Assessing International Opportunities

Chris Zinkhan
BACKGROUND FOR PURSUIT OF OFFSHORE INVESTMENTS

• US timberland sector is significant, but represents a modest portion of global opportunities.
• Completeness of timberland portfolio—USA forests account for less than 8% of global forests by area.
• Diversification of timberland portfolio.
• Significant competition for US opportunities—search for greater returns.
• Shrinkage in future acreage sourced from vertically integrated C corporations in USA.
• HBU component often plays more significant role in US sector.
• Pursue species not available in USA.
• Increased degree of globalization within forest products industry.
• Relative growth of US forest-products sector is modest vs. emerging markets.
BROADENING OPTIONS VIA INTERNATIONAL PURSUITS: ALTERNATIVE FOREST TYPES
CONSIDERATION 1: MPT MOTIVES

- Opportunity to shift efficient frontier of timberland portfolio.
- Expanding universe of opportunities increases completeness of portfolio.
- Lower correlation of periodic returns between portfolio components sourced in different nations.

However, consider the strategic reason for the institution’s allocation to timberland: Hedging against higher-than-anticipated U.S. inflation vs. optimizing Sharpe ratio of timberland portfolio.

- Has portfolio risk been accurately assessed? What about illiquidity?
CONSIDERATION 2: REPLICATING A GLOBAL TIMBERLAND PORTFOLIO

- North America only accounts for 17% of the world’s forest area. [However, US South alone has about 20% of the world’s industrial wood plantations.]
- Forest-products industry is global; why isn’t your timberland portfolio?
- What regions, if any, will be over- or under-weighted?
- Broadens exposure to species not native to US (e.g., Teak, Mahogany, Eucalyptus).
CONSIDERATION 3: SPECTRUM OF GLOBAL INVESTMENT BREADTH

• Constructing a fully diversified global portfolio vs. opportunistic pursuit of niches.
• Selected space within spectrum requires very different organizations.
• Extend US strategy: By focusing on same or complementary forest types.
CONSIDERATION 4: INCREASING BLENDED RETURNS

- **Emerging regions**: Can offer higher expected returns.

- **Institutional investors should exercise caution**: Is global allocation by the TIMO being undertaken simply to achieve a target absolute return greater than offered by US opportunities?

- What **return premium** is required for a given geographic allocation?
INCREMENTAL DISCOUNT-RATE SPREADS VIS-À-VIS US IN REAL BASIS POINTS (MEDIANS--SEWALL 2013 SURVEY)

- New Zealand Pine 150
- Australia Pine 150
- Australia Eucalyptus 225
- Southern Brazil Pine 300
- Southern Brazil Eucalyptus 325
- Panama Teak 400
- Columbia Teak 475
- Argentina Eucalyptus 500
- South Africa Plantations 500
- Cambodia Plantations 575
- China Plantations 600
- Russia Boreal Forest 1,000
CONSIDERATION 5: ACTIVELY MANAGING OTHER FINANCIAL METRICS

- **Composition of Returns**: Tilting proportion of total return attributable to biological growth. Potential growth rates in southern hemisphere greater than in USA.

- **Portfolio Duration**: Affordable land/planting opportunities are in greater supply offshore. Short-rotation plantations provide opportunity to shorten the blended portfolio duration. Or, broader raw land/planting opportunities enable deferral of cash flows and longer durations (perhaps to match liabilities, avoid need for short-term reinvestments, defer taxes, or match development of timber markets in region).
CONSIDERATION 6: MANAGING FACTOR LOADINGS

- Offshore investments expand array of factor-loading options for managers.
- Offshore investments enable a strategic reduction in factor loadings tied to US-based sectors. For example, a Brazilian Eucalyptus opportunity might be tied to the local charcoal market (and not the US housing or pulp & paper sectors).
CONSIDERATION 7: STRATEGIC FIT

• Are offshore investments consistent with firm’s competitive advantages?
• Are offshore operations consistent with firm’s human resources, investment style, organizational structure, and culture?
• Can manager add value to an offshore opportunity through its silvicultural expertise, global forest products distribution/marketing capacity, or its global business network?

............... 

• However, will geographic expansion dilute competitive advantages: Informational edge, network of domestic relationships, the need to engage new service providers, etc.?
• US management style will likely need to be modified (e.g., principals may need to rely more on expertise of agents).
PARTIAL STRATEGIC-FIT CHECKLIST

• Fund Compliance?
• Source of Informational Edge?
• Forest-Management Style: Outlier relative to core?
• Satisfactory Contingency Plan for local management?
• Attractive Add-On Opportunities?
• Others…?
CONSIDERATION 8: REDUCE REAL-ESTATE-TO-TIMBER-VALUE RATIO

- Increase in US timberland prices has been attributable, in part, to higher real estate values.
- A high Real-Estate-to-Timber-Value Ratio dilutes proportion of total return generated by biological growth and ingrowth.
- Significant real estate exposure changes the fundamentals of total returns on timberland.
- *Increased allocation to offshore investments* → Can increase the concentration of investment capital on the timber component (due to lower land prices).
GOVERNMENT CONCESSION OPPORTUNITY?

NO ALLOCATION OF CAPITAL TO LAND: FIJI
CONSIDERATION 9: EXECUTION RISK

- Greater number of variables which can influence return:
  - Foreign-exchange volatility
  - Less stable regulatory environment
  - Contract-law issues
  - Other sources of higher country risk
  - Perhaps thinner and thus less predictable markets
  - New relationships with service providers and customers
  - Infrastructure may require greater attention

- *Active approaches for mitigating risks* → Overweighting US export opportunities (US $ denominated revenues), financing acquisition in local currency, country-risk insurance, controlling processing of timber.
CONSIDERATION 10: LACK OF DEVELOPED MARKETS MAY LIMIT EMBEDDED - OPTION VALUES

• Deep markets for recreation, the demand for forested parcels by a diversity of wealthy families, and markets for conservation attributes provide large US timberland owners with a variety of strategic land-use options.

  - For example, 44% of the eastern U.S. Oak-Hickory forests are in at least small metro areas.

• Many offshore timberland opportunities will lack the diversity of highly valued, embedded options - at least for the intermediate term.
CASE OF BLUE DEVIL TIMO

• Blue Devil management is considering a $50 million investment in Panamanian Teak plantations, with a diversity of age classes. Firm projections suggest a base-case real IRR of 11%.
• Question 1: What are the incremental risks compared to Blue Devil’s core US investments?
• Question 2: If you served on the firm’s Advisory Committee, what two questions would you direct to management?
1. Incremental risks:
   a. ______________________
   b. ______________________
   c. ______________________
   d. ______________________

2. Two questions:
   a. _____________________________________
   b. _____________________________________
PANAMIANIAN TEAK PLANTATION