

A Submission to
The Inquiry into Agribusiness Managed Investment Schemes
Conducted by
Parliamentary Joint Committee on
Corporations and Financial Services

Submitted by

XXXX

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Abstract

In this submission, the business model of the agribusiness Managed Investment Schemes (MIS) of Great Southern and Timbercorp is analysed with a case study of Great Southern's FY2004 Financial Performance Account. A hypothetical business model of a bus company is used at the beginning of the paper to facilitate the analysis. It is found that the total cost of a forestry MIS project in its 10-year lifespan grossly surpassed the revenue. Funds collected from new investors were appropriated to support earlier projects and to pay dividends, tax and *etc.*, leaving little to the new project itself. Thus the business was fraudulent and designed to fail. The business model also resembled a Ponzi scheme being described in the ASIC website. Suggestions for legislative and regulatory changes are proposed at the end of the paper. Attached at the end of the paper is a past letter addressed to ASIC two years ago in which I contended that the MIS business of Great Southern was fraudulent and cautioned of a multi-billion dollar collapse.

0. Introduction

Recently, the agribusiness Managed Investment Schemes (MIS) of Great Southern and Timbercorp collapsed, taking with it billions of dollars.

Not long ago, these companies were both spectacular top performers in the Australian share market. For example, in the five financial years from 2002 to 2006 (ending 30 June), Great Southern's MIS yearly sales were \$56m, \$109m, \$304m, \$365m and \$458m, respectively, with an average compound growth rate of 69.1% p.a.; yearly net profits were \$17m, \$41m, \$91m, \$119m and \$132m, with an average compound growth rate of 66.9%; and its share price skyrocketed more than 10-folds from a low of \$0.35 in July 2001 to a high of \$5.03 in Feb 2008.

After the above booming period, its sales levelled out and started to drop by a fraction to \$415m in 2007 and to \$315m in 2008, but its net profits almost halved to \$71m in 2007 and reversed to a loss of -\$64m in 2008. It collapsed shortly after in May 2009.

People may ask,

“Why would such a profitable company suddenly reverse its fortune and collapse?”

“Where have the hundreds of millions of dollars of net profits earned in the boom period gone?”

“Where have the billions of dollars of MIS investors, shareholders, creditors and taxpayers money gone?”

“Was there any fraud involved?”

In this paper, these questions will be investigated within the limits of published ASX announcements of the both companies, combined with certain anecdotal data.

In order to understand the nature of the MIS business model of Great Southern and Timbercorp, first in Section 1 we will analyse a hypothetical case of a fraudulent bus company, of which certain crucial characteristics will be extracted. Section 2 will detail a case study on the Financial Performance Account of Great Southern for the

year ended 30 June 2004, and certain important conclusions will be drawn. Suggestions for legislative and regulatory changes will be proposed in Section 3. At the end of the paper, attached is a past letter addressed to ASIC two years ago in which I contended that the MIS business of Great Southern was fraudulent and warned against a multi-billion dollar collapse of the company.

1. The hypothetical bus company

In order to understand the nature of the MIS businesses model of Great Southern and Timbercorp, first we take a look at a hypothetical case of a bus company that might appear to thrive for many years but was destined for an inevitable collapse.

To start with, we assume that the yearly bus tickets would normally be sold for at least \$1000 each in order to cover the cost of providing necessary services to passengers. Now imagine a new bus company came onto the scene with a creative payment model with which they charged only \$5000 for a 10-year ticket. As a result, this company became very popular and doubled its number of new customers every year from 1000 in the beginning. (So the new passenger number increased in the sequence of 1000, 2000, 4000, ...)

Note that the price of \$5000 for a 10-year ticket was only about half of the cost required for serving a passenger for the entire 10 year period. Obviously this scheme could never be sustainable in the long-term. However, by utilising certain loopholes in the accounting system, the business would “prosper” for many years, as we will explain as follows.

In its first year the company sold 1000 tickets with \$5 million in revenue (\$5000/ticket * 1000 tickets), had \$1 million in costs (\$1000/passenger * 1000 passengers) and made a “profit” of \$4m. In the second year, it sold 2000 tickets with revenues of \$10m (\$5000 * 2000), costs of \$3m (\$1000/passenger * 3000), and a “profit” of \$7m ... and so on and so forth.

Table 1 below shows how the passenger number and the profit would skyrocket in coming years.

Table 1

Year	New Customers	Total Customers	Revenue	Cost	Profit	Profit Margin	Profit Increase
1	1000	1000	\$5m	\$1m	\$4m	80%	-
2	2000	3000	\$10m	\$3m	\$7m	70%	75%
3	4000	7000	\$20m	\$7m	\$13m	65%	86%
4	8000	15000	\$40m	\$15m	\$25m	63%	92%
5	16000	31000	\$80m	\$31m	\$49m	61.5%	96%
6	32000	63000	\$160m	\$63m	\$97m	60.6%	98%
...
...
...
n	2^{n-1} (thousand)	$2^n - 1$ (thousand)	$5 * 2^{n-1}$ (\$m)	$2^n - 1$ (\$m)	$3 * 2^{n-1} + 1$ (\$m)	~60%	~100%

We can easily see in the table, the customer numbers and profit were all able to double every year and the profit margin kept steady at 60%. If such a scheme would continue indefinitely, then the profit would reach \$1 billion in 10 years. \$1 trillion in 20 years, \$1 zillion in 30 years, ... If only it would continue!

But certainly it would not continue indefinitely! In the table we can also see clearly that the cost of serving customers was funded by payments made by new customers. Inevitably, when the number of new customers stabilised or diminished, the business would collapse.

This business is no doubt a scam.

With proper accounting practices, the company should have divided each year's revenue into 10 equal parts and recognised only one part per year as income in the 10-year period. The cash of the unrealised revenue would preferably be placed in a trust fund. Had the revenue been treated in this way, the income account of the company would show a substantial loss instead of profit from the very beginning.

From the table we can also see that the "net assets" in the company's balance sheet would grow rapidly if the "profit" were not all taken away by the company. This was because the liability of servicing passengers in the remaining years of their 10-year long ticket lifespan was deliberately hidden away. Had this liability been calculated and included in the balance sheet, the net assets would never be shown as positive from year one.

Many people would say that the business of this bus company is also a Ponzi scheme.

In the ASIC's website

([http://www.asic.gov.au/fido/fido.nsf/byheadline/10+percent+per+month+\(120+percent+per+year\)+-+where+do+you+get+it%3F?openDocument](http://www.asic.gov.au/fido/fido.nsf/byheadline/10+percent+per+month+(120+percent+per+year)+-+where+do+you+get+it%3F?openDocument)), there is a hypothetical example which explains how the notorious Ponzi scheme works. This example and its accompanying table are pasted below.

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A Ponzi scheme's cash flow month by month

Here's a worked example, assuming that the swindlers steal only 30% of everyone's money. (We have made them far too kind.)

Month	Investor	What investors pay in	What the crooks paid to investors	What the crooks pay themselves
Start	Joe Blow	\$100,000		\$30,000
Feb			\$10,000	
Mar	Joanne Blow	\$100,000	\$10,000	\$30,000
April			\$20,000	
May	Bruce	\$100,000	\$20,000	\$30,000
June	Melanie	\$100,000	\$30,000	\$30,000
July	Raelene	\$100,000	\$40,000	\$30,000
Aug	David	\$100,000	\$50,000	\$30,000
Sept			\$60,000	
Oct			\$60,000	
Nov			\$60,000	
Dec			\$60,000	
The end		\$600,000	\$420,000	\$180,000

===== End of paste =====

If we substitute all the columns in the above table (under titles of “Month”, “Investor”, “what investors pay in”, “What the crooks paid to investors” and “What the crooks pay themselves”) with columns in Table 1 under “Year”, “New customers”, “Revenue”, “Cost” and “Profit”, respectively, then apparently the business of this hypothetical bus company can be viewed as a typical kind of Ponzi-scheme according to this ASIC example.

To summarise, the business of the hypothetical bus company has the following prominent characteristics.

- (1) The scheme is never viable, as the cost grossly surpasses the income for serving each customer in the contract period.
- (2) Newcomers’ money has to be used to serve the existing customers.
- (3) The number of new customers must increase rapidly. If the number of new customers stops increasing or decreases, the business will collapse.
- (4) The business model resembles a Ponzi scheme being described in the ASIC website.

2. Analysis of MIS business of Great Southern and Timbercorp.

In this section we will first give a rough estimate of the total cost of a Great Southern's forestry MIS project with respect to its revenue in its 10-year lifespan. Then we will elaborate on the numbers of costs by analysing the Financial Performance Account of Great Southern for the year ended 30 June 2004 as a typical case of its business.

The reasons for choosing this particular 2004 account are mainly

- (1) In that financial year Great Southern's MIS business consisted of purely 10-year forestry projects, just before it started to expand to other kinds of MIS projects, such as grapes and cattle. This purity simplified the analysis process.
- (2) Around 2004, Great Southern was in the midst of rapid expansion with growth rates at 50-100% each year for both sales and profits. This resembled the hypothetical bus company discussed in Section 1.

Although the analysis is focused on the 2004 forestry MIS projects of Great Southern, in principle it also relevant for other MIS projects of both Great Southern and Timbercorp.

2.1 Estimation of total cost of forestry project in its 10-year life cycle.

From Great Southern's ASX announcements combined with anecdotal data, the total estimated cost of a forestry project in its 10-year life cycle could roughly break down to the following items (land cost excluded) with respect to the revenue of \$9000/ha.

Commissions to planners and promotions	~15%
Seedlings and planting	~15%
Maintenance in 10-year lifespan	~30%
<u>Overhead in 10-year lifespan</u>	<u>~30%</u>
Sum (land cost excluded)	~90% (w.r.t. revenue)

At the time, the lands suitable for growing forest cost approximately \$6000/ha and borrowing costs of around 8% p.a. If land had been purchased with borrowed funds, the total interest over 10 years would be around \$4800/ha or ~53% of the revenue of \$9000/ha. Had the lands been leased, the rent was about 5% of the land value, i.e. about \$300/year/ha, and the in 10 years it is ~\$3000/ha or ~33% of the revenue.

Thus, if we chose the latter choice of lower cost by leasing lands (33%), the total cost (including the land leasing) of a forestry project in its 10-year life cycle was ~123% of the original revenue of \$9000/ha.

On top of these expenses, Great Southern also paid ~15% or more of the revenue in tax and ~10% or more as shareholders dividends. Thus the total expenditure was ~150% or more of the revenue.

2.2 An anatomy of Income Account in FY2004 Report of Great Southern.

The following table is the main part of the Financial Performance Account hand-copied from the Great Southern Annual Report for the year ended 30 June 2004 (released in September 2004). The numbers in brackets were added by the writer to indicate the percentage of the items with respect to the total revenue of \$208.3m.

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Statements of financial performance
For the year ended 30 June 2004

	Consolidated 2004 \$'000	
Revenue from ordinary activities	208,344	(100.0%)
Other expenses from ordinary activities		
Administration	15,031	(7.2%)
Borrowing cost	1,040	(0.5%)
Commissions	11,337	(5.4%)
Agriculture and scheme related expenses	26,326	(12.6%)
Marketing, promoting of product & industry	21,894	(10.5%)
Profit from ordinary activities after income tax expenses	<u>132,716</u>	<u>(63.7%)</u>
Income tax expense	<u>39,490</u>	<u>(19.0%)</u>
Profit from ordinary activities after income tax expense	93,226	(44.7%)

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The “revenue from ordinary activities” of \$208.3m was predominantly from the forest MIS prospectus sales of \$240m (as announced by Great Southern on 1 July 2004). This “sales” revenue was actually the upfront application fee paid by investors for the entire 10-year long project. Normally these payments were rushed in during the last few weeks before the end of the financial year.

From the above account, we can see clearly that from this \$208.3m revenue nothing was spent on the 2004 MIS except maybe only \$11.3m on “commissions” and \$21.9 on “marketing, promoting of product and industry”, totalling \$33.2m. This total amount was about 13.8% of the \$240m in sales, which was in line with the estimate of 15% for “Commissions to planners and promotions” in section 2.1.

Among all expenditures, \$26.3m (12.6%) was directly spent on “agriculture and scheme related expenses”. This expenditure could be separated into two parts, (1), the cost of seedlings and planting them for the 2003 scheme, and (2), the cost of management of schemes of 2002 and earlier. Because there is no breakdown data available for these two different kinds of expenses, in order to continue our analysis, we assume that \$15.8m (60%) of the total \$26.3m was used for part (1) and the rest \$10.5m (40%) for part (2).

The 2003 sales of the forest MIS was \$109m (as announced on 1 July 2003). So the part (1) expenditure of \$15.8m on the trees was about 14.5% of its corresponding 2003 revenue. This figure also matched the estimation in section 2.1 that the cost of “seedlings and planting” was about 15% of the revenue.

The total revenue (value) of on-going MIS schemes of 2002 and earlier was about \$328m (data from a credible source), so the \$10.5m expenditure of part (2) on the trees of 2002 and earlier was 3.2% p.a. of the total revenue. This was close to the estimation of 30% for the cost of “maintenance in 10-year life span” in section 2.1.

In the total revenue, \$15.0m was spent on “administration”, that is, the “overhead” cost for the existing schemes that were worth \$428m (new 2004 scheme excluded). Thus, the overhead cost of these schemes was about 3.5% p.a. with respect to the corresponding revenue, which was again consistent with the “overhead” estimate of 30% in the 10-year lifespan as stated in section 2.1.

After deducting all above expenses from the \$208.3m revenue, the account showed a “profit before tax” of \$132.7m with a margin as high as 63.7%.

After a further deduction of \$39.5m (19.0%) tax, it finally produced an “after tax profit” of \$93.2m with a margin of 44.7%.

During the financial year, the company also paid \$12.1m (5.8%) in dividends and to shareholders and \$1.8m (0.9%) to convertible “TREES” unit-holders. If these amounts were also deducted, the remaining “profit” would be only \$79.3m. Obviously, this remaining \$79.3m would never be able to cover the impending costs of the 2005 project in the next 10 years.

To summarize, we conclude for the Great Southern’s forestry MIS projects that

- (1) The estimates of the breakdown expenditures proposed in Section 2.1 have been confirmed;
- (2) The total cost grossly surpassed the revenue in the 10-year life cycle;
- (3) No part of the 2004 sales revenue was used for the 2004 project, except for the ~15% on commissions and promotions;
- (4) The 2004 MIS investors’ funds were appropriated and spent on maintenance and overhead costs of earlier projects, on paying tax and dividends; the old projects and the whole company could not continue without doing so;
- (5) The whole business would inevitably collapse, especially when new sales diminish;
- (6) The business model resembles the hypothetical bus company;

- (7) The business model also resembles the Ponzi scheme being described in the ASIC website;
- (8) The business model is a fraud.

3. Suggestions.

In order to prevent such fraud from happening again, the following suggestions including legislative and regulatory changes are proposed.

- (1) Further issuance of tax rulings for MIS investment tax deductibility should be stopped.

Tax rulings for MIS investment tax deductibility do not affect the viability of the MIS projects directly. However, they do give MIS a legitimate appearance, assisting the MIS operators to lure investors. Were there not such rulings, disasters such as Great Southern and Timbercorp with such a huge scale might never happen.

- (2) The MIS revenue collected from investors of a particular scheme should only be realised each year as an income in the account with the amount proportionally to the estimated cost needed in that year. The rest of the revenue should be deferred to later years, preferably being kept in a separate trust account. This revenue must not be appropriated to cover expenditures (including overhead) of any other schemes of different types or of different years.
- (3) Full costs of future management of the existing MIS projects (including land rents and/or interests on debts) must be properly estimated and registered as liabilities in the balance sheet to reflect the true net asset value of the entity.
- (4) The major culprits of this fraud should be brought to justice.

4. Postscript.

Two and half years ago (on 5 Dec 2006), I wrote to ASIC and contended that the agri-MIS business of the Great Southern Ltd was fraudulent. I expressed my suspicion that the Great Southern was a Ponzi-type company and also cautioned against a multi-billion dollar collapse of this company. At that time, my views were rejected.

Now I have attached that letter of mine in the Appendix of this paper, with certain typographic errors corrected.

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Appendix: My letter to ASIC on 5 Dec 2006

The following letter was submitted on 5 Dec 2006 via an ASIC Internet device called "eComplaint" with reference number of 74409625 05/12/2006. Certain typographic errors have been corrected.

* * *

Dear Sir:

Great Southern Plantations is an ASX listed company (code: GTP), which describes itself in its website as "an investment manager, specialising in the agribusiness sector ... manages funds well in excess of \$1 billion on behalf of more than 35,000 investors."

However, I suspect GTP is a typical Ponzi-type company for the following reasons.

(1) All GTP's running expenses of on-going Managed Investment Schemes (MIS) started in previous years are mainly relying on the upfront fees from new MIS investors. The ever-increasing company running costs can only be met with rapid increase of sales of new MIS prospectuses. In recent years, GTP's sales of MIS prospectuses have dropped from a 100% p.a. growth a few years ago to around 30% p.a. last year. However, its earning per share has become static, and bank debts bearing high interest rates are increasing dramatically.

(2) All GTP's capital expenses (CAPEX) on new MIS business (mainly buying lands/farms) have been solely relying on raising equities or bank loans in recent years as follows.

(a) Issuing new shares (in 2003/04/05).

(b) Issuing hybrids: TREES, TREES-2 and TREES-3 (in 2003/04/05).

(c) On 17/8/2006, GTP had a "structured finance transaction" with ANZ, of which only \$136,655,000 was available as cash to GTP and "the amount to be repaid in 2012 including capitalized interest will total \$257,670,000" (Note 9, page 24, 2006 Preliminary Final Report, released 28/11/2006). The effective compound interest rate in the 6-year period is an extremely high 11.15% p.a. $[(257670/136655)^{(1/6)} - 1 = 0.1115 = 11.15\%]$. (The GTP 17/8/2006 announcement misled the public by saying to the effect that the final payable amount would be \$215M in 2012). This ANZ bank loan has secured about half of GTP's existing pulpwood lands.

(d) On 15/9/2006 GTP's existing short-term bank loans were restructured into a three-year \$245M facility repayable in 2009. This loan has been drawn down to \$200M at 30/9/2006. There was no indication of interest rate for this loan being lower than 11.15%. (also Note 9, page 24, The Report)

(e) Note that the above two bank loans (\$212M and \$200M in the Report) are both interest accumulative loans for 6 or 3 years. This indicates the lack of cash for GTP to pay interests on loans. The acceptance of the forbiddingly high interest rate of 11.15% p.a. and other conditions may well indicate the plight of GTP's present financial situation.

(3) A short history of GTP debts in the recent three years.

05/10/2004 TRESS-2 \$ 78 M
22/09/2005 TREES-3 \$122 M Total \$ 200 M +156%
30/09/2006 Bank debt \$412 M Total \$ 612 M +206%

(4) Given GTP's total equity of \$682.8M at 30/9/2006, the debt/equity ratio was 90%, up from ~25% a year ago. The \$412M new bank debts will cost GTP ~\$46M interest each year and reduce earnings per share by ~40% or say 15 cents each share.

(5) Looking forward to the end of this FY (30/9/2007), GTP would again have to have a big increase (30%?) in prospectus sales to survive. This in turn would again need a big increase in new bank loans. Thus its debt/equity ratio would probably reach 150% or 200%, and its financial situation would further deteriorate. If at any point of time, should GTP fail to raise more debts/equity, then a crisis would break out.

(6) Another view at GTP's "profit".

For example, GTP's 2006 FY (ending 30/6/2006) "profit" was \$133M. I put the quotation marks on the word "profit" because this "profit" was all appropriated from the 2006 MIS investors' upfront applications fees, which were meant to be kept and spent on the 2006 MIS during the scheme life spans of 7 - 20+ years. However, even if this \$133m "profit" would be kept somewhere, it would only be able to service the 2006 new debt of \$412M for 3 years or so.

(7) A simple anatomy of a cattle MIS.

According to the GTP prospectus, cattle investors pay every \$5000 for leasing 4 heads of cattle for 7 years, and GTP and the investor will share the profit by 50:50 in that period. Assuming that the investors should not lose money, then they must receive at least a 14.3% p.a. "profit" yield on average, or say, the whole profit yield should be $14.3\% \times 2 = 28.6\%$ p.a. before shared between the 2 parties. This 28.6% profit yield is extremely high, and it is not likely we can find any such cattle farm anywhere in Australia.

This year GTP bought a cattle station from AAC (Australian Agricultural Company). AAC is also an ASX listed company with its price/earning ratio of ~20 or its profit yield of ~5%. Thus the best GTP could get from AAC is a profit yield of only 10% at most if not 5%.

On the top of the problem of the disparity between the high expected and low real profit yields, GTP bought all cattle farms with bank loans, which bear an interest as

high as 11.15%. Even if the whole 10% profit goes to the banks, it still can't cover the interest.

Thus, it is apparent that this sort of MIS will never survive in long term.

(8) A rough estimation of funds at risk involved in the GTP's MIS business.

MIS Investors fund (by 30/9/2006)	\$1500 (million)
Bank loan	\$ 412
TREES-2/3 convertible notes	\$ 200
Market cap. of ord. shares (\$3/s)	\$ 930

Total	\$3042 (million)

In case of a crisis, this total \$3+ billion fund will be reduced to a fraction.

The above is a summery of my views on the present financial status of GTP's MIS business. I hope that, prompt, decisive and appropriate actions will be taken by your organization to prevent the GTP's financial situation from further deteriorating for the sake of all investors and our great nation.

Yours faithfully,

(Name withheld)