Institutional Forestland Ownership and its Effects on Forest Products Markets

Tapani Pahkasalo,
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Background

Co-authors Robert Flynn and Tapani Pahkasalo

“Institutional Forestland Ownership and its Effects on Forest Products Markets” chapter in the FPAMR was written together with Mr. Robert Flynn, RISI.

Data in the chapter and presentation is largely from RISI International Timberland Ownership and Investment Database, published in August 2015. Database covers 1,075 companies in 82 countries, identifying a total of 123 million hectares of forest ownership (approximate value of forest ownership identified >US$450 billion).

See chapter text for definitions and full analysis.
Quantum Global Alternative Investments (QGAI)

Unique investment opportunities, a team with solid track record to deliver value

- Direct investments with a focus on Sub Sahara Africa using equity, mezzanine and debt
- Experience in undertaking investments in complex environments
- Active management & value creation approach to investments

Sector Industries
- Agriculture
- Timber
- Mining
- Healthcare
- Structured Equity

Infrastructure
- Power
- Transport
- Water
- Industrial infrastructure

Real Estate
- Hotel
- Business
- Commercial

Sectors/Industries:
- Infrastructure
  - Power
  - Transport
  - Water
  - Industrial infrastructure
- Real Estate
  - Hotel
  - Business
  - Commercial
- Sector Industries
  - Agriculture
  - Timber
  - Mining
  - Healthcare
  - Structured Equity
Investment Approach

Active approach to developing and creating value of investments in Africa

**Investment Life-Cycle**

- **Sourcing and developing investment opportunities**
- **Active Management and Value Creation**
- **Exit Management**

**Advantage**

- Outstanding network across leading African market participants, including investors, governments, industry operators and local developers
- Internal structuring and execution capabilities for all deal aspects

- Set up for executing greenfield and buy-and-built development investments in various sectors across Africa
- Active ownership to implement value creation strategies benefiting from Africa’s market and investment complexities

- Broad investor network within and outside Africa to create exit opportunities
- Strategic partnering in investments to design exit scenarios in early stages of the investment life-cycle
Timber – Investment Strategy

Overall Investment Strategy

**Investment strategy**

- **QGAI** advises the Investment Manager of a USD 250 million fund targeting attractive returns and a sustainable dividend yields through a diversified portfolio of African timber assets

- **Investments focused on acquiring and management of existing timber plantations, greenfield plantations, sustainably operated natural forest enterprises and related downstream activities (e.g. sawmills, MDF, pole treatment)**

- **Preferred investment characteristics:**
  - Preferential location
  - Good growth biological growth conditions
  - Commercially attractive tree species
  - Opportunities for export

- **Invest in equity, equity-like (e.g. Mezzanine) SME focused funds, and exceptionally debt instruments**

**Timber Sector focus**

Forest Production
- Greenfield forest
- Timber plantation
- Natural forests

Forest products
- Saw-logs
- Pulpwood logs
- Harvest residues
- Veneer logs

Wood-based industry
- Sawmills
- Transmissions poles
- Wood panels

Secondary products

Primary products

- Early-mover advantage in an under-invested Sub-Saharan African sector, leveraging the undeveloped forest reserves for greater economic benefits

- **Investment opportunities include** land acquisition/concessioning and development, acquisition and optimization of operational forest farms

- QGAI as a company is member of FSC and targets sustainable investment opportunities
History of Timberland Ownership

Timberland investment by institutional investors began in the US in the 1980’s:
- Employee Retirement Income Security Act, 1974, “duty to diversify investments”.
- Recession in the early 1980s forced some forest product companies to divest their forest assets.
- Legislative change in 1986 did not allow forest product companies to continue reporting timber harvest revenues as capital gains, incentivizing divestment.
- Timberland Investment Management Organizations (TIMOs) answered the need and many were established in the 1980s.
- First Real Estate Investment Trust (REIT) formed in 1999 in the US.

In summary:
Forest product companies had the need to divest less productive assets (forests) from their heavy balance sheets, and invest into more productive industrial assets (industries). Simultaneously, institutional investors had the need to find well performing but stable investments in a new “low risk” asset class: forest investments provided that.
History of Timberland Ownership

The early emerging timberland market was characterized by limited information and good opportunities for rationalising the asset base. Forest product companies did not manage timberlands to maximize financial returns but to minimize raw material costs and to secure stable wood supply.

Under competent management timberland investors achieved good returns. Higher and better use (HBU) values were fully exploited. After this was exhausted, the returns have declined (perhaps with the exception of housing market boom years). Many timberland investors have turned their focus to other areas, leading to “internationalization” of timberland investment.

Also new investors have entered the market, and see some of the risks differently. Local investors may have better understanding of risks or have different risk tolerance, for example currency / FX rate, discount rate, country risk, understanding of land tenure.
## History of Timberland Ownership

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<td>United States</td>
<td>US, New Zealand</td>
<td>Inflation hedge, balanced portfolio returns.</td>
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<td>US, Oceania, Brazil, Uruguay, Chile, Europe</td>
<td>Instruments for institutional and private timberland investing emerge</td>
<td>Balance sheet optimization.</td>
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<td>US, Latin America, Oceania, Europe, Asia, Southern and Eastern Africa</td>
<td>In the US TIMOs and REITs manage more timberland than forest industry. Rapid increase in the number of timberland funds also in Europe and emergence of Latin American funds.</td>
<td>Benefits of diversification. Rising: growing demand for wood, new markets, favourable growing conditions in the South. Land price speculation during the first decade of 21st century. Government management outsourcing and restitution.</td>
<td>Benefits of diversification. Rising: Growing demand for forest products in emerging markets, climate change mitigation, sustainable investing.</td>
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Timberland Ownership by Forest Investors

- 77% of all financial timberland investment is in North America (mainly US), clearly making the forest investments a US led “industry”.
- Forest investments in Oceania were fueled by government privatization of forest resources, which is expected to continue.
- Latin America has seen the wave of forest investment in the past 10 years, still continuing albeit maturing in some areas. Biological growth drives this.
- Europe is an “emerging market” for forest investment, with some highly mature markets and some with higher risk/return profiles.
- Asia has seen the least amount of forest investments, mainly due to government ownership and population pressure. However, demand is there.
- Africa is considered the “last frontier” of timberland investment with lots of land potentially available.

Source: RISI, 2015.
Timberland Ownership by Forest Investors

• Timberland investors own 16.6 million ha of forests in the US, 69% of global total.
• Canada has the second largest concentration of forest land investments, 1.8 million ha or 7.5% of global total (making North America total 77%).
• Sweden (1.2 million ha, 5%) and Finland (0.4 million, 1.6%) are made largely of Bergvik Skog and Tornator assets: other holdings are small albeit growing now.
• Australia (1.1 million, 4.5%) and New Zealand (0.8 million, 3.3%) were early movers in timberland investment through large “crown forest” sales, more to come.
• Brazil (0.7 million ha, 2.9%), Uruguay (0.2 million ha, 0.8%) and Chile (0.1 million ha, 0.4%) have attracted most investors until today, the risks are perceived lower by large funds. P&P demand.
• Latvia and UK are “large” European destinations for timberland investment, with assets on sale continuously.

Notes: The US has by far the largest area of forest owned by financial investors but is not shown in this graph, which shows the next ten-largest such areas. * Includes only the shares owned by pension funds in Tornator and Bergvik Skog. ** Includes ownership of Fibria lands by Brookfield in 2014.
Forest Investors Impact on Forest Product Markets

- In some regions the forest investors have become significant forest owners.
- In Australia (56%) and New Zealand (42%) investors’ behavior is greatly impacting the markets
  - New Zealand does not have sufficient industrial processing capacity to consume the logs, thus investors have exported huge amounts of logs to China.
  - Forecast in Australia is that 1/3 of plantations may be converted back to agriculture, enhancing value for owner.
- Uruguay (38%), Brazil (11%), Chile (6%) (and partly South Africa, 9%) have witnessed forest investors taking control of significant share of wood markets, while markets have been traditionally in hands of just a few operators (P&P companies).
- In the US investor owned timberlands are large suppliers in some areas, for example driving the log exports to China at the expense of local sawmills.
Forest Investors Impact on Forest Product Markets

Typically timberland investors do not own wood processing facilities. (However, emerging markets may be different...) Primary management objective is to maximize total return over the holding period (typically 8 to 12 years). This is both cash yield during the holding period and capital appreciation, only realized at exit. Only in fast growing plantations the rotation age matches that of the holding period. Most other investments (especially greenfield) are largely based on the exit valuation.

- Forest management activities (investments) which result in value increase during the holding period can be justified (given they meet the hurdle rate).
- Investments that cannot be realized during the holding period, i.e. do not produce measurable added value, are generally not done. For example long term research funding could belong to this group.
- No need to subsidize wood processing facilities with low wood prices. If alternative demand is at sight, forest owners may increase the prices and force some industries to close down. Market prices.
- No need to secure stable wood supply for industry: if a conservation group or a real estate developer is willing to pay more, the forest (land) may be sold and put permanently out of wood production.

However, most timberlands are sold with a binding wood supply agreement which both seller (industry) and buyers (financial investors) are usually willing to sign. Timberlands only produce significant revenue when wood is sold to wood processing industries, thus the interests are aligned.
Forest Investors Impact on Forest Product Markets

• Many markets have seen the rationalization, consolidation and improvement of forest asset management.
  • Surprisingly few forests actually have optimal management and investors are able to increase the sustained yield and revenue.
  • Naturally, forests are often managed for multiple objectives that include also other objectives than (optimal) timber production.
• Eventually more capital on forest investment markets will lead to more perfect markets and a decline in returns, making brown field investments less favorable.
• Establishment of new forests (plantations) has not happened in large scale with financial investors’ money but is likely to happen in the emerging and frontier markets more in the future.
  • The investable universe is small and prices for existing assets are high, making it eventually more attractive to consider greenfield projects.
• Long term investments (with no revenue for many years) in high risk / high discount rate environments are challenging. Many institutional investors find better risk adjusted returns in other segments of investment industry.
• When land suitable for reforestation can be combined with the future demand growth in the same geography, the equation becomes more interesting.
Africa is the “last unexplored frontier” of timberland investment

African share of the timberland universe

African share of underutilized land

Population in Africa and Europe, 2100

Relative forest products consumption, 1961-2009

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Tapani Pahkasalo
Vice-President, Timberland Investment
+41 (41) 560 29 00
tapani.pahkasalo@quantumglobal.ch

Co-author:
Bob Flynn
+1-360-471-6578
rflynn@risi.com