Introduction to Timber Real Estate Investment Trusts (Timber REITs)

Brooks C Mendell, PhD, Tim Sydor, PhD, and Seth Freeman

Three basic alternatives exist to investing in timberlands. The first approach is to invest directly through buying and managing forests and land for timber production. A second approach is to place funds with an intermediary, such as a timberland investment management organization (TIMO), to acquire and manage timberland investments on behalf of you or your organization. In today's market, the first two alternatives often require substantial initial investments and may be beyond the reach of the average household. Fortunately, a third alternative exists, investing directly in the stocks of publicly-traded firms that focus on growing and selling timber, that is accessible and available to investors of all levels.

Real estate investment trusts (REITs) that specialize in timber represent one avenue for the average investor to invest in timberlands. REITs own and manage income producing real estate such as buildings, warehouses, rental properties, and, since 1999, timberlands. To qualify under IRS rules, a firm must satisfy specific criteria, the most important of which to shareholders is the requirement to distribute annually at least 90% of its taxable income in the form of dividends.

According to the National Association of Real Estate Investment Trusts, there are about 200 REITs registered with the Securities and Exchange Commission (SEC) in the U.S. that trade publicly on one of the major stock exchanges, such as the New York Stock Exchange. Total assets of these listed REITs exceed $475 billion.

Unlike traditional C-corporations, qualified REITs may deduct the dividends they pay to shareholders from corporate taxable income. Therefore, most REITs pay out most taxable income to shareholders, and therefore owe no corporate tax. For this reason, REITs have been popular with individual and institutional investors interested in relatively tax-efficient income stocks. In the end, shareholders pay taxes on dividends received and any capital gains generated.

Currently, four publicly-traded REITs focus on growing timber and managing timberlands (Table 1). One pending transaction and one speculated restructuring could affect this group in the near future. On February 5th of this year, Brookfield Asset Management and Longview Fiber entered into an agreement by which Brookfield would take Longview private through acquiring all of its outstanding shares in a transaction valued at approximately $2.5 billion. This deal is expected to close in the 2nd quarter of 2007. Second, Wall Street analysts believe that Weyerhaeuser will eventually restructure its timberland holdings into a publicly-traded REIT.

Table 2 provides a numerical example that illustrates how the current tax code affects the earnings of a traditional forest industry C-corporation differently from a publicly-traded timber REIT. The example is not a perfect head-to-head comparison. First, it represents a single snapshot for one year. Second, Weyerhaeuser is a fully diversified forest products firm with nearly

Table 1: Summary 2006 Statistics of Publicly Traded Timber REITs

	Longview Fiber	Plum Creek	Potlatch	Rayonier*
REIT since	2006	1999	2006	2004
Acres	587,000	8.2 million	1.5 million	2.2 million
Location	OR, WA	18 states	AR, ID, MN, OR	US
Market cap (as of 3/1/07)	$1.62 Billion	$6.82 Billion	$1.72 Billion	$3.36 Billion
Revenues	$950,666,000	$1,627,000,000	$1,607,827,000	$1,229,807,000
Net income	$18,975,000	$317,000,000	$139,110,000	$176,418,000

*Also owns land in New Zealand and manages land in Australia.

Table 2: Tax Implications for a C-Corp versus a Timber REIT

	Weyerhaeuser	Plum Creek
Structure	C-corporation	REIT
Revenues (2006)	$21,896,000,000	$1,627,000,000
Income before taxes	$826,000,000	$328,000,000
Corporate income taxes	$471,000,000	$13,000,000
Net income (w/ adjustments)	$453,000,000	$317,000,000
Effective tax rate	57%*	4%

*Relevant statutory tax rate is 35%; higher 2006 rate due primarily to "goodwill impairment"; in 2005 and 2004, Weyerhaeuser had effective rates of 35.9% and 33.4% respectively.

80% of its revenues generated from manufacturing (pulp, paper, building materials), while Plum Creek generates over two-thirds of its revenues from timber and land management. However, the table highlights how, for a given year, shareholders of these two firms, the largest timberland owning companies in North America, face different levels of tax efficiency.

Timber REITs also own mills and generate, in cases, most revenues from their manufacturing businesses (Table 3). This fact may discourage investors looking for "timberland-only" exposure, since the manufacturing sector correlates more directly with traditional business cycles than do timberlands. With their manufacturing capacities, timber REITs can compete directly for forest-industry investors. However, those looking for "pure timber" diversification potential in their portfolio could focus on Plum Creek or look elsewhere.

One choice would be Pope Resources, a forest products company that in 2004 generated 85% of its revenue from timberlands. Pope is the last remaining master limited partnership (MLP) that specializes in timber. MLP's are similar to REITs in that they distribute most earnings as dividends without paying corporate taxes. However, these dividends are viewed as a return of capital, thereby creating a potential future tax liability if shares hold or increase their value. Another option for the individual investor is Cambium Global Timberland Limited, a timberland investment organization that listed on London's AIM exchange as of March 6th. The company's goal is to invest in timberlands and not in processing facilities. In addition, Acadian Timber Income Fund, a limited partnership (LP) publicly listed on the Canadian TSX exchange, owns 765,000 acres of timberlands in New Brunswick and 311,000 acres in north central Maine.

Publicly-traded timber REITs provide an accessible, liquid vehicle for individual investors seeking to add timber exposure to their portfolios. However, they still retain direct relationships to their "vertically integrated" pasts. That said, timber REITs provide two major advantages to investors: 1) higher exposure to timberland returns by deriving a large (sometimes major) portion of their revenue from timberland operations, and 2) higher returns due to a lower tax base. The first advantage

Table 3: Timber REIT Revenues from Manufacturing, 2006

REIT	# of mills	Revenues from Manufacturing	Total Revenues	% from Manufacturing
Longview Fiber	16 facilities: 1 pulp, 15 converting	$757,600,000	$950,666,000	79.7%
Plum Creek	10 facilities: 4 lumber, 4 ply/MDF, 2 remanufacturing	$493,000,000	$1,627,000,000	30.3%
Potlatch	15 facilities: 6 lumber, 2 ply/board, 4 pulp/tissue, 3 converting	$1,111,211,000*	$1,607,827,000	69.1%
Rayonier	5 facilities: 3 lumber, 2 pulp	$783,000,000	$1,229,807,000	63.7%

*Total of revenues from wood products and pulp and paperboard favorably places timber REITs between the forest industry and TIMOs, by highly improving investment liquidity and reducing barriers to entry for an average investor. The second gives timber REITS a significant financial advantage to any investor looking to add forestry-related income stocks to a portfolio.

Mendell, Sydor, and Freeman are Principal, Forest Economist, and Market Coordinator of Forisk Consulting, a forest industry and timber market research and education firm. Drs. Mendell and Sydor will be teaching "Timber REITs Explained", a short course at the Georgia Center for Continuing Education on June 1. For more information on Forisk's Timber REIT research, please email bmendell@forisk.com