

Navigating Forestland Transactions

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The mass sale of forestlands across the United States by the forest industry has provided the resources to fuel surging interest in forestland as a financial asset. Nowadays, most of the investment-grade forest assets changing hands across the nation are being scarfed up by Timber Investment Management Organizations (TIMOs) and Real Estate Investment Trusts (REITs). The TIMOs represent mainly institutional investors such as public and private pension funds, endowments, foundations and high-net-worth investors. Hedge funds and other private equity investors are getting into the game too. In certain regions of the country, privately held forest industry is acquiring timberlands too. Finally, non-profit investors such as The Nature Conservancy, local land trusts, and public agencies are increasingly part of the investor pool.

With the emergence of timberlands as a financial asset, many of the players seek to hold timberlands as part of a much larger portfolio – in some cases hundreds of billions of dollars. They often have no real experience or expertise in forest assets, and must rely on other entities to: (a) place their money in forest investments; (b) manage their forest assets; (c) provide independent analysis and advice regarding investment opportunities and forest assets already in place; and (d) assist them in exiting their forest investments.

There is plenty of literature and discussion around what factors have been driving the increased demand for forestland investments. Some experts believe there is on the order of \$50 billion in potential investment money (equity and debt) for this unique asset class around the world. Consulting foresters may not be used to thinking on this scale, but we have an increasingly significant role to play in the transfer of forest assets among investors. There are business opportunities for ACF members in each of the four areas noted above, from helping investors get in to helping them get out. Let's first review what they are.

PLACING THE INVESTOR'S MONEY

A high-net-worth investor calls, saying he doesn't know much about forest investments but would like to place some money "in this space." The investor wants to know if you can help him, so you tell him about your firm's services and experience. The first step is to ascertain whether you or your firm has any sort of conflict of interest that would preclude engaging the investor as a client.

Are you already representing another party that is or might be interested in the same property? If so, does it present a conflict? Maybe not at first, but as the assignment unfolds, potential conflicts may arise. For instance, let's say a certain property matches the investor's objectives. If you or your firm manages this property for the owner or have recently helped the owner prepare the property for sale, you probably

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will not be able to represent the investor in looking at this particular asset.

Some conflicts can be overcome; others are deal breakers and should be avoided. For instance, the consultant may have appraised the property for the seller, but if the seller is willing to share this work with your investor client, this may not be a problem. On the other hand, if your firm is managing the land for the seller, you probably cannot represent a potential buyer. Even though the seller might be inclined to release you to work for the investor, the line between your obligation to the seller and the investor is now very muddled.

The test of whether the conflict can be avoided goes not only to the issue of whether you can objectively represent both sides, but also to the *appearance* of conflict. How would this look to other investors or other stakeholders? How would it reflect on ACF? Admittedly, there are times when the line of conflict is broad and gray. When it's not clear to you whether a potential conflict is resolvable, apply the old proverb, "In abundance of counselors there is wisdom." Ask an ACF colleague for friendly guidance.

Once you and your client are satisfied that you can ethically represent them, you discuss the investment objectives and learn that the investor is more interested in long-term capital appreciation than in short-term liquidity, and that recreation is secondary to return on investment over a holding period of 15 years or longer. They prefer that the investment be in the \$5-\$10 million range and lie in the U.S. Northeast. Once they do a deal or two, they will consider expanding geographically. You explain that you are connected with the marketplace and can help them identify investments that meet their goals, and offer follow-up services as needed. You establish a client relationship and are off and running. You run a few opportunities by them and agree on a good candidate property; so, arrange with the broker to inspect the property with your client. You may follow the inspection with some check cruising, comparable sales analyses, mapping and GIS, forest modeling, and cash flow analysis to give them a reasonable idea what the market value of the asset is and what kind of net operating income they should expect.

You assist them in preparing a bid and are delighted when the investor makes an informed decision.

TIMOs commonly extract a fee for placing the investor's money in an asset. Is this ethical for the ACF member? Some would say no, arguing that you can't provide objective services if you have a vested interest in your client acquiring the property. Certainly it is unethical to provide appraisal services where the results of the analysis impact the financial well-being of the appraiser or appraiser's firm. At the very least, placement fees are potentially dark water for third-party consulting foresters. Some ACF firms act essentially as TIMOs for some clients, and in this case, so long as there is full disclosure, the conflict issues may be able to be resolved, at least insofar as there are good guidelines and communication around what services the consultant can and cannot ethically provide.

MANAGING THE FOREST ASSET

It is helpful to distinguish between managing the financial asset and managing the forest asset. TIMOs and REITs manage the financial asset as part of a larger portfolio of properties. As fiduciaries for investors, most of whom fall in the "passive" category; they are responsible for placing the investment, overseeing forest management and enhancing returns. They are managing the financial assets of their investors.

REITs normally are fully integrated in the sense that they perform both the high-level oversight and the on-ground management with their own staff. TIMOs vary in the level of integration. Some have in-house management teams with foresters on the ground and may subcontract some of the field forestry to local consultants. Other TIMOs are less integrated and depend on forestry consultants to provide more comprehensive forest management services. Opportunities for ACF members to offer forest management services apply mainly to the less integrated TIMO models, high-net-worth investors, and other investors with little or no management capabilities. There are instances where even the more integrated TIMOs and REITs need outside consulting services. For example, they may have a relatively small ownership in a certain geography, lacking the

critical mass to deploy a fully integrated in-house management team.

Some ACF firms involved in managing investment-grade forestlands may focus mainly on forest management, while others offer a broader suite of services including aerial photography, forest modeling, inventory, GIS and appraisal.

Again, the question of conflicts of interest arises in the context of forestland transactions. Consultants need to be very careful to avoid situations where their objectivity is threatened or can be legitimately called into question due to their involvement in management services. Consultants managing lands for the seller are normally recused from offering services to potential buyers of the same property. A consultant conducting due diligence for an investor may later be offered the opportunity to manage the land for that investor if that investor wins the bid, but both the investor and the consultant should be careful to disassociate the promise or prospect of future management services from the due

diligence work. Objectivity, impartiality, and credibility should be first and foremost considerations in any due diligence work performed by an ACF member.

ANALYSIS & ADVICE

During and following the due diligence process, the forestry consultant may provide any number of services:

- aerial photo interpretation
- GIS auditing
- inventory analysis
- forest growth and yield modeling; harvest scheduling
- economic forecasts
- cash flow modeling
- appraisal

The forestry consultant might help a non-profit investor negotiate the terms of a wood supply agreement with the seller; assess the potential for selling a conservation easement; evaluate the potential for carbon market returns; assess the potential for recreation or mineral income; or formulate alternative silvicultural regimes that meet the

combined needs of the investor, third-party certifiers and other stakeholders.

TIMO investors commonly require periodic (annual being most common) appraisal and re-appraisal of each forest investment asset. TIMO contracts with investors often provide for incentive payments to the TIMO when periodic appraisals exceed some stipulated benchmark against which returns from income and market value can be measured, or when the sale price of the asset exceeds an index value or appraised value by a certain amount.

Certified general appraisers specializing in forestlands provide independent third-party appraisals used to track asset performance for these and other purposes. For obvious reasons, these appraisals are subject to fairly intensive review by the TIMOs, their investors and accounting firms hired to audit financial performance. It is therefore absolutely critical for any hint of appraiser conflict of interest to be disclosed and resolved.

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One of the conundrums appraisers sometimes face is the reality that TIMO staffers whose firms stand to benefit from high appraisals are heavily involved in the appraisal review process. This is where ACF members have the opportunity to distinguish themselves through highly ethical behavior – by avoiding the trap of submitting to unwarranted client pressure. The more entwined the appraiser’s business is with the client’s business, the more difficult it is for either party to claim objectivity and independence in the appraisal process. Even firms that offer only appraisal services can become so dependent on a particular client’s business that their independence is compromised or subject to question. In these cases, ethical behavior may dictate referring the appraisal work to another firm. One of the benefits of ACF is the ability to refer work to colleagues who are not conflicted.

Other types of services are less apt to trigger conflicts of interest. For instance, the ACF member may act as an advocate

for the client by negotiating on behalf of the client – assessing the client’s bargaining position, reviewing analyses performed by other parties, and so on. But many (hopefully most) ACF members would agree that *integrity* and *credibility* are hallmarks of our organization that a member should never compromise. This means never offering unfair criticism of another’s work (regardless of whether the other person is an ACF member); avoiding misleading comments or analysis; and otherwise abiding by the ACF Code of Ethics.

HELPING CLIENTS EXIT THE INVESTMENT

During the process of analyzing forest investment opportunities, most financially oriented forest investors contemplate or project some holding period, at the end of which they will sell the property. Some investments are in closed-end funds that have a defined holding period; others are open-ended. Direct investments may, in some cases, have no

real time horizon attached to them, with the focus more on long-term capital appreciation or “opportunistic” sale during a seller’s market or when it is otherwise expedient to cash in.

The investor contemplating selling a forest asset may need a consulting forester to perform a pre-sale forest inventory; this often gives bidders more comfort with the acquisition process, expediting the sale and resulting in higher bids. The consultant may advise the seller to wait until timber markets are stronger, or to sell because the prices for forestland appear to be at their peak. Again, the ability of the consultant to provide objective guidance in these areas can be compromised by conflicts of interest. For instance, why would a forest manager encourage a client to place a property on the market? The prudent investor will recognize this potential conflict and hire independent, objective assistance in evaluating the sale opportunity.

Some ACF firms offer brokerage services. Many such firms are skilled



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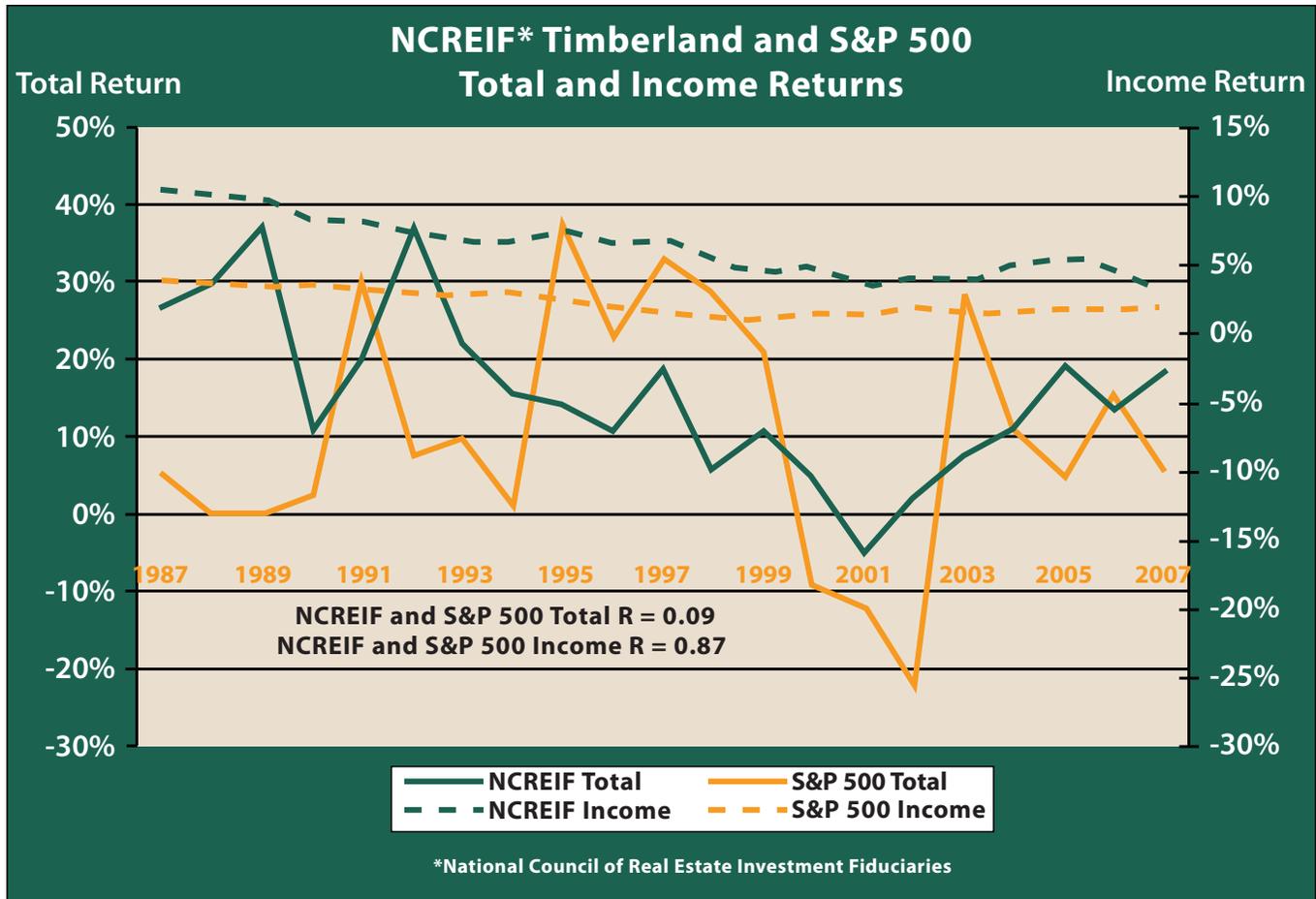
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at marketing smaller forest properties. A few firms offer high-quality brokerage services for large, investment-grade forestlands. For some of the more savvy forest owners, hiring an ACF firm to represent them as a broker is more satisfactory than paying an investment bank to do the same thing. The ACF firm will have more direct knowledge of the forest asset in play, and in many cases will be perfectly capable of exposing the property to the full suite of potential buyers.

Brokers, of course, are required to clarify which party they are representing, and unlike appraisers, they are expected to act as an advocate for their client. When acting as a sales agent, they are expected to secure the greatest price practical, and to exact a sale commission in return for their services. When consultants represent buyers in negotiations, they may act as advocates by seeking the lowest price practical. However, in neither case should the consultant/broker mislead anyone, misrepresent

anything, fabricate information, or distort the truth.

Brokers often must recuse themselves from other services, such as appraisal or other forms of due diligence where their objectivity could legitimately be called into question. My firm benefits from referrals by brokers who are representing sellers or buyers. This encourages us to return the favor with referrals for brokerage services. One of the great features of ACF as an organization is our diversity – our ability to meet a wide variety of client needs while adhering to the highest professional and ethical standards.

In cases where investment banks represent the seller of forest assets, some ACF firms still can play a role for the seller by offering “data room” services. But again, the consultant needs to avoid conflicts of interest if they are asked to represent potential buyers. Full disclosure and appropriate releases can, in some cases, clear the pathway for offering services, but the consultant needs to ensure that

no stakeholder has a legitimate concern over whom the consultant is representing or whether the services offered are compromised by other relationships.

CONCLUSION

Demand for forestland assets has never been stronger than in recent years. This greatest of renewable resources appeals to more and more potential investors every day. ACF, as the leader in forestry consulting services, will play a significant role in the success of forest investments going forward. The ability of ACF members to adapt to this marketplace and offer competent and ethical services will ensure that we continue to play a key role in forestland transactions and build respect among forest owners and investors. ©

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