



9 May 2017

File Ref: C2/2/7 Vol IV

Mr John Moloney
Chairman
Coillte
Newtownmountkennedy
Co. Wicklow

Strictly Private and Confidential

Updated Letter of Expectation

Dear John,

Following on from the Annual General Meeting of 26 May 2016 and further to the Letter of Expectation dated 9 July 2014, the Minister for Public Expenditure and Reform and I have given further consideration to the Government objectives for Coillte Teoranta (“Coillte” or the “company”) and our respective Departments have consulted with the New Economy and Recovery Authority (“NewERA”) in this regard.

This letter is intended as an update to the July 2014 Letter of Expectation, to provide guidance to Coillte and its Board of Directors (the “Board”) with respect to Government’s current objectives for Coillte and the primary considerations which will be taken account of by us (and other relevant Government Ministers) in respect of certain of the matters for which our consent is required under the Forestry Act 1988 (as amended) and the Code of Practice for the Governance of State Bodies (the “Code”). As with the July 2014 letter, we believe that this letter will be helpful to the company particularly in its corporate and strategic planning processes.

The specific objectives outlined in this letter should be considered in the context of the Government’s overall policy objectives for Coillte, namely that:

- The company should be profitable and cash generative, maintaining financial policies and a capital structure, taking account of future obligations (including pensions), that facilitate the payment of dividends to its shareholders;
- The company focuses on the core purpose as determined when it was established, being to commercially manage the forest and land assets vested in the company by the State;
- The company should deliver shareholder returns that exceed its equity cost of capital.

Specific Policy Objectives

The Government has a number of priority policy objectives for Coillte which it wishes to see addressed in the short term.

1. Partial Merger with Bord na Móna

As you know, the Government decision of June 2014 stated that both Coillte and Bord na Móna “should work towards a partial merger of their businesses, focusing on the areas of synergy between the two companies. A joint venture between the two companies will manage their common business activities in biomass, wind energy, shared services, and recreation and tourism”.

We note the progress that has been made to date in this regard and look forward to seeing further deepening of the collaborative endeavours of Coillte with Bord na Móna to ensure that the partial merger can be accelerated. We understand that Coillte and Bord na Móna are also exploring opportunities for collaboration beyond the boundaries reflected in the Government decision of June 2014 (in particular in relation to possible afforestation and fuel business opportunities) which we welcome. In this context the Minister for Public Expenditure and Reform and I remain committed to the objective of both companies using their best endeavours to jointly optimise the utilisation of land resources vested in them for the ultimate benefit of the State.

2. Fundamental Restructuring

As regards the decision by Government in June 2013 that Coillte is to undergo a fundamental restructuring, to be overseen by NewERA and the relevant stakeholder Departments, which will include operational streamlining, financial de-leveraging and a critical examination of the disposal options for its non-core activities such as telecoms and wind, a priority objective in this regard is the payment of a material annual financial dividend to the State by Coillte in line with the dividend policy referred to below.

We note that the company has undertaken a comprehensive review of the Coillte corporate strategy as a result of which it has developed a new plan for its business with forestry and land solutions at its core, and with the wood panel products business continuing to play a role in achieving the growth ambitions. We also note that the fundamental restructuring, operational streamlining and financial de-leveraging as required per the Government decision of June 2013 is now reflected in your strategy and that restructuring to support the delivery of the plan has commenced.

We would also like to note that the 2015 Coillte Financial Statements approved at the AGM reflect both the adoption of new accounting standards and the outcome of a review of certain of the Group’s accounting policies, which have jointly given rise to material adjustments to the carrying value of certain assets. It is our understanding that henceforth it will be possible to reconcile the asset values reflected in the financial statements with the commercial equity valuations which are to be undertaken in the context of General Policy 3 (Shareholder Returns) below. I welcome this development and would like to receive your assurances that this will remain the case.

General Policies

1. Dividends

It is our view that a dividend policy, tailored to specific circumstances of each commercial semi state body, should apply in the commercial state sector, with a view to facilitating management in prioritising objectives and providing greater clarity on dividend payments over the medium term. We understand that you and the Board of Coillte submitted a dividend policy for shareholder consideration reflecting the following principles:

- (A) an appropriate balance between payment of dividends and re-investment in the business, over the medium term; in this context the company has considered the strong objective to provide a robust medium term framework for the calculation of dividends which reflects the imperative that Coillte remain strong financially and in a position to invest commercially whilst also delivering an appropriate return to the Shareholders;
- (B) the new dividend policy gives consideration to comparable peer companies, taking into account structural, ownership, regional and other relevant differences; and
- (C) dividends being based on a proportion of some measure of cash flow in addition to having reference to net profit after tax.

We understand that, in finalising your new dividend policy, you engaged with NewERA.

As indicated above, the objective of formulating a dividend policy is to assist the Board and the Shareholder(s) by bringing certainty to future dividend payments over the medium term. Where any special dividend is requested, it is our expectation that the likely impact of such payment on the policy would be reviewed at the time. We also believe that a clear dividend policy will assist in enabling informed decisions to be made on financial management and investment by Coillte, while providing an appropriate, regular and predictable return to the Shareholders.

We note and are appreciative of the company's ongoing work in its non-commercial activities including recreation, culture and biodiversity. We also appreciate that Coillte's new proposed dividend policy focuses on delivering an increased material financial dividend to the shareholders based on the optimal use of the significant commercial assets, in particular forests, vested in the company by the State.

2. Financial Target Setting

Appendix I sets out a number of financial performance measures (these measures were also set out in the July 2014 Letter of Expectation). Consistent with its statutory functions to provide financial and commercial advisory services to relevant Ministers in relation to designated bodies (which include Coillte) under the National Treasury Management Agency ("NTMA") (Amendment) Act 2014, NewERA will monitor these financial performance measures and provide advice to us as necessary in accordance with the NTMA (Amendment) Act 2014.

Following discussions with NewERA, we now wish targets to be set for two of these measures. The targets include:

- (i) a capital structure target (gearing or debt/equity ratio) reflecting the company's underlying business mix; and
- (ii) a profitability target (return on capital employed) reflecting the risk profile of the expected business mix.

We recognise that you considered these measures prior to finalisation of your new dividend policy.

We consider that relevant financial targets should be used to assist in balancing value creation and maintenance of financial risks at a reasonable level, without incentivising increased business risk. The aim should be to formulate high-quality targets that are ambitious while remaining realistic, and that are well defined and clear and thus capable of being monitored on an ongoing basis.

In this context, and also to assist in assessing financial performance¹, Coillte should now develop appropriate financial targets² for the two measures set out above, in the context of Coillte's current strategy and the updated rolling five year strategic plan to be submitted annually under the Code. These targets should be agreed with the Minister for Public Expenditure and Reform and me, with the support of NewERA, by the end of August 2017. The Departments and NewERA should be kept informed of progress in the formulation of these targets with NewERA carrying out any detailed financial analysis it requires in order to provide its advice to the Minister for Public Expenditure and Reform and me in relation to the targets.

As regards the profitability target, this should be an ambitious but achievable target to be set relative to Coillte's expected cost of capital, which will be reviewed as part of setting the profitability target, and which should be seen as a minimum requirement for the return. It is considered that establishing a profitability target that exceeds the expected cost of capital will assist in ensuring that shareholder value is created over time. We expect that analyses of Coillte's business plan as well as assessments and comparisons based on relevant industry and peer companies will be important components in setting this profitability target.

As part of the evaluation and monitoring of the financial targets, we expect that both Departments, together with NewERA, would meet with Coillte at least once annually to discuss these targets, their outcome and relevance, Coillte's work to achieve the targets, and whether any changes need to be made to them.

3. Shareholder Returns

We propose to augment our monitoring and measurement of Coillte shareholder returns and in this regard we will be reviewing total shareholder return (TSR) over a 5 year period,

¹Pursuant to Section 21 of the NTMA (Amendment) Act, NewERA shall "... in respect of each designated body, assess its financial performance and prepare, at least annually, a report on its financial performance", with Coillte being one of the designated bodies.

² The targets do not necessarily mean a single number of X% but could include a tight range of X% to Y%.

assisted in this process by NewERA. We acknowledge that returns will vary from year to year, sometimes due to temporary or non-controllable factors but it is a key Government objective that Coillte delivers shareholder returns over the relevant period that are in excess of its equity cost of capital.

As regards measuring TSR, Appendix I sets out the financial performance measures in respect of profitability and shareholder return which we propose to apply. As you will see one of those measures necessitates the use of the commercial equity value of the entity. We ask that Coillte undertake a commercial equity valuation of the company with a valuation date as at 31 December 2016, to be submitted to my Department by no later than the end of the third quarter of 2017. We would expect that this valuation would be based on assumptions that are consistent with the assumptions used in the preparation of Coillte's rolling 5 year strategic plan to be submitted annually under the Code. This valuation will be reviewed by NewERA and my Department, in consultation with the Department for Public Expenditure and Reform (DPER), and your views in relation to any divergence will form part of the discussion. We expect that a similar valuation exercise will then be carried out on an annual basis with a valuation to be carried out by an independent party at least every three years (from the first such independent valuation carried out in 2015).

This proposed approach to developing a perspective on shareholder return will be reviewed on an on-going basis and may be adapted as necessary.

Sectoral Policy Objectives

In addition to the overall policy objectives of Coillte listed above, we wish to ensure that Coillte continues to work actively to support general Government policy in the forestry sector. This will require an appropriate level of on-going investment by Coillte, with care being taken to ensure that core areas of activity are prioritised within the resources available to the company for reinvestment.

The purpose of the Forestry Act 1988 is to '*make provision for the development of forestry and to provide for the establishment of a company for that purpose...*', namely Coillte Teoranta. The principal objectives and general duty of the Company continue to be those provided for in the Forestry Act 1988, as amended.

Sustainable forest management will continue to underpin the management of the Coillte estate. In this regard, it is important that Coillte pay attention to the following main economic, environmental and social considerations:

Economic

- a) Coillte will maintain and enhance the productivity of its underlying forest asset in a way that is consistent with good forest practice and the protection of the environment. It will ensure good stocking and appropriate silvicultural management throughout the rotation, maintain good forest health, avoid any excess removal of nutrients at harvesting, and apply appropriate species and provenance selection and sufficient stocking levels during the planting, establishment and subsequent growth of reforested areas so as to ensure their continued productivity and ability to supply wood fit for market.

- b) Coillte will ensure a sustainable, continuous and predictable level of roundwood and fibre supply from its forests, to underpin its own current and future asset return and to support indigenous industry, added value and employment.
- c) Where appropriate, Coillte will implement recommendations set out in the updated national forest policy, in particular, measures to increase wood mobilisation within its own estate and, where appropriate, the private forest sector, through the sharing of information and knowledge and other means.

Environment

- d) Coillte will adhere to good environmental practice in all its operations and practices, to protect biodiversity, water and soil, archaeology, landscape, and other aspects of Ireland's natural and cultural heritage.
- e) Where appropriate, Coillte will positively engage with initiatives, measures and partnerships aimed at protecting and enhancing important species and habitats, water, landscape, and other aspects of Ireland's heritage.
- f) Coillte will continue to protect and enhance carbon stores and sinks within its estate.

Social

- g) Coillte will continue to provide on a planned strategic basis for the use of its forest and non-forest lands for appropriate types of outdoor recreation and environmental awareness, in a way that is compatible with the maintenance of the forest resource and protection of the environment.
- h) Coillte will continue the policy objective of delivering recreation benefit.

Governance Arrangements

Corporate Plan

With respect to the rolling 5 year corporate plan which Coillte is required to prepare and submit to me pursuant to the Code, going forward, we would expect the company to engage with NewERA earlier in this process in order to enable feedback to be provided to you on the plan in a timely fashion.

Reporting

As you know the Code sets out current requirements in terms of reporting obligations, which supplement Coillte's obligations in this regard under the 1988 Forestry Act (as amended). We also expect Coillte to continue with the quarterly meetings that are held with NewERA, my Department and DPER, and I am very appreciative of the co-operation that Coillte has shown to date in this regard. We also anticipate a continuation of the existing policy of regular communication with both Departments and NewERA should any material matters arise.

Section 9 of the Code outlines the principles and requirements applicable to State bodies in relation to remuneration and superannuation including, in particular, the obligation to implement Government pay policy as expressed from time to time. In this context, we highlight the increasing drive towards transparency in relation to remuneration and expect that Coillte will make appropriate disclosures in line with the guidelines in this regard as they evolve. We note in this regard the disclosures regarding key management compensation made in the Coillte Financial Statements for 2015 following the adoption of FRS102.

Board evaluation

Consistent with the requirement in the Code, we expect that the Board constantly reviews its own operation and performance and that of its committees and individual members, that the Board undertakes an evaluation of its performance on an annual basis and that the Board considers having such an evaluation facilitated by an independent assessment every three years. We know that such a review and evaluation process in Coillte is led by the Chairman and expect that it allows each Director to give honest and constructive feedback on performance, both individually and for the Board as a whole. Your attention is accordingly drawn to the 'Board Self-Assessment Evaluation Questionnaire' issued in August (2016) in conjunction with the Code.

We request that, following the next evaluation of Board performance, a formal high-level feedback report should be provided to us (copied to NewERA) on overall Board performance, key focus areas for continuing development and assurance that the process has been properly implemented.

Engagement

Our expectation is that you will engage with NewERA and our Departments in the near term to discuss the matters set out in this letter in more detail. This process will enable the company to set out its perspectives in relation to the proposed approach outlined in this letter and appendix. We are, however, anxious that this process be concluded quickly and in this regard, we would be grateful if you would make appropriate arrangements for discussions with NewERA and the Departments as soon as possible.

Yours sincerely



Michael Creed T.D.

Minister for Agriculture, Food and Marine

- cc Mr. Paschal Donohoe T.D
Minister for Public Expenditure and Reform
- cc Ms. Eileen Fitzpatrick
Director, NewERA

Appendix I: Financial Performance Measures

Shareholder Return

Measure	Calculation
Total Shareholder Return (TSR)	(Commercial equity value(end) <i>less</i> Commercial equity value (beg) plus Dividends <i>less</i> equity injected) / Commercial equity value (beg)
Dividend yield	Dividends paid / Average commercial equity value
Dividend payout	(i) Dividends paid / Adjusted net profit after tax (prior year) (ii) Dividends paid / net cash flow from operating activities
Return on Equity Earnings Growth	Adjusted net profit after tax / Average Equity Compound Annual Growth Rate in Adjusted net profit after tax

Profitability / Efficiency

Measure	Calculation
Return on Capital Employed (ROCE)	(i) Adjusted EBIT / Average Capital Employed (ii) Adjusted EBIT / Adjusted Average Capital Employed

Leverage / Solvency

Measure	Calculation
Gearing Ratio (net)	(i) Net debt / net debt plus equity (ii) Net debt / Net debt <i>plus</i> pension liabilities <i>plus</i> employee related liabilities <i>plus</i> equity
Interest Cover	Adjusted EBITDA / Interest paid
FFO Interest Coverage	Funds from Operations <i>plus</i> Interest Paid / Interest Paid
FFO / Debt	Funds from Operations / Gross Debt
RCF / Capex	Funds from Operations (FFO) <i>less</i> Dividends / Capex [Measures ability of cashflow generated to cover Capex]

Definitions of Key Terms used in calculations

Term	Definition
Adjusted EBIT	Earnings before interest and tax adjusted for exceptional items and IFRS fair value movements
Adjusted EBITDA	Earnings before interest, tax, depreciation and amortisation adjusted for exceptional items and IFRS fair value movements
Adjusted Net Profit after Tax	Net profit after tax adjusted for exceptional items and IFRS fair value movements
Adjusted Capital Employed	Net debt <i>plus</i> equity <i>plus</i> pension liabilities <i>plus</i> employee related liabilities
Capital Employed	Net debt <i>plus</i> equity
Commercial Value	See Section 2 of this letter
Dividends Paid	Dividends paid during the financial year per the cashflow statement (excl. special dividends)
Equity	Total shareholder(s) equity taken from the balance sheet
Fair value adjustments	Includes unrealised fair value gains / losses on derivatives or all fair value gains / losses on derivatives where the entity does not separately identify unrealised items.
Funds from Operations	Net cashflow from operating activities (post interest and

	tax paid and pre-working capital changes)
Gross Debt	Interest bearing debt such as loans, bonds and commercial paper <i>plus</i> interest bearing finance leases
Interest Paid	Interest paid for the financial year on interest-bearing debt per the company's cashflow statement.
Net cashflow from operating activities	Taken directly from the cashflow statement - ensure interest paid is included
Net Debt	Interest bearing debt such as loans, bonds and commercial paper plus interest bearing finance leases <i>less</i> cash