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FOREST CONSERVATION PARTNERSHIP: CONSERVING FOREST LAND THROUGH INVESTMENT COLLABORATION

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NEED FOR A NEW CONSERVATION MODEL

- **Industry is Divesting, Conservation has become a Player**. 15 to 30 million acres of U.S. timberland will come to market in the next decade, enabling Conservation to dramatically increase its stake in forest management at a landscape level. Conservation has increased its level of activity during the last several years, in 2001 accounting for approximately 10% of total timberland acres acquired and influencing more through working forest easements.

- **Retail Conservation Won't Work.** Conservation has typically acquired its interest through post-closing spin-offs at retail prices. In order to continue its higher pace of influence during the next decade, Conservation must increase its scale.

- **Funding is Scarce**. Funding is always scarce, but current economic conditions cause the traditional sources of conservation capital to be less reliable. New approaches to raising and deploying conservation capital will be required.

CONSERVATION/PRIVATE INVESTOR PARTNERSHIP

Strategies For Forest Conservation Investments

- **Working Forest Easements (WFEs)**. The retention and protection of working forests will be the focus of forest conservation in the next decade. Where conservation and commercial use are compatible, WFE's will be the primary structure. WFE's at a landscape level must be transacted on a wholesale basis, requiring a scale traditionally inaccessible to Conservation.

- **Partnership with Financial Timberland Investors Provides Scale.** Through the partnership, the private investor provides Conservation the scale necessary to participate at wholesale.

- **Preservation of Local Geographies**. Local geographies and landscapes on which conservation and commercial activities are incompatible will continue to be important targets. Some will be acquired within the traditional spin-off format, but many can be acquired at wholesale, especially where they are combined with landscape-level WFEs.

Attributes of the Partnership

- **The Partnership is *A Priori***. The partnership agreement is negotiated prior to the initiation of the transaction. Valuation and allocation methodologies are defined in principle ahead of time, due diligence is conducted jointly, costs are shared pro rata and the partnership submits a joint offer. Investment capital will be placed at risk jointly. Without this *a priori* arrangement, Conservation will be restricted to a retail position.

- **Information is Shared**. The similarity of risk and effort, the complementarity of investment components, and the resulting alignment of interest will enable the partners to openly share assumptions, analysis, and conclusions.

Economics of the Partnership – The Driver

- **Conservation has a Low Financial Cost of Capital**. While conservation returns are social in nature and thus difficult to measure with financial metrics, its cost of capital can be approximated by the borrowing cost of Program Related Investments, typically 2.0% to 4.0% in nominal terms. Financial investors have expected return significantly higher – for timberland, approximately 10.0%.

- **More is Less - Low Capital Cost Gives Conservation a Competitive Advantage**. Because Conservation values attributes not valued by financial investors except in an after-market, and because its capital cost is low, where conservation value is high, Conservation will, at the margin, be willing to pay relatively more than financial investors for the conservation component. Thus by paying more on the margin on a wholesale basis for high value conservation, Conservation will conserve capital by avoiding the retail disadvantage. The typical range of savings is 10% to 30%.

- **Conservation Surplus**. Value is what a party *would be willing to pay* for an asset, while cost is what that party *must pay* to acquire it. Since Conservation will pay only what it must pay, so long as cost is less than value, Conservation will enjoy a surplus.

- **Financial Investors will be Drawn to the Partnership**. IRS Regulation 501(c)3 prevents private parties from benefiting financially from Conservation. Thus the financial partner cannot enjoy a higher risk-adjusted return as a result of the Partnership. However, because of Conservation's competitive advantage, the Partnership will have greater success at the bidding table than purely financial investors, attracting financial investors to participate.

- **Easement Risk – The Downside**. The key conservation asset is the Working Forest Easement. Because an easement is perceived to diminish liquidity, the financial partner will require a higher return to compensate for its higher risk – the more restrictive the easement, the higher the required financial return. This easement risk premium, typically 75 to 150 basis points, depending on the nature of the easement, is a cost to Conservation typically paid at retail. As the market for easement encumbered properties develops, this cost will diminish.

Potential Partners

- **TIMOs are the Most Likely Partners**. Timberland Investment Management Organizations (TIMOs), investing on behalf of institutional clients, will be the primary institutional timberland buyers and thus are the most likely candidates for partnership.

- **Private Investors**. During the last several years, private investors have had substantial influence in timberland acquisitions. Many of these are short-term professional investors speculating on development value and are unlikely to see Conservation as a partner. Others, including wealthy individuals, families, and some institutions, are longer-term investors seeking portfolio diversification, tax advantage, social responsibility, and other investment attributes compatible with Conservation.

- **Forest Industry**. While forest industry will be a net seller of timberland during the next decade, in strategic circumstances, particularly where privately held, they will remain a significant buyer. With a focus on supply and economic return, and eager to be perceived as socially conscious, this segment of the forest industry will be viable partners to Conservation.

- **We Know Them**. Jim Rinehart has been involved with the TIMO industry since its inception in 1983. He knows all of them and has personal relationships with their top management. In addition, Rinehart has developed relationships throughout the forest products industry and among private investors. These relationships will be useful in developing Conservation/Private Investor partnerships.

- **Some Investors Will Be Difficult To "Convert."** Some investors and investment management organizations are "partner-averse" and will not be open to increasing ownership complexity. Others will be eager to pursue the concept, particularly TIMOs who can view Conservation as a new source of capital.

INVESTMENT MARKETING

- ***A Priori* Partnership Requires Ready Capital**. In order to achieve the parity required to attract financial investors as partners, Conservation and private capital must be at equal risk. Thus Conservation capital must be more facile than has been the norm. Historical fund-raising methods will be employed at the outset, but new techniques must be developed.

- **Conservation Capital Reserve**. In today's economy, a revolving fund of ready cash will be difficult to establish. Thus investment marketing will be based on the private investment model of discretionary allocation. A capital reserve will be developed, consisting of regional portfolios of ***subscription agreements*** from foundations, government funding sources, and other donors. Funds will not be delivered until projects are presented that meet specific donor-defined criteria centering on ***transaction type, regional perimeter***, and ***expiration term***.

- **Leverage**. With subscription agreements as collateral, short-term PRI or commercial loans can be procured to deliver funds quickly.

- **Mission-Related Investments and Blended Value**. Foundations, with some exceptions, typically maintain an unassailable wall between program and investment arms, preferring to invest corpus in anything that maximizes return. While this strategy has been exceptionally difficult to alter, there is considerable discussion within the foundation community about Mission Related Investments (MRI), i.e., financial investment of foundation corpus in investments consistent with its philanthropic mission. In the forest investment model discussed here, it is possible to achieve both conservation and financial goals without attempting to breach the wall. That is, in a given investment, the foundation's investment arm can realize a full market risk-adjusted rate of return made "mission-consistent" through a contribution to easement ownership or preservation from the program division. Thus the "wall" can remain - only communication and mission fit are required.

Current economic conditions cause traditional foundation and agency capital to be relatively difficult to raise. In particular, to raise capital at scale, contributors must be provided a means of reimbursement other than through private donors or taxation. Mission-related investments (MRI) will thus be a growing source of capital. Such investments blend conservation and financial values, generating return that meets or exceeds the blended cost of capital of foundations’ investment and program elements.

In this model, conservation investments become “self-funding”, with income from the financial component paying for the conservation. In effect, two investments are made, the first in conservation, generating zero financial return, the second in a financial investment made environmentally sound by the first and generating full market return. Foundations thus become a deeper source of capital for Conservation and a new source of capital for investment managers.

- **Collaborative Effort Will Be Required**. Foundations and other private and governmental philanthropic sources have traditionally viewed program and investment components as inviolably separate. With a progressive movement toward MRI, this separation is beginning to break down. A determined marketing effort on the part of Conservation and private investment managers will be required, however, to fully exploit this potential. Joint presentations by Conservation and financial partners will be most compelling.

SOURCES OF BLENDED CAPITAL

Several foundations are likely to be leaders in the movement to MRI. The William and Flora Hewlett foundation is large and inclined toward environmental issues. The Packard Foundation is another California foundation with an environmental focus. The Merck Family Foundation, based in Milton, MA, focuses specifically on Natural Resources, has made numerous grants to various land trusts, and has investment specifically in forestland.

Other foundations making grants for forestry and other environmental purposes include:

- Paul G. Allen Forest Protection Foundation
- Gordon and Betty Moore Foundation
- Boettcher Foundation
- Compton Foundation, Inc.

- Frey Foundation
- Walter and Elise Haas Fund
- Maine Community Foundation, Inc.
- Richard King Mellon Foundation
- William Penn Foundation,
- Robert W. Woodruff Foundation, Inc.