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ESG and Its Growing Influence in the Timberland Investment Sector

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Introduction

As interest in Environmental, Social and Governance (ESG) issues increases, investors and investment managers are working to define and refine what ESG means and what ESG engagement looks like in the context of their portfolios and the asset classes in which they are active.

In the private equity timberland investment sector, the concept of managing ESG-related issues is not new. However, when assessing the ESG credentials of timberland investment management organizations (TIMOs), and the strategies they utilize to manage one's portfolio, there are certain attributes to which investors may wish to pay particular attention.

Working Forests, TIMOs and ESG

Most TIMOs have long recognized that society has a legitimate interest in how they manage large-scale working forests for their clients, which typically include pension funds, foundations, endowments, high-net-worth investors and financial institutions. This interest derives, in part, from the capacity of such forests to provide society with an important renewable resource, timber, which is essential for preserving and advancing our quality of life. However, the ESG profiles of the working forests TIMOs manage extend beyond their ability to sustainably produce the wood that is needed to manufacture the building, paper and packaging products that we use every day.

Investor-owned working forests also are increasingly providing us with renewable energy as their wind- and solar-generating resources are tapped and their capacity to yield wood-based biofuels is developed. Investment-grade working forests also provide society with important environmental benefits – like clean air and water, recreational and "green space," as well as wildlife habitat. Because of their ability to absorb and store massive amounts of atmospheric carbon through the process of photosynthesis, our forests also are an important tool in the battle against climate change. To provide some perspective on that particular issue, forests in the United States capture and sequester approximately 560 million metric tons of carbon dioxide each year. This is equivalent to the reduction in atmospheric carbon that would take place if 50 percent of the automobiles in service in the country today were taken off the road (Source: EPA).

Beyond these attributes, the working forests investors own through TIMOs help preserve and sustain the economic and cultural resilience of many rural communities. They do this by providing much-needed tax revenue and well-paying jobs. Many who live in remote, heavily forested areas support their families by working as foresters, silvicultural specialists, loggers, truck drivers and mill workers. Furthermore, many



investor-owned working forests are open and accessible to the public, which provides important, but often underappreciated, recreational opportunities.

These characteristics of working forests are well understood by TIMOs as ESG drivers. What is new for many is the degree to which they are now expected to demonstrate, explain and quantify to their investors and the public how they are integrating these and other ESG considerations across their investment, portfolio management and asset management functions.

These expectations are being driven by growing investor interest in how TIMOs are achieving their clients' objectives while adhering to clear and well-defined ESG standards – like the United Nations-aligned "Principles For Responsible Investment (PRI)." In fact, all investment managers are increasingly being evaluated on their ESG credentials – and specifically on the nature and extent of their affiliations with standards organizations, like PRI. For TIMOs and other natural resource investment firms, these considerations are increasingly "gating" issues during the manager-selection process. This is because of the high degree of public scrutiny and regulatory interest that already exists with respect to how the world's privately owned working forests are being managed.

Assessing a TIMO's Environmental and Social Engagement

An investor that is analyzing a TIMO on measures of environmental management and social responsibility may first wish to assess whether the firm is well versed in the process of reporting on how it manages land, practices forestry and serves as an environmental steward. One way to evaluate a TIMO in this regard is to determine whether it is affiliated with one or more of the global sustainable forestry standards. The two most prominent of these are the Sustainable Forestry Initiative (SFI) and the Forest Stewardship Council (FSC). To remain in good standing with these and other such organizations, TIMOs must report annually and comprehensively on their forest management activities. They also must subject themselves to independent, third-party audits of their forestry practices – the results of which are made public. This reporting and these audits account for everything from how harvests and reforestation activities are conducted to how ecological functions related to soil, water and wildlife habitat are preserved and enhanced.

In addition to their focus on environmental management, forestry certification organizations like SFI and FSC increasingly employ metrics to assess the climate impacts of forestry practices. They also assess a TIMO's capacity to engage with public stakeholders on issues of human rights, economic equity and land access for activities like public recreation, education, scientific research and cultural engagement. Among others, these stakeholders can include neighbors, conservation groups, community organizations, indigenous peoples, elementary and secondary schools,



colleges and universities, research institutions, and industry trade and advocacy groups. Further to this point, another indication of a TIMO's environmental and social sensibilities is the extent to which members of the organization, and its leadership in particular, are directly involved with such stakeholder groups on a volunteer basis and through efforts like board participation.

Another measure of a TIMO's environmental consciousness is the nature of its relationships with public regulatory and environmental organizations. The forest management sector is heavily scrutinized and closely monitored by state and provincial forestry, wildlife and natural resource agencies. Here in the United States, federal regulatory jurisdiction over private forest management practices is shared by the

U.S. Fish & Wildlife Service (USF&WS), the U.S. Environmental Protection Agency (EPA), the U.S. Army Corps of Engineers – as well as other departments. If a TIMO, in general, maintains positive and cooperative relationships with such groups, and is recognized by them as an "honest and trusted player" within the forestry community, this can translate into opportunities to partner on projects of mutual interest. It also can lead to collaborations that enhance client interests and advance environmental goals. An example of this is an initiative called "Conservation without Conflict." This is a coalition of private forest landowners and governmental agencies that have acknowledged that owners of private forests, including institutional investors and the TIMOs that represent them, are critical to conserving threatened and endangered wildlife populations. Those that support the effort, including my firm, advocate a collaborative approach, rather than a regulatory approach, to addressing the challenges of managing, protecting and conserving at-risk species and the unique habitats upon which they depend. The underlying thesis is that such collaboration, along with appropriate and effective incentives that recognize the benefits landowners provide to America's fish and wildlife, can help keep working forests working – which not only benefits those who own them, but also wildlife and society, in general.

In short, if an investor observes that a TIMO is third-party certified to one or more of the credible sustainable forestry standards, and also observes that the firm demonstrates a transparent and cooperative approach to working with regulators, public officials, conservation organizations and other stakeholders, the chances are good that it is taking its environmental and social responsibilities seriously.



Assessing a TIMOs Governance Engagement

On the matter of "Governance" engagement, there are actions and attributes an investor can assess to establish whether a TIMO is meeting its ESG obligations as they pertain to ethical behavior, transparency, investment integrity and client communication.

As is expected of any investment manager, TIMOs are compelled to operate in accordance with the fiduciary responsibility they assume when they agree to put the needs and interests of their investors first. A firm's commitment to governance engagement is further quantified by its need to openly and regularly report to its clients on its actions and on the composition of its businesses and management team. Thus, if a TIMO is a Registered Investment Advisor (RIA), this can, to some degree, serve as evidence of ESG engagement and legitimacy because it can demonstrate a willingness to subject itself to additional laws and regulations that govern its activities.

Another governance measure that can be used to assess a TIMO is the extent to which ESG themes are evident in the ways in which it articulates its investment strategy. If limiting risk and accessing opportunities by operating with a strong ESG orientation are clearly part of a TIMO's investment thesis, this should be clearly reflected in how it acquires assets, builds portfolios, and manages forest operations at a ground level. It also should be reflected in how it talks about those functions.

With respect to the issues of transparency and control, investors that are specifically evaluating opportunities to participate in commingled funds offered by TIMOs may wish to assess the form and structure of the agreements that codify that participation. As with any pooled, private equity investment, the management, operation and oversight of a timberland commingled fund, regardless of its structure, should be clearly explained in the offering materials and "partnership" documents. To the extent these reflect an intention and acknowledged obligation on the part of the TIMO as "Manager" to ensure that the "Fund Participants" are treated fairly, that they are granted appropriate levels of input and authority, and that they will have ongoing access to accurate and timely information on matters pertaining to the fund's operation, its performance, and the form and structure of the "Manager's" compensation, this too can be a strong indication of a TIMO's commitment to behaving ethically and practicing sound corporate governance.

A final consideration investors may choose to explore when assessing a TIMO's governance foundation is how it articulates its reason for being, its business objectives, and the values and behaviors that define its organizational culture. When an organization's narrative about itself reflects both comprehension of ESG considerations and a desire and willingness to operate with a high degree of ESG



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consciousness, these can be indications that it is focused on operating ethically and in accordance with the tenets of responsible corporate citizenship.

In closing, society has a growing interest in working forests that are owned by institutional and high-net-worth investors. The motivating factors are a universal desire to see our natural resources managed sustainably and in ways that can help us address climate change and support the economic viability of rural communities. Because of these interests, investors are recognizing that TIMOs that consistently demonstrate high levels of ESG awareness are better able to reduce and manage fundamental asset risk on their behalf. They also recognize that TIMOs that have strong ESG credentials, and brands that are, in part, defined by them, are much better positioned to help them participate in new markets and opportunities that are developing for forest-based values – like those for environmental mitigation banking credits, carbon credits and forest-based renewable energy generation. All of this means ESG engagement will be an increasingly important aspect of a TIMO's value proposition in the future.

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