

# Submission to Inquiry into Agribusiness Managed Investment Schemes

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## Parliamentary Joint Committee on Corporations and Financial Services

### Introduction

This submission has been prepared by Willmott Forests Limited, a publicly-listed forestry and timber company.

Willmott Forests is an active member of the Australian Plantation Products and Paper Industry Council (A3P), and supports that organisation's submission (with NAFI) to this Inquiry on behalf of the industry. However the contents of the present submission highlight particular aspects of Willmott Forests' philosophy, business model and operations with the aim of assisting the Inquiry to formulate recommendations for improving the wider timber plantations sector.

### Summary of recommendations

In summary, Willmott Forests makes five recommendations to the Inquiry, the reasons for which are elaborated further in this submission:

1. Bring stability to the plantation industry by avoiding further changes in regulations, and endorsing the outcomes of the Commonwealth's 2006 Forestry Taxation Review;
2. Elevate the level of disclosure of risks and other project information;
3. Introduce improvements in the financial adviser sector;
4. Encourage the establishment of an enforceable code for the plantation investment industry; and
5. Increase governments' commitment to publicly-funded regional infrastructure to facilitate downstream value-adding from the maturing plantation estate.

### Key submission points

**a) Managed investment is a sound model for Australia's timber plantations**

Willmott Forests Limited strongly supports a continuation of grower investments in timber plantations under the Managed Investment model. The inherent strength of this model has enabled the Company to aggregate growers around a regionally-focused business, with long-term growth prospects.

In the absence of direct government investment in plantations, which has been declining progressively since the late 1980s, there is no other workable means of attracting private investment for new timber plantations.

Accordingly, in the absence of direct government investment, the present private investment arrangements must be retained if Australia is to continue to meet its national plantation timber requirements.

**b) The reforms following the Commonwealth’s 2006 Forestry Taxation Review were logical and effective**

Willmott Forests was actively involved in the Commonwealth’s 2005/6 review of plantations and taxation arrangements and endorses the changes made at that time, particularly with respect to:

- The requirement for 70% of grower funds to be directly applied to forestry costs under the definition of ‘direct forestry expenditure’, commonly referred to as the ‘70% DFE test’. The legislation for this specific statutory deduction for MIS forestry was enacted in 2007 with a transitional year in 2008, and
- Enabling secondary markets to operate for established plantations after a 4-year qualifying period is working to encourage investment in long-rotation plantation investment.

Implementation of these changes has made a material and positive contribution to balanced investment and re-investment in the timber plantation industry and the Inquiry should not seek to introduce further changes that might undo these reforms. This position is argued in further sections of this Submission below, and in our recommendations.

**c) Abrupt legislative changes involving plantation forestry can distort long-term investment planning and resource flows**

Plantation forestry is an inherently long-term business and must therefore be based on long-term contractual arrangements. These include wood supply agreements with major processors, and management agreements. Abrupt or continuous changes to legislation interrupt plantation establishment activities, pose management challenges, and distort wood flows in an industry that is endeavouring to create long-term sustainable wood supply from plantation resources.

This is evidenced by the very “lumpy” plantation establishment patterns that have emerged in recent years, typically as tax arrangements have been adjusted, and where there has been a skewing of investment towards short-rotation plantation crops.

Willmott Forests recognises that some change is inevitable and has always supported reasonable changes that have been in the interests of continuous improvement to meet our national wood supply objectives. However, as set out in our first recommendation (see p.6), we strongly advocate that the present Inquiry should recognise the value of the changes resulting from the Commonwealth’s 2006 Forestry Taxation Review, and not recommend further changes that may undo or destabilise those reforms, and adversely impact on our national and regional wood supply dynamics.

**d) To be successful, a plantation company must base its operations on sound business principles applied through disciplined management**

Willmott Forests has operated successfully in the timber plantation industry for almost 30 years.

This success is due to careful implementation of a sound business philosophy and management approach, characterised by:

- Recognition that plantation forestry is our core business, and not deviating from it;
- Maintenance of a disciplined focus on long-rotation softwood timber plantations;
- Directing our on-ground business efforts at balanced regional development;
- A resource marketing plan that serves Australia's demonstrated national demand for long rotation (sawlog) timber resources;
- Ensuring our business is underpinned by a sound technical basis;
- Directly employing skilled, professional staff and field teams, and training new recruits; and
- Investing in timber value-adding and residue utilisation to realise harvest value.

Willmott Forests intends to continue to follow with this business approach into the future, which it believes will insulate it against the impact of external shocks that might destabilise companies not following these practices.

**e) Some recent company collapses could have been averted with sound business practices**

Willmott Forests is a resilient and consistently profitable business. The current directors believe there are sound reasons why the Company will continue in this way, despite the negative sentiment surrounding the Agri-MIS sector following the recent corporate collapses.

The strategy that directs Willmott Forests' continuing successful operation includes:

- Building our key competencies around our core business (plantation investment, management and processing);
- Conservative financial management with secure, long-term bank facilities in place, from diversified funding sources;
- Ongoing access to quality forestry land via prepaid leasing arrangements providing security of land tenure to growers;
- Long-term off-take agreements for wood supply to major fibre processors, such as a 12-year contract to supply Visy;
- Expansion through the softwood value chain, with niche sawmill operations as well as a recent entry point into the renewable energy market;
- A 20-year sawlog supply agreement with Forests NSW to bring our Bombala, NSW timber processing plant to a world-competitive scale;

- A strategy to utilise plantation wood and forest residues for energy production;
- Australia's only dedicated plantations for biomass and energy production, and
- Long-term business relationships with respected forestry industry participants such as Hancock Victorian Plantations, Forests NSW, Visy Pulp and Paper and Dongwha Australia Holdings.

The recent collapses of Timbercorp and Great Southern resulted from a combination of events rather than one specific reason and therefore should not be considered an inherent flaw in the MIS model. Some of the extenuating events that had a profound effect on their operations, are set out in the next section.

**f) Agricultural (non-forestry) MIS companies were adversely impacted by recent external events**

While significant, and sometimes valid, comment has been made about the management of these companies, it is clear that the combination of several external factors and events outside their control, coupled with an under-capitalised business models that relied heavily on increasing annual sales has contributed to their demise.

Those external issues are elaborated below.

**The agricultural (non-forestry) MIS test case**

By 2006, both Timbercorp and Great Southern had extended their operations beyond their previous forestry-only focus to encompass other agricultural activities and projects. For both companies, non-forestry activities accounted for more than 50% of annual revenue.

In 2007 the Australian Tax Office (ATO) formed the view that investors in agricultural projects were not "carrying on a business" and hence were not eligible to receive business deductions associated with the projects. The ATO then ceased issuing product rulings for agricultural (non-forestry) MIS projects. This effectively reduced the annual revenue of such companies' by more than 50%.

In conjunction with industry, a legal case to challenge the ATO's interpretation of the law was mounted. However, due to the length of time for the test case to be completed, the companies operating agricultural (non-forestry) MIS projects could not market projects for the 2007-08 year. The negative sentiment caused by the 'tax uncertainty' directly affected those individual companies ability to raise subscriptions to their projects and indirectly affected their continued support from equity and debt markets.

In December 2008 the Federal Court found in favour of the industry, and the ATO said it would again consider the issuing of product rulings for projects for the 2008-09 year. However, this meant that new project funds for agricultural (non-forestry) MIS projects were not available for the 2007-08 year.

This delay in funding inflows significantly affected the cash flow of those companies which were offering agricultural (non-forestry) MIS projects, creating pressure on banking covenants in companies that were geared.

It is clear that the business model of these companies relied too heavily on annual future sales revenue. That said, the interruption of some 18 months to their non-forestry business would have placed them under significant financial pressure, and such a prolonged interruption to any business would be difficult to recover from, even in a reasonable economic environment.

### **The global economic crisis**

The global economy has experienced the worst financial crisis since the Great Depression. This has resulted in a number of significant consequences for all companies in the Australian economy, including Agricultural MIS businesses.

Implications include the following:

- The fall in the share market has resulted in a significant reduction in the value (market capitalisation) of many publicly-listed companies;
- The impact on the financial sector has resulted in the significant tightening in available equity and debt by financial institutions;
- Debt markets have significantly tightened leaving those companies with short-term debt refinancing needs at a disadvantage; and
- The slowing of economic activity has reduced land values and commodity prices.

It should be noted, that highly leveraged earnings-based corporate models are symptomatic of a bull market fuelled by easy credit supply. It is not just Agri-MIS companies that have collapsed in these markets for example Allco Finance, Babcock & Brown, ABC Learning and MFS to name a few, have all failed due to their exposure to the unprecedented credit squeeze. Hindsight is a wonderful thing; however all of the abovementioned companies enjoyed significant equity and debt market support in better times from institutional and retail investors.

### **Long term drought and climatic instability**

Recent years have seen the majority of Australia's agricultural land subjected to the worst drought in living memory.

The drought has had a significant depressing effect on a wide range of agricultural returns. Timbercorp and Great Southern had considerable exposure to the agricultural sector during the drought, resulting in less than predicted returns to many of their agricultural projects.

While the growth performance of Willmott Forests' plantations are also linked to rainfall conditions, the nature of the dominant *Pinus radiata* plantation species is that it can withstand a significant variation in soil moisture conditions once the stands are past the very early establishment stages. Willmott Forests' commitment to long-rotation softwood plantations provides a longitudinal time buffer in productivity variation over the life of each project.

Willmott Forests believes that, despite always being subject to the pressures of external factors, the depth of its internal management disciplines can, and will, buffer the impacts of such external factors and events.

### **Recommendations to the Inquiry**

Willmott Forests makes the following specific recommendations to the Inquiry:

**1. Bring stability to the plantation industry by avoiding further changes in regulations, and endorsing the outcomes of the Commonwealth's 2006 Forestry Taxation Review**

The present Inquiry should recognise the effectiveness of the current tax arrangements, including the changes resulting from the Commonwealth's 2006 Forestry Taxation Review, and not recommend further changes that may undo or destabilise those reforms. This is because the Plantations and Taxation Review conducted in 2005 and 2006 delivered an effective and workable solution for the plantations investment sector.

That inquiry was extensive and comprehensive, and examined all aspects of forestry investments under the prevailing arrangements.

Specifically, two outcomes from that Review – which represented significant changes to the *status quo* at the time – were:

- the introduction of the new specific statutory deduction for MIS forestry based on 'direct forestry expenditure' commonly referred to as the '70% DFE test'. The legislation for this was enacted in 2007 with a transitional year in 2008. This new framework now **ensures that at least 70% of all funds raised are required to be spent on direct forestry expenditure** which provides a framework where managers must administer their projects in this manner; and

- the introduction of secondary market legislation **enabling secondary market sales of established plantations after a 4-year holding period**. This is already working to provide a more transparent and liquid market for plantation investments and encourage investment in long-rotation plantation investment.

Our single most important recommendation, therefore, is to recognise the effectiveness of the current tax arrangements and allow the 2007 changes to continue to take their proper effect within the plantations industry, and not seek to impose further changes that may destabilise or undo those reforms and destabilise existing or planned projects.

## **2. Elevate the level of disclosure of risks and other project information**

Willmott Forests strives to provide prospective growers with the highest available level of information about the plantation investment projects on offer, including data and assessments from independent technical advisers.

Accordingly, as a leading participant in the plantation industry, Willmott Forests would endorse any reasonable move to require greater transparency and demonstrated reliability of information provided in any initial documentation, and throughout the life of a project. In particular, the special risks associated with agricultural enterprises and investments should receive greater prominence in required documentation and reports.

## **3. Introduce improvements in the financial planning sector**

While Willmott Forests utilises the services of the financial planning sector to recommend investments to prospective growers, and will continue to need to do so, we believe improvements to that sector may well be warranted.

On this point, we understand that the Investment and Financial Services Association (IFSA) and the Financial Planning Association (FPA) have publicly committed to address over-reliance on the commissions model, to restore confidence in the quality and objectivity of financial advice. Willmott Forests endorses this move.

The introduction of the '70% DFE test' under Division 394 of the Income Tax Assessment Act (which is specific for forestry MIS) does limit the amount of commission that can be paid as it excludes commission, among many other things, from direct forestry expenditure.

In addition to this, current law provides for disclosure of commissions via the Product Disclosure Statement, Financial Services Guide and the Statement of Advice.



There are also current laws prohibiting misleading and deceptive conduct by licensees and their representatives.

The level of commissions paid to the financial planning sector for distribution of Agri-MIS products are set by the market. The level of these commissions is influenced by a much broader market than the Agri-MIS sector alone.

Willmott Forests is a supporter of reform in this area; however, due to our size and scale in the overall investment market we do not view ourselves or any other plantation investment company as an agent of change. This is a matter for the associations mentioned above and the regulator.

**4. Encourage the establishment of an enforceable code for the plantation investment industry**

The plantation industry is already subject to a high degree of regulatory control.

Nevertheless, we strongly advocate the development and enforcement of a code of practice specifically for the plantation investment industry. We believe this is the best way to protect growers, other participants, and communities from the potential for poor performance from within the industry, and to promote best practice and continuous improvement throughout the whole investment “supply chain”.

As a leading participant in the Australian plantation industry, Willmott Forests believes such a code would strengthen the overall level of compliance with existing laws and regulations, with the outcome of lifting the overall standards of governance to the ultimate benefit of growers.

**5. Increase governments’ commitment to publicly-funded regional infrastructure to facilitate downstream value-adding from the maturing plantation estate**

The underlying purpose of timber plantation investment is to deliver sustainable returns to growers and, in doing so, provide a sustainable supply of timber resources for domestic processing and export. Achieving this objective is a stated policy of the Government.

Efficient regional infrastructure is an essential component of the timber processing equation.

The ability to realise the harvest value of plantation timber, and thus complete the investment value cycle, depends on the timely provision of modern roads, power, water communications and other essential regional infrastructure. Facilitating its provision is a key role for governments.



Where the complementary roles of private plantation investment and public infrastructure investment are optimised, the outcome is more jobs and regional investment based on the growing, harvesting, value-adding, marketing and export of the timber plantation resource, and the replanting of subsequent rotations to sustain the industry.

Willmott Forests therefore recommends that the Inquiry examines ways to overcome the current limitations of regional public infrastructure in delivering on the plantation value cycle for regional communities.

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.../ Background information on Willmott Forests' business and operational context

## Background information

### **Willmott Forests has a long and stable corporate history**

Willmott Forests has been operating since 1979 and had total assets in excess of \$350 million as at 30 June 2008. In recent years, Willmott Forests has been responsible for approximately two-thirds of all newly established softwood plantations in New South Wales and around 25% Australia wide. Over its thirty year history, Willmott Forests has continued to grow. It is now an acknowledged industry leader with a reputation for establishing and providing ongoing management of long-rotation *Pinus radiata* plantations.

Most of Willmott Forests' operations are in the Bombala and Murray Valley regions of NSW and northern Victoria, however, recent expansion into a number of regions throughout Victoria via its arrangements with Hancock Victorian Plantations (HVP) and also into the North Coast of NSW and in Northern Australia. The company is delivering a diversified plantation model to the market by blending its traditional softwood plantation investment with silky oak plantations for high value veneer timbers and she-oak plantations for renewable energy production along with recently introduced mahogany plantations. The main ingredient in each of these diversified blends is softwood.

Willmott Forests is a fully integrated business, employing over 160 people and managing in excess of 47,000 ha of plantations, ranging from new plantings to mature trees. The Company's plantation establishment and management work also engages large numbers of contractors for peak seasonal activity.

Its downstream timber processing operations are located in Bombala and are managed by a subsidiary company, Willmott Timbers, which is part-owned by Dongwha Australia Holdings. This facility focuses on the production of landscape and outdoor timber products for the Australian market.

Willmott Forests has recognised the need to maximise its utilisation of plantation residues, with the opportunity to enter the renewable energy sector, with recent investments in directly establishing Australia's only dedicated plantations for renewable energy production and a strategic investment in bio-fuel technology company, Ethanol Technologies, which was recently awarded a significant grant from the Federal Government's Climate Ready Program.

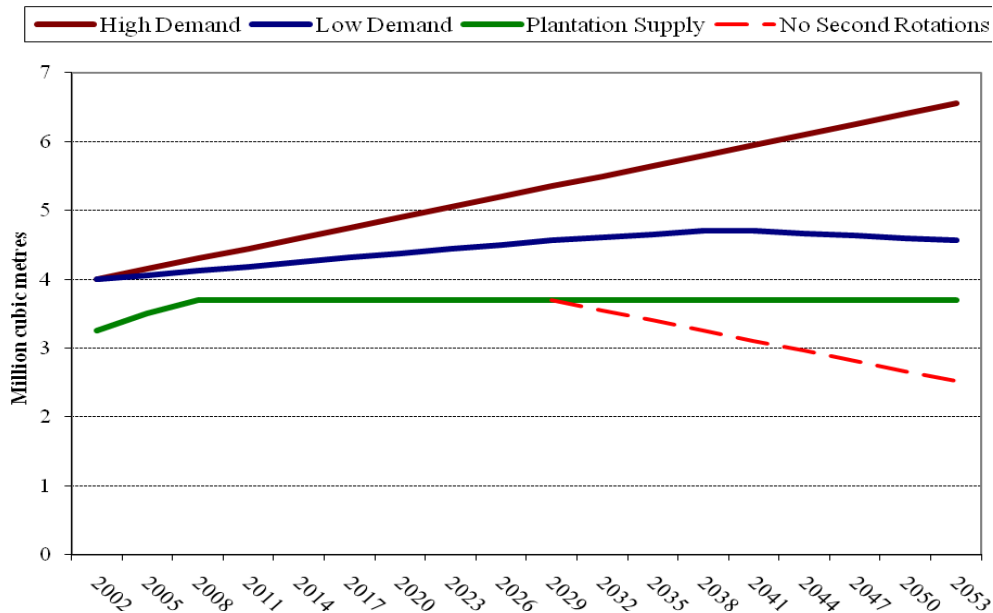
These factors demonstrate the important contribution that a company whose beginnings were firmly centred on plantation investment via the MIS structure can make to Australia and its regional communities.

### **Willmott Timbers' investment in long-rotation projects is targeted to meet the demonstrated national demand for sawlog resources**

Willmott Forests has matched its plantation investment strategy with the demonstrated future market demand for softwood sawlogs. The Commonwealth Government's National Plantation Inventory shows that, by 2030 in virtually all major timber plantations regions, there will be a softwood sawlog deficiency on the basis of the current planted estate.

On this trajectory, future regional production of sawlog-dependent products will be in jeopardy and serious social and economic consequences will arise within a decade or two (see Figure 1).

**Figure 1: Projected Softwood Shortfall: 2002-2050**



Willmott Forests' analysis of the inventory data shows a current shortfall of 2.84 million tonnes per annum of plantation sawlog resource in Australia, compared with the tonnage required for installed and planned capacity. To bring current facilities to full capacity will require some 184,000 hectares of new plantations to be established in the short-to-medium future, and a further 240,000 hectares to meet additional target processing capacity. This resource supply reality underpins Willmott Forests' focus on long-rotation softwood plantations.

### **Willmott Forests is expanding its timber value-adding facilities to realise harvest value for its growers**

Willmott Forests has a long-standing involvement with, and investment and employment base, in the Bombala Region of South-eastern NSW. As an integrated plantation timber company, Willmott Timbers operates an existing sawmill and timber processing facility on the outskirts of the town, processes some 100,000 tpa of softwood logs into value-added timber products, and markets them Australia-wide. Market studies confirm there is a significant opportunity to expand production to supply current markets and add other complementary products.

Willmott Forests' Bombala location gives it the advantages of synergy with the complementary plantation estate owned by Forests NSW. The combined scale of these Bombala softwood plantation resources offers the opportunity for world-scale value-adding.

Importantly, Willmott Forests' processing expansion proposals will enable the resource to be fully-processed within the Bombala Region, providing sustainable local employment and associated benefits to the community.

The expanded Bombala mill, a joint project with international timber company, Dongwha Australia Holdings, will optimise the value of the MIS-based resource into the future.

Further investments in plantation residue utilisation are being contemplated by Willmott Forests, including lignocellulosic ethanol. A pilot plant owned and operated by Willmott Forests' subsidiary, Ethanol Technologies Limited is currently in operation at Harwood in Northern NSW.

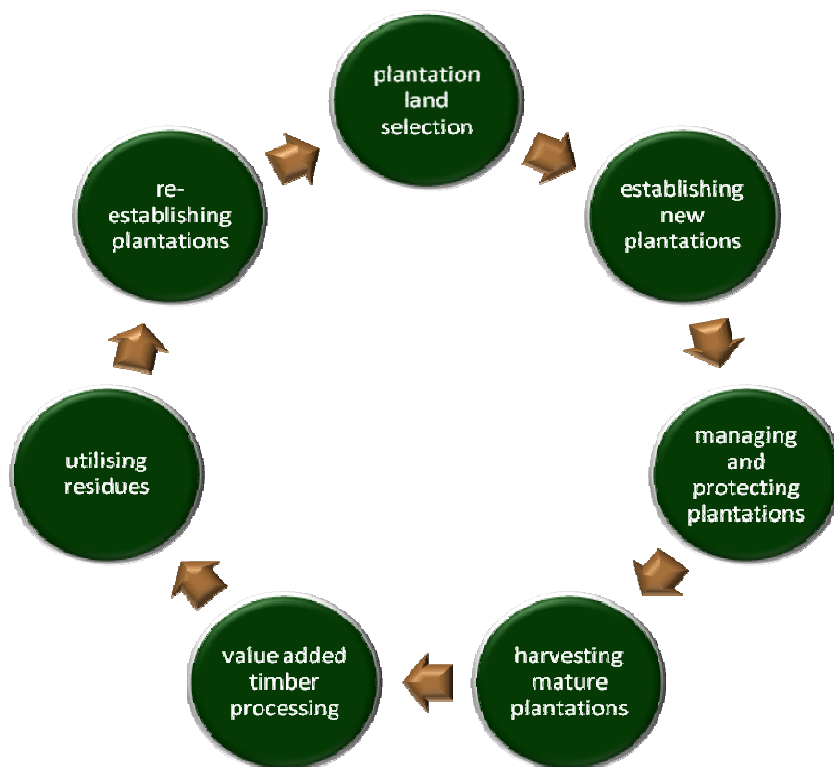
**Willmott Forests is committed to replanting to sustain the plantation value cycle for its growers and communities**

Willmott Forests' business model recognises the benefits of replanting once a full harvest rotation is complete.

This ensures the best ongoing utilisation of infrastructure, land and services, as well as providing employment certainty for planters, managers, harvesters and processors throughout the long rotation cycle.

Figure 2 provides a schematic view of the Willmott Forests' plantation value cycle.

**Figure 2 - Willmott Forests' plantation value cycle**



It should be noted that the Willmott Forests plantation value cycle is working and is reliant on the establishment of new plantations.

### Willmott Forests contributes strongly to the socio-economic health of its regional communities

Beyond the direct employment benefits, Willmott Forests' operations contribute significantly to the social and economic fabric of the communities within they are located. For example, a 2005 study by the Centre for International Economics<sup>1</sup> has shown that the Company's Bombala operations contribute significantly to the local economy, providing the largest number of sustainable jobs of any other employer, and contributing \$8.7 million to the economy. The details of the economic contribution are shown in Table 1 and Table 2 below.

**Table 1 Economic contribution of Willmott Forests' forestry activities (2003-4)<sup>2</sup>**

Type of Expenditure	\$/yr
Gross payroll	864,000
Creditors	
• Total purchase of local goods	218,379
• Purchase of local goods retained locally	32,757
• Services	821,520
• Freight	55,100
Total expenditure	1,039,899
Total expenditure locally retained	909,377
State and local taxes	522,000
Gross value of production	2,425,899
Gross value of production Bombala	2,295,377

**Table 2 Economic contribution of Willmott Forests' timber processing (2003-04)**

Type of Expenditure	\$/yr
Creditors	
• Purchase of services	3,382,518
• Total purchase of goods	809,504
• Purchase of goods locally retained	121,426
Freight	532,483
Logs and sawn timber	5,639,476
Total expenditure on goods and services	10,363,981
Total expenditure locally retained	9,675,902
<b>State and local taxes</b>	<b>218,000</b>

<sup>1</sup> Centre for International Economics. 2005. *Plantations, Jobs & Investment in Regional NSW - A socio-economic analysis of private forestry in the Bombala region*. Report commissioned by Willmott Forests. 42pp

<sup>2</sup> The figures in Tables 1 and 2 are from 2003-4 and have not been CPI adjusted to 2009 terms.

Willmott Timbers' proposed Bombala sawmill expansion (outlined above) will build on this socio-economic contribution and will comprise a primary sawing plant, timber drying and treatment facilities and associated site infrastructure to produce value-added softwood decking and other products for sale into domestic and export markets

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