

Iwi involvement in forestry ownership

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Background

This article contains an overview of an industry-wide panel discussion in relation to iwi ownership of forests held at the offices of Minter Ellison Rudd Watts in November 2013 in Auckland. The discussion was part of a series of industry seminars held by the firm's forestry team. Minter Ellison Rudd Watts is one of New Zealand's forestry advisers, with a long history of advising on this country's most significant forestry transactions and issues. The firm has also been involved in developments around forestry transactions (both freehold and cutting rights), forestry management issues such as the health and safety concerns currently faced by the sector, and developments relating to the ETS.

The panel was introduced by Ross Pickmere of Minter Ellison Rudd Watts and comprised of Bill Liley, Graham Pryor and Curtis Mercer. I moderated the discussion. Bill Liley is managing director of Indufor Asia Pacific, one of New Zealand's leading forestry advisers. Graham Pryor is a director of CNI Iwi Holdings Limited (CNI Holdings), the entity which holds more the 176,000 hectares of forestry land in the central North Island. Curtis Mercer is the head of primary sector lending within institutional banking at the BNZ and has extensive experience working with the New Zealand forestry and wood products sector as well as the major iwi groups.

The topics covered by the seminar included:

- The Treaty of Waitangi settlement process and a discussion around what forestry assets the iwi groups are actually receiving under the settlements
- The potential for a move from iwi land ownership towards tree ownership
- The economic case for iwi groups investing in tree ownership
- Differing iwi investment models
- Funding and the role of debt finance and/or joint venture partners
- The potential for vertical integration, toll-cutting and better marketing opportunities
- The possibility for expansion of the planted forest land base through Māori-led investment.

Forestry land and the settlement process

The panel initially discussed the settlement process and explored in detail what most of the iwi groups are actually being offered under it. Bill Liley explained that, in as far as the settlements relate to forestry, generally speaking the iwi groups are being offered forestry

land which is currently under Crown Forestry Licence arrangements. This means that the trees on the land belong to licensees who in most cases will have an extended licence, up to 35 years or potentially longer, to grow and harvest the trees. This happens progressively depending on the age profile of the trees and relevant market values for timber from time-to-time. Often the settlements are accompanied by a cash payment for accumulated rentals and a parcel of NZUs. Going forward, as landowners, the iwi groups are entitled to receive the rental stream from the licensees.

As each part of the land is deforested, that part is handed back to the iwi who can then decide how it wishes to use the land in the future. The reality therefore is that iwi groups are often only receiving an interest in land, but in most cases cannot actually do anything with it until the term of the Crown Forestry Licence has ended. As landowners, iwi groups can be exposed to fluctuations in the amount of the annual rental stream. Following the expiry of the Crown Forestry Licences, iwi groups will be faced with a decision about the best use of the land. Some of the potential factors that could impact on those decisions are discussed in more detail below.

CNI Holdings structure

As an example of the settlement process, Graham Pryor discussed the CNI Holdings settlement, which is New Zealand's largest forestry settlement. He explained that in July 2009 the Crown returned 176,000 hectares of forest land to CNI Holdings iwi, along with \$248 million in accumulated rentals and 18 ETS credits per planted hectare, and certain other assets. CNI Holdings was formed as a corporate trustee to receive, hold and safeguard the assets on behalf of its shareholder beneficiaries.

The beneficiaries are eight iwi groups, each owning equal shares in CNI Holdings, plus 10 per cent which remains owned by the Crown until June 2015. CNI Holdings determine what percentage of these profits each iwi group is to receive based on the percentage of land which that iwi had mana whenua over. That process of determination is still progressing. CNI Holdings' eight iwi groups intend to remain together until at least 2044. CNI Holdings reflects a desire of iwi to collectivise around forestry land. CNI Holdings is a land-holding vehicle, and Graham Pryor indicated that its purpose was not to invest in the existing trees on the land or to invest in afforestation of new trees at the expiry of the existing licences.

If the CNI Holdings beneficiaries do choose to invest in the trees on the land this would be done through a different investment structure so as to retain the structural integrity of having separate land owning and tree owning vehicles. Graham noted that having

a separate vehicle to invest in the trees provided the iwi groups with flexibility around the funding of that vehicle as well as opportunities for the groups to team up with joint venture partners to invest in the trees without losing ownership of the land. He also commented that as landowners the key objectives for CNI Holdings were:

- Protecting and enhancing land for future generations
- Sustainably 'managing' the land and forestry opportunities for the benefit of current and future generations
- Maintaining the safety of everyone who works on CNI Holdings' land
- Engaging with the forest investors on a constructive and long-term basis.

Options for iwi investing in forestry land in the future

As landowners, iwi groups will come across opportunities to invest in the trees on the land. This could either be through:

- *Option 1* – Investing in the existing licensee for the existing rotation of trees, for example, the iwi groups could acquire a portion of the shares from the shareholders of the existing licensee; or
- *Option 2* – At the end of the existing licence, as landowners iwi groups will need to consider whether they will be inclined to utilise land by replanting forests or to convert the land to another use. If forestry is the best option for the land, and iwi want to be involved in the ownership of the tree crop, the iwi landowners will need to consider whether they do that alone or potentially in conjunction with a third party forestry investor.

Option 1 is of course dependent on an opportunity to invest in the existing licensee arising. Should that opportunity arise, the panel noted that the investment could be attractive because generally speaking sales mid-rotation tend to involve a discount to the eventual return. However iwi groups will need to be able to fund that investment. Options for that may include using some of the accumulated rental payments which were received under the settlement process and/or potentially obtaining a portion of the money from bank funding. Curtis Mercer commented that one factor that would be important in assessing whether bank financing was available was the extent to which the forestry was cash flow positive, and that would obviously depend on the age of the tree crop.

Option 2 is likely to be the issue that a number of the smaller iwi groups will face. As the existing Crown Forestry Licences end the use of the land will be returned to the iwi. It was noted by the panel that this will often be done in a disjointed manner with blocks of land being returned as each block of forest is harvested. In this case, the panel noted that the first issue for the iwi

landowners to consider would be whether forestry is the best choice for the land. As landowners, they will need to consider the likely rental return from the tree owners and the likely returns they may be able to generate if they choose to invest in the trees.

Of course a relevant factor in the discussion is the obligations under the ETS. Generally speaking, the ETS requirements will make it costly to do anything other than replant the land. However it was noted by the panel that many of the iwi groups were granted ETS units as part of the settlement process and that there may be a limited window now to acquire international units at low prices. Graham pointed out that the diminution in value of land for iwi since the implementation of the ETS has been recognised, and to some extent remedied, by the Crown in granting ETS credits per hectare of planting on land given back to iwi.

In considering the replanting of forests, Bill Liley noted that it was important to consider the attractiveness of planting new trees as an investment. He observed that the internal rate of return from full rotations of pine trees, based on log prices demonstrated over the past decade at around 5.8 per cent, are not as good as what the market may be desiring – around 8.0 per cent based on surveys. However Curtis pointed out that 5.8 per cent is still a good return on an investment, especially for those used to dealing in the American market. Moreover, Bill commented that the return on forestry investments is highly sensitive to movements in log prices, which many people are forecasting to increase. He also commented that the market in New Zealand still clearly needs to be convinced that new planting of trees makes economic sense, with statistics showing a very small rate of growth of new planting in this country over the last 10 years.

Graham Pryor commented that for many iwi groups selling the land is generally not considered to be an option and therefore the potential inflation of land value, often associated with dairy farm investments, is not a relevant consideration for them. It was also noted by the panel that for much of the land forestry is the only realistic option due to its location or characteristics. The panel also commented that the costs of dairy conversion are significant, but that it is something that iwi will consider if the economic returns clearly outweigh the costs.

Graham noted that, in his opinion, forestry investments, particularly large forestry investments such as the CNI Holdings' forests which have a continual income stream, are a good fit for iwi investment models. They present stable returns, are a long-term investment, and are environmentally friendly and well understood by iwi.

Funding from where?

Where will the funding come from for iwi who wish to replant their own trees rather than continue to rent the land to licensees? The panel discussed the costs associated with replanting new trees, and how iwi groups could expect to meet the costs if they were to do that themselves.

The panel also discussed whether the rent received from the existing tree crop over the period of the licence would be likely to be sufficient to cover the cost of replanting the trees. Bill Liley pointed out that analysis shows that funding from rent would only cover half of what is needed for reforestation, assuming that rent is not used for other purposes. There will therefore be a substantial funding gap that needs to be filled. Many iwi groups may of course have alternative sources of funding they could use, or could potentially use cash provided to them under the settlement process. Capitalisation of future rental returns could also be an option.

Curtis Mercer commented that banks tend not to be attracted to funding the planting of a new forest as the expected return is 25 to 30 years away. Instead banks tend to fund the acquisition of forests already in their second or third rotation and which have a positive cash flow. Thus the likelihood of gaining funding from banks in the early stages of reforestation is difficult. The panel noted that if additional funding was needed, joint venture partners for iwi to invest in the trees would be an obvious solution. Graham Pryor commented that, from his perspective, co-investing alongside forestry investors makes sense depending on the joint venture partner. He also noted that iwi groups are value-driven and they would want to be sure that joint venture partners were the right 'fit' for the iwi value set.

In terms of structuring co-investments with joint venture partners, the panel commented that limited partnerships were becoming more popular. It was noted by Minter Ellison Rudd Watts that limited partnerships are often particularly popular for co-investments with offshore entities because they are 'look-through' for tax purposes, which can be seen as attractive. However there are complexities with limited partnerships and it is important that advice is taken to ensure the most appropriate investment vehicle for the circumstances is used.

Forestry as a job creation opportunity for iwi groups

Graham pointed out that job creation for local iwi is of course always a positive factor and he sees forestry in general as having the potential to create significant jobs for iwi. This could be through iwi involvement in forestry management, harvesting, transportation or other ancillary services. He also noted that one of the challenges for creating further jobs for iwi is that as investment in assets increases, bringing about greater mechanisation in the industry, job opportunities are decreasing. There are perhaps more opportunities in the value-adding process to the product coming out of the forest. There has been a lot of commoditisation and cost put into the mills and grading process, yet these graded goods are not separated when they are unloaded at their destinations. The disconnect between the grading practices in New Zealand and the treatment by processors and consumers overseas renders the process somewhat futile.

Will iwi be likely to be active investors in existing forests?

Graham also commented that from a commercial point of view it makes sense for iwi to invest in the trees on the land which they already hold as landlords. Many iwi are looking for balanced investments and portfolios, which means that it is sensible to move towards investment in forestry. However he cautions that many iwi groups would be wary about investing in forestry on land outside of their iwi territory.

Vertical integration opportunities – milling our own timber in NZ

The panel commented on vertical integration opportunities in New Zealand. It was noted that many small forests used to have their own associated sawmills, but that today larger sawmills compete on a global scale and outstrip association with any single forest. It is no longer feasible to run mills that are dedicated to a group of forests, let alone one forest. While wood processing may be an area of opportunity for iwi, that would be a major financial investment and one that would need to be carefully weighed against the competitive aspects that are currently facing the New Zealand processing industry. Free trade agreements mean that mills in this country are forced into competing against overseas mills that are automated and provide lower wages to workers.

The panel noted value-add benefits that iwi may bring to the forestry sector, such as that the exporting of logs is very much a commoditised industry and that there may be scope for iwi to focus on and differentiate their logs from a marketing perspective. Bill Liley commented that a well-organised and differentiated branding to New Zealand radiata, particularly radiata from iwi-owned forests, could potentially attract a premium on international markets.

Conclusion – opportunities for iwi and forestry in NZ

The panel concluded by stating that they strongly believe that iwi will be a major part of the New Zealand forestry industry for years to come. One part of that will clearly be iwi functioning as landowners and ensuring that their values are respected in relation to the activities carried out on the land. Another part will clearly be a move by iwi groups into tree ownership. There are funding and other challenges to address, but the panel's view was that perhaps in conjunction with international joint venture partners we are likely to see more iwi investment in the sector.

Further information about the seminar, the Minter Ellison Rudd Watts forestry team or future forestry seminars held by the firm can be obtained by contacting Mark Forman at mark.forman@minterellison.co.nz.

Mark Forman is a Partner at Minter Ellison Rudd Watts Lawyers based in Auckland. The industry-wide panel discussion event was coordinated by Mark Forman and Ross Pickmere, who both lead the firm's forestry team.