

## **Where did all the money go?**

The perennial question every time a company heads into bankruptcy.

It is of particular interest in cases of failed MIS companies for anyone trying to assess the effectiveness of the MIS model and the efficacy of Government policy in the important area of land use.

The recently fallen Great Southern Limited (GSL) represented 30% to 35% of the MIS industry in turnover terms. Whilst it has operated since 1987 it didn't list on the ASX until 1999. There's reasonably good data available from 1<sup>st</sup> July 1998 until 30<sup>th</sup> September 2008 which may shed some light on how the MIS industry has operated.

Profit and loss statements (P&Ls) only tell part of the story. In GSL's case it was profitable. Very profitable at times. All Ponzi schemes are, by their very nature. If not, they die. And quickly. GSL's profitability woes became starkly apparent in August 2008. Six months later it was gone.

But P&Ls only cover income and expenses and hence don't reveal what is happening with assets and liabilities and how the show is being financed. And most lay persons struggle to make much sense of a balance sheet.

Companies also produce a statement of cash flows. These list cash movements not only operating income and expenses but loans to and from lenders, proceeds from share issues and dividend payment, income tax payments, purchases of assets, in fact all cash transactions. If one is interested in following the money trail this is the place to start.

A summary of GSL's cash flow statements from 1<sup>st</sup> July 1998 to 30<sup>th</sup> September 2008 indicates all the cash in and out of GSL.

In 1998 GSL was a profitable little shell, with no tangible assets of substance, nor any loans owing. It had paid up capital of \$50,000 and retained earnings of \$30 million. But within 12 months, 28% of GSL was sold for \$33 million and the Company was floated. It sailed the high seas for 10 eventful years before meeting Titanic's fate.

The summary of cash flows indicates, needless to say, most inflows emanating from grower/ investors. But from where did they source their funds? Some investors paid cash invariably late in June. A few weeks later they were rewarded with an extra tax refund of say 40% of their contributions. In cash flow terms, the exercise had cost them 60%. Other investors borrowed the full amount of their grower contribution and too received a 40% tax refund of the contributed amounts. In their case the result was a bonanza. The immediate cash flow effect was a boost (when the tax refund arrived), because all contributions were borrowed.

Collectively investor loans were 60% of total grower contributions. The remaining 40% was provided from tax refunds as a consequence of the MIS contributions. Hence, collectively investor/growers did not contribute any of their own equity. The sources of their funds were loans and tax refunds. Over time however they have ‘contributed’ equity as they gradually paid off their investor loans.

The amount of tax assistance given via tax refunds to investors has been offset against the tax paid by GSL over the 10 year period (\$295 million) to give a net subsidy to GSL over the period of \$689 million.

The abridged summary of GSL’s cash flows is set out in the following table.

|     |                             | \$ m   |
|-----|-----------------------------|--------|
| IN  | Investor loans              | 1,476  |
|     | Bank loans to<br>GSL        | 350    |
|     | Proceeds equity holders net | 771    |
|     | Other income                | 86     |
|     | Tax subsidies net           | 689    |
|     |                             | 3,372  |
| OUT | Planting expenses forestry  | -340   |
|     | Overheads & legacy costs    | -1,302 |
|     | Other biological assets     | -226   |
|     | Land and plant              | -1,052 |
|     | Company acquisitions        | -127   |
|     | Other                       | -75    |
|     | Dividends                   | -166   |
|     |                             | -3,287 |
|     | Net cash inflow             | 85     |

By way of further explanation.

1. Investor loans are 60% of total MIS contributions. The total receipts from grower/ investors via loan securitisation as per the cash flow statements is \$1,373 million but this only dates from the 2005 year. Some investors also organised their own lines of credit.
2. Bank loans (net of repayments) of \$350 million have been lent to GSL. This was the amount due as at 30<sup>th</sup> Sept 2008.
3. Included in proceeds from equity holders of \$771 million are proceeds from the issue of debentures (\$210 m), hybrid securities (\$201m), and shares (\$335 m). There is also some related party loan transactions prior to the IPO in June 1999. All amounts are net of issue costs.

4. Other income includes interest (\$60m) and the sale of land and plant (\$23.5m).
5. Tax subsidies have already been explained, being assistance to investors less tax paid by GSL over the period.
6. Forest plantation costs are \$2,000 per hectare or \$340 million in total.
7. Other overheads and legacy costs of \$1,302 million include all commissions and legals, all employee costs, interest, all running costs such as rates etc. A detailed breakup is not available with the cash flow statements, but some detail can be gleaned from the P&Ls such as commissions, marketing and promotion expenses of \$356 million, finance costs of \$166 million and admin costs of \$161 million.
8. Other biological assets of \$226 million include expenditure on cattle (50%) with the balance being split evenly between horticulture crops and trees owned by GSL.
9. Land and plant of \$1,052 million consists mainly of land.
10. Company acquisitions of \$127 million relates to complementary businesses acquired by GSL,
11. Other of \$75 million relates to a sinking fund amount to provide security of interest payments to debenture holders.
12. Dividends of \$166 million are self explanatory. All dividends were fully franked. Franking credits were also used to subsidise interest payment to hybrid security holders.

That's where all GSL's money came from and where it all went.

It's quite staggering to find the cost of marketing and promoting MIS sales was equal to direct planting expenses. Most of the value adding in the MIS industry was achieved by paper shufflers. If Governments had planted the trees themselves they could have ended up with twice as many for the same price.

What's the current situation with GSL in the hands of undertakers?

1. GSL investor loans are still approximately \$500 million. Investor/growers have used their own hard earned to repay approximately \$1 billion of their loans.
2. Their trees are only worth possibly \$600 million.
3. GSL's land is worth maybe \$600 million to \$750 million.
4. Other assets e.g. cattle, horticultural crops are worth maybe \$100 million.
5. Banks are owed \$350 million plus interest and debenture holders about \$250 million. (These guys are the secured creditors).
6. Receivers and administrators will take most of the rest leaving little if any for unsecured creditors, hybrid security holders and shareholders.

Who benefited? Only those who managed to realise capital gains and dividends from GSL shares in the good times, and those employees and related parties who shared some of the GSL spoils.

Who lost? Banks and debenture holders will get their money back. Growers are currently about \$900 million under water but their trees are still growing. Equity holders will lose almost everything (\$500 million). What's to show for the \$689 million in taxpayer funded assistance? Not much. Could it have been spent more wisely elsewhere? And is it possible to encourage the planting of trees without MIS's. Are MIS's necessary? Does anyone really understand how they work, from the viewpoint of their actual costs and impacts?

It now transpires that no one ever understood how Allco worked? And very few understood Babcock and Brown. And a lot could never understand how with the Macquarie model it was continually possible to pay income distributions using increased borrowing. Of course the day of reckoning had to come, for all contrived structures that have grown during the last 15 years.

In case anyone is in any doubt, if a structure is unduly complex then it is bound to be hiding something. Martin Conlon, head of Australian equities at Schroders recently observed in the AFR that "we have almost never found a business in which undue complexity and lack of transparency are positive signs".

Planting 175,000 hectares over 10 years only cost \$350 million. Suppose the Government offered a grant for approved plantings of 40% of costs up to \$2,000 per hectare. That would have cost \$140 million. The tax subsidy on the balance of the planting costs at 30% tax rate (for farmers) would have been \$63 million, giving total Government assistance at \$203 million, a far cry from \$689 million. We would now have plantations on approved sites at a 70% savings to Government.

Just to reiterate.

The same 175,000 hectares of trees could have easily been encouraged at considerable savings to Governments and investors with a directly targeted system of grants to growers rather than the carte blanche application of the MIS system.

The tumultuous history of plantation forestry included an inquiry by the Federal Treasury initiated in May 2005. One of the terms of reference was how to encourage investment in longer rotation plantation crops. One of the interim recommendations in May 2006, at a time when Senator Abetz was still in charge of the Forestry ministry, was that "deductibility (of MIS expenditures) would also be conditional on the certification of the MIS company to ensure best practice in forestry, regional planning,

land use and natural resource management, under arrangements to be developed by the Department of Agriculture, Fisheries and Forestry”.

This recommendation needs to be reconsidered. The distortions created by current MIS operations have resulted in perverse site selections. With more directly applied assistance we could have hundreds of woodlots owned and managed by woodlot owners, mostly farmers probably and others with a closer affinity to the land than remote paper shufflers.

Why isn't this sort of approach embraced by forestry companies? The answer is simple when one looks at the above table. With the current MIS structure, where a forest company manages and controls trees, a Government subsidy of \$689 million is in effect a cash flow subsidy to that company. Whereas in the absence of MIS's, if any grant or subsidy is paid to a grower, then arguably it is not a subsidy to the company which may eventually buy the trees, but rather to the industry generally.

A recent industry financed report by Dr Felmingham from the University of Tasmania [http://www.forestrytas.com.au/uploads/File/pdf/pdf2009/flat\\_forestry\\_110609.pdf](http://www.forestrytas.com.au/uploads/File/pdf/pdf2009/flat_forestry_110609.pdf) stated on page 12 “(t)ax concessions or other forms of favourable tax treatment are not included because they are not necessarily paid to the industry directly or indirectly. In some cases tax havens are not designed to facilitate the operations of an industry, they are designed to attract investors to the industry. Investors and operators are not usually one and the same, so it is quite appropriate to disregard tax havens as a subsidy paid to industry when they benefit investors only”.

The industry view quite clearly is to deny that MIS assistance directly assists forest companies, but rather the investors themselves. This view is sophist nonsense. If grants were paid directly to growers in the absence of a MIS structure, this may be the case. But with MIS's, the cash flow effects of the tax subsidy clearly benefits the forestry company. Which MIS forestry company wishes to forgo subsidies of \$689 million over 10 years? That's \$2 billion for the entire MIS industry, as GSL represented approximately one third of the MIS industry. Other MIS companies differ in some respects from GSL, but broadly the similarities far outweigh the differences so it is not unreasonable to extrapolate GSL's data to obtain a picture of the industry.

As always, follow the money trail and the *raison d'être* for MIS's soon becomes apparent.

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