WELLINGTON REGIONAL COUNCIL FORESTS

INTRODUCTION

The Wellington Regional Council ("WRC") has decided that it is "a seller of cutting rights at the right price, rather than a holder at all costs". Consequently, the WRC appointed PricewaterhouseCoopers to undertake a scoping study to test the market value attributed to its forest holdings and the marketability or level of interest in acquiring these forest assets.

In order to conduct this study, PricewaterhouseCoopers talked to a number of industry participants in phone conversations. In addition, PwC prepared a one page information flyer providing information about the WRC forests which was distributed to interested parties determined during the phone discussions. Of those that were interested, follow up phone calls were conducted and a more detailed five page document distributed. Their feedback on the market and valuation fundamentals is as follows:

COMPANY	PRICE EXPECTATIONS	VOLUME EXPECTATIONS	DISCOUNT RATE	DISCOUNT RATE COMMENTS	REAL PRE-TAX DISCOUNT RATE (ADJ)
Carter Holt Harvey	Positive for K-Grade and Domestic Logs, flat for A-grade	Positive to Korea, Japan still weak	8%-10%	Tending to 10% at this stage of the cycle	9.5%-10%
Fletcher Forests	Flat projections for the next twelve months	Positive, however, Japan remains weak, Korea slightly better	8%	Real WACC, Inflation 1.5%-2%	9.5%-10%
Weyerhauser NZ (RII)	Weak – no dramatic turnaround expected	Positive, although both Japan and Korea remain weak, the US is strong	10%-12%	This is the rate WeyCo would use to assess the WRC Forest	10%-12%

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COMPANY	PRICE EXPECTATIONS	VOLUME EXPECTATIONS	DISCOUNT RATE	DISCOUNT RATE COMMENTS	REAL PRE-TAX DISCOUNT RATE (ADJ)
Rayonier	n/a	n/a	> 9%	P.F. Olsen analysis of the Rayonier GMO Tasmanian transaction	> 9%
Hancocks Timber Resources Group	Flat in the Asian regions, however US pricing is robust following a 1998 downturn	Positive, especially to the US, has heard anecdotal references to a pickup in Asian demand	9%-11%	NZ discount rate, concerns over the "wall of wood" and the reliance on an Asian recovery to absorb this.	9%-11%
Evergreen Forests	Very positive, CEO believes current prices are 20%-30% below trendline and thinks prices will exceed this in five years time	Positive, both domestically and to Asia and the US	8%-10%	Generally uses the lower end of this range. Real pre-tax WACC. But note shares trade at a significant discount to NTA	8.5%
Wenita Forest Products	Flat	Positive to Korea, domestically, log prices may increase, but at the expense of its sawn timber cost structure			
Winstone Pulp	Flat at best, pulp and sawn timber pricing domestically and globally cannot sustain log price increases	Positive. However, the MD believes the "wall of wood" will shift the power from the forest owner to the processor	8.5%	Nominal **WACC.** **Difficult to sell forests at DCF valuation currently – points to Evergreen's 42% discount to NTA**	10%-10.5%

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COMPANY	PRICE EXPECTATIONS	VOLUME EXPECTATIONS	DISCOUNT RATE	DISCOUNT RATE COMMENTS	REAL PRE TAX DISCOUNT RATE (ADJ)
P.F. Olsen and Associates	Assume the price will increase modestly above current levels (higher oil prices increase the cost of alternative building materials such as concrete and steel) and then remain flat.	A logging ban in China will increase demand for large sawn timber, however, log stocks in Asia are quite high currently	> 9%	Discount rates have risen from the 8% the Hi kurangi forest was transacted on	> 9%
Steve Strand and Associates	Prices should increase in the Asian markets			Not much movement in rates over the last three years	
Dennis Neilsen and Associates	Flat at best for the next 18 months, K-Grade and Pruned logs offer the best prospects for a lift in price	Positive, however, this is predicated largely on selling superior quality logs compared to historical product	9.5%-12%	Nominal, WACC's are running higher at present than for previous transactions	10.5% 13%
Groome Poyry	Pruned and A-grade are expected to decrease in value, however K-Grade is more positive with a lift of approximately 30% expected, pulp is forecast to be flat.	Positive, GP expect all new product will be able to be sold, however, only K-Grade has an assumed ready market.	9.0% Range of 8%-10%	Real – pre tax range.	9.0%

Discount rate *(adj)* is adjusted to pre tax real interest rates based on responses and *1%-2%* adjustments for post to pre-tax and *inflation*

VALUE DRIVERS

This study was used to not only gauge interest in acquiring the Wellington Regional Council's forest, but to determine current influencing factors on forest valuations and whether now is an appropriate time to sell or hold. In conducting its valuation of the Wellington Regional Council's forests Groome Poyry used a 9% real pre-tax discount rate to value pre tax cashflows. This tax wedge is due to the up front costs incurred over the thirty years it takes to develop the forest. In addition, its pricing assumptions for Pruned and A-Grade logs was negative, while K-Grade approached parity with the larger logs. Pulp prices were assumed to be flat. Volume growth was expected to be absorbed by both international and domestic markets.

The market evidence supported some of these arguments, others had less support but based on a short term view relative to Croome Poyry. The tables below condense the responses regarding the valuation assumptions.

DISCOUNT RATES

	Discount Rate
One	8.5%
Zero	9.0%
Two	> 9.0%
Two	9.5% 10%
Two	10.0% 10.5%
Two	10.5% plus

Both the PwC discussions with the forestry market and the historical transactional analysis, infer a discount rate that is higher than the pre tax 9% used by Groome Poyry. Although it is hard to infer actual market practice, market studies have implied a 9% to 10% range for historical transactions, with smaller forest sales being conducted within the range of 9.5% to 10%. These transactions included the Hikurangi and Forestry Corporation sales though which were conducted when the price spike of 1993 was still thought to be a period that could be repeated, and real price increases of 1% p.a. were expected.

PwC's discussions with forest industry participants has identified the current view on pre-tax discount rates used to value forests currently as between 9% and 11%. This appears to be consistent with historical studies. In 1997, one study identified the average pre tax discount rate of 29 historical transactions in New Zealand as 9.5%. We have adjusted the discount rates to real pre-tax discount rates for comparability to the Groome Poyry analysis (see end column of table one). Assuming a 1% to 2% change in the discount rate from post tax to pre tax and the same change from nominal to real most discount rates were between 9% to 11%.

There are other methods for determining appropriate discount rates including the use of the capital asset pricing model (CAPM). This is used to derive the cost of equity capital which represents that return required by an investor to compensate them for the variability of the return on their investment, essentially pricing risk. PwC followed up the transactional analysis with an analysis based on the CAPM model. It identified the unlevered (100% equity) discount rate as ranging between 8.4% and 13.8%. These cost of equity estimates are subjective, however, it makes the 9.5% discount rate defensible from a theoretical basis.

	LEVERED COST OF EQUITY		UNLEVERED COST OF EQUITY	
	Real Cost of Equity Post-Tax (%)	Real Cost of Equity Pre-Tax (%)	Real Cost of Equity Post-Tax	Real Cost of Equity Pre-Tax (%)
Nuhaka	7.0	11.4	6.9	11.2
Opio	8.6	13.8	8.6	13.8
Evergreen	6.2	10.2	5.0	8.4
Fletcher Forests	9.0	14.4	7.3	11.9

Based on the risk free rate of 6.6%, an effective investor tax rate of 24.9%, expected market return of 9%, and individual equity betas adjusting for individual company gearing levels using the PwC specification of the CAPM pricing model, our estimate of the cost of equity for the New Zealand listed forestry companies are as shown opposite.

We believe that the current discount rate lies between 9% to 11% for the WRC forest, based on the preceding analysis. Recent reports imply a 1997 discount rate of 9.5%. With the Asian export markets deteriorating since that date and the size and scale of the forest that this discount rate has increased. Consequently a 10% discount rate is the most favourable discount rate we would use to value the WRC forest. The risk is that the discount rates will rise as interest rates are increasing and are likely to continue to increase or at best remain at current rates. The sensitivity of this model to changes in the interest rate is high, with a 1% change in interest rates increasing the discount rate by approximately 0.6% According to the Groome **Poyry** model, increasing the discount rate to 10% reduces the value of the forest by approximately $3.7m, which we believe may be appropriate given the market analysis and theoretical evidence.

There are other risks and influences on discount rates that could also impact value. Rather than adjusting the cash flows, these factors may be reflected in an adjustment to the discount rate such as;

POSITIVE POINTS;

Groome Poyry only valued one rotation of the forest, yet the WRC would sell the cutting rights to two rotations. Although this additional value is small due to the longdating of the cashflows, it may be of significantly additional value to an investor as it provides security of its investment.

The forest has been well tended and has undergone a rigorous silvicultural program, consequently, there is a high proportion of pruned logs, which are of greater consequent value to an investor.

It is located close to the Port of Wellington, which provides an excellent distribution point for export product.

NEGATIVE POINTS;

The WRC forest is small and unless other forests within the area are consolidated into the package an investor may apply a higher discount rate due to lack of scale.

The recreational/social requirement of the WRC's forests may reduce the value to an investor as it reduces the ability to harvest certain areas when prices are optimal (unlikely to be a material factor).

Some of the market's concerns over what discount rate was considered appropriate included the "wall of wood", where New Zealand's harvest is expected to double in the next decade. In particular, Hancock's concern over the wall of wood and New Zealand's reliance on Asia to absorb this surplus implied a higher discount rate in its valuations of New Zealand forest assets.

Most importantly, the value of the forest will be maximised by the level of contestability of the auction process. Currently there are one or two parties that have expressed a moderate level of interest in the forests owned by the WRC. Contestability will impact where the value of the forest sits within the range that a 9.0% to 11 .0% discount rate throws up.

	VOLUME EXPECTATIONS	PRICE EXPECTATIONS
Positive	Eight	Four
Flat	Zero	Seven
Negative	Zero	Zero

LOG PRICES AND VOLUMES

Price expectations for the various grades remain mixed, however, a positive slant to these expectations was prevalent. Current prices are believed to have bottomed, with Russian and Chilean producers approaching cash costs. The Japanese economy remains weak which will maintain current pricing for A-grade. The Korean economy is improving though, but while demand is robust, pricing remains flat for K-Grade.

Expectations over the next twelve to eighteen months are for prices to remain flat. Pulp prices globally will not support a lift in pulp prices, however, Pruned log prices may improve on the back of strong US demand. The generally accepted price expectation beyond eighteen months is flat.

Demand for logs is improving and future saleable volume expectations are for higher levels in the next twelve to eighteen months.

IMPLICATIONS FOR VALUE

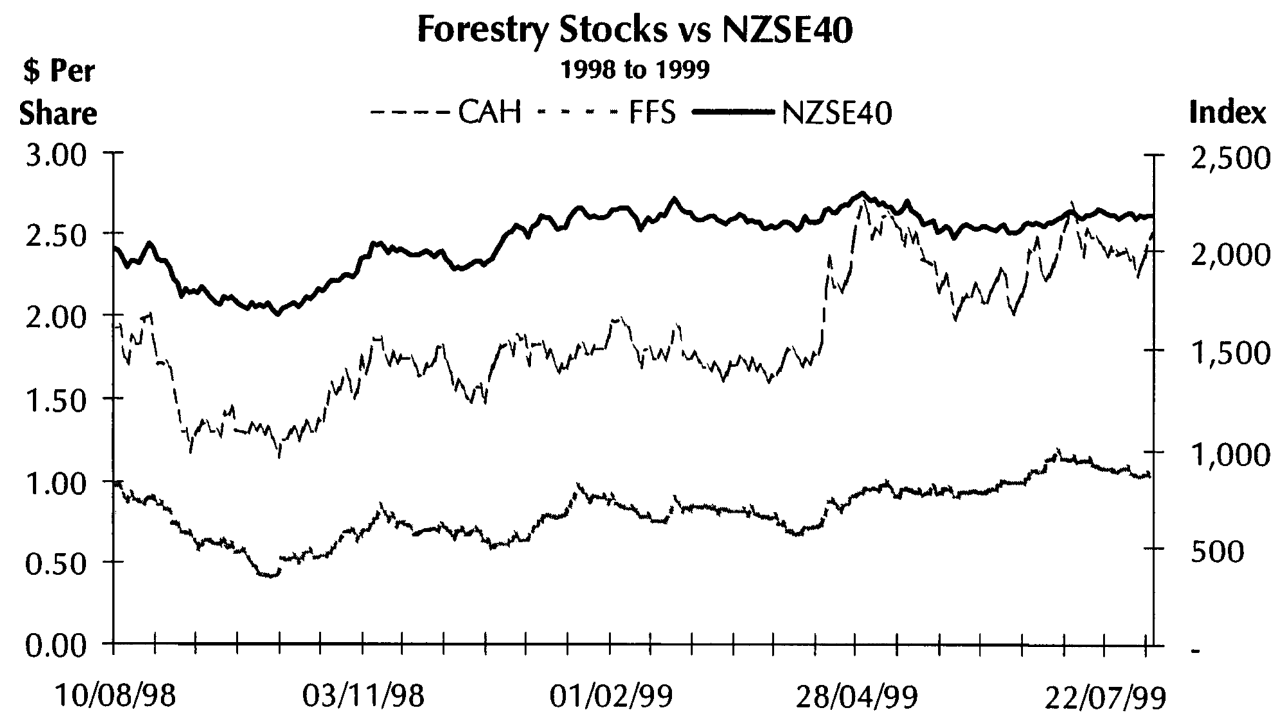
We agree that volumes will be saleable, however there are concerns over price. The “wall of wood” theory is a marked concern for some parties. The doubling of New Zealand’s wood harvest over the next decade will present difficulties for finding markets, and the reliance on Asian demand is also of concern. Despite this, we agree largely with the pricing that Groome Poyry has used. It appears that Pruned log values may increase though as the construction industry in Japan strengthens, with K-grade also increasing to achieve a greater level of parity with A-grade.

This greater pricing parity is expected to come at the expense of the quantity of K-grade and A-grade available for sale. NZ's large forestry firms are selling a log between A-grade and K-grade as a K-grade log. This implies that the amount of pulpwood available in the market will grow faster than previously expected. The expectation that Pruned logs will actually increase in value has implications for lifting the implied value of the forest. However, the possible increase in pulpwood availability and lowering of available saw logs from a tree will impact on lowering the forest value.

TIMING ISSUES

The feedback from the marketplace is that log prices will remain flat, at best small price increases are expected. The value of New Zealand's sharemarket listed forestry sector has recovered over the last year (see chart below). However, this is based on the halt to declining earnings as opposed to a significant lift in reported profitability. If log prices were to increase greater than expected, a significant increase in value could be attained, however, this would be likely to be offset by the impact that increased global demand generally has on high interest rates, which would increase discount rates and offset cashflow gains. Increased global demand would lift interest rates in two ways, firstly through higher inflation, secondly, an increase in demand is most likely to come from a rebound in Asian economies, if demand for capital from these economies should increase, so too will interest rates.

Consequently, it is difficult to see the value of the forest changing drastically as a result of a lift in log prices. In addition, Juken Nissho and others have pointed to Japan's economy as weak at best currently. The general perception is that nothing will change substantially in the next eighteen months to three years, as Japan's large corporates work through their financial difficulties. In the short term interest rates are likely to increase which will impact discount rates. Consequently, if the WRC chooses to wait for the Asian problems to be resolved, which could take up to three years, the value gain and increase in contestability that could result may be lost in terms of higher discount rates.



Since October 2 1998, the NZSE40 index has increased 31.2%. Carter Holt Harvey, and Fletcher Challenge Forests have both outperformed this index significantly, increasing 117% and 145% respectively. This has been influenced largely by the improvement in the Asian economies, particularly Korea, and increasing export volumes. Prices have not improved substantially, but have stopped decreasing at the rapid pace that they did in the first six months of 1998.

RECENT FOREST TRANSACTIONS

There has also been a high level of activity in terms of forest sales in the past year. The most recent of which includes the Hancocks Timber Resources Group's purchase of 411,000 acres from the Victorian government in Australia. This was completed in November 1998 and since then a further four announced deals in the Southern Hemisphere and the US have been completed. These latest deals are outlined in the table below.

RECENT TIMBERLANDS TRANSACTIONS (1998 TO 1999)						
Date	**Aquiror**	**Target**	**Value (US$m)**	**No. Acres**	**Value/A**	**Value/Ha**
May-99	RII (Weyerhauser)	Fletcher Forests (Forbio)	$60	62,424	$961	$2,307
April-99	GMO RR (joint Venture)	Rayonier	n/a	29,119	n/a	n/a
April-99	New Brunswick Government	Georgia Pacific Timber Ltd	$41	390,000	$105	$252
March-99	J.D. Irving Ltd	Bowater	$216	981,000	$220	$528
Nov-98	Hancock Timber Group	Victorian Plantations Corp.	$352	411,000	$856	$2,055

MARKETPLACE DISCUSSIONS

Attached below is the level of interest identified by PwC in its marketplace discussions:

COMPANY	LEVEL OF INTEREST
INTERESTED PARTIES	
Rayonier	Have been acquisitive in Australasia, but would be able to fully commit to a process starting later in the year. Genuine interest, with US based fund manager Crantham Mayo van Otterloo (GMO). They require clarity with respect to the recreational and social requirements that may impact on optimal management of the forest. Positives of the forest include closeness to deep water port and strong local market.
P.F. Olsen and Associates	Has two potentially interested parties, one American institutional investor (value driven) and a Korean investor looking to establish a MDF mill (through an intermediary).
Steve Strand and Associates	Two unnamed interested parties, a joint venture of US investors and an institutional investor (probably Rayonier/GMO).
forest Enterprises	Significant interest, very keen to show to an international investor, would want to move relatively quickly starting from late August
SOME INTEREST	
Dennis Neilsen and Associates	Some interest, may have a party that would be willing to look at this opportunity
Hancocks Timber Resources Group	Some interest
Evergreen Forests	Some interest, especially in a scrip merger
NO INTEREST	
Carter Holt Harvev	No interest

COMPANY	LEVEL OF INTEREST
Fletcher Forests	No interest
Weyerhauser NZ (RII)	No interest
Juken Nissho	No interest, its expansion plans are constrained by the poorly performing Japanese economy
Wenita Forest Products	No interest, debt was unsustainable before a new partner entered recently and cashflows are devoted to reducing debt further
Winstone Pulp	No interest, too small and outside Winstone's strategic catchment area
AMP Asset Management	No interest, looking at private equity options (MBOs etc).
Shell NZ	No interest, would not suit geography and is too small. May suit some Maori interests.
Todd Investments	No interest, exited Baigents 3 years ago.

CONCLUSION

We note that the expectation for value for the WRC forest would be based on discount rates towards the high end of the range indicated by Croome Poyry. For example, assuming a discount rate of 10% implies a value for the (existing) tree crop of $26 million. In terms of the market view, it is not clear that the next 18 to 36 months would provide any uplift in the underlying value of the forest, with any unexpected increase in prices likely to be offset by higher interest rates. The risk in holding the asset beyond 3 years is the uncertain long run trend in commodity prices. What is clear is the assumption of rising real prices is no longer valid.

In terms of marketability and contestability, we have identified two interested parties and four to five possibles. We feel the potential interest shown already by some parties could be fleshed out further to provide more useful information over the next month to fully test their interest. PwC would be happy to continue to develop and facilitate current interest levels to stimulate further interest in the forests.

In addition, further mapping requirements and a better definition of the asset would be required to facilitate a sale process. This time could be used effectively testing the full level of interest in the cutting rights.

We would propose to finally report back to you by mid September on the likely marketability/contestability of any tender for the asset.