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Discover the Forest: Long-Term Opportunities in Timber REITs

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Timber REITs occupy an unusual niche within the REIT and real estate universe. In one sense, they are part of newer sectors that aren't classic commercial properties like offices, warehouses or apartments, and they offer real estate investors exposure to new residential construction and repair/remodel activity. Conversely, they are old-line companies with manufacturing operations, which makes them an oddity among REITs. Their prime asset is a renewable natural resource, differentiating them yet again. These factors have historically been a disadvantage from an investment perspective as timber REITs didn't fit neatly into a category. Today, however, timberlands are at the center of several longer-term tailwinds that make for a favorable outlook.

Timber REITs benefit from their exposure to residential construction activity, both new construction and repair/remodel. Timberlands produce both sawlogs and pulpwood, but sawlogs are more valuable and are used to produce high-quality lumber, plywood and panels, among other things. There are commercial uses for processed logs, but a large share of wood products is used for building new houses and repair/remodel. U.S. new home starts have been slowly recovering from a sharp decline after the 2008 global financial crisis, climbing to 1.5 million starts per year before the pandemic. After a brief COVID-induced lull, both new home starts and repair/remodel activity rebounded in the second half of 2020 and into 2021. While home prices have risen over the last 18 months, interest rates remain historically low, mortgages are relatively easy to obtain and younger buyers that eschewed buying a house in 2007-2009 are now more likely to buy or rent a house, which should provide a long-term tailwind for residential construction.

Timber REITs have two ways to profit from higher residential building activity—manufacturing wood products (namely lumber and plywood) and selling trees. Historically, producing wood products has been a capital-intensive, low-margin business with volatile prices. In the late 1990s/early 2000s, many integrated forest products companies (that owned both forests and manufacturing assets) split their businesses and allowed forest owners to focus on growing and selling trees and maximizing land values. Today, only two of the four timber REITs—Weyerhaeuser and PotlatchDeltic—maintain substantial wood products manufacturing assets. Since mid-2020, lumber and panel prices have increased substantially but will likely remain volatile as additional production capacity takes off.

Selling trees, especially higher-value sawlogs, is also advantageous given the current supply-demand outlook for timber REITs. Increased lumber production leads to higher demand for logs, so REITs can increase both sales volumes and prices. However, there is a unique supply-demand issue that should give U.S. REITs a durable benefit—Canada's largest lumber-producing region, British Columbia, has been devastated by a pine beetle infestation, significantly reducing its long-term timber output. The infestation started in the early 2000s, and British Columbia responded by increasing harvest to salvage as much timber as possible before it became unusable. This increased supply and further depressed log prices at the time once housing demand shrank. However, because of dwindling supply, many British Columbia mills shut down in recent years, and supply is likely to be 30% to 50% lower for a longer period than peak production levels. Europe is also dealing with a bark beetle epidemic and will see lower long-term timber supply as well.

Today, the Western U.S. doesn't have much unused manufacturing capacity or excess timber and can't respond to this shortage, although they're likely to have pricing power due to the tight supply and growing demand. The Southern U.S. has ample timber supply without the harvest restrictions of the West, and several lumber producers, including large Canadian wood products companies, are opening new mills in the region. So, the Southern U.S. stands to benefit simply from production shifting from Canada, which can be further accelerated by strong housing demand. In addition, offshore demand for U.S. lumber should accelerate as Europe and China are timber constrained, but these markets are newer and will take time to develop. These factors are likely to result in robust log demand and higher log prices, which should translate into higher earnings and cash flow for REITs. The Southern U.S. is the largest region for many timber REITs, although some—including Weyerhaeuser—have substantial ownership in the Pacific Northwest.

As inflation continues to be a growing concern for many investors, timberland is generally considered a good inflation hedge because log prices can appreciate in line with, or better than, the inflation rate, particularly if housing and construction markets are strong. Wood products prices may see some inflationary upside, but the high variable costs of this business (log prices plus labor) could hurt margins in an inflationary environment even with nominally higher prices and volumes. Logging would incur higher labor costs, but these can be passed along in the log price to a decent degree, while the fixed costs of timberlands are far lower than manufacturing. In addition, timber REITs have significant size and scale, and consistently harvest their land, frequently using labor pools like independent logging crews, while smaller landowners who harvest less frequently will be at the mercy of labor availability. Finally, land values should grow in line with inflation, providing another potential hedge for investors.

The rise of ESG investing and the potential for carbon storage and trading is the final tailwind for timber REITs. The irony of timber companies and environmentalists working together is probably not lost on veterans of the 1980s forest conservation battles, but it's an alliance that makes a lot of sense today. Actively managed timber is a valuable resource that offers substantial carbon capture, and timber REITs are adept at sustainably managing forests. The movement towards more sustainable resources has several benefits for timber owners—it makes stocks more appealing to investors with ESG or sustainable mandates, and the companies can profit from emerging green energy areas, including selling carbon offsets and subsurface carbon sequestration. While this market is still in its infancy and could complicate the usual harvesting and sale of logs, land and tree ownership give REITs an advantageous position. Additionally, wood-based building materials are growing in popularity, as they're seen as more sustainable than concrete and steel which has historically been used in taller buildings. With an increasing focus on building emissions, mass timber construction is likely to increase over the coming years, driving further demand for wood products.

In short, timber REITs sit at the nexus of several developing trends that should help grow their cash flow and asset values over the long term.

As of October 31, 2021, Diamond Hill owned shares of Weyerhaeuser Co.