CONFERENCE PAPER

The Corporation and the business of Forestry in New Zealand

K.M. Ford and A.D. McEwen

The brief given for this paper was fairly open and I propose to take a broad look at the Forestry Corporation, where it fits within the industry in New Zealand, and the challenges that we both face. We want to convey to you some of the realities of the likely business future of the Corporation in the industry and at the same time convey some of our enthusiasm for the future opportunities that exist in New Zealand from a forest owner's point of view.

Firstly, an historical perspective

The production forests of the State which are in the process of being purchased by the Forestry Corporation were created for a variety of reasons of which you will be well aware. They include:

- The provision of a domestic timber supply in the face of dwindling natural forests;
- Providing for domestic self-sufficiency in wood and in more recent times providing a resource on which to base an export industry;
- The creation of employment opportunities, or perhaps more correctly the amelioration of unemployment problems;
- To reclothe steep and unstable country which had often initially been cleared for farming;
- And assistance to regional development programmes.

However, the policies which led to the afforestation programmes were not confined to the state-owned forests. Private and local government forests have also been created or expanded with the help of state assistance through forestry encouragement grants and loans, special taxation provisions, soil conservation grants and regional development incentives.

Moving out of the forests, we find that much of New Zealand's wood processing industries have been developed because of the availability of parcels of state wood. In many cases the price of wood was set (deliberately or otherwise) at a level which subsidized the fledgling industry. Further state involvement in the forest industry can be seen in the provision of forestry and forest products research, forest health and protection measures, forest education and advisory services, timber preservation, quality control, quarantine services, export incentives and so on.

The picture I have painted is of a forestry and forest products industry heavily supported by and dependent on the State. However, as in all evolutionary processes changes occur. Since the late 1960s new afforestation has been occurring in New Zealand at an unprecedented rate. Over half of the total planted forest area has been created in the last 15 years. As this matures, the volume of wood available for harvest will increase dramatically. From the 10 million or so cubic metres harvested annually today, the volume is predicted to increase to over 20 million within the next 15 years. Over this period a fundamental change will occur in our industry – it will shift from a largely domestic industry (currently 60% of extracted volume is consumed in New Zealand) to an export one with less than 30% of output consumed domestically. We can view our future market as an international one in which New Zealand is just the closest part (there are analogies here with the meat and dairy industries).

Let us now look at the international wood market scene – the one on which our future is to depend. There are some disturbing facts:

- Our nearest and largest market, Australia, has also had a policy to become more self-sufficient in wood. While it has not expanded beyond its domestic requirements as we have, it will require less of our product in the future.
- Our second largest market, Japan, is a notoriously fickle one with considerable self-protection measures. It has a declining per capita consumption of sawntimber and an increasing, although not well quantified, domestic supply. Other East Asian countries have also undertaken considerable reafforestation programmes in recent years.
- The other main exporter of radiata, Chile, has resources larger than ours, and a lower cost structure.
- Western USSR has huge timber resources. While these are barely utilized at present a shift in economic or political climate could see them becoming a major factor in world markets (particularly the Pacific rim).
- North America – the Pacific rim's largest supplier – still has large timber resources and, particularly in the south, has huge plantations. Despite continued talk to the contrary there is not much evidence yet of a falling off of supply from that area.
- Most of the world's major softwood producers are currently harvesting at a rate slower than their forests are growing – there is no evidence of an upcoming world shortage of wood.
- New Zealand is a minor player in world wood trade – currently about 0.6%.
- Because of the quantity and perceived quality of much of the resource, we will inevitably be involved in trying to market commodity products. The implication of this is that we will be a price taker in mature, competitive markets with low margins and low price elasticity. The potentially high quality of clearwood from pruned butt logs offers some opportunity for market niches.

To be successful will require considerable marketing effort and very high-quality management. When marketing our resource we need to sell the whole tree, and this has important implications for the interrelationship between products, in both product and marketing. Remember that for every pruned butt log we also have a large branched log which needs to find a home.

Whilst we may have generally good growing rates acting in our favour, this can easily be negated by our distance from important markets and our high internal cost structures, particularly transport and ports. To sum up our situation, we have a resource which, if it is to provide any benefit to the taxpayer who has provided so much towards it, must be sold on a fairly hostile international market. The only way that this will be achieved is by the production of products which others want at a competitive price. It is as simple as that.

The changing nature of the forest resource has come at a time of other changes in New Zealand. In pursuing its various policies the Government has deregulated the financial and other sectors, targeted greater efficiency in government spending (particularly in its trading activities) and has eliminated many subsidies and protection mechanisms. One of Government's stated objectives is to encourage industry to solve its own problems and become more competitive. The removal of subsidies will reduce the possibility of other countries claiming unfair pricing and raising barriers against our products as has happened in the agricultural area, and recently happened with Canadian forest exports to the US.

The Forestry Corporation was undoubtedly born from the drive for greater efficiency in government trading activities – despite the impression by some at the time that it was due to a drive for better conservation management. In accordance with the general thrust of economic reform the Corporation was set up as a company with a legal requirement to perform as well as comparable, non-government companies. Like private sector companies, the performance measurement will be financial or "bottom line". Thus, the Government has clearly separated its commercial forestry activities from other activities.

You will recollect that the State Owned Enterprise Act does provide for the Government to request the Corporation to carry out non-commercial activities, but that such requests are subject to payment being made for the work undertaken. Clearly the Government could engage other organizations to undertake the activity rather than the Corporation.

The Corporation is well aware of its legal requirement to perform and of the need to produce a product which is competitive on the world market. Most of you will be aware of our achievement to date and of our determination to succeed.

There are some unusual circumstances about the environment within which the Corporation operates. They include:

- Firstly a question mark over the economic viability of forest growing. Our research indicates that forest growing, on its own, is a risky business. As far as we can determine the Forestry Corporation could be the largest company whose activity is predominantly that of a forest grower. Most forestry companies are either solely processors or are processors with forests to supply their processing activities. Apart from this, forest growing is largely a government supported activity – through the selling of cutting rights in natural forests, the establishment of new forests or a combination of both. The conclusion one draws is either that forest growing on its own is perceived as too risky a venture or that it is perceived as unprofitable, in that the prices paid for wood cannot cover the cost of growing plus a reasonable return.
- Secondly, there is the inheritance of some wood supply contracts from the Forest Service at less than commercial rates. The Corporation is endeavouring to renegotiate these and has had a good and encouraging response from most of its customers, who seem to appreciate the real world. One major contract, with Tasman, has not yet been re-negotiated. However, if a satisfactory solution cannot be found then the Corporation will have no option but to make more money from its sales to the rest of the industry if it is to meet its legal requirement to perform. Perhaps the timber industry could do well to reflect on this and target its criticism towards its subsidized members rather than at the Corporation.
- Thirdly, the Corporation is expected to work in an unsubsidized environment in comparison with many overseas forest growers who continue to be subsidized by their Governments. This will require us, and all forest growers in New Zealand, to make the most of our technological and growth rate advantages to be cost competitive. When other countries remove subsidies – as we believe they ultimately must – we will expect at least an initial advantage while they try to catch up.
- Fourthly, while the Corporation has made great strides in its moves to efficiency, parts of the processing sector have been less quick to respond. We are not in a position to prop up inefficient industries if we can earn a better return elsewhere – for example by exporting logs. Some of the other major players have shown the same inclination, even at the cost of closing down their own sawmills.
- Fifthly, our age class distribution means any significant increase in our cash flow will not occur for some years. Although the degree of constraint that this imposes is dependent on the final purchase price and gearing, it is certain that we will face a tight financial situation in the medium term.
- And lastly, we have now been in operation for a year but have still not completed purchase of the assets. Apart from the need to negotiate the price to be paid and the separation of this into equity and debt, there are also the uncertainties on tenure resulting from the yet-to-be-passed legislation covering Maori land claims.

There is pressing urgency for the Government, specifically Treasury acting as its agent, to take a commercial approach to negotiating the sale and purchase of the assets to the Corporation, particularly acknowledging the realistic earning potential of the resource. Recognition must be accorded to some of the realities we face in the industry, such as competitive markets world-wide, both now and in the foreseeable future; the need to service our debt burden, which with an immature resource will place severe constraints in the near term; and the state of local industry which will take some time to become fully competitive.

Recent attempts by accountants to extrapolate forest values from the sale of forests between major companies have been naive. They have not recognized the part which strategic issues, financial consideration, maturity and location of forests, ancillary resources, and the need for companies to rationalize their shareholding may have played in the total value of the transaction and in the way the total was divided between the forests and the other assets involved.

The fact is that an investor needs some degree of assurance that future price and volume predictions will be attainable, and are not based on a hopelessly optimistic view of the world generated by some hypothetical academic predictions.

We are working actively with Treasury to resolve the purchase negotiations. Until it is completed we face severely limited management options in the short term and limited ability of the Corporation to raise capital should it desire to undertake further expansion, either of forest growing, or into downstream processing.

It is important that both asset price and gearing are pitched at a level which will maintain liquidity and allow at least some operating surplus to provide flexibility in managing the business. If the debt burden is unrealistically high the Corporation will be caught in a downward spiral, necessitating forced asset disposal and jeopardizing our ability to meet the legal obligation of making a "comparable rate of return to other successful companies".

Putting all these points together, it becomes clear what the Corporation's approach to future investment must be.

The fundamental questions to be asked of any investment, whether in forestry or downstream in processing and marketing, are: Does it provide us with our best return, and is it in accordance with out strategic objectives? This will raise fundamental questions about location of future plantings, silvicultural practices, and even the choice of species.

Furthermore, I believe it is not only the Corporation that needs to establish this tight discipline in its future investment decisions. There will be an increasing pressure for commercially efficient forestry throughout the sector. Total costs from planting to selling finished products need to be minimized. With the ever-increasing exposure to world competition there will be progressively less room to hide high forestry costs in the integrated production line. (I believe that the shakeout that started with the establishment of the Corporation is now in progress throughout the industry and the final outcome, if sensibly pursued, can only be good for the industry and the country.)

I would now like to turn to the issue of privatization which I know is of particular interest to many of us.

We currently exist as an unlisted wholly government-owned company. There are inherent problems in this both for us and for the Government, if we are to meet the legal requirement to perform. Two of the most important are monitoring and the need for capital. How without the normal disciplines of the market, such as takeover or disposal, can there be effective sanctions against underperformance by the Corporation, for whatever reasons? Is the monitoring system which the Government proposes to introduce the answer? The questions posed by monitoring from the Corporation's point of view include:

- Firstly, will the process become too onerous to the point where a bureaucracy has to be set up within the Corporation just to cope with the information needs of Ministers and officials?
- Secondly, will Ministers or future Governments resist the temptation to direct the Corporation to undertake or not undertake certain activities or investments for other than purely commercial reasons and to revert to the past?
- Thirdly, how can the problem of forewarning competitors of the Corporation's strategy by prematurely disclosing information, possibly removing a competitive advantage, be avoided?
- And fourthly, how can full accountability be achieved if spreading the decision-making process wider than the Corporation itself is perpetuated?

The fundamental question is whether it is better to get involved in the complex task of trying to model the real world, or let the real world do the job directly. Establishment of the Corporation as a listed company, with or without a Government shareholding, would of course remove the need for a monitoring process.

An advantage which the Government obviously sees from the sale of its ownership is the elimination of the need to provide further capital. It is elementary that if the Corporation, and indeed the industry, is to have a future, then it must be able to grow. This can only occur if the owners are prepared to invest in the very real opportunities that lie ahead. Long-term investment in our industry is no longer a high Government priority and without access to private capital the Corporation will therefore remain hamstrung in achieving its long-term objectives.

Sooner or later the Corporation will probably want to get into downstream processing activities. The reasons for this are many, but include the need to have greater involvement in the chain between forest growing and the ultimate consumer, the lack of processing capacity for the expanded future supplies of the Corporation's wood, the possibility of greater earning from added value products, and so on. There is no doubt that at least some of the capital needed for any such expansion will have to come from the shareholder.

Some may assert that Government ownership is needed on the basis that it provides strategic control of national resources. Is there a strong basis for this assertion when the resource remains in New Zealand and provides jobs and opportunities for New Zealanders regardless of ownership? Is not the critical issue the quality of commercial management and not the facility for imposing bureaucratic strictures? Why indeed should forestry be regarded any differently from that bastion of private endeavour, farming, just because the crop has a longer rotation? (Private ownership has never prevented Governments from imposing their will when they have perceived it as necessary.)

Does Government need to own assets to earn income? They can raise it by taxing the income of those who do have assets. In summary, because they can both control the way a nation's assets are used (and do this evenly across all owners of any type of asset) and can raise money for Government expenditure without owning assets, the question that needs to be addressed by those interested in privatization is not what is the justification for disposing of an asset, but rather what is the justification for retaining it?

The current situation is that the Government owns a forest-growing business which:

- has to become a competitive producer of exported products in a relatively hostile world market;
- currently has a relatively small cash flow compared with future expectations;
- and will probably need large capital injections in the future.

At the same time the country has high government expenditure and high government debt. Setting the forestry business up as a company with a requirement to be efficient solves some of the problems.

There are others which must now be addressed to fully realize the gains from corporatization. Whether the route is direct, by privatization, or takes some other less obvious form of corporatization is only an interim step, albeit an important one, for the development of the internationally competitive company essential to the challenges of the 1990s.

The Ministry of Forestry

Malcolm Douglass

1. General

Government reform has already reallocated responsibilities in central government and will shortly impact on regional and district government.

The relationships between the Ministry of Forestry and regional authorities is generally excellent, more especially because of the common goals of these two levels of government.

The author, Malcolm Douglass, is Chief Executive, Canterbury United Council.

At the regional level, the Forestry Corporation is developing close linkages with regional authorities. The SOE Statements of Corporate Intent have not yet developed in a meaningful way (apart from the commercial emphasis).

Other Government Departments (e.g. DOC, MFE) are still developing their new relationships with regional authorities and with local government.

2. Ministry of Forestry Corporate Plan

The 1988/89 Corporate Plan clearly sets out the internal relationships and