



Western Timberlands & Corporate Restructurings

Actual and prospective corporate restructurings in the forest products industry drove timberland investment activity and analysis in the Pacific Northwest in 2004 and year-to-date 2005. This activity included industrial timberland divestitures, announced conversions to real estate investment trusts (REITs), and investor activism to extract added value from timberland holdings of publicly traded firms. Several of these transactions and conversions take advantage of tax-preferred and tax-deferred treatments. Throughout, Western timberlands enjoyed strong returns relative to overall U.S. timberland investments.

TIMBERLAND TRANSACTIONS & CORPORATE RESTRUCTURING

In 2004 and 2005, over 2.8 million acres of western timberlands changed hands in closed, publicly-announced transactions exceeding 20,000 acres by forest industry firms and financial investors (Table 1). Boise's 2.2 million acre sale for \$1.65 billion to Forest Capital Partners – the single largest deal of 2004 – included approximately 1.3 million acres in the Northwest.¹ This transaction included long-term wood supply agreements for the Boise pulp and paper mills. Forest Capital subsequently sold approximately 375,000 acres of former Boise lands in Idaho and western Washington to investor and developer Tim Blixseth.

Seller	State(s)	Acres	Price (\$millions)	\$/acre	Buyer(s)
Rainier Timber Company ^a	WA	40,000			Port Blakely
Plum Creek	MT	42,927	32	745	Blackfoot Challenge; The Nature Conservancy
Roseburg Forest Products	N CA	133,000			Sierra Pacific Industries
Crown Pacific	OR	293,000			Cascade Timberlands
Crown Pacific	WA	229,000			Cascade Timberlands
Port Blakely	OR	23,000			GMO, Ueland Tree Farm, Kitsap County, Roseburg Forest Products, DR Johnson Lumber
Boise	Northwest ^b	1,300,000	1700 (total)		Forest Capital Partners
Forest Capital Partners	West	400,000			Tim Blixseth
Harvard (pending)	WA ^c	327,000			Hancock Timber Resource Group
Crown Pacific (pending)	WA	81,000			TIMO-led investor group
TOTAL		2,868,927	32		

^aOperated by The Campbell Group.

^bNorthwest portion of 2.2 million acre sale. According to TMS, the deal includes a series of long-term fiber agreements to source Boise pulp and paper mills.

^cWestern portion of a 930,000 acre sale. Includes 461,000 acres in TX, 135,000 acres in PA and 15,000 acres in New Zealand

Table 1. Western timberland transactions over 20,000 acres in 2004 and year-to-date 2005.

¹ As of December 31, 2003, Boise Cascade owned or controlled an additional 309,000 acres in the Midwest and 720,000 acres in the South. The Northwestern portion of the sale represented just under 60% of the total. Source: 2003 10-K.

The Roseburg Forest Products transaction with Sierra Pacific Industries was structured as a series of sale agreements allowing Roseburg to complete 1031 like-kind exchanges over five years, which allows them to defer the payment of capital gains taxes. Through Q3 2004, 45,000 of the 133,000 acres (34%) had been confirmed as transferred.

Harvard Management's pending 930,000 acre sale to the Hancock Timber Resource Group represents the largest institution-to-institution timberland transaction to date. Of the total, 327,000 acres lie in Washington State, with 461,000 acres in Texas, 135,000 acres in Pennsylvania and the remaining 15,000 acres in the Central North Island of New Zealand. This marks Harvard's exit from the U.S. timberland market. The deal is expected to close this month.

Bankrupt Crown Pacific Partners continued to transfer hard assets to creditor-controlled entities, such as Cascade Timberlands, through two timberland transactions totaling 522,000 acres. An 81,000 acre sale by Cascade Timberlands is expected to close this quarter to a TIMO-led syndicate of investors; Western hemlock is the principal species on this Olympic Peninsula property. Also, Cascade Timberlands placed the remainder of its Washington state ownership – the 146,800-acre Hamilton Tree farm – on the market in two blocks with bids due December 8th.

Several announced and implemented restructuring plans indicate increased focus on extracting value from industrial timberland holdings. Two regional forest products firms – Longview Fiber and Potlatch Corporation – announced in 2005 plans to restructure their companies as REITs effective January 1, 2006. Under the conversion plans, income from company-owned timberlands will qualify for REIT tax treatment, eliminating taxes at the corporate level for these earnings. Longview Fiber owns 585,000 acres of softwood timberlands in Western Washington and Oregon, while 667,000 of Potlatch's 1.5 million acres of timberlands lie in Idaho.

International Paper (IP) announced in 2005 plans to divest most or all of its remaining 6.8 million timberland acres. None of IP's holdings are in the West – nearly 90% (5.985 million acres) lie in the South, with the balance in the North (Lake States and northern New York regions). However, the expected sales have diverted due diligence resources – such as cruising and appraisal resources – of institutional and industrial investors from the West to timber markets containing IP timberlands.²

Weyerhaeuser also faces pressure to generate additional value from its timberland assets. In Q2 2005, Franklin Mutual filed a Schedule 13D with the Securities and Exchange Commission indicating it acquired beneficial ownership of more than 5% of Weyerhaeuser's outstanding shares.³ Simultaneously, Franklin Mutual initiated discussions with Weyerhaeuser to improve firm performance across divisions and asset classes, including its timberland base. As a traditional C-corporation, Weyerhaeuser timberland earnings are effectively taxed twice: first at the corporate level and second at the individual shareholder level once dividends are distributed.

² Current plans indicate that investment banks retained by IP will offer timberlands in phases, beginning with the Lake States and then the South. 452,000 acres in Michigan's Upper Peninsula went on the market as this newsletter went to press.

³ "Beneficial owner" includes any person or entity who directly or indirectly exercises voting power or investment power (the power to buy or sell the security).

TIMBER PRICES

Reported delivered stumpage prices in Oregon and Washington indicated improvement across Douglas-fir grades over the past two years. The Oregon Department of Forestry reported \$100 per MBF improvement for No.2 Douglas-fir prices over the past 10 quarters, equivalent to a 7% annualized increase in prices (Figure 1). Log Lines reported 10% increases in No.2 Douglas-fir delivered prices in the Puget Sound Region of Washington over the past twelve months to \$584 per MBF as of August 2005.

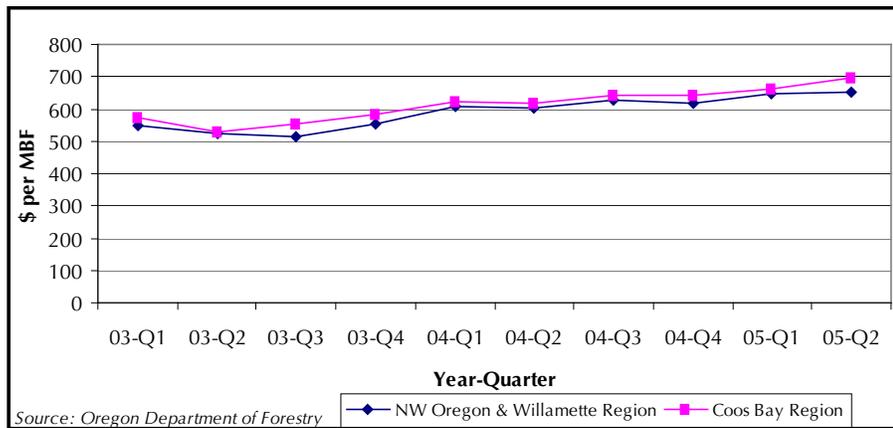


Figure 1. Western Oregon delivered No.2 Douglas-fir log prices.

Log export markets have stabilized after a steady, decade-long downward trend as measured in volume. From 1992 to 2003, total log export volumes from Seattle and Columbia-Snake customs districts declined 75% from nearly 2.2 billion board feet to 562 million board feet per year.⁴ According to the Foreign Agriculture Service, Japan, the largest market for Northwest log exports, has continued a shift of its consumption from Douglas-fir and hemlock to Russian-sourced larch.

TIMBERLAND RETURNS

Northwest timberland returns accelerated in late 2004 and through the first two quarters of 2005, as reflected by the NCREIF Timberland Indices (Figure 2).

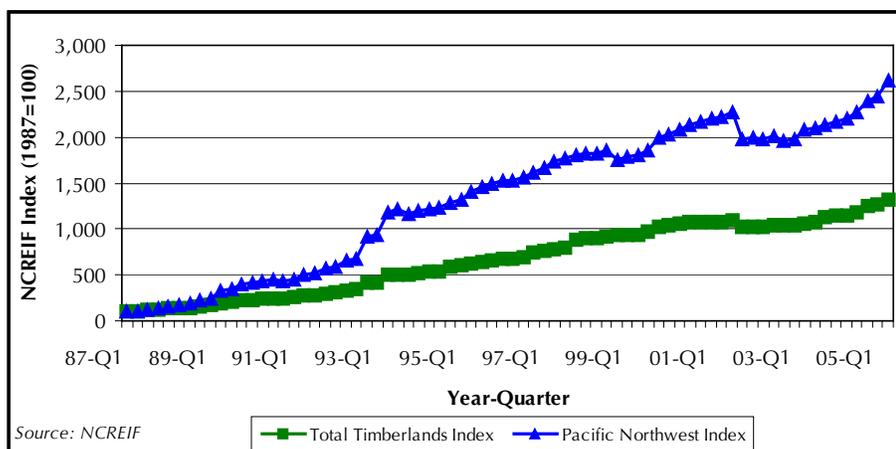


Figure 2. Pacific Northwest timberland returns.

⁴ USDA Forest Service 2005. "Production, Prices, Employment and Trade in Northwest Forest Industries."

The NCREIF Pacific Northwest Timberland Index outpaced the Total Timberlands Index, 12.4% to 11.2%, in 2004, 8.35% to 5.29% year-to-date in 2005 (Table 2), and in 15 of the past 22 quarters. Since 2000, the standard deviations of the Total and Pacific Northwest indices on a quarterly basis were 2.25% and 3.65% respectively, highlighting the increased risk (volatility) associated with these Pacific Northwest returns over the same period. Summarizing the year-by-year returns for the past five years of each index shows superior Northwest returns in three of five full years and in 2005 YTD.

Year	Total Timberlands	PNW Timberlands
2000	4.41%	8.30%
2001	-5.24%	-8.36%
2002	1.88%	-1.03%
2003	7.67%	8.57%
2004	11.20%	12.40%
2005 Q1-Q2	5.29%	8.35%

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

Observed differences in Western timberland performance find support in current research correlating trade flows and relative exchange rate changes with differences in regional U.S. timberland investment returns.⁵ For example, during the five-year period from June 2000 through June 2005, Western markets benefited from a 17.2% U.S. dollar depreciation relative to the Canadian dollar, eroding the price competitiveness of Canadian wood product imports. Also, the U.S. dollar appreciated a modest 5.1% relative to the Japanese yen, minimizing exchange related flow impacts on U.S. forest product exports to Japan. Results from China's 2.1% revaluation of the yuan are modest to date. However, in mid-September, China widened the band for trading Chinese currency against the euro and Japanese yen and continues to adjust policies associated with capital flows. Any further upward adjustments to the Chinese currency improve the relative competitiveness of U.S. exports to Asia.

HURRICANE KATRINA

Western stumpage prices have not, to date, reflected price impacts following Hurricane Katrina in the South, while end-product panel prices have jumped from \$15 to \$23 per sheet in California and Oregon according to the *Los Angeles Business Journal* (10/3/05). The USDA Forest Service reported that Hurricane Katrina damaged or destroyed approximately 19 billion board feet of timber valued at \$5 billion across five million acres in Mississippi, Alabama and Louisiana. Private timberlands comprise the majority of the forestlands damaged, and nearly 90 percent lie within 60 miles of the coast and predominantly in Mississippi.⁶ Mark Wilde, forest industry equity analyst at Deutsche Bank Securities, noted that Hurricane Katrina produced good short-term news for the forest industry through higher end product prices and lower raw material prices.⁷

⁵ Mendell, B.C. and T. Sydor. 2005 Foreign exchange rates and U.S. timberland investments. Working paper. Fo-risk Consulting LLC; Federal Reserve research on relationship between the economic performance of U.S. states and their proximity to export markets.

⁶ September 15, 2005 USDA Forest Service press release, "USDA Forest Service Report's Significant Damage by Hurricane Katrina to Public and Private Timberlands."

⁷ Comments made at the September 14-15 Future of Forestry Conference hosted by Dean Richard Porterfield of the Warnell School of Forest Resources, University of Georgia, Athens, GA.

The potential impacts on Western stumpage prices from Hurricane Katrina are unclear, particularly within the context of current housing and interest rate trends. The spike in end-product prices are expected to dissipate, as mills in Texas, Mississippi and Alabama have full wood inventories and are at full production. Sales of existing homes have increased to near record levels, while new home sales have slowed. At the end of August, total housing inventory levels increased 3.5 percent to 2.86 million existing units available for sale. This represents nearly a five month supply, according to the National Association of Realtors.⁸ Additionally, the Federal Reserve continued to raise the target for the federal funds rate – to 3 ¾ % on September 20th – increasing the cost of building funds and mortgages. However, Hurricane Katrina destroyed in excess of 200,000 housing units, necessitating the need for broad scale reconstruction.

CONCLUSION

Western timberlands showed improved prices and continued interest in 2004 and 2005. Sewall's appraisal work in the West, coupled with recent transactions evidence, tells us that timberland markets remain very strong west of the Cascades. Short-term timber price impacts from severe weather events in the South have yet to appear in nation wide price indices. Meanwhile, strengthening demand for wood products have buoyed the stock prices of solid wood product producers and sustained high production levels. The continued positive performance of timberland investments supports the continuing transition of timberland ownership to tax-advantage entities and those best positioned to maximize asset returns. Ongoing research into regional timberland investment performance highlights potential impacts of location and exposure relative to international trade and capital markets.

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The *Timberland Report* looks at the timberland investment industry with an emphasis on the United States. The opinions expressed are those of the editor, who is solely responsible for its content, and may not reflect the opinions of James W. Sewall Company.

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⁸According the National Association of Realtors, approximately a six months of supply reflects balance between home buyers and sellers.