Collective Harvest by Joint Venture

For Forest Enterprises Managed Investment Schemes

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Table of Contents

Introduction and Purpose of this Report

The purpose of this document is to set out in one comprehensive report all of the details relating to collective harvest by joint venture. Collective harvest by joint venture is proposed for 48 managed investment schemes (MIS) regulated by the Financial Markets Conduct Act 2013 (FMC Act) and managed by Forest Enterprises Limited. 15 such joint ventures are proposed for the 48 MIS.

Many parties have an interest in this proposal including, the Investors, the Supervisor, the Financial Markets Authority, Inland Revenue, the Forestry Auditor and the Financial Auditor. These parties will be involved in different aspects of implementation of the proposed collective harvest by joint venture. Ultimately it will be the Investors in the collection of MIS proposed for each joint venture who decide to proceed or not by a vote. The vote will be a special resolution requiring a 75% majority.

These notes are written from the perspective of the 44 MIS which are structured as limited partnerships. The balance of 4 MIS are structured as ordinary partnerships and consequentially implementation may require a different approach in the detail to the limited partnerships, however any differences will not change in any material way the overarching rationale and core structuring set out in this document. The 4 ordinary partnership MIS are included in 2 of the initial batch of 5 joint ventures proposed for 16 MIS, therefore any differences are relevant only for the processing of these 2 joint ventures.

Genesis for Collective Harvest by Joint Venture

Historical Problem Identified

Back as far as 2011 Forest Enterprises was concerned that harvesting as individual forest blocks was creating unnecessary risk for the Investors and not necessarily maximising the financial return. At that time the forests being harvested were small, had many age classes (which were consequentially very small), and these factors were often resulting in harvest programs of less than 1-year in duration.

The solution investigated at that time was a Forest Owners Cooperative, the concept being that many individual forest owners would pool their harvest such that it could be conducted as if one continuous program over a number of years. The concept also embodied an averaging of log prices over time such that each forest owner would receive the long run log price (the average over a period of time).

The fatal flaw in this concept was that forest owners would be keen to join the cooperative when the cooperatives average log price was higher than the spot market, but less enthusiastic to join when the reverse was the case. Also, there was a material tax issue which required a law change for which there was little political, Inland Revenue and broader industry support at the time.

To a degree the historical problems solved themselves as the forest blocks coming into harvest were generally larger and this scale addressed some of the issues.

'Wall of Wood' and Other More Recent Challenges

As the harvest of the large areas of forest planted in the 1990s loomed, Forest Enterprises had to turn its attention to the practicalities of harvesting these areas under the company's management but in an environment where there were also significant other areas of 1990's planted forest outside of the company's management.

It was clear that all 1990 forest areas (not just those managed by Forest Enterprises) would be competing for –

- Harvest infrastructure - logging contractors, roading contractors, cartage contractors.
- Access to sensitive roads - some not able to be used in winter, or with restricted winter access.
- Limited domestic market options.
- Limited port space for the large percentage of logs that must be exported.
- Potentially limited market uptake.

Forest Enterprises was also mindful of the increasing impact of changing legislative requirements including –

- Resource Management Act 1991 - the prospect of harvest quotas per river catchment and maximum continuous clearfell areas per annum;
- Health and safety regulation – incentivising more machinery and less labour requiring different relationships with harvest contractors who have more capital invested.

Forest Enterprises also needed to resolve the impact of some unique factors to many MIS under management including –

- MIS with large forest areas in just two or three age classes – consequentially it is not possible to harvest each age class at the selected optimum age (historically around age 28 years).
- Contiguous forest areas across different MIS – many MIS forests are sub-areas of a larger contiguous forest area comprising a number of MIS managed by Forest Enterprises. This arose from the historical consequence of the legislative environment necessitating the subdivision of farms purchased for investments into multiple MIS. It is recognised that the most efficient harvest will be achieved ignoring these artificial boundaries.
- Vulnerability to access from one public road.

Forest Enterprises' Responsibility to Act

Forest Enterprises has been managing forestry investments since 1972 and our success is in large part because of the company's Investor focus. In addition, Forest Enterprises is a licensed manager of forestry MIS in terms of the FMC Act.

Our obligation in respect of each MIS is therefore to act in accordance with the FMC Act, the governing documents, and the Statement of Investment Policy and Objectives (SIPO). This is expressed in section 143 of the FMC Act. It is specifically expressed in 143(1)(b) that *in exercising any powers or performing any duties as manager (the manager) will act in the best interests of the scheme participants.*

It is expressed in the SIPO under *Investment Objectives – Treecrop* that the *investment objective is to maximise the return at harvest and to harness the scale and common interests of the investment with those of other investments managed by the manager to maximise the investment return.*

Relevant section from SIPO below -

Investment Objectives – Primary Assets

The investment focus is on the Primary Assets as they contribute most to the investment return.

Treecrop

Of the two Primary Assets, the Treecrop is projected to contribute the largest portion of the investment return. The return generated from the harvest of the Treecrop is enhanced by the silviculture operations performed on the trees (pruning and thinning operations), plus the quality of the harvest management.

The investment objectives for the Treecrop are -

1. To maximise the eventual return from the Treecrops harvest by undertaking industry best practice silviculture operations identified as being able to add value to the Treecrop; and
2. To maximise the return at harvest by using industry best practice harvest methods identified as being able to add value; and
3. To contract with quality service providers able to add value to the silviculture and harvest activities; and
4. To harness the scale and common interests of the investment with those of other investments managed by the Manager to maximise the investment return.

Forest Enterprises therefore has a legal responsibility to act to resolve the known challenges, in addition to our underlying business focus to achieve the best investment outcome for Investors.

The solution the company has devised is collective harvest by joint venture.

Collective Harvest by Joint Venture

Objectives of Each Collective Harvest Joint Venture

The objective of each collective harvest joint venture is to resolve as best possible the known harvesting challenges and specifically –

- To ensure the forests of each participant MIS can be harvested.
- To maximise the opportunity for a better (more profitable) harvest outcome for each MIS.
- To minimise the risks for each MIS including crop, access to domestic markets, access to port.

- To aim to achieve an average age at harvest of approximately 28 years (the original expectation in the historical Prospectus[1] for each MIS).

The objective is also to endeavour to meet Investors' expectations around timing of harvest, therefore timing of payment of the investment return. To a degree this objective must be compromised to achieve the other objectives, however most joint ventures will still finish collective harvest no later than 4 years after the harvest conclusion expectation set in the Prospectus.

The Collective Harvest Solution

Collective harvesting as a joint venture has no regard to each MIS's forest boundaries, instead harvesting is focused on the most cost-effective harvest of the entire area of joint venture forest over a harvest period which may be 6 to 10 years.

In most joint ventures, harvesting starts early (before the oldest trees are 28 years) and finishes late (after the youngest trees are 28 years). All other factors being equal, the quantum of stumpage per hectare will be less but early for the younger trees harvested and more but later for the older trees harvested. The balance between early and late harvest is targeted to achieve an average age of the trees at harvest of the original Prospectus target of around 28 years.

Collective harvest in this manner over 6 to 10 years creates the environment for each participant MIS to resolve as best possible the known harvesting challenges and achieve the targeted objectives.

Directly or indirectly, achieving the targeted objectives should translate into increased return or less risk of reduced return from the harvest. Consequentially, agreement by the MIS in each joint venture of the sharing of the total revenue from the collective harvest is a very important component of the joint venture.

Calculation of each MIS's Equitable Share of Collective Harvest

Overview of Collective Harvest Share Calculation

The underlying principle behind sharing the total revenue from collective harvest is that each MIS is better off receiving a percentage share of the total revenue from the collective harvest of the forests owned by the multiple MIS in the joint venture than 100% of the revenue from harvest of their forest.

A sharing methodology is required, and the methodology used is to calculate each MIS's forest crop value at the same date using the same assumptions, and to input the calculated figures into the following formula –

Percentage Shares =	**The percentage of each MIS forest crop value to the total of the forest crop values for all MISs in the joint venture**

Worked example of formula –

MIS Name	Forest Crop Value	Calculation of % Share	Calculated % Share of Collective Harvest
MIS 1	$10.5 million	$10.5/$43.0	24.42%
MIS 2	$15.0 Million	$15.0/$43.0	34.88%
MIS 3	$17.5 million	$17.5/$43.0	40.70%
Total Forest Crop Value	**$43.0 million**		**100.00%**

[1] Prospectus is the name of the disclosure document provided to Investors when the MIS was regulated by the Securities Act 1978. This document has been replaced in the FMC Act by the document called a Product Disclosure Statement.

Forest Crop Value

The benefit of using forest crop value is because the methodology is –

- Prescribed by International Accounting Standard IAS 41, the accounting standard for valuation of biological assets.
- Complies with the New Zealand Institute of Forestry valuation standard.

The calculation uses a subset of each MIS's projected Cashflow.

Given the application of the calculated value, a valid question is *Does IAS 41 result in a logical value of a forest crop, especially for comparison purposes with other forest crops?* As the name expresses, international accounting standards apply internationally and are arrived at via a consultation process. Sometimes these processes can produce a less than optimal result in specific circumstances. In the case of a New Zealand plantation Radiata pine forest crop, IAS 41 produces a logical value for a forest crop, especially for comparison purposes.

The figures in the Cashflow are gross (before tax) therefore the discount rate used is 10%. This gross rate is equivalent to approximately 7.5% on the net after tax Cashflow, which is an historically used targeted after-tax return for forestry investments.

Calculation, Checking and Reporting Shares to Investors

Forest Enterprises prepares the forestry and other inputs, enters these into each MIS's Cashflow, and calculates the resulting shares for each MIS in the joint venture.

The assumptions for the forestry inputs are reviewed by the Forestry Auditor (Forme Consulting Group Limited).

The Cashflow, the calculated forest crop value, plus the resulting shares of the collective harvest joint venture revenue are reviewed by the Financial Auditor (Staples Rodway).

Forest Enterprises prepares a report to Investors in each MIS setting out the relevant forestry assumptions, the calculated forest crop values, plus resulting calculated shares of the collective harvest revenue. Supporting this report are the review letters received by the Supervisor from the Forestry and Financial auditors.

The key measure against which the calculated harvest shares is reported is comparison with the percentage of net stocked areas of each MIS in the joint venture. This is because, all other factors being equal, the percentage allocation of harvest to each MIS would be the same percentage as the net stocked area. The differences in the calculated percentage shares is therefore explained and rationalised with reference to the actual hard data relating to valid actual differences between each participant forest in the joint venture.

Selecting MIS for Each Joint Venture

Key Characteristics of each Joint Venture

Collective harvest by joint venture results in multiple MIS forming a joint venture specifically for harvest.

The key characteristics of a collective harvest joint venture are –

- The relationship between the MIS in each joint venture is that of contracted parties.
- The nature of a joint venture structure is that a party is appointed the manager. This party is the common manager of each of the MIS, Forest Enterprises Limited.
- The joint venture concludes when the last merchantable logs from the collective harvest have been harvested (and the resulting funds distributed to the participant MIS).
- Each participant MIS continues as an autonomous investment entity having exchanged the revenue arising from harvest of 100% of the forest on their land for the right to an agreed percentage share of the revenue arising from the collective harvest by joint venture.

Joint Venture not to Undermine Fundamental Character of each MIS

The forestry MIS established and managed by Forest Enterprises since 1972 have embodied a consciously targeted character arising from the following key elements –

- Single rotation investment with harvest occurring at the end of the investment period.
- A boutique investment for personal not corporate Investors.
- An investment which provides personal ownership and control by the Investors.
- An investment which can be visited and enjoyed first hand, rather than related to only on paper.

The selection of MIS for each joint venture must therefore endeavour to preserve this fundamental character of the MIS and achieve the joint ventures objectives.

Selection Process

In most cases, the MIS for each joint venture select themselves. The obvious joint ventures are of MIS which are contiguous or located relatively close. Being contiguous is however not the only criteria necessary to achieve the objectives of the joint venture. Most objectives are achieved by a minimum scale of 600 plus net stocked hectares of compatibly aged forest, regardless of location.

Value Added by Forest Enterprises and Fees

Although collective harvest by joint venture is the underlying solution, and Forest Enterprises' role as the manager of the joint venture is pivotal to the joint venture's success, there is a second important element of value added by Forest Enterprises. This arises from Forest Enterprises ultimately managing 15 substantial collective harvest joint ventures.

Individually each joint venture will be of sufficient scale to attract the interest of major contractors across the whole gamut of harvesting and log sale service providers. However collectively these 15 joint ventures are of a scale which enables Forest Enterprises to interact with the service providers as if one major corporate forest owner which status translates into further economies and value to the joint ventures.

This larger scale also enables Forest Enterprises to attract top forestry professionals to manage the harvest, plus enter into logistics solutions such as –

- The rail yard at Waingawa on the outskirts of Masterton.
- The rail operation to transport logs by rail from the Wairarapa to CentrePort in Wellington.
- The leased storage space at CentrePort in Wellington.

Forest Enterprises' fee for the management of the joint venture is the company's standard harvest management and marketing fee of $3 per tonne plus 2.5%of the net stumpage (excluding the cost of roading and related infrastructure). No extra fee is payable for the operation of the joint venture as from Forest Enterprises perspective the joint venture is a harvest management and marketing arrangement for the mature trees owned by each MIS.

An establishment fee is also payable to Forest Enterprises at the time of formation of each joint venture of an amount approved as an element of the implementation vote by Investors. This fee is for the establishment of both the joint venture and the consequential limited partnership for the purposes of owning the land (Land LP) discussed under the heading *Collateral Consequences of Collective Harvest* on page 12.

Legal Documents Required for Joint Venture

Overview

The collective harvest by joint venture operates within a legal structure comprising the following two documents –

- Joint Venture Agreement.
- Forestry Right.

plus, the following documents arising from these -

- A registered Encumbrance over each Forestry Right.
- Deed of Custodianship.

Joint Venture Agreement

Overview

The *Joint Venture Agreement* is the agreement that sets out the contractual terms and conditions of the joint venture as agreed between the joint venture parties in respect of their mature trees for collective harvest. The parties to the Agreement are each MIS plus Forest Enterprises Limited as the manager.

Specific Terms of the Joint Venture Agreement

The following are the specific key terms (in addition to other usual terms of a joint venture) included to reflect the details of the unique collective harvest arrangement -

1. Each MIS is required to grant themselves a forestry right (further details under the heading *Forestry Right* on page 8) and to allow an encumbrance to be registered against their forestry right in favour of the other MIS in the joint venture (further details under the heading *Documents arising from Joint Venture* on page 9).
2. The MIS appoint Forest Enterprises Limited as manager to implement and manage the collective harvest on behalf of the MIS.

The joint venture agreement also -

1. Sets out the percentage share each MIS will receive of the net harvest proceeds arising from the collective harvest. Refer to heading *Calculation of each MIS's Equitable Share of Collective Harvest* on page 5 for further details.
2. Sets out the equitable treatment of any relevant harvesting undertaken by any of the MIS preceding the commencement date of the joint venture.
3. Agrees that the joint venture will conclude when the last merchantable logs from the collective harvest have been harvested (and the resulting funds distributed to the participant MIS).

Forestry Right

Overview

As set out under the heading *Joint Venture Agreement* on page 8, each MIS agrees to grant themselves a forestry right. A forestry right is a legal instrument which separates the ownership of trees growing on an area of land from the land itself.

Using a forestry right each MIS separates the mature trees they are contributing to the collective harvest under the joint venture, from the land. Doing so then enables each MIS to meet its further obligations under the joint venture to –

- Register an encumbrance over the forestry right to secure the interests of the other MIS in the trees under the collective harvest (refer to heading *Documents arising from Joint Venture* on page 9 for further details).
- To separately deal with their land as set out under the heading *Collateral Consequences of Collective Harvest* on page 12.

There are two parties to a forestry right -

1. <u>Grantor</u> – who is the land owner; and
2. <u>Grantee</u> – party being granted rights over the trees.

Initially these two parties are both the MIS itself, however for the reasons set out under the heading *Collateral Consequences of Collective Harvest* on page 12, each MIS's land is transferred to a new land owner (new limited partnership). The terms of the forestry right therefore reflect what is necessary to protect the rights of each party as different persons.

Section YA 1 of the Income Tax Act 2007 specifically excludes the granting of a forestry right to oneself from the definition of *dispose,* therefore as there has been no disposal of the trees there is no tax liability (no sale of the trees) arising from granting the forestry right.

Specific Terms of the Forestry Right

The following are the specific terms (in addition to the usual terms of a forestry right) included to reflect the details of the unique collective harvest arrangement -

1. No payment to the Grantor (land owner) for the forestry right (ownership of the trees). Payment is not necessary because the MIS is granting itself the forestry right in respect of mature trees for which the MIS has paid all the costs over the years arising from ownership of both the land and trees.
2. An annual rental not being paid by the Grantee for the use of the Grantors land under the trees until harvested, because the land remains owned by the MIS (but as a limited partner in a new limited partnership discussed under the heading *Collateral Consequences of Collective Harvest* on page 12).

The forestry right also -

3. Authorises the Grantee (plus its contractors, agents etc) to pass over any of the Grantors land, and as required construct roads, landings and necessary infrastructure anywhere on the land to facilitate the harvest of the mature trees in terms of the resource consents obtained by the Grantor.
4. Requires the Grantee to harvest according to the resource consents and other similar third-party obligations entered into by the Grantor.
5. Acknowledges that all Climate Change Response Act 2002 obligations are the Grantors.
6. Requires the Grantor to –
   a. To obtain all resource consents necessary to harvest the trees and construct the roads, landings and necessary infrastructure on the land to facilitate the harvest, in consultation with the Grantee (or the Grantees manager).
   b. Pay the rates.
   c. Replant the cutover land post-harvest.
   d. Take any insurance in respect of the trees and harvest liabilities.

   The rationale for the Grantor, not the Grantee, being responsible for these costs is discussed under the heading *Collateral Consequences of Collective Harvest* on page 12.

Documents arising from Joint Venture

Registered Encumbrance over Forestry Right

A forestry right is an interest in land as that term is defined in the Land Transfer Act 1952. Consequently, an encumbrance can be taken over a forestry right and registered against the land title(s). The joint venture agreement requires each MIS to register an encumbrance to secure the financial interest of the other MIS in the trees being contracted to the collective harvest under the joint venture.

Deed of Custodianship

The joint venture deals with scheme property (the trees) as that term is defined in the FMC Act. The FMC Act requires the Supervisor to hold scheme property, therefore the Supervisor of each MIS (Trustees Executors Limited) is the contracting party in the Joint Venture Agreement as custodian on behalf of the MIS.

The forestry right is in respect of the trees (which are scheme property) plus the land which is also scheme property. The Supervisor is therefore the contracting party in the Forestry Right as custodian on behalf of the MIS as the Grantee (party becoming the owner of the trees) and as Grantor (the land owner).

A Deed of Custodianship is therefore entered into by the participant MIS and the Supervisor which expresses the terms of the custodianship by the Supervisor consistent with the FMC Act and the MIS's governing documents.

Implementation of the Joint Venture

Overview

As discussed under the heading *Forest Enterprises' Responsibility to Act* on page 4, Forest Enterprises has a responsibility to act to address the challenges arising from the upcoming harvest of the 48 MIS under management. The solution the company has formulated is collective harvest by joint venture. The

authority and process for implementation of the solution is derived from the FMC Act and the MIS's governing documents plus Statement of Investment Policy and Objectives (SIPO).

Manager's Authority to Act

The power of the manager expressed under clause 24.1(h) of the *Deed of Scheme Management* include the power to enter into any joint venture arrangement or grant rights to any property of the limited partnership which is consistent with the Plan[2] and the objects of the limited partnership and which will directly or indirectly benefit the LP.

> (h) to enter into any arrangement to profit sharing union of interest, amalgamation, co-operation, joint venture, reciprocal concessions, licensing, distribution or otherwise with any person which is consistent with the Plan and the objects of the Limited Partnership and which will directly or indirectly benefit the Limited Partnership and to take or otherwise acquire or deal in choses in action, choses in possession, shares in securities of any such person and to sell, hold, reissue with or without guarantee or otherwise deal with the same and to grant licences and rights to any property of the Limited Partnership to any such person,¶

The current Plan anticipates the harvest of each MIS's trees by the MIS and not by collective harvest. The manager therefore cannot act until *the Plan is varied in accordance with the Limited Partnership Agreement*.

Variation of the Plan

Implementation requires a variation of the Plan. Clause 3.9 of the *Limited Partnership Agreement* of each MIS sets out the process for a *Variation of the Plan* -

> 3.9 Variation of the Plan
>
> Subject to the proviso to this clause if during the term of this Agreement the General Partner is of the reasonable opinion that it may be to the commercial advantage of the Limited Partnership to vary the Plan or that any variation of the Plan is necessary or desirable to protect the interests of the Limited Partnership then the General Partner may establish, maintain, manage and harvest the Trees on the Land in accordance with the Plan as so varied provided the General Partner first:
>
> (a) obtains an opinion in writing from the Forestry Auditor that the variation to the Plan may be reasonably regarded as being to the commercial advantage of the Limited Partnership or reasonably necessary or desirable to protect the interests of the Limited Partnership; and
>
> (b) wherever practicable the General Partner should give at least 20 Working Days' prior notice in writing to each of the Limited Partners of any intended variation of the Plan together with a copy of the Forestry Auditor's opinion in respect of the variation
>
> PROVIDED THAT it shall not be necessary to give prior notice to the Limited Partners of any variation of the Plan in an emergency situation or any other circumstances where delay in taking action would have been injurious to life, property, the Limited Partnership's interests or the public interest; and
>
> PROVIDED THAT no variation to the Plan shall be made if such variation would increase to any material extent the likely contributions to be made by the Limited Partners above the projected Capital Contributions set out in the Prospectus unless such variation is first approved by a special resolution of the shareholders of the General Partner.

The variation process has two elements –

1. <u>A compulsory element</u> - obtaining an opinion in writing from the Forestry Auditor that the variation may be reasonably regarded as being to the commercial advantage of the limited partnership (MIS) or reasonably necessary or desirable to protect the interests of the limited partnership.

[2] The Plan means the plan for planting, tending, maintaining, managing, harvesting trees on the land and carrying away any forest produce set out in the Prospectus as such plan may be varied from time to time in accordance with this agreement.

2. A conditional element - a special resolution of shareholders if such a variation would increase to any material extent the likely contributions to be made by the limited partners (Investors) above the projected capital contributions (calls paid) set out in the prospectus.

Opinion from the Forestry Auditor

The Forestry Auditor (Forme Consulting Group Limited) is therefore requested to review the collective harvest by joint venture and confirm or not that in their opinion this solution formulated by Forest Enterprises to the harvest related challenges identified is either or both *to the commercial advantage of the limited partnership (MIS) or reasonably necessary or desirable to protect the interests of the limited partnership*.

A copy of the Forestry Auditor's opinion is circulated available to Investors.

Special Resolution of Shareholders (Investors)

Technically the Plan variation does not require approval as it will *not increase the contributions to be made by Investors* as the objectives of collective harvest by joint venture are to *increase revenue and reduce the risk*.

Given collective harvest by joint venture is a unique and innovative solution, a vote on the variation to the Plan is incorporated into the one Investor vote for or against implementation. The resolution voted on is a special resolution requiring a 75% majority.

Implementation Additional Requirement – Binding Tax Ruling

When developing a major proposal for an MIS (or group of MIS) it is not unusual for the detailed work on implementation to identify additional requirements. One such additional requirement was identified, namely the desirability of a binding tax ruling on the tax status of the collective harvest by joint venture.

Collective harvest by joint venture results in each MIS agreeing to its mature trees being harvested collectively with the mature trees of the other participant MIS, and the net funds arising shared. The requirement for a binding tax ruling is to confirm that agreeing to its mature trees being harvested collectively with the mature trees of the other participant MIS, each MIS is not deemed by the Income Tax Act 2007 to be disposing of timber (trees) and the revenue account requirements of section CB 24 *Disposal of timber or right to take timber* applying.

Collective harvest by joint venture could not proceed if CB 24 applied as this would have the harsh and unreasonable consequence of each Investor having to pay tax from their own financial resources consequential to the execution of the joint venture documentation. The immediate tax payable would be on each Investor's share of the deemed disposal value of the trees to the joint venture. In return for having paid the tax, each Investor would receive a *Cost of Timber,* which is a tax deduction to carry forward for eventual offset against their share of the harvest revenue arising from the collective harvest by the joint venture.

Assurance that collective harvest by joint venture as proposed does not trigger this tax effect is essential, therefore a Binding Ruling on the underlying tax question(s) is to be requested from Inland Revenue. The tax experts at Deloitte Wellington have been engaged to assist Forest Enterprises with this process which is underway at the date of writing this Report.

Although no collective harvest by joint ventures can be implemented until this Binding Ruling is received, the implementation process is proceeding subject to obtaining the Binding Ruling.

Joint Venture a Managed Investment Scheme

The joint venture meets the FMC Act definition of a managed investment scheme. Fortunately, there are provisions[3] in the FMC Act which recognise that in the circumstances of use of the joint venture, the resulting MIS does not have to be registered under the FMC Act as a regulated MIS (as are the participant MIS), and the disclosure for a new regulated MIS completed.

[3] The carve out provision being relied on is Clause 3(3)(b)(ii) of Schedule 1 of the Financial Markets Conduct Act 2013 – Offer to wholesale investor.

Collateral Consequences of Collective Harvest

There are collateral consequences of collective harvest by joint venture. These consequences fall into two categories –

1. Impact on each MIS's Second Rotation Crop.
2. Impact on Certain Costs and Revenue for each MIS.

Impact on each MIS's Second Rotation Crop

When and where harvesting occurs determines when and where the next rotation of trees can be planted, therefore when and where the second rotation harvest can eventually occur.

Collective harvest as a joint venture has no regard to each MIS's forest boundaries, as a result an MIS could have all their land planted early or late, or potentially large and small areas of early and late plantings which may not even be over consecutive years.

Consequentially, individual MIS end up with sub-optimal age class mixes (and areas of age classes), plus materially different age classes between MIS. These factors would have a material impact on the value of each MIS's land and second rotation trees, and the impact will not be consistent across each MIS in each joint venture.

Impact on Certain Costs and Revenue for each MIS

When and where harvesting and subsequent replanting occurs also determines the quantum of certain costs and revenues, plus their timing, on each MIS including -

- Replanting – will occur at different times for different area sizes for each MIS.
- Forest insurance – mature trees cost more to insure than replanted trees.
- Carbon lease income – stops when trees are harvested which will be at different times for different MIS.

These cost and revenue impacts will not be consistent across each MIS in each joint venture.

Solution is Aggregating the Land of the MIS's

Overview and Outcome of Solution

The solution Forest Enterprises has devised to the collateral consequences of collective harvest by joint venture is the transfer of each MISs land to a new limited partnership for the term of the collective harvest, plus some specific obligations in the forestry right agreement on the Grantor (the land owner).

For reference purposes in this Report, the new limited partnership is called Land LP. Each joint venture group has its own Land LP. The limited partners in Land LP are the MIS themselves, not the Investors. This is consistent with Land LP being a land holding entity for the group of MIS for the duration of the collective harvest by joint venture.

The collective land ownership by Land LP, together with the specific forestry right obligations on the land owner, means that the responsibility and payment obligation fall on Land LP for replanting, forest insurance and also rates. It also means that –

- The carbon lease income becomes a revenue stream of Land LP, as does the management of the obligations under the carbon leases.
- The resource consents are the obligation and cost of Land LP, as is the management of the obligations arising from these consents.
- Any increase in land value is to the benefit of Land LP.

This shift in responsibility and payment obligation to Land LP completely addresses the consequences which would otherwise have arisen to varying degrees as inequitable positive and negatives on each MIS in the joint venture.

Impact of Solution on each MIS

The Land LP solution ensures that each MIS is put in an equitable position relative to the other MIS in the joint venture. This is because each MIS is better off with a percentage share of the responsibility and

payment obligations arising from ownership of shares in Land LP, rather than 100% share of the responsibility and payment obligations arising from continuing to own their land.

As this solution results in each MIS forgoing ownership of its land for shares in Land LP, agreement on the allocation of the shares in Land LP to each MIS is an important component of the solution.

Calculation of Each MIS's Equitable Allocation of Shares in Land LP

Overview of Land LP Share Calculation

The methodology that is chosen to allocate shares in Land LP to each MIS must result in an equitable allocation reflecting each MIS's contribution to Land LP. The number of shares allocated is both –

1. A proxy for each MIS owning their own land.
2. A responsibility and payment obligation sharing mechanism for the costs of land ownership including replanting, forest insurance, rates etc.
3. A responsibility and revenue sharing mechanism for the carbon leases.

As a proxy for continuing to own their own land, each MIS is interested to ensure they receive an equitable share of any increase in value of all the land to be held by Land LP.

As a responsibility and payment obligation/ revenue sharing mechanism, each MIS is interested to ensure it pays a fair share of the land ownership costs and receive a fair share of the carbon lease revenue.

One methodology considered for allocation of shares in Land LP was to use the same percentages calculated for share of collective harvest. This was discounted because the Forest Crop Value Methodology used for collective harvest shares reflects all variables relevant to the current crop and its harvest, however the allocation calculation for Land LP must accommodate different variables generally, and specifically in each MIS, including –

1. The emissions trading scheme land classification as Pre-1990 and Post-1989 and the consequential major difference in the treatment of the carbon sequestration asset – Post-1989 Land has a carbon asset during the rotation whereas Pre-1990 land does not.
2. Significantly reduced harvest infrastructure costs arising from re-using the infrastructure built and paid for by the first rotation which increases the net stumpage as a percentage of total sales revenue balanced against higher maintenance costs arising from maintaining the infrastructure which are a drag on the investment return.
3. Higher crop yields due to improved genetics which increases the net stumpage as a percentage of total sales revenue, plus starting net stocked areas and crop yields without the impacts of the unique events during the first rotation that impacted upon these areas now being harvested e.g. any wind, fire and disease events.
4. Sensible age class locations relative to the built infrastructure and ability to harvest sequentially at a selected age, which increases harvest volume and therefore stumpage as a percentage of total sales revenue.

From a first principles perspective, the contributed asset by each MIS to Land LP is their cutover land and the infrastructure built on that land during harvest. This perspective suggests that the current value of each MIS's cutover land and infrastructure is the value contributed and therefore should be the input into the following formula to determine the percentage shares allocated in Land LP to each MIS –

Percentage Shares =	**The percentage of each MIS current land value to the total of the current land values for all MISs in Land LP**

Although the inputs are different, the calculation principle in this formula is the same as for the collective harvest share calculation. The worked example under the heading *Calculation of each MIS's Equitable Share of Collective Harvest* on page 5 therefore demonstrates the same calculation approach.

The relevance of current land value is reinforced by the knowledge that generally current value of cutover forestry land reflects the following –

- Location relative to market.
- Distance in forest to public road.
- Terrain –
    - percentage hauler and ground-based harvesting; and

    - District Scheme classifications relating to erosion susceptibility.
- Climate Change Response Act 2002 land classification as either Pre-1990 Forest Land or Post-1989 Forest Land.
- Site index (300 Index) as a measure of forest crop quality and quantity.
- Aspect relative to the sun and also the prevailing wind.

Allocation of shares in Land LP is not about the absolute determination of the value of the land owned by each MIS, it is about identification of equitable relative value between the multiple MIS in Land LP. Market value is not necessarily a perfect input into determining equitable relative value for forestry land, another relevant input is the Land Expectation Value.

Land Expectation Value is a standard discounted cashflow technique used to calculate the value of bare land planted in a forest. The calculated value is the net present value of the cashflow using as the discount rate the targeted return from the forest use of that land.

Land Market Value plus Land Expectation Value Combination Used

After discussion with Mark Morice, one of the most experienced valuers of forestry land in New Zealand, (and in consultation with the Supervisor), it has been agreed that using a composite of 80% Market Value plus 20% Indicative Land Expectation Value will produce values fit for the unique purpose they are required.

Mark Morice has been contracted to produce the composite market value/ land expectation value inputs required for the allocation formula. It has been made clear in his briefing that the value inputs are required specifically for the allocation of shares in Land LP, and that the resulting allocation must reflect the comparative differences between the contributed cutover land and infrastructure being built on the land.

The process to be followed includes a physical or aerial inspection of each MIS, plus desk work. A short form report has been specified as the relevant supporting commentary is only required on anything which creates a material comparative value difference in the value of the land of each MIS.

Although it is important to equitably allocate shares in Land LP, the financial consequences of material differences in share allocation percentage are relatively immaterial at the Investor level, compared with the more material consequences of relatively immaterial differences in allocation of collective harvest shares.

The materiality difference between the collective harvest and land value allocations arise from –

- The quantum of investment return from the harvest being a factor 60 to 70 times the quantum of the return from land value.
- The costs arising in Land LP being shared in the same percentage as the shares allocated.

Reporting Land LP Share Allocations to Investors

Forest Enterprises reports to Investors the input values provided by Mark Morice and the resulting share allocations arising from the formula. Unlike the collective harvest share allocations, no independent review of this reporting by the auditors is needed as the input data is independently sourced from the registered valuer engaged.

Other Important Elements of Land LP Solution

Exclusion of Trees Not Part of Collective Harvest by Joint Venture

The Land LP solution addresses the collateral consequences arising from the collective harvest by joint venture of each MISs mature trees. Where an MIS has areas of forest not included in the collective harvest, these areas are removed from ownership by Land LP by a separate forestry right held by the MIS.

The terms of this forestry right are materially different to the forestry right over the collective harvest areas as the purpose is different. The terms reflect the purpose which is to secure the MISs ownership of these trees until the end of the collective harvest by joint venture and the planned winding up of both the MISs and Land LP. This is discussed under the heading *Land LP exists for the Term of the Joint Venture* on page 15.

Land LP Calls and Tax

The funding of Land LP to meet its costs is by way of Calls on the limited partners who are the MIS participants. These Calls are budgeted by each MIS and funded from the MIS's share of the collective harvest by the joint venture. The practical effect of these Calls on Investors is therefore the same as would have occurred without collective harvest and Land LP and each MIS having to fund the costs direct from their harvest proceeds.

As Land LP is a limited partnership, the tax consequences pass through to the limited partners (the MIS), then from the MIS to the Investors. Again, the practical effect of the tax consequences on Investors is the same as would have occurred without collective harvest and Land LP.

Forest Enterprises Fee for Establishment and Operation of Land LP

Forest Enterprises does not charge a further fee for the establishment and operation of Land LP. Forest Enterprises costs are recovered from –

- The fees discussed under the heading *Value Added by Forest Enterprises and Fees* on page 7.
- The standard per hectare fee ($28 per hectare at the date of this Report) charged each MIS.

Land LP exists for the Term of the Joint Venture

Land LP is the solution devised to address the collateral consequences of collective harvest by joint venture. Consistent with this purpose, and also consistent with the expectation in each MIS's Prospectus that the investment concludes at the end of harvest, the limited partnership agreement for Land LP expressly sets as the default that the land owned by Land LP will be sold following the conclusion of the joint venture.

The land sale will include the replanted second rotation forest on the land. The land sale will also include sale of the separate forestry rights for the trees not part of the collective harvest discussed under the heading *Exclusion of Trees Not Part of Collective Harvest by Joint Venture* on page 14.

On sale of Land LP's land, the following occurs –

1. The net sale proceeds are distributed to the limited partners (the MISs).
2. The net sale proceeds from the separate forestry rights sold with the land are distributed to the Grantee (the specific MIS which owns the trees).
3. Land LP is wound up.
4. Each MIS distributes the net funds received from Land LP from the land sale to the MIS Investors as the last distribution (all funds from collective harvest having already been distributed).
5. Each MIS is wound up.

This sequence of events results in each MIS being wound up at the end of harvest consistent with the expectation set in the original Prospectus for investment in each MIS.

Opportunity Preserved for Second Rotation Investment

Although the default requirement in Land LP's limited partnership agreement is for its land[4] to be sold, the separate existence and structure of Land LP preserves the opportunity for a second rotation investment. This option is available because –

1. Land LP is a limited partnership which is the legal entity currently used by Forest Enterprises for investments.
2. The second rotation trees arising from the collective harvest areas are owned by Land LP. The other trees not included in the collective harvest owned by some MIS by separate forestry right could be sold to Land LP.
3. For the same reasons that each MIS was selected for its group for collective harvest by joint venture, plus the positive consequences of the collective harvest[5], the land and trees owned by Land LP represent a viable second rotation forest, therefore investment.

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[4] Sale of the land includes sale of the second rotation trees planted on the land plus other trees not included in the collective harvest owned by some MIS by separate forestry right.

[5] The positive consequences of collective harvest include the second rotation trees being a spread of consecutive age classes able to be harvested by a continuous harvest program using existing roading and other infrastructure present on the land.

If it is the wish of Investors at the time, Land LP would be transformed into a second rotation investment as follows –

1. The documentation would be changed to the documents required for a second rotation investment.
2. A second rotation investment created.
3. The other trees not included in the collective harvest owned by some MIS by separate forestry right would be sold to Land LP.
4. The shares in Land LP held by each MIS would be devolved to the Investors in each MIS in the same proportions as the shares they hold in the MIS, resulting in the Investors personally holding the shares in Land LP, therefore the second rotation investment.
5. The existing MISs would be wound up to bring the current investments to an end.

Proceeding with a second rotation investment would require a unanimous decision by the limited partners (the MISs) in the Land LP. Each MIS would have an earlier vote on the proposal, and this proposal would be voted on by Investors in each MIS by Special Resolution requiring a 75% majority. To achieve 75% plus support, the proposal would include an acceptable exit mechanism for those Investors in each MIS who wish to exit at the conclusion of the first rotation to be able to do so. Forest Enterprises has relevant recent experience with these sorts of proposals.

Legal Documents Required for Land LP

Overview of Legal Documents Required for Land LP

Land LP is the solution devised by Forest Enterprises to the collateral consequences of collective harvest by joint venture. Each joint venture group has its own Land LP which is a limited partnership. The legal documents therefore comprise the –

- Limited Partnership Documents.
- MIS Land Sale and Purchase Agreement.
- Documents arising from Land LP and Sale & Purchase.

Limited Partnership Documents

Overview

Land LP is a limited partnership, the same investment structure as each participant MIS. A limited partnership comprises limited partners and one or more general partner. The MIS in the joint venture group are Land LP's limited partners and also the shareholders of the one general partner which is a company (Land GP Limited). This structure parallels the structure of each participant MIS, including the appointment of Forest Enterprises Limited Directors as the directors of Land GP Limited.

Land LP Limited Partnership Agreement

Land LP exists exclusively for the benefit of the limited partners (the MISs) as the owner of their land and consequentially responsible for paying certain costs, receiving any carbon lease revenue, and managing certain land owner and related obligations (e.g. resource consents).

The *Limited Partnership Agreement* therefore expresses this purpose, plus the powers and responsibilities related to the consequential land ownership outcomes.

A key clause in the *Limited Partnership Agreement* is the requirement that the land owned by Land LP must be sold at the end of the joint venture UNLESS the limited partners (the MIS) vote unanimously otherwise. This is a key element underlying the rationale for Land LP set out under the heading *Solution is Aggregating the Land of the MIS's* on page 12.

The *Limited Partnership Agreement* also –

1. Prescribes that the MIS limited partners vote according to the majority vote of the Investors in their MIS decided by a prior vote by these Investors. This means that the majority view of the underlying Investors in each MIS determines the outcome of a vote by the Land LP limited partners. Voting on any statutory or procedural matters does not require a prior vote by Investors.

2. Appoints Forest Enterprises Limited to manage Land LP (and for the company's directors to be the directors of the Land LP) as an extension of the company's responsibilities as manager of the MISs.

Land GP Limited Constitution

Land GP Limited exists exclusively to be the general partner of Land LP therefore its *Constitution* expresses this purpose and the resulting requirements as Land LPs general partner.

A key clause is the appointment of the Forest Enterprises Limited directors as the directors of Land GP Limited, consistent with their current similar appointment as directors of each participant MIS general partner company.

The *Constitution* also prescribes the same voting system for MIS shareholder votes as prescribed for MIS limited partners votes.

MIS Land Sale and Purchase Agreements

Each MIS completes a *Land Sale and Purchase Agreement* to sell their land to Land LP. The sale is subject to any *Forestry Rights* required to exclude trees which are not part of the collective harvest by joint venture, discussed under the heading *Exclusion of Trees Not Part of Collective Harvest by Joint Venture* on page 14.

The *Land Sale and Purchase Agreement* also specifically agrees (acknowledges) -

1. That the consideration for the sale is allocation of the agreed shares in Land LP. For further details refer to the heading *Calculation of Each MIS's Equitable Allocation of Shares in Land LP* on page 13.
2. That –
    a. Similar *Land Sale and Purchase Agreements* are being entered into by the other named participant MIS.
    b. The named MIS have entered into a Joint Venture Agreement for collective harvest of the trees secured by the listed *Forestry Rights* secured by the listed *Encumbrances*.
3. That Land LP (the Purchaser) will grant a *Right of Way* over the title(s) in the *Land Sale and Purchase Agreement,* and also the titles in the similar *Land Sale and Purchase Agreements* being entered into by the other named participant MIS. The *Right of Way* is to facilitate access to undertake the collective harvest expressed in the *Joint Venture Agreement* and in each *Forestry Right* pursuant to the *Joint Venture Agreement*.
4. That any existing encumbrance[6] granted in favour of Trustees Executors Limited will be removed from the title(s) on or before settlement. These encumbrances are no longer required as Trustees Executors Limited will end up holding the land as custodian for Land LP rendering any existing encumbrances redundant.

Documents Arising from Land LP and Sale & Purchase

Forestry Rights

A *Forestry Right* is required if the *Land Sale and Purchase Agreement* specifically refers to the requirement for a *Forestry Right* to exclude trees which are not part of the collective harvest by joint venture.

The *Forestry Right* includes the following specific terms (in addition to the usual terms of a forestry right) to reflect the unique purpose for the *Forestry Right* in the context of Land LP -

1. No payment to the Grantor (land owner) for the forestry right (ownership of the trees) because the MIS is granting itself the forestry right in respect of trees for which the MIS has paid all the costs over the years arising from ownership of both the land and trees.
2. An annual rental <u>not</u> being paid by the Grantee for the use of the Grantors land under the trees because the land remains owned by the MIS as a limited partner of Land LP.

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[6] Those MIS which own their land directly (their land is not held in custodianship by Trustees Executors Limited) have an encumbrance registered on the title(s) in favour of Trustees Executors Limited. This encumbrance means that any land dealings require the consent of Trustees Executors Limited, a similar investment protection outcome to direct custodianship.

3. The rates being paid by the Grantee (the MIS) equal to the expressed proportion of the land area under the *Forestry Right* to the total land area. This formula is worded so that it correctly carries through to the calculation when the land area becomes part of the total land area which transfers to Land LP from all the participant MISs.

Right of Way Agreement

The *Right of Way Agreement* implements the specific requirement expressed in the *Land Sale and Purchase Agreement* that Land LP will grant a *Right of Way* over the title(s) in the *Land Sale and Purchase Agreement,* and also the titles in the similar *Land Sale and Purchase Agreements* entered into by the other named participant MIS. The *Right of Way* is to facilitate access to undertake the collective harvest expressed in the *Joint Venture Agreement* and in each *Forestry Right* pursuant to the *Joint Venture Agreement*.

Agreement with Carbon Lease Company

Some of the MISs have carbon lease agreements with New Zealand Carbon Leasing (No. 1) Limited. The transfer of the land to Land LP requires the consent of the lessee, New Zealand Carbon Leasing (No. 1) Limited. The terms of this consent are expressed in this agreement, including the consequential outcome that the obligations of the multiple carbon leases for the multiple MISs will be managed as one by Land LP.

Deed of Custodianship

The land transfers to Land LP (and any forestry rights) deal with scheme property as that term is defined in the FMC Act. The FMC Act requires the Supervisor to hold scheme property, therefore the Supervisor of each MIS (Trustees Executors Limited) is the contracting party as custodian on behalf of each MIS.

The Supervisor is also the contracting party as custodian in respect of the *Right of Way Agreement* and the *Agreement with Carbon Lease Company*.

A Deed of Custodianship is entered into by the participant MIS and the Supervisor which expresses the terms of the custodianship by the Supervisor consistent with the FMC Act and the MIS's governing documents.

Implementation of Land LP

Overview

As discussed under the heading *Forest Enterprises' Responsibility to Act* on page 4, Forest Enterprises has a responsibility to act to address the challenges arising from the upcoming harvest of the 48 MIS under management. The solution the company has formulated is collective harvest by joint venture which solution requires transfer of the land to Land LP to address the collateral consequences of collective harvest by joint venture.

The authority and process for implementation of the Land LP element of the solution is derived from the FMC Act and the MIS's governing documents plus Statement of Investment Policy and Objectives (SIPO).

Disposal of a Primary Asset

The transfer of the land to Land LP is a form of disposal of a Primary Asset. The SIPO for each MIS (referred to on page 5) addresses the requirements in respect of disposal of assets –

> **Disposal of Primary Assets**
>
> The disposal of the Primary Assets is intended to occur at the conclusion of the investment which is following the harvest of the Treecrop. The disposal of some or all of the Primary Assets prior to the conclusion of harvest requires a supporting special resolution of Investors.

Manager's Authority to Act

The manager's authority to implement Land LP and arrange for the transfer of the land to Land LP therefore requires a Special Resolution of Investors as limited partners in their MIS. This special resolution is in addition to the Special Resolution the manager (with the agreement of the Supervisor)

considers is required to approve the Plan Change necessary for proceeding with the collective harvest by joint venture (refer to heading *Special Resolution of Shareholders (Investors)* on page 11 for further details).

Decision by Investors in Each MIS

Implementation of the collective harvest by joint venture is dependent upon passing of both Special Resolutions –

1. Approving the Plan Change
2. Approving the Disposal of the land

The two resolutions are therefore combined into one omnibus resolution, one Investor Vote, For or Against collective harvest by joint venture. This omnibus resolution also incorporates all related elements consequential to collective harvest by joint venture and use of Land LP.

Land LP a Managed Investment Scheme

The use of Land LP by the participant MIS to address the collateral consequences of collective harvest by joint venture meets the FMC Act definition of a managed investment scheme. Land LP itself is therefore a managed investment scheme. Fortunately, there are provisions[7] in the FMC Act which recognise that in the circumstances of use of Land LP, the Land LP MIS does not have to be registered under the FMC Act as a regulated MIS (as are the participant MIS), and the disclosure for a new regulated MIS completed.

[7] The carve out provision being relied on is Clause 4 (3) of Schedule 1 of the Financial Markets Conduct Act 2013 – Offer to close business associates.