Notes on Institutional Timber

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Introduction

> "Thirty million acres of forestland have changed hands since 1996, says Michael Goergen, executive vice president of the Society of American Foresters. Another 12 to 15 million will transfer out of industry ownership in the next decade. That's over half the approximately 80 million acres timber companies nationwide owned during the 20th century. By 2015, analysts predict, they will have sold a forested area as large as New England...
> Transferring the ownership of this much forestland would have major implications under any circumstances, but under the current trend the implications are staggering. Financial institutions dominate the buyers: timberland investment management organizations (TIMOs), real estate investment trusts (REITs), limited liability and master limited partnerships. TIMOs alone have bought over a third of the 30 million acres of private industrial forests already sold, says Goergen. Another 5 million acres belong to various other financial institutions." (American Forests, Autum 2005)[1]
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> "A recent U.S. Forest Service study predicted that more than 44 million acres of private forest land, an area twice the size of Maine, will be sold over the next 25 years. The consulting firm U.S. Forest Capital estimates that half of all U.S. timberland has changed hands in the past decade." (Washington Post, March 24, 2006)[2]

The relocation of wood and paper manufacturing facilities, the transfer of timberland ownership and management to non-manufacturing institutions, and the conversion of timberland to other uses are complex phenomena influenced by many factors, including the cost of land ownership, the cost of building operating manufacturing facilities, the supply and demand for wood fiber, and evolving corporate structure and tax laws.

Tax benefits for traditional timber companies have included:

- routine disposition of timber is taxed as capital gain (which has lower tax than other income)
- gains from sales of timber can be offset by the maximum allowance for depletion
- sellers of timberlands have a low tax basis in their properties in relation to current values

But there are additional benefits to be had from certain corporate structures, including limited partnerships, limited liability companies, real estate investment trusts, and timberland investment management organizations.

Timberland acquisitions often come with strings attached. For example:

- After buying 538,000 acres in Arkansas and Louisiana, PC agreed to supply the seller, Riverwood International, with chips to make paper pulp for 20 years.
- Plum Creek bought timberland in Maine from Sappi, but agreed to supply Sappi's paper mill in Skowhegan for 40 years.
- Same in Michigan: Plum Creek bought 650,000 acres from NewPage Escanaba, but will supply Escanaba's paper mills.

Growth in the institutional investment in timberland:[3]

Year	$ billion
1985	69 million
1990	1.4
1996	4
1997	5.5
1998	6.5
2003	12
2005	15

Types of institutional ownership

There are several types of timberland investment management organizations (TIMOs)--"non-timber" instititutions that are increasingly turning to timberland as an investment without necessarily owning or operating wood and paper manufacturing. They include pension and investment funds owned by insurance companies or universities.

Below is a summary of the major types of institutional timberland ownership and some examples of the companies.

Real Estate Investment Trust (REIT)

REITs were created in 1960 as a way to sell shares in diversified real estate holdings. Today there are about 200 publicly-trade REITs, and 800 private REITs, in the US. Most REITs own residential real estate, office buildings, malls, industrial properties, resorts, nursing homes.

There are only a few timber companies that have converted to the REIT structure:

- Plum Creek (in 1999)
- Rayonier (in 2003)
- Potlatch (in 2006)
- Longview Fibre is apparently converting to an REIT (2006)

REITs are required by law to distribute at least 90 percent of their taxable income to their shareholders, so for real estate trusts that generate profit, that's a good deal for the shareholder.

For REITs, dividend distributions for tax purposes are allocated to (a) ordinary income, (b) capital gains and (c) return of capital, each of which may be taxed at a different rate. Capital gains taxes are less than corporate or individual income tax rate, so that's a good deal for the REIT shareholder too. Other advantages:

- Current, stable dividend income
- High dividend yields
- Dividend growth that has consistently exceeded the rate of consumer price inflation
- Liquidity: shares of publicly traded REITs are readily converted into cash because they are traded on the major stock exchanges
- Professional management: REIT managers are skilled, experienced real estate professionals
- Portfolio diversification, which reduces risk

Traditional timber tax benefits:

- routine disposition of timber is taxed as capital gain (which has lower tax than other income)
- gains from sales of timber can be offset by the maximum allowance for depletion
- sellers of timberlands have a low tax basis in their properties in relation to current values

Benefits of timber REITs:

- corporate income taxes are passed on to the shareholders
- 90 percent of reported earnings are paid out in dividends
- taxable investors receive the benefit of taxation at capital gains rates
- gains to tax-exempt investors are not treated as unrelated business taxable income
- property, manufacturing, and other subsidiaries of the company perform services for each other; their expenses are treated as reimbursements and not income

The IRS has ruled that an REIT's timber interests

> "will be treated as real property and reimbursements it receives from other subsidiaries will not be treated as gross income.
> "A publicly traded limited partnership with timber interests, citing potential economic benefits, plans to convert to a REIT. Following the conversion, a new corporation (the REIT) will hold the timber interests through entities disregarded for federal tax purposes. The REIT will dispose of timber held for more than one year under contracts in which it will retain an economic interest in the standing timber, consistent with the requirements of section 631(b). The REIT and its subsidiaries will perform services that benefit each other, and a reimbursement plan has been devised in which the entities will reimburse each other for shared expenses. The REIT will not report the reimbursements as income nor claim a deduction for expenses incurred on behalf of there subsidiaries.
> "Under a longstanding principle of law, the Service said, standing timber is treated as real property and is therefore considered real estate assets for purposes of applying section 856(c)(5)(B) and 856(c) (4)(A). The Service also said, citing Rev. Rul. 84-138, 1984-2 C.B. 123, which addressed an analogous situation, that the reimbursement of expenses was tantamount to the repayment of a loan. Thus the reimbursement to the REIT is not gross income. It also noted that that difference between the proceeds that the REIT received from the timber sales and the adjusted basis of the disposed timber is considered gain from the sale of real property under sections 856(c)(2)(D) and 856(c)(3)(C)."[4]
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> "[T]imber is a tax-favored asset (because routine disposition of timber is taxed as capital gain), and that, in most cases, sellers of timberlands have a very low tax basis in their properties in relation to current values. As a part of our work in representing buyers and sellers of timber properties, we have found creative solutions to assure that gains from dispositions of timber will be offset by the maximum allowance for depletion, that taxable investors will receive the benefit of taxation at capital gains rates, and that gains to tax-exempt investors will not be treated as unrelated business taxable income. We have also worked with sellers of timber properties to devise methods to defer recognition of capital gain. Frequently, these assignments are undertaken in a situation where the forest products company that will use the timber resource in its conversion facilities wants to be certain that the asset will not be reflected on its balance sheet."[5]

[T]he precedent-setting case of RLC Industries Co. v. Commissioner... established, for the first time, the substantial latitude timber owners have in establishing blocks for depletion in order to derive the greatest tax benefit. In RLC, the company used that latitude to combine newly-purchased, high-cost timber into a single pool with long-held, low-cost timber that it was preparing to harvest. The averaging which is inherent in the single pool approach substantially raised the depletion rate on the lower cost timber. In other instances, the acquirer of a timber property may find it advantageous to subdivide the property into multiple blocks, in order to enhance the depletion allowance on early harvests."[6]

"We have pioneered the use of a variety of timber cutting agreements, some extending for as long as three rotations (a total of 79 years), to provide continued capital gain treatment to the timber owner, with assured access (but off-balance sheet treatment) to the forest products company buyer. We have devised other cutting agreements that can provide either immediate cash to the timber owner or an assured cash flow over a period of years, with the contract still being treated as a disposition of timber with a retained economic interest in the hands of the timber owner, thereby avoiding the "dealer" issue and producing capital gain."[7]

Since the early 1980s, there have been "a series of private letter rulings from the Internal Revenue Service which recognize that dispositions of timber by an exempt organization (or by a partnership composed of exempt organizations) pursuant to a cutting agreement in which the timber owner has a retained economic interest, does not produce unrelated business taxable income to the selling exempt organization."[8]
Timber taxation controversies include
* valuation of timber for purposes of section 631(a)
* valuation of timberland for purposes of gift tax and for charitable contributions
* qualification of timber cutting contracts under section 631(b)
* depletion issues, including the proper composition of a timber "block"
* allocation of basis of purchased land and timber
* like-kind exchange issues
* losses of mature timber from pine beetle and other natural causes
* losses of timber seedlings from drought[9]

Limited Liability Company (LLC)

- Forestland Group LLC (1.8 million acres in 16 states)
- New Growth Forestry LLC
- Knight-Celotex LLC
- West Fork Timber Company LLC
- Smart Papers LLC
- FiberCorr Mills LLC
- Plum Creek Southern Timber LLC
- Essex Timber Company LLC
- GMO Renewable Resources LLC
- Soterra LLC subsidiary of Greif Inc

For profiles see TIMO section above.

Limited Partnership (LP)

LPs pay no corporate income tax

- International Paper created IP Timberlands Ltd in 1984-85; executives milked the profits, then IP bought back the stock in 1998[10]
- Global Forest Partners LP
- Grays Harbor Paper LP
- Crown Pacific was an LP; it went bankrupt and gave 525,000 acres to Cascade Timberlands (its lenders) in 2003-2004
- TimberWest owns land on Vancouver Island in British Columbia; its payouts are exempt from the normal withholding on Canadian dividends

Directory of TIMOs

Campbell Group, Portland OR. The Campbell Group owns Hawthorne Timber, and is in turn owned by the giant investment firm United Asset Management. In late 1999, Campbell Group held $1.3 billion of the $6.5 billion total TIMO investments. Click here for a profileof the Campbell Group.

Forest Capital Partners. Boston. Acquired 250,000 acres of timber holdings in the Idaho Panhandle after Crown Pacific filed for bankruptcy. In 2005 it bought 2.2 million acres from Boise Cascade for $1.6 billion.

Forest Investment Associates, Atlanta GA. In 1997, FAI bought the management rights to 175,000 acres in Pennsylvania and New York from International Paper for $200 million.

Forestland Group LLC. Chapel Hill, North Carolina. Formed in 1995. In 1999 acquired 115,000 acres in Adirondack Park, New York and placed them under a conservation easement. In 2001 acquired 78,110 acres in Upper Michigan from Mead, and 91,117 acres from Ned Lake Timber & Land Company. In 2002 bought 389,202 acres of timberland and timber cutting rights in Upper Michigan from the Kamehameha Schools trust. In 2002 bought 95,000 acres in West Virginia from MeadWestvaco for the Heartwood Forestland Fund IV. In 2004 bought 137,500 acres in southern Virginia from The Brink's Company. By 2006 owned 1.8 million acres in Michigan, New York, Pennsylvania, West Virginia, Tennessee, Virginia, Kentucky, North Carolina, Texas, Missouri, Maryland, Delaware, Vermont, New Hampshire, Arkansas, and Maine. Claims be the first TIMO to have its entire portfolio FSC-certified, in 2005.[11]

GATX.

Global Forest Partners LP. Formed in 2003 by a management buyout of UBS Timber Investors. By 2006 GFP managed a $1.5 billion portfolio of closed-end commingled timberfunds and separate accounts on behalf of institutional and other investors in the US, Argentina, Australia, Brazil, Chile, New Zealand, and Uruguay.

GMO Renewable Resources LLC. The timberlands investment division of GMO LLC. In 2005 GMO bought 1.1 million acres in Maine and New Hampshire from International Paper for $250 million. GMO agreed to supply wood fiber to the IP paper mills in Jay and Bucksport Maine, and

IP agreed to provide forest management services, including Sustainable Forestry Initiative (SFI) certification.[12]

Grantham Mayo.

Harvard University. At one time Harvard had 10% of its endowment portfolio of $26 billion assigned to timber, and was the second largest owner of timberland in New Zealand.[13] In 2005 it sold most of its U.S. timberland, worth $1.6 billion, to Hancock Timber Resource Group.[14]

Hancock Timber Resource Group. Unit of John Hancock Financial Services Inc. By 1996 had 2M+ acres worth $2B. Holdings include 500,000 acres in the Northeast US (including 67,000 acres acquired in the Adirondacks in 1996; and 115,000 acres acquired from JM Huber in 1997) 95,000 acres in Alabama and Mississippi, acquired from James River for $110 million in 1997; 104,000 acres in western Oregon, acquired from Willamette Industries for $350 million in 1996.[15] Acquired $1.6 billion in timberland from Harvard University in 2005.[16]

Massachusetts state pension fund. Bought timberland in 2005.

Molpus Woodlands Group and Molpus Timberlands Management LLC. Jackson, Mississippi. Molpus is the successor to the Woodlands Resource Management Group. Molpus holds 1,154,000 acres in Texas, Alabama, Tennessee and Mississippi. In 2005 Molpus bought 165,000 acres of timber rights eastern Alabama for $87,750,000 from TC & I Timber Company LLC (owned by United States Steel Corporation Plan for Employee Pension Benefits).

Prudential Timber Investments.

Resource Management Service LLC. Birmingham, Alabama. Founded in 1950 to acquire and manage forest investments in the US South on behalf of private clients and institutional investors. In 2002 and Virginia Forest Investments LLC bought 197,000 acres of timberland in central Georgia from Weyerhaeuser timberland on behalf of institutional investors, including Birmingham-based AmSouth Bank. In 2006 Resource Management Service bought 3.8 million acres in southern states and 440,000 acres in Michigan from International Paper for $5 billion.[17]

Robert Wood Johnson Foundation. Bought timberland in 2005.

Southern Timber Ventures LLC. In 2000, Packaging Corporation of America sold 385,000 acres of timberland to Southern Timber Ventures LLC while retaining one-third ownership of the partnership. The sale involved $250 million in cash for debt reduction, a long-term fiber supply agreement for PCA's Counce Tennesee mill, and a portion of the potential long term appreciation of the timberland assets.[18]

Strategic Timber Trust. Bought 60,000 acres in Mendocino California in 1998.

TC & I Timber Company LLC is owned by United States Steel Corporation Plan for Employee Pension Benefits. In 2005 it sold 165,000 acres of timber rights Alabama to Molpus.

Timberland Investment Services.

TimberSTAR. Atlanta, Georgia. Founded by iSTAR Financial Inc. In 2006 bought 900,000 acres in Louisiana, Texas and Arkansas from International Paper for $1.1 billion.[19]

Timbervest LLC. Manages 500,000 acres of timberland across the US with market value of $700 million.

UBS Resource Investments.

US Timberlands. Bought 600,000 cutover acres of Weyerhaeuser lands in southwest Oregon, and Boise Cascade's lands in Yakima Indian territory in Washington State..

Wachovia Timberland Investment Management.

Wagner Forest Management Ltd / Lyme Timber Co., a New Hampshire-based TIMO, bought 656,000 acres in Maine from Bowater. In November 1998, Bowater Inc. announced it was selling 656,000 acres in western Maine for $155 million to McDonald Investment Company Inc. of Birmingham, Ala. Wagner Forest Mgmt will manage the lands for McDonald. Hank Swan, chairman of Wagner, is a board member of The Nature Conservancy's New Hampshire chapter.

Woodlands Resource Management Group. See Molpus.

Timber companies with major real estate operations

Weyerhaeuser

- has sold real estate since the 1960s, mostly single-family housing, but also business parks.
- Weyerhaeuser has real estate subsidiaries in CA, MD, NV, OR, TX, VA, AND WA, and has real estate investment offices in AZ, CO, AND IL.
- In recent years Weyerhaeuser has sold $2-3B of real estate and it has accounted for 11-13% of total revenue and 29-88% of total income.[20]

	REVENUE			INCOME		
	Total	**Real estate**		**Total**	**Real estate**	
2003	19,249	2,029	11%	277	245	88%
2004	21,931	2,495	11%	1,283	376	29%
2005	22,629	2,915	13%	733	458	62%

Source: Weyerhaeuser 2005 SEC Form 10K

Plum Creek

- In 2004 Plum Creek sold 375,000 acres of land for $303 million. In 2005 Plum Creek sold 232,000 acres for $292 million. In those years real estate accounted for about 20% of Plum Creek's revenue and 30% of its profit.
- Plum Creek has real estate developments in Montana, Maine, Florida, Georgia, and Michigan

Year	Total land sales	Real estate sales	Timberland sales
2002	$98M		

2003	$241M		
2004	$303M	$174M (57%)	$129M (43%)
2005	$292M	$261M (86%)	$31M (14%)

Real estate as a percentage of Plum Creek's sales and profit:[21]

	REVENUE			INCOME		
	Total	Real estate		Total	Real estate	
2003	$1,196M		%	$303M	$47M	16%
2004	$1,528M	$303M	19%	$477M	$152M	32%
2005	$1,576M	$292M	19%	$448M	$140M	31%

Pope & Talbot

- spun off a real estate company called Pope Resources. In the late 1990s Pope made almost as much money in real estate as in timber; now they're back to making most of their money in timber is a small spinoff (Pope & Talbot revenues were $641 million; Pope Resources revenues were $30 million).

Potlatch

- rejected the switch to REIT in 1999, and then did convert in January 2006
- real estate and timberlands sales in OR, ID, MN, AR[22]
- real estate accounts for 2% of total revenue, but up to 3/4 of total income

Year	Real Estate Sales (% of total sales)	Real Estate Income (% of total income)
2003	$26M (2%)	$25M (49%)
2004	$23M (2%)	$21M (8%)
2005	$26M (2%)	$24M (73%)

Source: Potlatch 2005 SEC Form 10K.

International Paper

- has sold land for recreation/development in AR, AL, MS, FL, SC, GA, VA[23]
- in 2006 sold most of its timberland to the management companies Resource Management Service and TimberSTAR; 5 million acres for $6 billion

Rayonier

- Plum Creek and Rayonier are the only two timber REITs
- Rayonier is selling property along Interstate 95 between Georgia and Florida[24]
- Real estate accounted for 7% of revenues but 35% of income in 2005.
- TerraPointe real estate subsidiary created in 2005

Year	Acres Sold[25]	Real Estate Sales (% of total sales)	Real Estate Income (% of total income)
2003	40,595	$106M (10%)	$87M (82%)
2004	35,906	$96M (8%)	$75M (43%)
2005	30,026	$86M (7%)	$64M (35%)

Source: Rayonier 2005 SEC Form 10K.

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