



Foreword

By Clive Suckling and Chris Knight, PricewaterhouseCoopers LLP

Traditionally timberland as an asset class rarely featured in institutional investment portfolios. However, there are more opportunities to invest in timberland and, as institutions seek genuine diversification and 'green' investments move up their agendas, timberland can represent an attractive alternative investment to equities and bonds. Although timberland may provide immediate cash returns, they are by their nature primarily for the long-term investor, which may also promote sustainability and social responsibility.

Historically, large-scale private ownership of timberland had been mainly limited to integrated forest-products companies which owned forests to secure timber supplies. Although there had been divestments earlier, during the 1990s the sell-off of these forest assets in the US accelerated under the pressure on forest-products companies to enhance investor returns. The main buyers were a type of private equity vehicle called timber investment management organisations (TIMOs). TIMOs, some of which had been around for many years to provide tax-efficient investment in timberland for wealthy individuals, scaled up with institutional money to acquire these assets.

The progressive sell-off of timberland by forest-products companies in the US has resulted in TIMOs becoming major owners in US forest land, and as a result we have seen institutional investment in timberland grow hugely in the last ten or so years. In the US, timberland assets can now comprise perhaps 1-2 percent of some of the major pension fund portfolios. The popularity of timberland investment has spread, and in recent years there has been a significant growth in the number of non-US based timberland investment vehicles. There is also a choice of investment routes beyond the pooled TIMO funds including TIMO co-managed funds, listed fund vehicles, as well as direct investment for those institutions with the specialist skills.

The timberland investment universe comprises a diverse range of assets from managed native forests in developed temperate regions to plantations in emerging tropical regions. Regardless, there are essentially three drivers of return; two of these (timber value and land value) have their equivalents in mainstream real estate investment, but the third and usually largest component of return (biological transformation) is what sets timberland apart. Timber assets literally grow despite the prevailing economic environment, which explains both the relatively low volatility of returns and why investors worldwide see timberland as a counter-cyclical

investment. The interaction between timber value and biological growth is important. Timber prices are cyclical, as the huge swings in US sawn timber prices over the past ten years for example demonstrate vividly; however, when log prices dip, timber can literally be ‘stored on the stump’, where it will continue to grow and increase in value.

In addition to these attractive features, the increasingly high-profile sustainable development agenda has positioned more progressive timberland investments as a promising ‘sustainability solution’, with the potential for climate, community and biodiversity benefits.

Yet, with all this recent growth, US TIMOs have been finding it difficult to achieve their historic rates of return from new US timberland investments, as competition for available timberland properties increases. In part this is due to reduced supply as the sell-off by US forest-products companies is virtually over. It has also become harder to drive up non-timber returns through higher and better use, such as from recreation, the sale of mineral rights and conservation easements. Partly as a result of this, as well as being a sensible diversification strategy, opportunities for higher returns outside the US are gaining attention. Of the developed regions, Australasia has attracted institutional investment for some years. Europe is also attracting increasing interest, despite the barriers created by its traditionally fragmented and state-dominated forestland ownership structures. Among the emerging markets, Latin American plantations have been most favoured but Asia and Africa are attracting greater interest. Altogether probably around 20 percent of invested value by institutions (US and non-US) is now outside the US.

Investors are also seeking to increase returns by exploiting the asset class to ensure the most valuable and best use of forestlands. Conventionally, income has been derived from the harvest and sale of sawlogs and pulplogs to the wood-processing industries. As a renewable material with diverse applications, timber and wood fibres are seen to have a strong future. Thus while demand for paper might be on the slide, certainly in Europe and North America, alternative uses for fibre are opening up. Currently, energy forestry is one that is showing strong potential, and many timberland investments are looking carefully at monetisation opportunities for woody biomass from renewable energy and fuel usage. Forests do not compete (at least in the main) with land use for food crops, and the energy yield from wood per hectare is typically higher than short-rotation energy crops.

We also expect to see increased activity in sustainable forest management as a result of the emerging global financing mechanism for the UN Reduced Emissions from Deforestation and Degradation (REDD) scheme. This aims to pay national and local governments to keep their native forests intact and preserve the habitat of many species of animal and plant life indigenous to them, in return for tradeable REDD credits.

In short, the range of income sources from timberland is set to grow and in turn this is spawning a widening range of investment themes by both new and existing timberland investment managers. The asset class has certainly reached a major turning point, with timberland moving beyond mainstream pension and endowment fund portfolios in North America to both a broader

geographic range and type of investor, with niche 'green' or 'sustainable' investors now featuring prominently.

So if the timberland category offers an attractive investment proposition, is this alternative asset class now a natural consideration for institutional investors and family offices on par with private equity, real estate or infrastructure? The answer is probably 'yes but with limitations'. While timberland has a similar role in complementing traditional asset classes, the investible universe for timberland is ultimately much smaller in comparison. Still with the long-term demand outlook for forest-based products and services looking favourable, this supply constraint would seem to offer support for asset pricing for the foreseeable future at least.

Nevertheless, with opportunity there are numerous risks and challenges associated with timberland investment; they are featured in this guide and we highlight two which are tax and reputation.

From a tax perspective, finding a suitable fund structure for multiple classes of investors with contrasting, and sometimes conflicting requirements is invariably complicated. For instance, high-net-worth investors may be motivated by capital tax reliefs which have often been available to them on direct timberland investment locally, and will not understand if these are not available for timberland fund investments. Further, timberland funds with wide geographical investment remit must deal with many countries around the world with far less developed tax and legal regimes than found in Europe and the US, and extract cash returns back to their investors without losing too much on the way. In several key countries there are issues with land ownership by overseas investors, and while timber investment typically attracts some form of local tax relief it can be hard to get the benefits at a fund level. Timberland is a long-term investment and returns can be easily eroded if the wrong structure is used.

From a reputational-risk perspective, the large growth in activity around timberland investment has been matched by a large number of new industry entrants. Not all of these will have the appreciation of the historical and often complex environmental and social issues which forests present. PwC in association with the World Business Council for Sustainable Development launched the Sustainable Forest Finance Toolkit in 2009 to help investors manage these issues effectively and responsibly, and to minimise associated reputational risks.

In our view, timberland has an important role to play in investment portfolios whether because of the returns that may be available, the diversification benefits, the sustainability characteristics or any combination of these. As the opportunities from timberland investing grow, it will remain a sophisticated investment area demanding a sound understanding of the risk and return dynamics. We believe *The Definitive Guide to Investing in Timberland* is timely and will benefit those investors wishing to participate in this interesting and, hopefully, truly sustainable asset class. □

Clive Suckling is the UK and global leader of the Forest, Paper & Packaging Industry practice at PricewaterhouseCoopers LLP.

Chris Knight is an assistant director of Forestry and Ecosystems at PricewaterhouseCoopers LLP.