

Report to

Crown Forestry Rental Trust



A Framework for the Commercial Appraisal of Joining the CNI Iwi Collective Settlement

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1. Introduction

This report presents to Crown Forestry Rental Trust a framework for commercial appraisal of the Central North Island Forests Iwi Collective Settlement. It is intended as generic advice to guide a non-Collective iwi that may seek to claim a share of the Crown's retained interest as commercial or cultural redress.

The Crown's retained 13.3 percent shareholding is part of a mechanism in the Collective Settlement that is intended to protect the position of non-Collective iwi that have claims to CNI forestlands. In deciding whether or not to claim some of the Crown's retained interest, a non-Collective iwi will need to weigh up commercial matters that are additional to its mana whenua interest in CNI forestlands. A successful claim will give a non-Collective iwi a choice to seek return of land as redress or alternatively to accept part of the Crown's shareholding (subject to the acceptance of a majority of the Collective members).

This report presents a framework for assessing the investment decision represented by a choice to claim part of the Crown's shareholding.

The framework has wider applicability. For example, it may be used by a member of the Collective to appraise future commercial venture proposals developed by the Collective.

Iwi who have claims on Crown Forest Licensed lands in other areas of the country will find this report a useful starting point when considering a collective settlement of assets along similar lines to that agreed for the CNI Forests Settlement.

Part I: The CNI Forests Iwi Collective

1. Historical context

The decision to sell the Crown's commercial forestry assets was announced in the 1988 Budget. The commercial forestry assets had been managed by the Forest Service from 1919 to 1987, and by the Crown-owned Forestry Corporation from 1987. These were exotic plantation forests consisting mainly of *pinus radiata* that had been planted to replace native forests harvested for timber to feed housing construction in early part of the 20th century.

Māori objected to the proposed sale of the associated forestland out of Crown ownership and were successful in blocking the sale process. This was a direct follow-on from the 1987 "Lands" case¹.

1.1 1989 Crown Forests Agreement

The Court of Appeal² recommended negotiations to resolve the dispute. In July 1989, the Crown and the New Zealand Māori Council (NZMC and Māori Council) and the Federation of Māori Authorities Inc. (FOMA) entered into the 1989 Crown Forests Agreement. The 1989 Agreement provided that the Crown could sell plantation forests, but would retain ownership of the land, with protection mechanisms to safeguard Māori claims³ to the land.

1.2 Establishment of Crown Forestry Licences and Crown Forestry Rental Trust

The Crown Forest Assets Act 1989 was passed and the Crown Forestry Rental Trust (CFRT) was established as a result of the 1989 Agreement. The CFRT comprises three trustees appointed by the NZMC and the FOMA, and three by the Crown. The Trust receives and invests rental income from Crown Forestry Licensed (CFL) land, and uses the interest earned to assist claimants with claims before the Waitangi Tribunal involving CFL land.

The Act created Crown Forestry Licences (CFLs) that separated land ownership from the rights to occupy and use the forestland for plantation forestry. Of particular importance were two aspects of the CFLs:

- Termination arrangements that protected the occupier in the event of a successful land claim. On transfer of land ownership from the Crown to Māori, a termination notice is given to occupier. During the next 35 years, occupancy progressively returns to the Māori land owner as trees are harvested. The occupier may not replant harvested areas and improvements to the land transfer to the Māori landowner at no cost.
- The payment of accumulated rentals to successful claimants following a Waitangi Tribunal recommendation that CFL land be returned to them.

1.3 Initial attempts to settle claims including CFL forestland

In the 1989 Agreement the parties agreed to jointly use their best endeavours to enable the Waitangi Tribunal to process claims to CFL forestlands. However, early attempts to reach a collective settlement in respect of the Central North Island (CNI) forestlands did not succeed.

There were individual settlements in respect of Crown licensed forestland. For example, with Ngāti Awa in 2003 in respect of the part of the Northern Boundary licence and also the Rotoehu East and part of Rotoehu West licences.

The CNI forestlands are especially significant. They were planted earlier than most others so, at the time, represented a mature sustainable resource that had been well tended and had scale. Output from the 169,000 Ha CNI forests fed local sawmills and pulp mills and had the potential to support an export wood products industry.

¹ New Zealand Maori Council v Attorney-General [1987] 1 NZLR 641. This concerned the establishment of State-owned Enterprises (SOEs) to administer nine Crown-owned businesses. The State Owned Enterprises Act 1986, section 9, provides that nothing in the Act permits the Crown to act in a manner that is inconsistent with the principles of the Treaty of Waitangi. Māori were successful in arguing that transferring land to SOEs, without ensuring that land remained available for future Treaty settlements, was inconsistent with the principles of the Treaty, and therefore a breach of section 9.

² New Zealand Māori Council v Attorney-General [1989] 2 NZLR 142.

³ Under the Treaty of Waitangi Act 1975 (and a 1985 Amendment) the Waitangi Tribunal investigates historical breaches of the 1840 Treaty of Waitangi and makes recommendations to the Crown which then negotiates redress with the successful claimants.

In 2006, the Crown entered into a deed of settlement with the affiliated Te Arawa iwi and hapu represented by Te Pumautanga o Te Arawa Trust. The transfer of 27,086 Ha of CNI forestland with arrangements for deferred purchase of a further 23,881 Ha was part of that agreement. The accumulated rentals in respect of the 27,086 Ha provided the purchasing power in respect of the deferred purchase land. Under the original proposal, the Crown would have kept the accumulated rentals in respect of the deferred purchase land.

The Maori Council, FOMA, and Ngati Tuwharetoa commenced proceedings that were heard by the High Court in April 2007. Their concern was that the Crown had breached the 1989 Agreement in the agreement it had reached with Te Pumautanga. The Court of Appeal⁴ held that the Crown had acted lawfully but in November 2007, the Supreme Court granted leave for an appeal.

1.4 2007 Waitangi Tribunal inquiry

Meanwhile, in June 2007, the Waitangi Tribunal held an urgent inquiry⁵ into the impact of the Crown's Treaty of Waitangi settlement policy on CNI iwi. The Tribunal found that, by offering CNI forestlands to the Te Pumautanga, the Crown had prejudiced the forestland claims of other CNI iwi and breached the principles of the Treaty of Waitangi. The Tribunal recommended that the Te Pumautanga settlement be delayed until CNI iwi could jointly consider guidelines for the allocation of CNI forestlands.

1.5 Formation of the CNI Iwi Collective

Out of this, the CNI Iwi Collective⁶ formed amongst iwi with historical claims to the CNI forestlands. The intention of the Collective was to achieve mutual settlement of forestlands claims on the basis of mana whenua and in accordance with the principles of tikanga. The passage of time and work of the Waitangi Tribunal meant that the potential claimants to CNI forestlands could be identified and brought within the umbrella of the Collective.

Settlement negotiations with the Crown began in earnest in late 2007 with a Terms of Agreement for Negotiation signed on 20 January 2008. A Settlement Proposal was presented on 4 April 2008 and an Agreement in Principle of Substantive Terms of Settlement on 24 April 2008. The Agreement in Principle was approved by a Cabinet Committee on 28 April 2008.

Negotiation and consultation progressed towards a substantive settlement between the Crown and the Collective that was recorded in a Deed of Settlement in late June 2008. In addition to the size of land area returned to Māori, the Collective Settlement is noteworthy because of several departures from recent policy on Treaty settlement negotiations.

- The speed at which progress was made in the first half of 2008 to negotiate a settlement jointly with seven separate claimant groups to a successful conclusion.
- Allowing an “on-account” settlement instead of insisting on “full and final” negotiation of the comprehensive historic claims of large groups. The Crown is promising priority to resolve the comprehensive claims of the Collective members.
- Allowing claimants to settle competing interests by a mutually agreed process (as recommended by the Waitangi Tribunal) and in accordance with tikanga, instead of as Crown redress.
- A resource (forestlands) settlement instead of comprehensive settlement of all historic claims.
- Additionally, and importantly, the Crown has relinquished any notion that it might be adjudged to be a beneficial owner of CNI forestlands and accumulated rentals – its position in 2006.

Those policy changes broke the impasse that has bedevilled settlement on a collective basis over the years since the 1989 Agreement.

⁴ New Zealand Maori Council & Ors v Attorney-General & Ors [2008] 1 NZLR 318.

⁵ Waitangi Tribunal, The Final Report on the Impacts of the Crown's Treaty Settlement Policies on Te Arawa Waka and Other Tribes (2007).

⁶ The Collective comprises Ngati Tuhoe, Ngati Tuwharetoa, Ngati Manawa, Ngati Whakaue, Ngati Whare, Raukawa and Te Pumautanga o Te Arawa. Ngati Rangitihui was part of the Collective during the negotiations but was unable to endorse the Settlement proposal. Special arrangements are made for Ngati Rangitihui to accede to the Deed on the original terms if a sufficient mandate can be obtained within six months of signing.

2. CNI Forests Iwi Collective Settlement

The Deed of Settlement records the agreement of the CNI Forests Iwi Collective and the Crown to settle historical CNI forestland claims⁷.

2.1 Terms of agreement

Settlement legislation implementing the Deed had its first reading in Parliament on 25 June 2008. Features of the agreement are:

- The Crown forestlands, and the Crown forest licences and accumulated rentals associated with those lands, will be held in a Trust Holding Company (CNI Iwi Holdings Limited) in which the Collective has an 86.7 percent shareholding and the Crown a 13.3 percent shareholding.
- The Collective will receive 86.7 percent by value of the CFL forestlands, including all of the rentals accumulated and held by the CFRT in respect of those lands.
- An interest in the remaining 13.3 percent of the land (by value) and accumulated rentals will be retained by the Crown for six years to safeguard the position of any iwi outside the Collective with a well-founded claim to CNI forestlands. After six years, any residual land will be made available to the Collective at an agreed value.
- A forest management company will be formed before the settlement date of 1 July 2009 to manage the forestlands.
- The forestland will be allocated to iwi members of the Collective after 35 years, or earlier if agreed.
- In the interim, \$193 million of accumulated rentals and \$13 million annual future rental income will be distributed to members on the basis of agreed proportionate interests.

- The provisional agreed proportionate interest are as follows:

Ngati Tuhoe 26.3125%	Ngati Manawa 6.0125%
Ngati Tuwharetoa 25.9125%	Ngati Whare 4.7125%
Te Pumautanga o Te Arawa 15.6125%	Ngati Whakaue 3.6125%
Raukawa 14.2125%	Ngati Rangitihi 3.6125%

These are the Collective's agreed proportions including Ngati Rangitihi and excluding the Crown. The Crown's 13.3 percent holding will revert to 10 percent if Ngati Rangitihi decides formally to agree to the settlement and is able to satisfy the Crown there is broad support for doing so.

- The Crown will make settlement negotiations for iwi members a priority, so that iwi can conclude comprehensive settlements to their remaining historical Treaty of Waitangi claims.

2.2 Protection mechanisms

A number of references to the position of non-Collective iwi occur in the Deed and are intended to protect their historical claims to forestlands covered by the Collective Settlement. The general scheme of the protection mechanisms is as follows:

- Non-Collective iwi that wish to make a claim can choose to either:
 - Enter direct negotiations with the Crown (on just the CNI forestlands, or in the context of their comprehensive negotiations); or
 - Go through a Waitangi Tribunal claim process.
- To help protect the interests in the CNI forestlands of non-Collective iwi, during a six year period beginning on 1 July 2009:
 - The Waitangi Tribunal will retain jurisdiction over the Crown's share (but not the Collective's share).
 - The Collective will not be able to transfer land title to individual iwi.
 - There will be a Crown appointed observer on the CNI Iwi Trust holding company.

⁷ The lands are an area of 176,000 Ha under the Kaingaroa, Horohoro, Marotini, Waituhi, Pureora South, Waimihia, Taurewa and Whakarewarewa forests.

- The CNI Iwi Trust holding company will not be allowed, under its Trust Deed and Shareholders Agreement, to make any financial transactions that would put the value of the Crown shareholding at risk.

Claims to the Crown’s interest must be resolved within six years of the 1 July 2009 settlement of the Collective Settlement. After six-years “lock up”, any forestlands not used in settlements with non-Collective iwi will be available to the Collective.

The redress mechanism available for a successful non-Collective claimant to CNI forestland is either:

- A transfer of title to land in which a well founded mana whenua interest is established from the Collective to the successful claimant; or
- A transfer of the Crown’s shareholding interest:
 - Representing an equivalent value to the underlying land (i.e., an undivided interest in the land). The undivided interest will become a divided ownership interest at future time after 2015 and before 2044. The rights to occupy and use the land for commercial forestry will, presumably, remain controlled by the Collective.
 - Subject to a 75 percent vote of the Collective (by shareholding) to admit another member. There is no automatic right under the Deed for a successful claimant to become a shareholder in CNI Iwi Holdings Limited.

2.3 Risks for members and non-members

The main risks in the Collective Settlement for members and non-members are as follows:

- That iwi are not happy with a shared interest in land and want to establish exclusive interest in the whenua sooner than the six to 35 year horizon contemplated by the Collective.
- That they will not obtain a proper share of the lands made available in the Collective Settlement through the envisaged processes.
- That the normal channels of objection through political channels and appeal to the Courts and Waitangi Tribunal will be closed to them in the event that they do not obtain a proper share.

The other dimension to consider is how the “on account” nature of the forestland settlement will affect negotiation of comprehensive claims. This is not a problem for groups such as the Affiliate Te Arawa iwi/hapu that have already negotiated settlement of comprehensive claims. However, because the division of forestry lands will not be for thirty-five years, there may be a problem when dealing with the Crown in regard to other elements of claim as to the amount of redress already settled.

An additional matter, which has been rehearsed by Māori forestland owners in other forums, concerns the impact of the proposed Emissions Trading Scheme on forests planted before 1990. The liability for the carbon sequestered in such forests is the landowner’s. This liability associated with permanently removing trees from land forecloses all but the most valuable alternative uses for forestland and is likely to devalue forestland relative to non-forestland.

3. Conclusion: The Collective Settlement in perspective

The CNI Forests Collective Settlement is an important and historic settlement that marks the beginning of a new chapter both for the iwi members of the Collective and for the forestry and forest-products industry.

Despite its significance to the national economy as the third-largest export earner, the forest products industry struggles to compete and gain international market acceptance for higher-valued processed wood products. Fragmentation in the industry is seen as an obstacle to effectiveness in positioning New Zealand wood products in higher-value market niches. There are high expectations that transfer of CNI forestland to Māori ownership will bring stability to the ownership and management of the CNI forestlands that has been lacking since the 1980s. This has potential knock-on implications for participants at each stage in the planting, tending, harvesting, processing and marketing of forest products.

Māori are seen as uniquely advantaged as land-owning partners in the industry – having fought so hard for the return of their land they will not willingly part with it again. Moreover the Collective has available financial resources at its disposal to invest in value-creating industry development, if it so chooses.

Part II: Appraisal framework

1. Introduction

Whilst the framework outlined below is aimed at a non-Collective iwi that may seek to claim a share of the Crown's retained interest, it is generic in that it has applicability to any proposed commercial venture an iwi might undertake.

The framework is challenging to apply in practise, much harder than a novice might imagine. Nevertheless, the high level principles of thinking and acting like an investor, understanding how commercial value is created, and exercising caution, provide guidance to anyone charged with making or overseeing investments in commercial ventures.

The aim is to equip a trustee who has an existing modest grounding in finance concepts with the tools to direct the engagement of professional advisers towards gathering the "right" information and answering the "right" questions:

- Does the proposal add value for me?
- How can I protect my investment?

1.1 The importance of understanding value

Understanding value, how it is created (or destroyed) through business processes is a key commercial skill. It is not enough for a decision maker to simply be convinced that a commercial opportunity will make money. It is necessary to understand what is under your control that contributes to success, what is being left to chance, and what might get in the way of success. This is assessing the balance between risk and reward. It also tests your comfort with the consequences if "all the chickens come home to roost".

Ultimately it is about applying a structured approach to the question of whether the venture is an attractive commercial proposal.

1.2 Protecting your investment

Protecting the investment is an important parallel consideration. All business ventures entail risk of loss, so it is important to understand how much risk of loss exists and whether this will improve over time (say with a successful start-up).

If events unfold differently from expected, or you lose your appetite, or something better comes along, how could you extract yourself? If the venture fails, what are your contractual and legal rights, and if the worst happens what is likely to be left?

Equity investors who own shares in a venture take the most risk, and they expect to reap the greatest reward if things go to plan. However, equity investors are also last in line when things do not go as planned, and therefore they are also referred to as "residual claimants".

Minority shareholders in closely-held companies face additional concerns about the way their shareholding may be valued.

2. Think and act like an investor

Investors participate in commercial ventures because they want to create value. Creating value means investors will be wealthier as a result of the decision to invest in a commercial venture.

Smart investors think very carefully about value, how it is created, and what might get in the way of value creation. If value creation analysis is careful and comprehensive it can shed light on a reasonable and sensible course of action. In many cases saying “no, this is not for me” is a reasonable and sensible course of action.

The key elements for investors to consider include:

- Understanding the likely future.
- Understanding cash flows as indicators of economic reality.
- Consideration of acceptable risk levels.
- Estimation of the value of money over time.
- Consideration of the next best alternative to the investment on offer.
- The value of the information they have about the potential investment.
- The potential to reduce risk through diversification.

Each of these main elements of an investor’s approach is outlined further below.

2.1 Look to the future

Investment decisions should be based on forecasts of the future, not simply trends or extrapolations of the recent past. Most importantly, views about the value of an opportunity should be formed in relation to prospective results of business performance and not past results.

Past performances may act as a guide, but only if the circumstances and market conditions that gave rise to them will continue to exist into the future.

2.2 Focus on the economic reality

Investors focus on cash flow as the best estimate of the economically realistic performance of a business venture. Accounting earnings results, particularly results presented on a consolidated basis may reveal relatively little about the economic realities. The general definition of cash flow is:

$$\text{Cash flow} = \text{net earnings} + \text{non-cash charges} - \text{investments}$$

In this context, “net earnings” are measured after applicable taxes, “non-cash charges” include depreciation, and “investments” include both working capital requirements and capital expenditure on property plant and equipment.

Working capital, the requirement to finance inventory and net receivables, is often the hardest thing to get right because it depends so much on things outside the business’ immediate control such as the performance of creditors and suppliers, and short term market conditions.

Cash flow can be measured on different bases:

- “Free cash flow” is the cash flow that is available to service all providers of debt and equity capital.
- “Residual cash flow” or “free cash flow to equity” is the cash flow that is available to the ordinary shareholders after other claimants have been met.

Be aware that proxies for cash flow such as EBIT⁸ and EBITDA⁹ are just proxies and exclude cash costs such as interest, tax, working capital and capital investment.

2.3 Get paid to take risks

The more risk you accept, the more return you should require from an investment.

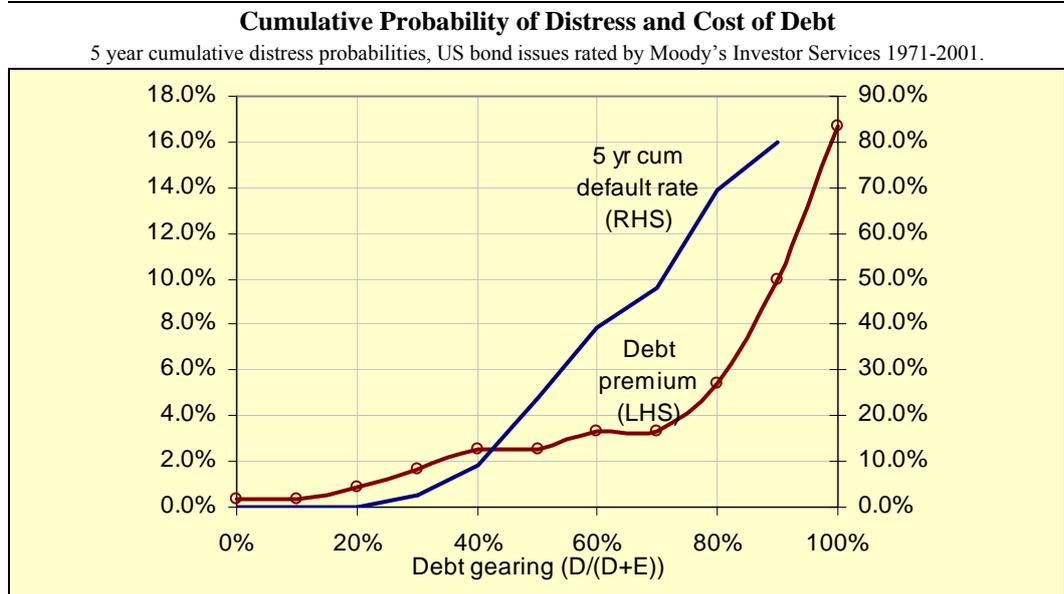
⁸ EBIT is defined as “earnings before interest and tax” calculated as revenue minus expenses, excluding tax and interest. EBIT is also referred to as “operating earnings”.

⁹ Earnings before interest, taxes, depreciation and amortization.

This is a general proposition that is demonstrated every day. Insurers charge more for premiums for exotic cars for which parts and repairs are expensive. Health and life insurance premiums are higher for smokers who experience greater risk of illness and premature death. In financial markets the yields on corporate securities are higher than for government securities, reflecting increased risk of default and non-payment.

An example of this risk return relationship is shown in the chart below.

Figure 1



Filename: Bond Rating & Default Probability.xls.
Sources: Moodys' Investor Services, Burleigh Evatt analysis.

2.4 Time is money

It is easily recognised that money received in a years time is worth less to you now than the same amount received today. The money received today could be invested and be worth more in a year than its current value. Investment decisions should therefore be made on the basis of present value of future cash flows so that the time value of money is taken into account.

In finance, the discounted cash flow (DCF) approach describes a method of valuing a commercial project, firm, or asset using the concept of the time value of money. All future cash flows are estimated and discounted to give them a present value. The discount rate used is generally the appropriate cost of capital, and may incorporate judgments of the uncertainty (riskiness) of the future cash flows.

The example below is intended to illustrate the effect of discounting to reflect the time value of money.

Note: this example ignores the impact of tax.

John buys a house for \$100,000. He expects to be able to sell this house for \$150,000 three years later.

The profit on such a transaction would be $\$150,000 - \$100,000 = \$50,000$, or 50 percent. If that \$50,000 profit is amortised over the three years, John's implied annual return would be 14.5 percent.

However, since three years will have passed between the purchase and the sale, any cash flow from the sale must be discounted. At the time John buys the house, the 3-year interest rate on government stock is 6.5 percent per annum. Government stock is inherently less risky than property, since payments and repayments are guaranteed by the Government and there is a liquid market for such securities.

Using 6.5 percent to discount the sale proceeds means that the \$150,000 received in three years actually has a present discounted value of \$124,177 in today's money terms. Those future dollars are not worth the same as the dollars today. Subtracting the \$100,000 purchase price of the house from the present value of the future cash flow results in the net present value of the transaction. This is a measure of the value created, which would be \$24,177 or a little more than 24 percent of the purchase price.

But what about risk? For instance, if the expected sale price of John's house in the example above was not \$150,000 in three years, but \$120,000 in three years, then on the above assumptions buying the house would actually cause John to lose money in present-value terms even though he is making an apparent 20 percent cash profit.

A word of caution: be careful in interpreting the results of calculation of net present value lest their apparent precision fool you into thinking they are any better than the information and assumptions that have gone into the calculation.

2.5 Everything has an opportunity cost

Having choices is always good. In making business decisions investors should always attempt to avoid the situation of making "go/no-go" or "all or nothing" decisions and instead frame decisions as "either/or" choices between alternatives. This leads naturally to a focus on opportunity costs.

The opportunity cost concept is helpful in two important respects:

- It focuses the investor on an understanding of their own risk appetite, mandate and competencies. For example, investors may specify certain types of situation that they would not contemplate because of size (too big or too small), start-up ventures and turnarounds (too risky), high debt (risk of bankruptcy), sectors with ethical or cultural taboos (lack of mandate), no management in place (because you cannot supply it), unfriendly takeover or contested bids (because they drive up price), or technology (because we do not understand it). In these situations the opportunity cost may be too high to even bother doing an analysis.
- It directs the investor to explore different ways in which a similar result might be obtained, perhaps through different deal structures. For example, if the situation entails an investment in manufacturing capacity it is worth investigating alternatives such as leasing capacity, joint venturing or outsourcing. The most you should be willing to invest is the cost associated with the cheapest alternative available. If you pay more than this then you are at risk of "winner's curse".

In a practical sense the concept of opportunity cost is pervasive and developing it as an automatic mode of thinking is vital. An example is given below.

Example of how opportunity cost analysis can usefully shape investment decisions

An investor may contemplate buying shares in a company that is priced at a premium to the value of the assets. *Why would you pay such a premium when you could assemble the same tangible assets at a lower cost?*

The main factors attributing to the success of young companies are not tangible assets, but intangible values such as founder's vision, customer base, know-how, and the skills of the assembled human resources.

The premium represents the opportunity cost of avoiding the early period in the life of a young firm when, in addition to the operational daily business, there is a focus on the initial acquisition of customers, on the establishing of supplier relations, as well as setting of internal workflows and processes.

So the acquisition premium represents the opportunity cost of the avoided losses associated with building a young firm into an established business.

2.6 Knowledge is valuable and costly to obtain

There is a saying "anyone who is not aware of the fool in the market probably is the fool in the market".

Knowledge is the core source of advantage in identifying value-creating investments. The term "knowledge" suggests being able to use the information and understanding gained to act. This is in contrast to a compliance mentality, which focuses on data gathering for the sake of it.

Good information, especially about markets and commercial ventures, is difficult, time consuming and expensive to obtain. Much of the best information is proprietary, being the result of internal research and intelligence activities, and cannot readily be accessed by outsiders.

Financial information on companies is difficult to obtain, especially on the commercial trading history of private companies in New Zealand. The factual picture that any investor seeks to build about an opportunity that can be obtained from public sources usually encompasses the following:

- Assessment of the industry and peer firms operating within it. Even just identifying which are the peer firms operating in similar or the same markets can be of benefit in understanding the intensity of competition. Trade journals and magazines are useful sources.
- Identifying economic forces that are affecting the industry and the business venture. Such economic forces may include deregulation, trade barriers, technological change, demographic change, exchange rates, new competitors, shortages (of raw material or skilled labour), cost changes (e.g., energy), and key infrastructure.
- The views and perspectives of commentators, industry experts and other investors.

The highest quality information is first hand, and is always the most expensive to obtain. The lowest quality is public information fuelled by rumours. Public information is promptly and symmetrically reflected in market prices and so is rarely of value in identifying value-creating opportunities.

First hand information in transaction situations where you are buying into an established business may be obtained through a process called "due diligence". Due diligence from the investor perspective¹⁰ is another term for detailed expert research. The research is aimed at confirming views on value, preparing for negotiations and testing the accuracy of representations and warranties being made by the firm. Fundamentally it is about gauging the risk exposure and the commercial attractiveness of the opportunity¹¹.

Some of the hardest but most critical matters to gauge in due diligence are those relating to the skills, talents, leadership abilities and motivation of key individuals employed in a business. Often it is the human

¹⁰ From the seller perspective due diligence can be seen as an exercise in legal compliance in fulfilment of disclosure requirements but with no true intention to inform the investor about the state and condition of the business.

¹¹ Due diligence normally covers the following subject matters: legal, accounting, tax, information technology, risk and insurance, environmental, culture and ethics, sales, operations, property, plant and equipment, intellectual property and brands, finance, human resources.

dimension of business ventures that is critical to success. Soured relationships or premature departure of key individuals are a recipe for business failure. If key people will not talk to you openly and confidently, or they appear to lack affiliation or affection for the firm, or they appear not to trust their bosses, then it is a fairly sure sign to an investor that all is not as it seems. Indeed it may be a “red flag” indicating that the situation is best avoided entirely.

2.7 Diversification is good

The core idea of diversification is that spreading wealth amongst uncorrelated assets reduces the risk of loss. The important principle for investors is to understand the risk added to (or subtracted from) an existing portfolio, rather than the total risk an investment opportunity represents on a stand alone basis. This is a core means of investment protection.

Not all investors have the ability to diversify in the way that portfolio investors may by spreading their holdings between shares and fixed interest securities, different maturities and geographies. Investors who choose such undiversified situations, or find themselves in such circumstances, manage their risk by seeking to influence a high degree of control over the strategic direction of the business.

The saying goes “if you have all of your eggs in one basket, keep hold of the basket”. In other words, risk of loss of value is managed by controlling what matters for value creation in the business, and leaving as little as possible to chance.

3. Understand how value is created

Value creation is the goal of any commercial venture. Value is created when you sell something for more than it is worth to you, or conversely when you buy something for less than its worth to you.

Intrinsic value and price may diverge, and this is the subject of business valuation. There are many reasons why one investor may value a business more highly than another. Chief among these are the ability to realise economics of scale and scope, to change the rules of the game in the industry, to make cost savings and realise synergies of various kinds¹².

The common characteristics of these situations is the opportunity for the business to control more of what contributes to success and reduce that which is left to chance, and what might get in the way of success.

3.1 Intrinsic value cannot be observed

Intrinsic value cannot be observed in the market since it depends upon the perspective of the investor who is making the valuation. Intrinsic value is not an absolute but must be estimated, and depends to some degree on what you as owner are able to bring to a business venture.

Any measurement or estimate contains errors because of flaws in the systems used to measure financial and economic data and because of the ever-present uncertainty about how future events will unfold. Given the possibility that many different errors can occur, “triangulation” may be useful. Triangulation is a process for measuring something indirectly based on different points of location.

Working with many estimators helps overcome the artificial sense of precision that comes with using single point estimates.

3.2 There are many ways to estimate intrinsic value

Questions of business value are usually answered by one or more of seven main ways in which value is assessed. The seven are as follows:

- Book value: estimates made by accountants based on financial and tax reporting.
- Liquidation value: estimates the value that would be obtained by selling the various components of the business.
- Replacement cost: estimates the cost to replace the assets of the business at today’s prices.
- Current market value: calculates the values of debt and equity as an estimate of enterprise value.
- Trading multiples of comparable listed firms: the value of similar firms is used to estimate the value of the enterprise.
- Transaction multiples of comparable acquisitions: uses the actual prices of similar firms to estimate the value of the enterprise.
- Discounted cash flow (DCF) analysis: calculates the presented discounted value of future cash flows at an appropriate cost of capital.

A further description of these valuation methods, including comments on their advantages and disadvantages, is contained in Appendix A:¹³

While there are many approaches to estimating intrinsic value none is flawless and, at best, each approach produces an estimate. Professional analysts understand these approaches sufficiently to be able to apply them when reasonable and tailor them to the circumstances. From the investor perspective, not all approaches warrant equal consideration, but to choose one approach without examining the vantage point provided by others is to take a view that may end up being wrong.

¹² In this sense for synergy enhancements to have value they must result from higher revenue, a faster rate of growth in revenue or a reduction or slower growth in expenses.

¹³ Other valuation approaches exist and are used such as “industry rules of thumb”, real options and “venture capital” approaches. Industry rules of thumb usually boil down to an alternative expression of transaction multiples. Real options valuations are insightful for firms that are heavily indebted. Venture capitalists often use a simplified DCF approach that mimics the financing rounds that are the established practice of that industry.

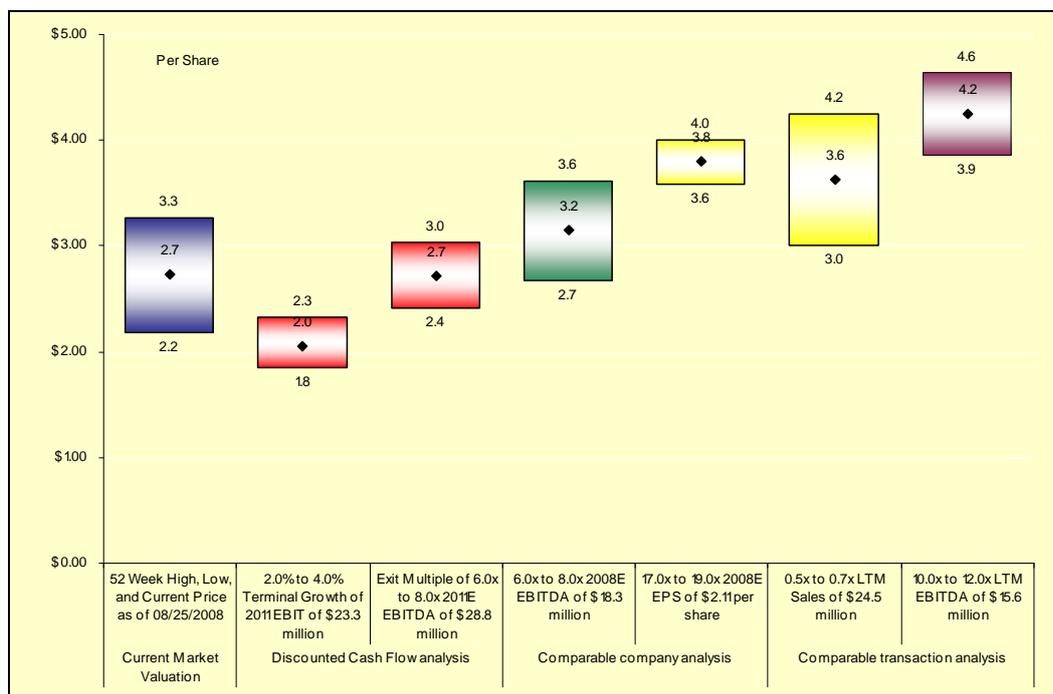
The following Figure 2 illustrates the pitfalls of relying on too few valuation approaches. A professional adviser should reconcile the different approaches in formulating a recommendation on value.

Figure 2

Using a “Football Field Chart” for Business Value Triangulation

The football field is a standard presentation of comparative valuations of a business.

The valuation estimators are not always overlapping, illustrating the pitfalls of using one or a few methods to value commercial assets.



Filename: CF 93-2 Generic Advice.xls.

Sources: Burleigh Evatt analysis.

Discounted cash flow analysis, when done properly, most closely approximates what it means to think like an investor. For this reason alone it deserves more weight than other approaches. However, this is not an unqualified recommendation.

- DCF generally does the best job but it is difficult, time consuming and expensive to apply. For this reason it may not always be justified in the circumstances.
- Explaining the inner working of a DCF analysis can be awkward, especially to novice decision makers who may become mesmerised by the detail and feel under-qualified to challenge the received wisdom of experts.
- DCF works best when there is a high degree of confidence about future cash flow forecasts. But things can get tricky when a firm’s operations lack what analysts call “visibility” - that is, when it is difficult to predict with much certainty sales and cost trends or capital expenditure requirements.

In estimating business value, assumptions must often be made to take the place of key information that is not readily available but important to the result. There is a saying “assumptions make an ass of you and me”. Analysts may unwittingly make tacit assumptions that might not necessarily be agreed by decision makers if they were explicit. Spreadsheet models that are the universal tool for such analysis these days most often contain errors that creep in undetected.

Finally, no model is a replacement for sound judgement, “if it seems too good to be true, it probably is too good to be true”.

3.3 Understand the value drivers

What makes the difference between creating value in a business and not? There are usually a small number of things that make the difference. If they are wholly or largely under the control of the business then they are known as “value drivers”, if not they are bets.

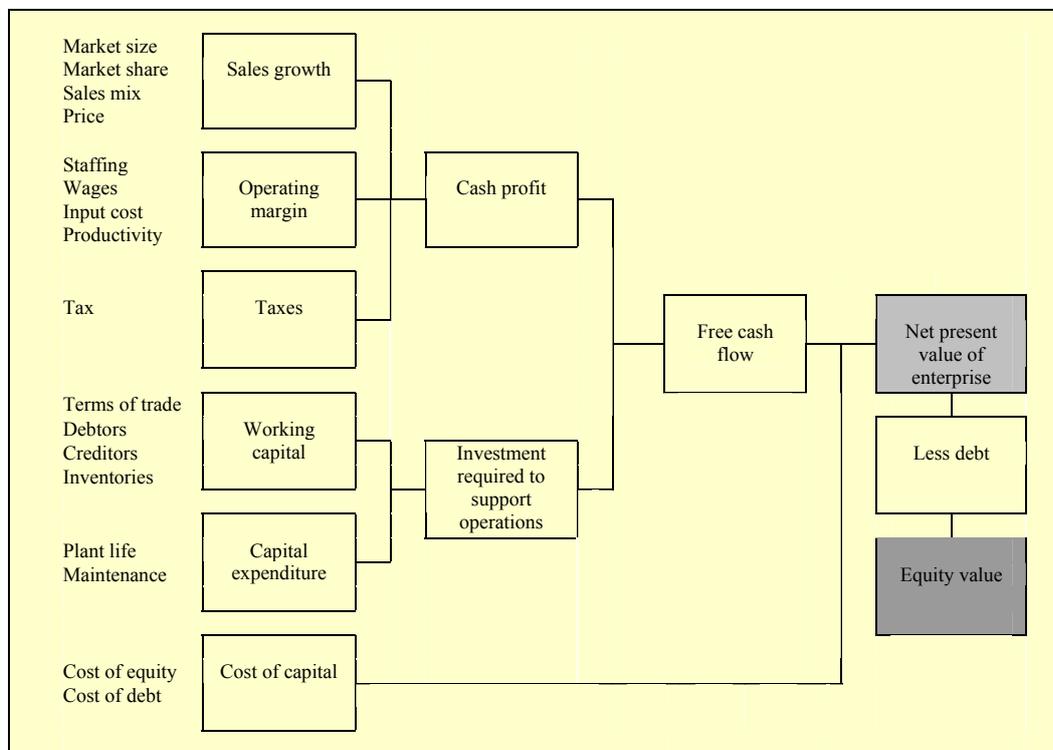
Achieving a balance of risk and reward means gaining as much control as possible over the value drivers that matter for success.

Businesses use a range of techniques to extend their control over key value drivers of their business. This includes marketing, product development, innovation, technology, new distribution channels, regulation, acquisitions of peer firms and mergers.

The following diagram represents the relationship between key value drivers and value creation for shareholders.

Figure 3

Creation of Shareholder Value



Sources: Alfred Rappaport "Creating shareholder value: a guide for managers and investors" The Free Press, 1998.

The value drivers that are the usual focus for investors are:

- Customer base. What is the buying trend from customers over the past five years? What is the extent of customer churn? How many new customers have been acquired annually over the past few years? What is forecasted revenue from these customers? How stable is the customer base? How vulnerable are these customers to economic fluctuations? What is the profit contribution from these customers?
- Recurring revenue. One of the top value drivers to consider is the recurring revenue coming from the customer base. Is there an opportunity to change the business model to create stronger recurring revenues for the business?
- Operating margin. This is most important line item on the financial statements. In-depth analysis needs to be completed to determine whether ultimately margins will improve or degrade.
- Intellectual property and proprietary processes can add a lot of value to a firm. Intellectual property is a catch-all term that is often interpreted differently from person to person. It includes trademarks, patents and copyrights and can also mean proprietary processes and market intelligence.
- Management experience and expertise.
- Reputation and operating history. This value driver is often overlooked, and reflects the stability and consistency of the business. The fact that the firm has been in business for some time does matter and does have value although it is very hard to measure. An in-place management team that has operated together for some time is a valuable commodity.
- Sales and marketing effectiveness. One key and very important element of a success is to determine whether the firm has developed an effective sales and marketing model.
- Barriers to competition are becoming more difficult to identify, as firms are reluctant to patent even if a technology or process is able to be protected. Barriers to entry also create potential value, for

example: Does the business have a “first mover” advantage in a particular market segment? Does the business have significant product features that would provide a product advantage when compared to the competition? How long are these advantages likely to last before the competition catches up?

3.4 All shares are not created equal

When it comes to protecting the value of investments, shareholders need to realise that all shareholdings are not created equal.

Shares in a company represent (evidence) property rights; the right to participate in dividend and other distributions including on wind up. Most shares are not redeemable for cash¹⁴ so a shareholder who wishes to cash up must find a buyer willing to purchase his or her shares at a market-determined price. In the absence of such a market, the practise is for an expert to value the seller’s shares.

The usual standard of value for shares is “fair market value”. Fair market value is the most probable price at which an exchange will occur in a free market assuming:

- A knowledgeable and willing seller unencumbered by undue pressure to sell and acting in their own best interest.
- A knowledgeable and willing buyer unencumbered by undue pressure to buy and acting in their own best interest.
- A reasonable time for exposure in a free and open market.

If such a transaction actually occurs, then the transaction price is usually the fair market value. However market transactions are often not observable and opinions on value are always based upon subjective interpretation of available information at the time of assessment. Discounts may be applied because the market for shares does not conform to a free market, for example when valuing a closely-held business or minority shareholding.

Probably the most controversial discount is for lack of control (also referred to as a minority interest discount). The theory behind paying more for control is straightforward: buyers will pay more for a firm if they can make decisions about the use of its assets. Control allows a buyer to take additional distributions, sell off pieces of a firm or use the assets to buy other operations, and make decisions about business strategy, among other things.

Marketability discounts attract less controversy, and are generally (not always) smaller in magnitude than control discounts. Most people value highly the ability to readily quit an investment and accept that this carries a price. Restrictions on the sale of minority shareholding interests are likely in any shareholders agreement. Transaction values will be affected by the potential for any sale of shares to interrupt the availability of credits/refunds under the Māori Authorities tax regime.

The practice of expert valuers active in New Zealand is to apply:

- Lack of marketability discounts ranging from 10 to 26 percent of the *pro rata* 100 percent equity value.
- Minority interest discounts ranging from 17 to 25 percent of the restricted market value.

The implication of this is that a minority shareholding is likely to be valued at a discount of between 25 percent and 44 percent of the 100 percent equity value, in the absence of contrary provisions in the shareholding agreement.

Investors can protect themselves from such discounts, in a number of ways, through shareholder agreements. Such agreements are common in closely-held company situations that resemble an incorporated partnership or joint venture.

Shareholder agreements provide “rules of the game” that are additional to rules derived from the Companies Act. For example, investors could seek agreement amongst the shareholders in a venture to the following conditions:

¹⁴ Section 37 of the Companies Act 1993 permits a company to issue shares that are redeemable (at the option of the company, the holder or on a fixed date) or confer preferential rights to distributions of capital or income, or have voting rights that are special, limited, conditional or have no attached voting rights.

- *Pro rata* share values (also called “fair value” shares) for the valuation, issue or redemption of shares unless unanimously agreed otherwise¹⁵.
- Stipulation of the method(s) of valuation of shares, in particular the non-applicability of discounts for marketability and control. (Note that conversely this prevents a premium being paid for a controlling or swing voting block).

Other protection mechanisms include investing through shares that are preferred or redeemable for cash.

¹⁵ A typical wording in a shareholders agreement stipulating pro- rata share values might be as follows:
... the valuer shall determine the fair market value of all of the NewCo shares, then shall determine the fair market value of the Sale Shares as the appropriate percentage of NewCo shares, so that no regard shall be had to the control of NewCo or to any premium or discount for lack of control or lack of marketability.

4. Conclusion

The aim of this section has been to equip someone who has a modest existing grasp of finance concepts with tools to help obtain the right answers to the right questions.

The high level principles of thinking and acting like an investor, and understanding how commercial value is created, provide guidance to anyone charged with making or overseeing investment decisions.

In the next section, we give a simple example of how this thinking might be applied to a small iwi that is considering joining the CNI Iwi Collective.

Part III: Applying the principles – an example

1. ‘Small iwi’: an example

In this section we consider how a small iwi might, in practice, explore the commercial implications of joining the CNI Collective.

1.1 Underlying principles

Crown Forestry Licenses (CFL) have termination arrangements that were intended to protect the occupier’s ability to harvest its crop after a successful land claim. During the 35 years following transfer of land ownership from the Crown to Māori, occupancy of the land and ownership of improvements progressively return to the land owner as the standing trees are harvested. Thus for any particular block there are many potential scenarios which might see it clear felled quickly, progressively over decades, or in the far distant future, depending mainly on when the trees were originally planted. This means there are two streams of commercial activity for a successful claimant; management of the Crown Forest Licence, and management of the resumed forestland¹⁶.

During the CFL termination the Māori landowner has no control over the harvest profile. Harvest profile is a major value driver for the owner of licensed land, but one that is not under the owner’s control. The Māori landowner also has no control over land values. Therefore the only value drivers it may be able to control during the termination phase of the CFL are rent and costs.

The following example for ‘Small iwi’ is hypothetical, but representative of the commercial situation.

1.2 Hypothetical example of ‘Small iwi’

Small iwi has successfully negotiated settlement of a historic claim which includes 6,000 Ha of licensed forestland included in the Collective Settlement. The annual rental income is \$545,000.

Small iwi understands that 6,000 Ha is probably too small a forested area to operate on a stand alone basis and it believes it lacks forest management expertise. *Small iwi* also knows that the forest was planted pre-1990 so the “carbon cost” of conversion is prohibitive, even if the land itself was suitable.

Therefore *Small iwi* decides it should investigate management of the forestland in conjunction with the Collective’s other holdings.

Small iwi understand that if it joins the Collective it will benefit from centralised administration of the CFL through to its termination, then the land will be replanted under a unified forest management plan. *Small iwi* estimates that this will save it the costs of negotiating three-year rental reviews that could cost \$10,000 per annum on a levelised basis for the remaining life of the CFL. Under the Collective, its share of the cost of rent reviews would be only \$2,000 per annum.

Small iwi also believes the Collective would have more bargaining power with occupiers. It believes that on its own it would experience a drop in rental at the next review of ½ percentage point, whereas it might increase by ½ percentage point under Collective management.

Small iwi believes that future inflation will average 2½ percent, and land values will rise in line with the general level of prices, and that an after-tax discount rate of 8½ percent is commonly used in such circumstances. It expects harvesting to commence in 2014 with 600 ha resumed each year until 2023.

An analyst for *Small iwi* models the situation and works out that if the rent drops as expected at the next review then the value of its licensor interest will drop from \$7.4 million to \$7.2 million. This is a 3.5 percent drop, not much because the land returns fairly soon. If the trees were much younger then the value drop would be bigger.

¹⁶ Forestland management options include re-licensing under private treaty or leasing. Under either arrangement the Māori landowner’s commercial role is as a landlord with no direct exposure to the re-planted crop. A more active role would be for the Māori landowner to replant that land resumed, possibly with a co-investor, in which case the landowner has a direct exposure to the crop.

Table 1

Stand alone management	As resumed	Less ½ %pt
	\$000	\$000
Licensor interest		
PV of rental income	3,236	2,913
PV of expense	-94	-94
PV of tax	-613	-550
PV of land	<u>4,897</u>	<u>4,897</u>
Total	7,426	7,166

The analyst then works out the effect of sharing administration expenses with the Collective. Instead of \$10,000 per annum (going up at the rate of inflation) the costs of administration would drop to \$2,000 (also going up at the rate of inflation). In after-tax terms the saving has a present value of \$60,000.

The analyst presents two charts for *Small iwi* to consider (see Figure 4 below):

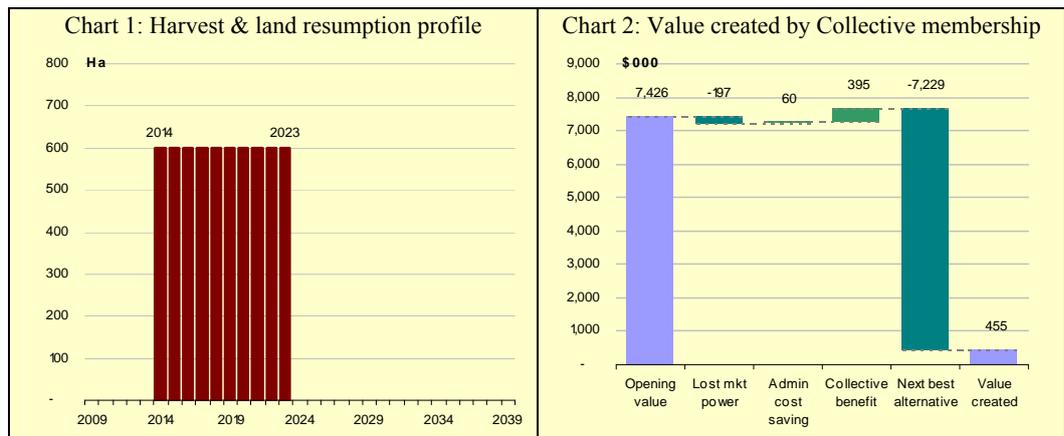
- Chart 1 shows the profile of harvest and return of land to *Small iwi*. The harvest starts in five years time and is complete in 2023. The analyst notes that each year 600 Ha is cleared and *Small iwi*'s rental income goes down by about 10 percent per year as land is resumed.
- Chart 2 shows the value creation by joining the Collective. The analyst explains that at this stage there is no consideration of the arrangements for replanting because he is simply looking at the termination of the Crown Forestry Licence and the best way it might be managed for the remaining 15 years until expiry. The analyst explains his estimates that joining the Collective will add \$455,000 of value for *Small iwi* compared with the next best available alternative. That alternative is to manage stand-alone and incur the ½ percentage point lower rental than currently and the full \$10,000 administration costs.

Figure 4

Harvest & Land Resumption Profile, and Value Created by Collective Membership

Chart 1 shows the harvest and land resumption profile for *Small iwi*'s holding. 600 Ha per annum returns over 10 years from 2014.

Chart 2 shows estimated \$455,000 value created by Collective compared to self management (the next best alternative).



Filename: CF 93-2 Generic Advice.xls.
Sources: Burleigh Evatt analysis.

The analyst recommends to *Small iwi* that, on purely commercial grounds, it should join the Collective.

In considering this advice, *Small iwi* weighs up these apparent commercial benefits alongside its views on what the relationship will be like with the other Collective members under the heading of “fit”, including:

- Do we understand how they run their meetings, how they resolve differences and how they avoid discord amongst individuals with strong personalities?
- Do we all want the same thing in terms of income versus capital appreciation?
- What information will be available to us as of right so we can assess that the Collective is well run day-to-day? Who will speak for us at board meetings?
- What happens if we decide down the track that we want out?

These are all important matters to be weighed up, and will influence the final decision of *Small iwi*, alongside the commercial value to be gained.

Appendix A: Making sense of valuation approaches

How do we make sense of so many different ways of valuing the same thing? The following summary table may help:

Estimator	Description	Advantages and disadvantages
Book value	Estimates made by accountants based on generally accepted principles, sampling and transaction analysis for the purpose of financial reporting and compliance with taxation.	Tendency to give little weight to factors that create value such as intangible assets, management competency, strong market positioning. Applicable to business with few intangible assets in slow-growing commodity-type markets and low inflation.
Liquidation value	Possibly the most conservative valuation approach. Liquidation valuation places a floor on the value that might be realised if the business was broken up, its assets sold at auction, and all liabilities paid (including staff redundancy). Usually liquidation value is less than book value, if only because book value rests on a going concern assumption.	Appropriate for businesses in financial distress or whose future prospects are cloudy. Often useful as a reality check on other value estimators to give a sense of the limits to downside if things do not go as planned. Results depend heavily on assumptions about how long it will take to liquidate, and the level of realisation. For example, receivables that would ordinarily be collectable may not be and specialist plant may have only scrap value. Estimates are highly influenced by how finely the break up may be, e.g., selling a fully stocked operating plant or selling the fixtures and fittings “down to the nails”.
Replacement cost	The cost today to replace the assets of the firm (in contrast to the actual cost of the piecemeal acquisition that occurred in the past).	Replacement cost estimates have one virtue over book value estimates in that they reflect current trading conditions. Issues include: <ul style="list-style-type: none"> Changes in technology may mean that old inefficient plant would not be replaced. Assumptions around the cost of “new” or “second hand” replacements. Some intangible assets may not be able to be valued by such methods.
Current market value	The current market value of an enterprise (enterprise value) is the sum of the market values of its debt (borrowing) and equity (shareholder value). The shareholder value is the current share price “P _{share} ” multiplied by the number of shares on issue. If the market value of debt is represented as “D” and the market value of equity at “E” then the enterprise value “EV” of the firms is: $EV = D + E$ and $E = P_{\text{share}} \times \text{No. shares issued.}$	The market value of debt will ordinarily be close to the book value unless the issuer has experienced a material change in credit standing since the debt was issued. Certain other debts, such as deferred taxes, are generally ignored and reflect in the value of equity. This is an important measure for listed or publicly traded companies because we can reasonably assume the market price of its shares reflects what is known generally about the firm and its prospects. This estimator is less useful for companies whose shares are only intermittently traded and is not applicable for closely-held company shares.
Trading multiples of comparable listed businesses	Comparing trading multiples of peer firms is widely practiced. There are two broad approaches: <ul style="list-style-type: none"> Multiples that value the enterprise, e.g., value/EBIT or value/EBITDA. Multiples that value equity (shares), e.g., price/earnings (PE). The art in using multiples is in choosing the peer group, ideally on the basis of current business lines, future outlook, financial policies and size.	Although widely used and simple to use, valuation using multiples has four main defects: <ul style="list-style-type: none"> It is rare to find a peer that is directly comparable leaving the question of “how comparable does a peer need to be?” Vulnerability to differences in accounting policies between firms. Timing problems between multiples calculated on historical measures versus prospective measures, particularly for growing firms. Such measures use proxies for cash flow such as EBIT and EBITDA that ignore drains on cash flow such as investment in property, plant, equipment and working capital. These may be material to value.

Estimator	Description	Advantages and disadvantages
Transaction multiples of comparable acquisitions	Comparing the same 'trading multiples' discussed above to actual prices paid in transactions provides another vantage point on value.	Transaction multiples often contain a "premium" reflecting the attainment of management control in a takeover situation. Control premiums may be 20 to 30 percent or more and are not present in trading multiples. In all other respects transaction multiples suffer the same drawbacks as trading multiples.
Discounted cash flow (DCF) analysis	<p>There are three main approaches to DCF that are nevertheless identical in theory:</p> <ul style="list-style-type: none"> • Free cash flow (FCF). • Residual cash flow (RCF). • Adjusted present value (APV). <p>All three calculate the present discounted value of future cash flows at an appropriate cost of capital (discount rate).</p> <p>This is usually done in two stages by forecasting cash flows to a horizon (the value growth period of 5 or 10 years) then estimating a terminal or continuing value to represent the future long-term prospects of the firm.</p> <p>A weighted average cost of capital (WACC) is frequently used as the discount rate. WACC is the minimum return that a firm must earn on its assets to satisfy its creditors and owners (providers of capital) investment return expectations.</p>	<p>DCF is the most difficult valuation approach, but if done correctly it is the most insightful. Main defects are:</p> <ul style="list-style-type: none"> • Difficulty and costs of doing it well, particularly generating sensible forecasts of future events and reliable cost of capital estimates. • Vulnerability to "garbage in, garbage out". • Over-reliance on continuing (terminal) value estimates that make up a large contribution to present value. • Reliance on the Capital Asset Pricing Model (CAPM) to derive estimates of the cost of equity capital. • Incorrect interpretation of the weighted average cost of capital (WACC). There are many different ways to calculate WACC taking account of available information, capital structures and tax. • Failing to properly allow for taxation and inflation resulting in an incorrect pairing of pre- and post-tax, and nominal and inflation-adjusted cash flows. • Incorrectly pairing cash flows and discount rates that relate to different DCF approaches. • Over-cooking spreadsheet modelling instead of focussing on the key drivers that contribute to value.