Timberland Report
JAMES W. SEWALL COMPANY
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Corporate Structure, Mill Capacity, & Product Prices in Western Timber and Timberland Markets

The forest industry restructuring in the Pacific Northwest reported and analyzed in the 3rd Quarter 2005 issue of this newsletter continues, with implications for current and prospective timberland owners and timber-REIT investors. Timberland ownership changes reflect a broad range of ownership structures and targeted fiber management strategies. Mill owners have made capital investment decisions with respect to mill openings, closures, and capacities that affect the relative attractiveness of markets for key forest products in the region. Assessing the relationship between localized capacity changes and reported prices by product also provides insights for future strategies considered by timberland investors.

TIMBERLAND TRANSACTIONS & CORPORATE RESTRUCTURING

From 2005 to early 2007, forest industry and financial investors participated in nearly 1.1 million acres of publicly-announced western timberland transactions exceeding 50,000 acres (Table 1).

TABLE 1: WESTERN TIMBERLAND TRANSACTIONS OVER 50,000 ACRES SINCE 2005

Seller	State(s)	Acres	Buyer(s)
Forest Capital Partners	West	400,000	Tim Blixseth
Harvard	WA	327,000	Hancock Timber Resource Group
Crown Pacific	WA	81,000	TIMO-led investor group
Cascade Timberlands	WA	146,000	Sierra Pacific Industries
Menasha Timberlands	OR, WA	135,000	The Campbell Group
TOTAL		**1,089,00**	

Tim Blixseth's 400,000-acre acquisition from Forest Capital followed closely Forest Capital's acquisition of Boise Cascade's timberland portfolio in 2004. Harvard Management's 930,000-acre sale to Hancock Timber Resource Group represented the largest institution-to-institution timberland transaction to date. Of the total, 327,000 acres lie in Washington State, with the balance in Texas and Pennsylvania, and 15,000 acres in the Central North Island of New Zealand. An 81,000-acre sale by Cascade Timberlands closed in the 4th Quarter of 2005 to a TIMO-led consortium of investors. Also, Cascade Timberlands sold the remainder of its Washington state ownership – the 146,800-acre Hamilton Tree farm south of Vancouver, BC – to Sierra Pacific in the 1st Quarter of 2006. With these final two transactions, bankrupt Crown Pacific Partners effectively completed its exodus from timberland ownership.

Recently, The Campbell Group announced its acquisition of the Menasha timberlands. Along with the forest assets owned by Longview Fibre, these timberlands were considered the finest large timberland holdings in the Pacific Northwest. They include 119,000 acres in Southwest Oregon in Coos, Curry, and Douglas Counties and about 16,000 acres in Washington around Lewis, Grays Harbor, and Cowlitz Counties.

In 2006, Longview Fibre and Potlatch Corporation executed plans to restructure their companies as REITs. Under the conversions, income from company-owned timberlands qualifies for REIT tax treatment, eliminating taxes at the corporate level for these earnings. Longview Fibre 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. These conversions temporarily increased the number of publicly-traded REITs that specialize in timber to four, along with Plum Creek and Rayonier.

However, both Longview and Potlatch attracted the interest of hedge funds and private equity investors. On February 5th of this year, Brookfield Asset Management (Brascan) and Longview signed an agreement allowing Brookfield to take Longview private by acquiring all of its outstanding shares. The transaction is valued at approximately $2.5 billion. This deal, instigated in part by The Campbell Group-Obsidian attempt to acquire the lands and mills, marks the third large investment for Brascan clients, the others being on Vancouver Island (former Weyerhaeuser lands) and New Brunswick/Maine (former Fraser lands).

Potlatch, in the 1st Quarter of this year, announced the sale of its 17,000-acre hybrid poplar tree farm in Boardman, Oregon, to a private-equity tree-farm investment fund for $65 million. The tree farm was started in 1992 originally to supplement Potlatch's fiber needs, but later focused on growing hardwood sawlogs. In a press release, the company said it plans to apply the proceeds from the sale to its recent 76,000 acre forestland acquisition in Wisconsin. The deal is expected to close in the 2nd quarter of 2007.

A smaller transaction deserves mention because of its aggressive closing price. In Oregon's Tillamook County, Forest Capital Partners sold its 4,820-acre Garibaldi Tree Farm to Ecotrust Forest LLC in December 2006. A property with rugged terrain, its stands comprise 60% hemlock and 23% Douglas-Fir with close proximity to two lumber mills, Stimson Lumber and Hampton Affiliates. It was also marketed as a possible elk hunting retreat. Ecotrust, like Conservation Forestry LLC in the East, represents a new type of TIMO serving green investors looking to profit from both timber and ecosystem services.

In a rare fiber supply play, Roseburg Forest Products acquired 13,708 acres near Coos Bay, Oregon from Westbrook Land and Timber, an old family ownership, in the 2nd Quarter of 2006. Bidders were surprised to find 13 competitors at the table. This acquisition, it is rumored, provided Roseburg with an opportunity to fill missing age classes in their raw material supply portfolio. Ecotrust subsequently acquired a portion of these lands – including salmon habitat – from Roseburg.

Weyerhaeuser remains under intense pressure from Wall Street to convert its forest holdings to a more tax-efficient ownership structure. Financial analysts believe much of the conversion value is already reflected in its stock price. At one time no one could imagine this venerable company divesting of its timberlands, but one must concede that it could happen. Weyerhaeuser recently added to its Board of Directors a member with significant REIT experience.

Several transactions mark an increasing trend among TIMOs and other owners to monetize development values and ecosystem services while retaining forest management rights. In 2004, Hancock Timber (HTRG) sold the largest working forest conservation easement in the West to King County in Washington for $21,960,000. Some 90,000 acres were encumbered by the easement, thereby protecting the land from development pressure spreading east from Seattle. HTRG originally acquired the property – with total acreage of 103,017 acres from Weyerhaeuser in 2003 for $184.7 million. The conservation easement restricts residential or commercial development, but permits the land be managed for forest production.[1]

In California, large-scale working forest easements have begun to take hold. In late 2006, Bascom Pacific (Forest Systems client) sold the state's largest easement on its 9,200 acres of prime forestland located at the base of Mt. Shasta to Pacific Forest Trust (PFT) for $7.3 million. The easement prohibits development and provides for public recreational access to the popular McCloud Falls and Pacific Coast Trail – all while maintaining forest management. Bascom Pacific's conserved forests will remain in private stewardship and productive use. Participants of the easement purchase, led by PFT, included the California Wildlife Conservation Board, the National Fish & Wildlife Foundation and the Richard and Rhoda Goldman Fund.[2]

Also in California, Pacific Lumber filed for bankruptcy protection under Chapter 11 in January 2007. The company cites an untenable regulatory environment, particularly at the hands of regional water boards. Unchecked regulation is blamed for blocking timber harvest permits and halving PALCO's allowable cut.

INDUSTRIAL WOOD CAPACITY CHANGES

According to *Random Lengths,* numerous mills reported downtime and/or curtailments during 2001-2005. Two Simpson Timber mills, now the two largest mills in the region, and a Tree Source mill led the pack (Table 2). Many curtailments coincided with Christmas or Easter holidays, although the majority of mills cited market conditions as justification. Despite frequent curtailments, Weyerhaeuser's Aberdeen mill, the second largest in the Coastal WA, closed in 2006. An older, large-log mill, it struggled to compete with newer Sierra-Pacific mills opened at Aberdeen in 2002 and 2005. A similar fate befell Weyerhaeuser's Lebanon, Oregon mill. It closed in late 2006, a victim of market conditions and unavailable large Douglas-Fir logs.[3] Weyerhaeuser still operates a small-log and a veneer mill at Aberdeen.

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[1] Seattle Post-Intelligencer. Deal ensures 90,000 acres in King County will stay wilderness. Sept. 3, 2004.

[2] The Pacific Forest Trust News. Historic Public-Private Partnership Keeps Threatened Forests Working for All Californians. August 24, 2006. http://www.pacificforest.org/news/McCloud-Close.html

[3] The Campbell Group LLC. Timber Trends. January 2007.

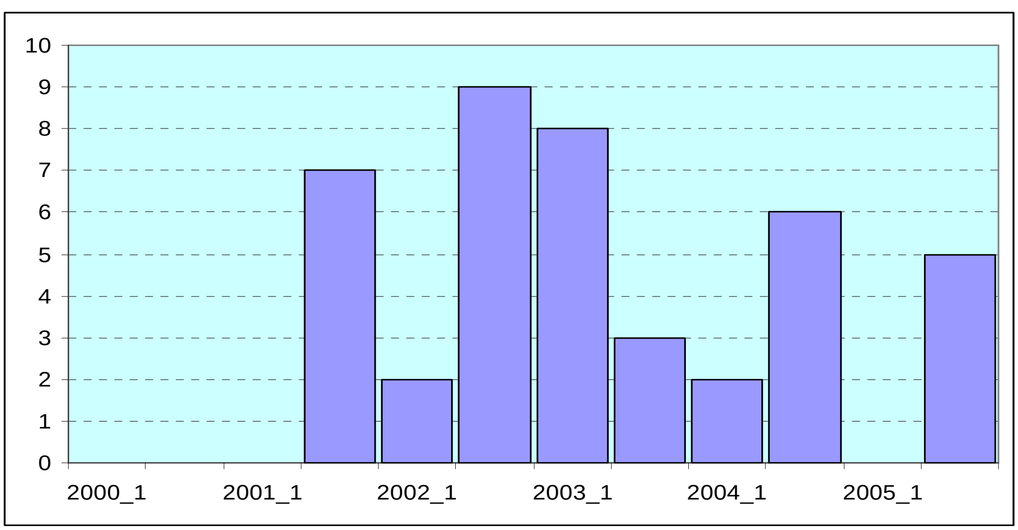
Table 2: Announced Temporary Curtailments in Coastal WA by Mill, 2001-2005[4]

Curtailements Announced	Mills Name	Species Used	Location
5	Simpson Timber	DF (0.5), Hem (0.5)	Shelton
4	Simpson Timber	DF (0.5), Hem (0.5)	Tacoma
4	TreeSource	DF	Tumwater
3	Weyerhaeuser Co *		Aberdeen
3	Portac	DF (0.65), Hem (0.35)	Tacoma
2	Portac	Hem (0.8), DF (0.1)	Beaver
2	Hampton Affiliates	Hem (0.55), DF (0.45)	Darrington
2	Lewis Co Forest Prod	DF	Winlock
2	Simpson Timber		Dayton
2	TreeSource		Spanaway
2	Weyerhaeuser Co		Enumclaw
1	Hampton Affiliates	Hem (0.9), DF (0.1)	Morton
1	Hampton Affiliates	Hem (0.9), DF (0.1)	Randle
1	Inter Forest Products	Hem	Marysville
1	Seattle-Snohomish	DF (0.5), Hem (0.5)	Snohomish

* closed in 2006

The increased competitiveness of small-logs mills comes as a result of a shift in harvesting from old-growth forests to younger stands. Curtailments of mill production in Coastal Washington reached their peak in late 2002-early 2003 (Figure 1), following the bottoming out of stumpage prices in the region (Figure 4). This was happening during a general increase in mill capacity, while lumber prices have been flat in the Coastal PNW since their modest rise in early 2002.

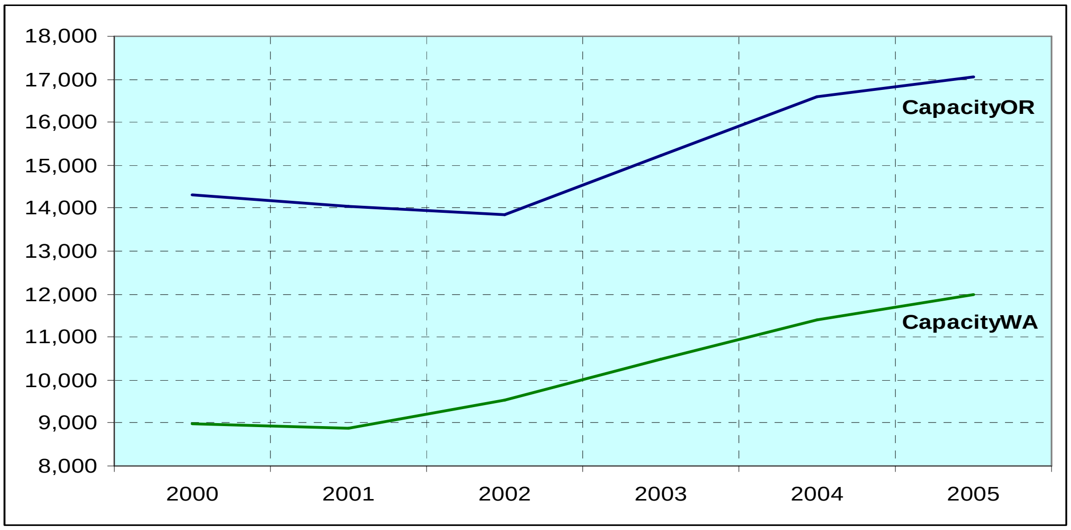
FIGURE 1: NUMBER OF MILLS THAT REPORTED TEMPORARY CURTAILMENT IN COASTAL WA[5]



[4] Source: Random Length Alerts.
[5] Source: Random Lengths Alerts.

With numerous curtailments listed, the increase in total capacity in the PNW comes as a surprise (Figure 2). In Coastal Washington alone, 5 new mills opened since 2001. Many firms invested in efficient mills better suited for the smaller-diameter logs now harvested on the state's timberlands. As new capacity increased, older mills quietly closed.[6] In addition, capacity increases occurred in existing mills, driving average capacity per mill higher. Capacity increases slowed down in 2004 as mills in Oregon and Washington responded to rising stumpage prices and falling lumber prices.

FIGURE 2: CHANGES IN WESTERN SAWMILL CAPACITY, 2000-2005[7]



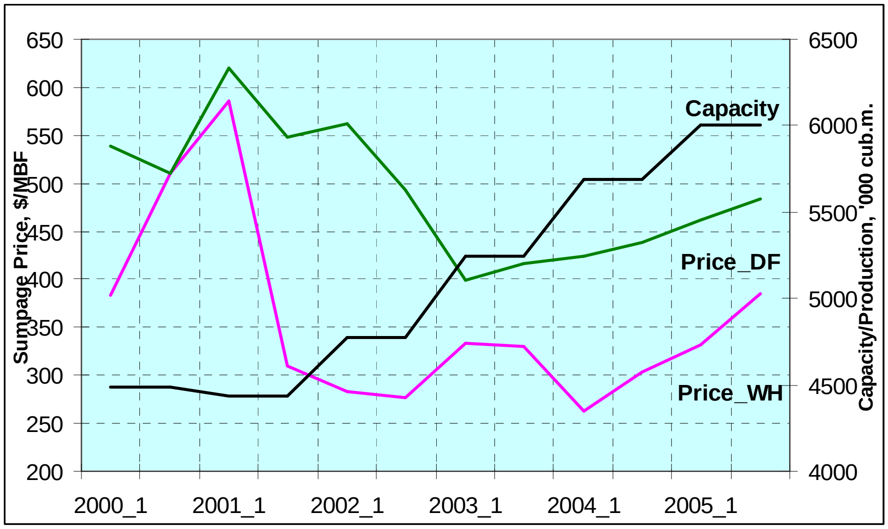
TIMBER PRICES

The Coastal Washington market has experienced many changes in the past 6 years. Stumpage prices for both Douglas Fir and Hemlock reached $600/MBF and $580/MBF in early 2001, but lost 30% to 45% of its value by late 2002 (Figure 3). Mill capacity/production in the region at that time declined slightly and seven mills reported temporary curtailments in the second half of 2001. Stumpage prices recovered somewhat in 2003-2004 as more mills started adding capacity. Between 2001 and 2005 mills increased capacity by 25%.

[6] Seattle Post-Intelligencer. Weyerhaeuser closing two mills employing 342. Oct 22, 2005. (www.seattlepi.com)

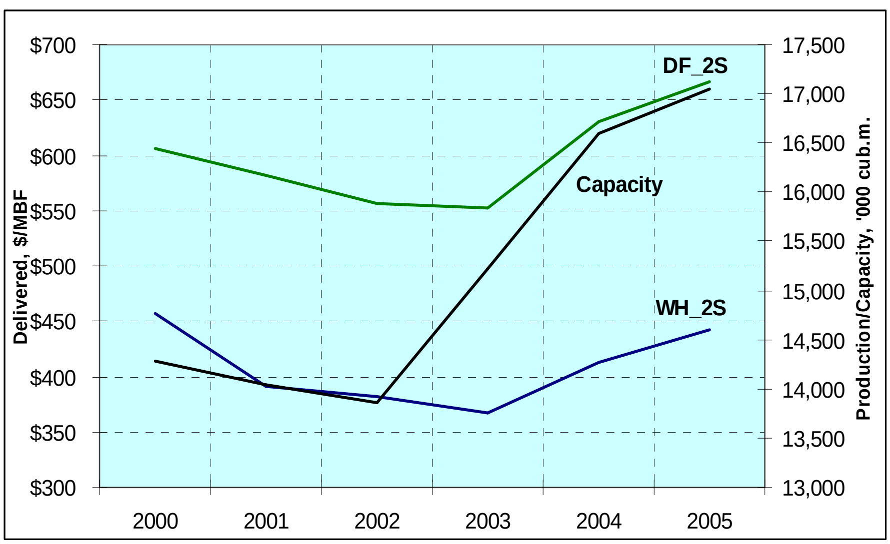
[7] Data: Spelte and Alderman. *Profile 2005: Softwood Sawmills in the United States and Canada.* USDA Forest Service.

FIGURE 3: DOUGLAS-FIR AND WHITE HEMLOCK STUMPAGE PRICES AND MILL CAPACITY/PRODUCTION CHANGES IN COASTAL WA



Similar to Washington, the coastal Oregon market added softwood mill capacity. However, unlike Washington where new and existing mills were increasing total production, Oregon has had no new mills open since 2000, and 10 softwood lumber mills – mostly small to medium size – closed between 2000 and 2005. Overall, mills in Coastal Oregon increased capacity/production by 17% between 2002 and 2005 (Figure 4).

FIGURE 4: DOUGLAS-FIR AND WHITE HEMLOCK TIMBER PRICES (#2 SAWMILL) AND CAPACITY CHANGES IN COASTAL OR



Capacity increases in both Washington and Oregon, coupled with mill operation and small log processing efficiency improvements suggests that the PNW market is trying to adjust to tighter margins and competition from Canada. This is an additional indication of market maturity and a clear sign to timberland owners that the industry will stay intact for now, with bigger and more efficient mills and flexible curtailment schedules.

TIMBERLAND RETURNS

The Pacific Northwest region leads the regional NCREIF Indices in timberland returns (Table 3). By acreage, PNW represents only ~20% of the Total US Index. The spread between the Total Index and Western Index declined from 3.62% from 1987 to 2006, to less then 2% over the past 6 years. This suggests that the differences in returns between the PNW and the rest of the US timberland market slowly, but surely, have been dwindling. For the last 4 years, with the exemption of 2005, PNW timberlands "out-performed" the average by a mere 0.6% to 1.2%. This is consistent with the fact that investors have been applying the same depressed discount rates to PNW investments as to investments in other U.S. regions.

Table 3: NCREIF Returns

Time Period	Total Timberlands	Western Timberlands
19870- 2006	15.18%	19.80%
2000 - 2006	7.30%	9.25%
2003	7.67%	8.57%
2004	11.20%	12.39%
2005	19.36%	35.64%
2006	13.68%	14.30%

PNW timberlands still look promising, despite Harvard's exodus from the region. It is unlikely that we will see double-digit multi-year timberland returns in the future, short of a major demand surge (e.g., exports) or supply shock (e.g., another spotted owl). Regardless, industry commitment to adding and upgrading capacity indicates the expectation of strong domestic log markets moving forward.

CONCLUSION

The PNW region remains a leader in timberland returns. The timber industry is overcoming tough times from competing with Canadian lumber and adjusting to both smaller margins and smaller logs. Frequent curtailments and efficiency improvements in the region suggest that the industry has matured and rationalized – it has been increasing capacity and improving efficiency during "lean" times, just as it should have been. For timberland owners and investors, this bodes well for timber markets, especially in Washington where new mills have come on line. Private and institutional timberland investors are increasing their market share in the region. As for the forest industry, competition is the key-word. Mills are becoming larger, and barriers to entry seem to be getting higher. Efficiency rules at the mill level.

The market for conservation easements and ecosystem services is picking up nationwide, and the PNW offers attractive opportunities for capitalizing these values. Forestland returns are bolstered by these values which, in some cases, supplant unpopular (in some circles) moves to develop or fragment property into economic units that do not lend them to sustainable forestry.

There is still speculation as to when the timberland price bubble will burst. In late 2006 some analysts thought discount rates were rising, reflecting softening demand for timber investments. However, Sewall acquisition analysis and research, coupled with empirical transaction evidence, suggest that this has not been the case.

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