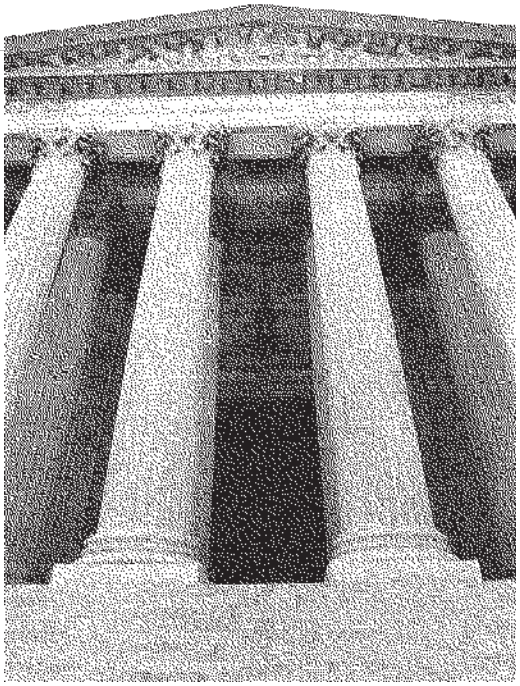

THE FORUM

Can Investment Vehicles Drive the Sustainability of America's Private Forests?

This debate arises from the fact that one of the biggest, and largely unknown, stories of the past decade has been the rapid liquidation of the land assets of the industrial pulp, paper, and aligned forest products industry. The land base has been sold off to investment holders. A total of 40 million acres have moved from large ownership blocks to more fragmented control.

There are two types of management that predominate. Timber Investment Management Organizations are for the most part investment vehicles for capital interests ranging from high net worth individuals, to Wall Street financiers, to pension funds, to universities. There are also a handful of Real Estate Investment Trusts that invest in forest resources. Forestry REITs sell shares to individuals who want to invest in timberland in the same manner as they invest in corporate equities.

TIMOs and REITs hold for essentially shorter term gains and aim to provide their investors with large returns — the fear is that they cannot do so by holding land for its intrinsic value as working forest, even with add-ons for recreation, tourism, and ecosystem benefits. This leads to the conclusion that the they will put all or significant portions of their land on the market again, this time clearly dividing it into parcels to sell off for development potential.

Is the trend to liquidation inevitable? Is it harmful to the environment? Can TIMOs and REITs manage their forest assets sustainably, contributing to society's well-being while benefiting their investors?

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Director
South Carolina Department of Natural resources

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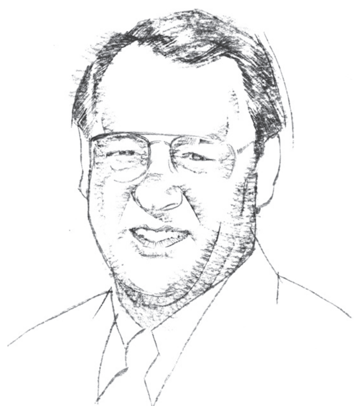

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Lawrence Selzer
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Sustainable Forest Management by TIMOs Is Unlikely

John E. Frampton

In the long run, TIMOs will have a negative impact on sustainable management of forests. Their ownership will do nothing more than continue to drive bare land values higher, attempt to inflate timber values, and further fragment forest land ownership. Opportunities for ecosystem management will be further reduced and absentee ownership will accelerate as lands are held and marketed for high profit and development.

Absentee ownership too often lacks a positive, dedicated land stewardship component. Does anyone really believe that the cumulative intellect of the forest products industry (made up of educated, professional forest managers) has been so off base that a group of investment wizards can come along and justify two-digit profit margins on the same lands?

The forest industry already had add-ons included in its management programs (hunting leases and other recreational leases). Attempting to elevate land and timber values and selling for development projects may be the only remaining opportunities — none of which are good for sustainable forest management or land conservation.

Timber product values are certainly not keeping up with inflation in today's market, and we are already seeing TIMOs divesting of their smaller tracts. Also, land transactions among the TIMO groups themselves are occurring so quickly that it is difficult to keep up with what tracts the separate TIMOs own. I suspect this is an indication or admission of their failure to meet investment objectives.

On the other hand, if there is a strong conservation ethic within the management of TIMOs (which I doubt exists because, to date, sales history does not support a visible conservation ethic), there could be some real benefit to their short-term ownership, both to sustainable forest management and to land conservation. For its ownership to be positive, a TIMO would need to make a concerted effort to sell the lands to an entity that could ensure the lands would be permanently protected. The TIMO could temporarily hold the land and allow nongovernmental organizations and government entities sufficient time to secure funding and enhance public interest in protecting the land such that fee-simple acquisition could occur. The lands could then be held in public trust or again be sold to a conservation-minded buyer or land trust with a non-developable conservation easement placed on the property.

Ownership either by a government entity, NGO, or private landowner with an easement would be a definite benefit to sustainable forest management, as forest products would continue to be provided into local markets. Also, fragmentation issues would be better addressed through future sales to government entities or NGOs.

Though maintaining lands in forested cover is an important component in any ecosystem management scheme, and fragmentation is one of the greatest concerns among natural resource managers, convincing investors that selling for conservation purposes is beneficial may be difficult because land decisions are driven by capitalizing on the returns for the investors.

The bottom line: if corporate forest managers could not justify to their headquarters the benefits of continued ownership of forest lands, with their very future often dependent on retention of forest lands, I doubt that the TIMOs will change the tide and, therefore, will contribute little to sustainable forest management.

John E. Frampton is Director of the South Carolina Department of Natural Resources.

The Economics of Keeping Forests Forested

Kent Gilges

The transition of industrial timberland ownership from vertically-integrated companies to TIMOs is largely completed. As of 2007, roughly 65 percent of industrial forests, or 36 million acres, was owned by TIMOs or REITs (Real Estate Investment Trusts, which are very similar to TIMOs for purposes of this discussion).

Industry sold its land base to TIMOs because of underlying economic drivers. First, ownership of timberland in a traditional "C" corporation is tax-inefficient because forest income is taxed once at the corporate level and a second time when distributed as dividends to investors. TIMOs are only subject to a single layer of taxation and can pass through some tax benefits to investors.

Second, timberland held for many decades is likely to be valued on the books at very low prices. A corporate sale of the timberlands allows companies to unlock hidden value in their balance sheets.

Lastly, changes to pension fund investment laws (ERISA) in the 1980s allowed a source of significant capital to invest in timberlands as a part of pension fund portfolios.

Although the term TIMO may conjure up an opaque, monolithic industry, behind the "I" is a diverse set of investors, which include public pension funds, university endowments, corporate pension funds, unions, and individuals. These disparate investors find in timberland an asset which provides them a long-term, stable investment in real estate that is relatively low-risk.

In terms of forest management, it is a critical part of our firm's strategy that we lower risk for our investors by managing to third-party certification standards and by seeking Forest Stewardship Council certification.

The longer-term implications of TIMO ownership on land use depend on the underlying economics of forests themselves. Forested lands will remain forested only as long as they are more valuable than some alternative land use. If they become more valuable as recreational land, or residential land, or land for biofuels, they will shift owners again.

Over the past ten years, we have seen a significant increase in the non-timber component of a forest's asset value. Timberland is selling now for 50 percent or more above historic timberland values, and the increase can only be attributed to the forest's speculative real estate value. TIMO buyers who acquire land with this "development premium" attached to it have little alternative but to pursue development options.

Our firm seeks to avoid this development imperative by partnering with conservation organizations who buy conservation easements and thereby strip out the speculative portion of the asset. This approach allows us to offer our investors something much closer to a "pure timber" investment, and it ensures the forests will remain forested in perpetuity.

TIMO and REIT ownerships represent some of the last unfragmented blocks of highly productive forest. To avoid the further conversion of these timberlands, conservation groups and public policy need to focus on approaches such as conservation easements that enhance the market value of forests as forests by purchasing and retiring the development value.

Otherwise we will all be fighting an economic tide that sweeps many forests away before it.

Kent Gilges is Managing Director of Conservation Forestry LLC.

Need to Expand Markets for Ecosystem Services

Jim Hubbard

Conservation is in trouble. One of its signature accomplishments was to halt the centuries-long decline of America's forest estate. For almost a hundred years, the amount of forestland in the United States has remained stable, but now the trend is reversing: More than 44 million acres of private forestland could see substantial increases in housing density by 2030.

The U.S. Forest Service is concerned about another trend as well, the restructuring of the American forest products industry. Vertically integrated companies have long owned and protected about 9 percent of the nation's forestland, some of the best timberland in America. They have also provided milling and other capacity needed to sustainably manage forests in all ownerships, private and public. But companies are increasingly divesting parts of their businesses, raising doubts about America's long-term capacity to sustain its forests.

Industrial restructuring is partly driven by the globalization of markets for wood. Of the softwood lumber used in the United States, about four boards in ten now come from other countries. It can be cheaper to produce lumber in Canada or even South Africa and export it to the United States than it is to produce lumber domestically. In response, American companies have taken such steps as restructuring, partly by transferring forestlands to Timber Investment Management Organizations and Real Estate Investment Trusts.

Although TIMOs and REITs might sell some land to developers under certain market conditions, they focus primarily on long-term timber management through forest-operating companies. In fact, their growing share of timberland ownership signals confidence in the long-term ability of America's forests to deliver a whole suite of lucrative products and services, including such ecosystem services as carbon sequestration, water purification, and diverse wildlife habitat. The question for conservationists is really this: What can we do to expand markets for those ecosystem services?

The time is ripe. Climate change and rising energy prices are attracting investments in conservation and green infrastructure as never before. Though still attracted to timber, investors are looking beyond to such emerging markets as carbon, endangered species, water quality, and bioenergy. These markets can strengthen the business case for protecting America's forests.

The federal government can play a role. We need a federal structure for establishing environmental markets and federal standards for ensuring their fairness and credibility. The U.S. Department of Agriculture has made a start; for example, the latest Farm Bill would create uniform standards for environmental credit trading. Forest Service scientists are also working with partners to demonstrate the value of water purification, carbon sequestration, and other ecosystem services and to find ways to quantify, measure, and monitor the value of these services.

Ultimately, the issue goes far beyond TIMOs and REITs. In an era of rising global competitiveness for wood, we can no longer afford to rely on timber markets alone to protect America's private forestlands for future generations. Markets for ecosystem services can help ensure that all private forest landowners, from commercial enterprises to family forests, have the means to sustainably manage America's forests.

Jim Hubbard is Deputy Chief, State and Private Forestry, U.S. Forest Service.

Mitigating Fundamental Investment Risk

Tom Johnson

In 1980, 15 percent of U.S. forests were owned by the forest products industry. Since then, much of this land has been acquired by institutional investors through TIMOs, who manage it to generate financial returns. Understanding the implications of this ownership shift requires a perspective on the complex regulatory and competitive factors that set these changes in motion as well as the motivations of TIMOs, their clients, and other non-industrial landowners.

While forest products companies historically owned forests to ensure continuous and reliable access to wood for their mills, over time, management and shareholders questioned the need for such control given the competing need for capital to upgrade manufacturing facilities in response to new environmental standards and increased global competition. Eventually, these factors combined to compel forest product companies to sell their timberland, which coincided with a growing interest in timberland as an asset class.

While it is widely recognized that TIMOs are fiduciaries obligated to manage investments to optimize financial performance for pensioners, charities, and university endowments, it is less understood that their clients do not view timberland as a high risk/high return investment. Institutional investors own timberland to capitalize on its capacity to produce income and appreciation and to provide inflation hedging and diversification benefits. These attributes are directly linked to TIMOs' capacity to cultivate and sell high quality timber. Therefore, managing clients' forests sustainably and responsibly is essential to mitigating fundamental investment risk.

Although TIMOs and other non-industrial landowners sell land to capitalize on public demand for conservation, recreation, and housing, that does not mean that every property acquired by a TIMO is on a fast track for conversion. TIMOs prefer to take a longer-term view — emphasizing realization of a full range of timber and non-timber values. This orientation has led TIMOs to help pioneer the use of working forest conservation easements and to make sensitive lands more accessible for purchase by government agencies and conservation groups. It also has led them to embrace management strategies that emphasize cultivating forests with broad species and age class diversity. Today, TIMOs are increasingly focused on meeting society's needs in the areas of climate change and energy dependency by promoting carbon sequestration strategies and by providing bio-fuel stocks to the nascent alternative energy sector.

Together, institutional investors (8 percent) and small, non-industrial landowners (60 percent) hold most of the private forestland in the United States and market forces will cause them to continue embracing options that minimize risk and maximize financial return. However, there are three practical strategies that could be employed to help address the public's concerns about future forest loss: Eliminating or reducing estate taxes that force families to liquidate their lands; providing property tax relief to landowners whose forests fall in "the path of progress"; and, enabling conservation groups to acquire working forests using tax-exempt revenue bonds. These strategies would have a profound impact on forest sustainability by providing landowners with economic incentives to hold property and by providing conservation groups with access to low-cost acquisition capital.

Tom Johnson is Managing Director of Timberland Investment Resources LLC.

A New Balance Will Need to Be Achieved

Roger Sedjo

From the late 1800s well into the latter part of the 20th century the expectation was for a future of timber scarcity. However, with the dramatic increases in forest growth and productivity brought on by the advent of planted and intensively managed forests, the expectation by the beginning of the 21st century was for a mature industry with little net expansion. Indeed, the policy decision to dramatically reduce timber harvests on the National Forests was feasible only because harvest declines on public forestlands could readily be offset by the increases in the productivity of private forests.

Associated with the changed perceptions have been massive changes in America's private forest ownership. The dominant force has been the divestiture of forestlands by previously integrated forest products firms. For example, International Paper, whose forest once exceed seven million acres, today has virtually no forestlands. The same is true for Georgia Pacific and several other large processing firms.

The area of timberlands held by the industry today is probably less that 20 percent of the land held in 1980. To a large extent these lands are now owned by Timber Investment Management Organizations, which own the lands for various investors such as pension funds, and by Real Estate Investment Trusts, whose role is real estate management. The proximal factor has been a system that taxed the timber of owner-processors at a higher rate than the new ownership institutions. The Congress is beginning to address this issue but it is surely too late to reverse the changes.

Other factors were also probably at work. In recent years the availability of timber has been plentiful, contrary to the expectations of the 1970s and 1980s, and future availability appeared more than adequate. As timber markets became more perfect, the rationale for controlling a mill's timber supply diminished and selling off timberlands provided capital for the processing firm.

However, the landscape is changing rapidly. With $4 gasoline, energy concerns are on the ascendancy. The limits of the use of grains like corn for bioenergy are becoming apparent by virtue of their physical limits and their contribution to rising food prices. Alternative biological sources are being sought. The future of transportation energy could be cellulosic biofuels with private forests providing the feed stock.

Currently, private forests provide a host of societal benefits including recreation, ecosystem services, and industrial wood. Some of us had believed that an acceptable balance was being achieved. However, in a world seeking to reduce its dependence on fossil fuels, a new source of demand for wood is arising. It appears the private forest could become a major source of energy and a new balance will be needed.

Roger Sedjo is a Senior Fellow and the Director of the forest economics and policy program at Resources for the Future in Washington, D.C.

Focus on How To Keep Forests as Forests

LAWRENCE SELZER

Until recently, managed or "working," forests were not recognized as conservation outcomes. In fact, until 1999, when The Conservation Fund completed the largest multi-state working forest conservation project in our nation's history, forest conservation meant only one thing — preservation. Today, working forests are not only acknowledged as a positive outcome, but in many cases as the ultimate conservation solution, protecting both the economics of forest industry-based communities and the many public interest values (habitat, clean air, clean water, recreation, scenic beauty) that forests represent.

What has changed? Three things. First, so much land came out of industrial ownership in such a short time that conservation interests were overwhelmed. Second, budget pressures on public agencies left them unprepared or unable to take on additional forest management responsibilities. Finally, there is an emerging consensus that economic and environmental objectives can be both compatible and complementary.

As a result, the stage is set for a host of new relationships aimed at achieving sustainably managed forests. Public agencies, nonprofit organizations and the new investor-owners (TIMOs and REITs) should explore all kinds of strategic alliances, joint ventures and even new forms of co-ownerships as they seek to balance economic return and environmental quality.

These new relationships, however, will not be easy. Environmental organizations must peel back their fear of — or contempt for — the marketplace, and the timber investor-owners must be prepared to work with conservation interests in more flexible and creative ways; nonprofits simply do not have access to the financing needed to address opportunities in the short time frames under which most timberland transactions take place today.

Historically, environmental and economic interests fought over how forests were managed, but, with the dramatic increase in the amount of acreage now under third party certification, we all should refocus our attention on the central question at hand — how to keep forests as forests? By focusing on this, we will not be distracted by questions about whether or not investor-owners are good or bad for the sustainable management of our forests. We will instead be focused on aligning our public and private policies and investments toward sustaining our nation's working forests — and bringing some urgency to the task.

Certainly, many investor-owners have shorter time horizons than did previous industrial owners, but we do have a window of opportunity to do the hard work of conserving our magnificent working forests that for 200 years have shaped us as a people and defined us as a nation. By fully integrating the free enterprise system and the environmental movement, we will minimize the phrase "asphalt, the last rotation" and maximize the amount of productive, intact forested landscapes that sustain us.

As the only environmental organization chartered for both conservation and economic development, The Conservation Fund has worked with many of the new investor-owners to protect more than 1 million acres of working forests. But as Will Rogers said, "Even if you're on the right track, you'll get run over if you just sit there." It's time we all got busy.

Lawrence Selzer is President and Chief Executive Officer of The Conservation Fund.