MADISON'S TIMBER PREVIEW

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In late September wealth management company Grantham-Mayo-van Otterloo, out of Boston and San Francisco, issued its projection for returns on eleven asset classes over the next seven years. Ranking third was 'managed timber', with an expected return of 6 per cent above inflation for the class as a whole, with another 1.5 per cent possible from active management.

"Forestry remains, in my opinion, a good diversifier if times turn out well, a brilliant store of value should inflation unexpectedly run away, and a historically excellent defensive investment should the economy unravel. Otherwise, I hate it," said GMO Chair Jeremy Grantham in the letter.

George Fisher at Seeking Alpha decided to do his own analysis.

"Timber has to be just about the most boring investment one could own – boring and profitable," begins his September 27 article.

Fisher goes on to explain that timber is unique in several aspects, because demand is cyclically generated from housing construction and general economic activity, while supply is priced as a commodity, but is renewable with long replacement cycles.

Investors in timberland can capitalize on their value quickly by harvesting and selling off timber, or do nothing and wait for that timber to grow, becoming even more valuable when market conditions improve. According to Professor Jon Caulfield at the University of Georgia, 61 per cent of timber returns is from biological growth versus 33 per cent from increasing timber prices and 6 per cent from land appreciation. Timber biologically grows in volume by 2 to 8 per cent a year, depending on species, location, and size.

A Merrill Lynch Timber Report found that Timber Investment Management Organizations (TIMOs), have grown from US$1 billion in 1990 to at least US$35 billion in 2007 and control over 50 million acres of forests. As of 2006, TIMOs controlled about 60 per cent of all privately-held productive timberland in the US.

In contrast, from 1987 to 2009, the NCREIF Timberland Index has generated an average annual return of 14 per cent while the S&P 500 has generated an annual return 9.4 per cent.

Interested parties have the choice of investing in Exchange Traded Funds like Claymore/Beacon Global Timber, which last week changed its name to Guggenheim Timber ETF, and iShares S&P Global Timber & Forestry Index, or in individual timber companies. Due to the tax efficiencies of the timber business, many of the latter are structured as a REIT, offering higher cash distributions.

There are only two Canadian companies which can properly be classified as a REIT: TimberWest Forest Corp, based on Vancouver Island, and Ontario's Sino-Forest.

Historical Average Annual returns for Various Asset Classes

	1998-2007	1988-2007	1978-2007	1960-2007
	10 yrs	20 yrs	30 yrs	47 yrs
Timberland	8.9%	14.6%	11.8%	12.5%
S&P 500	5.9%	11.8%	13.0%	10.4%
US T Bills	3.5%	4.5%	6.0%	5.5%
US CPI	2.7%	3.0%	4.1%	4.2%

Source: Pope Resources Investor Presentation, 2010

With plantation holdings in China, Sino-Forest Thursday completed its offering, announced October 11, of an aggregate of US$600 million principal amount of guaranteed senior notes. The notes bear interest at a rate of 6.25 per cent annually, payable semi-annually, and maturing on October 21, 2017. The company received a huge response from investors as the appetite for Asian credit continues. The offering was made on a private placement basis through a syndicate of initial purchasers formed by Bank of America, Merrill Lynch, and Credit Suisse.

On October 8, Credit Suisse reiterated an outperform rating and $28 price target on Sino-Forest as the investment bank ponders whether the company should distribute dividends.

"We believe there are several compelling factors for Sino-Forest to successfully introduce a dividend policy in the future. Yet, we do not place a high probability on the company instituting a dividend policy in the near-term. Notably, recent work by our Quantitative Analysis team highlighted that over the past fifteen years dividends accounted for roughly 40 per cent of total returns in Asia," Credit Suisse said in the rating note. "Over the longer-term Sino-Forest is well positioned to benefit from China's wood fibre supply-demand imbalance."

At that time Sino-Forest shares were selling for $18.04, by close of trading Thursday the price had gone up to $20.41.

The Credit Suisse forecast may not have been solely responsible for the company's share price improvement.

Paul Quinn, at the Royal Bank of Canada, boosted his 12-month price estimate October 5 on Sino-Forest shares to $25 from $23. In a note to clients, Quinn said China, where Sino-Forest operates, should have a “soft landing” as it seeks to cool down its economy. Company share prices jumped 4 per cent to $18.01 when the note was released.

July 27 TimberWest announced its strongest quarterly results in three years, generating positive distributable cash of $4 million in 2Q 2010, compared to a distributable cash loss of $5.4 million in the same quarter for 2009. TimberWest was $300 million in debt but had recently raised $60 million through increased share offerings.

3Q 2010 TimberWest results will be announced November 8.

So what will happen in 2011?

Forisk Consulting's President, Brooks Mendell, stated in a September 15 press release that 2010 is a “bridge” year and emphasized to investors the benefits of patiently following local markets.

Forisk Forest Economist Tim Sydor said in the same release, "We’ve adjusted our forecast of US softwood lumber consumption downward by 6.3 billion board feet for 2010. Lower lumber demand means lower stumpage prices, and pine sawtimber prices in the US South have been revised downward by nearly US$1 per ton for the year.”

“Robust local markets, with capitalized mills and resilient loggers and wood suppliers, pay dividends to their investors through faster recoveries,” concluded Mendell.

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