

Prospectus must answer pertinent questions

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Critics of Wool Partners International Ltd (WPI) have been circulating an analysis which makes for interesting reading.

The document claims that the forthcoming float will be financing “a loss making wool business which has yet to prove itself”. It also alleges that PGG Wrightson “will have made considerably more money from financing the sale of their wool business than they ever made from it trading.”

The analysis is well documented. It shows a careful scrutiny of Company Office filings and annual reports of PGW. Footnotes have been read diligently. Some aspects of disclosure are noted as being unclear; a comment I agree with.

What is clear is that WPI not been profitable and PGW has been acting as banker to it and to Wool Grower Holdings (WGH).

The sale of PGW’s strong wool business to WGH was announced in May 2008 and completed in July 2008. The notes in PGW’s 2008 annual report show the wool operations had contributed profits of \$1.6m in 2007 and \$3.0m in 2008. Net cash flows from Operations had been positive, \$2.1m in 2007 and \$3.0m in 2008. The net identifiable assets being disposed of totalled \$10m at book values.

The sale gave rise to a profit of \$17.6m according to PGW’s 2009 annual report.

Questions which immediately arise are “What assets were so undervalued that the profit, \$17.6m, was almost 50% of the selling price, \$37.5m?” Were they tangible assets, or intangibles such as brands or goodwill?”

An equally important question is “If they were intangibles, what is their value now in the light of the results for 2009 and 2010?” In 2009 and 2010 WPI recorded losses of \$3.9m and \$1.8m respectively. These results would cast doubts on a high value for goodwill, brands or other intangibles.

Potential investors will be looking to the prospectus for clarification of this important point. The sale of its wool business gave PGW 40 of the 100 voting shares in WPI, 10 million \$1 “Industry Shares” which have an entitlement to annual dividends of up to 12.5% and which are cumulative, and 17.5 million \$1 Convertible Preference Shares. The dividends on the latter are cumulative and are set at 5% above the 90 day bill rate.

Note 12 of the 2008 report of PGW indicates that the sale of the wool business involved the transfer of bank overdraft or loans of some \$16.1m along with trade and other payables of \$4.2m.

It is clear that both WPI and WGH may not be flush with cash. The 2010 PGW annual report notes the \$17.5m of redeemable preference shares was “a loan” to WPI and additionally there was “an advance of \$11.924m” to WGH.

The critics’ analysis says the loan appeared to have been \$10m originally, which suggests an interest rate of about 19% pa. The prospectus should provide details of all indebtedness and associated interest costs.

The critics also note that a forecast repayment from WPI of \$3.5m “is now deferred until the following year.” Readers of the prospectus will be looking for some explanation of this situation.

The critics’ concerns about the lack of profitability, and the accompanying lack of cash flow, appear to be well founded.

Of justifiable concern to the critics is the fact that although WPI made a loss of \$1.835m in 2010, PGGW has recognised a profit relating to WPI totalling \$967,000. This is possible because accounting standards permit or require the “derecognition” of previously recorded losses.

There are, sadly, many examples of accounting standards producing meaningless numbers; figures which do not represent reality and which are not useful for decision makers. The critics are correct in saying that “it is extremely difficult to understand how losses of an associate can be interpreted as profits.”

The finance provided by PGW to WPI and WGH carries with it high costs. Clearly PGW expect repayment. The forthcoming float by WGH will be an important source of funds for WPI and WGH. Cash flow reports and forecasts will be important information in the prospectus.

To date the publicity from WPI and PGW describes WGH as a “grower owned co-operative”. It is not –yet. Unless the prospectus provides a clear route by which it will become one, it is likely that the business model will remain one where control is firmly in the hands of a small number of large investors.

But whether farmers will be prepared to put money into an organisation depicted as “a loss making wool business which has yet to prove itself” is an open question. Much will depend on the openness with which the prospectus presents its case and whether it answers the questions raised by the critics.

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