



CORPORATE FINANCE

# Sealegs Corporation Limited

Independent Appraisal Report  
with respect to the issue of  
Share Options to Directors of  
Sealegs Corporation Limited

29 May 2009

ADVISORY



KPMG Centre  
18 Viaduct Harbour Avenue  
P.O. Box 1584  
Auckland  
New Zealand

Telephone +64 (9) 367 5800  
Fax +64 (9) 367 5875  
Internet www.kpmg.co.nz

**Private and confidential**  
The Independent Directors  
Sealegs Corporation Limited  
233 Bush Road  
Albany  
AUCKLAND

Our ref Report covering letter.doc

10 June 2009

Dear Sirs

**Independent Appraisal Report in relation to the proposed issue of options by  
Sealegs Corporation Limited**

The Directors of Sealegs Corporation Limited propose to seek shareholder approval, by way of an ordinary resolution to be passed at the Annual General Meeting to be held on 17 July 2009, to issue certain options to the Directors of the Company. Under the NZSX Listing Rules, an Independent Appraisal Report is required.

We have prepared the following Independent Appraisal Report for the Independent Directors of Sealegs Corporation Limited for this purpose in accordance with our engagement letter dated 20 May 2009.

Yours sincerely

Russell J Florence  
Partner

Justin M Ensor  
Director



## Glossary

<b>Code</b>	Takeovers Code
<b>Company</b>	Sealegs Corporation Limited
<b>Exercise Price</b>	The price at which shares can be acquired upon the exercise of the Options. The Exercise Price has been set at \$0.10 by the Independent Directors of Sealegs
<b>Independent Directors</b>	The Directors of Sealegs other than Mr. McKee Wright, Mr. Bryham and Mr. Burrell
<b>KPMG</b>	KPMG Corporate Finance
<b>Non-associated Shareholders</b>	Sealegs shareholders not associated with Mr. McKee Wright, Mr. Bryham or Mr. Burrell
<b>NZSX</b>	New Zealand Stock Exchange Limited
<b>Options</b>	The Options issued under the Options Plan
<b>Option Agreement</b>	The individual Option Agreements between Sealegs Corporation Limited and Mr. McKee Wright, Mr. Bryham and Mr. Burrell, for the issue of Options.
<b>Options Plan</b>	The proposed issue of up to 9,000,000 Options to Senior Executives of the Company
<b>Sealegs</b>	Sealegs Corporation Limited
<b>Senior Executives</b>	Mr. McKee Wright, Mr. Bryham and Mr. Burrell
<b>Trigger Price</b>	The volume weighted average share price (“VWAP”) that must be achieved at a specified date for the Options to vest
<b>Trinomial Option Pricing Model</b>	A three-dimensional lattice model for the valuation of options
<b>Valuation Date</b>	29 May 2009
<b>VWAP</b>	Volume weighted average share price (being the last practical day to calculate Sealegs VWAP)

## Contents

1	Introduction	1
1.1	Background of the proposed transaction	1
1.2	Implications of the NZSX Listing Rules for the proposed transaction	1
1.3	Purpose of the report	2
1.4	Evaluation of the Fairness of the issue of the Options for the purposes of Listing Rule 9.2.1	3
1.5	Information relied upon	4
1.6	Report restrictions	5
1.7	Qualifications, declarations and independence	5
2	Details of the proposed transaction	6
2.1	Overview	6
2.2	Rational for the issue of Options	7
2.3	Positive features	8
2.3.1	Escalating Trigger Prices	8
2.3.2	Long-term management incentives	9
2.3.3	Conservation of cash	9
2.4	Negative features	9
2.4.1	Trigger Price in Year 1 is marginally higher than the current share price	9
2.4.2	Cancellation of options issued in August 2007	10
2.4.3	Share price	11
2.5	Neutral features	11
2.5.1	Impact on control	11
2.5.2	Liquidity	11
2.6	Implications of the Resolution not being approved	12
3	Remuneration	13
3.1	Valuation Methodology	13
3.2	Valuation Assumptions	14
3.3	Valuation Results, before consideration of discounts for liquidity and restrictive terms	14
3.4	Discount for lack of liquidity and restrictive terms	15
3.5	Valuation Conclusion	15
3.6	Existing remuneration arrangements	15
3.7	Market remuneration levels	16
3.8	Conclusion on fairness of remuneration levels	17
3.9	NZ IFRS Requirements	18
4	Evaluation of the Fairness of the issue of the Options for the purposes of Listing Rule 9.2.1	19



5	Appendix 1	21
5.1	Qualifications	21
5.2	Independence	21
5.3	Declarations	21
5.4	Consents	22
5.5	Indemnity	22

# **1 Introduction**

## **1.1 Background of the proposed transaction**

The Directors of Sealegs Corporation Limited (“Sealegs” or “the Company”) propose to seek shareholders’ approval, by way of an ordinary resolution to be passed at the Annual Meeting to be held on 17 July 2009, to issue share options to certain Directors of the Company.

Resolution 1 requests shareholders to authorise and approve the issue by the Company of 4,000,000 share options in the Company to Mr McKee Wright, 4,000,000 share options in the Company to Mr Bryham, and 1,000,000 share options in the Company to Mr Burrell (collectively the “Options”), and the allotment of shares in the Company upon an exercise of the Options on the terms and conditions described in Section 2.1 of this report.

Key terms of the Option Plan are:

- an exercise price of \$0.10 per Option; and
- the Options are exercisable in four tranches over the next five years, provided the Company’s share price reaches certain price trigger points, or performance hurdles (hereafter “Trigger Price”).

Mr McKee Wright is the Managing Director of the Company and interests associated with him currently own 9.3% of the shares in Sealegs. Mr Bryham is currently the Company’s Development Manager and a Director of the Company. Interests associated with Mr Bryham currently own 7.1% of the shares in Sealegs. Mr Burrell is the Company’s Director of Operations in Australia. Interests associated with Mr Burrell currently own 7.8% of the shares in Sealegs. The other two Directors of Sealegs, Messrs Christopher Dickson and James Hill may be considered independent for the purposes of this proposed transaction.

## **1.2 Implications of the NZSX Listing Rules for the proposed transaction**

The following are the implications of the New Zealand Stock Exchange (“NZSX”) Listing Rules for the proposed transaction.

Under section 7.3.1 of the NZSX Listing Rules, no issuer shall issue any Equity Securities (including issue on Conversion of any other Security) 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.

Furthermore, under section 9.2.1 of the NZSX Listing Rules, an Issuer shall not enter into a Material Transaction if a Related Party is, or is likely to become a direct or indirect party to the Material Transaction, unless that Material Transaction is approved by an Ordinary Resolution of the Issuer. We are advised that the issue of Options represents a Material Transaction.

The requirement for an Ordinary Resolution arises in this instance, as Directors of the Issuer, Mr McKee Wright, Mr Bryham and Mr Burrell are Related Parties and the proposed issue of Options is a Material Transaction.

Under Listing Rule 9.2.5, the text of any resolution to be put to a meeting for the purposes of Rule 9.2.1 shall be set out in the notice of the relevant meeting. The notice shall be accompanied by an Appraisal Report.

Listing Rule 1.7.1 requires that an independent appropriately qualified person, approved as such by the NZSX, prepare such a Report. KPMG Corporate Finance (“KPMG”) has obtained the requisite approval from the NZSX on 24 April 2009.

Under Listing Rule 1.7.2, the Report must inter-alia:

- a) Be addressed to the Directors of the Company not associated with any relevant Associated Persons or if there are no such Directors, to the NZSX.
- b) Be expressed to be for the benefit of shareholders of Sealegs not associated with any relevant Associated Persons;
- c) State, providing reasons, whether or not in the opinion of KPMG the consideration and terms and conditions of the proposed transaction are fair to shareholders, other than those associated with the relevant Associated Persons;
- d) State, providing reasons, whether or not in the opinion of KPMG the information to be provided by Sealegs to shareholders is sufficient for shareholders to understand all the relevant factors and reach an informed decision as to the fairness of the proposed transaction;
- e) State whether KPMG, in preparing the Report, has obtained all information it believes desirable for the purposes of preparing the Report, including all material information which is known or should have been known to any Director of the Company and has been made available to the Directors;
- f) State any material assumptions on which KPMG’s opinion is based;
- g) State any terms of reference that may have materially restricted the scope of the Report; and
- h) If it contains a disclaimer of liability, not purport to absolve the reporter from liability for an opinion expressed recklessly or in bad faith.

### **1.3 Purpose of the report**

The purpose of the KPMG Independent Appraisal Report (the “Report”) is to satisfy the requirements of the NZSX Listing Rules, and to assist the Non-associated Shareholders of Sealegs to evaluate the proposed transaction. For the purposes of this report, the Non-associated Shareholders relate to all shareholders of Sealegs other than Mr McKee Wright, Mr Bryham and Mr Burrell.

Our Report considers whether or not the proposed transaction is fair to the Non-associated Shareholders of Sealegs. There is no statutory definition of “fair” in New Zealand law or in the Listing Rules. The New Zealand Institute of Chartered Accountants state in Guidance Note 10 “Guideline on Independent Chartered Accountants Reporting as Experts to Shareholders” that:

*“the expression of an opinion as to fairness will generally involve an assessment as to whether a proposal is just, impartial and equitable”*

## **1.4 Evaluation of the Fairness of the issue of the Options for the purposes of Listing Rule 9.2.1**

In our opinion, after having regard to all relevant factors, the consideration and the terms and conditions of the Options are fair to the shareholders not associated with any relevant Associated Persons.

In summary, the key factors leading to our opinion are:

- the rationale for issuing the Options is sound;
- the escalating Trigger Price performance hurdle seeks to ensure that a tranche of Options can only be exercised if Sealegs' shareholders have received a positive return on their investment. The use of a performance hurdle is consistent with the approaches adopted by other listed companies on the NZSX;
- the benefits to be derived by Messrs McKee Wright, Bryham and Burrell (hereafter also referred to as "Senior Executives") will potentially be spread over five years up to 29 June 2014, thus providing a long term incentive which aligns the interests of these Senior Executives with Non-associated Shareholders;
- while the cancellation of the options issued in August 2007 and the issue of the Options at a lower price could be considered a potential negative feature of the proposed transaction, in our view this should be viewed in the context of the decline in financial markets globally and consideration of whether the previous options were still effective in motivating the Senior Executives;
- the allotment of shares upon the exercise of the Options will have a dilutionary impact on existing shareholders' interests in the Company;
- there is no adjustment to the Trigger Price in the event that Sealegs share price is significantly above \$0.10 at the issue date of the Options which is a negative feature of the Option Plan. Subject to no material change in the share price we consider the positive features of the Option Plan outweigh the negative feature of no adjustment to the Trigger Price;
- the allotment of shares upon the exercise of the Options may have a small positive impact on the liquidity of Sealegs' shares;
- Mr McKee Wright's total remuneration, including the value of the Options, is within, albeit at the higher end of the remuneration range advised by Peter Ross Consulting;
- Mr Bryham's total remuneration, including the value of the Options, is higher than the remuneration range advised by Peter Ross Consulting for a Development Manager. However, we recognise the Independent Directors' view that Mr Bryham's significant leadership role and contribution to the Sealegs business is not adequately reflected in the title of Development Manager. This assessment of Mr Bryham's remuneration ignores the current voluntary reduction in Mr Bryham's salary, discussed further below;

- Mr Burrell's remuneration has not been benchmarked as he is not paid a salary. However, having regard to his role in developing the Australian market and the value of the Options issued, we are of the view that it is likely to be fair having regard to the nature of the services that he provides to Sealegs;
- Mr McKee Wright and Mr Bryham have voluntarily reduced their salary by \$50,000 per annum in recognition of the poor economic conditions. If the Option Plan were not approved, it may increase the likelihood that they would claim their full contractual salary as detailed in this report. The annualised reduction in the salary broadly equates to the annualised value of the Options in each year. If they required payment of their full salary this would represent a cash drain on the Company; and
- the allotment of shares on the exercise of the Options will not significantly increase Mr McKee Wright's and Mr Bryham's ability to exert shareholder control over Sealegs owing to the restriction in the Option Agreement which prevents the allotment of the shares if it meant that Messrs McKee Wright and Bryham held 20% or more of the voting shares, giving rise to a breach of the Takeovers Code.

Overall, we consider that the positive features of the Option Plan outweigh the negative features, and that the Option Plan is fair to Non-associated Shareholders.

In our opinion the information to be provided to shareholders by Sealegs, together with this Appraisal Report, is sufficient for shareholders to understand all relevant factors and reach an informed decision as to the fairness of the issue of the Options.

## **1.5 Information relied upon**

In completing the Report we have received and relied upon the following information:

- Un-audited financial accounts for Sealegs for the financial year ending 31 March 2009;
- Un-audited financial accounts for Sealegs for the six months to 30 September 2008;
- Audited financial statements for Sealegs for the financial years ending 31 March 2008 and 31 March 2007;
- A draft of the *Notice of Annual Meeting* for July 2009;
- An opinion on Executive remuneration from Peter Ross Consulting;
- A draft Option Agreement between Sealegs and Mr McKee Wright, which we are advised will be representative of the Option Agreement for Mr Bryham and Mr Burrell;
- Share price data for Sealegs, sourced from the NZSX; and
- Shareholder data provided by Sealegs.

## **1.6 Report restrictions**

This report has been prepared for the Non-associated Shareholders of Sealegs and is based upon information that has been supplied to us by the Directors and management of Sealegs.

In accordance with our firm's policy, we advise that neither the firm nor any member or employee of the firm undertake responsibility to any entity or person for any variance to the projected results of the business, or any statement made by the management of the Company which is subsequently found to be untrue, but is relied upon by KPMG in reaching our opinion.

We reserve the right but not the obligation to amend this opinion should any further relevant information come to hand. Nothing in this opinion may be extracted or reprinted without our express prior written consent.

We advise that we have not audited or independently verified the information we have received and this Report should not be construed as an audit or verification of the businesses.

The statements and opinions expressed in this Report have been made in good faith and on the basis that all relevant information for the purposes of preparing this Report has been provided by Sealegs' management and that all such information is true and accurate in all material aspects and not misleading by reason of omission or otherwise. Accordingly, neither KPMG nor its partners, employees or agents, accept any responsibility or liability for any such information being inaccurate, incomplete, unreliable or not soundly based or for any errors in the analysis, statements and opinions provided in this Report resulting directly or indirectly from any such circumstances or from any assumptions upon which this Report is based proving unjustified.

We stress that our advice in respect of the proposed transaction is limited to the Non-associated Shareholders of Sealegs.

## **1.7 Qualifications, declarations and independence**

Detailed in Appendix 1 are our statements regarding qualifications, independence and declarations.

## 2 Details of the proposed transaction

### 2.1 Overview

The purpose of issuing the Options is to provide additional incentives to Senior Executives and to raise further capital for the Company if the Options are exercised.

The Company will issue a total of 9,000,000 Options (4,000,000 to Mr. McKee Wright, 4,000,000 to Mr. Bryham, and 1,000,000 to Mr. Burrell), such Options to be issued within 10 working days of the date of the shareholders' meeting.

The Options will become exercisable in a series of tranches over a period of 4 years commencing from 30 June 2010.

The exercise price for each of the Options is \$0.10 per share. The respective commencement dates of the exercise periods and the Trigger Prices corresponding to the series of tranches for the Options are as follows:

Option terms - All Senior Executive Options combined						
Tranche	No. of options	Trigger date	Trigger price	Exercise price	Exercise period	
A	2,250,000	30-Jun-10	0.12	0.10	30-Jun-10 to 29-Jun-14	
B	2,250,000	30-Jun-11	0.14	0.10	30-Jun-11 to 29-Jun-14	
C	2,250,000	30-Jun-12	0.17	0.10	30-Jun-12 to 29-Jun-14	
D	2,250,000	30-Jun-13	0.20	0.10	30-Jun-13 to 29-Jun-14	
	<b>9,000,000</b>					

Source: Sealegs

As the individual Option Plans encompass exactly the same terms, in this report we have treated the Options together.

The key terms of the Option Agreement can be summarised as follows:

- The Options can be exercised by written notice to the Company, accompanied by the relevant exercise moneys, at any time during the period from the trigger date to 29 June 2014 (Clause 4.1);
- Where the exercise of the Options would result in a breach of the Takeovers Code, the Options will accrue and be exercisable on the trigger date applicable to the next tranche of Options, subject to not breaching the Takeovers Code (Clause 4.2);
- Any Options not exercised by 29 June 2014 will lapse (Clause 9.1);
- In the event of termination of the employment agreement between the relevant option holder and the Company, any Option not exercised will lapse (Clause 9.2);
- No Option will be exercisable unless the volume weighted average price per share ("VWAP") of shares sold on the NZSX during the 30 days ending on the date of commencement of the exercise period for that tranche, is more than or equal to the Trigger Price corresponding to the relevant tranche (Clause 4.1);

- The number of Options, the Exercise Price and the Trigger Price will be adjusted to take account of any share reconstructions (Clause 8.1);
- The option holder may not transfer or assign any rights under the Option Agreement (Clause 10.1);
- Upon the valid exercise of any Options, shares will be issued and allotted within 10 working days (Clause 6.1); and
- Shares issued upon an exercise of the Options will rank pari passu with ordinary shares then on issue in the Company (Clause 7.2).

## **2.2 Rational for the issue of Options**

The stated rationale for the Option Plan is to reward and provide additional incentives to the Company's Senior Executives and to raise further capital if the Options are exercised.

The Independent Directors have developed a remuneration structure which they believe provides a strong performance incentive to Senior Executives and rewards performance without drawing upon the cash resources of the Company.

The Independent Directors acknowledge that Mr. McKee Wright and Mr. Bryham have been largely responsible for developing the Sealegs business to its current position and that they, together with Mr. Burrell, are pivotal to driving the Company's future strategic initiatives. The Independent Directors consider it imperative that Mr. McKee Wright, Mr. Bryham and Mr. Burrell are appropriately incentivised and rewarded over the next five years as the Company develops its products, markets and production and seeks to substantially increase its revenue and earnings.

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:

- helping to attract and retain top executives;
- enabling executives to build equity ownership in the company, thereby aligning executives' interests more closely with the interests of shareholders.

In past years there has been criticism in New Zealand and abroad in respect of the granting of share options to executives. The criticisms centre on:

- the lack of performance hurdles and / or inadequate explanation of performance hurdles;
- options being issued to non-executive directors;
- the vesting period for the exercise of the options being too short and hence not aligning with shareholder interests; and

- the level of remuneration for executives, once the value of the options is taken into consideration.

In our view, the rationale for the Options Plan and in particular the Option terms are appropriate. Specifically:

- it is targeted at Sealegs' Senior Executives, being Mr. McKee Wright, Mr. Bryham and Mr. Burrell;
- it provides a long term incentive potentially spanning five years, thus aiding in the retention of the Senior Executives;
- it closely aligns the interests of the Senior Executives with those of the Company's shareholders through the use of escalating Trigger Prices which act as performance hurdles.

## 2.3 Positive features

### 2.3.1 Escalating Trigger Prices

The escalating Trigger Price performance hurdle ensures that Directors will only be entitled to exercise a tranche of Options if Sealegs' shareholders have received a positive return on their investment.

The Trigger Prices have been set by the Independent Directors based on a starting share price of \$0.10. This escalates by between 16.7% and 21.4% each year.

Escalation of Trigger Prices			
Tranche	Price (\$)	Annual Escalation	Compound average growth rate
Independent Directors assumed starting share price (30 June 2009)	0.10	na	na
Tranche A	0.12	20.0%	20.0%
Tranche B	0.14	16.7%	18.3%
Tranche C	0.17	21.4%	19.3%
Tranche D	0.20	17.6%	18.9%

Source: KPMG analysis

The assumed starting share price of \$0.10 was set at the time the Option Plan was developed, being March and April 2009.

Escalating the Trigger Prices at these levels means that (in theory) Non-associated Shareholders will achieve a return on their investment before the Options can be exercised. The annual escalator of the Trigger Prices sit within our estimated range of the cost of equity for Sealegs.

We note however that the share price at the date of this report is higher than \$0.10. This has the implication of reducing the return required in the first period and also reduces the compound returns required over future periods. This is discussed further in the following section.

### 2.3.2 Long-term management incentives

The Options are split into four tranches (A to D). Assuming the Trigger Prices are met, Tranche A Options can be exercised between 30 June 2010 and 29 June 2014 while Tranche D Options can be exercised between 30 June 2013 and 29 June 2014.

Therefore the benefits to be derived by Mr McKee Wright, Mr Bryham and Mr Burrell will potentially be spread over a five year period up to 29 June 2014. This provides a long term incentive to the Executives.

### 2.3.3 Conservation of cash

Providing compensation via the issue of Options helps Sealegs to motivate and retain its management team while conserving cash during the Company's growth phase. This is particularly important as the Company's operating and investing activities have generated negative cash flows over the last four years.

## 2.4 Negative features

### 2.4.1 Trigger Price in Year 1 is marginally higher than the current share price

Over the last month, the share price has moved with the range of \$0.102 to \$0.135. For the purposes of the Option valuation we have used a share price equal to the 30-day VWAP of \$0.111<sup>1</sup>, calculated at the Valuation Date. Based on this price, the percentage increase required in year 1 is in our view less than the cost of equity, as detailed in the table below.

Escalation of Trigger Prices having regard to VWAP 29 May 2009			
Tranche	Price (\$)	Annual Escalation	Compound average growth rate
Assumed starting price at 30-Jun-09 based on VWAP 29-May-09	0.111	na	na
Tranche A	0.120	8.1%	8.1%
Tranche B	0.140	16.7%	12.3%
Tranche C	0.170	21.4%	15.3%
Tranche D	0.200	17.6%	15.9%

Source: KPMG analysis

We understand that when the Option Plan was developed, Sealegs' share price was \$0.10 per share. In our view, the absence of any additional increase in the Trigger Prices for each tranche is a negative feature of the Option Plan at this date.

<sup>1</sup> This is calculated based on the daily volumes and closing prices.

## 2.4.2 Cancellation of options issued in August 2007

On 13 August 2007, Sealegs issued 12,000,000 options, including 5,000,000 options issued to Mr McKee Wright and 5,000,000 issued to Mr Bryham. On 31 March 2009, these options were cancelled as, according to Sealegs, the fall in the share price since these options were issued meant that these options were no longer effective in creating value or as an incentive for employees. Furthermore, the Company did not support carrying forward the accounting expense of the option plan given its view that the options provided no foreseeable future incentive for employees.

The Company proposes to issue the new Options discussed in this report to reinvigorate the incentives for Senior Executives.

We have considered whether it is fair to Non-associated Shareholders to cancel the previous options and replace them with a new Option Plan which reflects a lower share price.

One view that shareholders might hold is that the options issued in August 2007 were justified on the basis that it represented a long term incentive scheme, and that if the Company were to continually cancel and re-issue options each time the share price was below the exercise price, the effective value of management’s compensation may, over time, be far greater than that reflected in the current Option Plan.

A contrary argument is that the options issued in August 2007 are now so deeply ‘out of the money’ that they are unlikely to motivate Senior Executives. In this respect, irrespective of the historical value of the options at the date of issue, they would not achieve the objectives for which they were issued.

The collapse of the global financial markets has impacted upon Sealegs share price, with most companies listed on the NZSX and other global exchanges experiencing significant declines. The decline in the Sealegs share price is more significant than that of the market and may reflect the risk aversion of investors in the current market as well as the potential impact that reduced consumer confidence may have on Sealegs’ future sales.

The chart below shows the decline in Sealegs’ shares and the NZX50 Gross Index since the previous options were approved on 31 July 2007.

**Return of Sealegs shares and the NZX50 Gross Index since 31 July 2007**



Source: Bloomberg, 28 May 2009

At least to some extent, the decrease in Sealegs' share price and the fact that the options issued in August 2007 no longer incentivise Messrs McKee Wright and Bryham is due to the collapse in the global financial markets and associated factors which are outside the control of Messrs McKee Wright and Bryham.

### **2.4.3 Share price**

As the exercise price of \$0.10 is lower than the Trigger Prices, there will be dilutionary impacts on existing Shareholders in Sealegs each time Options are exercised. Each tranche of Options will represent approximately 3% of the total shares on issue, and in total the Options will represent 12% of the voting shares, should they be exercised.

## **2.5 Neutral features**

### **2.5.1 Impact on control**

Interests associated with Mr McKee Wright and Mr Bryham collectively own 16.3% of the shares in Sealegs. Under the Takeovers Code they are considered to be Associated Persons. The allotment of eight million shares, should Messrs McKee Wright and Mr Bryham exercise all of their Options, would mean that Mr McKee Wright and Mr Bryham would collectively own 23.3%<sup>2</sup> of Sealegs. This is based on the current number of shares on issue and assuming that other option holders also exercise their rights. However, clause 4.2 of the Option Agreement prevents the exercise of the Options in the event that this results in a breach of the Takeovers Code. A breach in the Takeovers Code would occur if the collective shareholding of Mr McKee Wright and Mr Bryham exceeded 20% of the voting shares.

Thus, Mr McKee Wright and Mr Bryham would only be able to exercise all of their Options in the event that they sold part of their existing shareholding in the Company or if Sealegs were to issue further shares to shareholders not associated with them, such that their combined shareholding remained below the 20% threshold.

In this respect, we do not believe the allotment of shares on the exercise of the Options by Mr McKee Wright and Mr Bryham, such that the combined shareholding rises from 16.3% to 19.99%, will significantly increase Mr McKee Wright and Mr Bryham's ability to exert shareholder control over Sealegs.

### **2.5.2 Liquidity**

The average volume of shares traded each month since 1 April 2007 has been approximately 1.6% of the total shares on issue.

The size of the pool of shares held by the Non-associated Shareholders will change as a result of the allotment of shares upon the exercise of the Options in the event Mr McKee Wright and/or Mr Bryham were to sell their existing shares in Sealegs to assist them to fund the exercise of the Options or to avoid any breach of the Takeovers Code.

---

<sup>2</sup> Due to rounding, this does not equal the summation of the percentages in Section 1.1 of this report.

If Messrs McKee Wright and Bryham were to sell existing shares so that they may exercise the Options, this would likely increase the liquidity of Sealegs shares. At the same time the sale of these shares may have a negative impact on the share price, albeit this impact may be only temporary.

## **2.6 Implications of the Resolution not being approved**

In the event that the issue of the Options to Messrs McKee Wright, Bryham and Burrell is not approved, the Independent Directors may need to re-enter into other remuneration negotiations with Mr McKee Wright, Mr Bryham and Mr Burrell. This is unlikely to be a desirable situation for the Company as it gives rise to a number of risks:

- increased costs to the Company arising from the potential distraction and lack of focus on the Company's operations as further negotiations continue;
- additional costs to the Company arising from the need for shareholder approval of an alternative remuneration package should this involve the issue of shares or options. The additional costs include the potential costs of a further shareholders' meeting;
- the possibility of Mr McKee Wright and / or Mr Bryham and / or Mr Burrell resigning from their positions or reducing their commitments to the Company if a suitable alternative remuneration package cannot be negotiated or approved by the Non-associated Shareholders;
- The possibility that Mr McKee Wright and Mr Bryham, who have voluntarily reduced their current salary payments due to the poor economic climate, seek to re-instate their salary to their contractual entitlement; and
- The possibility that Mr Burrell, who currently receives no salary for his executive services, seeks to receive a market level of remuneration for his services through a salary.

## 3 Remuneration

In assessing whether the Option Plan is fair, we have considered the remuneration of Messrs McKee Wright, Bryham and Burrell, including the value of the Options to be granted under resolution 1, and how this compares to market levels of remuneration for their roles.

### 3.1 Valuation Methodology

The Options can only be exercised provided Sealegs' VWAP of shares sold on the NZSX during the 30 days ending on the date of the commencement of the exercise period for that tranche, is more than or equal to the Trigger Price corresponding to the relevant period.

The Trigger Price represents a barrier that must be achieved before the Options can be exercised.

If the Trigger Price hurdle is met and the Options can be exercised, the Options have features of an American option. This is because the Options can be exercised, subject to exercise not resulting in any breach of the Takeovers Code, at any time during the period following commencement of the relevant exercise period.

To value an option with these features we use a Trinomial Option Pricing Model. A Trinomial Model is similar to the more commonly used Binomial Option Pricing Model but allows us to incorporate the barrier or trigger price hurdle criteria that is a pre-condition to the holder's ability to exercise the Options.

The key input variables into determining the value of the Options are:

- the share price of Sealegs at the valuation date of the Options;
- the Exercise Price of the Options;
- The Trigger Prices for the Options;
- The commencement of the exercise period and the final maturity date of the Options;
- The risk free rate;
- The volatility of returns; and
- Any dividends expected to be paid by Sealegs over the life of the Options.

In the event the Options are exercised, new shares will be issued by Sealegs at less than the market price and this will lead to a dilution of existing ordinary shareholders' interests in the Company. Our valuation takes into account any potential dilution of the existing shareholders' interest in Sealegs.

The value that we derive under the Trinomial Option Pricing Model implicitly assumes that the Options are freely tradable. This value represents the market value or the opportunity cost of the Options to Sealegs' shareholders.

### 3.2 Valuation Assumptions

The valuation assumptions that we adopt in our model to value the Options are:

- the Valuation Date is 29 May 2009;
- the market price of the Sealegs' shares at the Valuation Date is \$0.111 based on the 30-day VWAP at valuation date;
- the Exercise Price of the Option is \$0.10 per share;
- the commencement of the exercise period, Trigger Prices and the final maturity date of the Options tranches as summarised below;

Options Exercise Dates and Trigger Prices					
Series	No. of Exercisable Options	Commencement of the Exercise Period	Trigger Price \$	Final Maturity Date	
A	2,250,000	30 June 2010	0.12	29 June 2014	
B	2,250,000	30 June 2011	0.14	29 June 2014	
C	2,250,000	30 June 2012	0.17	29 June 2014	
D	2,250,000	30 June 2013	0.20	29 June 2014	

Source: Sealegs

- the risk free rate is proxied by traded yields on Government stock;
- we assume volatility of circa 70% having regard to Sealegs's historical share price returns; and
- we assume Sealegs will pay no dividends over the maximum life of the Options.

### 3.3 Valuation Results, before consideration of discounts for liquidity and restrictive terms

The table below provides our point estimate market values of the Options as at 29 May 2009.

Point Estimate of Market Valuation of the Options							
Series	Number	Commencement of the Exercise Period	Trigger		Point estimate Market Value per		Total Market Value
			Price	Final Maturity Date	Option		
A	2,250,000	30 June 2010	\$0.12	29 June 2014	\$0.051		\$114,750
B	2,250,000	30 June 2011	\$0.14	29 June 2014	\$0.052		\$117,000
C	2,250,000	30 June 2012	\$0.17	29 June 2014	\$0.054		\$121,500
D	2,250,000	30 June 2013	\$0.20	29 June 2014	\$0.057		\$128,250
						<b>Total</b>	<b>\$481,500</b>

Source: KPMG analysis

### 3.4 Discount for lack of liquidity and restrictive terms

The Option valuation methodology assumes that the Options can be sold in an active and liquid secondary market. However, the terms of the Options prevent their sale. There is also an argument that, due to management risk aversion, Senior Executives exercise options early and in some instances sub optimally. For these reasons we have applied a discount of 20% to the values assessed above.

### 3.5 Valuation Conclusion

Based on our analysis, we assess the fair market value of the Options as at 29 May 2009 as detailed in the table below.

Point Estimate of Market Valuation of the Options						
Series	Number	Point estimate Market Value per Option	Total Market Value	Discount	Discount for liquidity and restrictive terms	Total Fair Value
A	2,250,000	\$0.051	\$114,750	20%	\$22,950	\$91,800
B	2,250,000	\$0.052	\$117,000	20%	\$23,400	\$93,600
C	2,250,000	\$0.054	\$121,500	20%	\$24,300	\$97,200
D	2,250,000	\$0.057	\$128,250	20%	\$25,650	\$102,600
			<b>\$481,500</b>		<b>\$96,300</b>	<b>\$385,200</b>

Source: KPMG analysis

### 3.6 Existing remuneration arrangements

The remuneration arrangements for Mr McKee Wright provide for a salary of \$250,000, with a six week annual leave entitlement. In addition, Mr McKee Wright receives Directors fees of \$25,000 per annum. Owing to the poor state of the domestic and global economy, Mr McKee Wright has voluntarily reduced his salary entitlement by \$50,000 per annum.

Mr Bryham's annual salary of \$150,000 is on the basis of 14 weeks annual leave entitlement. If his salary was restated to reflect the more common six weeks annual leave, we estimate that the salary would be circa \$180,000. Mr Bryham also receives Directors fees of \$25,000 per annum. Owing to the poor state of the domestic and global economy, Mr Bryham has voluntarily reduced his salary entitlement by \$50,000 per annum.

Mr Burrell receives no salary for his role. He receives Directors fees of \$25,000 per annum.

Messrs McKee Wright and Bryham's employment agreements can be terminated by either Sealegs or those Senior Executives by giving one month's notice and neither Senior Executive is entitled to any payment in the event that their position becomes redundant.

The total annual remuneration provided to Mr McKee Wright, Mr Bryham and Mr Burrell, including the value of the Options proposed to be granted under this Option Plan is detailed in the table below.

Total remuneration of Senior Executives, including the value of the Options					
	Base Salary	Adjustment for annual leave	Options	Directors fees	Total remuneration
Mr McKee Wright	250,000	0	42,800	25,000	317,800
Mr Bryham	150,000	30,000	42,800	25,000	247,800
Mr Burrell	0	0	10,700	25,000	35,700
<b>Total</b>	<b>400,000</b>	<b>30,000</b>	<b>96,300</b>	<b>75,000</b>	<b>601,300</b>

Note: Mr Bryham's base salary has been adjusted for the equivalent of 6 weeks annual leave (approximation only)

Source: Base Salary as advised by Sealegs, Directors fees as advised by Sealegs, Option value as per KPMG analysis

This is based on the pro-rata allocation of the \$385,200 Option value over the four year vesting period.

### 3.7 Market remuneration levels

We are advised by the Independent Directors that the leadership of the Company is undertaken collectively by Mr McKee Wright and Mr Bryham. While Mr McKee Wright's primary focus is on the management of the Company and Mr Bryham's is on product development, the Independent Directors consider that both Mr McKee Wright and Mr Bryham have significant leadership roles. Mr Burrell plays an important role as a liaison point for selling agents in Australia.

The Independent Directors have received independent professional advice on the appropriate remuneration levels for a CEO and Development Manager in a company such as Sealegs. A summary of this advice is set out below.

Market evidence - CEO remuneration			
	50th percentile	Upper quartile	Average
Total sample - Base salary	187,500	285,000	228,565
Total sample - Gross remuneration	282,125	368,650	334,338
Comparable sample - Gross remuneration	266,598	463,434	361,778

Source: Peter Ross Consulting Report

The "Total Sample" data in the table above is based on a review of data produced in a variety of New Zealand employment surveys.

The "Comparable Sample" data in the table above is based on a sub-set of the Total Sample data, with the companies selected being refined based on similar characteristics to Sealegs including, export focus, sales, and market capitalisation. The more refined comparable sample was not produced for the Development Manager role.

Market evidence - Development Manager remuneration			
	50th percentile	Upper quartile	Average
Total sample - Base salary	142,087	198,329	151,624
Total sample - Gross remuneration	152,226	205,542	168,010

Source: Peter Ross Consulting Report

Recommended gross remuneration range provided by Peter Ross Consulting for Sealegs' executives			
Role	Lower	Mid	Upper
CEO	253,912	282,125	330,317
Development Manager	184,987	205,542	226,096

Source: Peter Ross Consulting, 25 May 2009

We note that the report prepared by Peter Ross Consulting states that the Development Manager role is difficult to benchmark due to “the diversity of activities that fall into the position and the relative seniority and importance this role plays within the Company”. The report goes on to say “I do not have conclusive data on performance pay at the Development Manager level other than to say it would be expected to mirror that of a CEO at least to some degree.”

The report by Peter Ross Consulting did not review the market remuneration for Mr Burrell. However, the Independent Directors of the Board advise that Mr Burrell is an ambassador for Sealegs in Australia, and that he makes himself available for all issues arising in Australia at no salary cost. This includes liaison with agents and re-sellers in Australia. There is no longer an established office in Australia, so his role is important in maintaining a visible presence in this market.

Having regard to the market data and the report, we make the following observations:

- The total gross remuneration of Mr McKee Wright is between the 50<sup>th</sup> percentile and the upper quartile for CEO’s for total remuneration, and within the remuneration band recommended by Peter Ross Consulting, albeit towards the upper end;
- The total gross remuneration of Mr Bryham is slightly below the 50<sup>th</sup> percentile for CEO’s and significantly above the upper quartile for Development Managers. Having regard to the Board’s view as to his importance in the development of the technology of the business, his leadership role, and the stated difficulties in benchmarking this particular role, we consider that it is appropriate that his remuneration may sit between that of a Development Manager and a CEO; and
- The total gross remuneration of Mr Burrell is likely to be below market parameters owing to his decision not to receive a salary for his services. Peter Ross Consulting did not consider the remuneration level for Mr Burrell. However, as his involvement provides access to a market where Sealegs has no permanent office and having regard to the value of the Options to be granted, we consider that this is likely to be below a market level of remuneration.

### **3.8 Conclusion on fairness of remuneration levels**

Based on the analysis above, we are of the view that the total remuneration of Mr McKee Wright, Mr Bryham and Mr Burrell, including the value of the Options, are within acceptable market parameters.

### **3.9 NZ IFRS Requirements**

Under NZ IFRS the value of the Options will be amortised as an expense over the relevant vesting period for each tranche of Options. NZ IFRS has specific requirements on valuation measurement and reporting of the Options that are not specifically covered in this report. These requirements may result in more of the value being recognised in earlier years, and less in later years.

## **4 Evaluation of the Fairness of the issue of the Options for the purposes of Listing Rule 9.2.1**

In our opinion, after having regard to all relevant factors, the consideration and the terms and conditions of the Options are fair to the shareholders not associated with any relevant Associated Persons.

The key factors leading to our opinion are:

- the rationale for issuing the Options is sound;
- the escalating Trigger Price performance hurdle seeks to ensure that a tranche of Options can only be exercised if Sealegs' shareholders have received a positive return on their investment. The use of a performance hurdle is consistent with the approaches adopted by other listed companies on the NZSX;
- the benefits to be derived by Messrs McKee Wright, Bryham and Burrell will potentially be spread over five years up to 29 June 2014, thus providing a long term incentive which aligns the interests of these Senior Executives with Non-associated Shareholders;
- while the cancellation of the options issued in August 2007 and the issue of the Options at a lower price could be considered a potential negative feature of the proposed transaction, in our view this should be viewed in the context of the decline in financial markets globally and consideration of whether the previous options were still effective in motivating the Senior Executives;
- the allotment of shares upon the exercise of the Options will have a dilutionary impact on existing shareholders' interests in the Company;
- there is no adjustment to the Trigger Price in the event that Sealegs share price is significantly above \$0.10 at the issue date of the Options, which is a negative feature of the Option Plan. Subject to no material change in the share price we consider the positive features of the Option Plan outweigh the negative feature of no adjustment to the Trigger Price;
- the allotment of shares upon the exercise of the Options may have a small positive impact on the liquidity of Sealegs' shares;
- Mr McKee Wright's total remuneration, including the value of the Options, is within, albeit at the higher end of the remuneration range advised by Peter Ross Consulting;
- Mr Bryham's total remuneration, including the value of the Options, is higher than the remuneration range advised by Peter Ross Consulting for a Development Manager. However, we recognise the Independent Directors' view that Mr Bryham's significant leadership role and contribution to the Sealegs business is not adequately reflected in the title of Development Manager. This assessment of Mr Bryham's remuneration ignores the current voluntary reduction in Mr Bryham's salary, discussed further below;
- Mr Burrell's remuneration has not been benchmarked as he is not paid a salary. However, having regard to his role in developing the Australian market and the value of

the Options issued, we are of the view that it is likely to be fair having regard to the nature of the services that he provides to Sealegs;

- Mr McKee Wright and Mr Bryham have voluntarily reduced their salary by \$50,000 per annum in recognition of the poor economic conditions. If the Option Plan were not approved, it may increase the likelihood that they would claim the full contractual salary as detailed in this report. The annualised reduction in the salary broadly equates to the annualised value of the Options in each year. If they required payment of their full salary this would represent a cash drain on the Company; and
- the allotment of shares on the exercise of the Options will not significantly increase Mr McKee Wright's and Mr Bryham's ability to exert shareholder control over Sealegs owing to the restriction in the Option Agreement which prevents the allotment of the shares if it meant that Messrs McKee Wright and Bryham held 20% or more of the voting shares, giving rise to a breach of the Takeovers Code.

Overall, we consider that the positive features of the Option Plan outweigh the negative features, and that the Option Plan is fair to Non-associated Shareholders.

In our opinion the information to be provided to shareholders by Sealegs, together with this Appraisal Report, is sufficient for shareholders to understand all relevant factors and reach an informed decision as to the fairness of the issue of the Options.

## **5 Appendix 1**

### **5.1 Qualifications**

This Report has been prepared by KPMG Corporate Finance. KPMG Corporate Finance provides advisory services in relation to mergers and acquisitions, independent appraisal reports, valuations and other corporate advisory services.

The people responsible for preparing the Report were Justin Ensor, Director (CA, PGDip Applied Finance & Investment, Securities Institute of Australia, BCom University of Auckland) and Russell Florence, Partner (CA, MCom University of Auckland). Messrs Ensor and Florence have significant experience in valuations, preparing independent appraisal reports and advising on mergers and acquisitions.

### **5.2 Independence**

KPMG does not have at the date of this report, and has not had, any shareholding in or other relationship with Sealegs that could reasonably be regarded as capable of affecting our ability to provide an unbiased opinion in relation to this transaction.

KPMG has not had any part in the formulation of the Options Plan or any aspects thereof. Our sole involvement has been the preparation of this report.

KPMG 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 Options. We will receive no other benefit from the preparation of this report.

### **5.3 Declarations**

KPMG has prepared the Report at the request of the Independent Directors of Sealegs. The Report meets the NZSX Listing Rules 9.2.5 and Rule 9.2.1 in relation to the proposed issue of Options to Mr McKee Wright, Mr Bryham and Mr Burrell.

It is not intended for the Report to be used for any other purpose.

The Report has been provided for the benefit of the Non-associated Shareholders of Sealegs.

KPMG consents to the issuing of this Report to the shareholders of Sealegs.

KPMG provided drafts of this Report to the Independent Directors of Sealegs to confirm the factual accuracy of the Report. There was no alteration to the valuation methodology, valuation of the Options or conclusion as a result of issuing the draft Report.

In KPMG's view, the contents of this report in its entirety are enough for the Non-associated Shareholders Sealegs to determine whether the proposed transaction is fair.

KPMG consider that they have had access to all relevant information.

The assumptions we have relied on to form our opinion are clearly indicated within the body of the Report.

The terms of reference for completing this report were agreed with the Independent Directors of Sealegs and in no way restricted our ability to act.

KPMG is independent in terms of the NZSX Listing Rules. KPMG's appointment was approved by the NZSX.

## **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 Sealegs' 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.

## **5.5 Indemnity**

Sealegs has agreed to indemnify KPMG to the maximum extent permitted by law, against any and all costs, expenses or liabilities we incur to any person:

- In relation to any claim against us by a third party arising from or connected with any breach of Sealegs obligations to us;
- By relying on any information provided to KPMG by Sealegs or on Sealegs' behalf and which is false, misleading or incomplete.