A Rationale for Risk Management in Forest Businesses

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Abstract

Hedging activities are designed to reduce the volatility of firm value or cash flows. The largest publicly-traded forest corporations make extensive use of hedging, including insurance and derivative contracts. In 2002 alone, 17 of the 19 largest publicly-traded forest industry firms utilized financial derivatives with a notional value exceeding $8.2 billion. Are forest industry corporations risk-averse? Why do these firms expend resources to reduce risk? Risk is costly to firms because of the indirect effects on shareholder income. These effects are realized principally through financial distress costs, taxes, managerial compensation programs, agency costs, the crowding out of promising investments, and the comparative advantage of providing real services. This research details examples of each in the forest products industry and discusses potential opportunities to expand and to reduce the use of financial contracts in the forestry sector.