

The rise of the service provider

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Introduction

In the last 10 years some larger forest owners have moved to outsourcing of services such as harvest planning, inventory, IT hosting, quality control plotting, log value recovery audits, mapping and environmental surveys and monitoring.

The preference for some companies and institutional investors to outsource forest management services has resulted in an expansion of forestry service providers over the last decade. There are now at least 84 firms active in New Zealand providing forest management, log harvesting and/or marketing services or both. I do not have comparative data from 10 years ago, but in 1971 when Olsens started in Rotorua only one other firm was providing independent forestry services – JG Groome and Associates of Taupo.

This paper reviews the drivers for the trend towards outsourcing. It also describes the challenges facing forest managers responding to the changes, based on the experiences of a medium-sized forestry service provider.

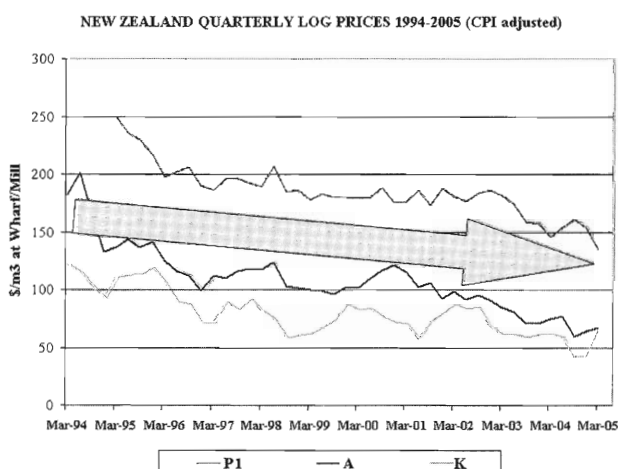
Change drivers and forest management implications

Declining log prices

Declining log prices (see Fig. 1) and forest values since 1994 have had three key impacts:

- Attempts (largely unsuccessful) to revolutionise the forest management and harvesting cost structure – evolution is a better approach.
- Sale of large forest tracts to financial institutions as forests on the balance sheet of public listed companies fail to earn their cost of capital.
- Forest earnings for ownerships less than 20,000 to 30,000 ha fail to support full management teams in-house. This has led to the expansion of independent service providers.

Fig. 1: New Zealand log prices have declined over the period 1994-2005.



Forests as public assets

Like it or not we live in an increasingly urbanised society. Democratic governments around the world are driven by urban voter perceptions. In New Zealand this has led to an erosion of forest owner private property rights in areas such as:

- Rights to rainfall (Environment Canterbury proposals).
- Public access as of right (Queen's chain proposed legislation).
- Nitrogen emission restrictions preventing land use change (Environment Waikato and Environment Bay of Plenty proposals).
- Nationalisation of forest sinks carbon credits (Government's domestic Kyoto policy).

We also face increasing restrictions and scrutiny in the way we manage harvesting and re-establishment operations (East Coast erosion-prone lands), and our management of reserves, pests and biodiversity.

These are public-good benefits of forest cover that the forest owner must manage; and absorb the associated costs. A huge (and expensive) campaign is required to influence the public (and as voters, Government policies) on the imposition of costs on forest owners. From the perspective of service providers, the implications have been the need for:

1. Research to support the science around environmental benefits of forests; and
2. Specialist experts employed to manage and monitor environmental impacts of our forestry businesses.

Green NGOs

Green NGOs have been successful in getting the attention of some large retail building products distribution chains – primarily in USA and Europe. This has created a demand for certified forest products. Regardless of the arguments for or against certification, forest managers are now faced with meeting standards prescribed in third party documents, and being audited against those standards.

In our experience these standards have not involved additional resources over and above meeting legislative requirements under the RMA consent process other than costs associated with:

1. Setting up of manuals and procedures, and improved systems to monitor and record environmental aspects. These also have efficiency benefits to the business.
2. Increased stakeholder consultation. Business benefits have accrued from this that more than offset the cost in most cases.
3. External audits that can be very costly initially.

As forest managers, Olsens has welcomed these challenges. They do however present a cost hurdle that

is beyond the capability of many small independent forest managers.

Forests as financial assets

Institutional investor ownership of forests throughout the western world is on the increase. Management of these forests is split between:

- In-house management teams set up or acquired by the institutional fund itself (e.g. Harvard Endowment Fund).
- Management teams set up by the Timber Investment Management Organisation (TIMO) that has managed the investment for the fund (e.g. Hancock Natural Resources Group, Viking Timber Management – marketing and land).
- Independent Property Managers (e.g. Olsens).

The increase in institutional investor ownership creates both threats and opportunities for independent service providers and foresters in company roles. The threat is loss of your role or management contract as forests change hands more frequently. The opportunity is new roles or management contracts as forests change hands more frequently. The key theme here is to expect and prepare for constant change.

Challenges for forestry professionals and management firms

There is an increasing need for specialists. Examples are:

- Land information – GIS
- Health and Safety systems and administration
- Environmental management and certification
- Commercial and financial management
- Technical specialists in:
 - Estate planning
 - Inventory, mensuration and statistical analysis
 - Harvest planning
 - Road engineering

There is increasing demand on auditable systems to cope with:

- Contract and information management
- Log tracking, payments and invoicing
- Stand records linked to spatial polygons
- Environmental monitoring and records
- Compliance with certification requirements.

Delivering value for forest owners

A good forest manager will add value in two primary areas:

- Harvesting and marketing the tree crop.
- Enhancing the value of the growing stock.

Institutional forest owners have two other value creation opportunities that will most likely not involve the forest manager, but may well involve independent

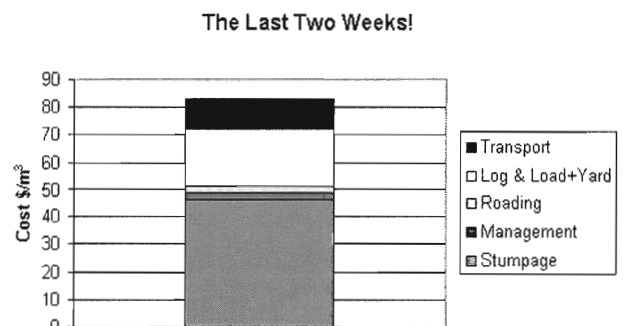
consultants. These are:

- Timing and process of the acquisition and disposition of forest assets.
- Land use change.

Forest Managers must keep their own overheads low, ensure they maximise stumpages and justify all expenditure on the forest estate. Price differentials that reflect the value of logs to processors will increase in the coming decade, as technology and tools enable internal log and timber quality to be assessed, and payment systems to growers that reflect log quality are established as the norm.

Other than asset protection (fire, pest, disease, wind loss), the biggest opportunity to make or lose money for the forest owner is in the last two weeks of the life of the tree. Fig. 2 illustrates where to focus attention on the cost side of the equation.

Fig. 2: What is done in the last two weeks determines the profitability of a forestry rotation.



Two examples of adding value

1. Value Recovery

Baseline data (gathered for 1 year prior to intervention using 95% value recovery as acceptable) showed a loss of \$717,000. This translated to approximately \$1.20/tonne harvested. With intervention this was reversed to a gain of \$147,000, or 25c/tonne – a total gain of \$1.45/tonne or \$864,000 over 1 year. The cost of intervention was less than \$30,000.

2. Systems Approach to Error Detection

Entry of log docket for Olsen client forest owners into our Log Tracking database as the basis of verification of customer Buyer Created Invoices showed up discrepancies totaling \$833,000 in 2000 (this was a period of many staff changes and upheaval of systems in larger log purchasing entities). Of this 97% was underpayment to the client. Client savings through this error detection process were approximately equal to the management fee Olsens charged for the entire harvesting and marketing service.

Invest in people

Stability of key staff provides retention of institutional knowledge and experience, regardless of who owns the forests.

Fig. 3: Age-class profile for PF Olsen & Company Ltd staff



Threats to staff stability are:

- Aggressive recruitment start-ups by new forest owners.
- Rising work opportunities in forestry in Australia.
- Rapid work fluctuations (we may lose some staff temporarily to other firms but under the right circumstances they can and do return).

Invest in technology advances

Investment in new emerging technologies is critical for forest management firms. Many institutional forest owners have no appetite to undertake these investments as forest owners, given that they often have relatively short-term investment horizons. For example it is no surprise that the purchaser of cutting rights has no interest in investing in genetic improvements that only benefit the next forest owner.

Examples of emerging technologies that have the potential to improve forest owner profitability are:

- Clonal forestry. The South Americans are winning this race at present.
- Tools that can measure internal log properties critical to processors and end users – WQI Ltd is the source of that knowledge in New Zealand.
- Improved pruning tools.
- Reduced chemical use and bio-control of fungal diseases.
- Value recovery and optimisation tools.
- Smart application of IT.
- Roading technologies to reduce aggregate costs (especially East Coast and Northland).

Invest in systems

Institutional investors have fiduciary responsibilities to their client investors. They must be able to demonstrate, by way of audits, that there are robust processes and systems in place for processing of all financial transactions, tracking and security of logs and statutory compliance with all laws and regulations.

In addition most have a low level of tolerance for any bad press related to adverse impacts of their forestry ownership or activities on local communities, ENGO stakeholders or staff or workers.

The best way for forest managers to comply with these requirements is to set up robust systems and carry

out internal audits for compliance. This can be a costly business but is essential for any manager of forests owned by pension funds or syndicated private equity investors.

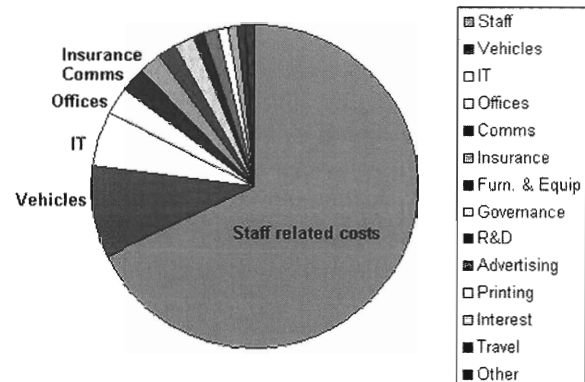
Control costs

Although forest and harvest management costs are a relatively small component of the ownership costs of forests, institutional fund managers are under constant pressure to demonstrate that the service providers they are using are indeed the lowest cost relative to service level. They usually manage this by benchmarking and negotiation with service providers rather than re-tender. Constant change in service provider is in itself a costly and risky process.

The best strategy for a service provider to retain or grow its business with this new breed of forest owner is to constantly seek efficiency gains inside their own business. Fig. 4 indicates what costs matter most.

Other than smart purchase or lease and a good fuel card there is little we can do about vehicles. But we can have a big influence over staff and IT costs.

Fig. 4: Staff costs are the dominant cost for a service provider. They are much more than just salaries and also include all variable staff costs such as superannuation, staff medical and insurances, FBT, and training.



Lowering staff costs

The keys to keeping staff costs down are to:

- Match numbers to workload. Periods of “stretch” & periods of “cruise” are inevitable but neither should last more than 4 months.
- Recruit well and pay well.
- Retrain and retain but dismiss if necessary. A bad apple really does rot the bunch.

Turnover adds to costs of recruitment, training, and loss of institutional knowledge. New employee selection must be done carefully. In my experience the best guide is previous employer and colleague references rather than the CV, interview or any psychological profiling. In fact, for an organisation with up to 150 employees, it is important to avoid any formal HR department, or limit its power to a support role. HR is everyone’s job and the CEO must play a key role.

feature: face up to change

Table 1: Other trends taking place and implications for service providers.

Trend	Response
Fragmentation (geographic and land vs. tree crop)	Systems to cope with multiple interests in the land and tree crop, and with many owners and log customers.
Certification	Adds cost but important for some log customers.
Statutory compliance costs rising	Good systems, auditing.
Civil litigation on the rise	<ul style="list-style-type: none"> • Robust contract documentation critical. • Professional indemnity insurance is essential. • Manage client/customer relationships. • Clarity of client expectations. • Agreement on scope. • Agent or principal? Must be clear. • Pay attention to area statements.
Cost of insurance has risen	Manage risks well to build insurer confidence. Insure only those risks where the potential loss cannot be absorbed.
Low tolerance by owners of establishment failure	Container trees helping. Focus on treestock handling, site preparation and animal pests.
Payment delay or default	Trade credit insurance. Timely invoicing. Active debt management.
Skilled staff shortages	Higher salaries and benefits. Build loyalty.

Staff Efficiency

Information technology (IT) is critical to improving staff efficiency. Although Olsens accounting transactions (e.g. cheques written, invoices created, financial transactions posted, log dockets manually entered) increased by over 80% between 2002 and 2005, accounting staff cost only increased by 15% because of IT investment.

IT - Some Key Decisions and Observations

IT can be a very costly business if not well managed. There are two key architecture decisions:

1. Common database for all business process data; or linking "best of breed" databases? The former involves building a system from scratch or modifying an existing one; the latter involves purchasing and linking existing applications. We chose the former and are happy with that decision.
2. Delivery mechanism to users – thin client (Citrix) to terminals or fat client (desktop PCs)?

Some observations about IT project implementation from my experience are:

- Even a poorly based cost/benefit analysis with lots of unknowns and assumptions is better than no cost/benefit analysis.
- Projects must be business needs driven, rather than "because we can".
- Do not leave the IT department in charge of IT investment decisions. It is a CEO/CFO role.
- Trying to model your business as the basis of a Request For Proposal is flawed. The world and your needs change faster than code is written. Also IT modelers must be empowered to improve business processes as part of their brief. They cannot do that if presented with a process flow-chart of how things have to work.

Some hosting and delivery trends are:

- Processing and data storage on central servers rather

than cumbersome data synchronisation processes. Central systems also afford better virus protection, backup and data security than a fragmented, distributed model.

- Outsourcing to specialist utility computing firms; but still there is a need for in-house IT specialist/s to combine technical knowledge with business needs and interface with outside providers.
- Outsourcing of IT Disaster Recovery.

Other Trends and Implications

Table 1 summarises some other trends taking place and implications for service providers (see above).

Consolidation

The new breed of forest owners will demand high levels of professional discipline from their forest managers around property and financial management and decision-making.

The forestry service industry is characterised by a large number of small-scale forest and harvest managers that can do well in buoyant times but find business a struggle in tough times. Many of these firms are not in a position to provide a full range of specialist services or to invest in the systems needed to satisfy larger forest owners. Some consolidation is inevitable as forests themselves are purchased by institutional fund managers.

There will, however, always be a place for the small-scale, low-cost forest manager to service woodlot owners that do not demand certification or the same level of auditable systems as institutional investors.