



Brent Sheather's RESEARCH

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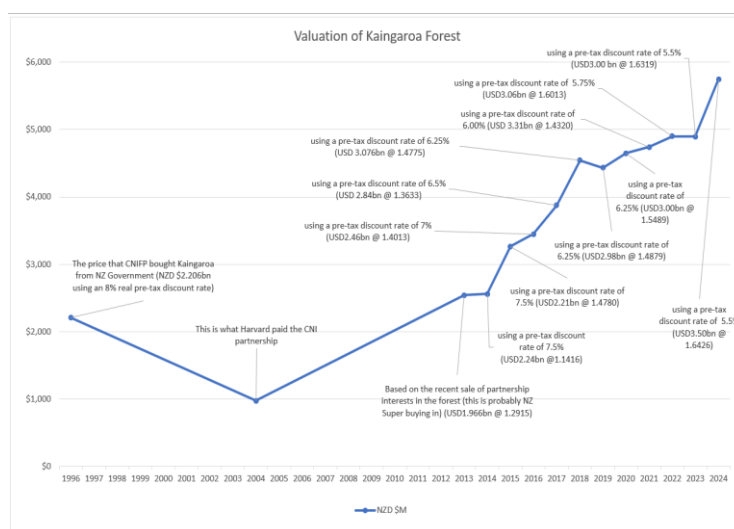
Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

THE SAD STORY OF FORESTRY AS AN INVESTMENT ASSET IN NEW ZEALAND – Part 4 : DAVID SWENSEN STRIKES GOLD IN NEW ZEALAND

As we saw in Part 2 of this series, Fletcher Forests' attempts to recapitalize and buy back Kaingaroa were rejected by shareholders for a number of reasons, not least of which, was a very poor recent performance of the listed forestry sector. FFS subsequently then sold its own forests using a very high discount rate. This unfortunate confluence of events allowed the Harvard University Endowment, in 2004, to buy Kaingaroa Forest at a bargain price from the receivers of the CNIFP. The sale price was a rumoured \$972 million, which apparently just repaid the partnership's creditors. Lumber prices are volatile and the old corporate finance rule, that businesses with high operating leverage should not combine that with high financial leverage, comes to mind. When questioned as to the rationale for the purchase a spokesman said that Harvard's analysis "*looked forward, not backwards*" and their investment decision wasn't "*constrained by debt*". Perhaps there was a hint of sarcasm in that comment nevertheless, with the benefit of hindsight, those forests were sold too cheaply, and not simply because Harvard's analysis "*looked forward rather than back*".

So Harvard bought into Kaingaroa in 2004, paying NZ\$972 million. The "partners" lost all their equity, or about \$1.2bn, given that they had bought the forests from the NZ Government for \$2.2bn in 1996. If we look at the graph adjacent it shows that Kaingaroa has proven to be a very good investment: As at June 2024 Kaingaroa was valued at NZ\$5.75

bn which is almost 6x what Harvard paid the receivers. Using the accounts of Kaingaroa Timberlands Limited (KTL) I built a simple internal rate of return (IRR) model to calculate the geometric (compound) performance of Kaingaroa, given the initial price which Harvard paid, the valuation in 2024 and estimates of the dividends paid to shareholders over that time. Unfortunately KTL weren't willing to disclose details of dividends paid in the period from 2004 to 2012 so I have assumed the same level of distributions were made in each year in that period as the annual average paid in the 2013-2024 period. Assuming no debt the internal rate of return has been an impressive 16.1%. For context the NZ stock market over the same 20 year period returned 8.0% pa. But that is not an apples to apples comparison – the share market return is a return on equity whereas the return on the



Source: Kaingaroa Timberlands accounts

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forest is calculated assuming no debt. We don't know how much debt Harvard originally used to buy Kaingaroa but looking at the accounts over the years there seems to be a high level of leverage. If we assume, for simplicity, 50/50 debt and equity then the internal rate of return jumps to an outstanding 26.6% pa.

It was impossible to calculate the exact return Harvard achieved given it had progressively sold down with the sale price not always disclosed. Despite talking up their long term perspective Harvard began selling down its position in Kaingaroa less than three years after its original purchase, firstly offloading 20% to the NZ Super Fund in 2006 and a further 10% each year in 2007 and 2008. By 2014 Harvard had exited completely. As has been well documented the Harvard Endowment's strategy of investing in illiquid private equity assets has proved problematic in recent times and the sell down possibly reflected a need for cash.

The estimated 26.6% pa is an outsized return, even, I imagine, by Harvard Endowment private equity standards. Why was David Swenson and his team attracted to Kaingaroa and how did they achieve those high returns? There were four important reasons:

- Kaingaroa was, and continues to be, one of the world's largest, single plantation forest estates offering scale economies in harvesting, transport and marketing. Harvard got into investing in timber land before many other institutional investors so Kaingaroa's high quality assets, size and low costs made it definitely on Harvard's radar.
- With FFS shareholders opting not to buy back into Kaingaroa and the recent short term poor performance of the forestry sector putting off other potential local bidders Harvard was able to buy Kaingaroa at less than half the price which the NZ government had originally sold it seven years earlier. This bargain price, more than anything else,

is behind the high estimated 16.1% pa unlevered return.

- Harvard further increased its return through leverage – we don't know the extent of the borrowings but in the first full year of operations, for which accounts are available, 2014, debt funded 55% of total assets.
- Harvard likely used very different inputs to the dcf valuation of Kaingaroa. The impact of these inputs meant that Harvard valued Kaingaroa much higher than local valuers and the extent of the difference might have been further improved by Harvard's favourable tax status. Harvard likely valued Kaingaroa using discount rates based on a US risk free rate. I note that the accounts for Kaingaroa are presented in US\$ terms, even today. In a paper on corporate finance a few years back Professor Aswath Damodaran of the Stern School of Business at New York University made the point, when choosing what discount rate to use in a valuation of an asset, that the risk free rate should reflect the currency that the sales generated by the asset are denominated in. Logs from Kaingaroa are primarily exported and sales are priced in US dollars so, if the FFS analysis is any indication Harvard may well have used a much lower discount rate than the local based valuers used. For example, back in 2004 the ten year US government bond yield averaged 3.47% whereas the ten year NZ government bond averaged 6.1%. The Harvard Endowment, from what I can see, was only subject to a 1.4% excise tax in the US on its endowment income. Therefore, it could, theoretically, pay a higher price for the Kaingaroa Forest than other interested parties.

These markedly different inputs to the dcf model, as used by local and overseas investors, are particularly relevant to the sale of the FFS forestry assets. Recall FFS chairman Dryden Spring's comments back in 2003 at the time of the sale of the forestry assets; he said

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"The sale decision was made because over the last decade with the exception of a brief period in the early 1990's, the forests have never earned the opportunity cost of the capital invested in them." I'm by no means an expert in capital budgeting but my limited knowledge of the subject is that the cost of capital for Fletcher Forests was derived from that company's cost of equity and cost of debt. Both of these metrics are likely to have been, in part, a function of the high relative yields prevailing in New Zealand's equity and debt markets rather than, as suggested by Professor Damodaran, that the risk free rate upon which both of these numbers depend "should reflect the currency that the sales generated by the asset are denominated in". In 2003 the 10 year US Government bond was priced at a yield about 200 basis points below the 10 year NZ Government bond. In terms of the DCF model for the forest assets that difference alone could have increased the valuation by around 30%. Furthermore the US specialist forestry investor, Prudential Forestry Investments which partnered with the local rich listers is very likely to have assumed a lower level of volatility in calculating the cost of equity, basing it on a model of the historic volatility of a forest asset rather than that implied by the highly depressed FFS share price. That company used a 10.5% real, after tax, discount rate to value its forest versus the 8% real pre tax rate used by the government to value Kaingaroa and the 5.5% currently employed to value that forest today.

What all this means is that both of these huge NZ forest assets were materially under-valued by their NZ owners providing once in a lifetime opportunities for overseas investors.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.