Brent Sheather's RESEARCH

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

SAD STORY OF FORESTRY AS AN INVESTMENT ASSET IN NEW ZEALAND – Part 2 : Selling at the bottom

In the last column we started a four-part deep dive into the recent history of the listed forestry sector in New Zealand starting back in 1983 when various reports were published forecasting huge growth in the output of NZ exotic forests and a concomitant expansion in the processing of that output in terms of new pulp and paper mill and sawmill capacity. Whilst the increase in log output from the forests occurred what the forecasts got wrong was that much of the expected processing didn't happen with the result that the majority of the extra logs have been exported and that is why we have so many logging trucks ruining our roads these days. Not only has the added value content disappointed but New Zealand's two major forestry assets, those owned by Fletcher Forests and the Government owned Kaingaroa Forest, were sold to overseas interests with the result that today there is no pure forestry company listed on the New Zealand stockmarket. Indeed, back in the '80s the forestry and forest processing sector was an important part of the NZ bourse with stocks like Tasman Pulp & Paper, NZ Forest Products, Carter Holt, Odlins, Winstones, Henderson & Pollard and Nuhaka all listed. In today's column we will take a close look at how the sale price of Fletcher Forests forestry assets was derived and speculate that it was sold at a bargain price.

As outlined in the last column, at the time of the sale, back in 2003, the FFS Chairman attributed the recent sharp revaluation downwards in the value of the forestry assets to lower log prices, a stronger NZ dollar and a higher discount rate. Log prices and exchange rates are easily observable variables but the determination of an appropriate discount rate involves some degree of opinion. In terms of the typical discounted cashflow model used to value a long duration asset like a not yet fully mature forest with cashflows ramping up over may be a five year timeframe the discount rate is a key variable. For example, a 2% increase in the discount rate, from 6% to 8%, for a mature forest with steady cashflows decreases the valuation by about 30%. If we assume long term inflation of 2% that real, after tax discount rate is equivalent to a nominal, after tax rate of 12.5%.

It is worth thinking about the significance of that 12.5% discount rate. What it means is that, if the cash flows occur as per the valuation, then the group who bought the FFS forestry assets at that valuation would achieve a compound return on their investment of 12.5% pa *after tax*. At the time, as an FFS shareholder who was selling those forests, that looked to me as being an extraordinarily good deal for the buyers given that NZ 10 year government bonds were yielding just 3.6% after tax at 33% back then. With the benefit of hindsight, the sale turned out even better for the purchasers because, as we will see in a future column, the discount rates used to value forests have fallen substantially since then, along with long-term interest rates. The disappointments don't end there: at the time of the sale the FFS directors talked up the fact that there would be a considerable increase in wood processing which would add value and be more profitable than owning a forestry asset. According to ChatGPT, referencing MPI data, that hasn't happened – in fact sawn timber exports 20 years later, in 2024, at 1.4m m^3 were actually lower than the 1.689m m^3 exported in 2004 and, of course there are no longer any NZX listed sawn timber companies around today.

Given how badly the sale turned out for FFS shareholders, exports and jobs we should acknowledge what might have been: on the 17th June 2002 FFS announced a deal with the receivers of CNIFP to purchase the Kaingaroa forest. At the time the Chief Executive of FFS, Terry McFadgen, said, "This is an exciting and unique opportunity. The CNIFP estate is the largest plantation forest in New Zealand which, when combined with our adjacent forests, will total over 260,000 planted hectares (643,000 acres). These well established forests, situated in the Central North Island of New Zealand, have excellent growth rates, low harvesting costs and access to a highly developed infrastructure of both on and off highway roads." He noted that the combined forests, together with their associated processing facilities and skilled workforce, would provide the scale, low cost position and customer base to underpin the strategic growth of the Company. "Our Company along with the rest of the New Zealand forestry industry must improve returns on capital employed through further cost efficiencies, more sophisticated marketing offshore and further investment in add-value processing facilities. This acquisition gives us the required platform for those initiatives," he said.

Unfortunately that deal required the approval of FFS' shareholders and despite the independent board members recommending the transaction it was rejected by shareholders. If that deal had gone ahead it would, as we will see in the next column, likely to have proved to be a transformational deal for FFS. So I contacted Mr McFadgen, now retired, to seek his thoughts as to why shareholders voted against the deal. By email he said "The deal to buy the forest was put to shareholders and it required a 75% vote to succeed. But it only got a vote in the low 70s. The issues were as follows:

1. Rubicon, which held an 18% interest in FFS, would not support the transaction because it didn't fit their future strategy, and they insisted on being paid out. Normally that might have been achieved via an equity raising, but the market environment at the time was negative. You may recall that log prices had not performed well, largely thanks to Russian wood. And, of course, the lack of a large pool of investable funds in NZ made the problem worse.

2. So, it was agreed to pay Rubicon out by transferring a chunk of forest to them. However, that created its own problems. First, the late Bryan Gaynor and some others decided there was some "insider" dealing going on with FFS looking after its old mates at Rubicon (in fact the reverse was true).

3. Worse perhaps, we had another large shareholder, Xylem, a forestry fund in Boston. But it had been very disappointed with its NZ investment and it decided that if Rubicon could be paid out, it should be paid out too, which we could not and would not agree to.

4. And matters were made worse by the fact that both UBS and Hancock were active in NZ looking to buy forestry assets - especially Kaingaroa. I suspect that they did whatever they could to turn shareholders against the deal.

5. Because FFS could not access equity it had to fund the proposed purchase using a lot of debt. And whilst that debt could be serviced at current log prices (or up to about 15% below I think), sharper falls in log prices would put debt covenants at risk. Some shareholders

were quite concerned about this risk, particularly those who had little confidence in the path of log prices.

At the heart of all this it was the NZ savings/investment problem. There simply was not a pool of long-term investors ready, willing and able to support the long term strategic view that forestry requires. This same problem has been with us for decades and has been at the heart of the demise of NZFP, CHH, NZ Steel, FCL and so on. Its a long and depressing list. In recent decades the savings problem has been exacerbated by bad policy which pulled billions into a housing bubble, now unwinding with ugly effects on the rest of the economy. Meanwhile here in Australia we are sitting on a savings pool of $4.2 trillion thanks to Paul Keating's compulsory savings scheme. That savings pool is picking off NZ assets at will."

So the no vote and subsequent liquidation of Fletcher Forests was a disaster for NZ investors – we lost control of all those forests, at low prices, to overseas investors and because we now export logs, rather than sawn timber, we increased our economic exposure to and thus the political influence of the world's leading hegemon, China. We also lost the opportunity to have a major world class forestry asset listed on the stock market enabling both small and large investors to get exposure to the forestry sector. That is enough for this week – in the third column of this series, in what has turned out to be an obituary for the NZ listed forestry sector, we will look at the sale of the Kaingaroa Forest by the NZ government to the Central North Island Forest Partnership.