Timberland Investments Today and Tomorrow

BY KEVIN BATES

Timberland as an asset class is still relatively young. In 1987, the National Council of Real Estate Investment Fiduciaries (NCREIF) first published the Timberland Property Index (TPI), which represents the most widely used benchmark for this asset class. The wholesale divestiture of timberland by integrated forest product companies in the 1980s and '90s, brought on in part by changes in tax law, allowed an opportunity for institutional investors to place capital in this asset. Now, nearly 30 years after the launch of the TPI, we can look back at the effect of these changes in the ownership of timberlands and where timberland as an asset class appears to be headed.

The most common timberland investors are pension funds, endowments, and other investors in need of long-term inflation-protected cash flow. Some of the factors that make timberland investment attractive for institutional investors include:

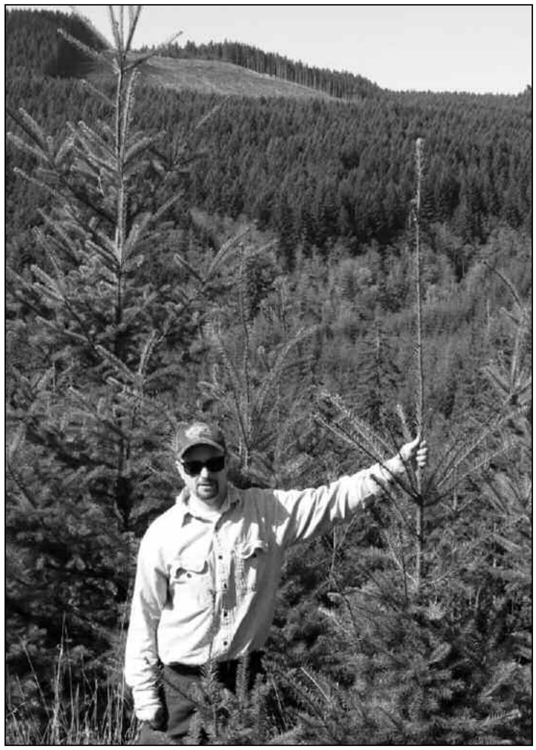
• Trees continue to grow during recessions—trees don't read the *Wall Street Journal!*

• Timberland returns are correlated with inflation, offering a great diversification in a large portfolio; returns are not correlated with most other investments.

• Planned harvests deferred during weak markets continue to grow in volume and value during the deferral period, but the rate of growth continues to decrease as you pass the optimal rotation age.

Timberland return expectations are primarily driven by two factors: biological growth and inflation. Typically, annually, biological growth ranges between 3-5% for US timberland and inflation averages 2-3%, which results in a return expectation of between 5-8% for the asset class. This is a reasonable expectation absent real log price appreciation or the realization of land values over the timberland value. The levers available to the manager to improve returns beyond this point are limited.

Like most investments, timberland was severely affected by the Global Financial Crisis of 2008 (GFC). The GFC led to a dramatic decline in housing starts, which in turn decreased lumber production and log prices. Since the GFC, log prices have failed to recover in most regions of the US as housing starts have remained well below projections. This has led to poor income performance for many timberland investments and disappointed investors. We believe some of this disappointment represents a misunderstanding of the risks and rewards of timberland investments. The aforementioned positive attributes of timberland as an investment have remained largely intact, and the lessons learned from the GFC will ultimately lead to more informed investors and better management of timberland investments in the future.



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Long leaders indicate fast growth and a thriving timber stand.

In portions of the US South, timber harvest has been deferred for 10 years or more resulting in a large overhang of timber volume. This excess inventory of mature timber creates a headwind for log price recovery in this region. Manufacturers have reacted to excess timber inventory by making investments in the region to increase mill capacity. Additionally, a timber stand's biological growth rate slows once that timber has passed its optimal harvest age. Over time, this reduces the benefit of the harvest deferral. This situation has likely resulted in a better understanding on the part of investors of the limits of harvest volume deferral as a tool for creating value in a timberland investment and a more sophisticated understanding of the risks associated with investments in timberland.

Recent disappointing investment returns can be traced back to decisions that were made prior to the GFC when timberland investment performance was buoyed by the twin effects of a domestic housing boom and the growing acceptance of timberland as an investment. This strong performance led to aggressive timberland valuation assumptions that in many cases included real log price appreciation into perpetuity and strong land appreciation driven by projected demand for recreational and development lot sales. In addition, many investments were capitalized with high levels of debt, which forced investors to harvest volume despite weak log markets to service that debt. US South investors are currently experiencing the opposite, but no less painful problem, with excessive deferred harvest volume keeping a lid on log price appreciation. Since 2009, housing starts have not recovered to historic averages, and in most cases, land price appreciation has failed to meet expectations.

Opportunities are available for a diligent manager to add additional value to their timberland investments through recognizing and monetizing land values, smart application of silvicultural investments, and modulating

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harvest volumes to specific market circumstances. However, if the initial valuation and acquisition value are overstated, it is unlikely that the manager will be able to make up for this mistake. Further, many of these value-added activities need time to be realized. An obvious example for foresters is the fact that many silvicultural investments may require 15 or more years to be realized. This led to situations where investment returns were in some cases boosted by avoiding silvicultural costs. When the timberland was subsequently sold, the buyer chose to ignore the impact of these deferred costs. We would argue that this may be less of an issue today than in the past during overheated timberland markets.

Today's market for timberland in the Pacific Northwest, where we operate, also reflects some of the lessons learned from the GFC. For example, we do not customarily see appraisers or timberland buyers using log price forecasts that assume real log price appreciation into perpetuity. We do, however, see some speculation on future land conservation or other land value appreciation, which was certainly a factor in some of the problems investors encountered post GFC. To be fair, some of this is likely a reflection of investor interest in diversifying their timberland portfolio into the Pacific Northwest at a time when there were very few properties offered for sale. As a result, there has been intense competition for the few properties available for sale in the region.

Our experience indicates that investors that continue to participate in the timberland asset class tend to have more realistic return expectations than prior to the GFC. They have learned the importance of a long-term investment and generally view a 10-year investment horizon as not long enough.

The arrival of evergreen funds

To facilitate longer-term investment periods, managers are creating vehicles with investment periods of 15 years or longer. Timberland investment managers are also working on raising capital for "evergreen" investment structures. These structures often have provisions allowing the investor to liquidate a portion of their investment periodically through a process facilitated by the manager that does not involve selling the underlying property, thus the moniker "evergreen." Investors in these vehicles generally need to rely upon the accuracy of the timberland appraisal at the time they seek to exit the investment. These types of vehicles commonly have very specific requirements for periodic third-party appraisals of the underlying timberland portfolio.

While changes to investment vehicles are evolving, we believe a shift toward investment horizons greater than 10 years are beneficial for both the timberland resource and the foresters who manage these properties, and will lead to long-term operating decisions that are truly long term. This longer-term philosophy should result in additional focus on the importance of early silvicultural investments such as managing stand density and site preparation. These practices maximize the value of the timberland investment by managing stand diameter sizes at harvest to match market expectations, and by reducing rotation ages to ensure the most efficient use of the underlying land.

For those of us who work in this industry, this is good news. By producing competitive returns from timberlands over the long-term, we maintain a healthy amount of capital for investing in this space and in the continued viability of this important community resource. None of us want to be responsible for forests that are underutilized with a focus on short-term results instead of on long-term value creation. It is encouraging that institutional investors are now recognizing the value of longer-term investment horizons in this asset class. ◆

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