

PRACTITIONER'S POINT

Thomas C. Adams, managing principal and founder of Summit Timber Advisors, LLC, has developed a keen understanding of land sale and general divestiture dynamics of companies in the forest products industry... here are his insights on what sort of returns should be expected, investment structures and the challenges that lay ahead.

How has investing in timber as an asset class, evolved over the last decade?

One of the most interesting aspects of the timberland market in recent years, is that it has evolved (at least in the United States) into a 'true' asset class. There has been an enormous land transfer in the US. Paper and forest product companies, under competitive pressure from declining margins, international competition and high debt levels, have been monetising their vast land-holdings. On the receiving end, investors; mainly Timberland Investment Management Organisations (TIMO's), timber Real Estate Investment Trusts (REIT's) and Master Limited Partnerships (MLP's), have sprouted up to take advantage of industry exit from the forest management business. Land that was previously 'locked-up' and unavailable for purchase, is now available to investors. This is probably the single most important dynamic in creating an increasingly active, liquid market for what was previously a 'niche' investment opportunity. Demand for alternative investments, especially those uncorrelated to more mainstream asset classes has also driven interest.

What sort of returns should and can be expected today?

Historically, timberland has been a relatively high return investment with low volatility. Performance has exceeded 12% annually over the past 30 years (NCREIF Timberland Property Index) through a combination of current income and capital gains. Timber returned (again according to the NCREIF index) over 18% in 2005 and approximately 13% in 2006.

Do we expect those returns to continue?

If they do, it won't be from basic forestry. Our investment models, given current pricing, reflect nominal return estimates in the 6-8% range for land managed in the traditional 'forestry' sense. What we think will boost these returns, but are admittedly, difficult to model, is the increasing 'optionality' associated with land ownership. The ancillary income potential in forestry investing is growing rapidly. Income from recreational leases, mineral exploration, cell towers, conservation credits, watershed management, biomass, carbon sequestration, etc., are increasingly adding to forestry returns. Plus the tendency for land to move to higher value categories over time, as urban encroachment and demographic patterns progress, provide potential for long-term, high single digit, low double digit returns. We're targeting 9-11% all in, with an aggressive land management strategy designed to exploit all ancillary revenue opportunities.

What are the different investment vehicles available to an investor planning to invest in timber today?

For direct investments in timberland, Timberland Investment Management Organisations (TIMO's) are the primary vehicles for institutional and high net worth investors. Most manage separate accounts, organised in LLC form in the name of the owner. Alternatives for smaller investors include investing in a timberland 'fund', many of which are sponsored by TIMO's, or by purchasing public shares in a Timber REIT or MLP. The best direct exposure, maximum control and flexibility, but most likely limited to institutions, is the LLC separate account.

What other "investment structures" do you think could and will be applied to making timber a more accessible asset class?

Growing cash flow and generally low capital expenditure, has led to the creation of timber-backed securitised debt vehicles allowing for secured fixed-income exposure for debt buyers, and levered returns for those willing to take the "first loss", or equity position in the capital structure. An example of this is the recent TimberStar deal. International Paper sold most of its timber holdings to investors last summer in a transaction valued at more than USD6 bn. Of this amount, over USD1 bn was securitised and backed by a long-term supply agreement. It resulted in an USD800 mn, multi-tranche Commercial Mortgage Backed Security (CMBS) that saw high demand from investors looking for alternatives to the more typical collateral backing these structures. It is probable that we will see more of these deals. Additionally, look for more 'pooled' equity vehicles of the type that we have already seen from some of the TIMO's referred to earlier.

Why is it interesting to hold timber in a diversified real estate portfolio?

There are some interesting differences between investing in timberland in comparison to the more traditional real estate investment opportunities. Trees grow, land values rise and timber prices have outpaced inflation over any measurable long-term investment period. Biological growth is a primary driver of timberland returns and represents a stable, predictable source of value. More importantly, as trees grow in volume, class changes result in higher values. Saw timber (Lumber for building material) is more valuable on a per ton basis than Chip-N-Saw (small boards, pulp products), which in turn is more valuable than pulpwood (newsprint). Growth is predictable and can be enhanced by applying modern forestry management techniques. Moreover, timber can be 'stored'. If prices are weak in any given year, you can exercise your option not to harvest. Trees will continue to grow and value will continue to build. Contrast that to commercial property. In a weak economy businesses close, rents decline, vacancies rise. Rents lost from a vacant office are lost forever. Timber, by contrast, builds value 'on the stump' and has an excellent history of capital preservation.

What are your concerns and the challenges that lay ahead?

I guess one of the biggest concerns right now is valuation. Capitalisation rates, basically current yields, have declined considerably over the past couple of years. Earning double digit returns from basic forestry is unlikely given recent market pricing, and many timber investment advisors have not sufficiently adjusted their marketing material for that reality. As mentioned earlier, double digit returns are still possible, but they will be earned through more speculative land plays and by capitalising on more of the ancillary revenue sources that have become available through forestland ownership.