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Iwi Distribution Policy:
Supplemental Report

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IWI DISTRIBUTION POLICY

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Introduction

This report is a companion document to the major release published in December 2012 “Distribution and Spending Policies: Considerations for Iwi”[1]. In that report we looked at methods used by permanent investment funds overseas for allocating their annual returns between (i) making further investments and (ii) withdrawals for current spending purposes (“distributions”).

The organisations we looked at needed to maintain their asset base in perpetuity, while balancing conflicting objectives, such as:

- achieving intergenerational fairness (commonly also referred to as “intergenerational equity”);
- maximising wealth;
- protecting against inflation; and
- providing stable annual distributions for spending.

There are of course other objectives, but we will focus on these four to keep the discussion manageable.

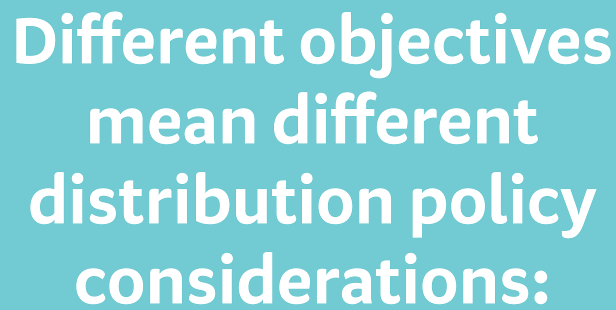
The calculation method for determining distributions used by Yale and Stanford universities in managing their endowment[2] funds is often cited as an example of leading practice in the US. It uses a weighted average of (a) last year’s distribution and (b) the market value of the investment fund multiplied by the policy target distribution rate (e.g. 5%). This method is designed to provide stability in annual distributions and to be responsive to changes in the value of the investment portfolio.

The principles behind these types of methods provide a useful platform when looking at the portfolios of iwi and other Maori organisations managing permanent investment portfolios (hereafter in this note we will mainly use the term “iwi”, just to keep the word count down). The methods themselves can be directly applied where iwi have market portfolios comprising bonds, term deposits, shares in public companies and the like.

However, in situations where iwi have portfolios dominated by direct holdings of property and commercial business enterprises (which many do), additional considerations are needed. Those considerations are the focus of this report. First we outline some core concepts, then we pull them together and illustrate with a mock example.

1. Copies available on request. Please refer to this document for background information and terminology.

2. An endowment fund is an investment fund formed from donations. They are often used throughout the world by the likes of universities, hospitals and charitable organisations. The organisations withdraw money from the funds regularly to meet expenses and finance initiatives.



Different objectives mean different distribution policy considerations:

What are the distribution implications when some property assets are retained in perpetuity?

As with an investment policy, clearly defining key objectives is a critical first step when establishing a distribution policy. A key area where the objectives of iwi might differ from those of a typical diversified portfolio is in relation to important tribal land and other property assets. For example, an iwi may prefer to retain land holdings of tribal significance in their local region, and develop them further; whereas a typical portfolio manager might prefer to own shares in a collection of property holdings, diversified geographically (around NZ and also offshore) and by sector (eg farm property, retail sector property, office property).

Some aspects of modern distribution methods were introduced to handle capital gains

To understand what this might mean for an iwi's distribution policy, we need to take a step back and look at how some of the modern methods for calculating distributions came about. Here is a quick recap on how distribution rules used by US endowment funds evolved from initial "income only" approaches:

1. **12th century** – Rental income from land holdings was used to support religious organisations. Land values and rents tended to rise over time.
2. **Early 1900s** – The predominant assets of endowment funds had shifted to Fixed Income investments. Distributions were sourced only from income earned, not from principal capital.
3. **1950s-1960s** –Endowment fund managers increased their focus on share market investments, which deliver a large part of their returns in the form of capital gains. This meant a distribution policy was needed to determine what portion of capital gains should be realised (e.g. shares sold) and proceeds distributed. Methods were developed whereby a set percentage figure (e.g. 5%) is applied to the value of a portfolio as part of the distribution calculation. This type of method is prevalent amongst modern permanent funds.

But if a particular individual asset is retained in the portfolio permanently, the capital gains are never "cashed in" by selling the asset

Now, if an iwi has decided to keep a particular income-earning property asset (e.g. dairy farm, orchard, commercial building) in perpetuity because of its intrinsic tribal significance, then there won't be any capital gains realised, because the property is never sold. So, as far as that particular asset is concerned, the distribution policy formula doesn't need a component to handle returns from capital gains.

However, ignoring returns from capital gains for these assets doesn't necessarily mean iwi members are missing out on something. For example:

- One reason assets increase in value is because their income potential improves. Let's say farm values rise because forecast dairy pay-outs for the next three years increase. By retaining ownership of the farm, the owner doesn't get an immediate benefit from cashing in the capital gain in property values. But they do benefit from higher dairy pay-outs over the next 3 years, assuming higher pay-outs eventuate.

Key point: *Where significant income-earning tribal property assets are to be retained in perpetuity, some distribution policy considerations will differ from those of a typical "permanent fund" (such as many US university endowment funds), particularly in relation to capital gains.*

Common distribution policy objectives can still be met

Let's look at the situation of an income-producing property asset that is held in perpetuity, in the context of the four common objectives we outlined in the introductory section. Assuming the condition of the asset is maintained over time (by appropriate investments, financed by the earnings of the asset), capital gains are ignored and all surplus income* is distributed, then:

- **Intergenerational fairness** is satisfied by providing each generation with the same parcel of productive land or property asset to benefit from. As opposed to the alternative of providing future generations with a constant (in inflation adjusted terms) portfolio of invested cash.
- **Inflation protection** is already "built in" - at least to the extent that over the very long term land and/or property values (and the values of the produce of the land) could be expected to naturally appreciate in response to inflation.
- If required, many measures could be taken to improve **distribution stability**. For example, if income returns from property assets held are volatile or quite cyclical, which is common for agricultural commodities, some of the additional profits in boom years could be put aside to later supplement distributions in lean years. On the other hand, if property income returns are relatively stable, such as a steady rental stream, then "smoothing" methods may not be as necessary. A financial adviser may be able to assist here.

That leaves **maximising wealth** as the remaining objective to consider, and a key focus point for iwi discussion.

Maximising overall wealth is a key discussion point

- Future wealth can be enhanced by investing some of the surplus income* from the permanent (or "core") property asset, rather than distributing it all.
  - In the short and medium term this decision is largely driven by a group's Investment Policy and the investment opportunities available. For example, investing a large part of annual surplus property income may mean planned land developments progress more quickly, and all iwi members end up better off in five years' time than they otherwise would have.
  - Over the very long term, not regularly distributing 100% of surplus income from permanent assets may come at the expense of intergenerational fairness. From one perspective, current iwi members would be forgoing some of their "fair share" of returns from the property to improve the position of future generations. Many may be very happy to do this – it is really an iwi judgement call. Financial modelling of future outcomes can assist with this process and ensure judgments are as "informed" as possible.
  - Another important consideration is whether there is a preference to grow the asset base in a way that keeps up with iwi population growth.

*By "surplus income" we mean net profits after tax, adjusted (+ or -) to take account of spending required to maintain the quality of the asset over time, including any provisions that might need to be put aside for this purpose.

Keeping property in perpetuity will still involve some investment trade-offs

There are still underlying investment trade-offs from holding property in perpetuity.

- It may sometimes mean forgoing more lucrative investment opportunities, which means the long term growth in wealth might not be as strong as it otherwise would; and
- Having a portfolio heavily concentrated in land holdings in a particular region and/or industry can accentuate the risk profile – i.e. there is limited diversification of investment risk if one's eggs are mainly in one basket.

The flipside is the non-monetary benefits that iwi members derive from maintaining ownership of land of cultural significance. These benefits can be substantial and are certainly not something we can express an opinion on.

Acknowledging investment trade-offs can open the way for some of them to be mitigated over time. For example, some sacrifice of distributions in the early years will free up funds for investing in a range of other investments that can progressively add to the diversification of an iwi's overall asset holdings. The current generation pay the price, but over the very long term the overall iwi may end up better off (i.e. less risk across their portfolio due to improved diversification).

How might a distribution policy work for an iwi with a diversified portfolio comprising bonds, term deposits and shares, alongside substantial core and non-core property holdings?

In this section we put the components together. We combine aspects from our December 2012 report with the above commentary on property assets being retained in perpetuity.

We outline a simple scenario and then discuss ways in which it could be extended and customised to suit alternative scenarios. Please note that this is not meant in any way to be definitive. Each situation requires a unique approach and the discussion below is an aid to decision making rather than a template.

In this example we assume an iwi has investments in a market portfolio, comprising a diversified range of shares and fixed interest investments that suit their growth aspirations and risk preferences. Alongside this the iwi owns sizeable land and property holdings, developed and undeveloped, some of which are core tribal lands never to be sold.

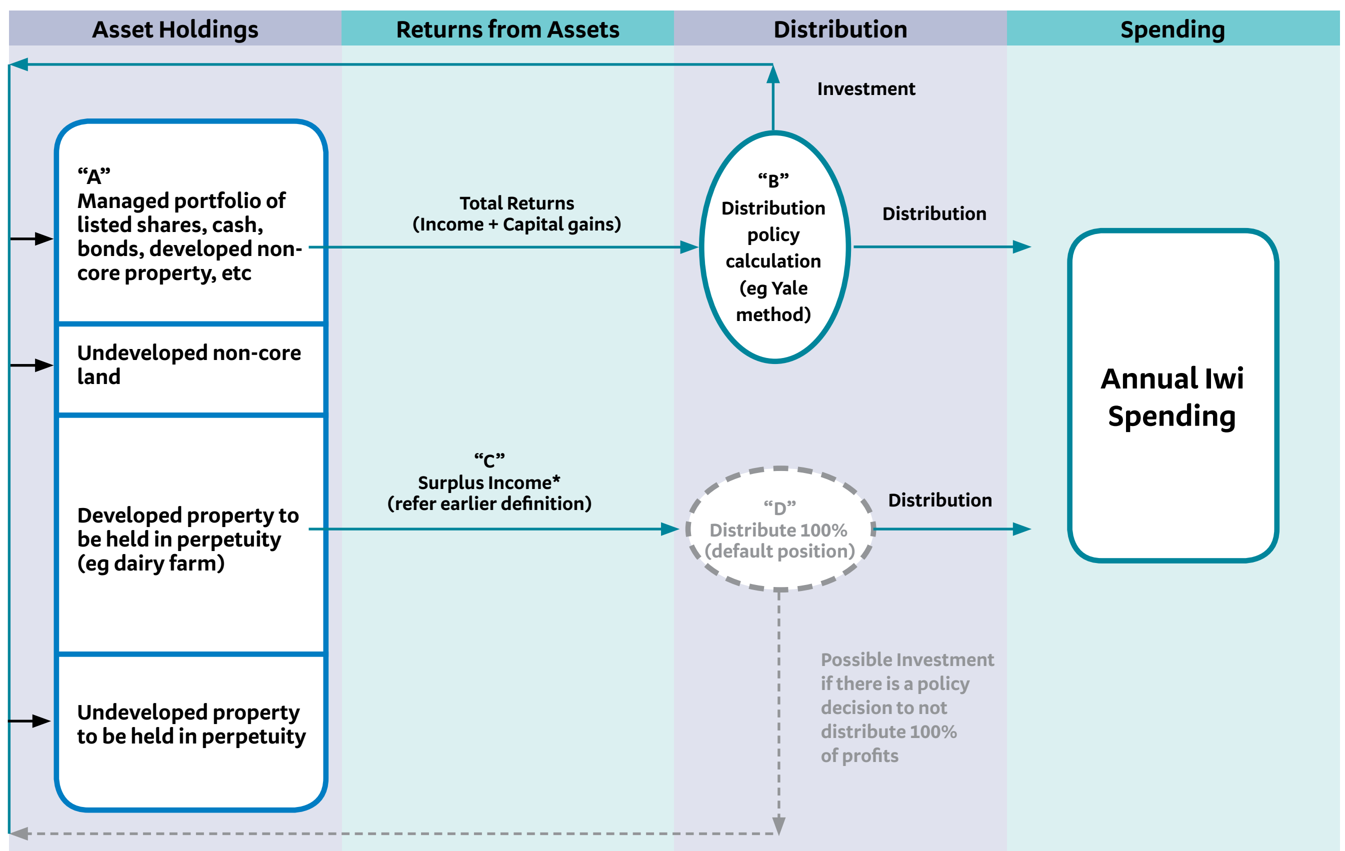
Key assumptions:

Some of the annual returns from the managed portfolio ("A") are withdrawn for current year iwi spending purposes, and some are re-invested.

- The split of these returns between spending and re-investing is determined by a Distribution Policy calculation method (please refer to our earlier report for a discussion of various alternatives) designed to balance the objectives of the iwi (e.g. inflation protection, stable distributions, wealth maximisation). This decision point is represented by the blue oval ("B").
- Returns which are re-invested are allocated across different investment opportunities in accordance with the iwi's Investment Policy. These decisions are represented by the 3 black arrows on the left.

Surplus income ("C") from developed land (eg dairy farm, orchard) held in perpetuity is fully distributed, net of any additional capital spending required to maintain the good order of the asset. This section ("D") is dotted and is in grey. We discus varying this 100% distribution assumption on the following page.

Stylised example of distributions from a hypothetical iwi portfolio of assets



Further comments on base case

- We have left undeveloped land out of the distribution policy calculation entirely, as this needs special consideration on a case by case basis. For example, if the land is a bush reserve held in perpetuity and not generating any income, then it might be inappropriate to include it as part of the distribution calculation. On the other hand, if the land is being developed with a view to future commercial sale, then it may eventually generate funds for potential distribution, but in the meantime factors like timing and borrowing requirements might need to be taken into account.
    - Despite the absence of income generation, undeveloped land may well be generating returns in the form of capital gains. However, (i) until the point of sale, these will be unrealised; and (ii) if undeveloped land is a major part of the commercial asset holdings, then mechanically applying a distribution formula could lead to spurious results, which could lead to distribution levels that are unable to be sustained by the income-producing assets in the portfolio.
    - If undeveloped non-core land is subsequently developed, it could be moved into the "managed portfolio" box.

Examples of extensions

Now we look at some of the ways to extend distribution considerations from the starting platform.

1. The grey dotted parts of the diagram show an alternate situation, where some profits generated by permanent property holdings are re-invested instead of distributed. In this case, the dotted grey circle represents a second point at which a distribution policy decision is made.
    - This particular re-investment/distribution decision relates to the discussion in the earlier section about "maximising wealth" versus "intergenerational fairness".
    - One alternative is for some of the profits from a "core" property asset to be retained within that business for further development opportunities. For example, it may make sense for the manager of a permanent dairy farm asset to manage further dairy developments on adjoining bare land. The ability to retain a portion of profits for a period of time provides the farm manager with certainty that some development funds will be available.

- This approach is similar to some publically listed[3] companies that distribute a portion of their profits each year, and retain the rest to invest as they see fit to grow and enhance the value of the business. It might be tempting for some iwi-owned businesses to copy the ratio of distributions to profits that listed companies use, especially where they operate in the same industry sector as the business in question. However, we would caution against this, as an iwi's wider objectives can vary considerably from those of the listed companies being used as a benchmark.

3. The term "listed" refers to being listed on a stock exchange, such as the NZX (New Zealand) or ASX (Australia).

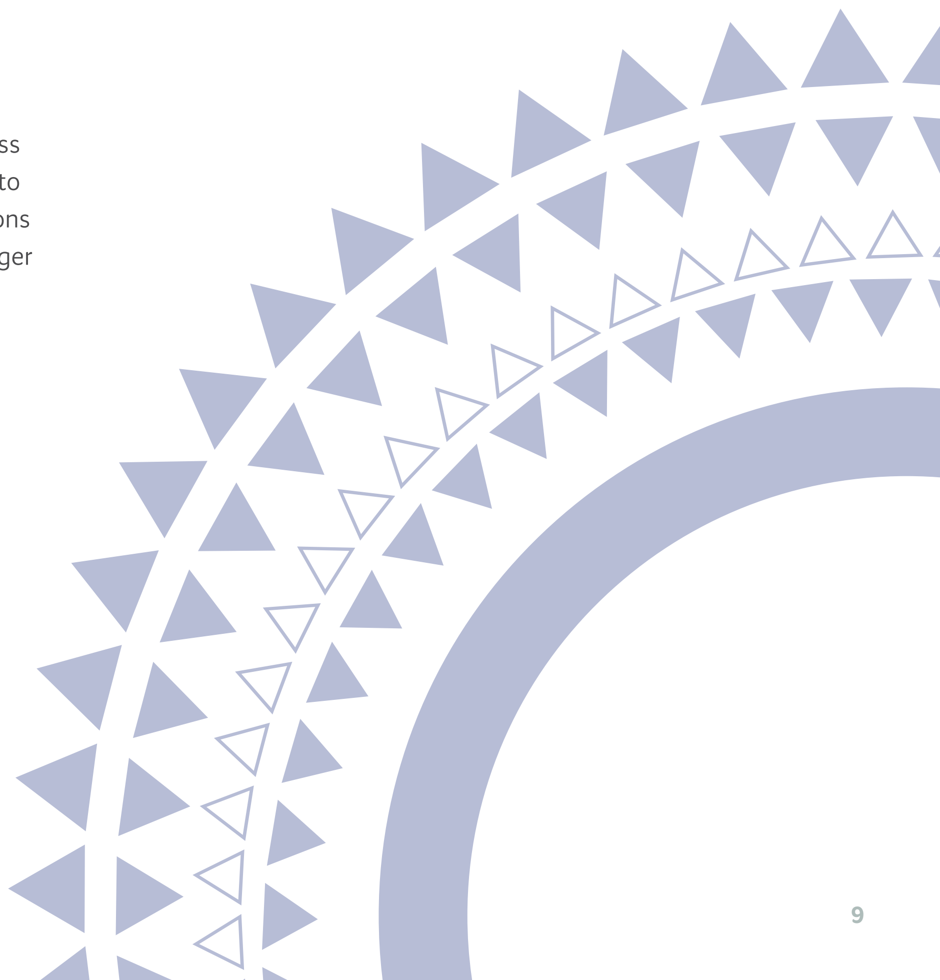
In particular, publically listed companies are focused on generating value for **current shareholders**, whereas many iwi have **intergenerational** considerations. Appendix 1 of this report provides additional discussion on this topic, commonly referred to as a company's "Dividend Policy".

- If desired, the allocation of returns from the "managed portfolio" assets ("A"), between distributions and further investment, could be temporarily altered to compensate for the amount of new investment being made by the manager of "core" property.

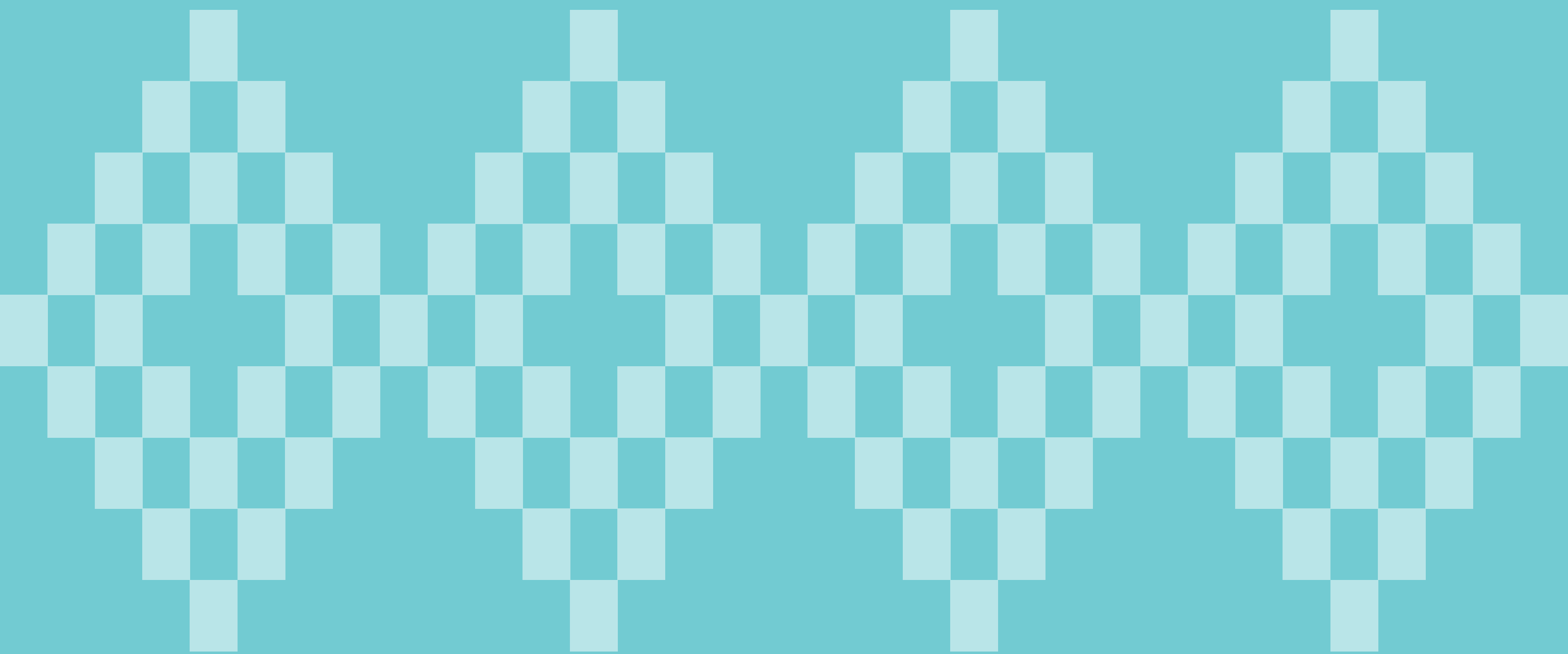
2. If borrowings are used to fund developments on core iwi land (being kept in perpetuity), then the speed at which those borrowings are paid down to their long term desired level (which may be zero) can have an effect on intergenerational fairness. Devoting 100% of surplus profits in initial years to paying down borrowings means current iwi members receive no benefits from distributions until the target borrowing level is reached.

3. Other assets could be brought into the mix. For example:

- Non-core commercial businesses might be best handled as part of the managed portfolio set of assets ("A"). Even if business assets are not revalued often, it is unlikely to meaningfully distort distribution calculations if the business is a small part of a much larger portfolio.
- With core (permanent) commercial businesses, distribution calculations might be best focused on income (dividend) returns (with regard to requirements for maintaining the business over the long term), as any capital gains will not be realised if the business is never sold.
- If fishing quota is to be held permanently, then the distribution decision in the first instance might be best focused on annual income (e.g. value of the year's annual catch entitlement), less relevant costs. However, if large structural changes in value are expected, then this may need to be revisited. For example, if the value was declining over time, then intergenerational fairness considerations might suggest that some of each year's earnings are invested elsewhere to compensate.
- Forestry assets will probably need special modelling, because of the potential for markedly different return profiles over different time periods.



Summary



An example of a simple set of starting rules might be:

1. *If assets are intended to be held in perpetuity ("core assets"), then the distribution focus is on the* ***surplus income returns*** *from those assets (after sufficient investment has been made to maintain the quality of those assets).*
2. *If assets are non-core and capital gains are easily measured and realised (such as investments in shares in listed companies), then the distribution calculation will take account of their* ***total returns****, including both income returns and capital gains or losses.*
3. *If appropriate, customised adjustments can be applied on a case-by-case basis, with regard to professional financial advice.*

A calculation of the annual distribution might then look something like this:

Distributions calculated using a distribution rule (eg Yale method) applied to:

- market portfolio investments (such as term deposits, bonds and listed shares);
- non-core developed property assets; and
- non-core small commercial businesses.

Total annual available surplus profits from assets being held in perpetuity, such as:

- developed land;
- annual catch entitlements from fishing quota; and
- core commercial businesses.

Less:

- Re-investment required because of a stated preference to grow the overall asset base over time, rather than just maintain it on an inflation adjusted basis.
- Requirements of other Investment Policy directives (e.g. forgo distributions this year so other assets can be developed more quickly for an enhanced outcome).
- The impact of any smoothing adjustments, such as putting aside excess returns from boom years and drawing on them in lean years.

We would stress that we have tried to keep to a simple and pragmatic focus in this report. More complex solutions and considerations are also possible. For example, capital gains and losses cannot be ignored completely in the distribution calculation if borrowings are involved (additional checks would be needed).

Appendix 1:
A few thoughts on Dividend Policy

We mentioned earlier in this report that it was important not to simply emulate the dividend policy settings of listed companies when determining the dividend policy for iwi-owned businesses.

This Appendix pens a few thoughts on the matter. We would stress that it is only a partial discussion on selected aspects of dividend policy.

To set the scene, we start by looking at the dividend policies of companies listed on the NZ stock exchange (NZX). There is quite a broad range of policy settings and we table a few different types below.

Company type	Pay-out ratio[4] example
Many listed property companies with well-established portfolios and stable income often pay out a very high proportion of their profits to shareholders and unit holders.	Property for Industry's dividend policy is to pay out 95% of its operating profit[5].
Property companies with a very strong development focus tend to pay out a lower proportion of profits, as they need to fund their growth aspirations.	Summerset (a builder, owner and operator of retirement villages) has a dividend policy of distributing "between 30% and 50% of underlying profit"[6].
Start-up and high growth companies may pay little or no dividends, with all their surplus cash being ploughed into growing and establishing the business.	Xero is a high profile example of a high growth company. It does not currently pay dividends.
A large number of companies on the NZX50 have dividend pay-out ratios residing between 30% and 80% of profits.	Fletcher Building currently has a target dividend pay-out ratio in the range of 50% to 75% of net earnings.[7] Meridian Energy has a policy to make distributions "...at a dividend payout ratio within an average, over time, of 70 to 80% of Free Cash Flow....."[8]
Other examples	Auckland International Airport has a high pay-out ratio, which is currently set to 100% of net profit after tax.[9]

Please note that while companies may have a target pay-out ratio, the amount that is actually paid out may differ, depending on a range of prevailing factors.

4.Pay-out ratio refers to the percentage of annual profits distributed as dividends.

5.http://www.propertyforindustry.co.nz/press-releases/pfi-17-feb-2014.php

6.http://www.summerset.co.nz/investor-centre/dividends/

7.http://www.fletcherbuilding.com/investor-centre/dividend-information/dividend-policy/

8. Meridian Energy Initial Public Offering Prospectus, page 17

9. http://www.aucklandairport.co.nz/Corporate/Investors/Dividends.aspx

The setting of a company's dividend policy and pay-out ratio is determined by a range of factors, which include:

- the growth potential of the business;
- the speed of implementing future developments;
- capital spending required to maintain the business as a going concern; and
- the dividend needs and expectations of the investor base.

For example, property companies with a focus on sustainable returns often attract investors seeking reliable income, as opposed to investors focused on strong growth potential.

A key reason for an iwi-owned business not to simply "copy" the dividend policy of a comparable listed company is the differences in **objectives** at play. Here are two hypothetical examples to illustrate this point:

1. A listed property company with a focus on new developments might have a *low* dividend pay-out ratio, in order to have a high level of funds available to pursue its property growth objectives. An iwi might adopt a similar policy, because it has a similar objective to grow its property assets. Or alternatively, the iwi may prefer *a high* dividend pay-out ratio from its property assets for a period of time, because its priority objective might be to free up funds for improving diversification outside the property sector.
2. As an extreme example, a company purely focusing on "maximising current shareholder wealth" might achieve that objective by running a property asset into the ground and then selling it, spending the minimum it can on maintenance, extracting as much cash as it can, with negative impacts on the environment stretched to the maximum allowable under law. An iwi with an eye to intergenerational fairness might manage that asset quite differently, especially if it was a core asset, such as significant iwi land being held in perpetuity.

Having said all that, sometimes an iwi-owned company might well end up with the same dividend pay-out ratio as a counterpart listed on the share market. It might just be that the rationale is different. Regardless, the process of working through that rationale is very important.

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