

Willmott Forests

Forestry business offering value

MIS season enters key period

- WFL enters the peak MIS sales season in June in its strongest position for many years. A funding deal with CBA and a land leasing deal with Hancock address the two main constraints faced by MIS operators.
- Increases in doubtful debt provisions recently announced by peers are company specific in our view. We believe that WFL will not face similar pressures as CBA funds the majority of grower loans with immediate cash payment to WFL. We believe that WFL's lending criteria is stringent, with CBA entrusting WFL with loan processing and administration.

WFL's substantial land holding

- WFL owned approx 27,500 ha of land at June 2007, valued on the balance sheet at cost of \$2600/ha. This value is impacted by the long term leases to growers which encumber the land.
- The price paid for forestry land has increased at a CAGR pf 5.2% from 1983-2007 and at 18.9% from 2000-2007, based on a sample of land purchases in Victoria and NSW.
- The replacement value of the land is substantially higher than book value. Applying a price of \$4300/ha, which is indicative of recent prices paid in Bombala, yields a value of \$118m or \$2.00/share.
- WFL continues to purchase land and is therefore impacted by rising prices. WFL manages its costs through utilising leased land.

There's more to WFL than MIS

- WFL comprises several value drivers in our view: An MIS business, a substantial land bank, a receivables book underwritten by forests (and leveraged to future timber prices) and a JV milling operation with 20+ year wood supply.
- Our valuation methodology understates the value of WFL, as it doesn't recognise the current value of the land bank (and the potential future value) and doesn't recognise the full fee stream to be earned at harvest, which is also leveraged to future timber prices.
- The JV executed with Dongwha, a global manufacturer of wood materials and timber processing company, transforms WFL into an integrated forestry company with scale and long term wood supply. The JV reduces reliance on MIS and is forecast to contribute significantly to earnings from FY11.

WFL.ASX

BUY

Thursday 29 May, 2008

Price	\$1.37
Target price	\$2.74
DCF valuation	\$2.74
Target valuation method	DCF

GICS sector	Materials
Avg monthly t/o	m 0.9
Diluted mkt capitalisation	\$m 81
Shares on issue	m 59
Enterprise value	\$m 144
Previous rating	Buy

Year Ended June 30		07A	08E	09E	10E
Operating revenue	\$m	69.1	74.7	70.4	83.6
EBITDA	\$m	19.0	21.7	27.3	30.4
EBITDA margin		27.5%	29.0%	38.8%	36.3%
EBIT	\$m	17.1	19.3	24.6	27.6
EBIT margin		24.7%	25.9%	35.0%	33.0%
Adjusted NPAT	\$m	8.1	9.0	12.1	13.8

EPS adj	c	14.3	15.0	21.2	23.7
EPS adj growth		-31%	5%	42%	12%
DPS	c	10.0	10.0	11.0	11.0
Franking		100%	100%	100%	100%
PER	x	9.5	9.1	6.4	5.8
PER rel Ex-100 ex Fins	x	46%	50%	39%	40%
Dividend yield		7.3%	7.3%	8.1%	8.1%
NTA/share	\$	1.55	1.50	1.58	1.73

EV/EBITDA	x	6.1	6.7	5.3	4.7
P/OCF	x	9.2	8.3	6.1	5.5
ROA		4.2%	4.4%	5.0%	5.2%
ROE		8.5%	9.8%	12.6%	13.1%
ROIC		9.6%	9.5%	11.5%	11.9%
Interest cover (EBIT)	x	4.0	3.7	4.6	4.4

WFL vs XSO



Source: IRESS

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Willmott Forests Ltd (WFL)

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Profit & Loss

Year ending June	2007A	2008E	2009E	2010E
Revenue:				
Operating revenue	69.1	74.7	70.4	83.6
Operating expenses	50.1	53.1	43.1	53.2
EBITDA	19.0	21.7	27.3	30.4
D&A	2.0	2.3	2.7	2.8
EBIT	17.1	19.3	24.6	27.6
Net interest	-4.2	-5.2	-5.4	-6.2
EBT	12.8	14.1	19.3	21.3
Tax	-4.4	-5.1	-6.6	-7.2
Reported NPAT	8.1	9.0	12.1	13.8
Non-recurring items	0.3	0.0	0.0	0.0
Adjusted NPAT	8.1	9.0	12.1	13.8

Cashflow

Year ending June	2007A	2008E	2009E	2010E
EBITDA	19.0	21.7	27.3	30.4
Increase in working capital	-6.8	-1.6	-2.1	-2.1
Net Interest	-1.2	-5.2	-5.4	-6.2
Income taxes paid & other	-2.2	-5.1	-6.6	-7.2
Cashflow from ops	8.8	9.8	13.2	14.8
Capex	-18.1	-29.2	-19.7	-19.5
Total FCF	-9.3	-19.4	-6.5	-4.7
Other investing cashflows	92.7	-2.9	0.0	0.0
Borrowings	-44.7	0.0	0.0	0.0
Equity raisings/(buybacks)	0.4	0.0	0.0	0.0
Dividends paid	-5.9	-5.9	-6.2	-6.5
Net change in cash	33.3	-28.2	-12.8	-11.3

Balance Sheet

Year ending June	2007A	2008E	2009E	2010E
Cash	46.2	18.0	5.3	-6.0
Debtors	30.2	22.2	27.8	32.3
Other current assets	20.0	22.0	22.8	23.9
Current assets	96.4	62.2	55.9	50.3
Debtors	56.2	55.7	55.1	54.6
PPE	88.6	114.1	131.2	148.0
Intangibles	2.7	2.7	2.7	2.7
Other non-current assets	19.1	27.6	37.6	51.6
Non-current assets	166.7	200.1	226.6	256.8
Total assets	263.0	262.4	282.5	307.1
Payables	17.7	14.2	17.1	21.0
Short term borrowings	3.1	3.1	3.1	3.1
Other current liabilities	48.0	52.5	66.1	69.3
Total current liabilities	68.9	69.9	86.3	93.4
Long term borrowings	77.9	77.9	77.9	77.9
Other non-current liabilities	21.2	17.8	16.9	16.1
Total non-current liabilities	99.1	100.7	99.5	107.9
Total liabilities	167.9	170.5	185.8	201.3
Net assets	95.1	91.8	96.7	105.7

Market Measures

Year ending June		2007A	2008E	2009E	2010E
EPS reported	cps	13.9	15.0	20.4	23.2
EPS adjusted	cps	14.3	15.0	21.2	23.7
EPS growth	%	-31%	5%	42%	12%
PE multiple	x	9.5	9.1	6.4	5.8
PE relative (ex-100)	%	46%	50%	39%	40%
EBITDA per share	cps	32.0	36.4	45.9	51.0
EBITDA growth	%	-14%	14%	26%	11%
P/OCF	x	9.2	8.3	6.1	5.5
FCF per share	\$	-0.16	-0.33	-0.11	-0.08
FCF yield	%	nm	nm	nm	nm
DPS	cps	10.0	10.0	11.0	11.0
Dividend yield	%	7.3%	7.3%	8.1%	8.1%
Franking	%	100	100	100	100
Enterprise value	\$m	116.0	144.2		
EV/EBITDA	x	6.1	6.7	5.3	4.7

Profitability & Liquidity Ratios

Year ending June		2007A	2008E	2009E	2010E
ROE	%	8.5%	9.8%	12.6%	13.1%
ROA	%	4.2%	4.4%	5.0%	5.2%
ROIC	%	9.6%	9.5%	11.5%	11.9%
NPAT/sales	%	11.8%	12.1%	17.2%	16.5%
EBITDA/sales	%	27.5%	29.0%	38.8%	36.3%
EBIT/interest	x	4.0	3.7	4.6	4.4
Gearing (ND/[ND+E])	%	27%	41%	44%	45%
NTA/share	\$	1.55	1.50	1.58	1.73

Valuation

	\$m	\$/share
NPV of Cash Flows	-4.9	-0.08
Terminal Value	39.6	0.68
Net Cash (Debt)	-34.8	-0.60
Land and receivables	133.4	2.30
DCF value	133.3	2.30
DCF JV (50% share)	26.2	0.45
DCF Total	159.6	2.74
Price target*		\$2.74
Upside/downside		101%
DCF		

WACC

Risk free rate of return	6.0%
Post-tax cost of debt	6.3%
Equity risk premium	5.5%
Beta target	1.0
Cost of Equity	12.6%
Terminal Growth Rate	2.0%
WACC	10.1%

Company Statistics

Current share price	\$ps	\$1.37
Ordinary shares	m	59.5
Options	m	0.0
Diluted market capitalisation	\$m	\$81.2

WFL's land assets

The majority of the forests managed by WFL are owned by third parties however the land on which the forests are planted is mostly owned by WFL. Out of a total plantation area of 31,000ha under management at June 2007, WFL owned 27,500ha. The land is encumbered by an obligation to the MIS investors, preventing WFL from re-using this land until the trees are harvested. This obligation to MIS investors complicates the valuation as land is encumbered by long term leases which have an impact on present day value. Accordingly, WFL currently values its land assets at cost.

The hidden value of forestry land

The use of the land for second rotation planting will yield significant value to WFL as it reduces the upfront cash investment in land. While the majority of WFL's land will not be available for second rotation for approx 15-20years, the capital appreciation of the land provides an ongoing return. This return, as measured by the average price per ha paid for a sample of land has increased at a CAGR of 5.2% from 1983-2007. The CAGR from 2000-2007 has been 18.9%.

The land assets are also generating a return in the form of the lease payments charged to MIS investors. This payment is deferred until harvest and is currently levied at a rate of 2% of harvest proceeds (2007 PDS). This rate is enhanced by rising timber prices which increase the expected harvest proceeds. WFL will therefore benefit from rising prices of agricultural land (capital appreciation) and rising value of timber assets (lease payment), both of which are not fully captured in our current valuation method.

We believe that the combination of lease payment and capital appreciation exceeds the cost of capital over the long term.

A breakdown of WFL's value

We believe that WFL comprises several value drivers:

- 1) An MIS business which is forecast to earn EBIT of \$17-\$18m in FY08.
- 2) A land bank of 27,500ha.
- 3) Receivables due from growers at the time of harvest, which are underwritten by the value of the growers' trees.
- 4) A milling JV which has a wood supply agreement with Forests NSW for a term of 20+ years.
- 5) Investment in Ethanol Technologies Ltd – developing a pilot plant for Lignocellulosic ethanol production. We do not attribute any value to this in our valuation.

Our current valuation method

We currently value WFL using a combination of: DCF valuation of the MIS business (\$0.60/share); book value of land and receivables (\$2.30); DCF value of the half share of the JV (\$0.45); less the value of net debt (\$0.60). This yields a total value of \$2.75 per share.

We believe that this method of valuing WFL is conservative for the following reasons:

- The DCF valuation of the MIS business is impacted by the substantial cash requirement for purchasing land. This cash outflow reduces FCF forecasts in the medium term, as well as the FCF base used to derive a terminal value. The MIS business should still recognise a charge for land, as this is a cost of providing the product, however that cost should be substantially lower than the cost of purchasing the land.
- WFL charges a land rental fee to MIS investors set at 2% of gross harvest proceeds (2007 PDS). This should be recognized in the FCF forecasts however we exclude it as the harvest period is approx 25 years after planting, making it difficult to determine an appropriate value. Furthermore, there is a maintenance fee of 7% of gross proceeds that is charged at harvest that is also not captured through the FCF forecasts. WFL recognises heavily discounted lease and maintenance fees in current earnings.
- Both the land rental fee and maintenance fee have an in-built escalator - the value of the timber increases over time, therefore the value of the harvest and the accruing fees is increasing. (This highlights one of the attractive characteristics of timber as an asset class – a component of its value is related to the natural growth in the tree).
- Land is valued on the balance sheet at cost. The average price paid for land, in a sample of purchases across Victoria and NSW, has increased at a CAGR of 18.9% from 2000-2007. Applying a price of \$4300/ha to WFL's suggests that the replacement value of the land bank would be \$118m.

An alternative valuation method

By changing our method of valuing the MIS business from DCF to EBIT multiple, and valuing the land at replacement cost an alternative per share valuation of WFL is derived:

- MIS business at an EBIT multiple of 2.7-3.5 times: \$0.80c - \$1.
- The land bank at current replacement value of \$118m: \$2.00/share.
- Non current receivables: \$0.95/share – no change from current method.
- WFL's share of the proposed JV: \$0.45/share – no change from current method

The combined value, less the value of net debt, would be \$3.60-\$3.80 per share.

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RATING

BUY – anticipated stock return is greater than 10%
 SELL – anticipated stock return is less than -10%
 HOLD – anticipated stock return is between -10% and +10%
 SPECULATIVE – High risk with stock price likely to fluctuate by 50% or more

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