Northwest Woodlands
A Publication of the Oregon Small Woodlands, Washington Farm Forestry, Idaho Forest Owners & Montana Forest Owners Associations

GENERATIONS TO COME: WHO WILL OWN YOUR FOREST?

Changes in Timberland Ownership

Estate Planning Options

Alder Creek Children’s Forest

The Rediscovery of Delta Wing Tree Farm

Hendrick Legacy Continues

NEXT ISSUE . . .
Wildlife and Managed Forests

This magazine is a benefit of membership in your family forestry association
Partners, who recently acquired Boise Cascade, and Cerberus Capital, who recently purchased the paper division of Mead-Westvaco.

Transaction Conservation.
Transaction-oriented nonprofit conservation organizations that have traditionally acquired small parcels for preservation, but are now turning to larger acquisitions of working forests or of working forest easements. Conservation organizations have the potential to resolve or attenuate forest loss through the large-scale acquisition of working forest easements in partnership with financial investors. Examples include Cascade Land Conservancy, Pacific Forest Trust, Trust for Public Land, The Nature Conservancy and The Conservation Fund.

The evolution of timberland as a financial investment
Large-scale change generally takes place gradually, building speed and momentum as the conditions underlying it develop. This is true of the shift in ownership of industrial timberlands. It has taken two decades for financial investors to dominate timberland ownership, with most of that change occurring since 1996. The remainder of this article describes the three phases that characterize shifting ownership.

PHASE 1: 1983 TO 1995—Life was Easy!
- Plenty of Land
- Low Competition
- Expected Returns of 8.0% on average
- Counter-cyclical to the Stock Market

The switch from strategic to financial investors started almost inadvertently in the early 1980s when agricultural lenders, including John Hancock Mutual Life Insurance Company and 1st Atlanta Bank of Atlanta, and their institutional investment clients found themselves with a growing portfolio of timberland and other agricultural assets through a series of loan foreclosures. These “investments” did well enough that these institutions began to promote timberland investment as a new financial asset class.

Applying portfolio theory to their new funds, they were able to demonstrate that not only did timberland yield attractive risk adjusted returns, but that historical timber returns were counter-cyclical to the stock market, making timberland investing a perfect diversification strategy. With the usual splitting and shifting of organizations, the Hancock and 1st Atlanta timber groups gave rise to Hancock Timber Resource Group, PruTimber, Wachovia Timberlands, Forest Investment Associates and several others. Timberland Investment Management Organizations, TIMOs for short, developed substantial presence. Today, Boston and Atlanta remain the primary geographic centers of the timberland investment industry.

TIMOs were not the only financial timberland investors at that time. In 1985, Sir James Goldsmith bought Crown Zellerbach and several other large timber-owning forest products companies, spinning off processing and marketing businesses and retaining timberland for arbitrage. This type of investor will return vigorously to the scene 20 years later.

Markets were imperfect during
this first phase and economic conditions were favorable. Demand was high, Japan was rapidly expanding its economy, there was a perception of supply shortfall, and stumpage prices were increasing in real terms at the rate of 1.5 percent per year compounded. Most important, there was very little competition and investors were able to acquire timberland and associated assets for timber value alone. Other values, even development potential, came along without cost. Projected returns were about 8.0 percent on average, net of inflation—very attractive for what appeared to be a low-risk investment.

When the spotted owl was listed in June of 1990, investment performance rose even higher. Western supply dropped by 50 percent, mills started to panic and prices shot up, generating big payoffs for private landowners and solidifying TIMOs as competent institutional investment managers. Some early investors saw 25 percent returns or higher. But there was a downside. As more investors were attracted to the market, they began to expect higher than “expected” returns, something the asset couldn't support for long. The success and maturation of the asset class began to create its own difficulties.

At the outset of this activity, some industry professionals with an eye to conservation promoted TIMOs as precisely what western states needed: a long-term, patient owner on a renewable asset that performed very well if managed with wisdom and patience, but was at the same time subject to degradation if managed solely for short-term gain. Pension funds were debt-averse and had no need for near-term income, content to see their investment capital appreciate. That view was correct at the time, until the market began to tighten.

By the end of 1995, we had a new eco-friendly asset class with a $5 billion portfolio poised for disappointment.

PHASE II: 1996 to 2000—Not So Easy After All

• Demand Down + Supply Up = Lower Prices
• Competition from REITs, MLPs and Private Investors

The industry story was now one of supply. Mills had closed in the West and capacity had moved to the South, taking demand with it. The Japanese economy had failed and western timber prices had plummeted. Plantation technology had advanced and there was a “Wall of Wood” coming from every direction—the South, the Northwest, Canada, Australia, New Zealand, South America.

At the same time, there were more investors buying timberland, forcing timberland prices higher in the face of declining income. This was a classic disconnect between value and revenue.

And pressure was mounting on the forest products industry to increase current return on equity. Timberland, with much of its value in the form of capital appreciation, just wasn’t performing in the short term for public companies. This resulted in marching orders from Wall Street to “unlock...

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timberland value,” i.e., sell it. Forest products companies found they could deliver greater value to their shareholders by selling their timberland to an investor with a lower cost of capital from whom they could in turn buy back raw material. The traditional need for raw material self-sufficiency was replaced by the realization that one needn’t own the forest in order to have it.

The separation of timber ownership from processing was in full swing and the forest products industry became net sellers.

Figure 3 illustrates this point. Note that what the forest products industry lost, TIMOs gained. Note also that arbitrage investors were net sellers as well. Sir James Goldsmith, who acquired his portfolio in 1985, sold it all in 1996. The “Arbs” will surface again.

Now a new class of investor is entering the scene. In addition to TIMOs, the asset class began to attract so-called “pure-play” publicly traded corporate-style investors, Master Limited Partnerships and Real Estate Investment Trusts (REITs).

The problem with TIMOs is a lack of liquidity. Once an investor buys in, it is difficult to exit. REITs and MLPs, with shares publicly traded in the stock market, resolve that issue. The problem they face, however, is similar to that faced by publicly traded forest products companies: pressure to always generate high and steady current income in order to maintain share value.

Crown Pacific, a classic example of this, was a company that built a portfolio of approximately one million acres over a 10-year period and went bankrupt in December of 2004. During much of their tenure, as debt mounted and markets fell, they developed a reputation for over-harvesting and fire sales in order to make their debt service and earnings goals.

There have been other notable failures that have touched the West: Strategic Timber Trust and U.S. Timberlands are two more would-be big successes that have cost investors a lot of money and the landscape a lot of trees.

Most REITs and MLPs have failed, but not all. Plum Creek Timber Company is the largest timberland owner in the United States with roughly eight million acres of land. Rayonier is another big player with a substantial western presence. Both are REITs. Potlatch has converted to a REIT, as has Longview Fibre. Thus far, these companies have been successful, but their future in the eyes of some professionals is dubious. Both REITs and MLPs are subject to current earnings pressures and both Plum Creek and Rayonier have recently created real estate divisions to enable them to find full value for their investors.

Another substantial buyer in the market is the so-called private investor. These are not to be confused with the typical small landowner and consist of 10 or fewer wealthy investors and their co-investors with a penchant for quick action and high risk. In the South they are known as

Figure 3. Change in Portfolio Value, 1996-2000
“pin-hookers” for their strategy of buying and quickly reselling, generally fragmenting larger ownerships in the process.

Some private investors have proven themselves excellent managers. Port Blakely Tree Farms and Merrill & Ring, both private investors based in Seattle, have always been known for careful stewardship.

In addition, conservation organizations, such as Cascade Land Conservancy, The Trust for Public Land, The Conservation Fund and The Nature Conservancy, have become increasingly active on a landscape level.

Phase II ends with the forest products industry downsizing their portfolio by $2.5 billion and TIMOs adding an equivalent amount to theirs.

PHASE III: 2001 to 2004—Here Come the Arbs!

- The Tech Bust
- Too Much Capital
- Too Few Acres to Buy
- Expected Returns Decline to 6%
- Large Scale Arbitrage

It is interesting to observe that around 2002 to 2003, it looked like things might improve. Investors, impatient with poor returns, were beginning to put pressure on their managers to become more realistic in their assumptions and to pay less. A correction seemed imminent. But then the tech bubble burst, the stock market declined dramatically, and institutional capital began seeking a new home. Five to six percent returns from timber suddenly looked attractive as a safe place to park capital. So instead of demanding higher returns and lower prices, investors capitulated to low yield, with the caveat that managers must aggressively seek value wherever it could be found. Today, TIMOs and other investors are awash with cheap capital and once again we have a sellers market and continuing pressure on parcelization and development.

Figure 4 illustrates the market profile by the end of 2004 and the likely condition for the foreseeable future.

Private investors have always been a factor, but never so much as now. The buyers referred to as pin-hookers in Phase II accounted for 27.9 percent of the $5.0 billion that traded in 2004.

And again, a new investor has entered the scene. More precisely, an old investor has returned. Recall Sir James Goldsmith in the mid-80s. Sir James died years ago, but his successors are back. These are very large arbitrage specialists who acquire companies whole, then actively spin off assets in transactions engineered to generate the highest possible return. They are highly leveraged, very sophisticated investors with little patience and little concern for sustainable forest management. Rapid turnover is their primary driver.

Just in the last few years, there have been two such mega deals for Boise Cascade and Mead Westvaco, with a total of three million acres. Madison Dearborn Partners, the buyers of Boise Cascade, almost immediately sold all of the former Boise timberlands to Forest Capital Partners for $1.65 billion. Cerberus Capital, the buyers of the Mead-Westvaco paper division recently sold 650,000 acres to Plum Creek for $345 million and the balance to Tolleson Investments for $165 million.

Today, a buyer who bids only on timber cannot hope to compete, and Higher and Better Use, otherwise known as HBU, or real estate, has become a large component of return.

PHASE IV: 2004 to Current—It’s All Over Now!

- Weyerhaeuser is the only one left.

Since 2004, another 20.9 million acres of industrial timberland has changed hands, roughly 50 percent of this in six mega-transactions. Some of this was “wrap-up” or “flip” of the Boise Cascade and Mead-Westvaco deals initiated in Phase III. Significantly, however, the divestiture of International Paper, Temple Inland and Longview Fibre alone accounted for 7.8 million acres. As of today, Weyerhaeuser, with roughly 6.5 million domestic acres, is the only publicly traded forest products company remaining with substantial forest ownership, and they face daunting pressure from investors to liquidate.

Interestingly, the “arbs” failed to materialize as ongoing purchasers of timberland, with most of the post-2004 activity going to TIMOs.

Implications for Family Forests

- Family forests are subject to different pressure
- Inheritance will be the primary threat
- Increasing number of heirs
- High real estate values

Market forces and pressure on financial performance have had dramatic impact on large holdings during the last 20 years, causing the nature of ownership to change utterly and threatening large assemblages with fragmentation. Family ownerships, on the other hand, have changed little as a result of these forces. While income from family forests is clearly an important motivation, small private ownerships are subject to a much broader array of

Figure 4. Change in Portfolio Value, 2001-2004
goals, including amenity value, recreation, family tradition and personal pride in management. Maximizing investment return is rarely the most important goal. Additionally, concern for fragmentation is less of an issue since, by definition, these ownerships have already been fragmented.

One factor, however, does stand out as a threat to family forests. For this class of ownership, the most important change is likely to be intergenerational transfer. In this category, ownerships are entering their third, fourth or fifth generations, and keeping the forest in the family is a challenge due to inadequate planning, lack of family involvement, increased focus on financial motives and other reasons.

According to the Pinchot Institute, “45 percent of America’s family forests are owned by individuals over 65 years of age. During the next two decades, the U.S. will witness the largest intergenerational transfer of private forestlands in its history.” Applying this to ownerships of 1,000 acres or less (see Figure 2), this means that during the next 20 years, 103 million acres of family forests will change hands. As nuclear families expand, the number of heirs increases, and relatively fewer are subject to the land ethic of their parents from whom they inherit. This pressure will find an outlet in increasingly higher values in what was once remote real estate, a temptation that will prove too compelling for some to resist.

Conservation in the Future: It’s the HBU!

- Direct Partnerships with Financial Investors
- More Conservation Capital
- Faster Capital Deployment
- Focus on Conservation
- Seek Low-Cost Partners

For conservation advocates, the increasing competition among institutional and private investors over the last few years has taken the focus off forest management and put it squarely on fragmentation and development and on keeping forests intact as working forests. This will manifest itself in their relationships with both large and family owners and competition with real estate values will drive their efforts. In order to do this, however, transaction-based conservation organizations must behave more efficiently than they have in the past, they must think more like financial investors, and, in fact, partner with them through efficient use of landscape-level working forest easements.

In this way, transaction conservation can invest with the financial buyer at the wholesale level, rather than employ its traditional retail strategy of acquiring small conservation components after the larger transaction has been done. Conservation organizations have a relatively lower cost of capital than financial investors. Properly applied, this can result in a competitive advantage that will attract TIMOs to partner with them and allow scarce conservation capital to go farther.

The following suggests ways in which policy makers and the conservation community might increase their effectiveness:

- First, relationships with TIMOs should be developed. They have a focus on managing working forests and conservation can partner with them. Other investment vehicles and fragmentation specialists are less attractive.

- More funding must be made available to conservation and it must have the capability of rapid deployment. If conservation is to partner with financial investors, their capital must be deployed alongside that of their partners in order to achieve parity of risk and to align interests.

- Conservation should focus on the conservation components of transactions rather than on the acquisition of the commercial component. The commercial component is best left to the financial partner. They are better able to manage for financial return, particularly when the conservation component determines the course of management events.

- Conservation must find those partners with the lowest cost of capital. With a surplus of 6 percent capital available, it makes no sense to partner with someone who needs 12 percent.

Conclusion

Increased population, expansion of communities, demand for space for homes and recreational property, and the ever-increasing pressure to generate investment return cause the future of working small private and industrial forests to be uncertain. Industry is faced with a diminution of their resource base and conservation must be more creative than ever in raising large sums of capital to combat pressures on forest fragmentation. On the other hand, increased global warming and loss of biodiversity may result in economic markets for ecosystem services, creating new products to help the forest compete. One thing is certain: the future is unknowable and the economics of forest ownership will be different a decade from now.

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