



## Structural Changes in the Timber and Timberland Markets of the U.S. South

Southern timber and timberland markets have been subject to significant structural and ownership changes the past five years. Local timber markets show signs of increased efficiency as industrial mills increase capacity and smaller players drop out of the market. Timberland ownership changes reflect the spread of strategic plans at the firm level to the entire forest products sector. The traditional fully-integrated forest products firm has officially become the exception to the rule, while TIMOs and timber REITs now manage over 10 million acres in the South alone.

### INDUSTRIAL TIMBERLAND OWNERSHIP CHANGES

International Paper (IP) joins the list of forest industry firms that divested Southern timberland holdings. In April, the company announced an agreement to sell 5.1 million acres of Southern timberlands across eleven states in two separate transactions. One transaction for 4.2 million acres involved a group of investors led by Resource Management Services. The second deal involved 900,000 acres purchased by TimberStar. Both transactions closed this quarter.

The IP Southern sell-off represents the beginning of the end for a trend started by other forest industry firms. Louisiana Pacific and Boise Cascade both sold all of their Southern timberlands within the last four years, while Bowater, MeadWestvaco, Temple Inland, and Weyerhaeuser have reduced and/or continue to sell additional Southern forests (Table 1). Southern timberland ownership by the traditional forest products firms listed below has decreased 54% in the past five years.

As was the case with the IP deals, most of these divestitures represented a shift from industrial ownership to financial investors and TIMO management. Louisiana Pacific sold its Southern timberlands to several different investment groups. The largest transaction was the sale of 463,000 acres in Texas to Molpus Woodlands Group on behalf of institutional investors. Boise Cascade sold its Southern timberland in 2004 to Forest Capital Partners, a TIMO. Primarily in Alabama and Louisiana, it represented the Southern portion of the 2.2 million acre timberland transaction between the two entities.

*Table 1. Key Changes in Southern Industrial Timberland Fee Ownership by Firm, 2003-2006<sup>1</sup>*

<b>Firm</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
International Paper	5,219,685	5,094,800	5,061,800	5,005,000	5,005,000	~800,000
MeadWestvaco	1,068,000	1,016,000	842,000	755,000	741,000	741,000
Boise	438,000	434,000	431,000	0	0	0
Weyerhaeuser	3,344,000	4,097,000	3,740,000	3,459,000	3,429,000	3,429,000
Bowater	498,000	382,000	300,000	300,000	300,000	199,000
Louisiana-Pacific	888,800	753,100	0	0	0	0
Temple Inland	1,800,000	1,800,000	1,830,000	1,830,000	1,830,000	1,800,000

In 2006, Bowater announced intentions to sell timberlands in order to (1) reduce debt; (2) monetize non-core assets; and (3) improve financial flexibility.<sup>2</sup> The firm owns and leases 60% less timberlands than it did five years ago and plans to continue to market their remaining Southern timberlands. MeadWestvaco has followed a similar strategy by reducing its southern timberland holdings over 30% since 2001. They have announced plans to sell over 393,000 acres in South Carolina.

Relative to other publicly-traded forest industry owners, REITs enjoy preferred tax advantages as they do not pay corporate income taxes on timber earnings. Plum Creek and Rayonier could arguably be classed as industrial owners, but their investments in wood-using facilities are minor compared to timberlands and to the traditional vertically integrated forest industry firms. Both have been in acquisition mode – Plum Creek in the North and West, and Rayonier in the East. As of 2006, Plum Creek and Rayonier own and manage approximately 4 million and 1.5 million acres, respectively, in the South.

## **INDUSTRIAL WOOD CAPACITY AND CONSUMPTION CHANGES**

Third quarter figures showed a drop in wood consumption for pine sawtimber and hardwood sawtimber in timber markets across the Southeast, including Alabama, Georgia, Louisiana, Mississippi, and East Texas.<sup>3</sup> Sawmills curtailed production during the quarter while others took unscheduled downtime. Alternately, pine pulpwood consumption increased during the quarter as market pulp prices increased, shipments of residual chips from pine grade mills decreased, and OSB mills increased production in total across the South.<sup>4</sup> The decreased shipments of residual chips corresponded to curtailed production at pine grade mills.

<sup>1</sup> Data collected from financial statements and press releases; MeadWestvaco figures do not include 377,000 acres in Virginia and West Virginia; Temple Inland acres represent only those designated by the firm as strategic timberlands; Bowater figures include varying amounts of leased acres; some 2006 figures estimated due to pending transactions; IP lands retained are HBU acres; compiled by Seth Freeman, Market Coordinator, Forisk Consulting.

<sup>2</sup> Investor presentation, [www.bowater.com](http://www.bowater.com)

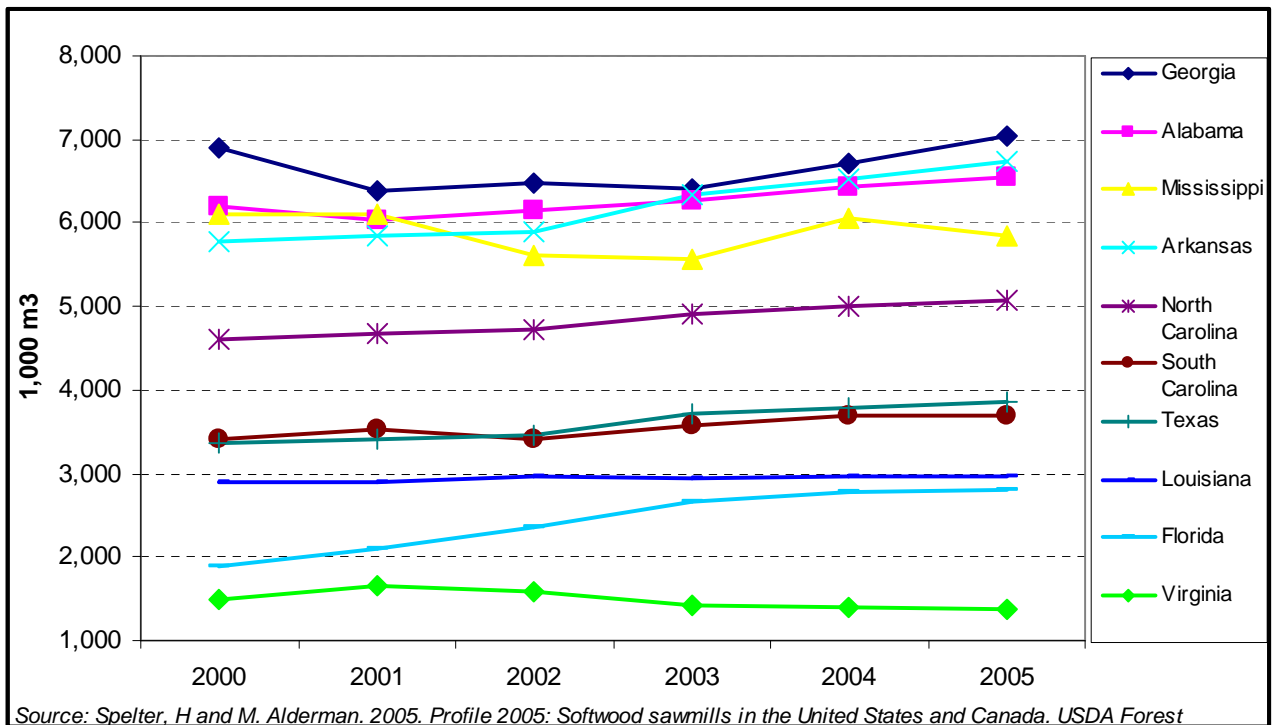
<sup>3</sup> Wood Demand Report, 2006. Forisk Consulting, 3<sup>rd</sup> Quarter Summary.

<sup>4</sup> According to the International Woodfiber Report, U.S. OSB facilities consumed 25.7 million tons of roundwood and captured 10% of the pulpwood consuming market in 2004.

Mill managers and procurement foresters report that these curtailments and shutdowns are reactions to several factors that include falling end-product demand due to decreases in building construction and housing starts. Also, at the beginning of the quarter, energy prices and fuel prices reached record highs which appeared to have a disproportionate impact on smaller, independent sawmills.

The sensitivity of smaller mills in the South to changing market conditions is not new. Between 2000 and 2005, every state in the South, with the exception of Florida, saw the number of softwood lumber mills operating in their state decline. Alabama, North Carolina, and Virginia saw the steepest declines in numbers of facilities. However, that does not tell the entire story. While the number sawmills declined, the capacity to produce softwood lumber increased in most states (Figure 1). Somewhat ironically during the most intense periods of the softwood lumber dispute with Canada, forest industry mills invested in upgrading sawmills and expanding their productive capabilities in the South. Justifications for these investments included the strong housing and remodeling markets, available economies of scale, and a shift towards smaller chip-n-saw logs.

Figure 1. Changes in Southern Sawmill Capacity, 2000-2005<sup>5</sup>



<sup>5</sup> Data source: Spelter, H. and M. Alderman. Profile 2005: Softwood Sawmills in the United States and Canada. USDA Forest Service.

## TIMBER PRICES

A year-over-year comparison of Southwide stumpage prices shows significant price drops in all major categories. Comparing 3<sup>rd</sup> Quarter 2005 to 3<sup>rd</sup> Quarter 2006, Timber Mart-South reported prices show a relatively modest 4.8% decline in pine sawtimber prices, but steep 12.0% and 25.5% price declines in pine and hardwood pulpwood prices, respectively (Table 2). For grade products, most of the price declines occurred in the past four months. These are associated with recent slowing in housing markets and the aforementioned mill curtailments.

*Table 2. Southwide Stumpage Prices (\$/ton), 2005 versus 2006, <sup>6</sup>*

Product	2005	2006	% Change
Pine Sawtimber	\$39.57	\$37.69	-4.8%
Chip-n-Saw	\$22.95	\$21.17	-7.8%
Pine Pulpwood	\$7.06	\$6.21	-12%
Hardwood Sawtimber	\$21.85	\$20.11	-8%
Hardwood Pulpwood	\$7.22	\$5.38	-25.5%

RISI forecasts recovering stumpage prices in 2007 (Table 3). Softwood sawtimber prices are expected to gain almost \$4.00 in 2007. Softwood and hardwood pulpwood prices are expected to show modest recoveries in the next twelve months. For pulpwood products, these increases are expected in part as OSB facilities come on line. For all of North America, RISI expects pulpwood consumption to climb 4 million tons from OSB demand alone.<sup>7</sup>

*Table 3. Southern Stumpage Price Forecast(\$/ton) <sup>8</sup>*

Product	2007
Softwood Sawtimber	\$40.50
Pine Pulpwood	\$6.90
Hardwood Pulpwood	\$6.40

## TIMBERLAND RETURNS

Investments in southern timberlands have, historically, generated strong returns. Given the timber supply and demand picture described above, and increasing interest of TIMO-managed investment funds seeking suitable investment properties, many investors believe that the future opportunities for high returns from U.S. timberland investments are mixed due to excessive competition. Regardless, forest products firms continue to divest prime timberland holdings, making additional forest assets available. Prior to the IP deal, an estimated \$10 billion of capital was seeking investment grade timberland. Billions of dollars remain available for timberland investing, as unsuccessful parties pursuing the IP deal generated additional capital, and a significant amount of the deal was covered by debt financing.

<sup>6</sup> Data source: Timber Mart-South

<sup>7</sup> International Woodfiber Report.

<sup>8</sup> Source: RISI North American Timber Forecast.

Even a cursory review of historical timberland returns helps explain the continued interest in the asset class. Using the NCREIF Total Timberland index, timberland investments returned 16.12 percent annually while the NCREIF South Timberland index returned 11.68 percent annually since inception in 1987 (Table 4). Total and South Timberland returns for the years 2000 through Q3 2005 showed reduced annual returns. However, 2004 and 2005 featured strengthening returns exceeding the past five year average.

*Table 4. Southern Stumpage Price Forecast(\$/ton)<sup>9</sup>*

<b>Time Period</b>	<b>Total Timberlands</b>	<b>Southern Timberlands</b>
1987-2006 Q3	16.12%	11.68%
2000-2006 Q3	7.78%	7.06%
2003	7.67%	7.54%
2004	11.20%	9.53%
2005	19.36%	14.27%
2006 Q1-Q3	6.78%	6.06%

As noted, timberland offerings over the past two years have been quite competitive. Institutional investors have led the search and bid activity. Pension funds have capital resources in need of placement, and an eye for domestic and international timberland investments to diversify their clients' portfolios. Industry and institutional owners have led the list of sellers. Continuing improvements in intensive silviculture promise to improve biological returns and reduce risks of output variability. And increasing comfort and use of long-term wood supply agreements and conservation easements have provided market participants with new tools for structuring transactions to meet specific needs.

## **CONCLUSION**

Timber and timberland markets in the South have changed. Millions of acres of timberlands have new owners, and these owners worry less about wood supplies and more about financial returns. These assets have become, for some investors, a specialized class of real estate that happens to grow trees, another plus for those with a penchant for green investments. Mill owners and managers appear to have refocused on marginal returns, giving them a willingness to curtail production and redirect raw material supplies if the numbers do not make sense. Wood dealers and procurement managers are increasingly managing long-term wood supply agreements between large industrial facilities and large independent landowners, a change from the days of large integrated firms managing wood flows from their own fee lands to their own mills. And new technologies, from curve saws to OSB facilities, continue to alter the type and volume of wood flows.

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<sup>9</sup> Annualized returns were calculated using data from the National Council of Real Estate Investment Fiduciaries (NCREIF). It is worth noting that the move of timberlands from industrial to institutional ownership will have a material effect on the quality and depth of the NCREIF Timberland Index, which depends on acres managed and transactions reported by NCREIF members. Since TIMOs represent most of the relevant membership, the result should be indices with higher quality and more representative returns for North American timberland markets.

In our view of regional timberland markets, we see TIMOs and REITs dominating the buy side, and before long dominating the sell side as well. Industry watchers now focus on efforts to squeeze inefficiencies from the forest industry supply chain, and on efforts of firms such as Temple Inland and Weyerhaeuser to maximize the value of their timberland assets. This change represents continued opportunities for strategic acquisitions in the South. There has been recent press on major stockholders and Wall Street analysts pressuring industry holdouts to “release” value from the woods and become more tax-efficient. If ongoing transaction activity in the West is any indication, discount rates across the nation remain at their very lowest in many years.

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