

Discovering Risks in Due Diligence— Are you looking under every log?

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Due diligence exercises in the forest sector are carried out for a variety of reasons and by a diverse range of interested parties. The motivation for performing due diligence can come from conventional acquisition or divestiture activities, or simply to provide investors with comfort (or discomfort) regarding the state of their holdings. Interested parties include banks, venture capital or private equity firms, pension managers, timber investment management organizations (TIMOs), forestry and forest products companies, conservation organizations and individual investors.

Our approach to due diligence is driven by comprehensive risk discovery and rigorous financial analysis.

Given the diversity in the list of potential users of due diligence in forestry provided above, it is not hard to imagine that there is considerable variation in the level of understanding of the complexity of forestry as an investment. With some exceptions, it is reasonable to assume that parties directly involved in forestry—like TIMOs and forestry and forest products companies—have a knowledge advantage owing to their professional training and daily involvement in the sector. Other parties may be less well informed about factors affecting the success or failure (returns) of a particular investment in forestry. Level of understanding aside, all investors benefit from rigorous and comprehensive due diligence. A recent study by CIFOR (Spek, 2006)¹ discusses the failings of traditional due diligence procedures applied to investments in pulp mills (and associated forests providing fibre supply) by investment banks. A number of these investments led to substantial financial losses (for example Asia Pulp and Paper) and, in some cases, significant loss and degradation to natural forests.

The mechanics of due diligence ...

Due diligence can be separated into three distinct tasks, any combination of which can and may need to be applied for a particular assignment. The purpose here is not to give a comprehensive treatise on how to conduct due diligence, rather to decompose these assignments into distinct units of work and then explore briefly how these relate to forestry activities, and later risk discovery.

Financial due diligence attempts to answer the question: *Is the company or investment financially sustainable?* Financial due diligence involves a full investigation of the financial status of the company or asset and, normally, some projection of the expected financial performance of the entity into the future.

Is the investment financially sustainable?

¹ Spek, M. (2006) Financing Pulp Mills. An Appraisal of Risk Assessment and Safeguard Procedures. Center for International Forestry Research, 86 p.

It deals with typical accounting and business measures of company/asset health including assets and liabilities, balance sheets, income statements and pro forma.

Operational due diligence attempts to answer the question: *Is the company or investment environmentally, socially, and economically sustainable?* Operational due diligence entails a full investigation of the operational factors that affect the performance of the company/investment, covering a broad range of performance indicators including financial, environmental, social, and possibly economic. The link to financial performance comes from a testing or probing of assumptions related to production rates (tree growth, timber yields, logging capacity, long-term fibre supply etc.) that have a direct impact on production costs and revenue. Environmental, social, and economic performance also has financial implications as clearly financial liabilities could exist in any of these areas (e.g., undetected or disclosed site contamination), but they also determine the quality of the social license of the entity and the associated reputational risk an investor may incur which increasingly are important considerations in the investment decision.

Is the investment environmentally, socially, and economically sustainable?

Legal due diligence attempts to answer the question: *Is the company/investment legally sustainable?* Legal due diligence requires a full investigation of the legal status of the entity, which also affects the performance of the investment financially, socially, and environmentally. Compliance with the laws of the jurisdiction(s) where the assets are located or function is critical as is the systems in place to ensure ongoing compliance. Also important are contractual arrangements conveying rights and/or obligations covering things like land tenure or fibre supply.

Is the investment legally sustainable?

Risk Discovery – looking under every log ...

The due diligence process is accurately categorized by Spek (2006) as risk discovery—identifying and, where possible, quantifying the risks a target company/asset faces or carries. Note we make no distinction between risk and uncertainty here which might offend (or even infuriate) pure economists; however to simplify the language we are lumping risks which can be assigned probabilities for alternative outcomes (objective or subjective) with risks to which probabilities of alternative outcomes cannot be assigned (uncertain events).

Risk discovery applies equally to the three categories of due diligence discussed above. In financial due diligence, any factors that might affect the realization of, for example, cash flow in a given year, must be investigated and quantified if possible, and if not, at least discussed and classified as to their potential impact on the company/asset value (e.g., serious, potential deal breaker). Similarly, during operational due diligence all operational risks must be assessed and, where possible, quantified. For instance, a shortage of labor in a particular region may put the projected timber supply to a manufacturing facility at risk, or compromise the ability of a private forest land owner to sell its timber. Risks to the legal status of a company or asset may arise from any number of compliance issues, such as contractual interpretations or land tenure.

Risk discovery applies equally to financial, operational, and legal due diligence

There are unique risks in the forestry sector

While forestry operations share many of the “normal” risks associated with most other businesses including economic/sectoral risks, environmental risks arising from pollution, and employee/contractor health and safety risks, several risks are unique when compared to traditional manufacturing or even other “outdoor” activities such as agriculture or vineyards. For instance, forestry is a long-term investment requiring years, and more commonly decades, to come to fruition; consequently forecasts of future value require predictions of forest/tree growth and the yield of products. Predicting tree growth requires inventory data typically collected by sampling the population of trees rather than measuring all of them which introduces error (risk) into the estimates of important drivers of tree growth such as current tree size (diameter, height), density (number of trees per unit area), and numerous other important characteristics. So there are resource measurement risks.

Forests are also subject to various destructive forces that reduce growth rates, decrease the quality of final products, or kill trees outright. Some damaging agents can leave lasting effects on the landscape and reduce growth of future crops of trees. These risks to forests take the form of either biotic (insects and other living agents) or abiotic (fire, or weather-related agents) and can occur at different stages in the development of a forest (seedlings, young trees, or mature trees).

Other risks that are somewhat unique to forests arise from threats to biodiversity. These risks are fundamentally natural in origin as it is damage to other natural populations or their habitat that give rise to the risk, but are realized in socio-political or legal action or liability. An added twist to this particular type of risk is forest certification, which some might assume mitigates these risks, that is, if a company is certified to some international standard of forest practice or environmental management it must be managing the risks to biodiversity effectively. The facts of the matter are that not all certification systems are the same, not all certifiers are the same, and certifications can and are being challenged by environmental groups on the basis of purported inadequate protection of biodiversity.²

Be sure to look under every log!

What does all this mean to prospective investors in forest land or forest products companies? It means that the traditional scope of due diligence exercises must be expanded to include the full set of risks associated with the unique circumstances of forests and wood products manufacturing. It also means that professionals with a wide range of technical expertise should be chosen for due diligence assignments to ensure that all risks are identified, quantified, and incorporated into the business valuation and considered carefully when the decision is made whether or not to invest.

Unique risks in the forestry sector include:

- long investment timeframes
- random external destructive agents
- threats to biodiversity
- forest certification

² Sierra Legal Defense Fund, Newsletter No. 44, Sept. 2005, pg. 2.