TIMBER FINANCE
SHAPING THE CARBON SINK BUILT ENVIRONMENT

Market Report:

Timber Stocks and Adjacent Sectors

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1. Introduction and Executive Summary

The analysis presented here covers the 10 years from the end of 2013 to the end of 2023 and is based on a sample[1] of:

- stocks in the **timber sector** as included in the *Timber Finance Carbon Capture and Storage Index* universe as well as
- other stocks included in the *iShares Timber & Forestry*, which tracks the *S&P Global Timber & Forestry* index
- U.S. **homebuilders** and selected European **developers** explicitly positioned for timber construction
- **Insulation materials**, selected **HVAC** and other related stocks
- **Cement** and aggregate producers

The goal of the analysis is to compare the characteristics of these sub-sectors and to identify businesses with extraordinary operating performance.

In the last 10 years, the best businesses in the universe considered here belonged to **multiple sub-sectors**, pointing to a broad potential opportunity set, at least sector-wise. **Engineered wood products** and **heat pumps** (and their components) manufacturers delivered particularly attractive underlying returns in terms of margin and return on equity over the period.

2. Sector Profitability

Total returns in the timber and construction sectors have been **positive and solid** on average over the 10 years taken into consideration in this analysis (Figure 1). The dispersion has been also relatively strong, ranging from mid-single digit negative returns to returns surpassing 30% per year. The largest dispersion is found in the wood products space, followed by homebuilding/timber construction and pulp & paper. The fact that the Wood Products sector had both the best (*Builders FirstSource*, a distributor of wood products and other building materials) and the worst (*Western Forest*

[1] From a methodological point of view, the dataset used may be subject to biases (positive, e.g. survivorship).

Products, a Canadian lumber manufacturer) performing stocks, points to the importance of stock selection and portfolio construction in this space.

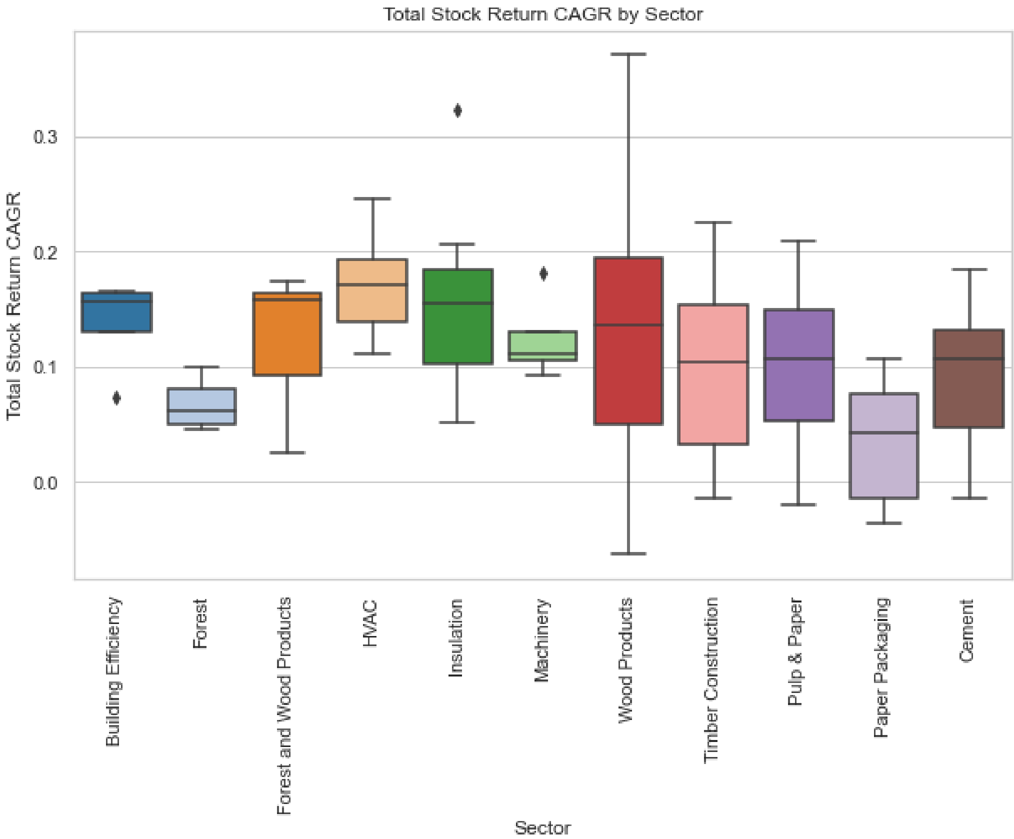

Figure 1: Total Returns (gross, in local currency) quartiles by sector.
Sources: Bloomberg. Calculations by Timber Finance.

In terms of underlying profitability of the businesses, forestry businesses have been characterised by the highest operating margins (Figure 2, upper chart) while at the same time having relatively low returns on equity (Figure 2, lower chart), which is intuitive given the nature of the business: ownership of forests with multi-decade harvesting cycles. Excluding timberland REITs and vertically integrated forest owners, the wood products sector had relatively low operating margins but at the same time robust returns on equity. The low operating margin can be explained by the presence, exclusively in this group, of distributors – retailers, wholesalers and other distributors naturally tend to have lower operating margins while they have high asset turnover. The highest average returns on equity have been achieved by equipment manufacturers – both in the areas of forestry and construction equipment, and in the area of heat pumps, a niche that has been enjoying strong growth thanks to the efforts towards improving buildings' energy efficiency, both in Europe and the U.S. As a comparison, cement producers delivered robust (average) operating margins while returns on equity were below average.

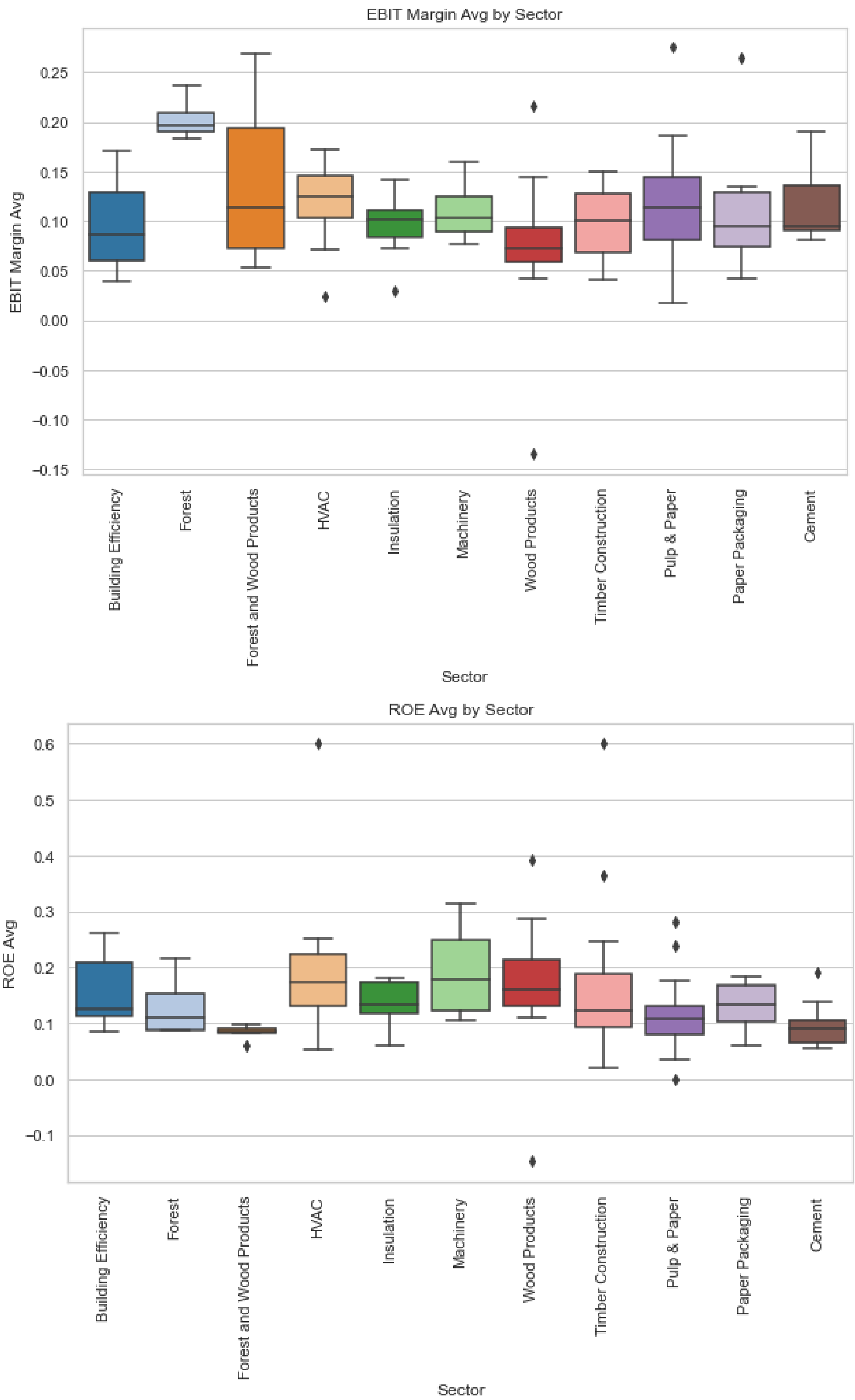

Figure 2: EBIT margin and ROE quartiles by sector. Sources: Bloomberg, company annual reports (for adjustments, e.g. in the case of SCA). Calculations by Timber Finance.

3. Companies

When looking at a scatter plot with operating margin vs. ROE for individual companies (Figure 3), there is a positive linear relationship between the two metrics, excluding major outliers and with an exception represented by the forest sector, which is characterised, as said earlier, by higher operating margins and lower returns on capital. The best performing companies over the period, according to these two metrics, come from different industries:

- Lennox International, a leading U.S. **heat pumps** manufacturer
- Trex, a **plastic-wood composite** manufacturer of decking and railing products in the U.S.
- Klabin and Suzano, two Brazilian **pulp, paper and packaging** companies
- Svenska Cellulosa, a Swedish **integrated forest owner** with a diversified forest products portfolio

Lennox's ROE was capped at 60% in the analysis as the company has operated for years with negative equity. SCA's high EBIT margin was in part driven by a gain on the revaluation of forest assets as the valuation approach was changed during the period.

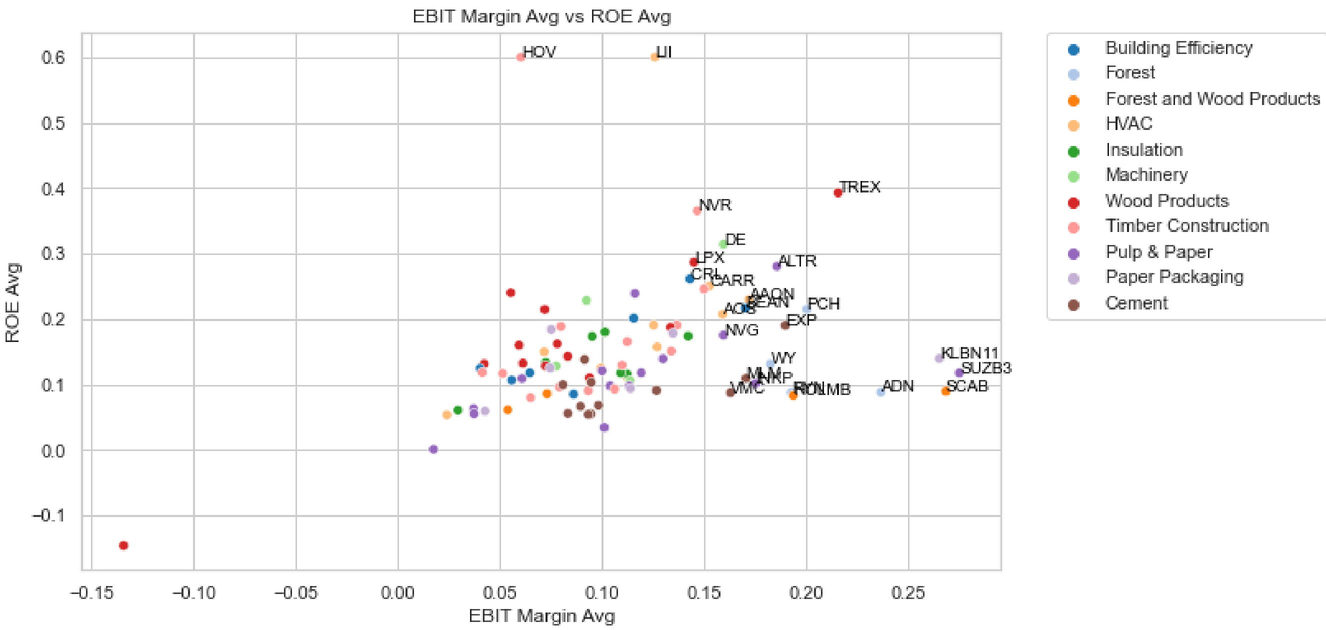

Figure 3: EBIT margin vs. ROE for each company in the sample. Sources: Bloomberg, company annual reports (for adjustments, e.g. in the case of SCA). Calculations by Timber Finance.

The other top performers in terms of margin and return on equity also come from multiple sectors, specifically wood products, timberland REITs, pulp & paper, heat pumps/building efficiency and homebuilding.

4. Valuation

The clear positive relationship between (historical) return on equity and (current) price-to-book ratio for the stocks in our universe (Figure 4) highlights the efficiency of the market in pricing exceptional businesses at a premium. Within wood products, two engineered wood products manufacturers stand out – Trex and Louisiana Pacific, both trading at significant premiums to book value, reflecting the high quality of the businesses. Both have a strong brand and management has been executing the respective strategy remarkably well in the last years.

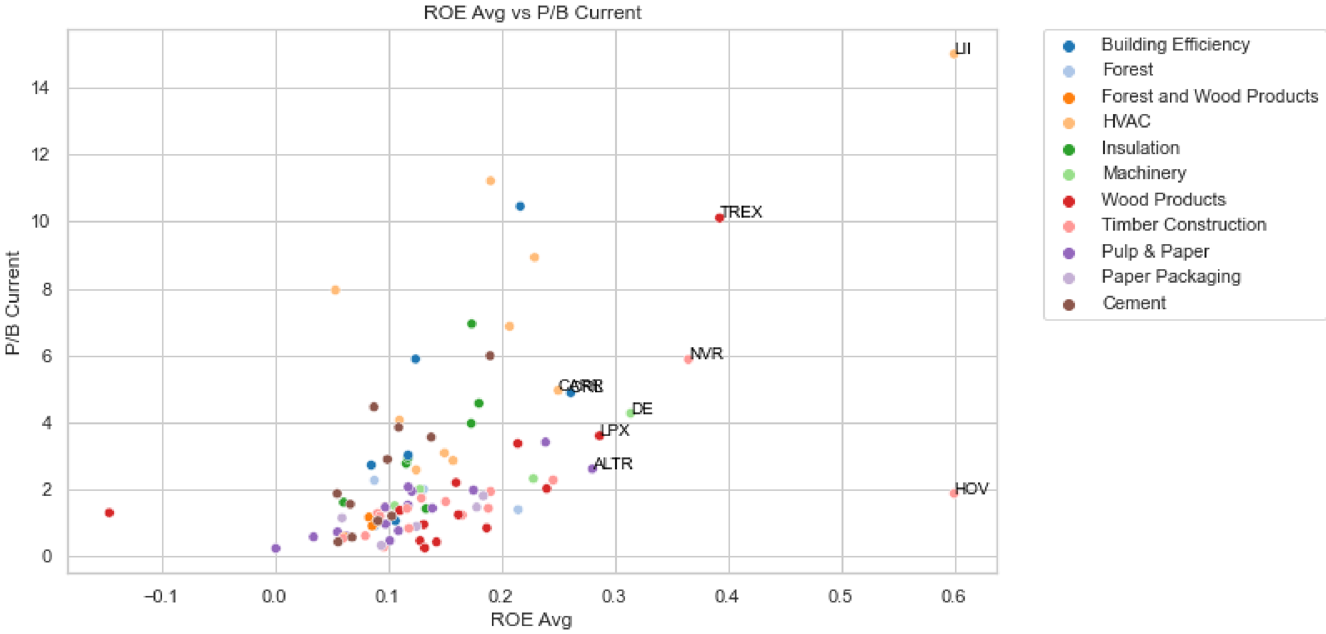

Figure 4: Price-to-Book ratio vs. ROE for each company. Sources: Bloomberg, company annual reports (for adjustments, e.g. in the case of SCA). Calculations by Timber Finance.

At the low-end of the P/B range we currently have commodity businesses such as lumber as well as pulp & paper producers that have been going through a challenging period recently, characterised by weak demand and destocking, after very strong performance during the Covid pandemic. These businesses, in general, have lower average returns on capital compared to engineered and branded products.

5. Disclosures and Conflicts of Interest

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