Timberland Report
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Tip for New Investors

The last 12 months have seen a large amount of capital allocated to timberland investment from institutional investors new to the asset class, probably well in excess of $1 billion. (Two pension funds alone accounted for $700 million.) As these investors will have been told by timber investment management organizations (TIMOs) responding to their RFPs, timberland is a wonderful asset class that will do all kinds of terrific things for the potential investor's portfolio.

So you've decided to allocate a few hundred million dollars to timber. What is the most important factor in successful timberland investment?

RULE #1--BE PATIENT!!

The ***most important*** rule in timberland investment is ***be patient!!*** Your investment manager can do one of two things: invest your money ***now*** or invest your money ***well***. Only rarely will they be able to do both simultaneously. Look at it this way: your broker can sell your Enron stock ***now***, or they can sell it for $50.00[1]—they can't do both!

WHY PATIENCE IS IMPORTANT

Briefly: if you pay more than you should for a timberland property, you will get lower returns than you would otherwise have received. Impatience is a leading cause of paying more then necessary for timberland. If you fuss and whine at your TIMO, they will bid high to make sure they get a property for you.

Note that there is a difference between ***paying too much*** for a property and ***paying more than needed***. The former is fatal to the investment. The latter simply reduces your returns.

PAYING TOO MUCH

Paying too much means, for example, paying $20 million for a property that's only worth $10 million. There may come a time, 50 or 100 years in the future, when the property will be worth $20 million, but your returns will be *disappointing*. The first appraisal of the property will provide you with a $10 million loss.

[1]Some day, perhaps!

Haste is not *usually* a factor in paying too much. Paying too much is *usually* the result of a failure in some aspect of the due diligence process. (Haste might contribute to that failure.) The most common failure occurs in the estimation of the volume of timber on the property or the potential markets for that timber. This happens when the buyer relies too much on information provided by the seller, with inadequate verification.

There have been a few spectacular cases where the timber inventories relied on in formulating a bid have been badly wrong. Once or twice this has meant there is far more timber than the seller thought, so the purchase price was low relative to the subsequent appraisal. These properties have generated fantastic returns. Usually and unfortunately, however, the actual standing timber has been much less than assumed by the buyer. In these cases, the purchase price was too high, and subsequent appraisals resulted in a drop in value for the property. If you believe the supply of timber and timberland in the world is relatively fixed and the demand for wood will keep increasing along with global population, then you can expect that *eventually* you will be able to sell the property for more than you paid for it. But you will have to wait a long time.

PAYING MORE THAN NEEDED

Paying more than you need to means, for example, paying $10 million for that same $10 million property when the next highest bid was for $8 million (or even paying $9 million for the $10 million property when the next highest bid was for $6 million). You will still get the returns you want in this case, it's just that you could have gotten higher returns.

Haste is more often a factor in paying more than needed. If the buyer is anxious to purchase a property (*any* property!), they will bid high to make sure they get one. TIMOs tend to be patient, but pressure from a client can cause them to become anxious about buying that client a property.

WHY DOES IT TAKE TO SO LONG TO BUY A TIMBERLAND PROPERTY?

It may take months (or *years*) for your TIMO to find a property that fits your timber portfolio requirements. Under normal conditions it takes months to go from the announcement that a large timberland property is for sale to the closing of the sale. The due diligence process is complex and time consuming. Large properties may consist of dozens or hundreds of parcels, each with its own deed that must be researched. Conducting a timber inventory or confirming the seller's data may take weeks.

The timberland investment strategy you develop with your TIMO may result in additional delays in fully investing your funds, no matter what strategy you are following. Your TIMO may be buying properties for their other investors while your money sits and waits. Why does that happen?

Different TIMOs advocate different strategies. Three common strategies are:

1. Geographic Diversification
2. Age Class Diversification
3. Deal-Driven or "Best Deal"

None of these strategies is followed blindly, and they are often mixed to a certain extent.

A Geographic Diversification strategy you develop with your TIMO might, for example, call for 50-60% of your funds to be invested in the U.S. South, 20-30% in Northeastern or Appalachian hardwoods and 10-20% overseas. The first purchase may come relatively soon, because your choices are wide open. But the first acquisition might fill your Appalachian hardwood allocation. Murphy's Law says the next few good timberland deals will occur in the Appalachian region—great deals that you should not participate in because it would unbalance your portfolio[2]. Your money will sit and wait while great deals are being announced.

The Age Class Diversification strategy is based on the differences in returns expected from forests of different ages. Young forests provide little cash flow but high capital appreciation rates. They are also a little less liquid, which suggests you can buy them cheaper. Mature forests provide lots of cash flow, but relatively less capital appreciation. However, most timberland properties contain a mix of ages. If you need a forest with a predominance of young stands, you may have to wait. Or maybe you need a mature forest, but paper companies are selling off their premerchantable stands. Hundreds of millions of dollars will be pumped into the market while your money sits and waits.

The Deal-Driven strategy may require the most patience. Everyone, no matter what their strategy, is looking for good deals. Best Deals tend to be negotiated sales, because many bidders would tend to drive the purchase price up. Your TIMO must be well connected with the current timberland owner and it may take months of negotiation to clinch the deal.

The first property for your portfolio may be relatively quick to find: if there are no assets in your portfolio, your investment manager can buy the first property that fits the strategy. The problem becomes more difficult as your timberland portfolio is assembled—it may take quite a while to invest the last 25% or so.

But remember this, ***if you insist***, your TIMO ***can*** buy you a timberland property ***now!***

Timberland and Terrorism

I was in the middle of an appraisal on September 11, 2001. A few days later, I realized that I had known what the market was thinking on September 10, but I did not know what the market was thinking on September 12. So I spoke to some forest economists and portfolio managers at several TIMOs.

The general consensus was that terrorism would have little impact on timber. Forests are not high on the list of targets (although the Japanese tried to set the Pacific Northwest on fire with incendiary balloons in World War II). Paper and wood products are not generally shipped by air, so a disruption in air travel would have little impact on timberland.

[2] This is why you don't want to rigidly adhere to a fixed allocation percentage. Would you really want to pass up a terrific opportunity just because it would result in your portfolio being allocated 61% to the South instead of your target of 60%?

The most common concern was the "denominator effect": a further decline in stock prices would result in timberland making up too much of the portfolio. Would investors then sell timberland to rebalance their portfolios? Would they sell the asset that was holding its value in order to balance their portfolio? Would they wait for stocks to recover?

One timberland economist thought some investors *will* sell, which means the next couple of years would provide good opportunities to buy. Another thought current investors would not increase their timberland allocations (With stocks down, where would they get the funds for further investments in timberland?) A third thought there might be more interest in timberland because it is a more stable asset than stocks.

Other Notes

Sewall recently added Dr. Donald G. MacKay to its forest economics group. Don was formerly a portfolio analyst with the Hancock Timber Resource Group in Boston. Don has received the Chartered Financial Analyst designation and wrote his PhD dissertation on timber appraisal. He will contribute occasionally to future issues of the Timberland Report

NEXT ISSUE

You will notice this issue of the Timberland Report is a bit late. Our 2001 fourth quarter at Sewall was very busy with appraisals and work on the Canadian lumber duty issue. In addition to this heavy work load, our Appraiser/Analyst Rob Clifford was called to active duty with the Maine Army National Guard. Rob spent the last four months guarding the Owls Head airport on the Maine coast.

We hope to get Volume 3, Number 4 out to you in a few weeks. It will look at recent timberland returns. The 4th Quarter NCREIF Timberland Index was just released and it showed negative total returns for 2001 for all three regions. Is that cause for concern? Should investors panic?

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The *Timberland Report* looks at the timberland investment industry with an emphasis on the United States. The opinions expressed are those of the editor, who is solely responsible for its content, and may not reflect the opinions of James W. Sewall Company.

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