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Forestry

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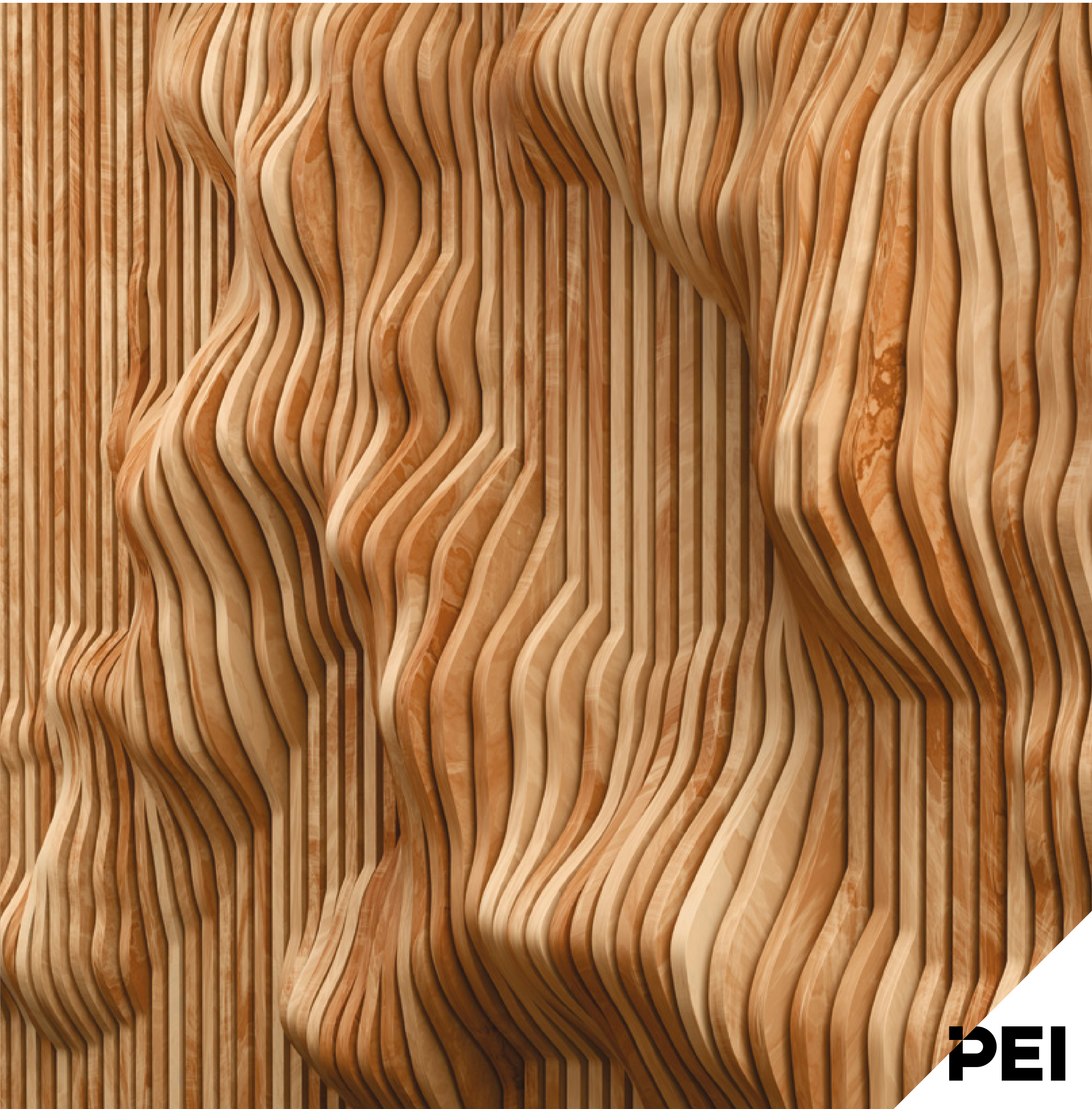

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KEYNOTE INTERVIEW

Continuity and change in forest investing

Forest investment solutions continue to evolve, but the main investment characteristics remain a solid foundation for the asset class, says FIA's Mike Cerchiaro

Forest Investment Associates celebrates its 40th anniversary this year. FIA's president and CEO, Mike Cerchiaro, reflects on changes in the asset class as managers embrace a more diversified range of strategies based around the emergence of natural capital. Still, he notes that many fundamentals remain the same. Further, as an inflation hedge and with its low correlation to other asset classes, forestry is continuing to prove its worth.

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Q What has remained consistent in timberland investing over the last 40 years?

What's interesting to me is that the same things we talked about in the early days of the asset class – inflation hedge, diversification, low correlation with other assets – have remained relevant. We've seen a world of converging correlations across asset classes, yet timberland continues to be a low-correlated asset across private equity, public equity, fixed income and infrastructure. That's a real strength of the asset class that has remained consistent.

The foundation of that is biological growth. It's something that we've maybe not talked about in our space as much as we should have, but that is the underpinning of the low correlations. At the end of the day, the trees keep growing. That's not going to change, so it's really a matter of markets around that theme of biological growth.

FIA published a paper last year that looked at 10-year holding periods beginning in 2000, which showed that if you held timberland for 10 years across the 2000 to 2015 vintages, you had positive real returns. Again, with all the volatility over that period, we believe that's a compelling finding for the asset class.

The inflation hedge aspect also really came through during the post-covid pulse of inflation. Timberland is continuing to deliver on that hedging characteristic today, which is a powerful consistent attribute.

Q What are the biggest changes in the competitive landscape for timberland managers?

Forest products markets continue to see innovation and investment in the technologies used in construction and fiber production, and we're seeing these technologies deployed at scale across many different markets.

The evolution of investment strategies within forestry has probably been the biggest development, especially over the last 10 years. The traditional objective of a forest investment strategy was to gain exposure to the sustainable generation of timber, monetize those products, replant and then let that virtuous cycle unfold.

Over the last decade, however, the asset class has evolved towards a natural capital concept, where we're seeing the stacking and layering of other values associated with the raw land and the forest itself.

Sustainability and stewardship have always been at the core of forestry management and forestry will always be a strong responsible investment solution. What's changed in sustainability is that the broader growth of ecosystem service markets is providing opportunities for investors to consider how they can tap into those values through different approaches to forest management and different investment strategies.

Q How large is the carbon sequestration opportunity?

Carbon is a revenue-generating opportunity. The narrative is that the US is retreating from climate commitments, while Europe and Asia are reinforcing commitments to net zero through continued guidance in the regulatory and voluntary arenas. In some markets, the regulatory overlay is real, which supports the demand for carbon solutions, so we see a bifurcation in how institutional investors consider these sorts of opportunities in carbon, based upon what regulatory regime they're subject to.

It's a real opportunity, although it is a fast-moving and volatile market. Certain managers are executing on carbon-centric themes, but the expected returns in those investments need to be commensurate with the

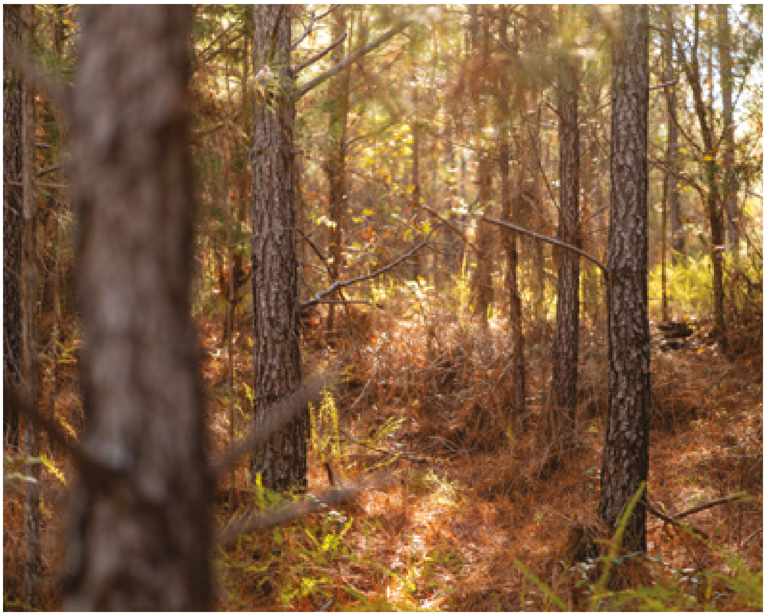
Q FIA has a focus on the Americas. What makes the region attractive for forestry investors?

As forest investors, we foundationally look at where markets exist today, and how those markets are constructed by demand and supply for a basket of forest products. This is our starting point.

The core of most mature markets in this space is driven by demand for fiber and logs. Forest products' end-use markets are largely commoditized, so keying in on where log/fiber conversion is exposed to low-cost industrial production is central. We ask ourselves where does demand sit? Where's the wood? Where's the supply? And then where is world-class industrial capacity?

We keep coming back to the infrastructure that exists in both the US and across South America, and specifically Brazil and Chile, as ways to gain exposure to key demand and globally competitive markets. This installs resilience to asset performance driven by consistent demand.

Then we can build from that core view on where there are other angles we can take, whether it be a nature-based solution, or thinking about carbon or climate-smart forestry, and where we can report in more rigorous ways around climate outcomes for our clients. So, our whole strategy builds off that core of understanding where markets are resilient and built to last while embracing evolving alternative values.



SOURCE: FOREST INVESTMENT ASSOCIATES

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risk. We take the view that an attractive strategy is to use carbon to diversify, so that we complement the fundamental supply of wood products with carbon market revenues.

Q To what extent is delaying harvesting a suitable response to price dynamics?

Wood prices are always going to be very micro-market specific. In the US, the Pacific Northwest has a much tighter wood supply versus demand. Then you have a commonly cited regional supply overhang in the US South, which we continue to work through. Contrast the US wood price dynamics with what we see in markets such as Brazil, where real price appreciation has been evident over the past five years. A manager needs to be refined in their view around local timber markets.

One of the inherent benefits of the timberland asset class is the wide window of optimal harvest. For softwood species, that window may be up to seven years in a location like the Pacific Northwest. That optionality is helpful, but one of our lessons in managing through weaker markets is that you must know your basin.

In an oversupplied market, it is often best to take your price in the current market, reinvest in a fast-growing, high-quality, sustainable forest plantation, and let biological growth do the rest. In markets like Chile, some markets in Brazil, or in the Pacific Northwest, however, you can wait for a pricing rebound, because once demand snaps on, timber price is going to respond in tandem.

Q How are natural risks assessed in forest investments?

We perform physical risk assessments to leverage science into creating scenarios in which we can assess those risks under different climate change scenarios. We can then consider operating solutions and integrate them into our investment decisions. So, with respect to fire, that helps us create a response system and to manage forests to minimize those risks in a way that's more prudent.

The physical risk assessment and the ability to manage and address risks at the time of acquisition or on existing assets is an increasingly important skill for forestry managers.

Q What are investors asking today that they wouldn't have asked 10 years ago?

We're getting more questions about revenue stacking, the overlay of alternative values, how managers can monetize those values, how we're acknowledging them at the time of acquisition and how we price them when we're considering exit. This detailed scrutiny around alternative values is becoming more important.

The intersection with different markets like renewables is becoming part and parcel of how we think about land in general, regardless of land use.

We continue to get questions about when the global wood products market is going to rebound. There is a housing shortage globally, not just in the US. More investors are asking about the demographic trends behind that, and when these will lead to the market for wood products being unstuck.

Housing construction has been slower relative to what the demographics would suggest. The biggest friction is around housing affordability. A flattening of house price appreciation in certain markets, along with lower interest rates, may be needed to create more affordable housing options and kickstart activity in the sector.

That dam will break. The demographics are too strong, and the dynamics around the pent-up demand for housing units mean that over the next five-10 years, the market for wood products is going to be freed. We're already seeing some sophisticated investors taking positions in the supply chain, including the homebuilders. ■