Blossoming interest in timber

Timber investment, previously confined to North American pension funds, has been finding a wider market in recent times. Dorothee Gnaedinger asks why

Still in its infancy, timber investment has been considered a promising investment asset by institutional investors in the US since the early 1980s. Now, however, more and more pension funds from further afield are waking up to the opportunities afforded by this asset class.

The growth of investment in timber resulted from the financial pressure US forest product companies were under to revitalise equipment and repay debts. Liane Luke, chief timber officer at FourWinds Capital Management, explained: "Forest product companies had this huge capital asset on their books which wasn't really helping them on Wall Street: their timberland holdings. But they could sell it to institutional owners like pension funds. Forest product companies were now able to take a fixed cost and make it a variable cost, as institutional investors would only manage the asset and then sell the wood back, without becoming competitors to the forest product companies."

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> Ivo Knoepfel, onValues

Consequently, as stated in a recent study by Caudex Capital Timber Investments, since the end of 1986, investments in US forests have generated an annual return of 15%, leaving most other asset classes behind. According to Otto Reventlow, managing director at International Woodland Company (IWC), the number of international pension funds entering the asset class and the level of assets invested has been growing rapidly since 2002. To date, most of the large timber investors are based in North America, the UK, Denmark and the Netherlands.

Ivo Knoepfel, managing director at Switzerland-based investment consultancy onValues, is one person who regards the future of timber investment positively: "I see timber investment increasing in importance as an asset class for pension funds in continental Europe. It is just a matter of time."

To invest in timber, pension funds typically use a segregated account, which requires an average investment of between US$30m to $50m; or a commingled fund, customarily with a minimum of US$5m and a ten-year lock-up. Generally, timber assets make up 3% to 5% of the total portfolio.

Eva Greger, head of GMO's renewable resources team, stated: "It doesn't have to be a huge [pension] plan to invest in timber, as long as one can find the right vehicle."

Why timber?

Timber is viewed by many investors as a good portfolio diversifier. It typically offers lower volatility risk than other assets in a portfolio, as the growth of tree plantations is unrelated to exogenous economic events. Furthermore, the correlation of timberland returns with other asset classes is also either low or negative, making inclusion of timberland investment beneficial from a portfolio point of view.

PME, the Dutch industry-wide pension fund for the Metalektro industry, invested €250m (US$383.7m) into timber in 2006. Later that year it increased the investment by another €200m to a total of around €450m.

"We think in the long run we can get a real return after inflation of around 7%," explained Bram van Els, spokesperson for PME.

In Denmark, PKA, the collective pension scheme for employees in the public social and health sectors, increased investment in forestry to about €335m at the end of 2007. Peter Daamgard Jensen, chief executive officer at PKA, explained: "We believe timber is a relatively secure asset class. For example, within a period of higher inflation, forestry investment is one of the asset classes that could protect you against inflation."

For the last three years, PKA's returns from timber have reached an average of 11.6%. "This is living up to the expectations we have from this asset class," admitted Daamgard Jensen. "Generally we expect a further 6% to 8 % return from our forest investments in the next few years."

The total return of investment from timber can be divided into two components: namely the income return and the capital appreciation.

Income return is characterised by the cash flow from the sale of harvested timber. FourWinds Capital Management's Luke pointed out: "On a fully diversified plantation or forest, you typically always have one product that is bringing in the money. There are a variety of products in a forest, so you have some flexibility in managing the asset."

Additionally, unlike other commodities, timber doesn't have to be harvested the end of a specific growing season. Luke explained: "If the price of timber is not high enough at the end of the season, you just leave it on the stump and it continues to grow. It doesn't cost you any more money to store it." Additionally, leaving the trees on the stumps increases the biological growth, the value of forests and land, and therefore capital appreciation.

It is also important to note the value of timber as an asset doesn't move one to one with the change in price.

GMO's Greger explained: "Let's say [there's] a 20% drop in the timber price, [it] doesn't necessarily mean the asset class will drop 20%, as buyers and sellers of timberland take a long term view and generally expect the price of wood to move back to trend over time, and because there are other non-timber sources of income."

These non-timber sources of income include the sale of recreational property and timber-easements and conservation-easements. Easements are financial agreements with interest groups to keep parts of the forest untouched, for example, for preservation reasons. Greger also mentioned the selling of carbon credits as a further source of income.

IWC's Reventlow added the concept of buying big and selling small to the list. "Pension funds have the potential to raise higher return when selling off their forest in smaller parts," he clarified.

Additionally, increasing oil and gas prices over the last seven years has put more emphasis on the usage of wood as energy source. Jim Webb, senior vice president at RMK Timberland Group, explained: "Further business opportunities are the wood-burning power plants. The amount of power generation from fossil fuels is reduced, which increases the demand of wood fuels."

OnValues Knoepfel added: "Long term trends, such as the increasing consumption of wood products in emerging markets and decreasing forest areas, support the long term investment case."

Risks

Nonetheless, there are risks associated with timber investment, not least of which are caused by nature itself. Reventlow stated: "According to Hancock Resource Group, on average, natural hazards have reduced the investment returns by four basis points per year."

In addition to natural disturbances, other risk factors must be considered, for example, changes in forest product prices, forest product substitution, problems with forest managers, production facilities, health, and environmental and social issues.

Greger argued the real concern should be the upfront risk of paying too much for the forest, overestimating the inventory on the ground today and overestimating future growth. "Additionally there is the risk of being overly optimistic. Those are underwriting errors that can impact the return."

Decreasing real returns for timber investments in the US (the traditional target region so far) pose new challenges. Knoepfel commented: "The market is becoming more crowded and the investment opportunities in North America are decreasing – that means timber investors will have to move to other regions to find interesting investments, e.g. South America."

Webb recalled: "In the 80s and 90s it was very easy to buy a timber investment in the US and real returns were 8%. With the change of demographics and the resulting increase of land value in 2001, the returns of timber have come down to 5% to 6% real return."

However, while previously the market was concentrated in North America, new markets have been emerging around the world. South and Central American countries, Russia and South Africa have been characterised as developing markets, offering a new environment to invest in. Other nations, mainly in Africa, are also starting to develop timber investment opportunities, piquing the interest of many investment managers.

A move away from safe, relatively low risk investments in North America will result in a changing risk landscape in the future. For example, Knoepfel pointed to the political and environmental risks associated with investments in emerging and developing countries.

"Investment managers and investors will have to look more closely at environmental and social issues related to timber production in the future," he said.

Going some way to mitigate the problem, a series of labels certifying sound management of environmental and social issues (e.g. the Forest Stewardship Council label) has emerged in recent years, facilitating the work of investment managers. "The importance of such labels will increase in the future, given the growing exposure to emerging countries, but the increasing number of such labels also poses a challenge," Knoepfel added.

Many pension funds are also attracted to the "green" aspect of timber investment. With the political focus on climate change, Webb stated he had witnessed an increasing interest in the asset class.

Daamgard Jensen agreed, stating: "We have the [opinion] that if you handle your ethical view in your investment process in the right way, then you will often see there is a good match between trying to get the highest return and making an investment that is also good for the climate and other positive areas."