

Northeast Timberlands: Strong Markets & Returns

The State of Maine starred in the largest timberland ownership changes in the Northeast over the past 24 months. While the majority of the *acres* reflect the continued trend of industrial timberland divestures (noted in the previous issue of this newsletter), the majority of the *transactions* reflect a growing market for timberland transactions among institutional investors themselves. Additionally, this active market produced prices reflecting strong timberland returns relative to other regions.

TIMBERLAND TRANSACTIONS

More than 2.8 million acres of timberlands in transactions exceeding 20,000 acres each closed in the Northeast in the last two years (Q3 2003 through Q2 2005). Two aspects of these transactions are particularly noteworthy. First is the central role played by timberlands in Maine. Second is the significant shift of timberlands from industrial to institutional and environmental owners.

Seller	State(s)	Acres	Buyer(s)
Domtar Inc.	NY	104,400	Lyme Timber Co (84,000 ac), The Nature Conservancy
Fraser Papers	ME	240,000	The Forestland Group, LLC
John Hancock	ME, NH	81,200	Plum Creek Timber Co.
John Hancock	ME	31,900	Robin Crawford (H.C. Haynes)
John Hancock	ME	49,200	Carrier Timberlands, LLC
John Hancock	NH	27,600	Dillon Logging
John Hancock	NY	22,400	Forestland Group
John Hancock	NY	71,500	GMO Renewable Resources LLC
International Paper	ME	24,800	State of Maine
International Paper	ME	36,700	Appalachian Mtn. Club
International Paper	ME	50,000	H.C. Haynes Inc.
International Paper	ME, NH	1,100,000	GMO Renewable Resources LLC
Irving Ltd.	ME	234,000	Timber Star LLC
Irving Ltd.	ME	24,100	Roxanne Quimby
Irving Ltd.	ME	25,000	Gardner land Company
Irving Ltd.	ME	22,500	H.C. Haynes Inc.
MeadWestvaco	ME	629,000	Bayroot, LLC (Wagner)
Plum Creek	PA	30,900	Lyme Tbr, Oak Ridge Lbr, GMO Renewable Resources
Seneca Resources	PA	71,000	FIA
White Birch Land LLC (Enron)	ME	61,300	TimberVest
TOTALS		2,937,600	Average of \$357 per acre

Sources: James W. Sewall Company

Table 1. Northeast timberland transactions over 20,000 acres in Q3 2003 through Q2 2005.

Recent interest in Maine can be partly explained by timely supply and low prices relative to other regions,¹ and by strategic opportunities associated with timberland ownership near the U.S./Canadian border. While the 1.8 million acres of investor grade timberland transactions in the South in 2004 had a weighted average of \$908 per acre (*Timberland Report*, Volume 7, No. 1), Northeastern timberlands over a similar time period traded at a weighted average of \$311 per acre.

However, the primary reason for the rapid pace of northeastern acquisitions, focusing chiefly on Maine, has been large-scale exits by industry. Nothing new here. As reported last quarter, there is far more capital than available deals, and wherever properties are offered for sale, cash has been beating a swift path to the seller's door. We see no change in this over the next six months. We guess that there is more than \$5 billion sitting on the sidelines in the hands of TIMOs alone, waiting for deals to surface.

Let's take a look at the transactions listed in Table 1.

Domtar's northern New York lands had been on and off the market for well over ten years. Management finally decided to pull the plug, but retained a long-term fiber supply agreement supporting its FSC-certified papers mills in Quebec, with the lands carrying the obligation to remain certified. Lyme Timber Company took fee interest in most of the property, while The Nature Conservancy took fee interest in some key water resources and sensitive habitat. Domtar could well sell its Quebec and Maine lands as well.

In late 2004 Fraser Papers – part of the Brascan group – announced plans to sell 240,000 acres in Maine and about 750,000 acres in New Brunswick. The initial deal involved only Maine assets, once held by James River who eventually sold all of its assets. This deal is a harbinger of the increasing pace of Canadian industry divestiture. It afforded The Forestland Group the chance to make its first big splash in Maine, subject to a long-term wood supply agreement. There was keen interest in these assets among their competitors.

The Hancock sales reflect the wholesale departure of key clients from the domestic timberland market. We expect them to return to the Northeast and other regions at some point. Meanwhile, one of these clients has focused more on offshore opportunities. These six transactions reflect the broad base of potential buyers. Some of the deals included substantial premiums for recreation-oriented values.

The four IP transactions mark this firm's final exit from New England, as well as GMO's largest deal ever (in acres). In area, this is the second largest TIMO acquisition in history (next to Forest Capital Partners's 2.2 million acres acquisition of former Boise assets last year). IP retained a long-term fiber supply agreement, and GMO acquired an attractive property in terms of the breadth of opportunities available for generating cash flows. The smaller IP transactions again illustrate the broad base of buyers for northeastern assets.

¹ The continued strong interest and available capital for timberland investments was further documented during a recent "Timber Summit" sponsored by Deutsche Bank with forest industry shareholders and five timberland investment managers. Summary comments indicate up to \$10 billion are currently available for new timberland investments. "Should They Own Land?" by Mark Wilde of Deutsche Bank, dated July 5, 2005.

We note with interest the recent announcement that IP is considering selling the balance of its 6.8 million acres nationwide. Their only northeastern assets are some 240,000 acres in New York. This comes as no surprise to us, as IP has been reducing its presence in every region. That would leave Weyerhaeuser as the only domestic industrial landowner left with over 2 million acres.

The four Irving deals reflect this New Brunswick-based firm's desire to reposition assets closer to its Canadian mills. Still the largest landowner in Maine, Irving's motto has historically been, "We don't sell; we buy." Irving represents among the last of industry stalwarts who remain committed to strong vertical integration. The largest transaction presents Timber Star as an emerging TIMO; again, the deal was encumbered by a long-term fiber supply agreement. One of the smaller sales is among several in the 25,000-acre range; we show it here because of the unique buyer. Roxanne Quimby, founder of Burt's Bees, a popular line of cosmetics, is a true preservationist, and she has been willing to put her money to work establishing what promises to be her personal legacy in setting aside otherwise productive timberland for low-impact, non-timber uses. This is just one among many deals Ms. Quimby has struck with loggers, TIMOs, and forest industry sellers.

MeadWestvaco preceded IP in exiting the Northeast by slightly more than a year. In 2002, MeadWestvaco announced its intention to sell 700,000 acres of non-strategic timberland. This was in addition to 250,000 acres of previously announced divestitures. In March 2003, MeadWestvaco announced it was exploring the sale of its ownership in Maine and New Hampshire and by December had completed the sale to an investor group through Wagner Forest Management. MeadWestvaco, like IP, also retained a long-term supply agreement. Wagner now manages in the neighborhood of 1.5 million acres in Maine and New Hampshire.

There were two northeastern sales south of the "Northern Forest", both in NW Pennsylvania's oak-northern hardwood-cherry forest. Plum Creek decided to exit the Quaker State by selling its entire land base. In 1Q 2004 Lyme Timber picked up about 22,000 acres, with GMO and Oak Ridge Lumber each picking up properties between 4,000 and 5,000 acres. This is the first investment for both Lyme and GMO in this part of the state, and the first ever for GMO in Pennsylvania. So Lyme and GMO join FIA, The Forestland Group, and TimberVest as TIMOs active in the state.

In 3Q 2003 Seneca Resources, wanting to raise funds for capital additions to the oil and gas side of the business, pared off a very fine cherry-oak-maple property in NW Pennsylvania. One of FIA's clients outbid other TIMOs. Interestingly, Seneca reacquired over 12,000 acres of this property in early 2005.

The White Birch property was the seller's only Maine asset. Nestled along the Canadian border, it included a half million maple sugar taps collectively managed by some 30 firms belonging to a Quebec Sucre d'Érable cooperative (plus one Maine producer). These and neighboring lands comprise the heart of Maine's largest scale sugar bushes along the Quebec border. Just like the timber on the Maine side of the border, most of the maple product finds its way into Canada before much of it returns to the States. For TimberVest, this was their largest (in acres) acquisition in the Northeast to date.

Most of the transactions listed in Table 1 reflect significant buyer expectations of non-timber products and revenues. Prices as a percent of gross timber value reached all-time highs in Maine. Subdivision of lake frontage and conservation easement plays top the list of non-timber revenue opportunities. Strong prices are also driven by the ability to “buy wholesale and sell retail,” taking advantage of more liquid markets for individual tracts – a trend that is growing nationwide, and increasingly necessary to justify competitive prices being paid.

TIMBERLAND RETURNS

Timberlands continue to enjoy positive total returns as reflected in the NCREIF-based timberland indices (Figure 1). Lest Figure 1 prove misleading as a picture of recent timberland returns, note that the shorter history and lower base of the Northeast Index hides its strong recent returns, which coincide with the aggressive transaction activity in the region. Focusing on the past five years, Figure 1 indicates that the Total Timberlands Index is more volatile than the Northeast Index. Focusing on the past three years, a cursory glance indicates superior Total Timberland returns. Closer analysis shows stronger performance of the Northeast Index.

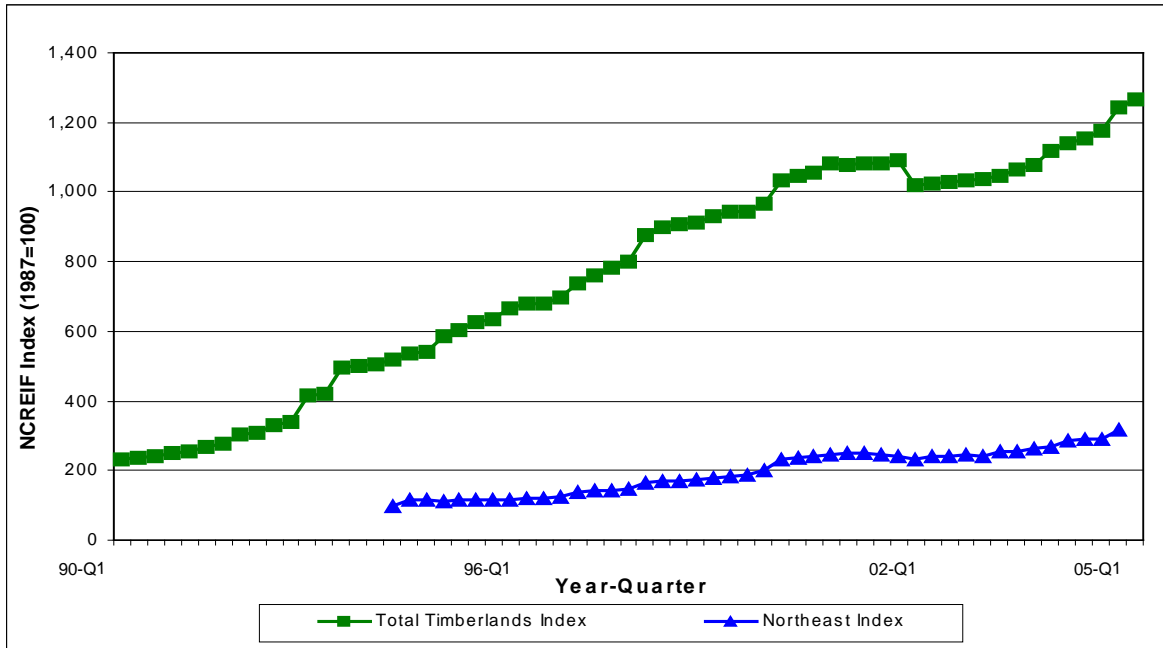


Figure 1. Northeast timberland returns.

In 2004, the NCREIF Northeast Timberland Index outpaced the Total Timberlands Index, 17.4% to 11.2% (Table 2). During the same period, the standard deviations of the Total and Northeast indices on a quarterly basis were 2.28% and 2.93% respectively. Summarizing the year-by-year returns for the past five years shows superior Northeast returns in four of five years.

Year	Total Timberlands	Northeast Timberlands
2000	4.41%	7.48%
2001	-5.24%	-6.19%
2002	1.88%	2.84%
2003	7.67%	12.17%
2004	11.20%	17.36%

Table 2. Annual Total and Northeast timberland returns using NCREIF data

Historically, Northeast timberlands have been noted for providing “lower volatility with lower returns” (Timberland Report, Volume 1, No. 2) because of the wide diversity of timber species – including spruce-fir, white pine, northern hardwoods, oak, and black cherry – and forest types, and the less direct link of many of these forest products to housing markets. In contrast, Southern timberlands, with its emphasis on pine plantations, are more of a “commodity” play relying on strong demand for softwood lumber and pulpwood.

Figures 2 and 3 show how Maine and Pennsylvania stumpage markets have fared over the past five years.

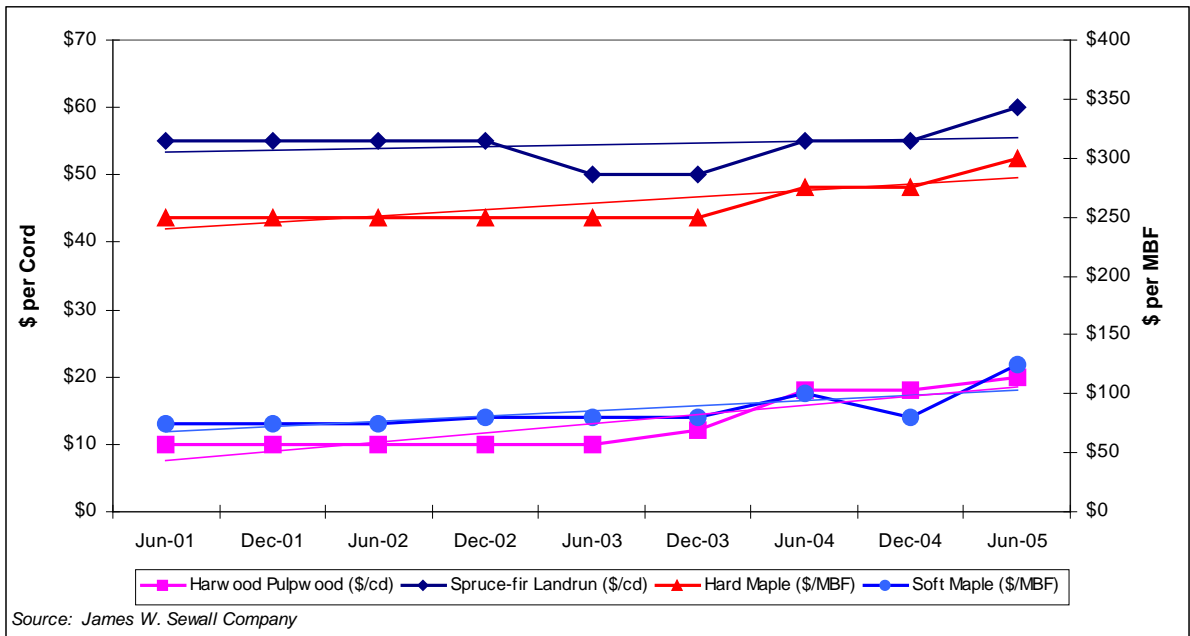


Figure 2. Central Maine Selected Stumpage Prices

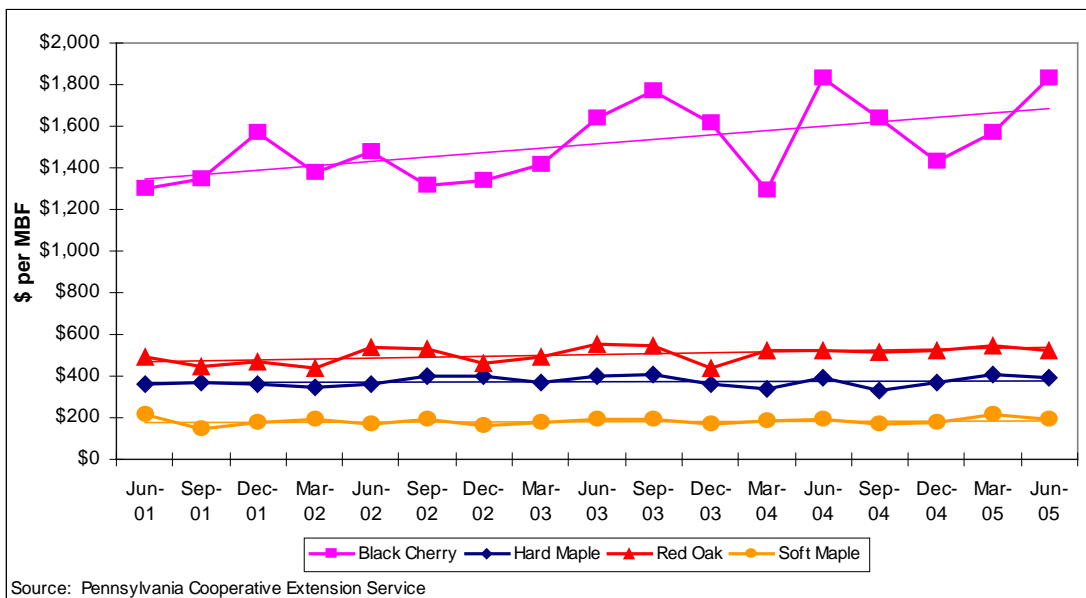


Figure 3. Northwestern Pennsylvania Selected Sawtimber Stumpage Prices

In Maine, markets have been strong, especially for hardwood pulpwood. Almost all products and species have seen increases over the last several years. In Pennsylvania, Cherry prices have been somewhat volatile but overall trending upward. Most other hardwood sawlog prices have remained fairly stable with an overall upward trend.

The investment demand from a wide range of buyers with a variety of investment objectives contributes to the recent strength of timberlands in the Northeast. This may be a result of a “spill-over” effect from the “hot” market for timberlands in the South. As was noted at the “Timber Summit” (Footnote 1), the “increased recognition and credibility” of timberlands attracted large amounts of capital, but after several years of buying and selling timberlands across the US (mainly in the South) the supply of attractive investments dried out. Hence, we should not be surprised by the continuous strong performance of timberlands in the Northeast. The Northwest has also been hot, and we expect very strong prices for timberland soon to be offered in the Lake States. We will address the recent activity and performance of the Northwest in the next issue.

CONCLUSION

The Northeast has enjoyed strong timberland markets and returns since 2003. This prompts bigger questions. How long will the market stay strong and/or how rational are the expectations of timberland investors? Are we looking at a timberland bubble? The question of the bubble, ever so important since the last internet stock “bubble”, remains a persistent theme in the popular economic and investment press.² Although some investors are not taking chances, for timberlands, the “bubble” is unlikely to burst soon.³ The long timber rotations, the possibility of “higher and better use” for timberlands, and the infrequent nature of timberland sales mitigate severe price shocks and value changes and effectively “lock value” for some time.

The Northeast may not soon repeat the two-digit returns of 2003-2004, especially given recent high prices. However, we expect continued short supply of deals relative to available capital, and sustained shortages of woods labor. Factors that could play a role in diminishing returns include rising interest rates, softening housing starts, import induced substitutions, and further losses to the pulp and paper capacity of the Northeast and Maritime provinces. One thing for sure: more changes are in the works.

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² The possibility of a housing bubble was discussed in the recent issues of Economist (“The global housing boom: In come the waves”, June 16, 2005) and Wall Street Journal (“Stocks? How Boring. If you want to get people really excited these days, just say the two magic words: real estate”, June 13, 2005).

³ CALPERS exited the Southern timber market last year (*Timberland Report*, Volume 7, No.1) and recently sold about \$7 billion in expensive real estate, as reported by Forbes (“In at the top”, July 2005, available at http://www.forbes.com/business/free_forbes/2005/0725/049.html?partner=yahoomag&referrer=).