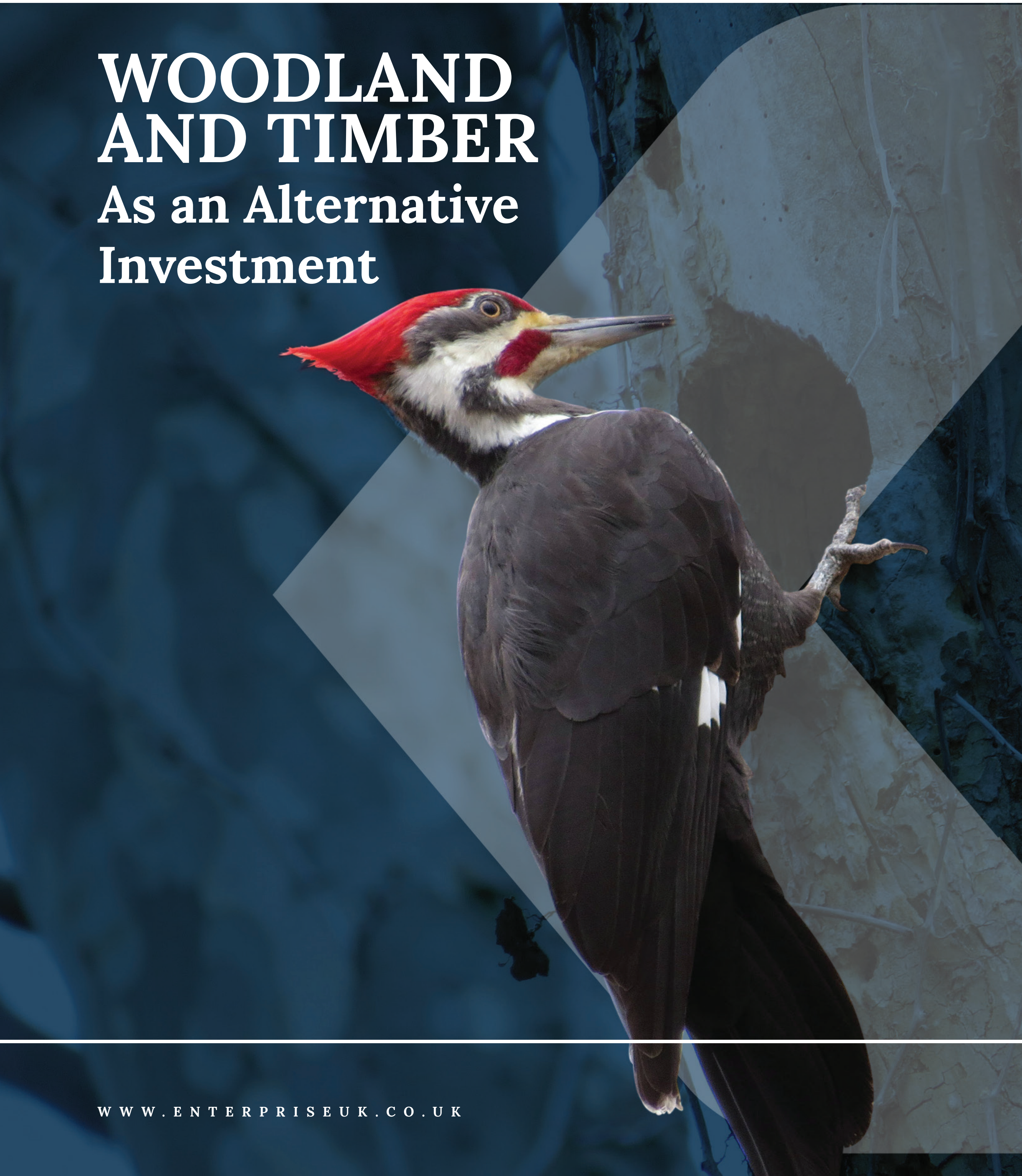
EnterpriseUK
The Financial Ecosystem

WOODLAND AND TIMBER
As an Alternative Investment



W W W . E N T E R P R I S E U K . C O . U K

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I. WHAT IS TIMBERLAND (FORESTRY) INVESTMENT?

In an investment context, what do we mean by the terms, “woodland”, “timberland”,” forestry” and “plantation forestry”?

Essentially, in each case, the investment asset being acquired is agricultural land together with the harvestable crop grown on it, which in all of these cases is trees or timber. The types of trees grown commercially also vary considerably, from softwoods like Spruce and Pine, to hardwoods such as Teak and Mahogany that are grown largely in tropical emerging economies and Robinia that is native to and grown in central Europe, particularly Germany.

Total returns are derived from the appreciation in the value of the land and of the trees growing on it, together with the eventual income from selling the harvested timber. Both of these factors are affected by the demand for and hence the price of timber. In many countries, and in particular in the UK, these returns are enhanced by various tax reliefs available to investors. More recently returns on forestry cultivated for biomass have been driven by wider energy prices.

Despite this relatively simple definition, there have been and remain many different forms that this unique and interesting asset class can take. The one thing that they all have in common is that, by their very nature, such investments are long-term and with very few exceptions have little or no secondary market in which to trade your interests. As a consequence this asset class has a combination of characteristics that we see in other, perhaps more familiar asset classes. It quite clearly possesses many of the features of real estate investments, but generates no yield from rental income (although some holdings may be leased for renewable energy production and the ground rents may sometimes be distributed as income, or used to offset management costs). The harvested timber also resembles other agricultural commodities, albeit the “growing period” is considerably longer than say corn, soybeans, oranges or coffee. The long investment horizon with a “bullet return” at the end also resembles venture capital type investments.

Timberland as an investment therefore, quite obviously falls into the category of an “alternative investment”.

Alternative investments typically are very focused on one activity in which the manager is a recognized specialist. Further they usually involve specific and identifiable risks, stemming from characteristics such as those mentioned above, i.e. illiquidity and sensitivity to fire, weather and other environmental cycles. While some risks can be mitigated by risk management methods, such as insuring the crop against fire, storm damage, floods, frosts etc., nevertheless investors typically demand an enhanced return, or risk premium, for bearing these additional risks. The risk premium from timberland investment is evidenced by the fact that the long- term rates of return have exceeded those of other, more conventional investment asset classes, such as developed market equities and bonds.

II. HISTORY

Investment in timberland has been going on for centuries. Originally the major land owners (in Europe this was largely the old aristocracy) sought a means of gaining a return on the vast acreage of land they held. Some land was already being used for regular farming, raising herds of cattle and sheep or planting annually harvested crops such as corn or soybeans. Planting longer cycle crops such as trees helped to smooth out the highly volatile, weather and disease dependent, yields from annual crops. Of course, they often used the timber themselves for construction, fencing etc.

In the US, the largest investors in timberland are the institutional pension funds with total investments at end-2016 in the region of $60 billion according to the RISI International Timberland Ownership and Investment Database (2016).

In the UK and Europe, the story is rather different in that the largest investors are wealthy individuals and family offices where the tax breaks, particularly IHT relief, provide strong investment incentives.

III. HOW CAN I INVEST IN TIMBERLAND?

The longest established method of investing in timberland is by direct investment, i.e. buy an existing forest or buy or lease the land and plant trees. While this used to require significant initial capital, possibly €575,000 or £500,000 to buy an existing forest, or to purchase and plant the land, it is now possible to buy or lease small parcels of planted land within a larger managed plantation, with minimum investments as small as €8,000 (£7,000). This is the least liquid form of investment, but it permits a much higher level of investor involvement in the decision making in relation to the management and harvesting of the timber.

Other ways of investing modest amounts of capital include:

1) Managed funds that either invest directly themselves, or, that invest in forestry related companies that may include timberland managers but also producers of biomass timber for fuel, pulp producers for the paper industry as well as conventional users of round or sawn timber.

2) Exchange Traded Funds (ETF), these funds usually set out to track the returns of some underlying industry benchmark index, e.g. iShares offer an ETF that tracks the S&P Timber and Forestry index which in turn monitors the wider forestry industry including REITs and paper & packaging companies. ETF also tend to move more in line with global equity markets than say directly invested timberland (i.e. they have a higher correlation with equity market indices). This is the most liquid means of investing in the broad timber industry.

3) Investment trusts, these are similar to managed funds in their underlying investments, but they are closed-end vehicles and often have a pre- determined, fixed life span, say 8 to 15 years. At the end of which the fund is liquidated and the proceeds after management fees are distributed to shareholders. While the returns of these investment trusts have been disappointing when compared to direct investments or some managed funds, they do trade in the secondary market but at significant discounts to their net asset values.

IV. FEATURES OF TIMBERLAND INVESTMENT

Timberland offers attractive features from several different perspectives, including, but not limited to its potential investment return.

1. Timberland has historically provided attractive risk-adjusted returns (i.e. return per unit of volatility risk), and its performance compares favourably with that of equities, fixed income and many other asset classes.
2. Timberland, like virtually all commodities, (agricultural, energy and metals) is considered a "real asset". Real assets derive their intrinsic value from their utility, i.e. they are used or consumed by the wider economy. As such, real assets are viewed by many as potential inflation hedges. Clearly the output from timberland is used in a wide range of sectors within the global economy.
3. Over time, the pattern of returns from timberland investment has been quite different from those of many other asset classes, i.e. they have not risen or fallen in step with each other. This low correlation with the returns of other asset classes means that timberland can add diversification to a broad portfolio of investments with the resultant reduction in overall volatility risk at the portfolio level.
4. Quite distinct from the issue of investment performance, there are certain intrinsic (biological) attributes of timberland that distinguish it from other asset classes. One such attribute is the ability of commercial timberland to add value through biological growth irrespective of what is happening in financial markets and the economy.
5. Another biological attribute of timberland, attractive to some investors, is the flexibility to "market time" the harvest, i.e. to increase or reduce the proportion of standing timber that is harvested in response to timber price movements. When prices are low, the timberland owner/investor can decide to reduce the scale of the harvest and "store timber" as standing trees. This has low opportunity cost because un-harvested trees continue to grow and add value through the extra growing time. When used judiciously, this process simultaneously raises the actual long-term performance while lowering the volatility of returns.
6. As mentioned above, timberland shares certain investment characteristics with other commodities. As a result, when global economic conditions bode well for commodities generally some investors will also view timberland in a similar positive light. Thus, the upward price pressure on many commodities and real assets usually associated with global economic growth should also benefit timber. This is supported by changing global demographics (the world population, projected to reach 9 billion by 2040, and its rising affluence) will increase global consumption of paper and wood products as needs for tissue, packaging and housing grows.
7. While future demand for timber is expected to continue rising, the supply is expected to be constrained. Governmental restrictions and popular conservation efforts are limiting harvests from natural forests, meaning there is an increasing demand for sustainably-grown timber cultivated in

managed forest plantations. However, the amount of land available for such plantations is limited due to competing land uses, such as agriculture, conservation and development. Because of these global trends, investors increasingly view this as an opportune time to make new and expanded commitments to the asset class.

8. Timberland investments are by their very nature “green” and meet all of the aims and objectives for investors seeking to follow a Socially Responsible Investment (SRI) program.
9. Due to the long time (typically 7 to 10 years) required for trees to grow to an economically harvestable size, usually with no interim income yield, potential investors must accept that timberland is a long-term investment. Generally, there is no secondary market and hence no early exit for investors, although some funds and now some direct investment schemes will assist investors who want or need to sell to find a private buyer. The price is normally negotiated directly between buyer and seller, so a forced seller will likely not achieve the best price possible.
10. As noted above there is usually no secondary market trading in timberland, partly because there is no easy way of valuing the investment prior to harvesting the timber. Appraisals are used but of course do not reflect the actual prices achievable in a transaction.
11. Tax reliefs are available in some jurisdictions. Investors who are UK resident and domiciled in the UK for tax purposes and invested in timberland across the European Union (EU) may claim the following reliefs.
    - Income tax
    - Capital gains tax (on the trees, but not the land itself)
    - Inheritance tax

    Of course, any such relief is subject to fiscal change and may be amended or withdrawn if tax legislation changes.

V. ATTRACTIONS OF TIMBERLAND AS AN ASSET CLASS

In many ways this section simply summarizes the features listed above.

The most obvious attraction is the potential for steady positive returns with relatively low volatility-risk. Historic returns over the past 20 years, while no guarantee of future returns, have outpaced most traditional asset classes and with lower volatility, i.e. they have generated better risk-adjusted returns, where risk here is defined as the volatility of returns.

Moreover, the correlation between the returns from timberland investment and those of mainstream asset classes like developed market equities and bonds has been very low (i.e. near zero, and even slightly negative over some time periods).

These characteristics mean that timberland offers strong diversification properties when added to existing portfolios of other assets. That having been said the timber industry is not completely immune from the wider economy. Timber prices vary with demand that in turn reflects growth or contraction in that wider global economy.

As a real asset, timberland is viewed as a potential inflation hedge. As a growing asset each year that passes the tree gets bigger and, all other things being equal, should be worth more.

The tax reliefs offered by some governments, especially in the UK, for investing in timberland recognize the importance of timber as a strategic resource and are there to encourage the development of commercial forestry plantations while acknowledging the long-term nature of this type of investment. To be eligible for any tax relief the woodland or forest must be commercial ventures for the purpose of making a profit. Assuming this is so, then the key reliefs available to UK tax- resident investors are as follows.

1) Income from the ownership of commercial timberland is free of income tax, including from the sale of standing timber or on the appreciation of the value of standing trees during ownership. It should be noted that certain commercial activities, that are deemed to be trading activities, remain subject to income tax, such as the sale of Christmas trees and short-rotation coppicing.
    - It should be noted that in general there are no tax-deductible offsets for interest charges or the input costs of managing the timberland.
    - Amounts received under forestry grant schemes are not taxable. However, grants that are received by way of compensation for change of land usage or farm income support, are taxable as income.
2) There is no Capital Gains Tax (CGT) chargeable on the increase in value of felled or standing timber. HOWEVER, on disposal (sale), any increase in the value of the land itself is assessable for CGT, after deducting the original cost (without trees) and purchase and sale expenses. Again, there is no offset for the costs and expenses of managing the plantation. Note that for a UK basic rate taxpayer there is a tax free CGT allowance of £11,300 for FY 2017/18.
    - Note that disposal of the land or shares in the forestry company on the death of the original

owner via transfer to a beneficiary is not subject to GCT.

3) Inheritance Tax (IHT) is payable on the value of an estate together with the value of certain lifetime transfers upon the death of the owner/donor, subject to the total value exceeding some threshold. This threshold is currently £325,000. However, Business Property Relief (BPR) legislation provides that commercial timberland that has been held by the owner for at least two years that is subsequently sold or transferred upon the death of the owner may be exempt from IHT. Again, DTA will govern the extent to which IHT or its equivalent may be offsettable via tax credits on investments in non-UK countries. Additional legislation caters specifically for non-commercial woodland.

At present these reliefs are available on investments made in the UK and via a system of tax credits, on investments in the European Economic Area (EEA). There may be tax breaks available for investments in other countries outside the EEA, but these will be subject to the specific Double Taxation Agreements (DTA) in place between the UK and the third-party country.

The above is not a complete analysis or statement of the conditions under which the tax reliefs are available. Any potential investor should seek individual professional tax advice prior to making a decision or an investment.

VI. ANALYSIS OF LONG-TERM RETURNS FROM TIMBERLAND INVESTMENT

In the following analyses we compare the historic returns from US timberland and forestry with the returns from the principal US equity market index, the S&P 500, for the years since end-2002 which marked the end of the market collapse in the wake of the bursting of the "tech-market bubble".

The returns data on US timberland are returns to the NCREIF Timberland Index, compiled and published by the National Council of Real Estate Investment Fiduciaries. This organization publishes a series of indices monitoring the growth in various aspects of the US real estate market.

Chart 1 below compares the growth in the NCREIF Timberland Index and the S&P 500 index between December 2002 and December 2016.

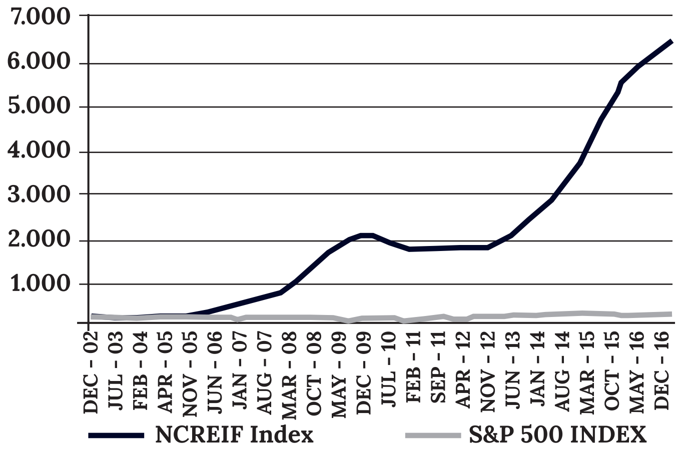

Chart 1. NCREIF vs S&P 500 Index (2002-2016)
Sources: NCREIF, Google Finance

	2002 - 2016	
	NCREIF Index	S&P 500 Index
Average Annual Return	38.5%	8.3%
Annual volatility of returns	33.3%	16.4%
	Correlation -0.43	

Table 1. Annual Returns (2002-2016)
Sources: NCREIF, Yahoo Finance, Timberland Investments Resources

				PORTFOLIO		
Asset	Avg (Ret)	Volatility	Correlation	Weights	Avg (Ret)	Volatility
S&P 500 returns	8%	16%	-0.43	90%	11.34%	13.6%
NCREIF returns	39%	33%		10%		

Table 2. Diversification Impact (2002-2016)
Sources: NCREIF, Yahoo Finance, Timberland Investments Resources

Table 2 shows that adding a 10% investment into US timberland to a portfolio tracking the S&P 500 for the entire period would have enhanced the return from 8% to 11% and reduced the volatility risk from 16% to 13.6%. These figures simply show the potential power of diversification and are not projections of future expectations nor a recommendation of the appropriate allocation to timberland. The figure below (Figure 1), shows the long-term correlation (1995-2014) between quarterly returns from the NCREIF Timberland Index and a range of other mainstream investment asset classes. This source of this figure is a report produced by Timberland Investment Resources (TIR), “Timberland Investments - A Primer”, by Chung-Hong Fu, originally published in June 2012 and updated in May 2015.

As can be seen, over this period the correlation between timberland returns and the S&P 500 was positive but still very low, around 0.21. Perhaps unsurprisingly the highest positive correlations are with commercial real estate and private equity.

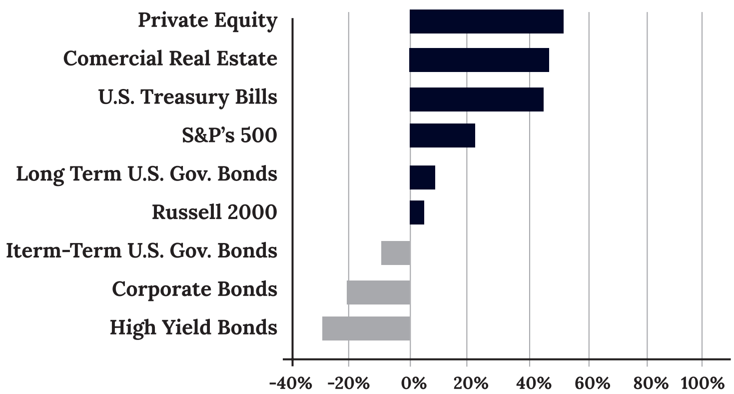

Chart 2. Correlation of annual returns between Timberland and other Asset Classes
Source: Timberland Investments Resources

VII. INVESTMENT RISKS AND HOW SOME OF THEM CAN BE MITIGATED

Timber prices are volatile. While over the long-term they have demonstrated steady positive returns, there are nevertheless periods when prices have fallen, and doubtless will do so again at some point.

If at the end of the expected growing period, say 7 years, the market price for cut timber is depressed, then it is possible for the plantation manager to decide to defer some or all of the felling until market prices have recovered somewhat. Such a delay could then benefit from two factors, first the hoped-for recovery in timber price and second the additional year's growth that should mean that each tree is worth more. This flexibility in harvesting policy provides at least a partial means of managing the volatility of returns. Potential investors should consider what type of trees to invest, what is the market for that timber and how sensitive is that market to general economic factors.

Land prices can go down as well as up and the total return from such investments is heavily dependent on the price of land. Again, investors should consider the potential future land price appreciation and the risk of falling prices when considering an investment in timberland.

Timberland investment is a long-term strategy, usually between 7 and 10 years, with no early exit opportunity. This illiquidity feature is common to other private equity and venture capital investments. Some plantation managers will help facilitate an early exit if they can, by identifying a potential buyer. However, as the price must be negotiated privately between buyer and seller, the seller rarely gets the best possible price. Forestry ETF effectively mitigate the illiquidity issue but suffer from their higher correlation with traditional markets and thus offer less diversification to the portfolio.

Growing trees are subject to certain physical risks, many of which can be totally devastating in their effect, for example, fire, flood, wind, pests and diseases. Many of these risks can be successfully insured against, but usually only after the plantations have established themselves, say after 2 or 3 years growth. Specialist insurance underwriters take on these risks and the costs of premiums are usually included in the management fees.

With the exception of ETF, all forms of investment in timberland and forestry are unregulated by the FCA in the UK. Investors get no protection from the Financial Services Compensation Scheme.

Investments in tropical timberland also involve the political and economic risks associated with investments in developing economies, as well as foreign exchange rate risk.

Long term climate change may have significant impact on where and how commercial timber can be grown, particularly when competing for land with farming for food crops.

VII. BREXIT AND THE POSSIBLE IMPLICATIONS FOR INVESTMENT INTO EUROPE

For UK investors acquiring an interest in UK timberland, the current taxation rules will persist subject to no changes in domestic legislation. However, the triggering of “clause 50” to formally put in train the withdrawal of the UK from the EU and the EEA will almost certainly impact the long-term status of non-UK investment timberland. This formal announcement is expected before end-March 2017. Over the ensuing two year period the entire relationship between the UK and the EU, including the taxation of cross-border investment activities, will be renegotiated. The outcome is far from certain, as therefore is the future of cross -border tax relief.

Given the long-term nature of timberland investment, care should be taken in making decisions that will not come to maturity for some 7 - 10 years. However, some European based managers of timberland investments are already anticipating changes and are creating UK regulated investment vehicles, to provide access to overseas investment opportunities.

VIII. CONCLUSION

Experienced (accredited) investors who already have a significant proportion of their financial investments in traditional exchange traded liquid assets, and who are prepared to lock-up some of their capital for up to 10 years, may find attractive the potential for higher returns with tax advantages and risk diversification at the portfolio level.

One key consideration is the form that the investment should take. While there are many variations available, there are essentially two primary routes. First there is direct investment involving the acquisition of freehold or leasehold land that is commercially planted and managed. The second route is via a comingled investment vehicle that may be structured as an ETF, a fund, or an investment trust. A potential investor should make each decision in turn based on their own individual circumstances and always after conducting appropriate due diligence and taking professional advice.

Data sources:

Google finance:

- Historical data on asset class returns

Yahoo finance:

- Historical data on asset class returns

Timberland Investment Resources (TIR):

- “Why invest in Timberland?”, Risk and Return

- Timberland Investments: A Primer” June 2012, May 2015 MSCI Investment Property Databank (IPD) UK Annual Forestry Index National Council of Real Estate Investment Fiduciaries, (NCREIF): U.S. timberland’s investment performance is measured by the NCREIF Timberland Index, which is published by the National Council of Real Estate Investment Fiduciaries. The NCREIF Timberland Index is analogous to the NCREIF Property Index, which NCREIF sponsors to track the performance of the broader commercial real estate market.

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Many Investors are realising high growth through “Alternative Investments” that differ from traditional asset classes, such as developed market equities and sovereign bonds.
Deemed to carry a higher risk, alternatives, also offer the potential of higher returns.
Through our Invest Safe Initiative, we identify exclusive opportunities that we introduce to our growing community of investors. Opportunities like these tend to appeal to investors who self-manage at least a part of their portfolio.
These investors often will use an IFA or professional wealth advisors, particularly for the design and implementation of their core investments and these core investments will typically be in the traditional asset classes, whether invested directly or through managed funds.
However, if they are savvy and can manage a part of their portfolio themselves, they may want access to innovative opportunities that are often in asset classes that are not systematically or even typically researched or offered by conventional routes.
These alternatives very often have zero correlation to publicly traded investments.
We conduct primary due diligence on the investment concepts we feature so investors can have access to key facts. This usually provides investors with enough information to make up their minds if the proposition is sufficiently interesting for them to carry out the additional research and due diligence they would need to know if the investment is appropriate for their portfolio and whether to make an investment.
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All investments involve a certain amount of risk however, investments in alternative assets are inherently riskier than some other more conventional savings and investment schemes. Investors are reminded that the value of such investments can go down as well as up and that past performance is not necessarily an indicator of future returns. Investors should not consider such investments unless they can withstand the potential loss of all their invested capital.
Alternative investments are only appropriate for investors who are able and willing to accept the higher risk associated with such investments. It is generally recommended that such investments are made part of a broadly diversified portfolio. Professional advice is recommended before making any investment decisions.

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Small things make a big difference.

We support NGO´s that focus on preserving the Amazon and supporting the local people who protect and nurture this beautiful land.

We commit 1% of our revenue to environmental causes close to our heart.

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