Ownership of U.S. industrial forestlands has dramatically changed since the 1980s. Whereas forest products companies had been the dominant owners 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.

CHAPTER 12

New Partnerships for Conservation: Trends in Forestland Ownership and Conservation

Peter R. Stein and Marc Hiller

When House Speaker Joseph Cannon appointed Representative John Weeks to the Agriculture Committee in 1908, he did so because he wanted a businessman who understood the need for fiscal responsibility when drafting legislation that would require federal spending on forestlands. Cannon did not favor spending money on scenery, as he put it, but he must have recognized the futility of fighting the rising tide of conservation, and the good that protecting natural resources could do for the country. Ultimately, the law that bore the New Hampshire native's name provided a model for timberland investment: spending money to conserve land for the many could reap greater long-term benefits than letting a few develop it for short-term profit. What neither man could have anticipated is that the spirit of the law would be alive and well a century later, let alone how it would affect Weeks's home state.

The United States has seen a major shift in industrial forestland ownership in the past thirty-five years, due to the breakup of forest products companies and the ensuing divestiture of their lands to other types of private buyers. Until the 1980s, publicly traded, vertically integrated forest products 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 the sources of fiber for their mills. Beginning in the late 1980s, however, various pressures catalyzed divestures of timberland, and the publicly traded forest

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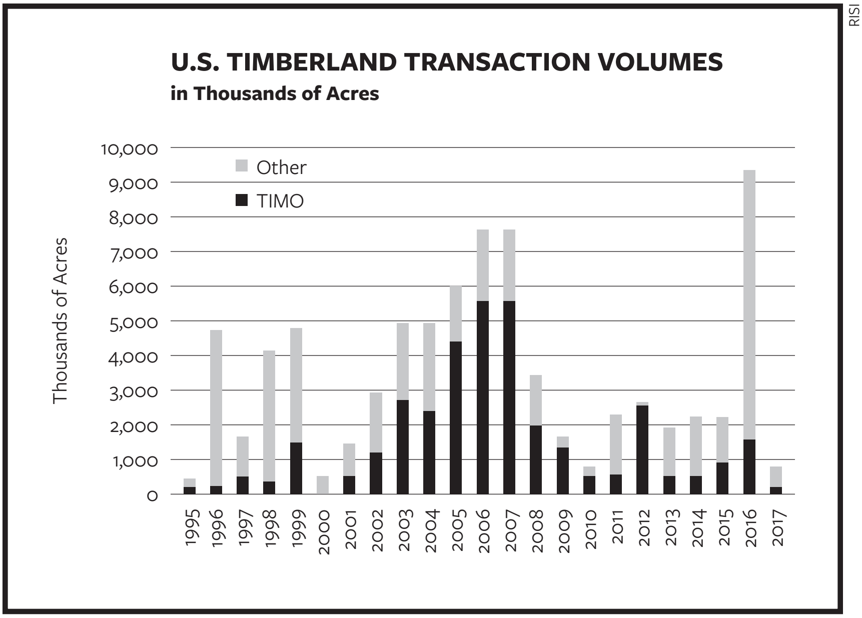
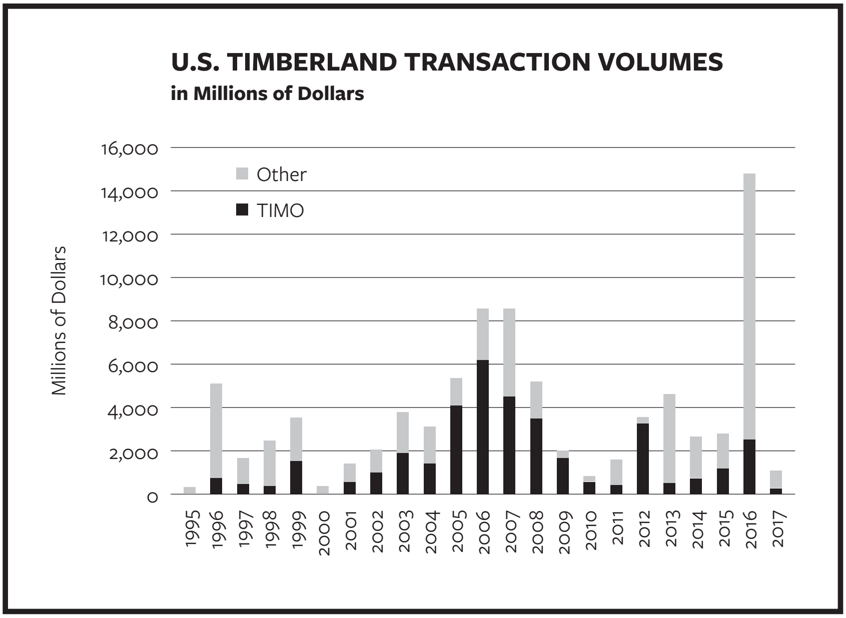


products companies narrowed their focus, concentrating on the production and distribution aspects of the business.

Specialized private equity firms called timber investment management organizations (TIMOs) evolved from these substantial timberland sales. TIMOs manage timberland investments for institutional investors and high-net-worth individual investors through separate accounts or comingled private equity funds. Public timber real estate investment trusts (REITs), emerged as a publicly traded version of TIMOs. The primary goal of both structures is to maximize risk-adjusted returns to their investors through management of timberland assets.

The scope and speed of this change in ownership have been impressive. In 1981, all fifteen of the largest forestland owners in the United States were integrated forest products companies. By 2004, only six of these fifteen still were; of the other nine, seven were TIMOs and two were REITs. In 2017, only four of the top fifteen U.S. forestland owners were integrated owners, while eleven were TIMOs and REITs.[1] In addition, since 1995, timberland observers have recorded sales of 75 million acres of U.S. private industrial timberlands, across an estate of approximately 68 million acres.[2]

What caused this vast change in ownership? Five major reasons underlay the shift. First, owning forests was no longer a necessity for traditional forest products companies. Previously, the volume of trees cut from a property was driven by the mill's demand instead of the market. Integrated forest



RISI

products companies signed long-term wood supply agreements with new timberland owners that ensured supply and managed fiber cost volatility, and mills could sometimes find cheaper fiber from third-party forestland owners. Companies realized that removing timberland from manufacturer balance sheets improved investment performance ratios and provided investors the flexibility to invest in higher-risk and higher-return manufacturing, or lower-risk and lower-return timberlands, or both.

Second, in the 1980s, financier Sir James Goldsmith recognized that he could make a quick profit by using short-term debt to capitalize corporate takeovers. He would then break the companies into their component parts and sell them off to the highest bidder. He is famous for purchasing companies like Crown Zellerbach and Diamond International, both traditional forest products companies that in a 1978 study were found to own "timberlands valued at two to three times their stock prices: their trees were worth more than their shares."[3] 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 products 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 publicly traded companies. In essence, the revised GAAP assumes that from an accounting standpoint, trees neither appreciate nor depreciate. For the publicly traded forest products companies, the value on the books of the trees at purchase was the same as the book value 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 products companies were taxed twice: once at the company level and again at the investor level. For TIMOs, whose funds are often structured as limited liability companies or limited partnerships, taxes are passed through to their investors, who pay taxes only once, typically at the favorable capital gains rate. This gave many taxable entities incentive to invest in timberland through TIMOs.

Finally, timberland was "discovered" by institutional investors who were attracted to the characteristics of the asset and wanted to diversify their portfolios and invest in an alternative real property. Investors observed that timberland's returns were consistent with public equities[4] but less volatile; the returns had low correlation with other asset classes but were positively correlated with inflation (more so than public equities and corporate debt).[5] Further, because tree growth is independent of the state of the economy, timber was viewed as a mechanism to preserve capital.

THE RISE OF THE TIMO

Because of the flood of institutional money, the interest of high-net-worth investors in timberland in the 1990s and 2000s, and the divestiture by the traditional forest products companies, TIMOs and REITs now own a significant amount of private forestland in the United States. The number of TIMOs has also grown dramatically. In 1990 only two or three TIMOs existed nationwide, but today more than thirty TIMOs buy, own, manage, and sell timberland.[6] As of 2017, the top thirty international TIMOs managed more than 57.6 million acres of domestic and international timberland assets valued at $33 billion.[7] Domestically, TIMOs own and manage more than 26.5 million acres nationwide, with a market value of approximately $40 billion in 2017.[8]

TIMOs, unlike traditional forest owners, have comingled fund terms, usually in the ten- to fifteen-year range, which means large timber tracts are now traded at a higher frequency than under past ownership. This has resulted in a much more active timber market. However, timber transactions quieted after the 2008 economic downturn. Figures 1 and 2, showing the volume of transactions made over the past two decades, illustrate how transaction frequency began to increase around 1996, peaked during 2006–2007, and has since been lower. Because many comingled funds (with ten- to fifteen-year terms) were raised between 2000 and 2007, the number of transactions and traded acres should increase between 2018 and 2025. Owners forced to liquidate assets as a fund's wind-up deadline approaches may sell at less attractive valuations. Investors, therefore, are increasingly investing via separate accounts (providing greater exit flexibility), and some TIMOs have raised funds with terms of fifteen to twenty years.

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

EASEMENTS AND TIMOs

When a buyer purchases a tract of timberland, she acquires a "bundle of rights" that include, for example, recreational rights, water rights, mineral rights, timber rights, and development rights. The owner can retain the complete bundle by owning the land and all its associated rights or else can transfer or tie up any number of rights in the form of a working forest conservation easement (WFCE). 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. For example, an owner could retain timber harvesting rights but transfer the development rights in a WFCE, thereby forgoing the opportunity to subdivide or develop the property in the future, even as she continues managing the timber resource. The landowner can then be compensated for what she is giving up while retaining ownership of the land and the right to sustainably harvest timber.

WFCEs are being used by some TIMOs to earn a competitive return on timberland investments while preventing forest parcelization. WFCEs can be donated or sold. If they are donated, the owner receives 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 few other TIMOs have succeeded in doing just this, thereby receiving a return of capital on a portion of an investment early in its life while still enjoying the benefits of a pure timberland investment, albeit with some harvesting restrictions and often the requirement to become certified as a sustainable timber manager. WFCEs are often bought by environmental nongovernmental organizations (NGOs), land trusts, or state and federal natural resource agencies through a combination of public money and private 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.

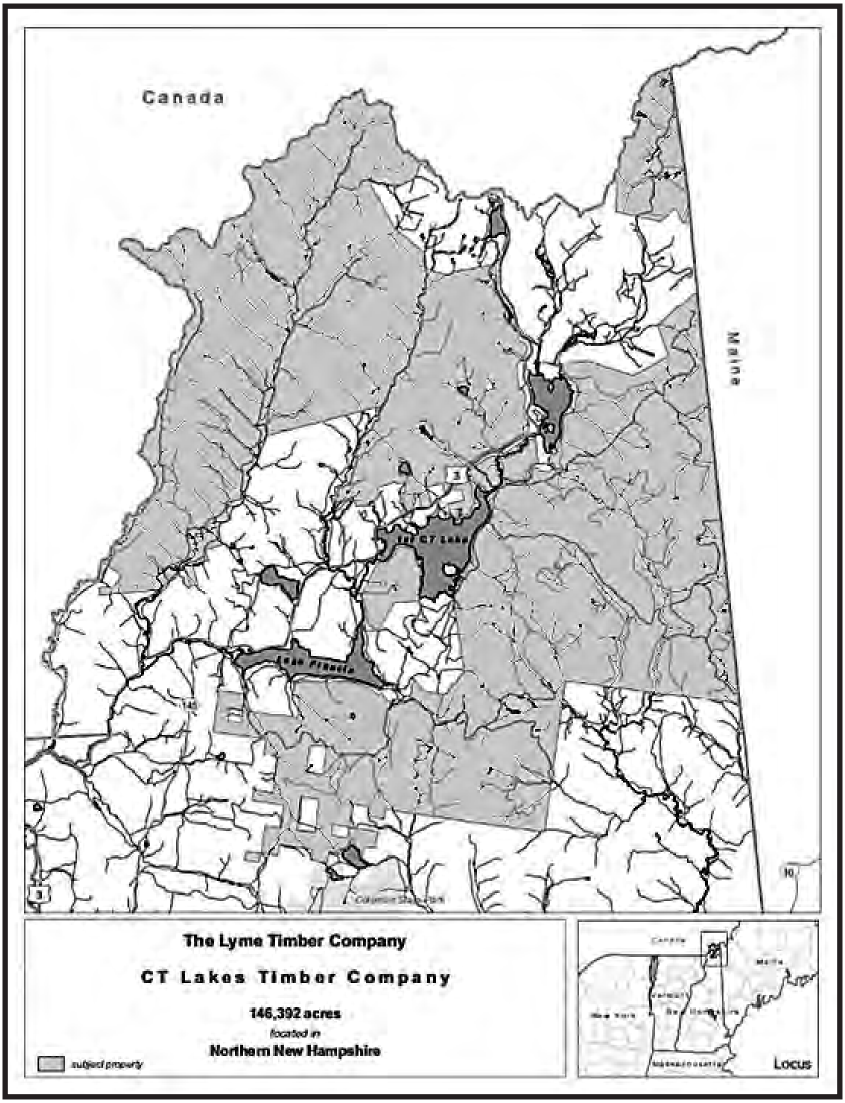
This investment strategy has become a model for using public-private partnerships to achieve land conservation at the landscape scale. In fact, conservation easements are now a preferred tool for conservation groups; according to a 2010 study by The Nature Conservancy, organizations are looking to stretch their dollars by purchasing development rights through easements instead of buying land outright. These groups are finding that easement purchases help them accomplish their conservation objectives and be involved in more deals. Whereas easements were rarely used by The Nature Conservancy before 1976, in 2003 they accounted for 70 percent of the land it protected but only 50 percent of its land protection outlays.[9]

Among TIMOs, the Lyme Timber Company pioneered the strategy of partnering with NGOs and state agencies interested in conserving forestland areas. In many cases, Lyme brings capital to a deal up front and holds the land while its conservation partners assemble public and private money to purchase the easement; it is also willing to manage timber according to the terms of the WFCE by obtaining Forest Stewardship Council certification for each property it owns. In doing so, it maintains a steady cash flow, realizes a return on its investment from the easement sale, and eventually sells the easement-encumbered land for a reduced price to another investment entity, such as a TIMO or public timber REIT.

Lyme has completed major transactions in New Hampshire, Wisconsin, Tennessee, and New York that resulted in the permanent conservation of more than 600,000 acres of high-priority conservation lands. These transactions were accomplished through collaborations with land conservation NGOs, state and federal natural resource agencies, and local community leaders. In each case, the conservation outcome was secured and Lyme delivered a strong financial return for its investors.

CASE STUDY: THE CONNECTICUT LAKES

International Paper (IP), a large traditional forest products company and forestland owner, at one time owned more than 11 million acres of forestland in the United States, along with numerous saw, pulp, and paper mills. Like



THE LYME TIMBERCOMPANY

other vertically integrated forest products companies, it began selling off large portions of its forest holdings in the 1990s. One such forest holding was at the northern tip of New Hampshire, not far from where John Weeks was born in Lancaster. The area surrounds the Connecticut Lakes, the headwaters to the Connecticut River.

This 171,000-acre forest makes up nearly 4 percent of the entire land area in New Hampshire and has been vital to the North Country's rural forest-based economy. As the primary source of the Connecticut River, it is also of critical importance for water quality all the way down its course through New England. Its position, north of the White Mountain National Forest, could have made it a target for Weeks Act funding at the beginning of the twentieth century: the timber resources on the property had been aggressively harvested and thus the forest was emblematic of the cutover landscapes that advocates of the Weeks Act were using to make a case for its passage. Instead of becoming a national forest, however, it remained in private ownership.

In 2001, the state of New Hampshire, responding to concerns that this property would be sold for purposes other than a working forest, assembled a team of conservation groups to negotiate with IP. None had enough money to purchase the property. The partners, including the state, the Trust for Public Land, the Society for the Protection of New Hampshire Forests, and The Nature Conservancy, then turned to the Lyme Timber Company, which could provide the 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. The Nature Conservancy purchased the remaining 25,000 acres for a wildlife management area, which it later transferred to the state, with The Nature Conservancy retaining a conservation easement. Overall, this successful conservation deal turned on the convergence of four factors: the impending sale of a large tract of high-priority conservation land by a divesting paper company; the willingness of a private company to put up private capital for the deal; the efforts and different capabilities of public sector, nonprofit, and for-profit partners; and use of the WFCE tool to make the deal viable and attractive to local economic development interests as well as state natural resource agencies and the conservation community. As a result, a TIMO—an economic instrument so transformative over the past three decades and so worrisome to conservationists—ultimately enabled conservationists to preserve a critical tract of forestland, intact and in perpetuity.

In bringing visionary public and private players to the table to preserve land and livelihoods for millions of New England residents, the Connecticut Lakes deal is just one of many examples that shows the spirit of the Weeks Act is still with us.