



Evaluating Overseas Timberland Investments and Discount Rates

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About Forisk Consulting

- Forisk provides management consulting and educational services to senior management and investors in the forest industry and timberland investing sectors.
- Founded in 2004.
- Key products:
 - *Wood Bioenergy US*
 - Timberland Owner List
 - Forisk Forecast
- International research projects include:
 - Algeria, Argentina, Australia, Brazil, Caribbean, China, Colombia, Costa Rica, Egypt, Guatemala, Libya, New Zealand, Nicaragua, Panama, South Africa, South Korea, Ukraine, Uruguay.

The “Big Picture”: Our Forest Finance Framework

Value: what are we trying to answer? What are the appropriate criteria?

Cash: how well can we nail down expected cash flows?

$$PV = \frac{CF}{(1+r)^t}$$

Risk: what is the appropriate discount rate for this asset and opportunity?

Time: what is the investment period?

Domestic (US) timberland investors pursue multiple strategies that directly or indirectly lower implied discount rates (DR).

Approach	“Thinking” and Strategy	Implication
Land use arbitrage	Acquire timberlands with expectation of converting to ag during investment period	Willingness to pay more
Leverage	Increase ROE through use of debt financing	Willingness to pay more
Long-term ownership	Own through the business cycle; emphasis on diversification and income	Willingness to lower DR
Sum of parts	Ties forest management to disposition strategy; value equals the sum of units; HBU emphasis	Willingness to pay more

US-based investors in international timberlands have specific concerns.

- Forisk conducted research on behalf of Colombia's Ministry of Agriculture and Rural Development
 - Mendell, B.C., T. Sydor and A.H. Lang. 2011. U.S. investor perspectives of international timberland investments and Colombia, *International Forestry Review*, 13(4): 1-5.
- 83% of TIMOs had strong interest in international assets. Interest tempered by two categories of questions and concerns:
 - International/country risks
 - Includes political stability, property rights, tax regulations, and exchange rates
 - Forest asset quality and market risks
 - Includes volume risk, demand and prices for wood, and forest industry capacity

% of TIMOs who identified these issues as critical to evaluating potential international timberland investments

Political stability	83%
Markets for wood	83%
Property rights	75%
Legal structure/ contracts	67%
Tax regulations	58%
Exchange rates	58%
Repatriation of capital	25%
Available timberlands	25%
Volume risk	25%
Liquidity of land market	25%

Key insights from previous research and investment execution:

- While approaches to evaluating investments differ, the key concerns are similar.
 - Country risk: factors assessing health of investment climate.
 - Data.
- Wide range of risk tolerances across investors.
 - Risk for one is opportunity for another.
- Comfort with doing business in the country more important than forest asset quality.
 - Step 1: TIMO/investor gets comfortable.
 - [Step 2: TIMO helps clients get comfortable.]
- Exchange rates (ER) poorly understood.

Myth 1: ER changes always increase the risk of international investments.

- Over time, we expect changes in ERs to be offset by changes in prices (inflation).
- Example:
 - Falling currency helps an exporter.
 - Exports just became relatively cheaper to foreigners.
 - While inflation erodes dollar profit margins.
 - Which can only be reversed if a local currency devalues.
- We assume an “asset approach” to exchange rates.
 - ERs change as investment capital and assets flow between countries.
 - ***Goods and services account for <5% of the trading volume in foreign exchange.***
 - Most from buying/selling currencies, bonds, etc

Myth 2: Multinational investors are more subject to ER risk than domestic investors.

- Multinational players may have more flexibility.
 - Can adjust marketing, shift production, and reallocate capital between countries and across portfolio.
- Example:
 - Local sawmill selling locally but facing import competition.
 - May be seriously hurt (helped) by ER changes, while a firm with sawmills and markets in many countries is diversified.
- Impact of real ER changes on timberland returns depends on:
 - Location and maturity of markets;
 - Sources of inputs;
 - Degree of flexibility in shifting its marketing and management efforts.
- At the end of the day, we want to know if the client project will sell logs and buy services a world market or a domestic market.

Investors “build up” DRs for overseas timber.

Element	Description
Base/Benchmark	Cost of capital or minimum hurdle rate for the allocation
Country risk	Sovereign/political risk Start with spread between US/country treasuries Accounts for regulatory concerns
Market risk	Maturity, diversity and access to wood markets % domestic versus export % growth rates of domestic wood demand
Firm/Client risk	Execution risk Most relevant for first and/or greenfield investments Client specific; can vary over time with staggered DRs

Accounting for (1) client experience and (2) risk tolerance directly influences applied discount rates.

Real DRs for overseas timberlands can vary over time as experience and transparency increases.

Element	US South	New Zealand	Colombia (Phase 1)	Colombia (Phase 2)
Base	5%	5%	5%	5%
Country	0%	1.5%	2.5%*	2.5%
Market	0.5 – 1.5%	1 – 2%	1.5 – 3.5%	1.5 – 3.5%
Firm/Client	0%	-1.5%	1 – 3%	0 – 1%
Estimate	5.5 – 6.5%	6 – 7%	10 – 14%	9 – 12%

*Current spread is 5%; assuming normalized spread with U.S. treasuries

Actual/applied real DRs between 2005 and 2010

- Australia: 5.4 – 9.3%
- Colombia: 10.0 – 15.0% (2008+)
- New Zealand: 6.1 – 8.7%
- Uruguay: 6.5 – 8.5%

Conclusions: overseas risk is a function of both the project and the client.

- Disadvantages (or advantages)
 - Low domestic demand for forest products
 - Uncertain regulatory stability
 - Real costs associated with security
 - High potential for additional frictions
- Advantages (or disadvantages)
 - Strong economic indicators
 - Enviable forestry conditions
 - Well positioned to access export markets
 - Improved safety and political situation