Seeing the Forest for the Trees, Next Generation in Timber Investing

By Michael Underhill

Simply defined, timber assets represent areas used to grow and harvest wood, including primary, commercial, and plantation forests. Examples of listed timber investments include, but are not limited to, forest products companies, timber real estate investment trusts (REITs), paper products companies, or paper packaging companies engaged in the ownership, management, or upstream supply chain of forests and timberlands. Global listed timber represents a market value of roughly $1 trillion of outstanding equity securities.1

Timber has emerged as its own differentiated asset class providing unique investment characteristics. Timber is a hybrid asset class—it provides investors with income and the potential for capital gains. Typically income accounts for one-third of total timber returns and capital gains account for the other two-thirds. Timber assets have potential to generate primary income from the sale of wood and secondary income from other sources including mineral, oil, and gas leases; recreation; and carbon credits. Given these characteristics, timber assets provide unique income-oriented streams of cash flow that tend to be attractive to investors and that result in investments with distinct qualities.

The primary attraction of timber for institutional investors is the allure of diversification. The dependence of pension funds on traditional equities and fixed-income investments combined with the recent financial crisis gives rise to the insatiable interest in low-correlation investments. Numerous studies provide evidence of timber’s ability to improve overall portfolio returns per unit of risk for pension funds.2

Other long-term investors such as sovereign wealth funds, endowments, foundations, and insurance companies are viewing timber as a critical component in the overall inflation portfolio risk bucket to modify risk-based factor models (see figure 1).

What is the Timber Investment Opportunity?

Global demographic trends are driving the need for timber in the world’s developing economies. China and India have shifted from agrarian to industrial, urban societies. These countries require new, modern buildings and timber to facilitate expansion of industry, urbanization, and otherwise support continued population growth and an expanding middle class. China, for example, historically has depended on timber imports to fuel growth, and imports from

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1 Includes Russian timberland for long-term lease

Source: International Woodland Co.
North America specifically are up dramatically, with log imports up 20 percent in 2014. Indeed, in 2014 North American soft-wood lumber accounted for 45 percent of all Chinese imports. Moreover, Canada overtook Russia as China’s largest lumber supplier in 2014, with shipments reaching 6.8 million cubic meters.3

The investable timber market totals roughly $473 billion and is growing daily as new companies seek to capitalize on equity market listings through publicly traded companies and REIT structures. The North American market for investable timber is surpassing the $165-billion mark with institutional investors dominating nearly all holdings through direct ownership, private timber funds, or publicly traded securities (see figure 2).

Ways to Invest in Timber
In today’s uncertain markets, timber assets can provide sustainable yield, inflation protection, growth potential, and portfolio diversification to help investors reach financial goals. Timber securities and direct forestland investments historically have provided greater inflation protection due to their commodity nature and generated positive returns in higher inflationary periods.

Timber as a Stable, Sustainable Investment
Timberlands provide essential products for the global economy on a sustainable basis. Demand for these products tends to be correlated to the economic growth cycle, but timberlands experience biological growth, which can lead to capital appreciation during periods of slowing economy.

Understanding Timber Investment Approaches
No matter what type of investor you are, there is bound to be a timber investment that fits your style utilizing direct investments, pooled funds, mutual funds, or exchange-traded funds (see table 1).

The underlying returns of listed and unlisted/private timber can be anticipated to converge over the intermediate term, but the shorter term holds noticeable structural differences relating to liquidity and volatility (see table 2).

Publicly traded timber investments have been recognized recently by investors as a viable alternative to traditional private-equity type timber. Numerous constraints to investing in private timber deals and funds include the following:

- Lack of liquidity of direct investments in the asset class
- Clients typically require long time-horizon to successfully capitalize upon investment
- Significant governance required to implement an exposure to private timberlands
- Highly concentrated nature of the private timber asset class (significant portion of investable assets are in the United States)
- Potential tax issues related to gaining ex-domestic exposure to timberland
- Limited number of managers in the asset class
- High investment minimum in private timber commingled funds

Investors also have experienced additional challenges with private timber investments when it comes time to value the investment. The market for private timber transactions remains opaque and shallow, so valuation poses a challenge for even the most astute investor. In contrast, publicly traded timber securities have transparent pricing and valuation.

Investors are viewing listed timber securities as another club in the golf bag, offering them alternative access to a dynamic market opportunity. The liquidity and transparency have become more attractive than ever in today’s investment environment. The ability to generate income and total return explains some of the recent gain in popularity, particularly after the past three years’ drubbing of investment portfolios combined with unprecedented volatility.

Benefits of Listed Timber Investments
Investors responded to a survey conducted by Capital Innovations in 2015 and listed their top attributes of an attractive investment:

- Diversification
- Liquidity
- Reasonable fees

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Table 1: Typology of Timber Investments

<table>
<thead>
<tr>
<th>Type of Investor</th>
<th>Private Equity Funds</th>
<th>Direct Investments</th>
<th>MLPs</th>
<th>Listed or Publicly Traded SMA</th>
<th>40 Act Mutual Funds/ETFs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Small Investors</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Medium Size</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Large Institutional</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

Table 2: Pros and Cons of Public Securities and Private Investments

<table>
<thead>
<tr>
<th>Category</th>
<th>Listed Timber Securities</th>
<th>Unlisted/Private Timber Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Geographic Diversity</td>
<td>Very High</td>
<td>Low</td>
</tr>
<tr>
<td>Asset Diversity</td>
<td>Very High</td>
<td>Low</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Very High</td>
<td>Low</td>
</tr>
<tr>
<td>Daily Valuations</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Control</td>
<td>Low</td>
<td>Low to Very High</td>
</tr>
<tr>
<td>Volatility of Valuation</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Transaction Cost</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Portfolio Turnover</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Investment Horizon</td>
<td>Medium Term (5 years)</td>
<td>Long Term (10 years)</td>
</tr>
</tbody>
</table>
Valuation and daily market pricing  
Transparent corporate governance  
Active management and value creation  

Listed timber can provide these attributes to investors in a straightforward and easy-to-understand framework, differentiating it from other complex, unlisted (private-equity type) investments.

Diversification. There are a series of risk and return elements to any investment strategy. Listed timber permits investors to diversify across sectors, which may help to ameliorate some of the inherent risks present in timber. These risks include regulatory risk, demand risk, interest-rate risk, and refinancing risk. Diversification across regulatory sectors, physical assets, currency exposure, and political risks (country or regions) helps investors construct a portfolio that achieves the desired risk-return profile or risk-budgeting process. This can be achieved in a global diversified portfolio of holdings.

Large investment universe that provides liquidity. Investors may access investment vehicles, separately managed accounts, and exchange-traded funds, all of which have liquidity that is unavailable in direct timber deals. This liquidity feature allows investors to easily put money to work and conversely to trim their listed timber exposure to maintain their asset allocation models.

Reasonable fees. Fees assessed to an investment portfolio challenge investors and portfolio managers alike when it comes to investment performance. Fees typically are higher in private timber transactions. An actively managed portfolio of listed timber investments at institutional pricing can be more attractive than buying the benchmark in an exchange-traded fund and paying active management fees.

Valuation and daily market pricing. Unlisted timber valuations are performed by an independent auditor or administrator. Because listed securities are exchange-traded and market priced, investors get the transparency they need, especially in the current market environment where investment transparency is at a premium.

Table 3: Investment Attribute Comparison of 20-Year Returns (March 2015)

| Table 4: Correlation with Inflation |
|-----------------------------|-----------------------------|-----------------------------|-----------------------------|

<table>
<thead>
<tr>
<th>Asset Class Performance</th>
<th>Inflationary Environment</th>
<th>GDP Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rising</td>
<td>Common Equities Resources Real Estate Timber</td>
<td>Resources Timber</td>
</tr>
<tr>
<td>Falling</td>
<td>Bonds Real Estate Timber</td>
<td>Bonds Common Equities Real Estate</td>
</tr>
</tbody>
</table>

Transparent governance. Listed companies are subject to examination by regulatory authorities, governments, investor advocacy groups such as UNPRI/UN Global Compact, and labor unions, and they are subject to media scrutiny. These companies increasingly are focusing on social issues, the environment, and governance.

Active management. The value proposition behind active investments in a portfolio of listed timber securities can be seen through examining the composition of the frequently used benchmarks. The S&P Global Forestry and Timber Benchmark includes constituents of the S&P Global BMI universe, which includes GICS subindustry categories of forest products, homebuilding, paper packaging, paper products, and specialized REITs.

The index leans heavily toward forest REITs and paper products, but active management can add value by exploiting opportunities in the larger investable universe. Furthermore, active management allows for response to relevant changes in the marketplace that can affect pricing and allow for both the minimization of downside risks and the capitalization of upside.

Risks and Rewards

Timber investments can help smooth the ups and downs of the equity markets while still producing income returns as well as returns in the form of capital appreciation. Timber investments have performed well in the increasingly volatile markets of the near past. Timber’s unique investment characteristics have held up well when compared to other asset classes (see table 3).

Investing in listed timber provides the potential ability for investors to add income, diversify a portfolio, and improve overall long-term performance. Listed timber may provide an excellent portfolio.
diversification effect through its relatively low correlations with other equity asset classes. The asset class is unique in its hybrid status, which combines equity features of the industry and holds real assets that show positive correlation to inflation. Using the NCREIF timber index as a proxy for listed timber and the consumer price index (CPI) as a proxy for inflation, listed timber demonstrates an excellent correlation with inflation with respect to other equity asset classes (see table 4).

If history is an indicator, stock market recoveries have come in relatively short bursts and outperformance has occurred in a select number of sectors; timber has been one of these sectors. As the markets continue to rebound, listed timber is well-positioned to capitalize for investors.

The elements of return are broken down into three main components: biological growth, timber price changes, and land value.

Further examination of the timber asset class reveals that with the aforementioned sources of return come multiple sources of economic and physical risks. Among the primary economic risks are:

- Supply-side risks such as an increase in market supply due to increase in volume production, housing construction slowdown, or government sell-down in national forests.
- Demand-side risk or replacement risk such as finished wood products being replaced or substituted for with fabricated composite or steel products.

Other risks that are physical in nature may include fire, weather, insects, disease, animal damage, and theft (see figure 3).

**Investment Outlook**

Global growth dynamics continue to drive investment in timber worldwide. Populations in Latin America, China, and India are experiencing growth in residential and commercial building investment over multiple-year cycles; another 1 billion people will be born in the next 10 years. Timber investment growth is necessary for these regions to accommodate burgeoning populations.

In China in particular the emerging middle class is growing quickly (see figure 4). In 2014, the Chinese Ministry of Housing and Urban-Rural Development announced a $163-billion program to provide social/government-subsidized housing for 4.75-million households.

In contrast, examination of the United States and Europe reveals a different story in terms of demographic trends. Growth in these regions has been stagnant over the past few years, but we are beginning to see some recovery.

Macro trends will continue to dominate the timber industry in the near future. With the dominant use of timber as a building material, the asset class is poised to respond well to any upturn in the housing market, both domestically and internationally. Security selection will remain critical as timber firms with exposure to different domestic and international regions frequently encounter very different operating environments.
Paper and paper packaging products will continue to be a mixed bag. Paper products continue to face reduced demand, especially in developed regions where digitized content becomes increasingly available and accepted by consumers. Paper packaging producers tend to be located near nondurable manufacturers and, as a result, these firms are growing in China but cutting back in the United States. Furthermore, paper packaging products compete with plastic packaging and plastic use is inversely related to the price of oil. Regardless, growth in paper packaging continues. According to a recent report by Resource and Information Systems, Inc. (RISI), paper packaging demand growth through 2024 will average 1.4 percent per annum in North America, followed by 5.6 percent per annum in Asia with China leading the way at 6.6 percent per annum. Global tissue paper consumption continues to grow at a rate of 4.9 percent per annum.

On the timber supply side, over the next few years we expect a 340-million-cubic-meter swing in global log supply and demand, leading to a timber crunch (see figure 5).

Timber supply issues in Canada and Russia, as well as ongoing global deforestation, will remove an estimated 171-million cubic meters per year and annual demand growth will jump by an almost equal volume.

The macro trend toward environmentalism warrants attention in regard to the timber industry. The often-debated carbon offset program, though not a major component of timber returns, could add potential value to an investment. Perhaps the trend to watch is the prospective development of a market for ecosystem services. If ecosystem services can become monetized much like wetlands mitigation, the benefit to forest owners would be immense.

With the transition of forestry ownership from paper-products firms to REITs or timber investment management organizations complete, the outsized returns of the past likely will not repeat. Therefore, active management will become critical. The timber asset class is unique in its characteristics and will continue to offer many benefits to investors in the future. As a natural hedge against inflation and a super portfolio diversifier, timber is an asset class that brings utility to investment portfolios. The timber asset is an interesting mix between international and regional demand, regional land values, and a constant underlying growth in the commodity.

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Endnotes