appraisal Report is sufficient to enable the Independent Directors and the Non-associated Shareholders to understand all the relevant factors and to make an informed decision in respect of the Director Options.

4.2 Reliance on Information

In preparing this report we have relied upon and assumed, without independent verification, the accuracy and completeness of all information that was available from public sources and all information that was furnished to us by MHI and its advisers.

We have evaluated that information through analysis, enquiry and examination for the purposes of preparing this report but we have not verified the accuracy or completeness of any such information or conducted an appraisal of any assets. We have not carried out any form of due diligence or audit on the accounting or other records of MHI. We do not warrant that our enquiries would reveal any matter which an audit, due diligence review or extensive examination might disclose.

4.3 Disclaimer

We have prepared this report with care and diligence and the statements in the report are given in good faith and in the belief, on reasonable grounds, that such statements are not false or misleading. However, in no way do we guarantee or otherwise warrant that any forecasts of future profits, cash flows or financial position of MHI will be achieved. Forecasts are inherently uncertain. They are predictions of future events that cannot be assured. They are based upon assumptions, many of which are beyond the control of MHI and its directors and management. Actual results will vary from the forecasts and these variations may be significantly more or less favourable.

We assume no responsibility arising in any way whatsoever for errors or omissions (including responsibility to any person for negligence) for the preparation of the report to the extent that such errors or omissions result from our reasonable reliance on information provided by others or assumptions disclosed in the report or assumptions reasonably taken as implicit.

Our evaluation has been arrived at based on economic, exchange rate, market and other conditions prevailing at the date of this report. Such conditions may change significantly over relatively short periods of time. We have no obligation or undertaking to advise any person of any change in circumstances which comes to our attention after the date of this report or to review, revise or update our report.

We have had no involvement in the preparation of the notice of meeting issued by MHI and have not verified or approved the contents of the notice of meeting. We do not accept any responsibility for the contents of the notice of meeting except for this report.

4.4 Indemnity

MHI has agreed that, to the extent permitted by law, it will indemnify Simmons Corporate Finance and its directors and employees in respect of any liability suffered or incurred as a result of or in connection with the preparation of the report. This indemnity does not apply in respect of any negligence, wilful misconduct or breach of law. MHI has also agreed to indemnify Simmons Corporate Finance and its directors and employees for time incurred and any costs in relation to any inquiry or proceeding initiated by any person. Where Simmons Corporate Finance or its directors and employees are found liable for or guilty of negligence, wilful misconduct or breach of law or term of reference, Simmons Corporate Finance shall reimburse such costs.

5. Qualifications and Expertise, Independence, Declarations and Consents

5.1 Qualifications and Expertise

Simmons Corporate Finance is a New Zealand owned specialist corporate finance advisory practice. It advises on mergers and acquisitions, prepares independent expert's reports and provides valuation advice.

The person in the company responsible for issuing this report is Peter Simmons, B.Com, DipBus (Finance), CFIP.

Simmons Corporate Finance and Mr Simmons have significant experience in the independent investigation of transactions and issuing opinions on the merits and fairness of the terms and financial conditions of the transactions.

5.2 Independence

Simmons Corporate Finance does not have at the date of this report, and has not had, any shareholding in or other relationship with MHI or Mr Parsell or any conflicts of interest that could affect our ability to provide an unbiased opinion in relation to this transaction.

Simmons Corporate Finance has not had any part in the formulation of the Director Options or any aspects thereof. Our sole involvement has been the preparation of this report.

Simmons Corporate Finance will receive a fixed fee for the preparation of this report. This fee is not contingent on the conclusions of this report or the outcome of the voting in respect of the Director Options. We will receive no other benefit from the preparation of this report.

5.3 Declarations

An advance draft of this report was provided to the Independent Directors for their comments as to the factual accuracy of the contents of the report. Changes made to the report as a result of the circulation of the draft have not changed the methodology or our conclusions.

Our terms of reference for this engagement did not contain any term which materially restricted the scope of the report.

5.4 Consents

We consent to the issuing of this report in the form and context in which it is to be included in the notice of meeting to be sent to MHI shareholders. Neither the whole nor any part of this report, nor any reference thereto may be included in any other document without our prior written consent as to the form and context in which it appears.

Peter Simmons
Director
Simmons Corporate Finance Limited
15 October 2010