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Why Buy UK Forestry?

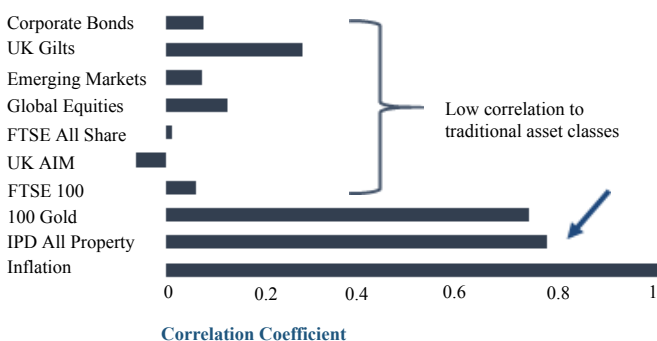
Investing in forestry and timberlands is not new – many people think of David Swensen at the Yale Endowment when the topic comes up. Others will go further back to Otto von Bismarck and his banker Gerson von Bleichroder in 19th century Germany. My late and great Mentor, Barton Biggs, investment strategist at Morgan Stanley, years ago described Bismarck’s appetite for owning timber as “insatiable”. What those historical investing icons recognised in timber as an asset class are exactly the same characteristics that still exist today – a real asset that produces income, gives inflation protection, doesn’t correlate with financial assets and grows!

Increasingly forestry is becoming a recognised asset class globally, albeit for a small but appropriate percentage of asset allocations. The US TIMOs manage around \$60bn of assets and the big endowments hold positions, but many institutional investors are becoming aware of the financial attributes (especially as low interest rates have dragged returns elsewhere to rock bottom levels) and the “green” credentials that forestry can deliver.

Why Invest in Forestry?

Trees Grow! – Regardless of what GDP or the stock or bond markets are doing, trees will grow and the volume of timber that is standing in the forest available for sale will increase every year. On a UK commercial softwood 35-40 year cycle this equates to a 4-5% annual volume growth rate. Not only is that more volume but the percentage of the tree in the more valuable large diameter cuts increases too as the tree expands.

Low correlation to traditional asset classes



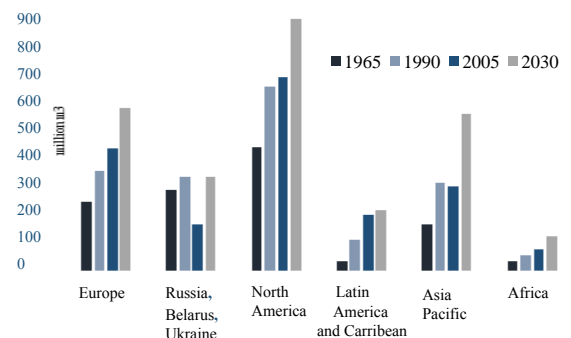
Uncorrelated and low volatility

Forests are not daily screen traded assets so correlation and volatility statistics are run over less frequent datasets. On UK data, the last 10 year volatility of returns has been slightly higher than corporate bonds and correlation against stocks and bonds has been below 0.3.

Inflation hedge: Forests are real assets and historically pricing correlates positively with inflation. For those worried about deflation, the available history suggests that, as with other real assets, they have outperformed financial assets in deflationary times.

Income: Forests produce healthy but lumpy and irregular cash flows, largely from timber sales. A diversified portfolio of mixed ages of trees can produce the cash to smooth the peaks and troughs – on a diversified UK portfolio we would currently project a distribution of 2-4% on an annual basis.

Industrial Roundwood: Consumption trends and projections



Environmental credentials: Trees absorb carbon – the faster they grow, the more they use – planting trees is a viable answer to Climate Change; The end product of timber is substantially less energy intensive to produce than other building materials or energy sources; Growing trees are often said to be the Earth’s lungs – they scrub the air of pollution and improve air quality.

Growing demand: Growth in emerging markets, increasing use in the construction sector globally and increasing biomass power usage have all contributed to a significant upwards trend in demand for timber over the last 50 years. That demand growth rate is forecast to accelerate in coming decades driven by the same trends and an increasing focus on economic sustainability and climate change.

Why Invest in UK Forestry?

We expect long term returns of up to 10% nominal p.a. A combination of 4-5% volume growth, 1-2% value increase p.a. in older trees as they move up the value categories and 1-2% p.a. REAL price rise (i.e 3-4% nominal) underpins our forecast return levels. Additional return sources can be found from renewable energy developments, housing sites, shooting rents etc but we have not included these in our figures.

It's close to home: No FX risk for UK investors, a stable political system with clear legal title, professional contractors and lower supervision risk. And easy to visit!

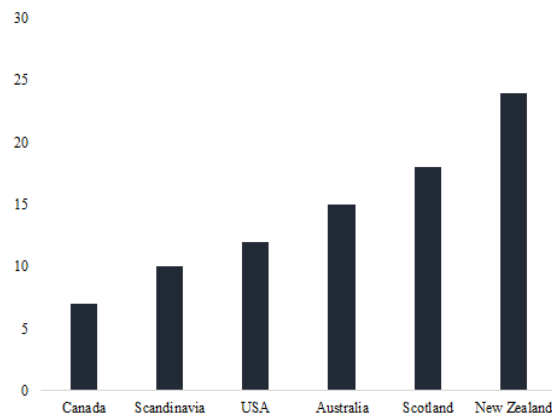
We expect timber prices to rise: Real timber prices in the UK are still well below levels seen in the 1970s and 1980s, despite doubling from their low point. We expect the strongly positive supply/demand balance for UK timber to underpin real price rises of 1-2% per annum over the next two decades.

One of the best softwood conifer growth environments in the world. The wet and mild climate of the British Isles provides great growing conditions for softwood conifers including the principal species grown in UK forestry, the Sitka Spruce. Sitka Spruce are grown on an average 35-40 year cycle from planting to harvesting – substantially faster than Scandinavia, the Baltics and Russia and even the Pacific North West of America/British Columbia in Canada which is the native environment for many of the UK grown species. At the UK rate of growth, the trees will add 4-5% of timber volume per annum.

Demand is growing. Significant investment has resulted in the UK having a highly productive and technologically advanced timber processing industry with a growing demand for domestically grown trees. The UK still imports over 60% of the timber that the country uses, fluctuating with FX rates. However, the growing timber component within housing and demand for biomass are expected to see demand growth remain strong and the UK processing industry needs UK trees.

UK has one of the best Softwood growth environments in the World

Softwood conifer growth rates (yield class)



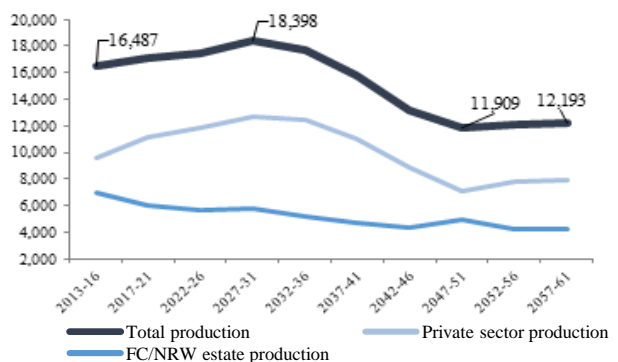
There are tax benefits too. For years, one of the main buying groups for UK forests have been wealthy individuals sheltering from inheritance tax. After two years of ownership, forest assets are IHT liability free. In addition, timber sales are income and corporation tax free and there is no capital gains tax on growing timber.

Government support/grants. Across the UK, the constituent governments believe in planting more trees to tackle climate change, mitigate flooding and develop rural economies. This is particularly the case in Scotland, where the Government's target equates to a 13,000 ha per annum planting rate for new forests over the next 5 years, with grant support on offer and a stronger recognition of the need for commercial forests.

Characteristics of the UK forestry market

Estimates suggest that 80-90% of active global timberland investment is made in the US, Canada, Australia and New Zealand. Some funds have been willing to spread their wings in Latin America, Africa and Asia. The UK is almost nowhere to be seen in institutional forestry portfolios. Forest ownership in the UK has been roughly split down the middle between the State-owned (and now devolved to England, Scotland, Wales and Northern Ireland) Forestry Commission and the private sector. In total, the commercial (softwood conifer) forest area in the UK is roughly 1.6 million hectares (16,000 sq.km). On current valuations that puts a valuation of about £4bn on the commercial private sector half of the forest base, with a turnover of £150m in 2015.

UK timber supply forecast to decline while demand grows



Supply is contracting from the late 2020s. Based on figures drawn up by the Forestry Commission, the availability of softwood timber from domestic sources is set to continue to grow by about 1% per annum over the next 10 years. From that peak, the FC forecast that UK timber supply will contract by one-third over the following 20 years as a result of poor planting levels after the removal of Schedule D tax relief at the end of the 1980s. Commercial forests in the UK are dominated by the production of softwood conifers, growing timber for construction uses (about 60% of the total), fencing and pallets (20%), pulp and chipwood (15%) and biomass (5%). Private ownership has historically been concentrated in a mixture of processors, wealthy individuals and a few domestic funds and endowments. However, our view is that building scale is achievable in UK forestry for an appropriate percentage of institutional portfolios – possibly in conjunction with global timberlands exposure.

Richard Davidson
Fund Manager

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