

The Changing Landscape of Timberland Ownership in the South

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Introduction

Private timberland ownership in the southern United States represents almost 75 percent of all timberland acres, as compared to roughly 60 percent nationwide. Recently, however, the makeup of private ownership has been changing due to a variety of factors including, but not limited to (1) federal income tax policy, (2) strategic decisions by many vertically integrated forest products companies, and (3) tax mitigation tools to delay and minimize, or in some cases eliminate, capital gains taxes on transferred timberland assets.

Private timberland ownership trends in the south have been changing rapidly. With over 25 million acres of private timberland changing hands over the past five years in large transactions (over about 20,000 acres per transaction) across the US, the South has seen the largest change over this period. Large timberland transactions like Boise Cascade's 2.3 million acres sale to Madison Dearborn Partners (a private equity capital firm), or Plum Creek Timber Company's merger / acquisition of The Timber Company (Georgia Pacific's Timberland Letter Stock) have become commonplace in timberland markets.

Much of this increased activity has been a result of increased interest by institutional investors (pension funds, university endowments and other tax advantaged entities such as REITs) searching for relatively low risk but higher return investments (relative to Treasury Securities) . Additionally, timberland has been shown to provide substantial portfolio diversification – an important component in portfolio selection by these institutional investors. We have seen between 1.5 and 2 billion dollars of investment capital allocated to timberland every year for the past five years by institutional investors. Their interest in timberland as an investment is strong and growing. A primary challenge has been to locate enough investment grade timberland to allow investors to place these funds in the timberland asset class.

The primary seller have been the traditional vertically integrated forest products companies (C-Corporations like Georgia Pacific, International Paper, and Weyerhaeuser) and the buyers have been institutional investors, Real Estate Trusts, and in some instances wealthy individuals and family trusts. In over seventy percent of the transactions we have studied tax efficiency has been increased through the transaction (i.e. the new owner will pay less tax on a percentage basis than the old owner due to federal and state income tax regulation).

Most of these institutional investors participate in timberland investing through an intermediary such as a forestry consultant or Timberland Investment Management Organization (TIMO) that purchase and manage timberland investments on behalf of their clients. Hence, TIMOs do not, in most instances, own any timberland but they act as investment advisors and timberland managers for clients interested in timberland investments. Many of us in the forest industry fail to make this distinction between ownership and the fiduciary management responsibility of TIMOs.

Factors Affecting Timberland Ownership Changes

Several primary factors have affected timberland ownership decisions and strategy by the traditional vertically integrated forest products companies including:

- Poor shareholder returns and significant long-term financial performance issues of the sector.
- Industry consolidation and increased levels of debt that follow a consolidation strategy in most instances.
- The development and implementation of more efficient tax structures for owning timber and timberland.
- New tax strategies (installment notes) for mitigating or eliminating capital gains on transferred timberland assets.
- Recognition that to be in the forest products manufacturing business does not require companies to be in the timberland ownership business.

From the buyers perspective there are a number of important attributes that attract investors to timberland. The asset class has posted strong risk adjusted historical returns, particularly relative to both stocks and bonds. Returns are uncorrelated with other, more traditional asset classes thus providing a diversification opportunity for many investment portfolios. Many investor have become increasingly interested in holding real assets such as timberland as part of their portfolio as a hedge against anticipated inflation. Consequently, large sums of investment capital have been made available for investment in industrial grade timberland with approximately 1.5 to 2 billion dollars being placed annually over the past five years by institutional investors, university endowments, and high net wealth individuals.

Impacts on Southern Timberland Management

Our research has focused on understanding the impacts of the changing private timberland ownership base. A number of trends are evident from this research including changes in forest management practices, increased or accelerated fragmentation across the landscape, and a reduction in fire suppression resources. The large contiguous ownerships characteristic of industrial ownership are disappearing from the forested landscape. As these

ownerships are sold smaller parcels result as acres are carved out for other uses. These trends are exacerbated by the fact that many, if not most, institutional timberland investments are ten to fifteen years in length – far shorter than the traditional forest products companies ownership horizons. This change in investment horizon will result in increased sales activity in the future.

In most cases timber management activities have not changed drastically as ownership changed. Timber management activities have generally been similar and silviculture treatments like thinning and midrotation fertilization continue to be applied. However, in some transactions, particularly where high debt levels are employed, increased pressure on near-term cash flow to meet debt interest obligations shortens rotation ages and changes management strategies.

With increased population pressures in the south, coupled with a dynamic timberland ownership base, we expect these ownership changes to continue unabated. With about 10 million acres left in the hands of the traditional vertically integrated forest products companies, we expect to see additional asset sales to the institutional investors. We expected that in three years no traditional forest products company will own more than a million acres in the south. Trends across the United States will be similar. Similarly, we expect institutional investment in timberland to increase as acres are sold to more tax efficient owners like REITS and pension funds.

