

Timber industry's future depends on ordinary investors' continued backing of MIS sector



BY ALAN CUMMINE

Once upon a time, government forest agencies and large timber corporations determined which trees rose and fell. But since the launching of the 2020 Vision national plantations strategy in 1997, a sea change has taken place.

Plantation managed investment schemes (MIS) have risen to become by far the dominant source of private investment in new broad-acre plantations in Australia. Indeed, it has been estimated that growers participating in MIS plantations have been responsible for financing around 70% of all new plantations, both private and public, during that period.

By far the highest proportion of the MIS plantations up until now has been in short rotation eucalypt and acacia hardwood for export woodchip – a rapidly growing share of Australia's total woodchip exports, as political pressure forces more and more native forest to be withdrawn from production. But an increasing estate of softwood plantation is being grown for sawlog, veneer, preservation treatment and pulp. And smaller areas are being established for hardwood sawlogs and for specialty value timbers and plantation products, such as teak and mahogany, paulownia, sandalwood and willow.

The MIS plantations sector is maturing beyond the plantation establishment phase. The early managed timber investments are being harvested and sold, with proceeds being paid to participating growers. Furthermore, the total resource is now reaching a 'critical mass' that justifies investment in mills and other value-adding facilities. Several MIS plantation managers own sawmills, preservation plants, woodchip plants and port facilities, or have committed their resource to supply others' pulpmills and sawmills.

In decades past, the Federal Government funded the state and territory governments via 'soft loans' to establish large areas of softwood plantations. These are now the basis of important regional development activity (sawmills, pulp and paper mills, fibreboard plants, supporting investment, jobs, and related consumer spending). But state governments are no longer, overall, establishing new plantations at their former rates. Furthermore, corporate plantation processing industries have mostly withdrawn from establishing or even owning their own plantations, and farm forestry is contributing only a fraction of the future wood resource. And, contrary to years of expectation by analysts and government advisers, institutional investors such as superannuation funds have demonstrated that they prefer to invest only in established plantations (say at 10 years, first thinning) where the early agricultural risk has already been absorbed by others.

While this decline has been going on, the MIS plantations sector has emerged as an effective and expanding source of funds



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to establish and manage new broad-acre plantations to supply resource to the domestic and export forest products industries. By any measure, the future of the Australian timber industry is increasingly reliant on the MIS plantations sector. Similarly, the 'critical mass' created by the MIS plantations sector expands the opportunities for small-scale private growers to access markets for their own forest products.

BACKED BY INDIVIDUAL INVESTORS

This investment in the MIS plantations sector comes primarily from individual Australian investors, either directly or through their corporate structures, and represents a substantial movement of city-based capital into rural industries in regional Australia.

A primary production managed investment scheme is a type of enterprise that allows

people who are not 'on-the-land' to carry on an agricultural production business. People have participated through such schemes in a broad range of agricultural businesses, including cattle farming, production of wine and table grapes, vegetables, stone fruit, citrus, almonds, olives, and plantations growing timber and other forest products.

In an MIS, an investor becomes a grower by accepting the offer made in a Product Disclosure Statement or PDS (formerly called a 'prospectus'). Investors do not have day-to-day control over the operation of the project, which is in the hands of a professional manager (the promoter), known legally as the 'Responsible Entity' (RE).

In plantation projects, growers buy one or more woodlots (usually around one hectare), and sign lease and management agreements with the plantation manager to establish, manage and harvest the plantation and sell its produce on behalf of all the growers. At harvest, the produce from the total plantation is pooled, and growers receive their returns from the woodchip or sawlog output in proportion to their number of woodlots. Some MIS plantation projects also offer growers the opportunity to purchase a share in the land under the plantation.

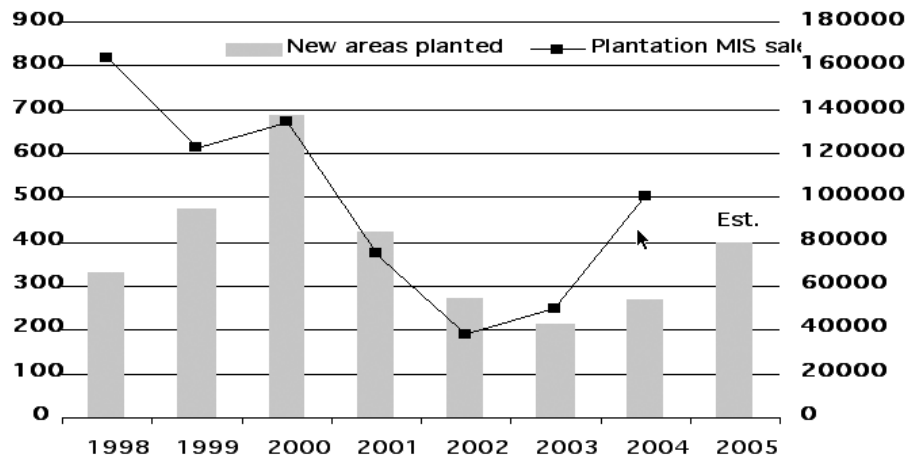
Because a PDS is offered to 'retail investors' (i.e. 'ordinary folk'), the promoter of a project is subject to complex and expensive licensing, compliance and monitoring requirements under the Managed Investments Act 1998, now embodied in the Corporations Act 2001, and tightly regulated by the Australian Securities and Investments Commission (ASIC). The level of investor protection has been steadily and significantly improved over the last decade.

Although it is entirely voluntary, compliance with the AFG Disclosure Code for Afforestation Managed Investment Schemes and promotion of the AFG Investors' Guide to Afforestation Investment provide other ways in which the MIS plantation companies demonstrate their commitment to high standards of disclosure and conduct, so as to protect retail investors. The year 2003-04 was the first year of operation of the new Code, and



MAXIMISING
PROFITS

Private investment in afforestation MIS^a and total area of new plantations established



^a Plantation MIS sales pre-2002 are estimates only, based on 75 per cent of total agribusiness MIS sales. Sales are reported for financial years, and plantings are reported for calendar years. Note the time lag between woodlot sales and plantation establishment.

around 75% of the funds were raised through product disclosure statements that had been independently certified against the Code.

WHY THE MIS BUSINESS MODEL IS EFFECTIVE IN RAISING FUNDS

People involved in growing timber plantations for future profit are carrying on a business of primary production, and expect to pay tax on that profit when it arises. Contrary to some popular misconceptions, plantation establishment is not subsidised through the tax system. In fact, it can be shown that plantation investment may ultimately be taxed more heavily than rural production based on annual crops and livestock.

All non-capital costs of establishing, managing and harvesting a timber plantation and transporting its produce are business expenses, deductible against a taxpayer's total income in the year the taxpayer incurs the expense. And because of the nature of growing a forest crop, the biggest proportion of tax-deductible expenditure in a plantation cycle occurs in the establishment years.

A grower in an MIS plantation project is at law carrying on such a business, and is thus entitled to the same business tax deductions described above. It is this simple fact that enables the MIS plantation sector to be so effective in raising funds for new plantation establishment.

The long wait for commercial return from an MIS plantation investment (as for any plantation) is partially offset by the capacity for the investor to take advantage of the full tax-deductibility of the business expenditure. MIS companies use this feature in promoting their projects, which are sold largely through networks of licensed dealers and financial planners, who receive a commission on sales. Growers may borrow the investment funds through commercial arm's length loans to be fully paid out before the full rotation, and claim the loan interest as a tax deduction. Borrowing the funds can offer cash flow benefits in the year of investment.

It is important to note that growers cannot claim the tax deductions for expenditure the Australian Taxation Office (ATO) defines as being 'on capital account', such as the purchase of land, or operations carried out before the contracts are signed between the grower and manager. MIS plantation managers finance their land acquisition in the same manner as other businesses – from their own working capital, from capital raisings, and from external loans.

The tax outcomes of investing in an MIS plantation project are confirmed when the ATO issues a Product Ruling for the project. A Product Ruling doesn't confer any new tax concession, nor does it warrant the commercial viability of the project. A Product Ruling simply confirms that the Tax Commissioner recognises and will honour the business tax deductions available to a participant in the project, as long as the project is carried out in accordance with the Product Ruling. All the MIS afforestation projects on offer carry product rulings.

SECTOR HAS CONSOLIDATED AND MATURED

After several years of well-documented turbulence, the MIS plantation sector has consolidated and matured to the point that there are now about a dozen medium to large and well established MIS plantation management companies, eight of them listed on the stock exchange, and another four or five smaller specialty operations. By 2004, they were managing about 350,000 hectares of plantations for around 40,000 growers, and both these numbers are steadily increasing.

The bulk of the funds raised for these projects (over \$500 million in 2003-04) is spent with employees, contractors and local businesses in regional Australia – in south west WA, the Green Triangle and northern Tasmania, with smaller areas in NSW, Queensland, Northern Territory and the Kimberley. Independent economic analysis estimates that this direct investment stimulates up to three times that amount in indirect investment and commercial and household spending in these regions.

The bar chart shows the relationship between the funds raised by the MIS plantations sector and the total area of new plantations in recent and current years. After the volatility of the late 1990s, the rates of investment and new plantings are now rising steadily and more or less in parallel, demonstrating the dominant contribution of the MIS sector towards achieving the notional target of the *Plantations 2020 Vision*.

This level of investment is likely to be maintained if the regulatory, tax and policy environment remains stable and predictable. This is the primary objective of AFG's special interest branch, Treefarm Investment Managers Australia (TIMA), which uniquely represents the interests of the MIS plantations sector in its dealings with government, with other industries, and with the communities in which the MIS plantation companies operate.

