Flash update: Foresight Sustainable Forestry

FSF has made progress on its operational targets, it reports in an update covering the half-year ending 30/09/2023...

Update
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Foresight Sustainable Forestry (FSF) has reported good operational progress in its latest update to the market, which covers the six months to the end of September. As with many private or alternative asset classes, activity in the market has been muted as investors consider the implications of uncertainty on rates, inflation and economic growth on their investment strategies. The first nine months of the year saw a dramatic fall in the number of transactions for UK forestry assets – in fact, those that did complete were worth just 12% of the average total value sold in 2021 and 2022. Values implied by this limited number of transactions were down, reflecting perhaps distressed sellers being more likely to sell into uncertainty. FSF has been prudent in marking down its portfolio in line with these declines, which was the key driver behind a reported 9.3% decline in NAV for the six month period. Declines in valuations were higher in afforestation assets than standing forestry prices. Afforestation sites are typically held by leveraged owners – often farmers – who have been more motivated to sell amidst rising debt and materials costs, while standing forestry is typically not levered. All else equal, declining prices for afforestation land potentially enhances the returns available by successfully converting it into forestry.

As a result, amidst this backdrop, the company actually reported mark-to-market gains on acquisitions made during the period, thanks to being able to acquire afforestation sites at lower prices. The managers attribute this to their disciplined and highly opportunistic acquisition strategy, which sees them aim to use their knowledge of the market and the asset class to find desirable assets they can acquire at attractive prices, as well as realise 'marriage value' when combined with existing properties in their portfolio. In total, 18 assets were acquired for £38.4m during the period (including tax and transaction costs), which compares to an end-period NAV of £169.2m. The company also disposed of £1.6m in non-core assets at book value.

We understand the acquisition and deployment phase has completed, and the focus is now on bringing the assets through the various planning and planting stages. This will reduce the demands on the cash account for taxation and transaction costs. There are 37 afforestation projects in process, with many expected to complete over this winter and the remainder by spring 2025. During the period, planting was completed at 4 sites, bringing the total to 6 since IPO. The NAV saw the value of the carbon credits held by the company rise by 8.6%, although the impact on NAV was small at just 0.1p per share (NAV per share previously being 108.5p) due to the small size of this asset. This relates to value recognized in the potential carbon credits from the newly planted sites. With numerous sites planned to be planted in the coming quarters, there is scope for these credits become a meaningful contributor to the NAV over time. Additionally, we understand that some of the progress made on development stage afforestation assets is yet to be recognized in the NAV, so there is more than one possible net contributor to the next NAV.

Investors are rightly nervous about debt given the sharp rise in financing costs for businesses over the past year. FSF does have floating rate debt which has been used to fund some of the acquisitions. Of the £30m credit facility available, £10.4m was drawn down to make the three acquisitions in Scotland announced to the market in October. Fund costs including interest costs detracted 0.8p per share from NAV over the six months, so are clearly meaningful in the current environment. The managers' strategy is to service and ultimately repay debt through timber sales from the mature sites in the portfolio as well as the sale of non-core assets, including some residential properties attached to existing afforestation assets.

Clearly there are risks in a relatively immature asset class, and recognition of this may be a driver behind the discount of c. 35% at the time of writing. Additionally, we note that inheritance tax is a matter of political debate with both parties discussing changes which could reduce the incentives to invest in agricultural land such as forestry. That said, we note discounts have widened across all alternative asset sectors in 2023.

In the case of FSF, we think the repayment of the floating rate debt could help improve sentiment toward the shares, as it could help illustrate timber sales are sufficient to pay management and operational costs. In the long run, we think the development of the carbon credit market could be a critical factor for the rating as well as the NAV. If this market becomes established, then the attractions of FSF should increase and it could drive a narrowing of the discount.

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