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NewForests

Rationalizing Timberland Managed Investment Schemes

The Changing Landscape of Australia's Forestry Investment Sector

In the 1990s Australia faced a growing deficit in wood products trade. The federal *Managed Investments Act of 1998* responded to this timber supply shortage by creating a retail investment structure that allowed investors to take a personal income tax deduction for the cost of investing in timber plantation and agribusiness development activities through Managed Investment Schemes (MIS). The creation of the timberland MIS industry was more successful than anticipated. New companies were formed to offer MIS products to the retail market, and the sector grew quickly in response to investors wanting to manage capital gains tax bills associated with the rapid gains of the Australian Stock Exchange (ASX) between 2000 and 2007. The MIS sector established almost 1 million hectares (2.5 million acres) of timber plantation in Australia between 1998 and 2008. In the peak year of 2006-07, investors placed over AU$1.2 billion dollars in MIS projects.

To meet the surging demand, MIS companies needed to acquire substantial land assets. However, the cost of buying land is not tax deductible to the investor under the *Managed Investments Act*, so the MIS companies financed land purchases on their balance sheets with substantial bank debt. After the financial crisis of 2008-2009, the combined effect of a volatile share market, reduced demand for MIS products and an inability to roll over debt facilities led to a raft of bankruptcies and a somewhat disorderly re-structuring of the MIS sector. In 2009, MIS sales fell to below $AU300 million and in 2010 fell further to below $100 million. With major MIS companies being liquidated and most MIS investors losing much of their investment, it is unlikely that the sector will ever recover. The opportunity for institutional investors is to rationalize the land and forestry assets – 1 million hectares of timber plantation – into a consolidated timberland asset.

How MIS Products Work

The MIS sector is a direct product of tax legislation designed to encourage investment in plantations. This was particularly effective as a means to drive forestry investment because the early tax deduction was seen as balancing the risks associated with investing in newly established plantations that require 10-14 years of growth before the timber becomes marketable. Tax deductions are awarded in the year the investment is made, and the MIS companies were allowed to charge all the reforestation costs, management costs and leasing costs as a single-up-front payment—often in the order of $10,000 per hectare. In many cases the MIS companies financed the investments with up to 100% debt, allowing the investor to gain the tax deduction with no upfront payment.

Forestry MIS companies were to establish and manage the plantations and market the timber products on behalf of the individual investors in the scheme (known as "growers"). The MIS company was typically paid a management fee and a share in the harvest proceeds. Upon raising the funds, the MIS operator had 14 months to secure land and undertake reforestation operations.

Rise and Fall of the MIS Industry

The MIS industry first rose to prominence in the late 1990s as rising stock markets drove interest in tax management products. In 2000 the Federal Government of Australia tried to limit the growth of the schemes by requiring that the reforestation occur in the year of investment, but as the stock market contracted in 2001, the entire industry went into a near collapse. The government reversed its tightening of regulation, and the commodity-led boom of the early 2000s led to recovery and further expansion of the MIS sector. This resulted in a kind of land grab, as firms scrambled to buy enough land to fulfil their tree-planting quotas within the required 14 months of selling an MIS product to the retail investment market.

The MIS company investments focused primarily on blue gum plantations near ports for woodchip export, which are attractive because of the relatively short (10-14 year) rotation length. There were also MIS projects for radiata pine and tropical hardwoods, including sandalwood. While there is high demand for many of these quality wood products, MIS cost structures were generally considered too high to make commercial sense, even factoring in the tax benefits.

In 2009 the government moved to curtail the MIS sector, but again the effort was poorly timed, coming as global markets felt the shock of the credit crisis. Most MIS operators were listed on the ASX and quickly came under pressure from falling sales, falling share prices and a refusal by the banks to continue to extend or roll over their debt facilities. Timbercorp and Great Southern Plantations, the largest MIS companies, went into administration/receivership in April/May 2009, leading to questions about the viability of the whole sector. In fact by late 2012, all the main MIS companies other than Elders Forestry had failed, and Elders Forestry only survived because it was part of a diversified conglomerate and sold almost all its forestry assets at a loss. The corporate turmoil has been a challenge for the many tens of thousands of grower investors, but the resulting restructuring and sale of assets also creates the opportunity to institutionalize forestry investment in Australia. The rationalization should lead to the consolidation of Australian hardwood plantations into a smaller, high-quality forestry estate on a core area of the former MIS landholdings.

Market Activity

Since 2009, the effort to recapitalize the Australian forestry sector has been ongoing. As of January 2014, nearly all of the major MIS assets have transferred to institutional ownership:

- In late 2008, Great Southern Plantations, the largest MIS operator with over 40,000 investors, saw the writing on the wall and offered to buy out its growers in bulk. Only one-quarter of the forestry investors accepted an offer to trade their woodlots for shares in Great Southern. Subsequently, Great Southern was unable to service its debt and went into Administration and Receivership in May 2009. The management rights to the plantations were sold to Gunns in December 2009, and in January 2011 New Forests' Australia New Zealand Forest Fund along with Alberta Investment Management Corporation acquired the 270,000 hectare forest land holding for $415 million. This transaction left 40,000 or so retail plantation investors in APT (managed by Elders Forestry) and Great Southern Schemes in place.

- Timbercorp was placed into Voluntary Administration and then Receivership in April 2009. The Receiver, KordaMentha, went through a Court process to wind up the retail investment schemes and then sold the land and trees collectively as a timberland asset. There were approximately 95,000 hectares of trees, predominantly on leased land but also 39,000 hectares of freehold land. This sale was widely publicized during October 2009, when the assets were purchased for $345 million by Australian Bluegum Plantations, an Australian company managed by US-based Global Forest Partners. A portion of the purchase price was used to repay the bank debt and release the security charge over the land, and a portion was distributed among the company's 15,000 woodlot investors.

- Forestry Enterprises Australia (FEA) was placed in Administration and Receivership in April 2010 owing $215 million in debt. The company has an estimated 77,000 hectares of plantation land in Tasmania, New South Wales and Queensland, which, at time of writing (January 2014) is being marketed as a consolidated land and timber plantation asset by an investment bank.

- In May 2010, Rewards Group, which managed 12,000 hectares of forest and horticultural plantations, including teak, was placed in Administration, leaving the fate of $250 million of MIS investor funds uncertain. A sale of the land and trees for $46 million was concluded to US timberland investor GMO in 2011. News items since then suggest that the land is being entirely returned to agriculture.

- In July 2010, Willmott Forests entered a trading halt after its MIS sales missed projections, and in September 2010 entered Receivership, owing $120 million. In December 2011, it was reported that Global Forest Partners had purchased the Willmott assets for approximately $80 million, subject to final court approval. The transaction has now been completed.

- Elders Forestry also saw their MIS forestry sales plummet after 2007, and undertook a review of their forestry business and assets in 2010. In 2011 it was announced that Elders would completely exit from all forestry business and sell all their forestry assets. Elders sold 14,000 hectares of land and a proportion of ex-ITC and Elders Forestry woodlot projects (via a court mediated process) to Global Forest Partners (GFP) in April 2012 for a reported $105 million. Elders also sold their woodchip export facility in Albany to GFP as part of the transition. Elders sold its woodchip export facility in Tasmania (Smartfibre), which was a JV with FEA, to Neville Smith Timber in October 2012. Elders also sold the 32,000 hectares of APT MIS plantations to New Forests for an undisclosed price in March 2013, allowing the land and the trees to be recombined into an integrated ownership.

- Gunns ceased offering new MIS products in 2010 and was systematically selling down assets as it sought to restructure its business and raise capital for a major pulpmill project in Tasmania. Gunns sold its 40,000 hectares of green triangle softwood plantations to New Forests' Australia New Zealand Forest Fund for an undisclosed price in March 2012, and its Portland woodchip export facility to Global Forest Partners for $61 million in July 2012. Gunns was unable to recapitalize its business or raise finance for the pulp mill and was placed into Administration and Receivership in September 2012, representing the last major piece in the MIS restructure puzzle. Gunns managed approximately 94,000 hectares of hardwood plantations in Tasmania, half as MIS Projects. The Gunns Tasmanian estate includes almost 200,000 hectares of freehold land. Gunns was also the manager for the remaining 120,000 hectares of Great Southern timber plantations across all six Australian States. In March 2013, the courts approved the liquidation of Gunns assets. In April 2013 the Liquidator announced that it was abandoning efforts to appoint a new manager for the Gunns MIS projects, and that the assets would be the subject of a court mediated sales process. In December 2013, the

Forestry Investment Trust managed by New Forests acquired the former Great Southern plantations that had been managed by Gunns since 2009. This transaction included approximately 80,000 hectares of plantation trees purchased at an undisclosed price. As of January 2014, the Gunns Tasmanian assets are on the market.

Lessons Learned from the MIS Industry

Australia's plantation forestry sector has been almost entirely developed through either direct government funding in the case of the softwood plantation estate or through tax inducements via the MIS legislation in the case of the hardwood plantation estate. This government intervention was largely justified by the growing wood products trade deficit of Australia and the view that private investment was not available for long-term forestry programs. The era of large-scale Government intervention and support for forestry in Australia now appears to be ending. The softwood plantations, owned by State Governments are now systematically being sold to institutional investors, and the MIS forestry estate is also now being rationalized into institutional ownership.

The failure of the MIS industry is in some ways a reflection of the inherent problem of using tax inducements to fund an industry. The tax deductions become the goal, and the underlying investments become a kind of by-product of the tax deduction. While most of the MIS timber plantations in Australia were professionally established, the drive for land and planting deadlines pushed new plantations into areas of low rainfall, poor market access or areas of limited historical forestry experience. As MIS companies acquired extensive land banks with debt finance, the sector became overleveraged. The high costs of managing large numbers of retail clients, packaging and selling the products, and financing the whole cost base upfront, meant that the projects were commercially non-viable. So while the calamitous end of the MIS was unforeseen, many commentators felt it was overheated and due for some form of correction. Ultimately, the stress of the financial crisis led to a complete collapse of the industry.

The restructuring of the Australian forestry sector to institutional ownership is beneficial for the industry's long-term outlook. The industry will be consolidated into core areas that are commercially viable, and concerted work on market development and improved commercial returns will lead to a sustainable and internationally competitive industry. New Forests has established a significant position in the restructured Australian forestry sector and will be seeking to contribute to future growth and opportunity for the industry.