Sunraysia Irrigators Council Inc.

www.mdic.com.au

Chairman
Malcolm Bennett

Secretary
Nancy Prevedello

Dear Sir,

Please find on the following pages a submission to the Senate Inquiry into agribusiness managed investment schemes.

The Sunraysia Irrigators Council (SIC) is a group of irrigators from the Mildura, Merbein and Red Cliffs pumped irrigation districts, as well as private diverter irrigators outside of the pumped districts.

The SIC lobbies State and Federal Governments for fair outcomes for irrigators on all water and irrigation issues.

Malcolm Bennett.

Inquiry into agribusiness managed investment schemes.

This submission by the Sunraysia Irrigators Council will attempt to address the 12 points as noted in the Terms of Reference.

Irrigation in the Sunraysia area has a continuous history of over 100 years since the initial irrigation scheme set up by the Chaffey brothers in the 1880's. The vast majority of crops in the area are permanent, consisting mainly of grapevines and some citrus. Up until the mid 1990's dried vine fruit had been the predominate crop, but since then wine grape production has dominated, with table grape production also increasing. Citrus production has decreased over that time.

Comments made in this submission will be based on the cumulative experience of successful growers in the district, and their views on the rise and fall of the 2 major players in MIS, Timbercorp and Great Southern.

1. Business models and scheme structures of MIS.

Scrutiny of MIS in Sunraysia by local irrigators started around 2005 when the almond schemes at Boundary Bend (near Robinvale approximately 100 km from Mildura), promoted by Timbercorp started to gain momentum and publicity. Prior to this large-scale irrigation development had been earmarked by the Victorian State Government for the Mildura area, tacked on to existing irrigation district infrastructure through the "Deakin Project". This project never went ahead.

Almond schemes in particular turned out to ideal for MIS. Irrigation infrastructure had been refined to a point that it could be installed quickly in very large areas, with virtually no regard to contours or lay of the land, and could be operated, monitored and maintained with minimum labour requirements. Once the irrigation infrastructure was installed the only other capital expense was the trees, which would not start yielding for 3 years, and not reach full maturity for 7 years. This would mask poor yield performance for many years.

The structure of the Timbercorp schemes certainly raised questions when a prospectus was read. Investors in the schemes could purchase "almond lots" for a given amount per quarter hectare. In June 2007 this was $7000. Post June the price was $9000 per almond lot.

This level of fees equates to between $28,000 and $36,000 per hectare and entitled the investor to the crop only, and was subject to ongoing management fees. Horticultural property values in and around the pumped irrigation districts ranged between $20,000 to $50,000 per hectare. These prices would include freehold title to the land and water, plus plant and equipment and possibly a dwelling.

It seemed that investors were paying a significant premium to participate in such schemes, especially when the only asset they owned was the crop on the trees. It appeared that the MIS was using investor money as cheap finance to set up these schemes and then run them for a fee for the life of the project (25 years), avoiding the risk of the uncertainty in the crop – the investor took all the risk – and then ending up with a significant asset at the conclusion of the project.

The management structure was also convoluted in that Timbercorp were the scheme promoter, Timbercorp Securities were the responsible entity and Select Harvest was the orchard manager. Proceeds from the eventual crop would have to wash down through these layers of management before the investor would see a return.

This is a very different business model to the majority of irrigated horticulture where variations of family and partnership businesses have direct hands on management of the business.

2. The impact of past and present taxation treatments and rulings related to MIS.

Favourable taxation treatments and rulings have been critical to the operation and expansion of MIS. It was interesting to note that MIS investors, when MIS came under increased scrutiny, became “Growers”, as this formed an important part of the scheme obtaining tax ruling. Along with the tax rulings, there must also be people with tax liabilities willing to enter MIS to minimize their tax obligations.

Taxation treatments have had significant effects in other areas of horticulture as well. At the start of the wine grape boom, new vine plantings could be depreciated at 30%, rather than over the life of the vine. This was one of the factors that contributed to the massive oversupply of wine grapes that the industry now faces. Of course MIS have also contributed to the over supply of winegrapes.

Several years ago the 30% deduction for new vine plantings was removed.

3. Any conflicts of interest for the board members and other directors.

In the case of Timbercorp, the myriad of companies that have been spun of the parent are of course all inter related. The reason for this diversification of companies is purely financial, nothing to do with agricultural production. In fact it is interesting to note that none of the board members have any background in agriculture and all come from the accounting/business sector.

As an example of the interrelationship of companies in Timbercorps horticultural projects, Select Harvest, the company that operates the almond orchards is partly owned by Timbercorp. Boundary Bend Olives which operates the Timbercorp olive plantations has as one of its directors Robert Hance, the founder of Timbercorp. Timbercorp Primary Infrastructure Fund, which owns land and water for 2 almond projects is partly owned by Timbercorp.

The responsible Entity for the Timbercorp almond projects is Timbercorp Securities. This company is responsible for the interests of investors in the projects, but is an offshoot of Timbercorp, who is responsible for the interests of shareholders.

4. Commissions, fees and other remuneration paid to sellers of MIS.

It has been well documented that the commissions paid to sellers of MIS schemes have been exorbitant, figures of 10% and more have been quoted. This has obviously done with the express approval of the original promoters and has been a key element in the development of the schemes.

5. The accuracy of MIS promotional material relating to claimed benefits and returns.

As full time horticulturalists, we are acutely aware of the returns we receive for our produce. The production figures quoted in the Timbercorp almond prospectus were the maximum achievable for fully mature trees. Experience has shown us that the average yield of any agricultural enterprise is significantly lower than the ‘record’ bumper crop in the life of a plant. Unfortunately ‘experts’ are usually quoted when projected yields are forecast, distancing Timbercorp from the task.

6. The range of individuals and organizations involved with the schemes.

As previously noted, it seems that no board member, and probably no senior executive has any background in irrigated horticulture, their expertise being in the financial sector. This background it seems did not serve them very well.

Consultants would no doubt have been engaged in any agricultural matters, with outcomes usually favourable to the interests of Timbercorp.

Governments both Federal and State have been keen in the past to see these schemes up and running. The Federal Government has had control of the legislation to enable the tax rulings to be given, and then faced enormous pressure when the previous Federal Government decided to stop the schemes, only to later give a 12 month extension, and after a court case they were free to continue.

State Governments have been keen to see the investment in country areas at no cost to themselves, and anecdotally have gone out of their way to ensure a minimum of red tape stands in the way of implementing the developments. The irony here is that most of the money generated by these schemes eventually finds its way back to the city. Investors are mainly city based, as are the headquarters of all the MIS's. Ongoing full time jobs in these schemes are kept to a minimum due to the economies of scale.

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

There 2 parts to understanding these schemes. The first is the agricultural aspect, and although there is reference in the prospectus to the suitability of the site for the product involved, all the information provided is very positive, with virtually no downside except for the rider that the promoter could not guarantee any of the returns.

The other part is the financial side of the schemes, and apart from passing references to other companies owning land and water, very little is revealed of the complex nature of the MIS structure. What is highlighted is the tax effective nature of the schemes, and references to the Tax Office rulings.

A closer scrutiny of the Timbercorp annual reports could possibly have highlighted the growing debt being incurred. It is incredible that the last Timbercorp annual report (2008) showed a profit of $44 million, and yet 6 months later they called in administrators.

It seems a simple task to set out a set of figures reflecting the previous 12 months financial performance, clearly stating assets and liabilities. For many companies this does not seem to be the case.

8. The performance of the schemes.

It is our understanding that there is no requirement to report the performance of MIS. This must be made a requirement of all such schemes, with a method that reflects the true returns to investors.

9. The factors underlying the recent scheme collapse.

In simple terms, Timbercorp had run out of money to pay its bills. To expand on that statement, it can be said that the projects Timbercorp set up cost more to run than the income they received from managing them. This is curious, as the way the projects were set up was that the investors only received income from the crop being grown, whereas Timbercorp received prescribed annual management fees from the first year of the project until the termination of the project in year 25, with only a small proportion of the management fee tied to production.

At best it can be said that Timbercorp totally underestimated the costs involved in setting up and managing the schemes, although they did have at least 8 to 10 years experience in operating such schemes. A more likely scenario is that to reflect the true cost of these schemes would have meant vastly increased upfront and ongoing costs to investors, which would have drastically reduced any investor return and consequently any investor interest in such schemes, even allowing for the upfront tax deductions. Economies of scale are quoted in the almond prospectus, but this does not seemed to have helped Timbercorp at all.

As has already been noted, the complex nature of the Timbercorp model would have incurred costs not normally associated with an agricultural enterprise. To cover these costs, at least in the short term, Timbercorp relied on the cash generated from new schemes to cover the running costs of all the previous schemes, to all intents and purposes a ‘pyramid’ or ‘Ponzi’ type scheme. This was actually alluded to in the 2008 Timbercorp annual report when it was stated that it could no longer rely on new MIS.

Timbercorp, as is common with all other MIS, also offered finance to investors. This no doubt produced another ‘revenue stream’, but quickly became a liability when investors started defaulting on loans.

And all the time the debt that Timbercorp was incurring was piling up as costs could still not be controlled. That banks had been willing to lend Timbercorp money would point to some lack of due diligence on their part.

At this point in time the Timbercorp administrators have identified approximately $1.1 billion of debt, although this does not reflect the true level of debt. At least 2 associated companies, Timbercorp Primary Infrastructure Fund and Timbercorp Orchard Trust own land and water for almond and olive projects (purchased from Timbercorp) and have combined total liabilities of $219 million. Although Timbercorp Primary Infrastructure Fund and Timbercorp Orchard Trust claim not to be subsidiaries of Timbercorp, they in essence are, and until recently shared board members. They derive income solely from rent received from Timbercorp.

10. Projected returns, including assumptions on product price and demand.

As previously noted, the Timbercorp almond prospectus aims at the top end of performance, and to reinforce this, it seemed to believe its own hype and has included a performance bonus for itself if almond production exceeded a certain level.

Many assumptions and estimates of costs are made, which may or may not stand up in the future. A small graph of historic almond prices does show a dramatic decline in price over the last 2 years, although a trend line shows a convenient long-term increase in price.

11. The impact of MIS on other related markets.

Anecdotally Timbercorp has paid historically high prices for the predominately farming dry land that it has purchased for almond projects. This appears to be true in forestry MIS as well. MIS companies were able to outbid genuine farmers for land. In the case of land for forestry it is ironic that it will probably generate less return per hectare than its traditional farming use.

The price of High security water entitlements has doubled since MIS has been in the market. High security water currently has a value of $2200 to $2400 in Sunraysia. MIS have been the major water buyer up until their collapse.

It must be pointed out that the later Timbercorp almond projects do not have enough high security water for mature trees. It has been calculated that they will need another 100,000 Megalitres to have their full requirement of 12 Megalitres/Hectare as per the prospectus.

In 2007/08 high security water allocations on the Murray in Victoria reached 43% and the price of temporary water reached $1200/Megalitre. This was due in part to Timbercorp aggressively buying water for its requirements. This created a large amount of financial distress for many genuine irrigators along the Murray. In 2008/09 high security water allocations on the Murray in Victoria only reached 35% and the price of temporary water reached $400/Megalitre. Apparently Timbercorp were not in the market to the same extent as the previous year.

In 2006/07 (allocation 95%) irrigators in Sunraysia faced restrictions in the amount of water that could be pumped at the peak of summer due to capacity restraints in the Murray River itself. This had been bought about by the large amount of water that was now being extracted by the MIS almond schemes upstream of Mildura. The Victorian Government has had to come up with a scheme to use Lake Boga as a balancing storage and manipulate the Euston weir pool over a greater range to cater for an increased draw down. Because of the last 2 years of extremely low allocations restrictions have been avoided. Once allocations return to a more normal level and if all the almond plantations are still in operation irrigators in Sunraysia will face the possibility of restrictions.

Overproduction is another feature of MIS, with MIS in wine grapes contributing to a huge overproduction, which will take many years to overcome. Almond overproduction is almost a certainty, and as the world almond price has declined over the past 2 years it is hard to see that a doubling of Australia's almond crop in the next 3 years will improve things.

12. The need for any legislative or regulatory change.

We believe that there is an urgent need for legislative or regulatory change. A lot of people are going to lose a lot of money by the time Great Southern and Timbercorp are sorted out. Apparently Managed Investment Schemes in the UK and the USA are illegal. If this is the case then Government must closely look at the legislation involved in those countries.

Financial reporting standards must be reviewed in the light of the current world financial situation so that financial and accounting practices, which are not sustainable in the long term, are abolished. Company debt to equity ratio seems to have been running at very high levels in these companies, indicating that income was never great enough to service debt. Debt can be very clearly defined as long as it clearly identified. Equity is somewhat harder to measure and relies on a valuation of assets, which is usually overstated. Assets in a fire sale are worth much less again. It seems that the responsibility of banks lending money needs to be tightened up in these situations.

For any horticultural development water is critical. To show good faith, any large scale horticultural development should be required to purchase the full amount water required before the development can take place. Timbercorp has been able to plant many thousands of hectares of almonds, knowing that it would never be able to buy sufficient water to enable the projects to reach maturity. If these projects are allowed to proceed, they will be in the market for water, either permanent high security water, or temporary water, year by year. The schemes will be competing with the Federal Government if they buy permanent water, and other irrigators if they buy temporary water.

Conclusion.

It appears that the much-heralded corporate foray into irrigated horticulture has been a complete failure. In the case of Timbercorp, it has not been able to develop a sustainable enterprise. The costs of managing the enterprise have exceeded the income derived from it. It has paid too much for land and water and has not been able to service the large debt generated. Timbercorp has employed seemingly every financial maneuver to try and buy itself some time, but it has all come to nothing. It has drawn in investors with the lure of an upfront tax deduction, but they will more than likely lose all their investment. The shareholders of Timbercorp will lose all their money. The Federal Government, who has helped finance Timbercorp through the upfront tax deduction for investors, will get nothing.

Timbercorp has not been able to show any resilience through a severe drought and economic downturn, unlike the majority of farmers in Australia.