The ownership of U.S. industrial forestlands has dramatically changed since the 1980s. Whereas forest product companies had been the dominant owner of such lands and sent that timber to their mills, now the lands are owned by investment management organizations and trusts that manage the land to maximize returns. Some of these organizations, however, are delivering returns and helping to conserve the land.

TRENDS IN FORESTLAND

OWNERSHIP AND CONSERVATION

The United States has seen a major shift in industrial forestland ownership in the last twenty-five years, due to the breakup of forest product companies and the ensuing divestiture of their lands to other types of private buyers. Until the 1980s, publicly traded, vertically integrated forest product companies owned and managed not only large tracts of working forests but also the nearby facilities that processed the trees coming off those tracts. The forests were viewed as essential sources of fiber for their mills. However, beginning in the late 1980s, various pressures catalyzed divestures of timberland, and the publicly traded forest product companies narrowed their focus, concentrating on the production and distribution aspects of the business.

New kinds of owners, called timber investment management organizations (TIMOs), evolved from these substantial timberland sales. TIMOs manage timberland investments for private institutional investors and high-net-worth individual investors through separate accounts or private comingled funds, as well as public timber real estate investment trusts, known as REITs, a publicly traded version of TIMOs. The primary goal of TIMOs and REITs is to maximize returns to their investors through management of timberland assets.

The scope and speed of this change in ownership is impressive. In 1981, all fifteen of the largest forestland owners in the United States were traditional forest product companies. By 2004 only six of these fifteen were traditional forest product companies; of the remaining nine, seven were TIMOs and two were REITs. In 2010, only one of the top fifteen U.S. forestland owners was a traditional owner, while ten were TIMOs and four were REITs.[1] In addition, since 1995, more than half of the nation's 68 million acres of private industrial timberland has changed hands, most within the period from 2000 to 2005.[2]

What caused this vast change in ownership? Five major reasons underlay the shift. First, owning forests was no longer a strategic necessity for traditional forest product companies. Previously, the volume of trees cut from the property was being driven by the mill's demand instead of the market. These companies realized that they could make a larger profit by focusing on one part of the business, such as manufacturing, instead of spreading their efforts across multiple lines of business. They also found that in some cases they could find cheaper fiber from forestland owners other than themselves.

Second, in the 1980s Sir James Goldsmith discovered that he could make a quick profit by taking over companies using short-term debt to capitalize his purchases. He would then break the companies into their component parts and sell them off to the

BY PETER R. STEIN

SEAN ROSS, LYME TIMBER COMPANY

A deal involving one of the nation's oldest conservation groups and two relatively new ones, the state of New Hampshire, and a TIMO made the preservation of areas like this in the Connecticut Lakes area in northern New Hampshire possible.

highest bidder. He is famous for purchasing companies like Crown Zellerbach and Diamond International, both traditional forest product companies that no longer exist. As part of this strategy, he sold the forest ownerships in various packages to TIMOs and REITs and then sold the processing facilities to other paper companies. Anticipating his attacks, many forest product companies preemptively sold off their fee-owned timberland themselves, usually with some long-term wood-supply agreements with the new owners. This greatly reduced the attractiveness of leveraged buyouts like those engineered by Goldsmith.

Third, changes to generally accepted accounting principles (GAAP) in the United States established mandatory reporting methods for all publically traded companies. In essence, the revised GAAP stated that from an accounting standpoint trees neither appreciate nor depreciate. In other words, for the publicly traded forest product companies, the value on the books of the trees at purchase was the same as the value on the books of the trees when harvested after ten years of growth. Any gain that came from the growth of trees was added to the balance sheet but not as forest appreciation. These new rules resulted in an undervaluation of timberland assets and thus lowered reported returns to investors. TIMOs, as privately owned entities, were exempt from this reporting requirement.

Fourth, returns on timberland for traditional forest product companies were taxed twice: once at the company level and again at the investor level. For TIMOs, which are often structured as limited liability companies or limited partnerships, taxes are passed through to their investors, who only have to pay taxes once, typically at the capital gains rate. This incentivized many taxable entities to invest in timberland through TIMOs.

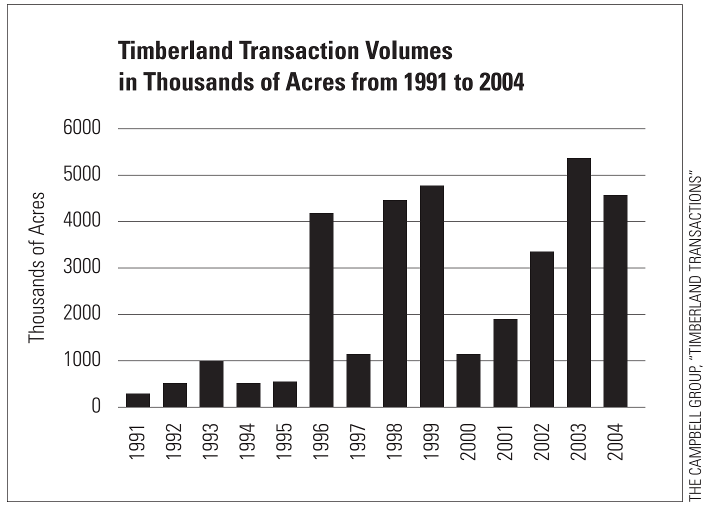
Finally, timberland was "discovered" by institutional investors who were attracted to the fundamental characteristics of the asset. Timber, compared to the traditional asset classes of equity and fixed income such as stocks and bonds, is a relatively low-risk investment because it correlates negatively with other markets and provides reduced volatility and superior risk-adjusted returns. It also allows for investors to diversify their overall portfolios and invest in alternative real assets. Ultimately, timber is an inflation hedge because trees continue to grow in size regardless of the state of the economy and therefore timber serves as a mechanism to preserve capital within a portfolio.

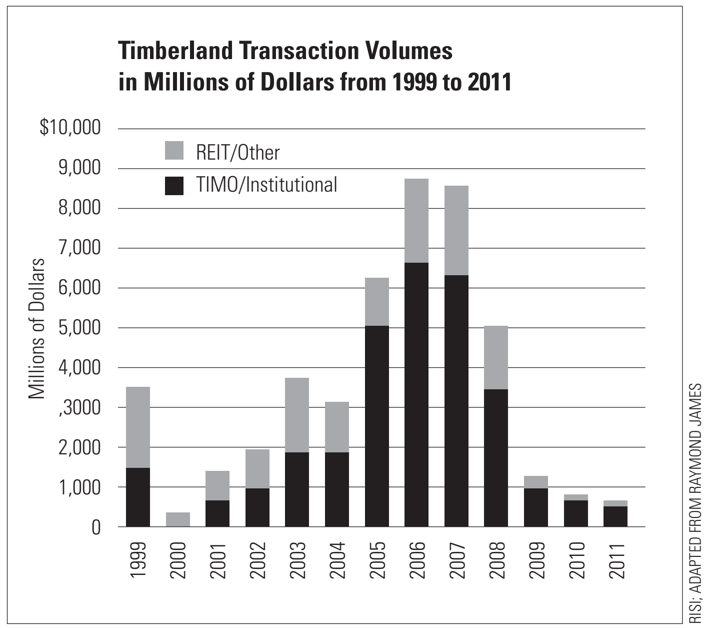
THE RISE OF THE TIMO

Given the flood of institutional money and the interest of high net worth investors in timberland in the 1990s and 2000s and the divestiture by the traditional forest product companies, TIMOs and REITs now own a significant amount of private forestland in the United States. The number of TIMOs in existence has also grown dramatically. In 1990 only two or three TIMOs existed, nationwide, while today more than 25 TIMOs buy, own, manage, and sell timberland. As of the end of 2010, TIMOs managed more than $44 billion in private capital for both domestic and international timberland. Of this capital, about 43 percent of the commitments were from public pension funds. Foundations and endowments made up the next largest portion, at 19 percent. High net worth individuals and families contributed 7 percent of this capital. All told, TIMOs own and manage more than 23 million acres nationwide, with a market value of $29 billion in the middle of 2011.[3]

TIMOs, unlike traditional forest owners, have comingled fund terms usually in the ten- to fifteen-year range, which means large timber tracts are traded at a higher frequency today than under traditional ownership. This has resulted in a much more active timber market in recent years. However, timber transactions have quieted since the 2008 economic downturn. The figures to the right, showing the volume of transactions made over the last two decades, illustrate how transaction frequency began to increase around 1996, peaked during 2006–2007, and have since been very low.

The implications of TIMO ownerships for timberlands are profound. Due to the short fund duration, TIMOs have a strong financial incentive to sell their lands for the highest price at the end of the term so they can realize a favorable return for investors at the end of this relatively short ownership frame. This often results in selling portions of the holding for "highest and best use" purposes (i.e., development), which can lead to fragmentation of the larger forest landscape. This growing trend has been disturbing to conservationists and forest workers who aim to keep forests as forests.





WFCES AND THE ROLE OF TIMOS

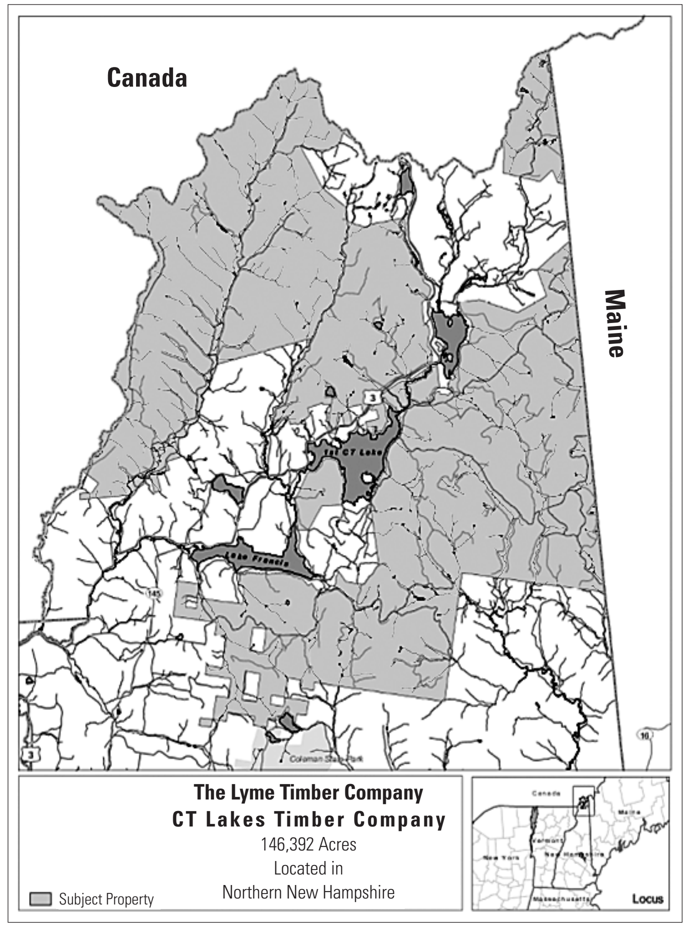
The working forest conservation easement (WFCE) is a tool used by a handful of TIMOs that allows them to earn a competitive return on timberland investments while preventing forest parcelization. WFCEs are conservation easements that apply to forestlands actively managed for the goods and services associated with the land, such as timber resources, recreational opportunities, and ecosystem services including carbon sequestration. In other words, when a TIMO or another buyer purchases a tract of timberland, it acquires a "bundle of rights" that includes recreational rights, water rights, mineral rights, timber rights, development rights, and many more. The owner can choose to retain these rights by owning the land and all its associated rights or else choose to transfer or tie up any number of these rights in the form of a WFCE. For example, an owner can choose to retain timber harvesting rights but capture the development rights in a WFCE, which means that the owner forgoes the opportunity to subdivide or develop the property in the future but can continue managing the timber resource sustainably. In doing so, the landowner can then be compensated for what it is giving up while retaining ownership of the land and the right to sustainably harvest timber.

WFCEs can be donated or sold. If they are donated, the owner will receive significant income tax and estate tax benefits. For TIMOs with extensive investments by tax-exempt institutions, selling WFCEs is the sole avenue for securing adequate compensation. The Lyme Timber Company and a handful of other TIMOs have succeeded in doing just this, thereby receiving a return of capital on a portion of an investment early on in its life, while still enjoying the benefits of a pure timberland investment, albeit with some harvesting restrictions and often the requirement to get certified as a sustainable timber manager. WFCEs are often bought by interested parties—conservation nongovernmental organizations (NGOs), land trusts, or state and federal natural resource agencies—through a combination of public money (federal and state) and philanthropy. Common public sources used to purchase these WFCEs are the Forest Legacy Program and state appropriations and bond acts, which in a sense are similar to Weeks Act funding that was used a century ago to establish national forests in the East.

This investment strategy has become a model of public-private partnerships that are achieving land conservation at the landscape scale. Thus conservation easements are now a preferred tool for conservation groups; according to a 2010 study by The Nature Conservancy, organizations are looking to stretch their dollars by purchasing development rights through easements instead of buying land outright. Frequently conservation groups are finding that through easement purchases they can accomplish their conservation objectives and be involved in more deals. According to The Nature Conservancy, while easements were rarely used before 1976, in 2003 they accounted for 70 percent of the land protected by the organization but only accounted for 50 percent of the money spent on land protection that year.[4]

Among TIMOs the Lyme Timber Company pioneered this strategy of partnering with conservation NGOs and state agencies that have an interest in conserving certain forestland areas. In many cases, Lyme is chosen as a partner for conservation interests because it can bring private capital to a deal up front and hold the land while its conservation partners assemble public and private money to purchase the easement on it; it is also willing to manage timber according to the terms of the WFCE. This usually means that Lyme obtains Forest Stewardship Council certification for each property it owns and manages. In doing so, it is able to maintain a steady cash flow, realize a return on its investment from the easement sale, and eventually sell the easement-encumbered land for a reduced price to another investment entity such as a TIMO or public timber REIT.

Lyme did just this in a deal in northern New Hampshire that resulted in the conservation of the Connecticut Lakes Headwaters Forest. This was a high-profile conservation deal, where Lyme partnered with the state of New Hampshire and conservation NGOs to achieve a strong financial return for its investors and a successful conservation outcome for the public.



THE LYME TIMBER COMPANY

CASE STUDY: THE CONNECTICUT LAKES

International Paper (IP), a large traditional forest product company and forestland owner, at one time owned more than 11 million of acres of forestland in the United States, along with numerous saw, pulp, and paper mills. Along with other vertically integrated forest product companies, it began selling off large portions of its forest holdings in the 1990s. One such forest holding that came on the market was located at the northern tip of New Hampshire, surrounding the Connecticut Lakes, the headwater lakes to the Connecticut River.

This 171,000-acre forest makes up nearly 4 percent of the entire land area in New Hampshire and was critical to the rural forest-based economy in the North Country. As the primary watershed of the Connecticut River, it is also of critical importance for water quality all the way down its course through New England. Located north of the White Mountain National Forest, it could have been a target for Weeks Act funding in the beginning of the twentieth century. At that time the timber resources on the property were aggressively harvested and thus the forest was emblematic of the cut-over landscapes that advocates of the Weeks Act were using to make a case for its passage. However, instead of becoming a national forest, it remained in private ownership and came up for sale almost one hundred years later.

In 2001, the state of New Hampshire, responding to concerns about this property being sold for purposes other than a working forest, assembled a team of conservation groups to negotiate with IP. However, neither the conservation organizations nor the state had enough money to purchase the property. So the partners, including the state, the Trust for Public Land, the Society for the Protection of New Hampshire Forests, and The Nature Conservancy, turned to the Lyme Timber Company, which could provide the much-needed up-front capital for a future conservation transaction.

The deal closed in 2003. Lyme purchased 146,000 acres concurrently with the sale to the state of New Hampshire of a comprehensive working-forest conservation easement over the same tract. At the same time, The Nature Conservancy purchased the remaining 25,000 acres of former IP land to establish a wildlife management area, which it later transferred to the state, with The Nature Conservancy retaining a conservation easement.

Overall, this successful conservation deal would not have been possible without a number of converging factors, including the following: 1) large tracts of high-priority conservation land coming up for sale by a divesting paper company; 2) Lyme Timber supplying private capital for the deal; 3) many partners, including public-sector, nonprofit, and for-profit groups, bringing different strengths to the endeavor; and 4) working-forest conservation easements making the deal affordable and successful in the view of local economic development interests as well as state natural resource agencies. As a result, a TIMO—an economic tool so instrumental in transforming land ownership patterns over the last two decades and so worrisome to conservationists—ultimately enabled conservationists to retain a critical tract of forestland, intact and in perpetuity. □

Peter R. Stein is managing director of the Lyme Timber Company. *Many thanks to Sarah Mahlab at the Lyme Timber Company for her work in helping prepare this article.*

NOTES

1. Statistics are based on company filings, company websites, and *Timberland Markets Report*.
2. Jane Braxton Little, "Timberlands Up for Grabs," *High Country News*, January 23, 2006.
3. TimberLink, LLC. "Timberland Assets under Management as of 30 June 2011. Survey of 23 timberland investment managers."
4. Ethan Smith, "Landlocked," *Nature Conservancy* (60) 1 (Spring 2010): 12.