

Why Continue to Invest in US Timberlands?

As expected returns from timberland investments in the United States in recent years have decreased slightly, concerns regarding the future role of such investments in institutional investors' portfolios have naturally emerged. The International Woodland Company (IWC) recognizes the lower return expectations, but still considers the US regions an essential component of a diversified international forest investment portfolio.

Overview of the US timberland market

Not so long ago, investors were talking about 8% real returns on timberland investments in the United States, whereas today the norm is closer to 6%. Many institutional investors are actively seeking an exposure to the asset class, which means that the US timberland investment market is maturing. Consequently, investors are paying higher prices per hectare for timberland, which serves to lower the expected return on invested capital.

IWC recognizes the lowering of return levels in the US and has fully integrated this trend into IWC regional allocation models. Even with lower expected returns, IWC considers investing in the US regions as highly beneficial in terms of diversification of an international timberland portfolio.

A growing concern regarding timberland investments in the US is the deal flow and the amount of capital available for the market. The number of large deals has decreased recently as the timber industry sells off what remains of large private forestland holdings. However, investing activities have not slowed. The challenge now is to create investment opportunities among

the non-industrial private landowners who still represent the vast majority of private timberland owners in the US. Currently, private landowners hold about 83% of the US timberland base, compared to 10% held by industry, and 4% held by TIMOs (source: USFS, Timberland Markets Report).

The US is the largest single-country producer of forest products as well as the largest consumer of forest products in the world. Thus, investing in the forest resource in the US is low risk in terms of market demand. Furthermore, return characteristics are unique for every investment opportunity depending on local market conditions within a radius of 100 miles. However, overall macro economic trends can have a lagged effect on returns from forest investments in the long term.

Traditional asset classes and alpha

While the timberland market in the US is maturing it remains inefficient, meaning that information useful for making investment decisions is not easy to obtain. This results in a greater variation in returns, with the best returns posted by managers who have a better ability to access critical information, or to better apply the limited information that is available. IWC capitalizes on this management alpha by matching the best manager with the best investment opportunities, thus beating the market.

With traditional asset classes providing lower expected returns than before, various sources state that diversified portfolios should be developed, while searching for liquid and/or uncorrelated assets. There is a clear analogy between traditional asset classes and timberland investments, where the US regions can be categorized as the "traditional timber assets". Following the anal-

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Summary of latest IWC e-mail news

All signs point to 2006 having been another challenging year for global forest and paper companies. Analysts expect that at the end of the year the most successful companies will be those that have been innovative and have developed methods to produce more with less material. Factors impacting the industry include foreign exchange fluctuations, increased energy, transportation and raw materials costs, plus the impact of emerging markets. For the second year running no European companies appeared in the top performing global companies. The Latin American region held the regional top spot at 8.6 % return on capital employed.

North and South America

Canada and the United States formally signed a softwood lumber agreement on September 12, 2006, ending a decades-long dispute. The agreement stipulates that the US must pay back about USD 4 billion of USD 5 billion in duties paid by Canadian lumber producers. Most US timber is harvested from private land at market prices, while in Canada the government owns 90 percent of timberlands and charges fees for logging. The fees are based on the cost of maintaining and restoring the forest.

Record lumber demand during 2005 in the U.S. helped Western sawmills elevate lumber production to the highest volume since 1990 paced by increased output at mills in Oregon, Washington and Idaho. Washington led the state gains, rising 5 percent to 5.7 billion board feet, the highest production year since 1929. Oregon remained the largest lumber producing state in the US, climbing 4.3 percent to 7.4 billion board feet.

International Paper signed an agreement to sell its Brazilian coated papers business to Stora Enso

for approximately USD 415 million. The business includes a coated paper mill and lumber mill in Arapoti, Parana State, Brazil, as well as 50,000 hectares of forestland in Parana.

Europe

European sawn softwood output was up 1.9% to 101.1 million m3 during 2005, thanks to growth in Germany, Sweden, Switzerland and the Czech Republic. Softwood consumption retracted from 2004 levels to 67.2 million m3, with significant drops in Finland and Russia.

Many European softwood lumber producers retreated from the US market during the summer, citing lower prices and the euro's continued strength against the dollar. Robust demand within Europe has contributed substantially to the trend, as many European suppliers have focused increasingly on taking advantage of stronger returns in domestic markets. Some European producers reportedly plan to cut shipments to the US by 25-40 % during the last months of 2006.

Asia

China has emerged as a net exporter of softwood lumber in its trade with the US. Until this year, US imports of softwood lumber from China represented only a fraction of the volume shipped to the US. But surging US imports from China have overwhelmed US exports so far in 2006. Chinese cedar is the most common species shipped from China to the US, accounting for about half of the total volume through May. Importers sell Chinese cedar as a substitute for traditional Western Red Cedar fencing, which has been scarce and in high demand in North America for most of the year.

Tropical timber

Brazil remains the world's largest producer of tropical industrial logs at a stable 30 million m3 during 2005, according to the International Tropical Timber Organization. Official estimates from Indonesia show a significant decrease in production from 2003-2005, but the country is possibly still the largest tropical timber producer if unofficial harvests are taken into account.

Timber Prices and Housing Starts

Housing starts are often cited as one of the major drivers of timber prices. This might not always be the case. Here is why.

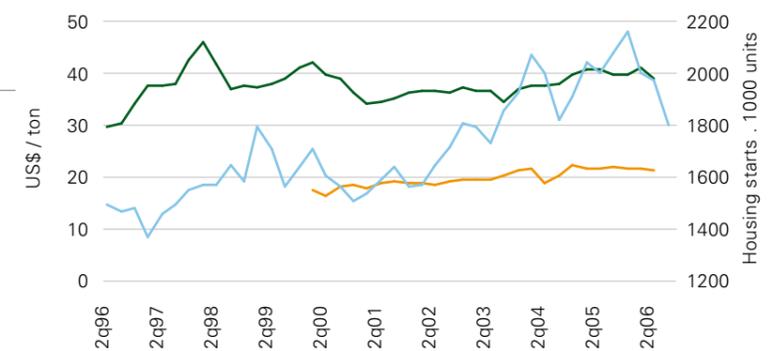
Empirical evidence is often cited in making the claim that housing starts are the primary driver of forest product demand globally. Wood material is used in houses in many parts of the world. As the number of new houses built increases, so too does the demand for forest products. Hence, housing starts have a central role in driving timber prices, and thus returns from forestland investment. However, housing starts have less influence on local timber prices than one might expect. This is due to several aspects of the forest products supply chain, the globalized market, and the fact that not all wood is used for housing.

The average home built in the US in 1970 was approximately 1,400 square feet. By 2005, average home size increased to 2,434 square feet, requiring about 18,000 board feet (38 m3) of structural and sheathing material, and millwork (for windows, doors and moldings).

In addition to a gradual increase in average house size, the US experienced an unusually strong housing market in 2005, culminating in a seasonally-adjusted record number of housing starts in January 2006. These factors affected an increase in lumber demand and helped Western US sawmills to elevate lumber production to the highest volume since 1990. Increasing lumber prices followed. However an increase in housing starts is not readily apparent in timber prices as seen in the figure.

The lack of correlation between increases in housing starts and higher timber prices can be attributed to a number of factors:

- Most homes in the US are built primarily from structural lumber and panels, which are made from softwood. In 2005, 36.7 million m3 of softwood was harvested in the US, about 67 % or (24.4 million m3 of which was milled into lumber, plywood and OSB to be used in construc-



tion. Of that amount, about 43 % goes into new home construction. The end result is that just around 20 % of the total timber harvested each year in the US is used for new home construction. One should recognize that wood is not only used in new homes but also in remodeling and commercial building activity.

- Global trade in forest products allows producers outside the US to capitalize on domestic needs when it is economically prudent to do so, thereby balancing demand and supply.
- The amount of lumber to enter the market is largely dependent on milling capacity and existing mill supply. This creates a buffer between the lumber market and the forestland owner, and results in forest products manufacturers shouldering the economic brunt of a drop in housing material demand.

While the lack of correlation between housing starts and timber prices means that forestland investors should not expect substantial increases in returns during periods of strong housing growth, it also means that they have less to fear when housing markets cool. The US housing market is currently experiencing a substantial downturn. The National Association of Home Builders expects that family home starts will decline from 1.51 million in 2006 to 1.33 million in 2007 (versus 1.72 in 2005). This has already translated into a decline in expected earnings from forest products companies on behalf of Wall Street analysts, but is yet to have any affect on timber prices.

Most importantly, trees grow each year independent of market fluctuation, which offers forestland investors the flexibility to ride out market downturns. Timber appreciates when it is not harvested. If prices for forest products are low, forest owners can forego harvesting if necessary, thus decreasing supply and preventing substantial price drops.



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IWC selected as a Gazelle Company for the second year in a row

IWC was selected as a Gazelle Company for the second year straight. The price is given by the leading business periodical in Denmark, Børsen, and Jyske Bank, recognizing the company as one of the most knowledge-oriented, dynamic and innovative small businesses in Denmark in 2006. Since 1991 IWC has assisted clients in investing

in forests throughout the world. Today, IWC is well positioned for the future with its staff of six professional foresters and two economists.



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ogy, a diversified timberland portfolio should comprise “traditional timber assets” i. e. US, as well as non-US regions that offer low correlations and/or liquidity.

Timberland investments in an institutional portfolio

Timberland continues to have a unique role in a portfolio, including a low correlation to other asset classes, a hedge against inflation, and low capital intensity. According to IWC’s study Timberland Investments in an Institutional Portfolio*, it is evident that investing in timberland, including an allocation to the US, is highly beneficial to overall portfolio performance. This is highlighted in the figure, where the timberland portfolio is an even split between US and non-US investments. Even when return expectations for the US are lower than in previous years the benefits of diversification including the US regions are achieved by the investor.

* LEARN MORE ...

Read the full publication on http://www.iwc.dk/index.php?show_page=67

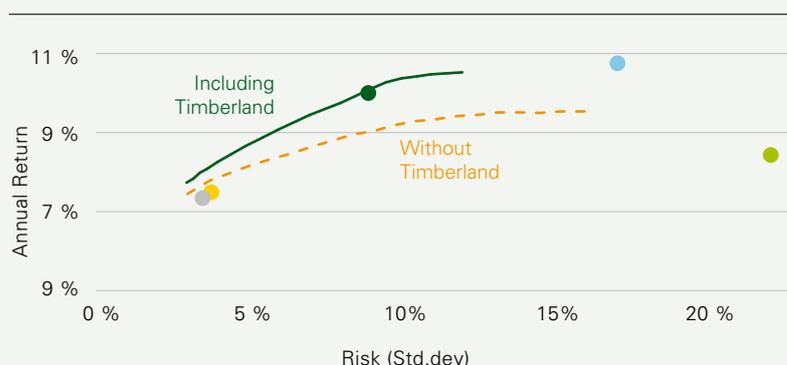
Conclusion

Even though return expectations for investment in the US have decreased in recent years, IWC firmly believes that US timberland investments are an essential and beneficial component of a diversified international forest investment portfolio.

As a consequence of the maturing US market and the accompanying lowered expected returns, IWC now even more than ever, emphasizes investment opportunity screening and careful attention to management alpha before recommending an investment. Once the investment is made, active and sustainable management are crucial throughout the investment term in order to achieve target returns.

Efficient frontier for an institutional portfolio including and excluding timberland investments.

- Timberland
- European Bonds
- Real Estate
- Global Stocks
- European Stocks



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