

**TIMBERLAND OWNERSHIP PATTERNS –
The More Things Change the More They Stay the Same**

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**California Forest Futures Conference
Sacramento, CA
May 23, 2005**

ABSTRACT

In 1983, research sponsored by UC Forestry Extension predicted a shift in ownership of U.S. timberland from industry to institutional financial investors. Since then, institutional ownership, primarily pension funds, has grown from less than \$500 Million to a portfolio valued at more than \$12 Billion and industry no longer dominates large-scale timberland ownership. A long-term owner in control of a long-term asset initially appeared a more logical match, one that would result in better forest management. But has that proven true? Has maturation of timberland as an asset class, competition, and pressure on returns merely replaced one myopic owner with another? This presentation will review the evolution of investment forestry from its inception as an obscure low-risk investment asset, through the mounting competitive pressure of its growth, to the current cast of characters that includes truly long-term investors as well as mega-investors with a focus on fragmentation, development, and shortest-term arbitrage. In so doing, we will touch on the economic climate that impinges on the industry, the unique case of California, the fit of Conservation in the solution, and how policymakers can help.

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I loved that quote that Ralph Alig and John Beuter had at the beginning of their December article in the Journal of Forestry: “With what you have to pay for forestland these days, you can’t afford to use it to grow timber.” I think that’s true, certainly not only to grow timber. And that’s clearly a problem.

SLIDE:

FRAGMENTATION PRESENTS A CHALLENGE TO CONSERVATION

- **Conservation Must Think And Act More Like Financial Investors**
- **Must Operate At Higher Scale**
- **Must Make Scarce Capital Go Farther**

Fragmentation and development compete directly with non-market values for habitat, open-space, and working forest. This delivers a fundamental challenge to Conservation to think and behave more like financial investors, to operate at higher scale, and to make their scarce capital go farther. We’ll come back to this in a few minutes, but for me it represents the basic take-home message of this conference.

Forests come under greatest threat when ownerships change – and the last 20 years have seen a lot of that. And this change has been structural – it’s not simply passing acres from one guy to the next who will operate it in the same way. So for the next 15 minutes let’s take a look at what motivates these new landowners and the levers they provide to Conservation and policy makers.

SLIDE:

ESTIMATED U.S. OWNERSHIP DISTRIBUTION

	Size Class	Acres	%	Owners	%
BIG	100,000+	65,000,000	17.62%	60	0.001%
	5,000 - 100,000	59,370,000	16.09%	2,350	0.024%
	1,000 - 5,000	14,843,000	4.02%	21,135	0.220%
SMALL	<1,000	229,753,000	62.27%	9,580,400	99.8%
	TOTAL	368,966,000	100.0%	9,603,945	100.0%

This table divides U.S. private forestland ownerships into two classes – BIG and SMALL. Big means over 1,000 acres. Small is the rest. 1,000 acres isn’t exactly your back yard, but on an institutional scale, it’s pretty small.

At 5,000 acres or less, the big ownership change to deal with is intergenerational transfer. In this category, we’re now entering the 4th or 5th generation. Inheritors are many and motivated primarily by “show me the money!”

At 5,000 acres and up, the big change is from strategic owners – that is, the forest products industry – to financial investors. These guys, by nature and definition, also want to “see the money.”

Note that the BIG category represents less than 1/4 % of total owners, but one-third of private forestland, and nearly all the landscape level private forestland. This applies for the most part across the country, including California, presenting the most efficient policy and Conservation target. I’ll take a triage approach today and focus on big.

So let’s take a walk through the last 20 years and look at these players as they enter the scene. What I want you to notice is that each new entrant ups the ante and causes all to focus less and less on long-term forest values.

SLIDE:

PHASE I: 1983 to 1995– Life Was Easy!

- **Plenty Of Land**
- **Low Competition**
- **Expected Returns Of 8.0%**
- **Countercyclical To The Stock Market**

The switch from strategic to financial investors started almost by accident in the early 80's when a couple of life insurance companies found themselves the proud owners of some timberland as a result of a few loan foreclosures. These “investments” did well enough that they thought they should see if they could raise some money from their pension clients and do it on purpose. With the application of some portfolio theory that says diversification is a good thing and the discovery that historical timber returns are counter-cyclical to the stock market, Timberland Investment Management Organizations, TIMOs for short, were off and running.

Let's note that it wasn't all about TIMOs. 1985 was when Sir James Goldsmith took over Crown Zellerbach and some other companies, along with a lot of timber land. We'll come back to him in a minute.

Life was easy then. Demand was high, Japan was spending money like they had it, there was a perception of supply shortfall, and prices were increasing every year in real terms. Most important, there was very little competition. And you could buy timberland for timber value. Any other values – even development potential – you got for free. Projected returns were about 8.0% on average, net of inflation, which seemed pretty good for what appeared to be a low risk investment.

When the Spotted Owl was listed in June of 1990, things really took off. Western supply dropped by 50%, mills started to panic and prices shot up, making fortunes for private landowners and heroes of TIMOs. Some early investors started seeing 25% returns or higher.

But here's the downside. More investors started coming into the market, but now they were expecting higher than “expected” returns, something the asset couldn't support for long. So now we're beginning to see a few dark clouds.

And I have to say that I promoted TIMOs as what we wanted to see here in California. What could be better than a long-term owner on a long-term asset? These guys were debt-averse and had no need for near-term income, happy to see their investment capital appreciate. The best possible investor for forests in need of a rest. I think I was right at the time. But then 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 major disappointment.

SLIDE:

PHASE II – 1996 to 2000 – Not So Easy After All

- **Demand Down + Supply Up = Lower Prices**
- **Competition from:**
 - **REITS and MLPs**
 - **Private Investors**
- **Wall Street says: “*Unlock Timberland Value.*”**

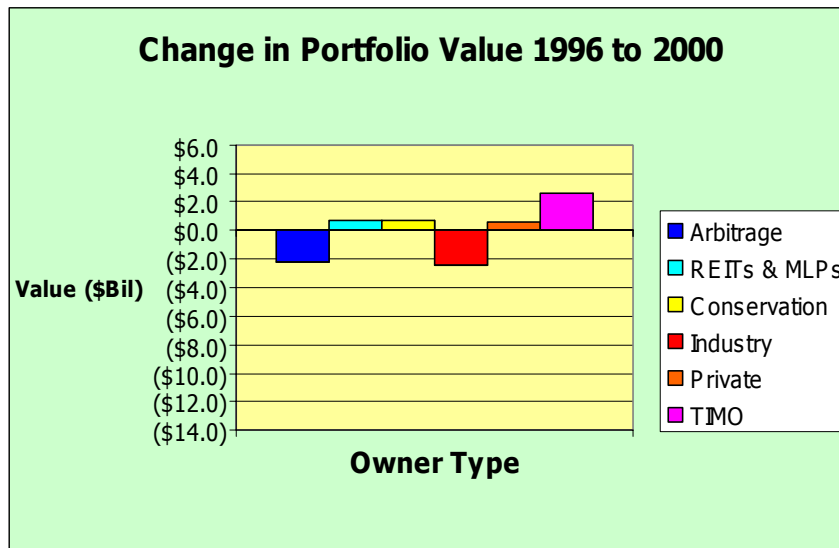
Now it's becoming a supply story. Mills had closed in the West and capacity had moved to the South, taking all that demand with it. Japan was in the tank and western timber prices had plummeted. Plantation technology had advanced and there was a “Wall of Wood” coming from every direction – the South, 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. 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 cutting it in the short term for public companies. This resulted in marching orders from Wall Street to “unlock timberland value”, i.e., sell it. You can make more money by getting rid of your timberland and buying raw material. The old self-sufficiency addiction began to be replaced by the realization that you don't need to own the forest in order to have it.

What an opportunity. Industry, with a need to sell its timberland, turned to this new set of buyers and caught the heady scent of DUMB MONEY, something every seller yearns to see. The separation of timber ownership from processing was in full swing and the forest products industry became net sellers.

SLIDE:



Note also that the “Arbitrage” people were net sellers as well. This was Sir James Goldsmith, who acquired his portfolio in 1985 and sold it all in 1996. We’ll see these fellows again.

Now a new class of investor was 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.

The problem with TIMOs is a lack of liquidity – once you’re in it’s tough to get out. REITs and MLPs, with shares publicly traded in the stock market, resolve that issue. The problem is that, like public forest products companies, they are subject to pressure on current income in order to maintain share value.

Crown Pacific, a classic example of this, was a company that built up about a million acre portfolio over a 10 year period and just went bankrupt last December. During much of their tenure they developed a reputation for burning the furniture during the winter in order to keep the cabin warm.

There have been other debacles that have touched down in the west: Strategic Timber Trust, who we saw right here in California, and U.S. Timberlands, two more would-be big deals that have cost people a lot of money and the landscape a lot of trees.

Buy me a beer this evening and I’ll tell you some wild stories about some very colorful characters.

Most REITs and MLPs have failed, but not all. Plum Creek Timber Company, is the largest timberland owner in the U.S. with roughly 8 million acres of land. Rayonier is another big player in the West. Both are REITs. You would have to call these successes

thus far, but frankly I wouldn't buy their stock. Both are subject to current earnings pressures, Plum Creek does a lot of churning and has recently created a real estate division to make sure that they extract full value for their investors.

Another buyer in the mix is the so-called Private Investor. These are not your typical small landowners and consist of 10 or fewer wealthy investors and their side-kicks with a penchant for quick action and high risk. In the South they're known as "pin-hookers" for their habit of buying and flipping - and fragmenting in the process.

There are some good guys out there as well. On the private side, Mendocino Redwood Company, with much fortitude and persistence, has proven themselves to be one of the best landowners in the State. Good for them. We need more like them!

And Conservation organizations, such as The Trust for Public Land, The Conservation Fund, and The Nature Conservancy have become increasingly active on a landscape level and I have great hopes that they will continue in this mode.

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

SLIDE:

POSITIVE TRAITS OF TIMOs

- **Focus on Forest Management**
- **Debt Averse**
- **Patient Investors**

TIMOs have become as myopic as everyone else in order to compete. But they have three positive traits that we want to keep in mind: they tend not to carry debt, they would rather focus on timber value, and their investors tend to be patient. These are investors Conservation can partner with.

SLIDE:

PHASE III – 2001 to Current – Here Come the Arbs!

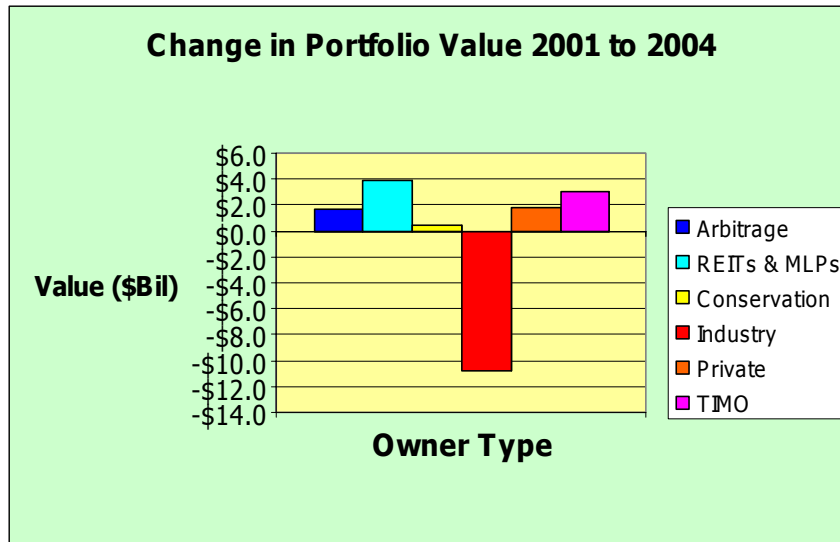
- **The Tech Bust**
- **Too Much Capital**
- **Too Few Acres to Buy**
- **Expected Returns Decline to 6%**
- **Large Scale Arbitrage**

Its interesting that around 2002 to 2003, it looked like things might improve. Investors, tired of poor returns, were putting pressure on their managers to get real on their assumptions and to pay less. It looked like a correction was in the wind. But then – the

tech bubble burst, the stock market went into the tank, and all that institutional money started looking for a home. 5.0% to 6.0% returns from timber didn't look so bad any more. In fact, timber became even more attractive because it looked pretty safe.

So instead of demanding higher returns and lower prices, investors just said "Oh, what the hell! – bring me 6.0%. But squeeze it as hard as you can." 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.

SLIDE:



So here's how things looked by the end of 2004.

Private investors have always been a factor, but never so much as now. The folks we referred to as pinhookers in Phase II accounted for 27.9% 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-80's. Sir James died years ago, but his successors are back. These are very large arbitrage specialists who acquire companies whole, then spin off assets for as much as they can get. They are highly leveraged, very savvy investors with little patience for or focus on good forest management. It's all about turnover. Just in the last year, there have been two such mega deals for Boise Cascade and Mead Westvaco, with a total of 3 million acres.

Today, a buyer who bids only on timber value isn't even in the running and Higher and Better Use, otherwise known as HBU – translate: Real Estate - has become a big deal.

SLIDE:

CALIFORNIA IS DIFFERENT – “Risky as a Third World Dictatorship”

- **California Seen As A High Risk Environment**
- **Regulatory Burden**
- **Regulatory Unpredictability**

It’s interesting to note that California has not attracted a great deal of activity on the part of institutional investors. Four TIMOs currently have a presence here. Two of those are legacies of investments from more than a decade ago, and the more recent ones I suspect would love to get out. Just offer them anything approaching what they paid and they’d be gone by tomorrow morning.

Those that do invest here have always been here. The most recent transaction was between two forest products companies in the Inland region. It took place without a Conservation participant at a per acre price substantially exceeding its timber value. Not hard to see where that can lead.

The reason for this lack of attention centers on regulatory burden and unpredictability – one executive, not Clark Binkley, though I suspect he would agree, likened the level of risk in California to that of a third world dictatorship. (I want to note that this complaint is not to be confused with those of Pacific Lumber Company. While they make a similar argument, theirs is a wholly different situation.)

This lack of forest investment interest leaves owners who wish to cash out with only one option - sell directly to people with a view to conversion and development. So we are likely to find that our regulatory safeguards will actually increase the pace of forest loss. Quite a paradox.

SLIDE:

CONSERVATION IN THE FUTURE: It’s the HBU, Stupid!

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

For Conservation, 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. In order to do this, however, Conservation must behave more efficiently than it has 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 Conservation can invest with the financial buyer at the wholesale level, rather than coming along behind

buying up small pieces at retail. There are very attractive economic advantages available to Conservation that I'd love to discuss but we'll have to leave that to another time.

In closing, though, I have some suggestions for policy makers and the Conservation community.

- First, we need to attract TIMOs. They have a focus on managing working forests and Conservation can partner with them. Other investment vehicles and fragmentation specialists are not good partners. We need greater investment certainty from our regulations.
- More funding must be made available to Conservation and it must be deployed quickly. If we're to partner with financial investors, our money must go on the table at the same time as theirs. Let's make sure the proposed Park Bond contains a mechanism to do that.
- Let's put that money to use in conservation rather than spending it to acquire the commercial component. Let our financial partners do that. Their money is cheap and they're better at it.
- Let's make sure Conservation finds those partners with the lowest cost of capital. With plenty of 6% money available, let's not partner with someone who needs 12%, otherwise we may find ourselves subsidizing them. Let's not ourselves be DUMB MONEY.

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