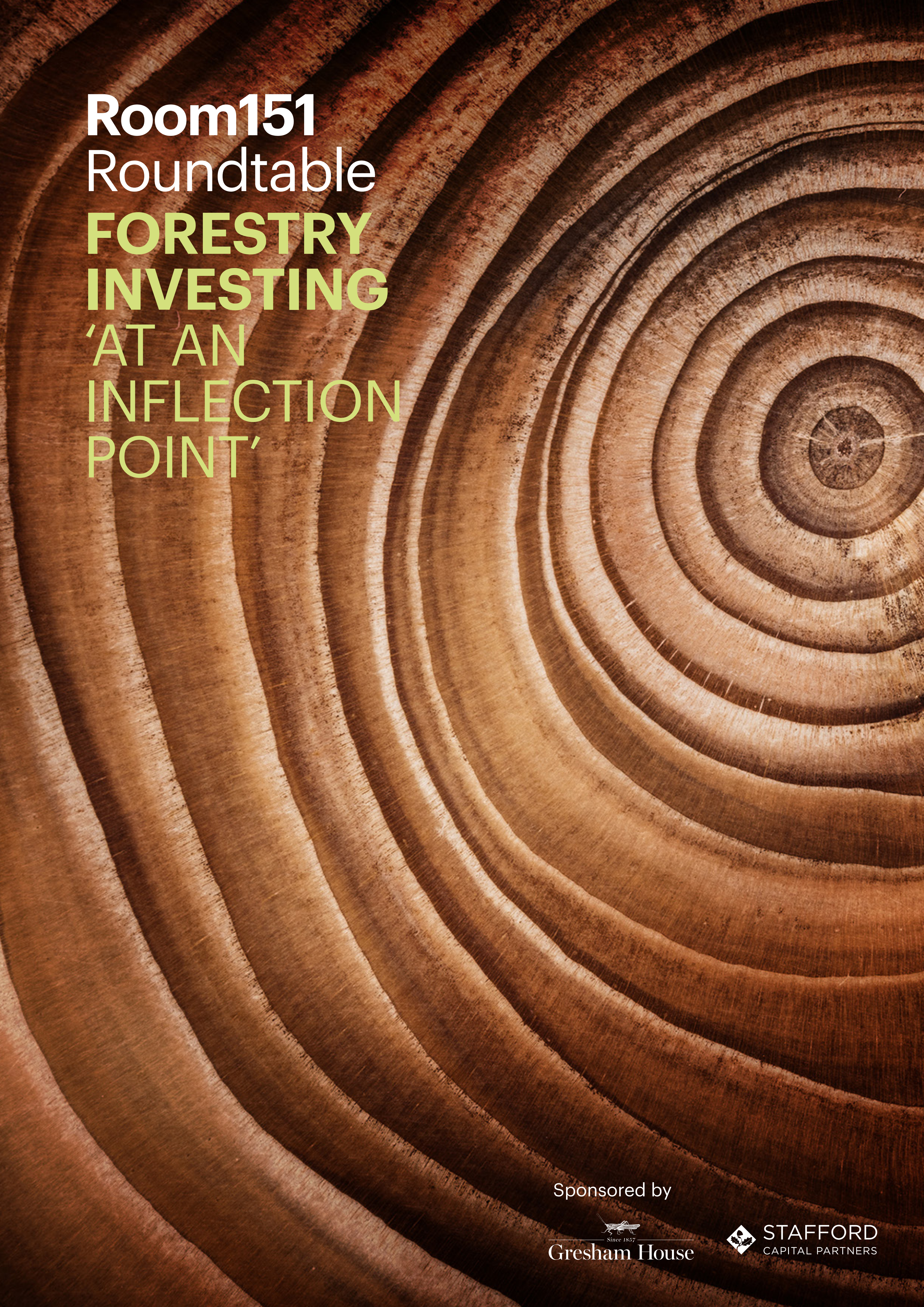

Room151 Roundtable

FORESTRY INVESTING ‘AT AN INFLECTION POINT’

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Investment in forestry is at an inflection point. It's an asset class that has historically delivered compelling returns, but now also brings much-needed sustainability benefits. Interest in the sector has never been higher and UK pension funds, including the Local Government Pension Scheme, are keen to explore opportunities.

A perfect time then for **Room151** to convene its latest roundtable. Sponsored by Gresham House and Stafford Capital Partners, the forestry roundtable took place at the London Stock Exchange as part of Room151's LGPS Investment Forum.

With attendees including local government investment professionals and asset managers, the debate covered inflation protection, diversification, competition with other real assets and the sustainability advantages of forestry.

Room151

ATTENDEES

Stephen Addicott
managing partner, timberland
Stafford Capital Partners

Peter Findlay (chair)
publisher
Room151

Heather Fleming
managing director, institutional business
Gresham House

Olly Hughes
managing director, forestry
Gresham House

Sean Johns
pensions investment manager
Cornwall Council

Alison Lee
responsible investment manager
London CIV

Sherief Loutfy
finance planning manager
Worcestershire County Council

Dermot McCloskey
vice-president, climate solutions
Stafford Capital Partners

Peter Wallach
director of pensions
Merseyside Pension Fund

ROOM151 ROUNDTABLE:
Forestry investing 'at an inflection point'

The latest **Room151** roundtable brought together a group of local government investment professionals and asset managers to discuss the pros and cons of investing in forestry, writes **Peter Findlay**

Forestry is a proven asset class that historically has delivered compelling returns for institutional investors and brings with it much-needed sustainability benefits. So what should institutional investors such as the Local Government Pension Scheme know about this asset class?

Room151's latest roundtable discussion looked at the key risk and return drivers for forestry, the outlook for timber prices, the diversification and inflation-linked characteristics as well as the sustainability credentials. The debate began with the two sponsors of the event, Gresham House and Stafford Capital Partners, outlining their experience of forestry investments.

Olly Hughes: Gresham House has 40 years' experience in direct forestry investment and today our portfolio sits across the UK, Ireland, Australia and New Zealand. Predominantly we're in the business of growing trees and producing timber for long-term sustainable materials, although we are also involved in the carbon sector by extension.

It's an area that is sometimes misunderstood and I think we have a responsibility to explain what we do and how we do it. There are misconceptions about timber and not everyone's experience in the sector has been positive.

On the fundamentals, our funds – since inception (over the last 15-20 years) – have delivered a year-on-year IRR [internal rate of return] of around 13.5%. That's an incredibly strong performance over two decades and, ultimately, one of the core drivers for investors. It's a long-term, stable return, underpinned by the fundamental biology of trees.

If you get the right tree, in the right place, it will deliver a valuable long-term return. It's a very good diversifier in that it de-links from equity and debt and traditional asset classes; correlations tend to be very low. On the flip side, it has a very high correlation to inflation, so it delivers a long-term inflation-linked, diversifying addition to an institutional portfolio.

Lastly, because of the nature of the funds we manage, and of the gradual, perpetual harvesting of our trees (there's no clear-felling anymore), you can build stable cashflows and income over the long term if the forests are managed properly and sustainably.

Every scrap of our wood is used for some purpose before replanting, whether it's construction, pallet wood, fencing, pulp, chipboard and, in some cases (very little in ours) biomass and power production.

Stephen Addicott: I've been in the timberland business for 30 years and the last ten of those with Stafford Capital Partners, the only dedicated secondaries buyer in this space. So, when we talk about sustainability it comes from a position of experience.

On a global basis, there is about $100bn of institutional capital within timberland, which is relatively small, and there are probably about 30 or so managers with over $1bn of assets under management. So how do you access that as an institutional investor while demand is increasing because investors see the sustainability and the ESG benefits?

Our strategy is about accessing the secondaries market – we don't have to wait for an asset to come to market – we can find opportunities, buying out LPs [Limited Partners] from existing funds and more recently there have been some good opportunities in fund restructures. Closed-end funds are often willing to sell their positions as their fund nears the end of its lifecycle, and that's more than matched by demand from open-ended funds

"If you get the right tree, in the right place, it will deliver a valuable long-term return. It's a very good diversifier in that it de-links from equity and debt and traditional asset classes"

Olly Hughes, managing director, forestry, Gresham House

"It's hard to find anything critical to say about forestry because it ticks a lot of boxes that a long-term investor is interested in. Historically, however, we invested in timber and the old adage applies: once bitten, twice shy"

Peter Wallach, director of pensions, Merseyside Pension Fund

and insurance companies looking to access the asset class.

Peter Findlay: Let's turn to our LGPS guests then and what are they persuaded by? Also, what are the challenges for them as investors?

Peter Wallach: I think what we've heard is very persuasive. On the face of it, it's hard to find anything critical to say about forestry because it ticks a lot of boxes that a long-term investor such as a pension fund is interested in. It sounds very attractive. Historically, however, we invested in timber and Olly alluded to some LGPS investors having had a poor experience first-time around, so the old adage applies: once bitten, twice shy.

Heather Fleming: And presumably, because it's not necessarily going to be a really big portion of your overall asset allocation, it must be difficult to recommit? As you said, you have to get comfortable again, after a bad experience, and I'm sure it's harder a second time round.

"On a global basis, there is about $100bn of institutional capital within timberland, and there are probably about 30 or so managers with over $1bn of assets under management"

Stephen Addicott, managing partner, timberland, Stafford Capital Partners

"From a responsible investment perspective there are a number of attractive qualities in forestry and it all sounds very attractive, but there are clearly challenges here too"

Sean Johns, pensions investment manager, Cornwall Council

Peter Wallach: It's partly that but also, we're considering it against other real assets like infrastructure and property. And with some of the subsidies there have been on renewable energy opportunities over the last 15 years, those have looked particularly attractive. That said, the time for some of those assets is starting to play out. Infrastructure returns have come down, renewable subsidies in the main have disappeared because they're no longer required.

Alison Lee: London CIV is currently not a forestry investor and I agree with Peter that timber does find itself in competition with a number of other real assets. So, for example, we're currently exploring social housing and renewables and this would probably compete among those assets. However, I'm a responsible investment manager so, coming from a sustainability point of view, timber is something that we need to look at. We signed a COP26 deforestation and biodiversity commitment; that's one of our key stewardship themes, so forestry is an important adjunct to that.

Sean Johns: We've historically had a relatively large proportion of our assets in private markets – it's about a third of our fund. So, for us, it's more about looking at opportunities that

"Timber does find itself in competition with other real assets. We're exploring social housing and renewables and this would probably compete among those assets. However, I'm coming from a sustainability point of view, [so] timber is something that we need to look at"

Alison Lee, responsible investment manager, London CIV

"I recently went on a site visit to some of the investments we're in, and I'll admit that I went with preconceptions about deforestation. But, after spending some time with the workers on the ground, I built a sense of their having a really well-managed plan"

Sherief Loutfy, finance planning manager, Worcestershire County Council

could offer something a bit different, something that's less correlated to our other private assets. From an RI [responsible investment] perspective there are a number of attractive qualities in forestry and so far it all sounds very attractive but there are clearly challenges here too. When it comes to harvesting the timber, I'm interested to understand more about the sustainability challenges, because ultimately the trees are chopped down. Elected members would want to know what the sustainability and biodiversity risks are and would need to be very comfortable with that.

Sherief Loutfy: At Worcestershire, we are a current timber investor; we've been invested since December 2021 and, in fact, we've just decided to dip our toe in the water a little further with an increased allocation. We don't have quite the level of private markets allocation that Sean does at Cornwall but we have a decent amount and this investment was about broadening our diversification with an eye on future cashflows. We're a rural local authority so it fits quite well alongside our ESG activity.

To Sean's point, I recently went on a site visit to some of the investments we're in, and I'll admit that I went with a lot of preconceptions about deforestation. But, after spending some time with the workers on the ground, I built a sense of their having a really well-managed plan.

There's a 35-yr rolling cycle and they're meeting regularly to discuss the ongoing plan. What I hadn't understood before this was that each time a tree is harvested, it's done in a highly skilled way, with a lot of effort going into finding the most productive use for each individual cut.

There was more care paid than I'd realised to the soil too, to improve its quality for the next round of planting and protect the land for long-term use. It was a fascinating process and I'd recommend it to anyone exploring an investment.

Heather Fleming: We recommend those trips for that very reason. A lot of visitors come with varied preconceptions, but both the process and the future use of the wood can be much better understood with a site visit.

To the sustainability point also, the majority of our wood goes into construction and building houses so it's locked-up and put to long-term use, rather than used for biomass which is not our model at all.

Peter Findlay: Olly, back to you, how does timber compare to some of the other real assets that have been mentioned?

Olly Hughes: Returns-wise, with timber you're looking at a nominal net-net IIR of somewhere around 7-8% with carbon income on top of that.

"We always focus on the fundamental drivers: diversification, inflation-protection and the lack of correlation to other asset classes. Sustainability factors are an added component, but the starting point has to be: what fundamentally underpins this investment?"

Heather Fleming, managing director, institutional business, Gresham House

Peter Findlay: What does "carbon income on top" mean?

Olly Hughes: We all need more trees to grow globally; this is not a sunset industry. In the UK we have a target of about 30,000 hectares per year and currently we're planting about 10-12,000: we need a lot more trees. Planting a new tree will generate a sequestered unit of carbon and that unit will have a value. In our funds, the LP can either take that value in specie for their own offsetting purposes, or they can sell it into the market. That value is in addition to the return the timber business makes for you.

Stephen Addicott: A lot of investors coming into our funds are doing so from their infrastructure bucket. We've split our funds into brownfield and greenfield which we call "core" and "core plus". In the brownfield investment, the targeted 8% return would be made up of roughly 4% cash yields from timber harvesting and operations, and then 4% capital growth. In the greenfield strategy, you're looking at similar 8% returns but you're not going to get cashflow from timber harvesting because of the growing/harvesting timelines, but this is where you can claim carbon credits.

We've had a lack of planting over the last 30 years, which has led to shortages of wood, and carbon will be the impetus, I think, to lead to a new level of planting, but it won't affect supply in the markets for another 20-25 years.

I also want to raise the issue of the inherent carbon value of the products we produce. There's no monetary value placed on the carbon locked-up in a piece of wood; there's no carbon tax put on a piece of concrete or a piece of steel. But who's to say that won't change? If you see climate policy drive up the value in timber because of its sequestration benefits, then demand is going to ratchet up considerably.

On sustainability, the industry now is at such a high standard and over the last 20-25 years I struggle to think of forestry investments that haven't been sustainable. That comes down to harvesting cycles and strict codes of practice: you can't pollute waterways, there are restrictions on where you can operate,

and typically only 60-70% of each property is established.

Dermot McCloskey: Commercial forests also work very hard in meeting global demand for wood. Seven percent of the world's forested area is commercial forestry, but it meets 50% of the world's demand for wood. So, commercial forests are not only delivering sustainable building materials and products, but also helping to alleviate pressure on natural forests.

Olly Hughes: An important part of the sustainability discussion is also being realistic about the limits of what forestry can offer. We meet a lot of investors who come to us with a carbon or a net-zero strategy and see forestry as a part of the solution. Of course, it is part of the long-term solution, but if you have a 2030 net-zero target and you're planting trees today, the rotation in Europe is 60 years. Are you going to address your short-term carbon targets with new trees? Probably not.

Alison Lee: I'm interested to hear more about managing the physical risks to trees that comes with climate change. Does anyone have a view? Different geographies are going to be affected in different ways, so how will that impact production?

Olly Hughes: There are broadly two areas of risk within forestry: you've got physical risks and you've got pests and disease. The physical risks are fire and wind damage. Firstly, of course we insure against those risks, but more importantly where we are planting and how we are managing both the growth and harvesting, can mitigate physical risk considerably. A well-managed forest will not suffer so badly from wind or from fire.

There's a much bigger question over how we manage the pest and disease risk and that also is touched upon by climate change. Beetle damage in Central Europe is being driven by very long, hot summers, for example. We're focusing all of our new planting on temperate northern or southern areas where we're expecting climate change to result in the sort of climates that trees like and pests don't.

Stephen Addicott: I agree. The levels of losses to assets we've experienced over the last few decades has been around 0.06%. So, it's been pretty low historically, but we can't afford to have the blinkers on about climate risks in the future. The one thing I would say is that where we're seeing fire, wind damage and drought stress is typically in the natural forests of the world, not the managed forests.

Sean Johns: When we operate in emerging markets, there are often additional governance challenges from a pension fund's perspective. Outside of Europe, what challenges do you face where, for example, you're coming into contact with indigenous cultures and their land rights?

Stephen Addicott: We have 15% of our portfolio in South America and about 5% in Brazil. These aren't natural forests, rather they are plantations on ex-farmland, so we haven't had issues with indigenous peoples but it's always something to be mindful of particularly when you're buying new land. You have to be very aware of the "S" in ESG with new land, for example, land farmers have previously occupied. It might not be indigenous people, but it will be local people, and you have to consult and engage thoroughly before you invest.

Sherief Loutfy: I'd just like to pick up on the income generation and cashflow fundamentals if I could. On that side of the investment, given that the US and Scandinavia are so dominant in global timber pricing, what can we do to mitigate potential for price volatility?

Stephen Addicott: As a forest owner, the price you get will depend on the mills that buy your logs, it won't necessarily be driven by the broader markets. I certainly think they will be more influential in the pricing of the finished products; the lumber that gets transported around the world. For the forester the economics will come down to: how many

sawmills or pulp mills are there near your forests or whether you have access to a port to facilitate the sale of your logs in international markets?

Peter Findlay: Lots of interesting thoughts here on the fundamentals and the sustainability discussion, but what are the best reasons for going into timber?

Heather Fleming: We will always focus on the fundamental drivers: the diversification, the inflation-protection, and the lack of correlation to other asset classes. Of course, the sustainability factors are an added component but the starting point has to be: what fundamentally underpins this investment? That's how we approach it. The educational process is ongoing and that's going to be really important as demand increases.

Dermot McCloskey: I think what has been so interesting about this discussion today, is that it echoes so many of the conversations we've had in recent times. Forestry is at an inflection point – we've probably never seen greater interest in the sector – and UK pension funds are really at the fore of this, having consistently set ambitious decarbonisation pledges across their portfolios. Many have made a great start in equities and are now looking across to private markets, with timberland proving a very natural starting place, due to its ability to sequester carbon from the atmosphere at scale, while offering a stable long-term return.

WHY INVESTORS ARE TURNING TO FORESTRY IN DIFFICULT TIMES

Francis Ireland from Gresham House discusses how forestry can offer a compelling opportunity for investors at a time of high inflation, rising interest rates and uncertain returns elsewhere

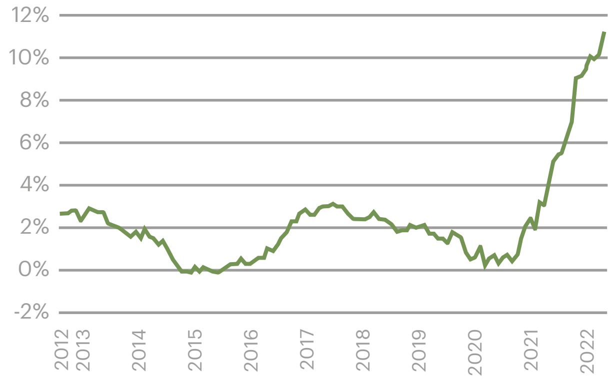
Inflation was long considered yesterday's problem. Double-digit price growth in the UK last occurred more than 40 years ago, when Margaret Thatcher was in Downing Street, the Brixton riots took place, and the Specials were in the top ten.

The latest data from the Office for National Statistics to the end of October 2022 show consumer price inflation at 11.1% for the preceding 12 months, up from 10.1% in September, 9.9% in August and 10.1% in July.

Rising food and energy prices stemming from the Russian invasion of Ukraine have been the protagonists in a story of increasing price levels across the world.

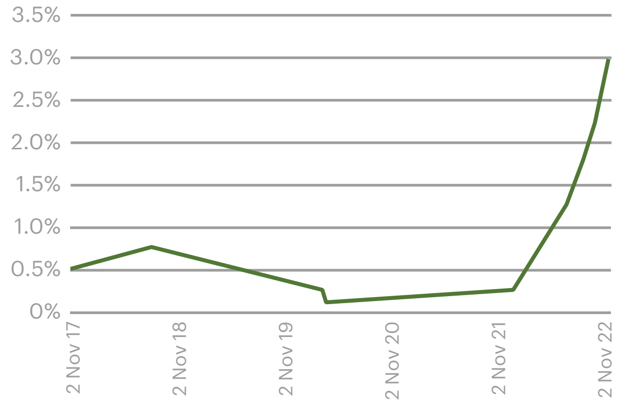
Central banks have responded by using the main tool at their disposal: hiking interest

INFLATION OVER THE LAST TEN YEARS



Source: ONS, August 2022

UK INTEREST RATE



Source: Bank of England data, August 2022

rates to the highest levels in a decade. With debt more expensive and the supply of money tightening, growth prospects around the world look bleak.

Many will remember the period of stagflation in the 1970s, characterised by rising prices and low growth.

Public markets have responded to this economic outlook, with the FTSE 250 having fallen 18% at the time of writing for the year to date.

Investment strategies

Despite consensus on the UK's dim growth prospects over the next few years, views on the winners and losers are less aligned. The preceding decade-long bull run saw capital moving away from fixed income into equity markets, based on an investment strategy predicated on capital growth. What we are seeing now is a reversal of this trend, with investors looking to batten down the hatches.

Forestry as an asset class has provided a haven for investors in times of macroeconomic downturns, underpinned by the biological growth of trees, low correlation to mainstream asset classes, and timber acting as a strong inflation hedge.

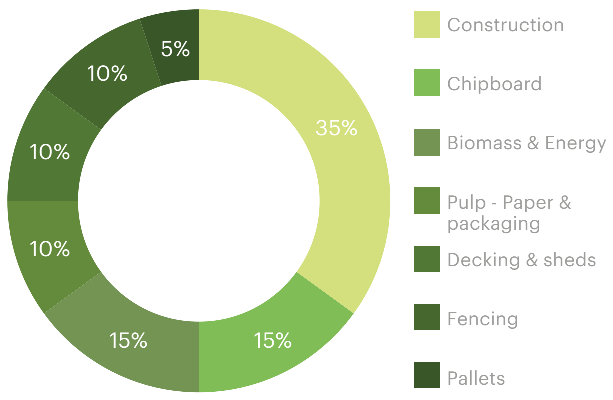
The sector provides resilience to an investor landscape increasingly demanding protection against rising price levels and low growth.

Flexibility is crucial to the resilience of the sector. Sitka Spruce, the most popular commercial conifer in the UK, has a harvesting window of 15 years. This is significantly longer than the average business cycle length of seven years, permitting forest owners to time the harvest to capture opportune market conditions to maximise potential returns.

Thirty-five percent of UK timber is used in construction, a sector that has faltered in bear markets. Rather than harvest and sell timber into a cold market, foresters can leave the crop on stump to grow volume while the timber markets recover.

Forestry as an asset class has provided a haven for investors in times of macroeconomic downturns, underpinned by the biological growth of trees, low correlation to mainstream asset classes and timber acting as a strong inflation hedge.

TIMBER USES IN THE UK



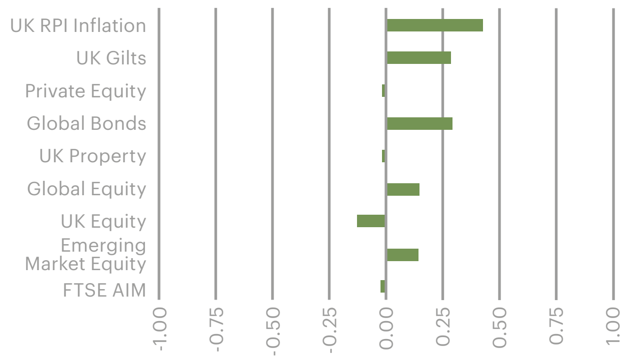
Source: Gresham House Global Timber Outlook, 2020.

The ability to navigate the business cycle through harvest timing lends a unique return profile to forestry as an asset class.

Forestry has a return profile with low correlation to traditional asset classes.

A key tenet of institutional portfolio construction lies in mitigating risk without compromising returns. Allocation to a sector with little relationship to mainstream asset classes diversifies risk, reducing institutional exposure to the volatility surrounding financial markets. While inflation continues to rise, it is important to recognise that forestry has historically acted as an inflation hedge.

15-YEAR UK FORESTRY RETURNS CORRELATION COEFFICIENT



Source: Gresham House, May 2022

Forestry returns in the UK are correlated to inflation, where the asset class offers protection against rising price levels. The end use of timber is varied, with construction, food and battery energy storage all potential destinations for UK timber, amongst a multitude of others.

Given the CPI basket contains a number of timber-based products, the timber price naturally rises during periods of high inflation.

As investors scramble to protect themselves from a weak economic outlook coupled with inflationary pressure, forestry offers a tangible solution.

With its strong inflation correlation, low correlation to mainstream asset classes and the ability to navigate business cycles through the biological growth of trees, forestry is a compelling opportunity for investors as a refuge in uncertain times.

Francis Ireland is analyst, forestry, at Gresham House.

Gresham House plc (GHE.LN) is a London Stock Exchange-quoted specialist asset manager providing funds, direct investments and tailored investment solutions, including co-investment, across a range of differentiated alternative investment strategies. We focus on five areas of alternative investments: Forestry, New Energy and Infrastructure, Housing, Public and Private Equity - across two divisions, Real Assets and Strategic Equity. As of 30 June 2022, the firm managed £7.3bn in assets under management on behalf of institutions, family offices, high-net-worth individuals, charities, endowments and private individuals.

The Gresham House Forestry division has been investing in and managing commercial forests for over 40 years. Two key strategic acquisitions established our forestry capability; Gresham House acquired Aitchesse Limited in November 2015 and FIM Services Ltd in May 2018 as part of its strategic plan to become a leading investment manager in this asset class.

WHY PENSION FUNDS NEED TO ACT NOW TO AVOID FUTURE OFFSETTING COSTS

Stephen Addicott from Stafford Timberland examines the role of forestry and land-use projects in the voluntary carbon market

The number of pension schemes setting net-zero targets is rising as organisations commit to greater environmental, social and governance (ESG) regulation. Carbon offsetting is a vital part of reaching "true" net zero, but can the supply of voluntary carbon offsets keep up with predicted demand? And why should trustees act now in order to minimise substantial future compliance costs?

The UK's Climate Change Governance and Reporting Regulations 2021 required larger occupational pension schemes to set climate-related targets from October 2021. In doing so, they have become part of a rapidly increasing number of public and private sector organisations that are setting such targets.

A major focus for these organisations will be to reduce emissions across their operations or investments. Most, however, will have some level of residual emissions remaining, and to reach a net-zero position they will need to make use of carbon offsets.

Rise in demand

This requirement is expected to fuel demand from around 161 million tCO2e in 2021, to around 1 billion tCO2e in 2030 – and 3-4 billion tCO2e in 2050[1].

Against this backdrop of strongly growing demand, a key question for net-zero organisations is whether supply of offsets will develop in line with demand. In our view, this is unlikely due to a number of factors:

Firstly, forestry and land-use projects have accounted for the largest share of voluntary carbon offsets issued to date – and more than a quarter have come from projects that aim to protect existing forests and avoid potential emissions from deforestation. Unlike afforestation projects (and to some extent also Improved Forest Management projects) these emissions avoidance projects do not contribute to new and additional removal of emissions from the atmosphere.

While both emissions avoidance and removals projects have a role to play in climate action, the voluntary carbon market is expected to shift towards removals-only as regulations around the world obviate the need for avoidance offsets.

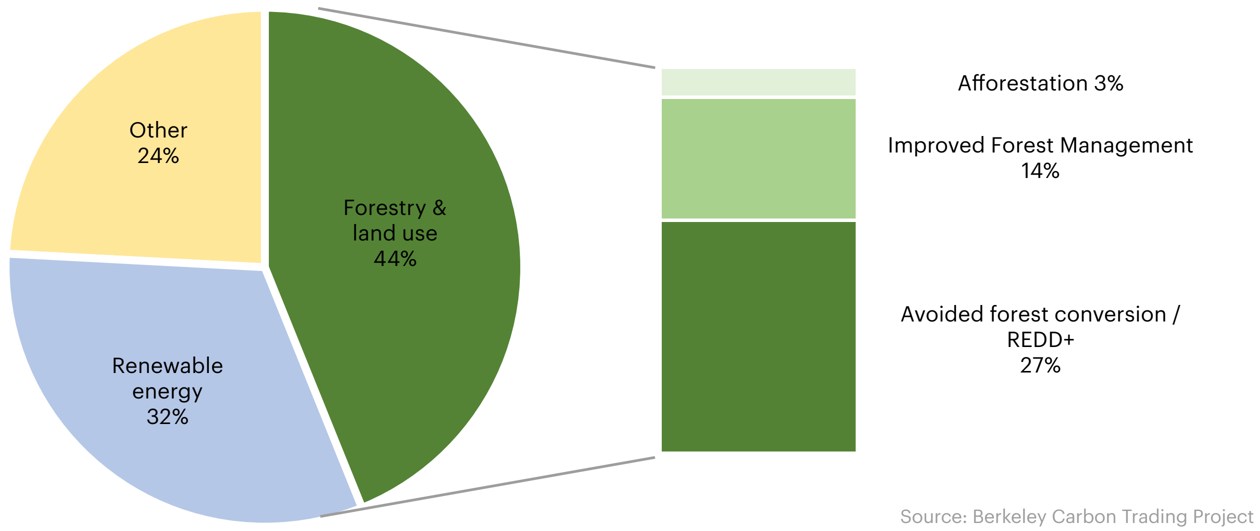
Afforestation projects have considerable potential as a removal technology, particularly given that they are far more established and cost effective than alternative engineered solutions such as BECCS[2] or DACCS[3].

However, lead times for afforestation projects can be lengthy. Developing a carbon project will frequently take up to 18 months, and it will usually be four to five years after planting the trees before any offsets can be issued by a project. Availability of skills and logistical resources will also present a challenge if mobilisation of afforestation projects occurs on a large scale.

> *While both emissions avoidance and removals projects have a role to play in climate action, the voluntary carbon market is expected to shift towards removals-only as regulations around the world obviate the need for avoidance offsets.*

Since the beginning of 2020, two of the main registries in the voluntary carbon market (Verra VCS and Gold Standard – which together represent around 75% of all offsets issued to date) have no longer accepted new projects based on renewables technologies, except for those located in Least Developed Countries (LDCs). Offsets from renewables projects have made up almost a third of the total supply to date, leaving a substantial gap to be filled.

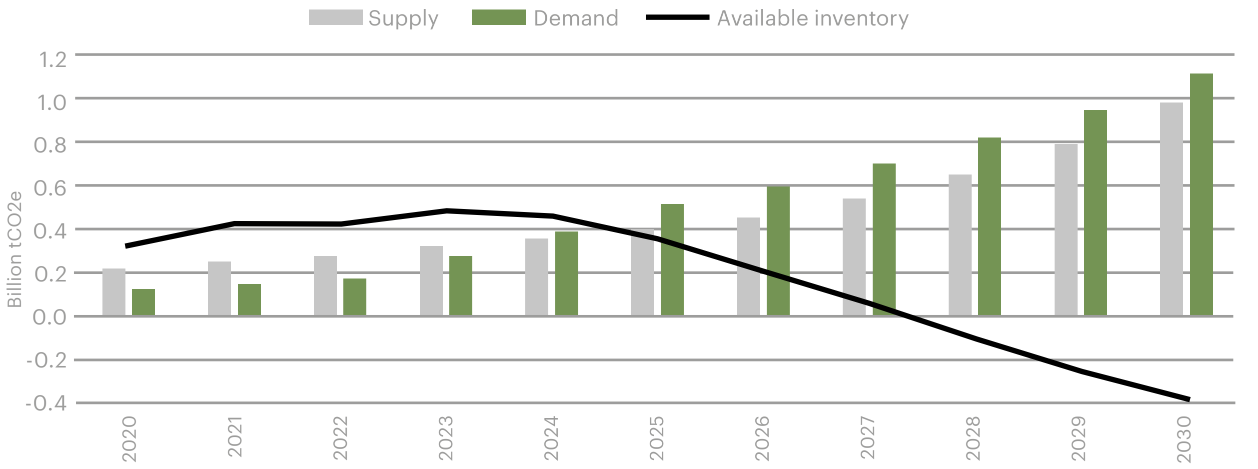
ORIGIN OF TOTAL VOLUNTARY CARBON OFFSETS ISSUED TO DATE



Source: Berkeley Carbon Trading Project

[1] These were the projected demand levels envisioned by subject matter experts within the Taskforce on Scaling Voluntary Carbon markets and published in its final report in January 2021 (www.iif.com/tsvcm)
[2] Bioenergy with carbon capture and storage
[3] Direct Air Carbon Capture and Storage

OUTLOOK FOR SUPPLY, DEMAND & AVAILABLE INVENTORY OF CARBON OFFSETS



Source: Based on “An outlook on the Voluntary carbon market”, Shell & Boston Consulting Group

The right vintage?

Lastly, carbon offsets are issued with a “vintage”. Although typically cheaper, older vintages tend to raise more questions of quality, and many organisations therefore look for offsets from vintages within the last three years.

Current inventory levels of around 718 million tCO2e appears substantial relative to demand – retirements reached 161 million tCO2e in 2021 – but a third of those have vintages dating back earlier than 2016 (the cut-off date for offsets eligible for use in CORSIA, the UN’s emissions scheme for international aviation). The available inventory that can satisfy demand for more recent vintages will therefore be materially reduced.

The issue of tightening supply was highlighted in a report published last year by Shell and Boston Consulting Group, where the central scenario points to a cumulative deficit of approximately 400 million tCO2e by 2030.

Getting out in front

The implication of a supply-constrained market is a potentially drastic rise in offset prices as we approach 2030 and beyond. Pricing for voluntary carbon offsets has weakened through the year as markets responded to Russia’s invasion of Ukraine and more recent concerns around recession. But the International Emissions Trading Association’s (IETA’s) latest annual GHG Market Sentiment Survey contains a bullish outlook. In it, respondents indicate that they expect average pricing for CBL’s Global Emissions Offset (GEO) futures to reach the equivalent of USD46/tCO2e between 2026 and 2030.

Other analysis contains scenarios with even higher pricing levels. Earlier this year BloombergNEF suggested that, in a supply-side constrained market, prices could exceed USD200/tCO2e in 2030 before gradually reducing over time, although still remaining at above USD100/tCO2e by 2050.

Trustees of pension funds will therefore need to consider the implications of much higher compliance costs. Those who develop approaches, such as investing directly into carbon projects now to secure offsets for future use, could find considerable value in them as hedging strategies.

In practical terms, early movers investing into afforestation projects will be able to secure the best resources in terms of land and management expertise, and should be in a position to start issuing offsets in time to avoid the worst of the deficit. That will be a key benefit given that the Department for Work and Pensions is pressing trustees to set climate-related targets no further than 10 years away, even if they already have longer-term net-zero targets.

Stephen Addicott is co-managing partner at Stafford Timberland.