The changing attitude to forest investment

Thomas Song
Managing Director, Ernslaw One Limited.

Ownership and history

The investment made by Ernslaw One during a period of downturn in the New Zealand forest industry has generated some curiosity and interest in industrial forestry circles. To understand what drives Ernslaw’s continuous investment in new forest planting, forest acquisition, sawmill acquisition and development, it is necessary to understand the background to its ownership and its management philosophy.

Ernslaw One Limited was formed in 1990 as a bid vehicle to participate in the first New Zealand Crown Forestry Assets sale process. The company is wholly owned by the Tiong family from the state of Sarawak, Malaysia. The driving force of the Tiong family business is Tan Sri Datuk Tiong Hiew King with the unyielding support of his five younger brothers.

Tan Sri Tiong, as he is now known in Malaysia, began his first business in 1975 investing in his home state of Sarawak, the then backward East Malaysian state on Borneo island, which joined Malaysia in 1963 after gaining independence from Britain. Sarawak has a land area of 124,450 square kilometres and comprises 37.5% of the land of Malaysia. It now has a population of 2.177 million. Sarawak has a rich multi-ethnic population comprising Malays (21%), Chinese (29%), Iban (30%) and other important indigenous races such as Melanau, Bidayuh, Kayan, Kelabit, Kenyah, Penan and Orang Ulu.

To successfully manage the prosperity of an independent state, just emerging from colonial status in 1963 with few overseas trained personnel, was a difficult task. To keep the population fed, housed and educated needed resources. The only known resource then was petroleum which was controlled by Shell. Forest as a resource was hardly noted with insurgents still operating in all forests throughout Sarawak. Few have the stomach to manage such adversities. However, it was vital that Sarawak manage its forests successfully to ensure peace, harmony and prosperity amongst the various races.

The successful acceptance of amnesty by the insurgents in the 1980s and the subsequent economic prosperity and peace enjoyed by the State reflect the important role forestry played in generating the much needed funds to feed, house and educate its population. Poverty breeds dissent and insurgencies. You remove the source of poverty, you remove the hotbed for dissent and terrorism. The prosperity enjoyed by Sarawakians today is a huge contrast to its Southern neighbour, Indonesian Kalimantan.

Tan Sri Tiong took the challenge to manage a small timber forest licence issued by the State in 1975 during the early part of his capital formation. During the early 1980s the industry was facing a very severe downturn with frequent bankruptcies. Revenue from sale of logs was then far below variable costs. The family had to face the choice of either laying off all its workforce or continue operating at a huge daily loss and battle on, relying on its capital reserves, the support of its suppliers, customers and banks. It not only chose the latter but acquired further forest resources.

When the industry went into a huge upswing a year later, with its expanded resources, infrastructure and a loyal extended workforce, the family’s business was propelled into prosperity. The log price spike of the 1990s added to further successes.

Why Invest in New Zealand?

In the 1980s I was working as the International Division Manager of the Tiong family business. On a trip in 1989 with Tan Sri Tiong to Japan visiting our customers, Tiong posed a question to them as to their view on the future of forestry. The answer we received was “plantation forest in New Zealand, particularly radiata pine as a sustainable resource”.

As none of us had been to New Zealand before and we did not have a base here, I suggested we start to acquire a small sawmill worth about $200,000 in the Aorangi district and from there explore the potential of forest investment. I then approached New Zealand Timberlands to inquire whether they were prepared to support us with the long term supply of logs. We were then told that the long term supply of logs was not possible as the Crown Forests were soon to be sold by international tender.

In the 1980s, successive New Zealand governments had been viewed as having transparent and consistent policies. Country risk was greatly discounted or not considered a problem. During a marketing tour in 1990 by the Crown Forestry Assets Sale Team, I enquired as to what strategy we should adopt apart from price in order to be successful. The advice given was never to bid for the forest you want in isolation, the best strategy is to bid for the forest you want and tag it with two dogs! That was probably the best advice I had and resulted in Ernslaw buying the Tapanui, Santom and Whangpoua forests plus the Conical sawmill for $102 million. The latter being one step further than the initial advice.

Four year-old Douglas fir at Haltwyn.

What drives new planting?

Between 1994 and 2000, Ernslaw planted 27,000 ha
of Kyoto forests including 11,000 ha in Douglas fir. This boost of new planting was driven by various factors.

Firstly, shortly after entering New Zealand, the group quickly diversified into four other industries, namely urban land development, salmon farming, plastic manufacturing and scientific consumable and equipment trading. All these businesses proved very successful after difficult initial restructuring and a tax effective way of growth was required. Forestry tax legislation in New Zealand, where most of the initial planting costs are deductible in the first year, was extremely attractive for those not driven by cash flow and having a long term view.

Secondly, the desire to expand the group's forest estate was then hampered by the extreme expectations of vendors due to the log price spike of the early 1990s. The only way then was to plant new land to create new forest estates.

Thirdly, while visiting Central North Island forests, Tiong was mesmerised by the tall 60 year-old Douglas fir trees swaying in the wind. A rule of thumb calculation gave a value of $80,000 - $100,000 per hectare. That was enough to prompt the planting of 11,000 hectares of Douglas fir in the south.

Fourthly, the initial desire was to plant 10,000 ha per annum. However, the manpower and logistics required were obviously not available then. The revised target was then set to expand the forest estate to 100,000 hectares by the year 2010. This was a realistic and achievable target.

Fifthly, it is Tiong’s view that Douglas fir plantation is his answer to the desire of an inter-generational growth asset. If we can’t buy them in New Zealand, we have to plant them.

Lastly, the potential to sell carbon credits under the Kyoto Protocol was the potential icing on the cake. Earnswey in fact did spend quite a substantial sum in the late 1990s exploring the options of trading carbon in the international market. Carbon credits, if available to foresters, could encourage perpetual planting of marginal farm land. Money and funding from the banks would not be a problem since the young forests in fact would be generating revenue making them highly fundable. This is in contrast to the current sorry state of affairs.

Why more investment in forests?

Despite the serious forestry downturn in 2004, the successes the Tions had with their counter-cyclical investment strategy in the 1980s gave the confidence to further increase their investment in New Zealand forests.

The East Coast forest, despite posing a difficult challenge for foresters, actually represents good value. The high growth rate and superb quality pruned logs will likely be well in demand if managed properly with a 30-year rotation.

By Earnswey acquiring the forest estate rather than the failed company, it can claim cost of bush deductions each year to offset against income. This gave the group a tax effective way of shielding its recurring income from tax while it concentrates on the business of growing long term forest value. Tax will only be payable on the harvest of timber. To choose when to harvest and pay tax therefore is in the company’s control.

The group also has faith that the losses and errors made by the industry can be reversed. The answer lies in the production of high premium, higher age-class quality logs. The rationale is that such logs are the cheapest to produce and the easiest to capture end product value. This translates easily into profitability.

What drives sawmill investment?

There are different reasons for further investment and development of sawmills. Whangapoua forest is well known for its production of small knot, high density structural logs. Currently, there are no small log lines in the area capable of utilising smaller logs from the forest. Transport from the forest to either Port of Tauranga or Central North Island sawmills is extremely expensive.

The development of Whangapoua sawmill will, by a rule of thumb calculation, increase the forest value by up to $30 million; $20 million of which is by capturing the reduced transport costs and $10 million of which is by increasing the sawlog recovery against the pulping component.

Pruned logs being sawn at Prime Sawmill, Gisborne.

1The Whangapoua sawmill consent has subsequently been rejected by the Environment Court.
Profitability of the sawmill and environmental benefits also influenced the decision.

In the East Coast, we are of the opinion that to successfully manage the forest we need a sawmill. It is by synchronising both the forest and sawmill management that maximum value can be derived both by the company and the community.

The sawmill will be concentrating on large diameter, high value pruned logs both from the company forests and also from other forest owners. The common sense approach here is that it is easier to sell premium product than to push buyers to buy rubbish.

Owning both sawmills would give both forests more market options, the ability to better penetrate the wood market and also the flexibility to manage a stable workforce. This ability and commitment will be highly beneficial to the community.

An example of Ernslaw's policy is to harvest difficult blocks during downturn periods to reduce production and only to harvest the normal blocks in better times. This enables the contractors to fully employ their crews. Lower production volumes at a higher piece rate mean the same income for the crew. Reducing production also stabilises an over-supplied market. The rationale is that the trees on difficult terrain need harvesting anyway, and the best time to harvest them is in fact during a down market. For Ernslaw, this approach reserves its gun powder for better times resulting in higher overall profitability. Having sawmills adds more capability to achieve this policy.

Our Corporate belief

Ernslaw is firmly of the opinion that in order for the industry to prosper it must concentrate on the production of high quality premium logs suitable for their end purposes. That's the only way to retain a satisfied and loyal customer.

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### REVIEW OF REGISTRATION

The following individuals have made an application under Article 41.2 of the NZIF Articles of Association for the review of Registration.

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<tr>
<th>Name</th>
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<tr>
<td>Peter Charles Brown</td>
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<td>Peter Douglas Clark</td>
<td>Rotorua Registered Forestry Consultant</td>
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<td>Stephen William Croskery</td>
<td>Masterton Registered Forestry Consultant</td>
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<td>John Edmund Keating</td>
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<td>Allan Cecil Laurie</td>
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<td>Rob Ralph Lawrence</td>
<td>Blenheim Registered Forestry Consultant</td>
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<td>Hamish Levack</td>
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<td>Angus Neil Malcolm</td>
<td>Whangarei Registered Forestry Consultant</td>
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<td>Geoffrey Manners</td>
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<td>Jaquetta Rosemary Bradshaw</td>
<td>Christchurch Registered Member</td>
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<td>Christopher John Keith Perley</td>
<td>Dunedin Registered Member</td>
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Any objection should be made in writing and sent to the Registrar, NZIF Registration Board, PO Box 19840, Christchurch within 20 days after the date of despatch of the Journal of Forestry in which this notice appears.