

An assessment of VicForests' Finances



**AUSTRALIAN
CONSERVATION
FOUNDATION**

Prepared for Healesville Environment Watch Inc.



**NEW ECONOMICS
ADVISORY SERVICE
AUSTRALIAN
CONSERVATION
FOUNDATION**

Funded by the Lord Mayor's Charitable Foundation



About ACF's New Economics Advisory Service

The New Economics Advisory Service (NEAS) is currently operating as a pilot project in Victoria.

NEAS aims to provide low-cost or pro-bono economics consulting services to environment and sustainability-focused individuals, community groups and other organisations.

NEAS funded by the Lord Mayor's Charitable Foundation.

More information is available online at:

www.acfonline.org.au/neas

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BACKGROUND

Healesville Environment Watch Inc. asked the ACF New Economics Advisory Service to review the financial statements of VicForests and form an opinion on the economic viability of VicForests.

Analysis was based on information contained within VicForests' annual reports from 2005 through to 2012.

The Victorian Government is responsible for managing native forests on behalf of its citizens. VicForests is the State-Owned Enterprise that is tasked with the "sustainable harvest, regeneration and commercial sale of timber from Victoria's public forests".

Our analysis of the annual financial statements has identified a number of trends that are of great concern regarding the sustainability of VicForests.

ASSESSMENT METHODOLOGY

In a competitive commercial market, funds will generally be directed to activities that offer the highest return on invested capital. In the case of VicForests, the shareholder is the Victorian Government. The Victorian Government, via the Treasury Corporation of Victoria (TCV) is also the main creditor to VicForests.

Nevertheless, as a commercial (albeit government-owned enterprise), we have applied commercial valuation methodologies in our approach to analysis of the financial statements.

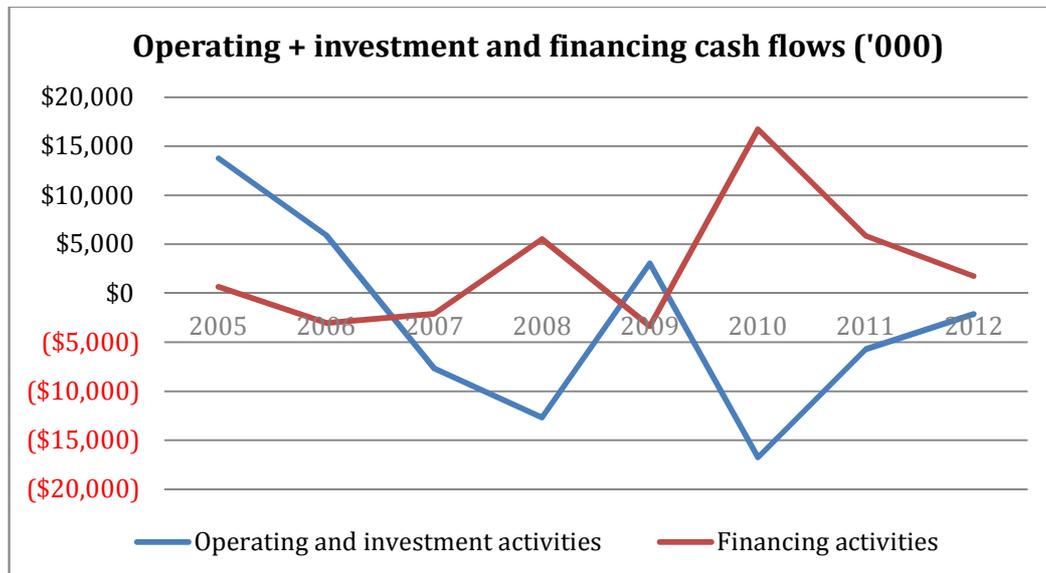
This assessment focuses on cash flows and the balance sheet. Cash flow statements are a better indicator of financial health than profit & loss statements so we have chosen not to assess the P&L.

VICFORESTS' CASHFLOWS

Since 2005, VicForests has accrued operating cash flow losses of \$11.9 million on their core activity, forestry. VicForests has accrued investment losses over the same time of \$10.2 million. Combined, this loss of \$22.2 million equates to a loss of approximately \$1.50 per m³ harvested to date.

Financing activities, consisting of payments of dividends, borrowing and repayment of loans have over this period resulted in positive cash flows of \$21.9 million. However, this is not representative of a successful enterprise. This represents a reliance on borrowing to fund operating and investment cash flow losses already mentioned.

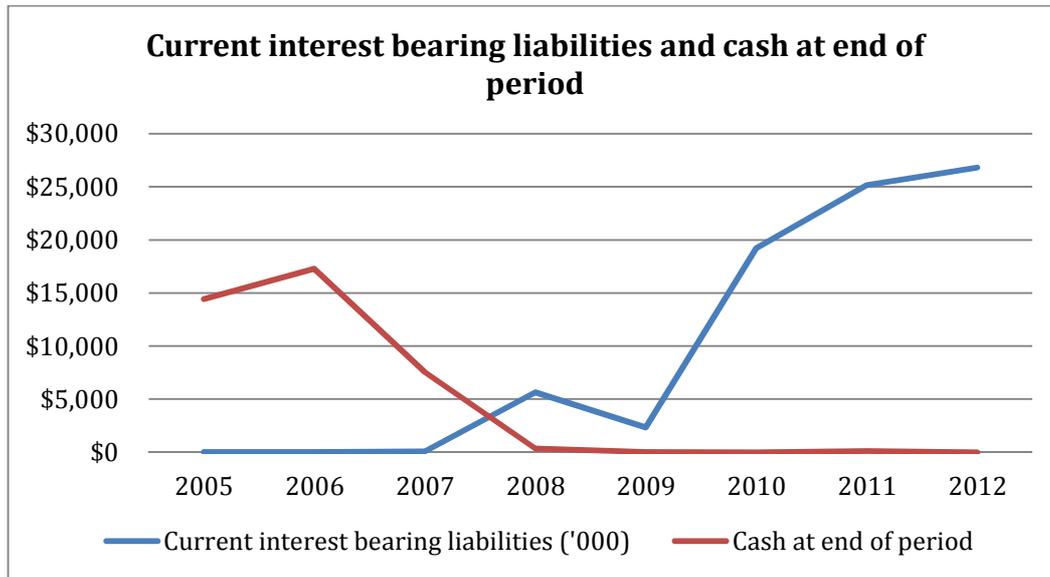
This can be seen by looking at the chart below that considers the operating and investment cash flows by comparison to financing activity cash flows.



A reliance on borrowing and a run up in short term interest bearing liabilities can be seen on VicForests' balance sheet.

VICFORESTS' BALANCE SHEET

The balance sheet for VicForests lists a current interest bearing liability of \$26.8 million in 2012. The chart below demonstrates the run up in interest bearing liabilities incurred by VicForests.



Money is borrowed from the Treasury Corporation of Victoria (TCV) under a loan arrangement that provides a loan facility valued at up to \$30 million. The investment rate of TCV is currently listed as 2.82% as at 23/05/2013ⁱ. Servicing of this loan is likely to be the main contributor to the cash flow *item Interest and other costs of finance paid*. This can be derived by applying the interest rate listed on the TCV website to the amount of \$24.9 million borrowed by VicForests in 2011. The resulting figure of around \$700,000 equates to over 80% of VicForests' borrowing costs of \$850,000 in 2012.

Accruing interest bearing debt is not a problem if you can generate operating surpluses and profits with which to pay down debt. Nor is it a problem if you have assets that exceed liabilities. As we have shown, VicForests' cash flow situation indicates a business struggling at its core operations. So does VicForests have sufficient assets to justify high levels of borrowing? The following sections will explore this question.

Assessing the true value of VicForests' assets

To apply a commercial valuation to VicForests' current assets, one of two methods is possible. The first is a market approach. In other words, if VicForests' assets were taken to the market, would they sell? The second approach is to use a discounted cash flow analysis to estimate the internal returns possible from the asset. The key current assets that VicForests claims are:

1. Trade and other receivables.
2. Inventories.
3. Biological timber assets.

Trade and other receivables

We can take this value at face value, minus any recovery costs and the actual ability to obtain payment. Although the notes to the financial statements indicate that VicForests has had much trouble getting paid.

As of 30 June 2012, trade receivables of \$15,109,524 (2011: \$16,442,467) were past due but not doubtful. These relate to a number of customers for whom there is no recent history of default and/or where extended payment terms have been agreed in order to ensure a structured reduction of the debt. \$10,653,579 represents costs which previously have been disputed but will now be paid following the agreement of a payment plan. (p.51)

It is worth noting that \$6.4 million of the \$15 million in receivables is over 1 year in arrears. More detailed analysis would require a better understanding of the credit worthiness of the corresponding debtors.

Inventories

Inventories consist of seed banks and logs in storage. These have both increased significantly from 2005. At the end of 2004/05, the combined value of these assets was only \$1.35 million. By 2012, it is \$15.95 million.

Over this time seed bank and log storage assets have both increased by \$7.3 million. So how exactly are these assets valued?

The 2010 VicForests annual report explains:

VicForests uses seed to regenerate coupes subsequent to harvest and does not as a practice sell seeds to third parties. Furthermore, there is a limited market for Victorian native forest seed within Victoria thus not allowing the establishment of the net realisable value. Therefore all seed inventory are valued at cost only which are assigned to seed stock quantities on hand at balance date on a weighted average cost (WAC) basis. The cost calculation is based on direct labour and materials used in the seed collection and extraction processes. (p.30)

According to the 2005 annual report for VicForests, seed inventories are valued at cost, in-line with accounting standard *AASB 1019 Inventories*. However, this standard states that inventories should be valued at 'the lower of cost and net realisable value'ⁱⁱ. Net realisable value is simply the value that can be obtained by selling the accumulated inventory. Since VicForests admits that there is a limited market for seed and so they cannot establish a net realisable value, it seems ambitious to revert back to using a cost of recovery method for inventory valuation.

As for logs in storage, for an asset value to be realised requires two things. First is the ability to actually sell the logs and the second is the ability to collect payment. The accumulation of the logs is likely to be a result of a failure to sell logs and the accumulation of bush fire salvage logs, rather than an increase in a genuinely saleable asset. We can also assume that some deterioration in asset quality occurs over time as logs sit in storage.

Knowing the quantity, age and quality of logs in storage as well as market forecasts for saw wood and pulp wood would allow for independent valuation based on current market conditions.

Biological timber assets

The valuation of biological timber assets is critical to an assessment of the potential to generate profits and repay debt accumulated. Because each TRP would potentially have a different cost associated with recovery and delivery, VicForests should ideally understand profitability at a timber release plan (TRP) coupe level. This is akin to a large miner knowing the marginal profitability of each mine they own.

Based on note 8 to the 2012 financial report, it would seem that VicForests does calculate this to some extent, although it is not clear if the analysis is at a coupe level or an average across the entire range of TRPs:

The current and non-current TRPs represent 4 years timber supply which has been evaluated on the basis of the discounted cash flow methodology taking the current budget and corporate plan into account. (p.53)

To accurately value this asset, an analyst would need to know the cost profile of each TRP / coupe available to VicForests. Operating cash losses in the previous eight years suggest that profitably extracting timber from native forests has proven difficult. This is compounded by the fact that according the 2010 annual report, regeneration costs are not considered in valuation of biological timber assets (p.28).

Non-current biological timber assets

The other major assets that stand out on VicForests' financial statements are non-current TRP and regenerated coupe assets. These are timber assets that are deemed non-current because they will not be harvested within 12 months.

According to the notes to the 2010 report, these assets are valued as follows:

the timber stands were valued using a discounted cash flow method based on expected cash flows adjusted for known variances to derive a net present value. (p.28)

This valuation method is used because "Within the current regulatory environment, no active and liquid market for large areas of native forest exists" (p.28). In 2010, a new agreement between VicForests and DSE led to regenerated coupes being re-valued at \$4 million and total regenerated coupes being assigned a value of \$6.9 million.

The nature of the agreement between VicForests and DSE is unclear and precisely why regenerated coupes increased from \$727,000 in 2009 to \$6.9 million in 2010 is unknown. Regenerated coupes would in theory require a long time to regrow and be harvested. Any discounted cash flow analysis of such coupes would in theory return a very low present value due to the time frame of analysis.

Without further information about the nature of the discount cash flow analysis undertaken and assumptions used, it is difficult to accurately value these assets.

SUMMARY & RECOMMENDATIONS

After reviewing VicForests' financial statements for the financial years ending 2005 through to 2012, we conclude that significant questions exist about the viability of VicForests and the commercial sustainability of native forestry.

- Consistent operating cash flow deficits indicate trouble with core business.
- Accumulation of assets in recent years appears to be based on favourable valuation methods that may not hold up to commercial due diligence.
- Accumulation of current interest bearing debt of \$26.8 million is concerning, although interest is serviceable given very low interest rates offered by TCV.
- Significant decreases in cash assets and increases in trade and receivables indicate severe cash flow issues.
- Result of two points above is a risky imbalance between current assets and current liabilities.
- Net equity position may be overstated once realistic valuations are applied to assets.
- If VicForests was required to finance operating losses at commercial rates, it would struggle even further.

We recommend that a thorough financial audit be undertaken by an independent agency focusing on viability of operating cash flows, asset valuation methodologies and DCF of individual TRPs that ultimately determine profitability. Such an audit should also consider the significant environmental degradation caused by native forest logging and the potential for a transition to more sustainable plantation and woodlot forestry that is better suited to private sector involvement.

DATA

Summary of VicForests' financial statements (2005-12)

Note: The table below is a summary table developed to assist research, it is not a comprehensive list of financials for VicForests.

	2005	2006	2007	2008	2009	2010	2011	2012
Volume (m ³)	1,848,000	1,833,923	1,590,520	1,917,701	1,784,370	1,812,618	1,784,370	1,917,701
Profit & Loss	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
Total revenue	\$40,870	\$38,959	\$103,361	\$132,812	\$130,434	\$144,797	\$139,274	\$119,381
Total expenses	\$27,735	\$35,979	\$103,384	\$132,042	\$135,555	\$143,020	\$137,212	\$119,290
Net result before tax	\$13,135	\$2,980	\$23	\$770	\$5,121	\$1,777	\$2,062	\$91
Current assets								
Cash and cash equivalents	\$14,413	\$4,204	\$7,524	\$343	\$33	\$3	\$125	\$405
Trade and other receivables	\$7,310	\$6,650	\$17,484	\$29,019	\$19,407	\$30,083	\$32,449	\$33,244
Biological timber assets (TRPs available for harvest within 12 months)	\$4,902	\$4,204	\$0	\$3,550	\$3,051	\$3,514	\$3,387	\$3,065
Inventories - seed at cost	\$802	\$929	\$845	\$3,141	\$5,658	\$7,897	\$8,089	\$8,112
Logs in storage	\$555	\$606	\$5,527	\$8,535	\$6,754	\$8,809	\$7,938	\$7,835
Non-current assets								
Biological timber assets - TRPs	\$6,231	\$0	\$0	\$3,451	\$7,116	\$5,818	\$10,859	\$8,460
Biological timber assets - Regenerated coupes			\$0	\$0	\$727	\$6,889	\$13,168	\$18,455
Current liabilities								
Interest bearing liabilities	\$25	\$29	\$71	\$5,648	\$2,344	\$19,209	\$25,155	\$26,822
Provisions	\$1,851	\$977	\$2,628					
Employee benefits		\$2,771	\$2,920	\$2,546	\$2,211	\$2,238	\$2,377	\$2,734

Non-current liabilities								
Interest bearing liabilities	\$127	\$98	\$0	\$88	\$172	\$84	\$0	\$0
Provisions								
Employee benefits	\$149	\$208	\$212	\$292	\$388	\$420	\$559	\$524
Total equity		\$23,218	\$21,128	\$28,865	\$30,740	\$36,907	\$46,252	\$45,531
Cash flows from operations								
Receipts	\$33,829	\$43,892	\$103,994	\$135,331	\$152,619	\$155,150	\$147,331	\$136,044
Payments	\$18,752	\$35,759	\$110,214	\$146,637	\$148,059	\$171,457	\$152,514	\$136,740
Net outflow/inflow	\$15,077	\$8,133	\$6,220	\$11,306	\$4,560	\$16,307	\$5,183	\$696
Cash flows from investment								
Net outflow/inflow	-\$1,320	\$2,209	\$1,457	\$1,391	\$1,503	\$446	\$540	\$1,432
Net outflow/inflow from operations and investment	\$13,757	\$5,924	-\$7,677	-\$12,697	\$3,057	-\$16,753	-\$5,723	-\$2,128
Cash flows from financing activities								
Proceeds from borrowings		NA	\$0	\$5,600	\$58,921	\$132,676	\$128,930	\$111,516
Repayment of borrowings					\$62,288	\$115,953	\$123,085	\$109,559
Dividend paid		\$3,024	\$2,062					
Net outflow/inflow	\$656	\$3,049	\$2,087	\$5,516	\$3,367	\$16,723	\$5,845	\$1,757
Net change in cash held	\$14,413	\$2,875	\$9,764	\$7,181	\$310	\$30	\$122	\$371
Cash held at beginning of fin year	\$0	\$14,413	\$17,288	\$7,524	\$343	\$33	\$3	\$125
Cash held at end of fin year	\$14,413	\$17,288	\$7,524	\$343	\$33	\$3	\$125	\$0

ⁱ http://www.tcv.vic.gov.au/page/Individual_Investors/Investment_Rates/

ⁱⁱ http://www.aasb.gov.au/admin/file/content102/c3/AASB1019_3-98.pdf