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Scottish Woodlands

Savills World Research
Rural

Spotlight
UK Forestry Market

2015

This publication

This document was published in March 2015. The data used in the charts and tables is the latest available at the time of going to press. Sources are included for all the charts. We have used a standard set of notes and abbreviations throughout the document

Foreword
A COMPLEX AND UNIQUE COMMODITY

Scottish Woodlands and Savills have come together to offer a fresh perspective on the UK forestry investment market

Forestry along with farmland has outperformed many other assets during the past 20 years. It offers a strong combination of benefits, being land-based, commodity-driven, tax efficient and often counter-cyclical to other investment products.

Its role as a credible investment alternative was clearly demonstrated against the backdrop of the 2008 financial crisis. It is testament to its strength that the industry fared well in comparison to other sectors, most of which were impacted over a longer period.

The forestry sector has witnessed many phases over the past 75 years from its importance as a major national natural resource, through a period of extensive new planting driven by tax mitigation, followed by a more recent focus on the conservation and biodiversity aspects of woodland.

Since the early 2000s, commercial timber forests have held a great attraction for many as investment assets and forestry is now increasingly being purchased as part of a diversified portfolio.

Multiple benefits

Forestry offers multiple benefits, from access and conservation through to the genuine enjoyment of ownership. However from an investment point of view, the sector is primarily about timber production and the demand from processors for raw materials. As the economy continues to recover and the construction sector grows, the future of this commodity looks very promising indeed.

In practical terms the volume of available forestry in GB is limited and, therefore, the likelihood is that a relatively small transactional market will continue to support and enhance capital values over the medium to longer term.

Coupled with the effects of market size, Great Britain has a world class wood processing sector that requires long term continuity of wood supply and there are already concerns in the industry over the future availability of timber.

Based on simple supply and demand economics it is difficult to forecast anything but positive future investment performance for the sector.

> "It has many benefits, being land-based, tax efficient and often counter-cyclical"
> Scottish Woodlands

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EXECUTIVE SUMMARY

The total transaction value of forest area sold has increased significantly over the past five years
See pages 04/06

Forestry along with farmland has outperformed most other assets during the past 20 years
See page 07

There is a strong relationship between timber age and freehold capital value
See page 08

The GB forest area is tiny when compared with other global locations
See page 09

Timber is set to become forestry's primary market driver
See page 10

FOREST INVESTMENT ANALYSIS

The total value of forest transactions has increased significantly over the past five years

"The significant increase in value between 2011 and 2012 correlates to a period of higher investor demand"
Savills Rural Research

Our research on the investment forestry market in Great Britain is based on our transactional database of forest sales. This database collates data from all mainstream forest sales, and where we are aware off-market or private transactions.

The investment forestry market by area sold has remained relatively constant for a number of years, but we have seen a slight contraction (just over a tenth) over the past five years from 16,000 hectares in 2010 to 14,000 hectares in 2014. The commercial forest area in Great Britain is approximately 1.6 million hectares, of which 1.3 million hectares are located in Scotland, Wales and Northern England (80%), therefore the annual turnover of investment forests represents just over 1% of the commercial forest in these regions.

Whilst the overall turnover of forest area has fallen, the total transaction value has increased significantly (50%) over the past five years from £43.3 million to almost £65 million and reached a peak in 2012 of £73 million (Graph 2).

This significant increase in value between 2011 and 2012 correlates to a period of high investor demand leading to increased competition for investment assets. Demand for timber has also strengthened since 2010 in line with an improving economy driven by the resumption of housebuilding activity, increased activity in the distribution sector (pallets) and the continued uptake of low grade wood for biomass. Demand for roundwood from the biomass sector grew from 300,000 tonnes in 2008 to 1.25m tonnes in 2013, an increase of over 300% in what is an entirely new, not substituted market. The positive effect of improving timber prices has filtered through to improve values.

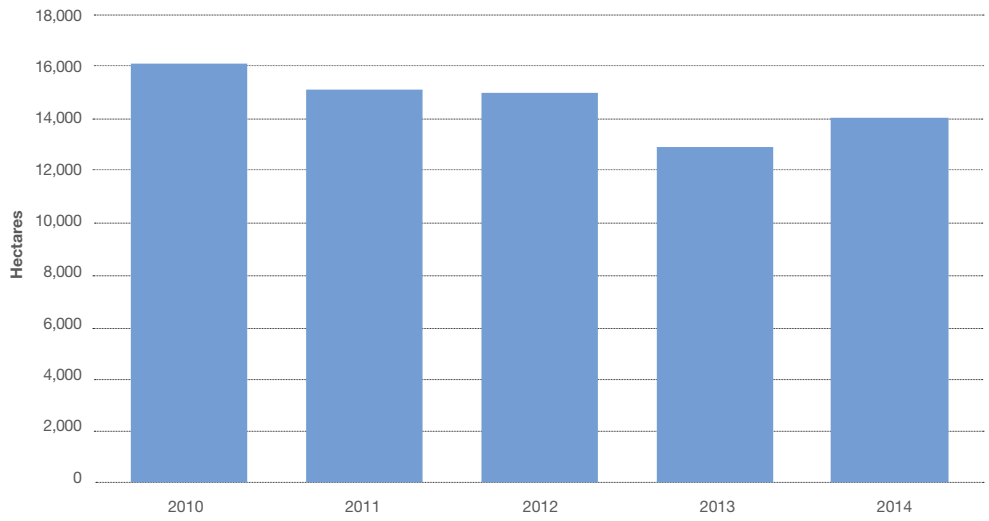
Over the past three years the value of total market transactions fell slightly reflecting the reduction in area sold coupled with a levelling out of the average values per hectare across the total market (see Graph 3). Based on our analysis the average value per productive (stocked) hectare is around £7,600 per hectare.

The relationship between the value of the total (gross) forest area and the productive or harvestable area has changed, especially over the past five years (Graph 3). This is an important measure when appraising investment forests as the area of unplanted or unproductive land can vary considerably, from as little as 5% to as much as 50%. The unproductive area has a relatively low and fairly constant value, therefore the market price, and ultimately the investment performance, is driven by the value of the productive area.

The average proportion of unproductive area in the forests analysed increased from 20% in 2010 to 30% in 2014 and this is a contributory factor to the increasing

GRAPH 1

Total market area



Source: Scottish Woodlands and Savills Research

gap between gross and net productive value per hectare. A proportion of this increase is due to the natural variability in forests and will be unique to the sample period, but as the GB forest estate matures and is restructured going into the second or subsequent rotations the requirement to improve biodiversity through the UK Woodland Assurance Standard has led to a gradual increase in the unproductive land area.

In 2014, the average productive value was £7,600 per hectare; 42% higher than the average gross value at £5,350 per hectare. The annualised rate of value growth over the past five years (2009 to 2014) was stronger (17%) for productive values than for the gross forest area (13%) which reflects the influence of timber price on value over this period. Graph 3 illustrates how net values levelled out more quickly than gross values after 2012 reflecting a slight weakening in the rate of timber price increases in 2012/13 (Graph 5).

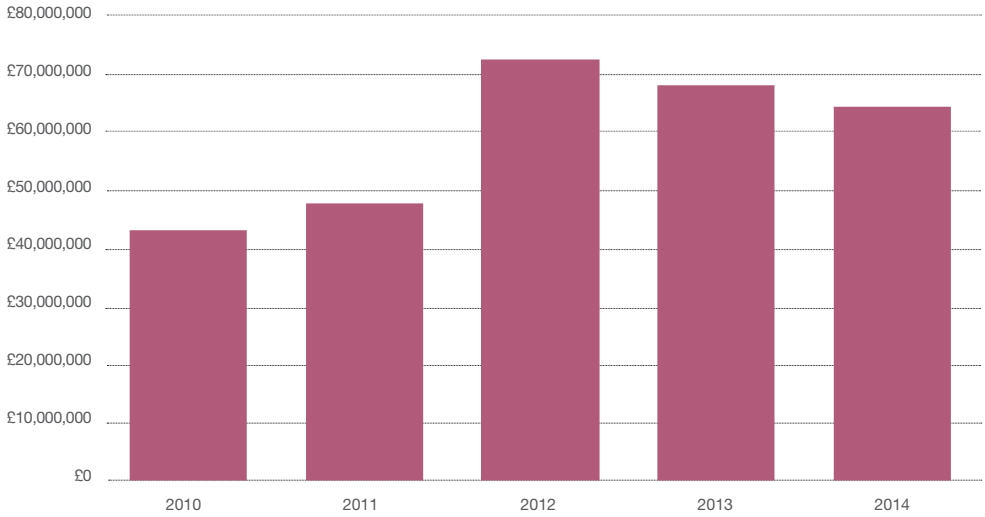
As part of our analysis we have sought to identify regional variations in the market. After consideration we split the investment forestry market into four key regions:

1. North Scotland
2. Central Scotland
3. South Scotland
4. England (predominantly northern) and Wales

The highest values are achieved in the south of Scotland and across England and Wales as illustrated in Graph 4. This is because these areas are where the key attributes of good physical growing conditions, relative ease of access and a range of competing wood users come together to provide the best timber growing and marketing conditions. The graph also shows the relationship between the age of the forest and unit value. More detail on the age/price curve and management of forestry is given on page 8.

GRAPH 2

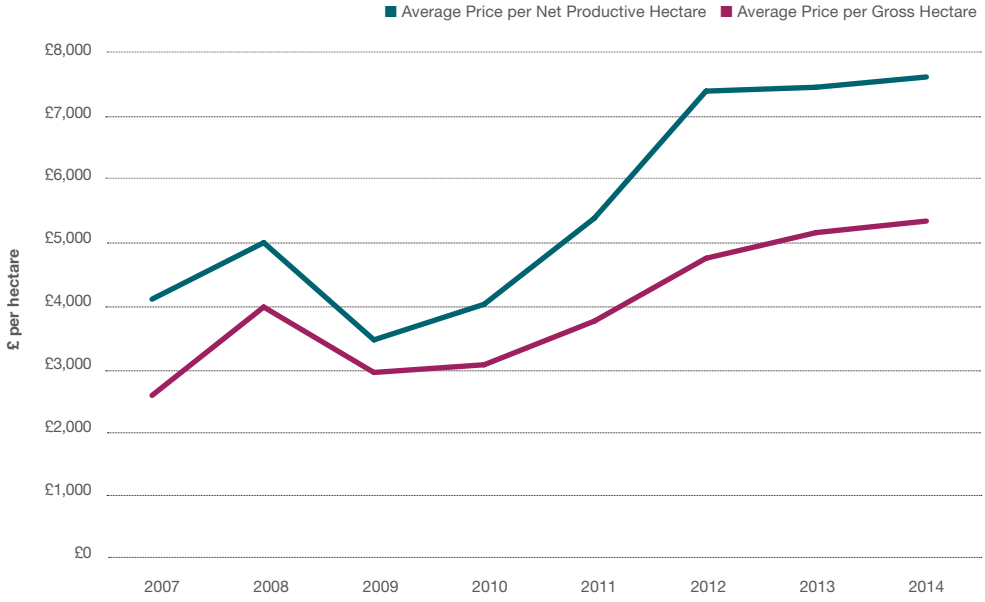
Market transactions



Source: Scottish Woodlands and Savills Research

GRAPH 3

Average sale price



Source: Scottish Woodlands and Savills Research

Total transaction value of forestry in 2014 is almost £65m

Demand for timber has improved capital values

In 2014, average value was £7,600 per productive hectare

As would be expected, forest values increase as the age and, therefore, yield of harvestable timber increases. In year five of the production cycle the average value of forests across all regions was around £3,500 to £4,500 per hectare. In the south of Scotland, average values increased exponentially over the next 40 years of growth to around £12,000 per hectare, giving a value increase of 165% or just over 4% per annum, ignoring any inherent annual market capital growth in values.

In England and Wales, where the market is more diverse, average values increased exponentially over the same period to around £8,250 per hectare giving a more muted overall value increase of 85% or just over 2% per annum.

In central Scotland the annual value growth rate was similar to England and Wales but started at a lower base level peaking at just over £7,000 per hectare. This reflects the impact of Argyll and the southern Highlands where rugged terrain and remoteness to timber markets subdues the market price.

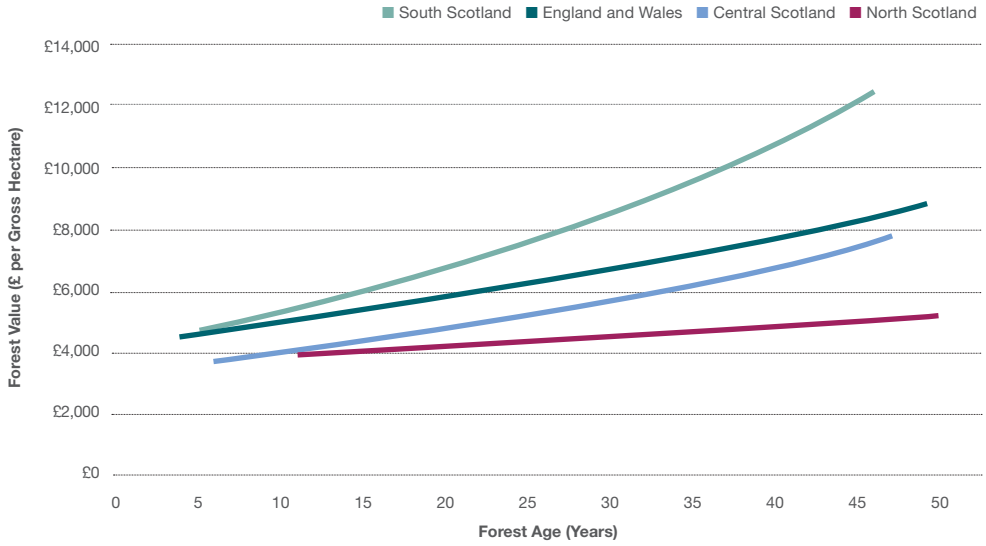
The market in the north of Scotland, which includes some of the Scottish islands where timber is grown (including Skye, Mull, Islay, Jura and others), is more diverse and the graph plots a very weak upward trend. This is not because the timber is less valuable as it gets older, but instead reflects a number of very large forests with a high average age, but low quality timber due to very poor physical growing conditions. Therefore the correlation between value and increasing age is much weaker as Graph 4 shows. It is considered by most to be a tertiary investment area.

As we have discussed, timber is a key value driver in investment grade forestry. One of the oldest timber price measures is the Forestry Commission's Coniferous Standing Sales Price Index which provides a long term trend of timber prices. The index (Graph 5) shows timber prices have generally increased over the past 10 years following a significant period (1985 to 2004) of mainly price falls.

In the 2014 harvest year the Index recorded a significant 28.2% nominal increase (25.8% in real terms). This followed two years when timber prices fell slightly after a period of strong growth in 2010 and 2011. Forest value growth lags slightly behind timber prices and we would expect average values to increase in 2015, following strong timber prices during 2014.

GRAPH 4

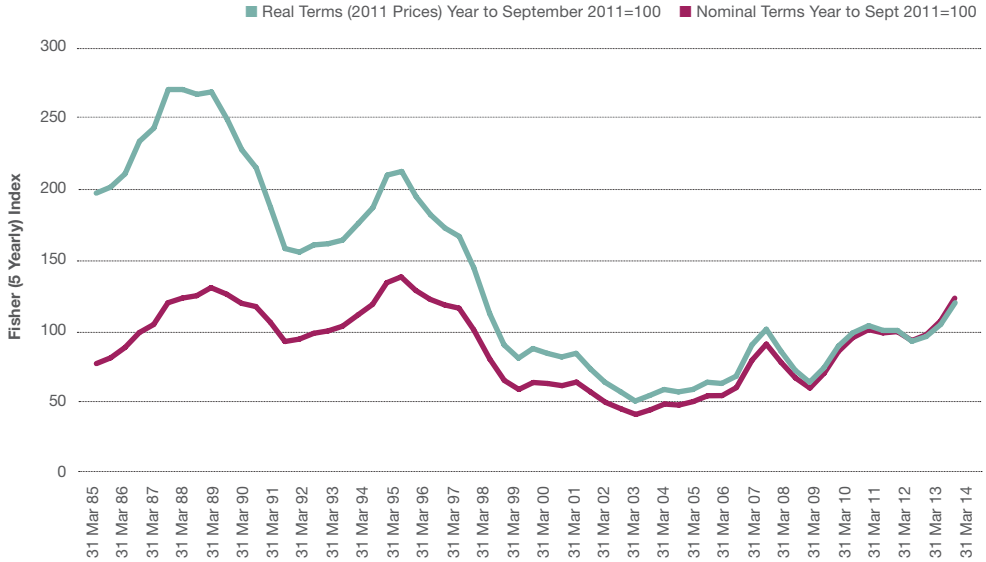
Regional performance (the relationship between forest age and value by region)



Source: Scottish Woodlands and Savills Research

GRAPH 5

Forestry Commission Index (long term)



Source: Forestry Commission

Footnote 1: *Our analysis is for commercial forests where the primary planted species is Sitka spruce, but includes areas of other conifer species commonly grown for timber production. Transactions under 20 hectares and less than £50,000 in value are excluded from the analysis to ensure the emphasis is on investment grade assets.*

Footnote 2: *Our analysis refers to the traditional Forest Year which runs from 1st October to 30th September. Therefore 2014 refers to the year 1st October 2013 to 30th September 2014.*

Timber is a key value driver in investment grade forestry

FORESTRY V FARMLAND & OTHER ASSETS

Forestry along with farmland has outperformed most other assets during the past 20 years. Forestry, according to IPD, and top quartile arable farming have recorded annualised total returns during this period of 9.2% and 11.8% respectively.

This is comparable to alternative assets with commercial property, equities and gilts recording annualised total returns of 8.7%, 7.5% and 7.5% respectively. The exception was residential property where annualised performance over the past 20 years was 13.1%. However, the recession had less impact on rural assets (farming and forestry) and these have outperformed over the past 10 years.

Economic pressures

The investment performance of these forestry and farming assets in GB is mainly driven by capital appreciation rather than income return. The growth in farmland values tends to be more recession proof than forestry.

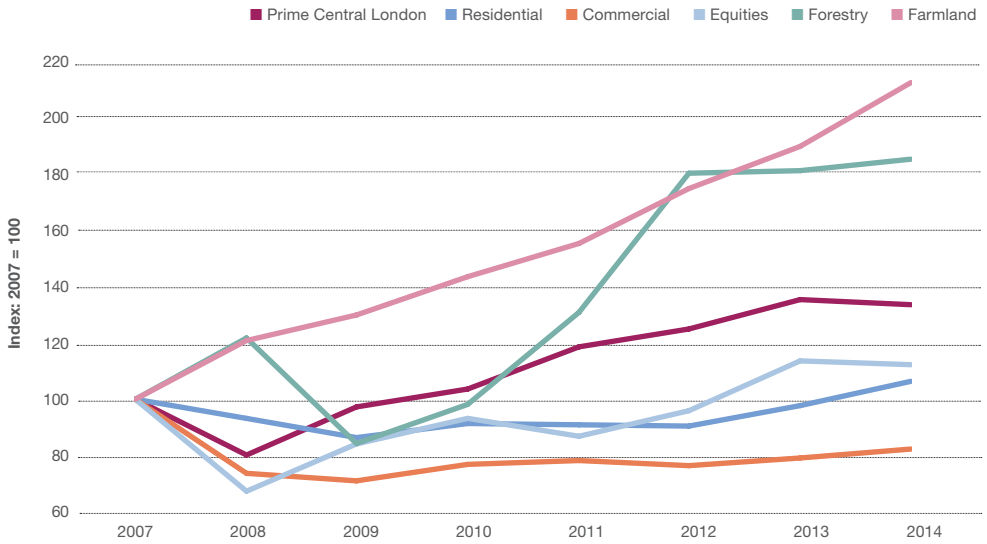
Forestry is more exposed to economic pressure due to its close relationship with timber prices and therefore the prosperity of the construction industry. However, as Graph 6 shows, the recovery in forestry values has been significantly stronger than alternative assets.

Forestry, and indeed farmland, are assets which are ideal for diversifying investment portfolios, as they both have a weak correlation with other real estate and the stock market and therefore allow risk to be spread across the total portfolio.

It should also be mentioned that both assets are suited to medium and long term holding to reduce the exposure to climatic and price volatility and, as noted in this report, the forest growth cycle.

GRAPH 6

Capital growth of forestry and farmland outperform alternative assets



Source: Savills Research

TAX AND RISK MITIGATION

Commercial forestry has long been seen as a tax efficient investment, with the fiscal policies of successive British governments since the 1980's having a greater influence on woodland values than timber prices. Income Tax relief on forestry planting expenditure in the 1980's fuelled investment in woodland creation, whilst shelter from Inheritance Tax has been of primary importance since the 1990's.

The tax benefits of commercial forestry remain. Income generated from the sale of timber is exempt from Income Tax and Corporation Tax, making forestry an effective means of converting capital into tax free income. Commercial forestry also qualifies for 100% Business Property Relief once held for two years, so that if held at death there is no Inheritance Tax payable on the total value of the land and the trees.

When the global financial crisis struck in 2008, we saw a surge of interest in the sector, with investors turning to forestry as a low risk asset to see them through the recession. At the time, few can have expected to benefit from the strong capital growth we have witnessed.

As the economy recovers and the price of timber rises, we are seeing timber income potential overtake tax shelter as the primary driver behind forestry investment. This can only be a good thing for the wider industry.

Like any investment, forestry sits best as a part of a balanced portfolio of other assets. Risks specific to forestry are best mitigated by creating a woodland portfolio of mixed age structure, spread across different geographic locations. Like any commodity, timber prices can be volatile, but in the event of a significant price drop forestry provides the opportunity to delay felling and 'bank it on the stump' effectively holding value as stored capital until such time as prices recover.

TIMBER AGE & CAPITAL VALUES

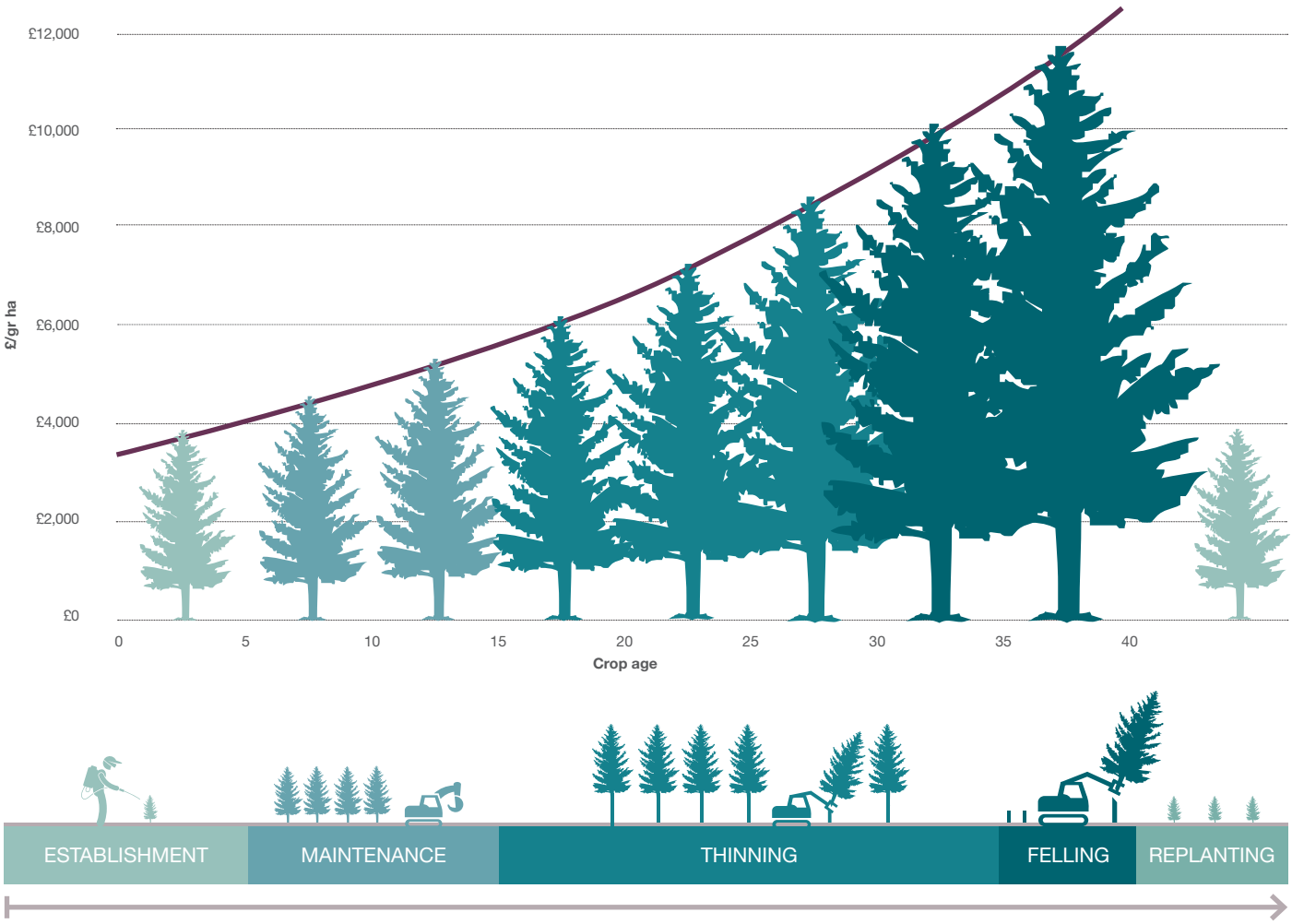
It is important to fully understand the stage of the timber's growth at acquisition

There is a strong relationship between the age of timber and freehold capital values. Figure 1 shows the rise in average capital value per hectare for a typical south Scotland Sitka Spruce forest, with the appropriate crop rotation stage annotated below.

Forest values are dynamic, rising until harvest, and then resetting as the next rotation is replanted and grows up again. The stage of growth at acquisition and change of average age profile going forward must be understood when appraising investments.

FIGURE 1

Prime Sitka Spruce: Value by Crop Age



Source: Scottish Woodlands and Savills Research

INTERNATIONAL FORESTRY

On a global scale the GB forest area is tiny compared with many other global locations. For investors looking for scale some of these may present additional opportunities (see Graph 7).

This is supported by the increasing accessibility of global markets, the ability to relocate management and technical skills, as well as capital to underdeveloped areas.

In GB, the size of forests generally limit the potential for large scale operations. The mature markets, for example the US and Canada, enable scale with a political and economic stability similar to GB.

Whereas, the emerging markets, such as central Europe and the Baltic States, may potentially offer higher returns but the risks are greater due to, amongst other factors, the difficulty in obtaining ownership security.

Good understanding

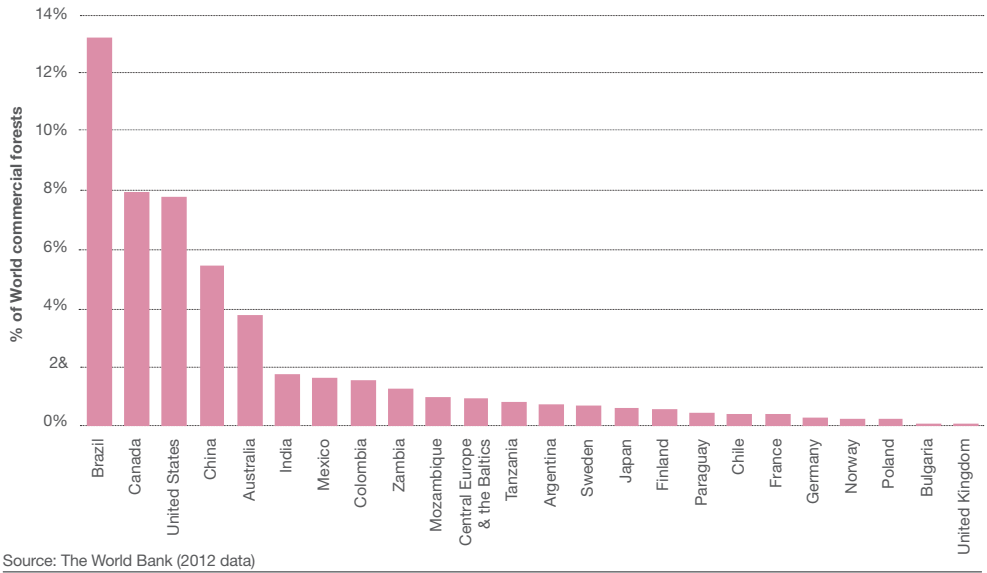
As with any investment a good understanding of the market is needed to ensure that the risks are quantified and mitigated as far as possible. In addition to the factors mentioned above, other considerations include currency, infrastructure and climate (wild fires and storms are not unknown).

As with farmland there are various investment strategies and options available. These include a direct investment or through a managed fund. In addition, the investment can be 'hands on' being directly involved in the operations or 'at arms length' by leasing forests to third parties.

Footnote: *Forest area in Graph 7 is land under natural or planted stands of trees of at least 5 metres in situ, whether productive or not, and excludes tree stands in agricultural production systems (for example, in fruit plantations and agroforestry systems) and trees in urban parks and gardens.*

GRAPH 7

Proportion of world's commercial forests



Source: The World Bank (2012 data)

AMENITY WOODLAND

Active market for small woodlands

This research has focused on investment forestry, but there is an active market for small woodlands where the drivers are more diverse and include leisure, amenity, conservation, sport, or simply domestic firewood production.

These purchases are normally sentimentally driven and the price payable is more likely to be determined by the desire to secure the property as opposed to any measurable value per hectare or forecast return. This market is more mature in England and Wales due to a correlation with high centres of population.

In Scotland there are wider ranging permitted access rights that allow the public to enjoy many of the benefits and amenity that woodlands provide without having to be involved in ownership. While often only small these woodlands can be up to 20-30 hectares in size, but as size increases any small woodland premium reduces.

There are, therefore, always transactions where it is unclear whether they are small commercial properties or large lifestyle purchases. With increasing pressure on rural space and more leisure time and disposable income, small woodlands will attract interest and we anticipate further growth in this sector over the coming years.

OUTLOOK

Timber to become the primary market driver

The strong growth in investment forestry has been driven by various factors, but over the last 20 years undoubtedly the favourable taxation regime has been seen as important. Recently however, a general re-focus on future availability of timber has become increasingly important in determining forest value, and our prediction is that this will become the primary market driver over coming years. This pins forest investments to the quality, volume and future productive potential of the timber stock, with any fiscal benefit simply being an added value advantage. Arguably, this is the way it should be, with assets finding a natural value in balance with their ability to generate a return, rather than being acquired at a hurdle rate over the book valuation, driven by a fiscal advantage of sheltering wealth.

We have looked at the regionalisation of value and the reasons behind this. The core investment attributes of good physical conditions, timber stock and quality, access and timber markets all come together to make south Scotland, North England and parts of Wales the most valuable regions, but there are good investment forests around much of Great Britain. Investor preference remains prime Sitka Spruce in these core regions, but the changing dynamic in timber marketing brought about by woodfuel is providing stimulus to forest blocks that would otherwise look unappealing. The problem remains the location of end users and until a more regional distribution of small to medium scale biomass markets comes on stream, any investor benefit in marginal forests will remain limited.

At this stage we can still see a clear separation between prices for different grades of timber, with sawlog (construction) grade ultimately the most valuable. This means that forests with high volumes of sawlog timber remain the most valuable and ultimately we consider this will remain the case for prime forest assets, with growers rewarded over the long term for practising proper silviculture with the objective of maximising sawlog return.

There is also keen interest in forest renewables, particularly wind and hydro electricity developments. Undoubtedly, such development projects have the ability to generate one thing that most pure forest investments cannot, which is an annual cashflow. But the opportunity is limited and especially in the case of wind energy, the market is now sufficiently mature to make new opportunities less frequent.

Taking all factors into account it is possible to define the outlook for forestry investment in one word: timber.

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Scottish Woodlands Ltd is a leading forest services provider with a long tradition of serving forest owners and investors in Scotland and the rest of the UK. Founded 75 years ago we are client and customer focused and operate to the highest standards of safety and environmental awareness. We actively manage around 150,000 hectares of forestry and in 2014 harvested and marketed over 1 million tonnes of client timber. The Company operates from a network of 17 offices around the UK.

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