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Taking Stock

Forestry. An accident waiting to happen and a lesson in why things should be kept simple

By Martin Conlon, Head of Australian Equities

UK singer/songwriter Billy Bragg was no doubt unaware of the existence of managed investment schemes (MIS) when he released the album "Don't try this at home", but the opening track, the name of which I have stolen for the title, aptly captures what I and many others, have always thought of them. The demise of two of the major scheme operators, Great Southern Plantations and Timbercorp, has given us a cornucopia of lessons on what not to do when setting up and running a business. In the hope that we might remember some of these lessons prior to embarking on another boom, I thought we'd reflect on a few.

Prior to examining the scene of the accident and performing the autopsy, it's probably worth understanding how these businesses arose in the first place.

The schemes arose from the "Plantations for Australia 2020 Vision" to treble the size of commercial tree crops to around 3 million hectares by 2020. Based on the assumption that demand for both hardwood and softwood products would continue to grow and that timber resource in other regions was becoming uneconomic, Australia could be positioned to fill the void and create significant employment along the way. Whilst the vision may have had some merit, it's fair to say it has become a little blurred since its launch in 1997. Given the vision of the experts in the field has gone a little awry, I feel the amateurs (me) are entitled to have a go. As they say, in the land of the blind, the one eyed man is king!

Even for an ignoramus like me, whose forestry experience consists of the occasional bushwalk and the more direct experience of paying a gardener to replant trees I inadvertently killed, the required elements for trebling the amount of plantation land would seem relatively simple. Key elements might include:

- Land on which trees might feasibly be expected to grow
- Seeds/saplings to plant on abovementioned land
- Water to nourish abovementioned trees
- Funds to pay for acquiring the land and making sure the trees grow

Sounds relatively simple so far. So, where did the mistakes start?

Lesson 1: For a business to make sense it must make acceptable returns

One part of the 2020 vision which seems to have lacked a little vision, is the often overlooked question of whether this enterprise of procuring land, planting trees, waiting for them to grow and subsequently harvesting, actually made money. Creating jobs is one thing, but unless the exercise created sufficient cashflow over the life of the investment to deliver the investors an adequate return, the business premise is debatable. For investors to lock away their money for 10 or 20 years without any cash return in between, one would anticipate that rational individuals would expect a reasonably high rate of return. Not so apparently in the case of this intrepid bunch of 'growers'.

In the case of forestry (and agriculture in general), one of the greatest hurdles to generating an acceptable return is the cost of land. As with real estate generally in Australia, land is expensive. The Australian psyche dictates that one must subscribe to the theory that land prices always rise and that no price is too high for a

good block. Regardless of how low the cash returns are on an investment in land, one must assume that there will always be a future buyer at a higher price. In the case of residential real estate, that has moved us to a situation where it is almost impossible to buy a property which yields sufficient in cash terms to pay the interest if the purchase price is borrowed. This acceptance of exceptionally low returns on land has created significant issues in making any investment in an enterprise which involves land ownership, look sensible. Whether it is farming, forestry, property development or retirement villages, all are hamstrung by this issue.

Contrary to popular opinion, this situation has in my view, substantially lessened the probability of land values continuing to rise in the future. Unless the cashflow returns on the enterprises which employ this land are permitted to rise, the continuity of these enterprises will rely on investors continuing to make investment decisions which entail accepting exceptionally low rates of return in the hope that a future investor will accept a lower one. Last I looked, this was roughly the definition of the greater fool theory. For me, this also represents a great example of the perils in extrapolating historical experience as the basis for investment decision making rather than applying logical thought. For example, for Federal Ministers to now be quoting 10 and 20 year returns from equities and bonds unfavourably to returns from residential property seems dangerous, even foolhardy. In my early days as an analyst a colleague of mine used to refer to the general popularity of the techniques employed by the famed analyst Phil Wright. This pseudonym was a reference to the function in Microsoft Excel which permits us all to apply a seemingly innocuous growth rate and copy it effortlessly as far into the future as one desired. Phil has a fair bit to answer for as far as analytical errors are concerned!

In the case of plantations, the vast majority of the investment to grow a tree to maturity is in the cost of land, and it is this variable that has killed the economics. In the early years of plantation establishment, land prices may have been reasonable and there may have been a reasonable chance that investors could secure an adequate return assuming everything else went well (decent forestry practices, rain, reasonable woodchip prices etc), but as might be expected when artificial demand is created, the booming demand for new plantation land caused the prices of land to escalate rapidly. Without commensurate changes in the prices which investors were likely to receive at harvest, the returns to investors were falling sharply. Each year of sharply rising land prices was driving returns to investors lower and making the business less economic. In any well run business, declines in the prospects for future return would cause operators to review the investment case and wind back the amount of capital being invested. This industry would not fall into that category.

At the risk of falling into the trap of some of my old Latin teachers (deftly combining verbosity with intense boredom), I think I've spent enough time on lesson 1. The point? The overall return on capital of a business (on an ungeared basis), needs to be constantly reviewed to ensure it makes sense. A business making very low rates of return will eventually go broke. Identifying them in retrospect is easy, in prospect more difficult. As returns fall and reach unsustainably low levels, sensible investors should starve these areas of capital until the returns reach adequate levels again. Land intensive operations in this country are, in my opinion, prime candidates for this problem, and need to be rectified prior to going the way of many plantation operators.

Lesson 2: Financing an asset in a manner commensurate with its cashflows

The financing issues for forestry schemes are not simple, but the issues are broadly similar for every investment. Two major factors complicate the financing of a business enterprise:

- The level of the cashflows relative to the initial outlay (the return on investment)
- The pattern of these cashflows over the life of the investment

When the return on investment is high and the cashflows are extremely regular, the financing exercise is straightforward. If a \$1m investment makes a 20% return every year, whether you choose debt or equity financing or a mixture of the two, you'll generally be OK, as even with almost all debt financing, you'll have plenty of cash to pay the interest.

When the return on investment is low, but the cashflows regular, options become a little more limited. Using debt, at least to a degree, is still an option, but some equity is likely to be required, as the cashflow from the investment will either be insufficient to accommodate predominantly debt funding, or it will make the remaining equity extremely sensitive to small changes in the cashflows or the rate of interest paid on the debt. We could probably put the bulk of the listed property sector in this category. The cashflows were stable, but small changes in the rate of interest or the bank's propensity to lend had fairly dire consequences for equity holders.

When the return on investment is low and the cashflows volatile, unpredictable and some way in the future, funding options become more limited again. Using debt in this instance is extremely problematic, as one either requires a banker that is not overly desirous to earn interest on money lent, or shares your optimism on cashflows into the future and is happy to defer his interest until judgement day arrives. In case you hadn't guessed, I would put plantation investments into this category. In case you hadn't also guessed, I tend to prefer investments in category 1.

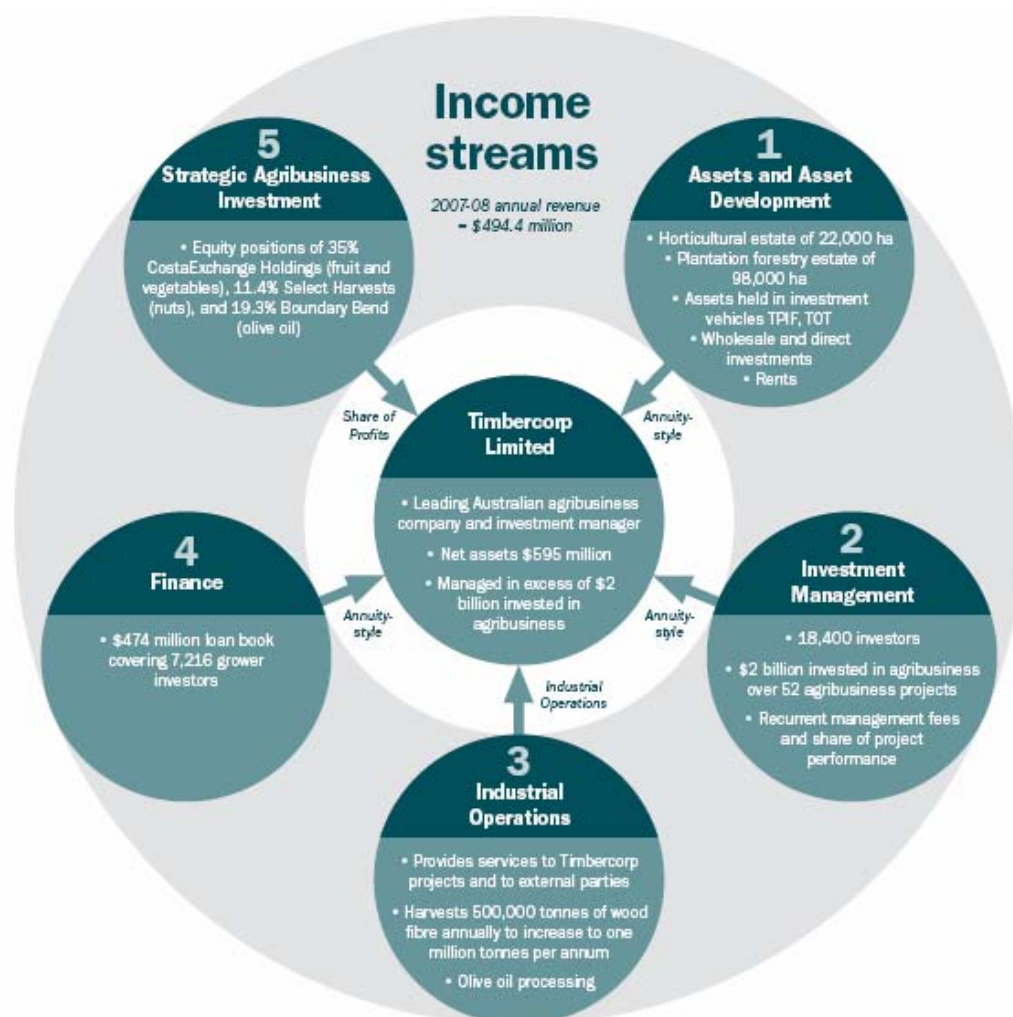
These statements are obviously simplistic, as return on investment is rarely as stable and predictable as investors would hope. Also, there are many instances where returns may start at low levels and grow over time. A currently low rate of return on investment is not always bad and a high one good. The point is, that investments such as forestry where the cashflows are some distance into the future, are not conducive to debt funding. They suit investors with long term time frames able to provide 100% equity funding on the expectation that cashflows at the end of the period will provide sufficiently high returns to justify the risks in the investment. As current plantation owners are likely to find out, these investors will enter the market only at a price where the expected returns justify the uncertainty. I will hazard a guess that this level will not justify current prices of forestry land.

The moral of this lesson is straightforward. Think about the quantum and pattern of the expected cashflows from an investment before deciding on a funding structure. Leverage should be introduced to an investment because the fundamentals justify it, not because a banker offers it.

Lesson 3: Keeping the business structure as simple as possible

Despite the apparently simple set of pre-requisites laid out in my idiots guide to forestry earlier, the approach which was taken to solving these problems was anything but simple. Although some of the better operators are still in business, those left standing are still facing all sorts of challenges to rectify the flaws in the industry related to undue complexity. Interestingly, the players left standing are largely the ones that emerged from a background in forestry, rather than those seeing opportunity to create an investment management business. Even those left standing are on decidedly wobbly legs.

Trying to ascertain whether Timbercorp made any money, where the cash was, and how much debt they actually had, was one of the greater challenges in analysis. Trust structures, off balance sheet financing, a list of products which expanded to include almonds, olive oil, citrus, table grapes, mangoes, avocados and tomatoes on top of the original plantation projects made you wonder whether they were in structured finance, funds management or running a fruit shop. Anyone whose integrated business model diagram looks like the chart below has probably got a few issues (especially if on reading it, you still have no idea how they make money). The trust structures and complex financing plans did little to disguise the fact that the schemes were not generating any cash and the purchasers of most of the schemes had to borrow the money to make the investment in any case. The 'growers' knew as much about agriculture as most car owners know about the inner workings of their car's anti-lock braking system.



Source: Timbercorp annual report 2008

All this is a circuitous route to a simple message. We have almost never found a business in which undue complexity and lack of transparency are positive signs. Either the managers of the company are trying to hide something from shareholders, the business actually makes less than it appears or takes more risk than it appears, or customers are being misled as to the value proposition of what they're buying. The industry to which I owe my living is a prime offender. I can't find too many complex products in new fangled asset classes which are being launched to allow fund managers to provide lower cost and better value services to their clients. Keep things simple!

Lesson 4: Aligning the incentive scheme with the desired outcome

Perhaps the most egregious mistakes in the managed investment scheme industry, were made in the area of incentives. By the time the schemes were up and running, the interests of those purchasing, operating and flogging the schemes were out of alignment to a truly alarming degree.

In the case of the purchasers, the rationale for buying was being dictated almost solely by the insatiable desire to not pay tax. The sentiments of the average Australian taxpayer were probably best summed up by Kerry Packer. "Now of course I am minimizing my tax, and if anybody in this country doesn't minimize their tax they want their heads read, because as a government I can tell you you're not spending it that well that we should be donating extra". Whilst I share Mr Packer's sentiments, the desire not to pay tax should not overwhelm a sensible analysis of the investment prospects. In my language, terms like negative gearing are a fancy way of saying "loss". Investing \$10,000 for a \$5,000 tax deduction leaves you \$5,000 behind if you don't get anything back. Even if returns were reasonable, tax was always payable on receipt of harvest proceeds, leaving the value residing in the present value of the tax deferral. Whilst there can be very sound logic in tax deferral, there

is little doubt in the case of many managed investment schemes that it was the lure of the tax deduction which drove the investment. Offering tax deductions creates powerful incentives. It doesn't necessarily make the object of the deduction a good investment.

It is probably not going out on a limb to suggest that those flogging a number of the less auspicious managed investment schemes are likely to be the object of some vitriolic criticism in the future. The commission structures set up in many of these products were instrumental in engineering the train smash. Higher priced schemes offered the seller higher commissions while simultaneously ensuring the purchaser received lower returns. Fairly basic logic would dictate that in the absence of an operator weaving some magic to allow his scheme to deliver markedly higher returns than competitors, the more an investor paid for his hectare of land, the lower his likely return on investment. However, as the higher priced products offered far higher margins to operators, they were able to fund far higher commissions and became far more attractive to the salesmen. Understanding why the highest priced products were also the biggest sellers becomes straightforward. While the salesmen were merely responding to the basic financial incentive of making more money, the incentives were wrong.

The last links in the chain were obviously the scheme operators. Having set up businesses specifically to aggregate investor funds and deploy them into growing timber, they set about responding to the demands of public company investors. Profit (or, even more fortuitously for the promoters, some theoretical derivative of profit as mandated by a ludicrous Accounting Standard named SGARA). This short term profit incentive played a vital role in designing a business model which contributed significantly to the companies' eventual demise. The long dated nature of the schemes and the accounting methodology used to report profits were also significant factors. The profit reporting methodology dictated that operators were almost obligated to sell a greater volume of product each year to drive profit growth, regardless of the cashflow consequences. Reported EBIT margins on every dollar of project sales were more than 50% (a figure which probably should have caused people to ask a few questions. If a \$10,000 plantation investment was allowing the company to report more than \$5,000 in profit after paying commissions of more than \$1,000, not that much of the investment could be left to invest). These sky high margins actually resulted in significant cash outflows (due to the nature of the schemes as previously discussed), and the more that was sold the bigger the outflow. In satisfying investor demand for rising profits to drive a rising share price, management were presiding over an increasingly negative cashflow hole. As has been the case in all too many companies, the drive for short term profit and earnings per share growth has been a hugely destructive incentive. With Rupert Murdoch agreeing to pay Chase Carey tens of millions of dollars a year based on earnings per share growth targets which exclude abnormal items, it would appear we're making slow progress on this front.

Humans respond to incentives, and if these incentives are poorly structured, the scope for accidents is greatly increased. The quantum of incentivisation is one aspect, but the control of risk taking, the time frame over which incentives are paid and the ability to claw them back when things go pear shaped are equally important. Paying Great Southern executives and salesmen in woodlots or deferring payment until the long term cashflows of the product had been delivered might have changed the outcome a little I'd suggest!

The mistakes made in the forestry industry offer plentiful lessons in how not to approach business, and the ones explored above are without doubt only a subset of those to be learned from the demise of Great Southern and Timbercorp. As with all lessons, they have value only if we avoid making the same mistakes next time.

For any readers supportive of the above themes, we encourage you to take advantage of our newly launched '180/80 Long-short, alpha beta separation, volatility capture hedge fund', available for a fee of only 3% of FUM plus performance fee of 50% above cash. An 800 page PDS is available on request. Just kidding!

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