IPE REAL ESTATE

Forestry: Slow growth market

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*Institutional investors are heading for the trees as they desperately seek alternative sources of income. The forestry and timberland markets are ripe for picking, writes **Christopher O’Dea** reports*

If money really does not grow on trees, someone forgot to tell the global pension fund community. Around the world, institutional investors’ appetite for timberland is rising, consultants are advising pension funds on how to add more timberland to their portfolios – and how to identify suitable strategies and managers – and the timber industry is adapting to the ESG and stewarding requirements of institutional capital.

The growth in the market reflects underlying demand for wood and forest products around the world, in particular from China, where consumption of a wide range of timber and products continued to increase despite the country’s economic slowdown. Industry participants say there was perhaps $1bn (€0.9bn) of institutional capital allocated to timber about a decade ago. While the next few years are likely to see smaller investment managers offering a wider range of timber and forest-product strategies, timber remains a fairly concentrated market where scale matters.

The top 30 timber investment management organisations (TIMOs) have approximately $57bn of assets under management between them, not including real estate investment trusts (REITs), according to RISI, a forestland research and consulting firm based in Boston. The five largest companies account for more than 54% of that total, and the 10 largest TIMOs account for roughly 76% of total assets.

Most timberland investment is focused on a handful of developed markets, with between 80% and 90% of capital targeting the US, Canada, Australia and New Zealand, according to the 2015-2019 Timberland Investment Outlook from New Forest, a Sydney-based forest investment firm. But investors are increasingly looking at emerging and semi-mature forestland in Latin America, Asia, Africa and Europe, says New Forest.

In the UK, for example, timber investing had a banner year, with a record £151m (€199m) of productive forests trading last year as the sector “becomes an increasingly mainstream investment”, according to the annual UK Forest Market Report from woodland manager Tilhill Forestry and forest surveyor John Clegg & Co. Timber production in the UK also set a record, as forest operators took advantage of the highest prices for standing timber since 1998. High timber prices have contributed to the continued increase in average timberland property prices as well, the report says, which has helped the average annual return from UK forestry reach 18.8% over the past decade, according to the IPD UK Annual Forestry index.

The NCREIF Timberland Fund & Separate Account index posted a 0.4% gross return in the quarter ended 30 September 2015, for a gross return of 9.29% in the prior year and 9.76% over the prior three years. The index, which tracks 102 accounts totalling $17.5bn in assets run by 10 managers, currently illustrates the performance of the US market – NCREIF requires funds and accounts to have at least 95% of assets invested in US timber, timberland, timber leases, deeds and cutting rights. NCREIF plans new indices for other regions.

Demand for wood is increasing, especially from China

Those returns highlight the attraction of commercial forests for investors with long-term commitments, such as pension funds. With interest rates at or near historic lows, the asset class offers a total return made up of land ownership and potential value gains, and real income growth from crop harvests that feed timber processing industries' demands for raw material in the form of raw timber and intermediate forest products such as wood chips.

Pension funds enter the woods

Pension funds are flocking to the forest sector as a source of income to replace scant bond interest, as well as inflation protection. One of the most innovative approaches is under way at the State Investment Council of New Mexico, where deputy state investment officer Robert Smith has steered the $19.5bn portfolio ever deeper into the forest since joining the Council in 2010 to lead a revamp of the investment policy and team.

At the time, the portfolio was heavily exposed to equity risk, with about 80% or more of assets in publicly traded stocks and equity-like real estate. Following an asset allocation study, the portfolio has been steadily diversified towards a classic endowment structure, and now includes a real-return sleeve of financial assets, such as TIPS and bank loans, and real assets allocated between energy, infrastructure and timber.

New Mexico SIC's long-term target allocation to real-return strategies was raised to 12% from 10% in 2014, Smith says. "We're committed," he says. Capital deployed to real return managers stood at 6.95% as of November 2015. Real assets commitments totalled $1.6bn across 21 funds with 14 managers, according to SIC's second-quarter 2015 portfolio. With that sleeve, the Council recently raised its real assets

allocation to 75% of assets from the initial 60% weight. The Council has "become more comfortable with the space", Smith says. The objective of the real-assets allocation is to generate cash flow to replace fixed-income payments that have declined in the low-interest-rate environment.

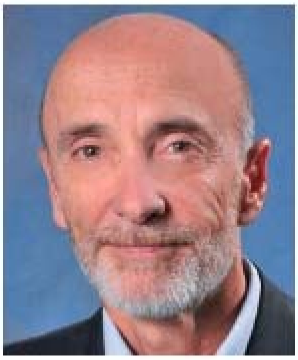
More than half of the assets in timber are invested in the US, with Brazil being the largest non-US allocation, Smith says. As of the second-quarter 2015 SIC performance report, the fund had committed just over 14% of the real assets allocation to three timber strategies, with a committed value of $250m. Timber can comprise as much as 40% of SIC's real-assets allocation. Smith says SIC will target IRRs from 7% to 11% for timber investments. With the objective to generate cash flow, "we like good old timber harvests", he says.

As asset owners have become more comfortable with timber and other real assets, the bar for managers has been raised. "There seems to be a trend, especially for investors who have been active in timberland for some time or are of a larger size, to prefer to know the underlying assets before making a commitment," says Céline Claudon, director of due diligence at The International Woodland Company, an independent private timberland investment consultancy based in Denmark that develops customised timber portfolios for institutions. "We see fewer blind pool mandates being given."

Asset owners are tightening the reins in other ways. They are interested in "having more control over entry and exit timing, and how long one holds an asset is an increasing topic among investors", Claudon says. "Both trends, if applied, require a higher forestry expertise than simply committing to timberland through a REIT or a PE-like fund structure."

More finicky institutional investors are just one aspect of the evolution of the timber market. New Forest founder and CEO David Brand says: "While institutional investment in timberland and ecosystem services expands, the nature of the forest sector is evolving. Investors need to navigate a maturing asset class and position their timberland portfolio to benefit from shifts in market conditions and competitive dynamics."

One of the biggest shifts in conditions came late last year when Weyerhaeuser acquired Plum Creek Timber Company in an $8.4bn deal that combined Weyerhaeuser's 6.9m acres of timber with Plum Creek's 6.3m acres to create the largest private timber owner in the US. The combination also brought more concentration of the timber REIT sector; the new entity will account for over 80% of the market cap of the timber REIT sector.



"Even with the recent slow-down in China's economy and construction, Chinese demand for wood is still increasing"

Bob Flynn

Just before the merger, Plum Creek formed Twin Creeks Timber, a joint venture with several US pension funds to own and manage a portfolio of US timberland. Washington State Investment Board, the Oregon Public Employees Retirement Fund, and the Alaska Permanent Fund Corporation formed the initial investor group. In exchange for a 75% share in Twin Creeks, the institutional investor group will contribute approximately $420m to Twin Creeks, and commit about $330m for future timberland acquisitions. Plum Creek will sell timberlands valued at approximately $420m to the venture for cash. Silver Creek Capital Management, a Seattle-based fund manager, is the managing member and independent fiduciary of the venture, which is targeting the acquisition of $1bn of timberland over its initial 15-year term.

Such massive scale might be the way forward. Brand says: “The world will need to double its timber production by 2050 at a minimum, and to achieve this we need to deploy technologies that can dramatically increase existing plantation timber production.” The firm advises institutions to extend mandates to emerging markets and development of greenfield plantations for specific woods. The future of Southeast Asian forestry, Brand says, “will be based on a shift to sustainably-managed, high-quality timber plantations”, for species including teak, rubberwood, acacias, mahoganies, and eucalypts.

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China will loom large for timber investors. “Even with the recent slowdown in China’s economy and construction, Chinese demand for wood is still increasing,” says Bob Flynn, director, international timber at RISI.

In the last couple of years “we estimate China’s imports of logs and the wood content of imports of other primary products were roughly equal to 10-11% of total global timber production, and that over the next decade this will increase to 12-13%”.

While expecting slack demand from the country in 2016, “China is the major driver of international trade in forest products”, Flynn says, ranking as the world’s largest importer of softwood logs, hardwood logs, hardwood lumber, and wood pulp, and as the second-largest importer of softwood lumber and wood chips.

That broad-based demand will affect most timber segments. “Whether investors are growing trees in New Zealand, Australia, western North America, or Latin America, they are often producing wood whose end-market will be in China.”