Forestry assets in Africa: promising returns

Solid biological growth rates, low establishment and maintenance costs, land availability, and demand for forestry products make Africa an attractive forestry option. Typical emerging market risks as well as environmental and social issues are involved. Local and international strategic partnerships are the means to success, driving economic development through direct job creation and providing an economic multiplier estimated to be as high as 20-1.

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The chief attribute of the forestry asset class is its superior historical risk-return profile relative to other asset classes. Investors have been drawn by its performance: its stability of returns and positive correlation with inflation, providing an effective inflation hedge. These investment strengths are supported by the most basic characteristic of these assets – the biological growth of trees. This growth is uncorrelated with financial markets: it continues as long as there is soil, water and sunlight. Furthermore, continued biological growth not only increases the marketable volume of timber, it can also increase the value of the forest, as larger-diameter logs yield a greater proportion of high-value products. Also, harvests can be accelerated or delayed based on the market prices for forest products, providing unique inventory flexibility that can mitigate the impact of downturns in business cycles.

Investors in mature market timberlands have achieved sizeable returns in the past two decades. Based on the National Council for Real Estate Investment Fiduciaries (NCREIF) index[1], an investment in a U.S. timberland in 1986 would have grown at a compound annual return of nearly 16% through 2008. Adjusted for inflation, the real rate of return for this period exceeds 12%, more than twice the real return one would have achieved investing in stocks or residential real estate during the same period, with low variance. Returns for the timberland asset class in developed markets have significantly outperformed all other major asset classes over the last twenty-two years (Bary 2009).

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In developed markets, it is unlikely that the sizeable returns of the past two decades will continue, as this market is now fairly efficient and mature. The best timberland investments now usually rely on conversion to the highest and best use of land for their increases in value. For example, land can be sold for uses such as recreation and residential accommodation.

Emerging market timberlands, however, provide promise for investors. Tropical emerging markets, for example, provide higher producing growing sites and lower establishment and labour costs than the temperate forests of mature markets.

In emerging markets, investors such as GEF have found focusing on timber plantations instead of exploiting natural forest concessions to be an attractive strategy. Plantations are indeed more productive and less costly to run than natural forest concessions, whose exploitation involves high costs in order to comply with certification constraints. Furthermore, the market for wood products is evolving: in order to easily replicate sophisticated final products, the

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[1] *http://www.ncreif.org/indices/timberland.phtml.*

furniture and building industries increasingly require raw materials with standard dimensions, which only plantations can offer.

A comparison in Brazil of wood residues from natural forest operations with those from plantations illustrates that plantations are a considerably more viable option. In natural forests, 60%-70% of the wood harvested is considered as waste, compared with 10-20% in plantations.

After processing, the final product from natural forests is 10-20% of the wood harvested, while for plantations, this figure is 30-40% (GEF, 2009). Logging residues account for 60-70% of lumber in natural forests, compared with 10 to 20% in plantations.

Why invest in forestry in Africa?

For plantation investments, Africa offers solid biological growth rates, with relatively low costs to establish and maintain plantations. Sub-Saharan Africa provides attractive growing conditions for species such as eucalyptus and pine. Due to the combination of soil conditions and rainfall, many countries in Africa have already exceeded or have the potential to exceed a mean annual increment (MAI) – a measure of rate of tree growth – of 20 cubic meters per hectare per year. This compares favourably with growth rates in most parts of the world, and is considerably higher than for mature markets in temperate regions.

Africa also offers among the lowest plantation establishment costs of any region in the world. This and the low maintenance costs position properly sited African forestry projects well to serve growing domestic demand as well as traditional European and North American markets.

Land limitations in other regions and increasing demand in Asia are expected to lead to new market opportunities for forest products originating in Eastern and Southern Africa. The tremendous availability of land in Africa – of the estimated 500 million hectares of degraded land (formerly forested tropical land not being used for agriculture, settlement, or other purposes) worldwide, 300 million hectares are found in Africa – makes the continent an attractive option for establishing plantations. The ability to site plantation projects on land without a competing use is critical to developing socially acceptable large-scale forestry projects in sub-Saharan Africa. Opportunities are available to invest in both existing and greenfield plantations, and a number of these have the potential for even higher yields on the land through integrating elements of agriculture and forestry.

Further, significant population growth and increasing demand for renewable biomass energy supports more investment into African forestry projects. Early entrants into this sector in Africa may benefit from the increased liquidity associated with a maturing of the sector in the coming years.

Investment constraints?

However, Africa has seen a limited amount of foreign direct investment in the forestry sector to date, because of several challenges. In most African countries, it is not possible to buy 'fee simple', titled ownership – ownership that is absolute and unqualified, as is the standard in most common-law countries. The only way a company can 'own' land is through a long-term lease or a concession right. This makes it possible for rentals or concession payments to be increased over time, beyond the expectations of the investor, reducing the prospect of providing risk-adjusted returns.

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Another consideration is the broad spectrum of sensitive environmental and social issues that investments in Africa involve. The large tracts of land necessary requires involvement of the communities. Care is also needed to mitigate any adverse impacts on natural ecosystems, especially due to road-building and harvesting. Institutional investors are responding by increasingly focusing on environmental stewardship, creating environmental and social safeguards that have become benchmarks (IFC, 2012). While the 'costs' of responsible governance more than pay off in the long run, they represents an entry-barrier for short-term profit seekers.

Also, in Africa it is not usually possible to outsource services and sell timber on the stump as traditional timberland investment management organisations (TIMOs) are able to do. This requires operators to perform all maintenance and processing functions 'in-house' to capture the full stumpage value (Merrill Lynch, 2007). Therefore, inves- ▶▶▶

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Global Environment Fund (GEF), is a Washington-based private equity firm investing globally in businesses that provide cost-effective solutions to pressing energy, resource and environmental challenges. Its experience results from investments in three markets: southern hemisphere timberlands and US and emerging market clean energy technology and services companies. It manages approximately 1 billion dollars in private equity investments for institutional investors.

Utilising, developing and preserving forests: finding the balance.

▶▶▶ tors need to be sure that they have solid management teams with a wide range of technical and operational skills. Developing the local industrial capacity to process timber, as well as the market for it has the potential to significantly impact success, with many African governments requiring domestic milling or providing incentives for investors to process wood domestically.

Additionally, investing in Africa involves a host of typical emerging market risks. These include a range of political and economic risks, as well as non-transparency and other corporate governance issues. Each African country has its unique policies and obstacles relating to operating a business. Licensing, taxes, exporting, investor protection, and employment regulations, among others, all need to be understood prior to making an investment decision.

Unlocking development and financial returns

GEF has been investing in Africa for more than 10 years, and has drawn the following key factors of success from this experience.

The first success factor concerns human resources and local knowledge. The constraints for investors and the concerns of host African states are best dealt with through local and international strategic partnerships. Due to the small pool of experienced managers in Africa, partnering with experienced, capable management teams with the appropriate strategy – accessible through an organisation like GEF – can help mitigate risks for investors, providing timber operations with the necessary marketing and technology knowledge and networks. Partners also include local allies who can assist in navigating local regulations and processes. Both types of partners can become part of attractive exit options. Conservation and development NGOs too can serve as important allies, reducing reputational risks and improving the local standing of portfolio companies.

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The integrated nature of the investment comprises the second success factor. For African states, having value added to resources locally so that local populations benefit is an important aspect of hosting investments. In much of Africa, a market for logs on the stump does not exist. Hence, it is usually necessary to own or build the manufacturing capacity to process raw logs into marketable value-added wood products. In areas with significant energy supply challenges, the use of biomass residues from forest thinning and sawmill operations to generate renewable electricity provides an opportunity to generate additional revenue while mitigating the unreliability of grid electricity supply. Supplying regional and international markets with wood pellets is often another profitable option for residual biomass.

The third success factor incorporates social, and local environmental issues. Social and cultural issues are particularly sensitive in Africa and a weak acceptance of the project by local communities can lead to its failure. Properly executed, African forestry investments drive economic development through direct job creation and provide an economic multiplier estimated to be as high as 20-1. Investors can add significant value by providing extensive training to employees at all levels of the business, and smart managers often seek to develop opportunities for community businesses. The relationships built in this process can pay off in various ways. For example, fire – most commonly started by humans – is one of the biggest risks in forestry investing. Having good relationships in a community is one way to mitigate this. For investors, social and environmental sustainability is the outcome of internal standards, active management, industry best practices and third-party certification. ●

Box: Forest investment in South Africa

In 2001, GEF invested in Global Forest Products (GFP), owner of approximately 65,000 hectares of productive pine plantations in Mpumalanga Province, South Africa. GEF made the investment as the result of an analysis indicating high productivity, the low cost of standing fiber, and mispriced country risk

GEF brought in North American forestry managers, who initiated an extensive capital expenditure investment program to modernise facilities and improve efficiency. In addition, .GFP also responded to other threats to its employees with education designed to keep employees healthy and responsible, and management led classes for GFP's 2,000 employees on personal financial management and credit awareness.

GFP operated in an environmentally sustainable way (GFP atteined the Forest Stewardship Council), while delivering financial results to employees and shareholders.

GFP, under GEF's ownership, grew revenue by a compounded annual growth rate of 15%, and went from unprofitable to growing profits every year, until GEF's exit in 2007.

GEF's investment in GFP shows that the approach described above can yield both excellent financial returns to companies and their investors and benefits to the surrounding community, economy and environment.

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