1.1 Can timberland investments in emerging markets secure forest sustainability?

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Introduction

Timberland investments emerged as an option only about 20 years ago. Forests became subject to an industry that purchases, manages and sells forest properties at a commercial and business scale. Market participants are not primarily forestry professionals, but institutional investors; they include pension funds, endowments, foundations, insurance companies and families with high net worth.

These investors are interested in owning assets where performance is not subject to stock market volatility, sustainable returns can be achieved, and the investment horizon is medium- to long-term. Increasingly, these investors are providing financial resources for forests and forestry activities. It is estimated (Rinehart 2010) that around US$ 50 billion worth of forests is held by these institutional investors, most of it (80%) in the United States.

Although data for the global market are vague, estimates suggest that the value is in the vicinity of US$ 300 billion (Maher and O’Conner 2010) to US$ 467 billion (IWC 2009). The trend to invest in forestry outside the U.S. is strong and KPMG (2011) suggests that major areas of interest are emerging markets in Brazil and New Zealand, attracting more than 50% of investors. Australia, Chile, China, India, Malaysia, Russia and South Africa also attract attention (more than 15% of investors, but less than 50%), while Uruguay, Indonesia and Vietnam receive less attention (cumulatively less than 33%).

Forests, particularly in emerging economies, are still dwindling at alarming rates and the international community is developing various regulatory systems to reduce forest loss and degradation. In addition to these efforts private or institutional ownership of forests can significantly contribute to sustainable management of forests. There are many practical examples of forest investments in emerging markets safeguarding sustainable
management of natural forests (e.g., Precious Woods) or establishing significant areas of planted forests (e.g., the F.I.T. Timber Growth Fund). Moreover, an array of private investments, predominantly in teak, is important but also controversial; some are overpriced.

However, there is a wide gap between forest investors and potential investment recipients in emerging economies. On one hand, investors have due diligence requirements set out in financial terminology; on the other hand, recipients do not meet these requirements and they lack the funds and financial expertise to prepare for these processes. To improve understanding of forest investments, Tropenbos International, FAO and the National Forest Programme Facility commissioned a study to survey an array of investors and investment managers on their experiences and perspectives on investing in forest investments.¹

A study of timberland investors

The study assessed past patterns and sought to reveal barriers and opportunities for forest investments in emerging economies and identify ways to enhance new investments. The survey was carried out through structured interviews; respondents could provide their answers in writing or in a telephone conversation. In total, 78 persons/groups were contacted: 46% came from the investment manager group (referred to here as managers; Box 2) and 54% were classified as potential investors (referred to here as investors; Box 1). There were 43 respondents, of which 44% were managers and 56% investors.

The study was part of a broader effort to improve communication and mutual understanding between forestry and finance professionals and to identify additional sources of finance for forestry initiatives. The responses obtained represent approximately US$ 36 billion in forestry investments: 92% of capital was non-European, largely from North American institutional investors with median portfolios of approximately US$ 1 billion. European investors comprised the balance, with median portfolios of approximately US$ 100 million.

Box 1. Definition of investors

In the context of the study, “investors” refers to institutional investors. They are specialized financial intermediaries who manage funds collectively on behalf of small investors toward a specific objective in terms of acceptable risk, maximum returns and maturity. Institutional investors are constituted mainly of pension funds, insurance companies and mutual funds. Endowments and family foundations are often grouped in and treated under this category as well. For the G7 as a whole, the value of institutional investments rose from 23% of GDP in 1970 to 108% in 1998.

Source: Davis and Steil 2004

Globally, approximately 8% of funds invested by institutions is held as “timber” (Table 1). Stumpage-value investments — i.e., those without operational risks — are preferred.
Table 1. Institutional investment (%) in various asset classes, 2010

<table>
<thead>
<tr>
<th>Asset class</th>
<th>2003</th>
<th>2009</th>
<th>Asset class</th>
<th>2003</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>96</td>
<td>99</td>
<td>Commercial real estate</td>
<td>50</td>
<td>57</td>
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<tr>
<td>Public equity</td>
<td>91</td>
<td>95</td>
<td>Hedge funds</td>
<td>21</td>
<td>48</td>
</tr>
<tr>
<td>Fixed income</td>
<td>91</td>
<td>95</td>
<td>Energy</td>
<td>17</td>
<td>22</td>
</tr>
<tr>
<td>Private equity</td>
<td>58</td>
<td>78</td>
<td>Timber</td>
<td>2</td>
<td>8</td>
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</tbody>
</table>

Note: n = 206; Source: Houser and Tackett 2010

Most of the estimated US$ 50 billion in forest investment value is located in North America, followed Australasia and South America. Few managers have global portfolios; most of them concentrate on one or two continents (Table 2; Box 4).

Table 2. Forest investment by selected investment managers and geographic regions

<table>
<thead>
<tr>
<th>Investment Manager</th>
<th>U.S.</th>
<th>CA</th>
<th>LA</th>
<th>OC</th>
<th>A/S</th>
<th>WE</th>
<th>EE/R</th>
<th>A-P</th>
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</thead>
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<tr>
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<td>✓</td>
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<td></td>
<td>✓</td>
</tr>
</tbody>
</table>

U.S.: United States; CA: Canada; LA: Latin America; OC: Oceania; A/S: Africa south of Sahara; WE: Western Europe; EE/R: Eastern Europe and Russia; A-P: Asia-Pacific
Source: Modified by Glauner 2011, based on Chung Hong Fu in Maher and O’Connor 2010.

A study by KPMG (2011) came to similar conclusions (Figure 1).

**Box 2. Investment managers**

Investment managers control investment portfolio on behalf of clients. They make investment decisions on behalf of clients according to the parameters set by the client. Some investment managers have more autonomy than others; this depends on the client’s needs and desires. Unlike brokers, investment managers are not generally paid by commission, but by a percentage of the value of assets under management. This gives the investment manager an incentive to work for the client’s profit, since the more money the client makes, the more the manager makes.

The subjects of the KPMG study were investment decision-makers in North America and Europe, who are the primary source of capital for forest investing (Box 3).

**Box 3. Study question 1**

*Question: Are you already investing in forestry or do you plan to invest in forestry?*

Findings: All North American investors surveyed were already invested in forests, although some of the capital they have allocated to invest in forests has not yet been invested. The European investors surveyed were only partly invested in forests; those already invested planned to increase their amount. Those not yet invested plan to do so in the near future (less than three years). This can be partly attributed to the type of subjects contacted; since they are forest investment specialists, most of them are with organizations that have invested in forests or plan to do so. Some of the subjects who haven’t yet invested in forests felt that the survey was meant for institutions already invested in forests.

**Investor and investment manager responses**

Diversification and a hedge against inflation were the primary reasons respondents mentioned for investing in forestry. They consistently cited research indicating low or no correlation between timberland and mainstream assets. The lack of correlation provides the opportunity for higher risk-adjusted returns to portfolios containing timberland. Respondents also frequently cited positive correlation between inflation and timberland investment return as contributing to their decision to invest in forests.

**Box 4. Study question 2**

*Question: Is your allocation to forests done geographically, and if yes, can you describe it?*

Findings: Investors were split between i) allocation by geography in a very broad way (such as U.S./ex-U.S., or North America/other OECD (Organization for Economic Cooperation and Development)/ex-OECD); and ii) primarily focused on best opportunity, with geography a factor in screening for best opportunity or a secondary consideration to prevent excess exposure to a geographic category. Most investors subscribe to a manager’s fund or hire managers who then have discretion regarding investment geography. Therefore, investors who allocate by geography should have the resources to search for managers and monitor investments accordingly. Investors who retain discretion over investment decisions are a smaller but growing proportion of forest investors. This type of investor is waiting for opportunities in countries where they are already invested in other sectors, or where their business partners are invested. A number of countries were mentioned by European investors as “no go” areas (negative selection). Most of these countries are affected by war or other social instabilities.
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Figure 1. Countries where investors have significant timberland interests

Note: Results of a KPMG survey (2011) to the question “In which countries do you have significant timberland interests outside North America?”

Investors generally do not invest in forest-based businesses such as processing and manufacturing. They cite a lack of expertise in managing operating and labour risks, and prefer the investment attributes of forests themselves to value-added returns from processing.

Although water quality, biodiversity, carbon sequestration and other ecosystem services may well be emerging sources of potential value, investors consider them to be secondary outputs. Forestry for timber production was the survey participants’ primary reason for investing and therefore was the focus of the survey. Despite the focus on forestry, investors also placed great importance on several related factors:

- political stability;
- established private property rights;
- well-functioning legal and banking systems;
- a stable tax environment;
- acceptable currency policy/risk; and
- proven management.

Investor satisfaction with the performance of their forestry investments has been mixed. The rate of satisfaction is strongly related to investment timing. Investments made between the two most recent recessions, in 2001 and 2007–09, have not yielded the anticipated returns.

Scope for increasing forestry investments will likely come through new investors. Although several investors cited potential forest allocations of 5–10% of their total portfolio, actual allocations rarely exceeded 2%.
Investors prefer planted forests. None of the North American respondents reported specific allocations by forest type (plantations vs. managed natural stands). Some were concerned about type diversification and intended to monitor performance on this basis. Nearly all investors considered natural stands in tropical forests unsuitable for investment. Management of natural tropical forests was seen negatively as “forest clearing,” “illegal logging” and “conversion,” while investing in natural forests in temperate regions was acceptable. In general, planted forests are more likely to be of institutional quality, and to have a history of professional management and availability of forest information (inventories, maps, silviculture treatments, etc.) Plantations are seen as more manageable and more predictable and thus a better investment.

Investors generally seek forests that can be certified as sustainably managed. Survey respondents seldom explicitly address sustainability in documented investment policy, but they do cite it as an important requirement of their managers. The majority of respondents expressed a requirement for acceptable certification, although they expressed no preference for a specific certification standard.

There is scope for attracting further interest by investors in forestry in developing regions. The number of investors interested in forestry is growing and developing regions have the potential to meet this demand. The survey revealed that several investors, primarily European, are in the process of developing forest portfolios. North American and European investors differed in their responses. Few North American investors anticipated major new investments in forestry, while European investors had plans for new or expanded forest portfolios.

Sound government policy and investment conditions at the national level are highly important to investors. Important country factors cited were political stability, established private property rights, well-functioning legal and banking systems, strong domestic consumption of forest products, a stable tax structure, acceptable currency policy/risk and availability of proven management. Most investors cited ten years of stability as being necessary as a pre-condition for investing in a developing country. The most prominent negative condition noted by managers was the prevalence of corrupt business practices.

Intermediaries with experience in forestry investment and country conditions are particularly important in emerging markets. Specific means of gaining expertise included relationships with local partners, internal in-country staff, hiring local industry consultants with a good reputation and having strong professional networks.

Knowledge of forest investing among investors remains limited. Specific recommendations made by respondents as to how governments can help included advocacy for financial instruments that reduce risk; support for research and publication of market and technical information in emerging markets; discussions of timber attributes and product uses in emerging regions; reliable site-specific growth information; improved property rights and
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land tenure systems; provision of log tracking systems and other impediments to illegal logging; and basic law enforcement and impediments to corruption.

Conclusion

The outlook for forestry investments in emerging markets is positive but challenging. Survey respondents were optimistic when asked about their outlook on forestry investments. They cited increasing confidence in the ability of the southern hemisphere and Asia — particularly in China and India — to provide increasing demand for forest products. There is a sense that over time wood use follows wealth development and that processing will move closer to end-use markets. Wood for energy also has a future.

Expected returns from developed markets are low and investors seek higher returns from markets where risk can be managed. This provides an opportunity for developing regions to meet the increasing demand for sound forest investment.

Nonetheless, investors have doubts that emerging markets will thrive and concerns that risk will not be compensated. The study also clearly identified the wide gap between investors who provide capital and those who expect benefits from their businesses in emerging markets. Forestry remains a niche market for investors. Natural forests in tropical countries in particular are so far removed from the standard investment screening process that it will take either decades or concerted efforts to bridge this gap.

Investment opportunities can be found in a number of countries, including non-traditional forest investment countries (e.g., teak on Fiji, above) through a wide range of stumpage investments to those where the downstream-processing component is fully included.

Endnote

1. See www.fao.org/docrep/015/an901e/an901e00.pdf. The study was commissioned by FAO and Tropenbos International, with support from the Canadian Forest Service.

References


KPMG. 2011. KPMG’s Timberland Investor Sentiment Survey.
