Australian Agribusiness Group

Submission to Parliamentary Joint Committee on Corporations and Financial Services

Inquiry Into Agribusiness Managed Investment Schemes

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Background

Australian Agribusiness Group (AAG) provide this submission in our capacity as an independent researcher of agribusiness MIS. AAG has been researching agribusiness MIS since 2000 and has been consulting to the wider agribusiness sector since its establishment in 1997, and through its principal's since 1989..

AAG employs 16 staff from its Collins Street, Melbourne head office. It has three areas of activity – consulting into the agri finance sector, research and rating of agri investments and investment management (of wholesale, directly invested funds – not MIS).

AAG provides consulting advice to Government and industry in areas as diverse as the impact of bio fuel mandated content on the wider agri sector and options for action for smaller listed agri companies in the current economic environment.

AAG's research and rating business is recognised as the market leader. AAG also developed and produces the AAG Agri-Index, the only comprehensive comparative index of the performance of ASX listed agri related stocks to the ASX All Ords.

AAG's sister company AAG Investment Management Pty Ltd has funds under management of over AU$330 million and manages portfolios of Australian farmland for overseas and domestic investors.

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Submission

AAG has elected to comment on only some of the specific sections of the terms of reference. We have kept the number consistent with those of the terms of reference.

1. Business models and scheme structures of MIS

There has certainly been significant media commentary regarding the structure of MIS since the collapse of Timbercorp and Great Southern. Several of these are worth exploring.

(a) Upfront vs. Ongoing Fee Models

It is important to note the distinction between the two structures of investments common to timber MIS:

- Upfront Fees – where a higher upfront amount is charged and the MIS operator uses the profits to manage the scheme through to harvest when lease and management fees are charged as a portion of harvest proceeds.

- Ongoing Fees – where a lower upfront fee is charged on application and the investor commits to paying lease and management fees annually.

Due to the success of one timber MIS operator in particular (Great Southern Ltd) in raising funds under an upfront fee model most timber operators switched to this structure. This was also driven by financial planners who found the “set and forget” structure easier to explain and sell to clients.

The upfront model has inherent difficulties in the event of corporate parent insolvency where a replacement Responsible Entity is effectively being asked to manage the schemes until harvest without any income. This can presents a significant road block in the appointment of a new responsible entity.

Following the collapse of Timbercorp and Great Southern it is possible that the market may revert to the ongoing fee model structures. Indeed, AAG is of the opinion that a structured ongoing fee model, incorporating set hurdles for release of investor funds, offers a sustainable future for agri MIS. In the development of such policies and disclosure, this will seek to offer further checks and balances in terms of corporate transparency.

(b) Handling of Scheme Funds

It is common for application monies to be held in a separate trust account for a particular scheme and for the money to be released to consolidated revenue of the group once applications have been allotted a particular land interest.

The resulting impact of this is that funds for all of the schemes by a single promoter or manager are mixed together and not separately identified by scheme.

This is particularly significant when a manager operates several schemes and there is an event of insolvency, which has been the case with Timbercorp and Great Southern.

Legislative changes could require MIS managers to hold funds within separate custodial trust accounts or demand the use of third party custodians. This would be similar to the operation of agribusiness investments prior to the introduction of the Managed Investments Act 1998.

Without legislation, it is possible that market forces could see changes to best practice scheme documentation for the handling of grower funds. Money could be set aside for future management operations and lease obligations in separate trust accounts. The active participation of the Compliance Committee could be used to periodically review the adequacy of account balances against forecast expenses for the life of the schemes. As Compliance Committees are already in place under existing ASIC licensing requirements for all Responsible Entities, they could be used to sign off on when funds can be released following the achievement of set milestones (e.g. planting of trees).

As long as grower funds are held separate to company assets and remained the sole property of an individual scheme, in any event of corporate insolvency this would allow for a much easier replacement/transition of the Responsible Entity.

If this model were in place, we would have less investor, court and market disruption than we are currently witnessing with the administrations of Timbercorp and Great Southern. In effect, the ongoing operations and continuation of commercial activities of the schemes would be much less disrupted as investments would be fully “in the money”, making a replacement RE a simpler exercise.

In turn, investors would be protected for their final outcome, and the goals of the MIS project would have a reasonable chance of being achieved.

Clearly, the independence of the Compliance Committee members is paramount in their role of acting on behalf of investors.

4. Commissions, fees and other remuneration paid to marketers, distributors, related entities and sellers of MIS to investors (including accountants and financial advisers)

AAG has previously commented on the level of commissions in our submission on Review of Non-Forestry Managed Investment Schemes in September 2008. In that submission we commented on the fact that for a long term agribusiness investment the upfront commissions charged at 10% were not significantly different to those of a managed fund following a discounted cash flow analysis.

That said, we believe there is scope for the high upfront commissions to be reduced. This reduction could be shared between the MIS manager and the investor creating a better outcome for each of those parties. Indeed, for at least the last six years, AAG have been calling for commission rates to be reduced to a range of 4 – 8%.

Our principal concern arises when an advisor (accountant or financial planner) receives a commission for the sale of an MIS and where they are only licensed to provide advice through the product provider. Our concern is over whether that is financial advice or the sale of a product. We suggest investors would believe they are getting the former, but this may not be the case in reality.

We would also like to see greater transparency and quantification in statements of advice to clients as to what constitutes a commission. That is, the inclusion of indirect financial benefits such as marketing allowances and other benefits as well as the exact commission amount.

Further, we have concerns that the sale of an agri MIS product, has in many cases created revenue streams for advisors which have the potential to influence the initial investment decision.

The current debate being waged in the media regarding commissions versus fee for service advice in the financial planning industry will impact the sale of agribusiness MIS. Apart from the position which we have put above (an upfront fee versus fees over time often being much the same thing) we would draw the Committee’s attention to the fees charged by hedge funds. Such funds charge up to 8% per annum of FUM, Venture Capital up to 4% per annum plus 20% of the upside and non-industry super funds (up to 2% per annum).

7. The level of consumer education and understanding of these schemes

Agribusiness MIS are inherently risky and have a suite of risks involved that are not seen in more common asset classes (e.g. agricultural risks). We sometimes question whether some investors fully understand the structure of what they have invested in and the nature of the associated risks involved. The fact that the Promoter is engaged by the investor to do almost all of the actual farm work, distances the investor from these agricultural realities. We urge better and more regular communication, which is incorporated in the AAG Part B Track Record Review being directly communicated on an annual basis to all investors. This will at least allow for a closer engagement with the performance of the investment and the impacting market and agricultural risks.

It is clear by the nature of the questions we receive direct from investors (and sometimes financial planners) that some investors still do not understand the investment. Clearly their financial advisor has not explained the investment, or the investor (or financial planner) has not read the PDS or the investor (or financial planner) has not read any independent research. Simply reading the rating is by no means a sufficient level of due diligence for the advisor.

Given the average size of investment in this sector is in the order of $30,000 to $45,000 there is really no excuse for a lack of understanding or explanation.

8. The performance of the schemes

The performance of agribusiness schemes has been substantially criticised. It is true that many (not all) of the older timber schemes and some of the horticultural schemes have not performed to expectations.

By the closed end nature of the schemes which often include a development phase (e.g. horticulture) or many years of growth before income (e.g. timber) it is often only at the completion of the scheme that a true quantification of returns can be obtained. As result it is not possible to compare previous agribusiness MIS with that of say superannuation funds on a 5, 3 and 1 year basis as is common for other asset classes.

In addition, there is no requirement for disclosure of the performance of previous schemes.

In our research of "this year's scheme" we undertake a track record review of all past schemes and look at their performance. Other than being provided directly by the individual MIS manager, the AAG Track Record Review is the only public source of information on track record.

We would encourage greater disclosure and standardisation of information on previous schemes, including the mandatory disclosure of past performance, set within the context of the prevailing agricultural realities.

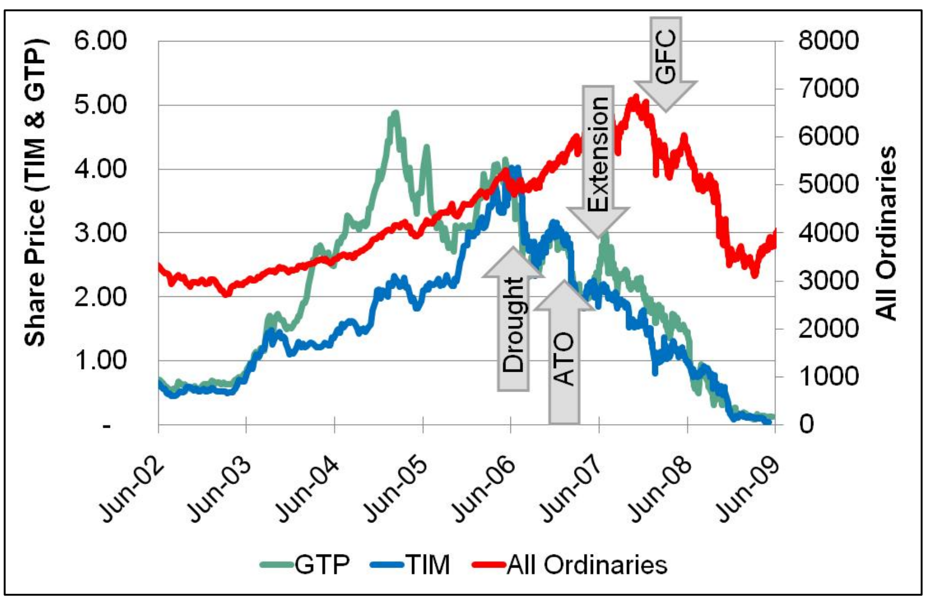
9. The factors underlying the recent scheme collapses

It is important to note that it is NOT in fact the schemes which "collapsed" but the promoter, manager and Responsible Entity (RE) – the corporate entity – which went into administration or receivership.

Clearly, issues of the level of debt and the management of debt are the primary causes of the recent corporate collapses of Timbercorp and Great Southern. However, there were some significant factors over the past few years which we believe also contributed.

The chart below illustrates the movement in the Timbercorp (TIM) and Great Southern (GTP) share prices against the All Ordinaries.

The period between 2003 and 2006 saw substantial increases in sales for the overall industry as well as for Timbercorp and Great Southern. This rapid expansion lead to increased debt levels (principally funding land and infrastructure development, and investor loans) for both companies.



Both companies had an increasing reliance on horticultural investments, which require substantial amounts of irrigation water. Furthermore drought concerns raised questions about the future viability of the horticultural MIS and the future profits of these two companies. In 2006 concerns over drought substantially impacted both Timbercorp and Great Southern's share price.

In 2007 the ATO announced changes to the tax deductibility of MIS which saw further declines in share price. The uncertainty for non-timber MIS continued through to the end of 2008. The extension granted just prior to the end of the 2007 financial year saw a jump in share price aided by solid new MIS sales for both companies.

By this time the uncertainty surrounding the future availability of non-timber investments to access tax deductions had substantially eroded investor confidence. Soon, the Global Financial Crisis (GFC) hit and banks became increasingly concerned over their security position, reappraising their risk assessments to this sector, and demanding asset sales in what can only be described as an extremely difficult market. When the companies were unable to sell sufficient assets, the banks moved to protect their interests. The rest is history.

What may have assisted the process was a more medium term view by the banks (all of Australia's main banks are involved). The reality is that in our opinion, these same lenders which precipitated the flight to the appointment of an insolvency practitioner are likely to lose tens of millions of dollars of their loans.

The above is AAG's opinion only, and the equity brokers/analysts who undertook research on these two companies may have a differing view.

10. The projected returns and supporting information

Prior to 2002, MIS managers were able to outline their forecasts for returns in their prospectuses/PDSs.

In 2002, ASIC issued the 'Regulator Guide 170 – Prospective Financial Information (PS 170)' for investment offer documents which outlined when financial information could be used, what were 'reasonable grounds' for its inclusion, when it could be disclosed and what could be disclosed in its absence. The admirable objective of PS 170 was to prevent financial forecasts which were not based on reasonable grounds and prevent those financial forecasts from appearing in project disclosure documents on the grounds that they may have been misleading and unlikely to be achieved. There is no doubt that a number of prospectuses included misleading, or at the least very rosy and risk free information in relation to returns forecast.

The practical implications of PS170 mean that project managers do not have to include returns forecasts in their offer documents.

Today, the vast majority of MIS managers outline likely yield and price scenarios for their investments in the PDS. Yield and price information is usually provided by both the project manager and an independent expert (the latter in a separate report included in the PDS).

We believe that there should be an adjustment to ASIC's view of what 'reasonable grounds' is such that project managers should be required to include returns forecasts in PDSs. In this way it will be easy for investors to determine if annual returns are being achieved in line with forecasts. This would have to be done carefully so that a repeat of the misleading figures from the past does not occur.

Further, the Directors of the project manager should be obliged to "sign off" on these forecasts and ultimately take responsibility for same. At present they need do neither.