

Application Assessment Report

JAAKKO PÖYRY CONSULTING

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Assessment TFI 6

Tasmanian Forest Industry Development Program (TFIDP)

Assessment of Application

AW Harvesting Pty Ltd
- Purchase of Waratah Harvester Heads -

PREFACE

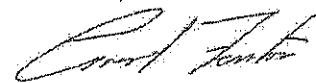
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The report contains the opinion of Jaakko Pöyry Consulting as to the eligibility and ability of applicants to undertake the proposed projects under the Tasmanian Forest Industry Development Programme (TFIDP). Under the terms of the engagement we have not conducted an audit of the company's financial statements and other information relied upon in the preparation of this report. Furthermore, as the achievement of any prediction as to the result of the subsequent trading is dependent upon future events the outcome of which cannot be assured, the actual results achieved may vary materially from the attached projection. In all circumstances, no warranty of accuracy or reliability is given.

Nothing in the report is, or should be relied upon as, a promise by Jaakko Pöyry Consulting as to the expected future returns of the applicant's proposed capital expenditure. Actual results may be different from the opinion contained in this report, as anticipated events may not occur as expected and the variation may be significant. Jaakko Pöyry Consulting has no responsibility to update this report for events and circumstances occurring after the date of this report.



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SUMMARY

AW Harvesting Pty Ltd (AWH) operate in the harvesting and haulage sector, harvesting around 120 000 tonnes per annum (t/a) of native forest and hardwood plantation wood for Gunns Limited (Gunns) in Northern and Central Tasmania.

AWH had previously held harvest agreements to a volume of 160 000t including a 90 000t/a Forestry Tasmania native forest harvesting contract with Gunns. Following the Tasmanian Community Forestry Agreement (TCFA) in May 2005, this contract was replaced with a 50 000t/a contract for harvesting from hardwood plantations.

In order to efficiently transfer from a native forest resource to a hardwood plantation resource, AWH purchased two new Waratah HTH622B harvesting heads. AWH are applying for reimbursement of 25% of the purchase and installation costs incurred for these new harvesting heads. The amount sought is \$125 960. Jaakko Pöyry Consulting consider the machinery purchased suited to hardwood plantation harvesting in Northern Tasmania and that the concept is well founded, however, the financial health of the applicant must be considered.

The applicant has a relatively weak historical and current financial position and has a high level of gearing and finance commitments. Although debt gearing is considered high it is at a level frequently observed in the harvest sector. Losses in 2004/05, following profits in the previous two years, was largely due to a reduction in volume, which the applicant attributes to a period of no harvesting at customer request, and the disruption of moving to plantation forest operations. The reduction in harvest quota is now confirmed and the business case, based around the revised quota volumes, appears realistic.

AWH's financial forecasts rely on a large reduction in maintenance costs as a result of the change in activities and the purchase of this equipment. This reduction appears realistic and will result in maintenance at an industry norm level. The forecasts do not provide for any salaries to the working proprietors.

The equipment which is the subject of this funding request has already been 100% debt funded. Because of AWH's high level of debt, we recommend the grant be subject to a condition that the applicant applies the net (after tax) proceeds to debt reduction, subject to refinance or repayment without substantial penalties from the financier.

It is the understanding of Jaakko Pöyry Consulting that AWH has a good relationship with creditors and that there is little reason to believe the business shall not be financially viable going forward. It is also understood that AWH has refinanced recently in order to reduce the debt burden.

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1 SCOPE OF REVIEW

The following review assesses the application by AWH for funding under the Tasmanian Forestry Industry Development Programme (TFIDP).

The current operations of AWH are classified under the **harvesting and haulage** sector. Funding is requested by reimbursement of 25% of the purchase and installation costs incurred for two new Waratah HTH622B harvesting heads. The amount of funding sought is \$125 960.

2 BACKGROUND

AWH commenced harvest and haulage operations in 2001 following the acquisition of the business. Since starting operations, AWH has held contracts with Gunns to provide harvest and haulage services for chip log and saw log from the Central and Circular Head/Western regions of Tasmania. Since the TCFA implementation, the previous Forestry Tasmania native forest contract has been revoked and a new reduced plantation harvest contract offered.

The business is owned and operated by Mr Robert Hickson who is supported by Mr Vic Weller. Mr Hickson has a background in accounting and has spent six years with the Weller Group acting as accountant for their forestry, engineering and motel/restaurant business. Mr Weller reportedly has 40+ years experience in the forestry industry and is responsible for the day to day management of the harvest operations as well as liaison with Gunns.

An associated company, Camdale Services Pty Ltd (CS), provides transport services to AWH. The resale of these services by AWH represented approximately 25% of AWH's turnover in year ended 30 June 2005.

3 SOURCES OF INFORMATION

Sources of information relied upon in consideration of this application include:

- TFIDP Application Form
- AWH business plan (as attached to TFIDP application)
- Correspondence with Gunns dated 30 May 2005
- Unaudited Financial Statements of AWH for the year ended 30 June 2004, with prior year comparatives
- Unaudited Financial Statements of AWH for the year ended 30 June 2005
- Unaudited Financial Statements of CS for the years ended 30 June 2005 and 2004, with prior year comparatives
- Cash flow forecast of AWH for the year ending 31 December 2006
- Correspondence dated 21 June 2005 from Finance Broker confirming settlement and copies of Hire Purchase Agreements
- Discussions and email correspondence with the Directors.

For the purposes of preparing this report, reliance has been placed upon the material, representations and information that we have specified above and the instructions provided to us. Original documentation has not been required (unless otherwise stated) and no audit or examination of the validity of the documentation, representations, information or instructions provided has been undertaken save as may be expressly referred to in this report.

4 TFIDP PROPOSAL

4.1 Description of Proposal

The AWH proposal requests support for investments in harvesting equipment undertaken in June 2005.

As a result of the implementation of the TCFA, 90 000t/a of a total 160 000t/a of native harvest agreements were withdrawn and replaced with a 50 000t/a contract for plantation wood harvesting (the balance of 70 000t/a remains under a three year evergreen contract). In line with this change to plantation timber harvesting, two Waratah tree processors were purchased and commissioned in July and August 2005.

4.2 Project Budget

The project budget covers the acquisition and fitting of two Waratah tree processing heads, including necessary hydraulic components and the alteration of current excavators.

The budget and timing of the investments are contained in Table 4-1.

Table 4-1:
Project Budget

Cost Item	Cost (excl. GST)	Timing
Waratah 622B felling/processing head	\$241 000	July 2005
Waratah 622B felling/processing head	\$241 000	August 2005
Removal/alteration of excavators	\$21 840	
Total	\$ 503 840	

The applicant has requested assistance at 50% of the project cost. They have subsequently been informed of the 25% maximum funded component and have since requested support to this level amounting to \$125 960.

The project expenses have been met via hire purchase financing brokered through Heritage Finance with CBFC Limited and ESANDA for the full value of the harvesting heads. The removal/alteration of the excavators has been solely financed by AWH.

4.3 Access to Necessary Resource

Access to resource declined in 2005 as Gunns withdrew a 90 000t native forest harvest contract and replaced it with a five year evergreen 50 000t plantation harvest contract. A further 70 000t agreement has continued on a three year evergreen contract (see Table 4-2).

Table 4-2:
Harvest Volume Agreements

Source	Pre 2005 volumes (t)	2006 onwards volumes (t)
Native	160 000	70 000
Plantation		50 000
Total	160 000	120 000

The reduction in volume has been reflected in the forecast revenue. Plantation harvesting demand is expected to increase significantly over the next decade. The timing of the increase will depend somewhat on the success of the Gunns pulp mill project.

Although AWH is a smaller operator, it is advantageous for the industry to have a number of contractors available and thus it is likely existing agreements will be rolled over or substituted in like.

5

MANAGEMENT AND INVESTMENT HISTORY

Capital investment history demonstrates a commitment to the industry and includes the purchase of three new and three secondhand excavators during the period October 2002 to May 2004.

The two shareholders provide senior management expertise that is appropriate for the industry. One of the shareholders is a Chartered Accountant with experience in the forestry industry and the other has 40 years experience in harvesting operations. The financial expertise is particularly appropriate given the high gearing and relatively poor historical profit performance.

6 FINANCIAL ANALYSIS

6.1 Historical Operation and Financial Performance

The following table summarises the financial performance of AWH for the three financial years ended 30 June 2005:

Table 6-1:
Revenue Statement

(\$000's)	FYE 2003	FYE 2004	FYE 2005
REVENUE			
Contract income	4,544	5,416	4,267
less subcontract costs	-1,769	-2,420	-1,435
Other	0	12	0
Net Revenue	2,775	3,008	2,832
EXPENSES			
Depreciation & amortisation	262	427	422
Fuels & lubricants	321	299	447
Finance Costs	480	242	234
Repairs & Maintenance	614	683	611
Wages & oncosts	825	942	971
Other	215	266	297
Total Expenses	2,717	2,859	2,982
OPERATING PROFIT	58	149	-150
add non operating income			42
Profit before tax	58	149	-108

The management accounts for year ended 30 June 2005 indicate an adverse trading position with a 22% reduction in contract income, a loss of \$108 000 and a reduction in interest coverage ratio¹ to 0.54 (2004 - 1.62). The applicant attributes this weak performance to a move from native forest to plantation forest, together with a period of no harvesting as their customer ceased receipt of product for a period. The prior two years report a modest profit but record no expense for the working shareholders.

The historical balance sheet position of AWH is relatively weak with a high level of gearing and a low level of equity, not unlike other companies providing similar services (see Table 6-2).

Thus, serviceability of the high levels of debt is a critical consideration for the future of AWH.

The associated company, CS, has been materially dependant upon AWH for approximately 40% of its revenue. CS also moved from profit to loss in the 2005 financial year.

¹Earnings before interest and tax / interest expense.

Table 6-2:
Summary Balance Sheet and Financial Ratios

Summarised Balance Sheet				
(\$000's)	FYE 2003	FYE 2004	FYE 2005	
Current Assets	564	561	265	
Non-current Assets	2,829	3,205	3,204	
TOTAL ASSETS	3,394	3,766	3,469	
Current liabilities	1,580	1,829	1,661	
Non -Current Liabilities	1,527	1,554	1,563	
TOTAL LIABILITIES	3,107	3,382	3,225	
		FYE 2003	FYE 2004	FYE 2005
Current ratio		0.36	0.31	0.16
Quick Ratio		0.33	0.29	0.15
Debt/Equity ratio		8.73	6.89	10.36
Total liabs/Equity		10.85	8.81	13.22
Total liabs/total assets		0.92	0.90	0.93
Total liabs. / tangible assets		0.92	0.90	0.94

The current and quick ratios indicate a weak position but are exaggerated by a related party loan owing to CS, of \$336 000 and an interest bearing debt of \$1 113 000 classified as 'current'. While the company has been able to meet its obligations with this weak position, its future viability is dependent upon the success of its changed operations producing profits and positive cash flow as forecast.

6.2 Current Financial Position

The most current financial reports available are for the financial year ended 30 June 2005. These show a poor trading result with a reported loss (refer to section 6.1 above).

AWH has a high level of debt compared to equity and tangible assets. Its balance sheet reflects a relatively weak position (refer to section 6.1 above).

From the Hire Purchase documentation, the full amount of GST on the equipment has been financed. As this can be claimed back as an input credit, this is sometimes a means of achieving a boost to short term cash flow.

We recommend that the portion of any grant directly related to the equipment be conditional upon its use in the reduction of the specific asset finance. This may need to be tempered by the practicalities of refinancing or possible penalties on early repayment.

7 BUSINESS PLANNING

7.1 Applicant Financial Projections

Forecasts prepared by the applicant are summarised in Table 7-1 below:

**Table 7-1:
Forecast Revenue Statement**

(\$000's)	2006	2007	2008
REVENUE			
Contract income	2929	2,896	2,969
less subcontract costs	-104		
Net Revenue	2,825	2,896	2,969
EXPENSES			
Fuels & lubricants	388	434	445
Finance Costs	743	692	692
Repairs & Maintenance	336	400	440
Wages & oncosts	758	785	812
Other	245	258	253
Total Expenses	2,470	2,569	2,642
Net Cash surplus	355	327	327

Finance costs in Table 7-1 above include principal and interest repayments.

The predicted cash surpluses are highly dependent upon achievement of volumes and the planned reduction in maintenance. If actual volumes are 10% below planned volumes, the cash surplus will be reduced by approximately \$110 000. If maintenance is reduced by only 15% instead of the planned 36%, the cash surplus will be reduced by approximately \$180 000.

There is no provision in the forecasts for any salary payments to the working directors.

7.2 Applicant Business Plan

Jaakko Pöyry Consulting believe AWH have used good logic in developing the business plans in support of the TFIDP grant. The justification for funding on the basis of change in resource from native to plantation forest harvesting is well presented.

7.3 Review of Assumptions

Employment levels have not been increased but security for existing/remaining employees given reduction in volumes appears realistic. The application envisages a reduction in headcount from 12 to 9 staff and a 22% reduction in wage costs.

Harvest quotas for Gunns consist of 50 000t/a until July 2010 on a five year evergreen term and 70 000t/a of native from the central region. Confirmation of the agreement rollover, dated 26 May 2005, has been received which secures fibre until 1 July 2008. The forecasted revenue figure is in line with the harvest quota and there is no reason to believe this will not be achieved.

Key underlying financial assumptions in the forecast are:

- Forecast revenue in aggregate is consistent with prior years
- Revenue drivers
 - Harvest volume is consistent with contract volumes
 - Rates appear reasonable
- 36% reduction in annual maintenance costs due to new equipment and change in activities. Although this looks optimistic this should be achievable and result in maintenance spending in line with the industry norm
- Reduction of fuel expense, wages and on costs due to change in activities.

7.4 Project Financing

The equipment has already been 100% financed by Hire Purchase, fully amortising over five years with no deposit and no residual.

In view of the highly geared financial position of the company and the high level of debt repayments, we recommend that any grant be conditional on the (after tax) funds being applied directly to debt reduction.

7.5 Technical Feasibility

The transfer of the AWH contract from native forest harvesting to hardwood plantation harvesting has meant that they have had to invest in new harvesting heads to efficiently process the resource.

The native forest resource in the Circular Head / Western Region of Tasmania is characterised by larger diameter trees than those in hardwood plantations. The system of harvesting in native forests is whole tree or long wood extraction to a roadside landing for debarking and further merchandising. The extraction to roadside landing is often undertaken by skidding 1 to 3 trees and/or logs using a grapple equipped rubber tired skidder. The debarking and merchandising is undertaken with an excavator based at the roadside landing.

Plantation resource in North West Tasmania is characterised by smaller diameter trees than in native forest harvesting coupes. The system of harvesting in plantation forests is a short wood system which involves felling, delimiting, debarking and merchandising of trees in the forest. The logs are then extracted to the roadside using a forwarder which can transport 10-15t per load.

The resulting change in resource has meant the existing native forest harvesting heads are not that efficient at being able to cope with smaller diameter wood that requires delimiting, debarking and merchandising at the stump. AWH has had to purchase plantation based harvesting heads to make this adaptation to the processing of the new resource.

Jaakko Pöyry Consulting believe that the two Waratah HTH622B harvesting heads purchased are capable of efficiently processing this change to plantation hardwood. Waratah is a well recognised manufacturer and supplier of harvesting heads in the forest industry and are widely used by contractors throughout hardwood plantations in Australia, New Zealand, South Africa and South America. The HTH622B is most efficient at processing trees in the 45cm to 55cm diameter range with a maximum felling capability of 72cm and maximum processing capability of 61cm. Jaakko Pöyry Consulting believe that the range of diameters the head is designed for are representative of much of the resource the contractor is likely to experience in the hardwood plantations of Gunns in North West Tasmania.

8 RISK ANALYSIS

There is a high but acceptable level of financial risk for the company. Finance commitments are covered approximately 1.5 times from projected cash surplus before finance commitments. However, the projected cash surpluses rely to a material degree on meeting the target reduction in maintenance costs as well as meeting volume targets.

As noted in section 7.1 above, if actual volumes are 10% below planned, the cash surplus will be reduced by approximately \$110 000. If maintenance is reduced by only 15% instead of the planned 36%, the cash surplus will be reduced by approximately \$180 000. If the combination of these two events occurred, there would still be a modest cash surplus and debt would be serviced.

9 OTHER ISSUES

Jaakko Pöyry Consulting has thus far not identified any other critical issues that should be raised in assessing this application. Jaakko Pöyry Consulting intends to undertake a field visit to several of the harvest operations to further check the assumptions and operation status.