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Forestry

Forestry: Trees lumber along

It isn't an exciting business, but things are looking up for the forest sector.

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By Bryan Borzykowski

Michael Underhill has made a career out of following the timber sector, but he admits that investing in trees is not for Type A investors. "Timber is as boring as it gets," says the chief investment officer of Capital Innovations, based in Hartland, Wisc. There are no flashy brand names, no fast-moving stocks that offer a quick windfall and no products that everyone must get their hands on.

But Underhill may be selling his sector's sex appeal short. Timber's fortunes are often tied into serious world events — when Japan rebuilds towns affected by the earthquake, it will need lumber; a slowdown in housing starts during the economic meltdown curtailed demand for timber. But investors should hope that most people think the way Underhill does — generally, the less attention paid to a sector, the cheaper the companies. And that's what analysts are seeing. Many businesses are underpriced, and with increasing demand conspiring with recent supply disruptions, the share prices on these stocks are only going up.

Steadily increasing demand for timber-made goods is one reason why the sector has produced strong returns over the past two decades. From 1987 to 2009, the National Council of Real Estate Investment Fiduciaries Timberland Index has generated an average annual return of 14% compared to 9.4% for the S&P 500. Returns don't vary wildly quarter to quarter, so this isn't a great investment for speculators. "Timber isn't a short-term play," says Underhill. That is because the longer a tree stays in the ground, the more money a company can make. When timber prices are low, companies can hold back their harvest. When prices rise, and firms decide to cut down trees, they not only profit on the higher price, but they make more money per tree since the forest has grown. "It's one of the unique characteristics of the asset class," says Tim Cayen, director of business development at Boston's Hancock Timber Resource Group. "You don't have to realize value when prices are down."

Many analysts think harvests will strengthen over the next few years, since prices are expected to rise. Daryl Swetlishoff, head of research at Vancouver-based Raymond James, is one industry watcher who takes that view. He has developed a "peak lumber" theory that says prices should rise from today's \$300 per thousand board feet to \$500 in the next three to five years, thanks to increasing demand, especially from emerging markets. Already China is short 100 million cubic metres of wood fibres, or double B.C.'s entire yearly output. While the country doesn't use much lumber to build houses — most of China's residential buildings are made from concrete — they still ravenously consume the commodity. "Everything that goes into a building that's not holding it up is made from lumber," he says.

U.S. demand is also expected to soar over the next few years. Before the financial crisis, there were two million housing starts per year; now there are just 500,000. As the economy recovers, more houses will be built, and demand for lumber will rise. It may not return to 2006 levels, but even one million housing starts would put serious pressure on supply, says Swetlishoff. Indeed, supply is already tightening. Over the past decade, B.C. has experienced a

devastating mountain pine beetle outbreak, which has destroyed 16.3 million hectares of forest. The beetle targets mature trees, which is what companies usually prefer to harvest. Swetlishoff says the outbreak has wiped out 80% of the region's pine trees, and pine makes up about 40% of the trees in interior B.C.

The trifecta of Chinese demand, a recovery in the U.S. housing market and the pine beetle outbreak has Swetlishoff convinced that lumber prices are heading higher. "It's really a question of time," he says. "We won't go back to average levels." David Segal, a portfolio manager with New Jersey-based Franklin Mutual Advisers, shares Swetlishoff's view, though he says investors have to be patient. A lot of companies withheld supply when prices were low, so it could take longer before prices dramatically swing higher. "That will act as a buffer," he explains.

Canadians can get exposure to the sector in three ways — investing in an exchange-listed lumber supplier, buying a timber exchange-traded fund (ETF) or purchasing a timber real estate investment trust. The last gives people the most direct access to timberland. Prices more closely reflect the price of timber and benefit from increasing land value. Underhill points out that some REITs have other business lines, such as developing performance fibres for plastics, so pay attention to the percentage of revenues that comes from the forestry operation; the more exposure the better.

There are only a handful of timber ETFs, but the ones that exist have exposure to both REITs and companies that own or manage timberland. It's an easy way to get broad exposure to the global timber market. But while diversification is always important, not all forests are the same, and some areas of the world, such as western North America, are expected to perform better than others. There are no area-specific funds, though, so ETF investors have no choice but to invest globally.

Stocks are more complicated. Free cash flow is especially important in this industry, says Underhill, as that gives management more discretion on whether to hold back a harvest. The higher the cash flow and lower the debt, the more chance these companies will continue paying dividends when timber prices are down. It's also important to compare companies located in the same region. Ari Levy, manager of TD Asset Management's resource fund, says eastern timber companies aren't the same as western ones. There may be different fees or tariffs, and demand could vary market to market. Many timber investors like to look at the enterprise multiple, calculated by dividing the enterprise value (EV) by earnings before interest, taxes and amortization (EBITA). This metric is a way of measuring the value of a company and it can be used to compare timber producers with wildly different debt levels, capital bases and tax burdens. "It neutralizes the impact of these differences so we can compare on a more apples-to-apples basis" says Levy.

While timber investments can make a good addition to a long-term portfolio, it only makes sense if people believe the U.S. housing market is at its bottom. If an investor thinks it's still falling, put those investment dollars elsewhere for the time being, says Levy. However, the American housing market will bounce back at some point, and compared to other sectors, this one comes with far less risk. "How many failed startups do you see in the tech sector?" asks Underhill. "You don't see that in timber investments."