

# **Institutional Investment (TIMOs & FMOs)**

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## Introduction

Institutional investors typically invest in large parcels of land, or large aggregations of smaller parcels of land, which are typically researched by the fund manager. Land is then acquired by the investment firm or an agent acting on behalf of a group of investors, either through land leases (as is often done under forest management investments) or outright land purchase (as is often done under real estate investments). There are a number of different structures in the timberland investment industry that operate under this framework, each with their own approach to investing in plantations.

Timber Investment Management Organizations (TIMO's) are increasingly acting as intermediaries for pension funds, wealthy individuals or businesses. As Brand (2001) points out, while TIMO's are only one class of international forestry investor, the criteria that they use to judge investments can be considered as a good benchmark of the requirements of global capital.

### *TIMOs*

Timberland Investment Management Organizations or Companies (TIMOs or TIMCOs) are organizations with fiduciary responsibility to investors in timberlands. Private sector investments by these organizations are considered capital assets, and could take many forms. Currently the most popular of these are Timberland Real Estate Investment Trusts (TREITs), Master Limited Partnerships (MLPs), and Income Trusts. Typically TIMOs determine the geographic allocation of the timberlands, find the land to acquire, and oversee the operations of the forest resource.

### *FMOs*

Forest Management Organizations (FMOs) manage their own timber operations and employ foresters directly. FMOs are generally not TIMOs, although the lines between the two are blurring. These organizations typically make leasing arrangements with private landowners in order to supplement fibre supply.

A number of these organizations already operate private land leasing schemes in Canada and other countries, and many of them seem to be expanding their operations. In Canada, for example, Al-Pac is probably the most active among these, although they are cautious about joint-venture arrangements where the landowner provides the land for free. There is a concern over security of the land, and external contract obligations would have to be written in to the land title.

## What are the main concerns of Institutional Investors?

Discussions to date with institutional investors have revealed that their primary concerns are profit maximization and risk reduction, along with land aggregation and land tenure. Moreover, and as the experience of other jurisdictions has shown, these large-scale investors typically do not even become interested in timberland investments in a country or region until a solid track record of profitable investments has been established.

## How do these Mechanisms Operate?

Institutional investors typically invest in large parcels of land, or large aggregations of smaller parcels of land, which are researched by the fund manager. There, however, are a number of different structures in the timberland investment industry, each with their own approach to investing in plantations.

### *TIMOs*

The most popular timberlands investment vehicles are currently Timberland Real Estate Investment Trusts (TREITs), Master Limited Partnerships (MLPs), and Income Trusts. Because these asset classes typically have a solid underlying asset base in the form of private or long-term leased land, and reasonably stable cash flows, these assets typically have access to debt markets at reasonable rates (currently between 6 - 8.5% p.a.). Debt-to-total capitalization is dependent on confidence in cash flows and typically ranges between 35 - 60%. Investors in publicly traded private timberlands vehicles of these kinds currently demand yields between 8 to 25%, again depending on confidence in the sustainability of future cash distributions. Privately held timberlands investments may be willing to target slightly lower yields in the 7 to 8% range for well-diversified and well-managed timberlands funds. As Reid Carter (2003) notes, due to the unavailability of near-term cash flow, greenfield investments will generally be unsuited to use for debt market financing.

Buying existing mature forests can allow immediate access to cash flow from timber harvesting. However, for purchase of immature forests or investments based on reforestation, the cash flow is delayed, in some cases for many years. Technically these types of investments are similar to a discount bond, where all the returns are back loaded. This structure is generally less attractive to investors than investments with immediate cash flow, as the investor will perceive greater risk and more problems with intermediate liquidity. There are many very good examples of subtropical plantation investment opportunities in teak, mahogany, Acacia, Eucalyptus, Gmelina, etc. that offer expected returns of 20-30% p.a. that cannot find funding due to the lack of near-term cash flows and, and, in many cases, country risk.

Investors will generally look for secure ownership of resources. In short-term investments or timber-related investments this is usually via a logging concession or lease. For long-term management, however, investors will often require land ownership or legal title to the forest being managed. The process of acquiring land for investment is often complex and time consuming. Where partnerships are required with government agencies, where land titles are uncertain or unclear, or where land is under highly fragmented ownership and control, this adds difficulty to investments. Investors will prefer situations where work has been done to remove some of the complexities of land or forest acquisition, as it expedites the investment period.

### *FMOs*

For FMOs, the key element in their asset management process is adding value through intensive, hands-on management. FMO foresters spend time in the field reviewing properties and making decisions about management practices. Sophisticated analytical tools are used in asset management decision-making. Computer-based growth and yield models are often used to analyze the timber's economic maturity and to develop long-term harvest schedules for their portfolios. Harvest schedules are designed to optimize returns and meet other portfolio objectives such as cash flow. They provide long-term estimates of cash flows and portfolio values, and serve

as guides for the timber sale portion of operating plans. Timber sale timing is continually reassessed as market conditions change, and FMO's foresters monitor local stumpage markets closely in order to time sales for maximum income. Timber sale decision-making is likely to be one of the most important services that FMOs offer, since income from asset sales is often a large component of portfolio return.

FMOs generally implement operating plans by combining their forestry staff with local forestry consultants as needed for field services. FMO foresters may serve as decision-makers, supervisors and coordinators, working closely with local consultants on field work. For some FMO's, an important part of their intensive management strategy may also be to boost returns by maximizing non-timber income. For example, almost all of Forest Investment Associate's managed land is leased for hunting, to recognize the value of lease income as well as the "custodial" benefit of local lessees. FIA foresters also continually look for additional sources of non-timber income such as pine straw sales and stump sales.

Under Alpac's leasing arrangements the landowner has no involvement in management of the trees. Al-Pac is responsible for planting, maintenance, tending, and protection from fire, insects and disease. The option for the landowner to do all the site preparation and maintenance work exists however, if the landowner wishes to take this on. Under such circumstances Al-Pac negotiates a separate maintenance contract with the farmer. These maintenance contracts are often viewed favourably since many farmers are close to retirement and the plantations only require major maintenance for the first five years.

Al-Pac is considering alternate contract arrangements, including a system that is already in use in the US. Under this arrangement the company supplies the tree stock at cost, provides a field person (i.e. extension service) to advise on site preparation, maintenance and any other issues. They also guarantee a certain minimum price at the end of the 20-year rotation intended to cover the costs incurred in the first 5 years, such that in a worst-case scenario the landowner at least recovers any financial outlay. The landowner owns the trees, but there is a buy-out clause that comes into force if the owner decides to sell the land or sell the trees to another buyer. Effectively this allows the company to recoup their costs, which mainly consists of the provision of the support service person.

This clearly seems to be an attractive mechanism to expand forest cover in Canada, as a proven track record has already been established; one which utilizes the size of land holdings that are likely to be available in Canada. There may be a role for government to encourage an expansion of these activities across the country, particularly through incentive schemes or partnerships that reduce the level of risk for investors, or through land conversion incentives for landowners.

### *Investment Structures*

The planning process for investments must be moved from a paper analysis of risks and returns to the actual design of the investment vehicle structure. In most cases, this is based on an analysis of the potential investors' requirements and the characteristics of the investment jurisdiction. Problems can arise related to double taxation, difficulty in exiting the investment, and incompatibility of investor objectives with the characteristics of the investment. The "return profile" of the investment is generally determined by three key factors:

Tax structuring

Appropriate tax structuring ensures that the investors actually gain the benefits of cash flows and value appreciation and are not exposed to double taxation on revenue, which erodes the financial returns. International funds, which may have multiple investor jurisdictions and multiple investment jurisdictions, each with its own tax laws and regulatory framework, can be particularly complicated.

## Liquidity

Liquidity is an important element of investment in forests. Forests are a special form of real property and require careful appraisal and assessment before they can be sold. Complex regulations on foreign ownership or lengthy approvals for changes in title or business ownership are an impediment to liquidity. Liquidity requirements also affect the structure of the investment. For example, closed-end funds have a termination date where the assets are wound up and sold, with proceeds distributed to investors. Open-ended funds generally require the investor to sell shares in an entity. In a private placement, investment liquidity and exit strategies are generally much more limiting than in a publicly traded investment.

## Investment Period

Most institutional timberland investors are willing to accept an investment term of a decade or more. In that period there is generally a positive cash flow from the forests under management and, with good management, an appreciation in the value of the forest and underlying land resources. Investor willingness to accept long term investment periods will be heavily influenced by their confidence in the Timberlands Investment Management Organization (TIMO) and possible third party guarantees (see Government Guarantees below).

## Why do these instruments work?

Timberland in the United States, Australia, and New Zealand is more widely included in investment portfolios than they are in Canadian portfolios. This is mostly due to the wide availability of large areas of private forest land and the higher returns. Hancock Timber Resource Group, a leading timberland manager and investment adviser, produces a number of research notes reviewing the use of timberlands in investment portfolios. There is a standardized index of timberland financial returns, known as the NCREIF (National Council of Real Estate Investment Fiduciaries) index, which is currently weighted with 68% of its property in the US South, 26% in the US Northwest and 6% in the US Northeast.

A recent research note (Hancock Timber Resource Group 2003a) compared the performance of U.S. stocks, bonds, and commercial real estate and timberland investments from 1960 to 2002. A timberland portfolio with 50% in the US South, 40% in the Pacific Northwest, and 10% in the US Northeast would have returned an average of 12.57% per annum, exceeding other classes of investments except small capitalization stocks, which returned 13.47. Large cap stocks returned 10.0%, US Treasury bills 5.83%, and meanwhile the average annual rate of inflation was 4.33%. Moreover, the annual variability in rate of return from timberlands was low compared to the rate of return earned; small cap stocks had twice the variability of yield as timberlands, for example. Returns from timberland are well correlated with rates of inflation, indicating that timberland provides partial hedging against inflation, and inversely correlated with rates of return from equities, corporate bonds and commercial real estate. These characteristics make timberland an

attractive component of a large portfolio, such as might be held on behalf of a pension fund or other institutional investor interested in reasonable returns with a relatively low level of variation from year to year.

Hancock Timber Resource Group (2003b) reported that timberlands in the United States returned 7.7% in 2003, a rate of return in line with historical averages. This is based on the NCREIF index. Of this return, 3.9% was due to capital appreciation (e.g. increases in the value of the land and standing timber as prices for those goods rose) and 3.8% was due to income from operations, excluding capital appreciation. Historical analysis has shown that changes in timber prices are the primary determinant of rates of return from timberland (Hancock Timber Resource Group 2003c).

Hancock (2003c) estimated historical rates of return from timberlands in the US, as well as Australia, New Zealand, and coastal British Columbia. Their findings showed that B.C. timberlands would have yielded an annual rate of return averaging 12.81% from 1963 to 2002, which is roughly 1.25% lower than returns from the US South and Pacific Northwest, but much higher than returns from New Zealand. This indicates that timber management in B.C. is potentially very competitive with management elsewhere in the world.

## **What is required for this mechanism to work?**

Creating incentives to encourage investment into fast-growing plantations is clearly a complex process. For some countries, the ability to attract large-scale investors may be limited due to the size of holdings they typically invest in, particularly given the large number of smallholders in many countries. There may, however, be ways to aggregate land into parcels that they find attractive.

## **What basic elements are needed?**

### *Risk*

The lack of large-scale involvement by institutional investors in main countries is, in part, due to the lack of readily available information on growth, yields and average returns. Without this sort of information, investors will remain reluctant to enter into the marketplace, and will be more likely to invest their money into countries where these parameters are already well-established.

To overcome this, questions surrounding profit and risk may be answered through government research into pilot-scale studies, which confirm yield expectations, management costs and potential risks. Capacity for this work can usually be found in existing government forestry organizations, but may also be found in post-secondary educational institutions.

### *Aggregation*

Questions concerning land aggregation, however, may prove to be more challenging in many cases. Certainly, one of the major prerequisites that most large investors look at concerns the size of land holdings. Most of the investments into timberlands made by large investment firms or corporations tend to be into relatively large parcels, or aggregations, of land.

Brascan's holdings in New Brunswick, for example, comprise of some 238,000 acres of land, which in turn is only a small portion of a larger holding of just over 1 million acres, the majority of which is located in Maine. In order to maximize profits, large investment firms want to minimize transaction costs and maximize on economies of scale. Large parcels of land allow them to do this.

Many of the countries that have managed to attract large institutional investors have done so through the privatization or monetization of large tracts of crown forestland. If governments are reluctant to go through either of these processes, then the only way for smaller landholders to attract investment dollars from large investment firms is to find ways to aggregate their land holdings with other landowners. Government support for regional forestry agencies may facilitate this process.

### *Joint Venture and Cost Sharing*

Alternatively, the government may wish to have some of these investment groups as potential partners. As an example, the government may wish to partner with investment fund managers. Such partnerships would be interesting because neither the government nor the investment fund managers are necessarily interested in owning the wood. Fund managers are more interested in a predictable return with some upside but little downside risk.

Some form of cost sharing could also be put in place, with a fund manager being guaranteed a minimum rate of return. They could also be eligible for additional return if the returns are particularly favourable. This would essentially be a case of the government issuing a plantation-backed bond to the fund manager. The plantation manager under this scenario might be a forestry company, a forest management consultant or a private woodlot owner with the assistance of an extension service. The forestry company could also become a partner, perhaps trading the management services for a right-of-first-refusal to purchase the wood at a specified price.

### *Taxation*

Taxation issues relating to TIMOs also need to be addressed. In the United States, for example, pension funds typically do not pay taxes, whereas in many other countries they do. Clearly, this is a competitive disadvantage for these countries, but one that could be addressed through policy interventions.

Existing tax treatment of other investors who own and manage timberlands would be identical to that of timber companies, however other investors also include those who purchase timberland index-based securities, and these investors are only indirectly affected by the tax treatment of timberlands.

### *Carbon*

Clearly, the potential value associated with carbon credits from plantations would only add to the returns from timberland management, as long as administrative and monitoring costs were below the value of the credits. However, it may take some time before large investors are comfortable with the dynamics of the carbon markets before they attribute much additional value to timber due to the carbon.



## **Bibliography**

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