Timberland ownership is still only a minute proportion of the total financial market asset base, but ownership is rapidly moving from regional to global; and transaction prices continue to defy gravity -- or do they?

By Dennis Neilson, DANA Limited, New Zealand

Although the total investable timberland (forestland) universe in the United States is only a microscopic percentage of the total institutional asset base (about 0.2%); in the last decade institutional and private equity timberland investments have graduated from being an obscure asset class pursued by only pioneering investors, to rapidly becoming a "semi-mainstream" investment for an increasing number of pension funds, university endowments and private equity/hedge fund firms.

In the United States there has been a massive swing away from C Corp company ownership of timberlands. In just three years from 2004 to 2007, the area of timberland owned by forest products companies halved, while areas managed by Timber Industry Investment Organisations (TIMOs) increased by 120%, by private investors almost 110% and T-REITS by 35%. Of the top 10 company timberland owners in 1981, only one (Weyerhaeuser) had any significant "core" holdings left by early 2008. TIMO - only investments have increased three-fold from $9.0 billion in 1997 to more than $29 billion in early 2008. On top of that Endowment and private equity funds have also invested – and so the total new ownership investment is perhaps more than $50 billion; out of a total timberlands investment space of $70 billion.

There are many reasons for this move to institutional investment, but in a major survey of institutional investors by Merrill Lynch in 2007, three major reasons were identified: investment diversification, a low correlation with other asset classes, and inflation protection. Surprisingly, only 11% of those surveyed cited high historical returns as a reason for investing. And these returns have been high. As measured by a NCREIF Index, they have been an average of 11.2% p.a. from 1987 to 2006, higher than the S&P 500 Index returns, but with only 40% of the volatility (as measured by standard deviation). However, given that only 40% of USA-based pension finds were actually invested in timberlands in late- 2007 (and mostly with only 1-2% of their assets in this class), there is a lot of scope for further expansion.

The biggest challenge facing the investment timberlands industry in 2008 is a lack of "affordable" properties on the market. The excess liquidity searching for timberland deals has driven up timberland prices by 2-3 times over the last several years. For instance, timberland values in the US South, which averaged only about $500 per acre in the late 1980s, now sell for in excess of $1,500 per acre; and the most recent large- tranche transaction in February this year went for almost $1,900 per acre. Incidentally the very highly geared investment in this 900,000 acre property (purchased by TimberSTAR in mid-2006) returned an estimated annual equity Internal Rate of Return (IRR) approaching 90%. This compares with fundamental annual returns on timberlands of perhaps 5-8% in the US PNW, and 4-6% in the US South.

There are certainly vast amounts of money to be made by aggressive, clever and risk- taking financial engineers using timberlands as their vehicle. More and more observers conclude that timberlands prices have become overheated; but this was a consensus three years ago, and each succeeding transaction seems to set new per- acre records. In early 2008, buyers exceed sellers. In late- 2007 Merrill Lynch (ML) had identified a further $4 billion of finance available for new timberland deals. However, DANA believes that the actual amount could be at least double this, or more. For instance, ML would probably not have included funding for the $1.7 billion Manulife - TimberSTAR deal in Q1 2008; nor the recent announcement by the nation's largest pension fund, CalPERS that it is back in the timberlands market -- wanting to allocate a heady $2.4 billion (only 1% of its funds) to "environmentally friendly" forest projects.

By early 2008, a number of TIMOs had become the largest landowners/managers in the United States. Several manage more than 1.0 million acres and some more than 2.0 million acres. One TIMO now manages more than 2.5 million acres in the USA; and the largest TIMO, counting its international assets manages more than 3.5 million acres. This compares with the largest truly private landowner in the United States (Sierra Pacific) with "only" about 1.8 million acres under (timberlands) management.

As transaction opportunities in the USA become less frequent and available, more investors are turning to investing in overseas timberlands, where both returns and risk levels can exceed those in the USA. A few of the 26 US/Canadian- based TIMOs, including GMO RR, GFP, TFG, HTRG, RMK, GEF and a division of Brookfield Asset Management (BAM), are actively seeking timberlands overseas. This process started in New Zealand in 1992, but has now spread to Australia, Chile, South Africa, Brazil, Uruguay, and an increasing number of new more risky and "non traditional" countries. These include transactions completed or contemplated in Latvia, Romania, China, Costa Rica, Belize, Malaysia, Mozambique and Tanzania.

Another new phenomenon is the spread of new non-USA-based timberland asset managers, including listed companies. Several European based fund/companies have been established in 2007-2008 including the London AIM- listed Phaunos and Cambium Funds, the German- based First Forest and Glensilver Funds and the new Finnish- based Dasos Fund. In addition Canadian- listed timberland companies such as Sino Forest and Cathay Forest have been catching investor's attention; with share prices in Sino- Forest increasing several times in the last five years -- at a time when almost all North American based listed forest products (timberlands) company shares have been languishing. Yet another new timberlands company is due to list (in Hong Kong) in 2008.

Plans to establish a number of country specific timberlands investing funds have been developed in 2007-2008 including in Russia, Brazil, Chile, Colombia and Japan.

Most timberland transactions recently have been funded by equity (with a few notable exceptions, e.g. see above TimberSTAR) and -- because they have been long term (with10-15 year time frames) have not had product prices hedged in any way. However, at least two timberland-related index funds have been opened in 2007; and so perhaps there is now an opportunity to hedge private transaction values against listed indices.

And finally a few of the smaller of the $2.5-3.0 trillion capitalized "Sovereign Wealth Funds" (SWF) industry have also begun dabbling in timberland ownership; and in 2008 some of the larger funds are likely to get onboard timberland investment opportunities. These SWF will be searching for any hard asset investments as their combined funds grow to an estimated $12 trillion (yes, trillion) by 2015. In addition countries may wish to use timberlands as a hedge against increasing FX reserves; e.g. just China and Russia alone now have more than $2.0 trillion in (mainly USD denominated) reserves.

The number of global timberlands owners, funds managers, "fund of funds" managers, listed vehicles and institutional funds in North America, Europe Oceania, Latin America, Africa and Asia have grown so much recently that DANA Limited has been able to identify and profile/list more than 600 global players in the timberlands business; to provide material on historic and recent trends, and on the timberlands investment risk profile outlook in a new Review: ***"The International Timberlands Ownership and Investment Review*** published in early March 2008. For more information visit www.dana.co.nz, or contact the author's office at jan@dana.co.nz

ENDS