Timberland Report
VOL. 8, NO. 1
1st Quarter 2006
JAMES W. SEWALL COMPANY
ESTABLISHED 1880

Conservation Easements, Supply Agreements, & Green Certification

Timberland transactions increasingly involve conservation easements, wood supply agreements, and green certification considerations. On the one hand, these features can reduce the price and total flexibility associated with timberland ownership. They can also reduce the risk and variability of investment returns, or meet objectives related to taxes, public recreation, and regional development. Understanding these instruments has become essential to negotiating many timberland transactions.

CONSERVATION EASEMENTS

Conservation easements have grown increasingly popular for marketing and managing timberland properties and their environmental attributes. For small, non-industrial private forest (NIPF) owners they provide an opportunity to incorporate environmental concerns or "legacies" into longer-term property management. For larger investors, they provide a vehicle for monetizing development values, public access, and other non-timber products. Easements can be sold for cash, or transferred by gift or bargain sale. Gifts and bargain sales afford taxable owners the ability to make charitable donations, subject to certain sideboards.[1]

Conservation easements generally include declarations of general purpose, restricted rights (what the underlying fee owner may not do), reserved rights (what the underlying fee owner may do), and affirmative rights (rights conveyed to the easement holder and public). Working forest conservation easements address sustainable forestry in several ways. One is limiting parcelization through subdivision restrictions.[2] Timber management plans may be required, subject to periodic review and revision. Such plans can be flexible, which most landowners prefer to highly prescriptive easement language that limits forest management to a narrow set of goals. Early easements included vague language like, "Commercial forestry shall be conducted according to scientific forest management practices." The next generation of easements commonly contained very specific prescriptions that one would expect to become outdated before long. Some more modern working forest easements have attempted to provide the landowner flexibility, acknowledging that the economic, scientific, and social contexts of forest management and ecosystem services are dynamic.[3]

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[1] For the IRS to approve a charitable donation, an easement must be perpetual, there must be donative intent (e.g., no *quid pro quo*), and the landowner must not retain mineral rights.
[2] This addresses concerns that small parcels would not be managed for timber production or allow public recreation.
[3] Vicary, Bret. Working Forest Conservation Easements. The Consultant, Summer 2001, Vol. 46, No. 3, pp. 24-28; Lind, Brenda. Working Forest Conservation Easements. Land Trust Alliance, 2001. 44 pp.

Investors are often wary of conservation easements, concerned over their perpetual status and future interpretation as names and faces of the players change. Investors should understand that easement holders legally must be prepared to go to the wall to enforce easements. Fiduciaries must recognize the potential for easements to reduce the liquidity of forest holdings, as encumbered properties attract fewer buyers, often extend marketing periods, and generally result in hefty discounts off fee simple value.

Easement programs are currently under scrutiny by tax authorities concerned that these programs represent nothing more than "tax loopholes for the wealthy." Under IRS Code 170(h)(4)(A), a conservation easement must be specifically designated for at least one of four purposes:[4]

1. Preserve land for outdoor recreation by, or education of, the general public;
2. Protect fish, wildlife, or plant habitat;
3. Preserve open space for public benefit; or,
4. Preserve an historically important land area or historic structures.

For taxpayers to claim a charitable donation of $5,000 or more, they must provide the IRS with a qualified real estate appraisal. The U.S. Treasury instructs appraisers to use one or two valuation methods: Direct comparison analysis and before and after analysis. Direct comparison analysis uses sales of similar easements as the basis for valuation. Before and after analysis requires the appraiser to estimate the market value of the underlying property before and after the easement is imposed, and then compute the difference. Treasury rules unambiguously state that direct comparison is preferred.[5] For transactions involving federal funds (e.g., Forest Legacy projects, USF&W acquisitions), appraisers must limit the analysis to the before and after method.

The appraiser must account for acreage designated for special treatment or no cutting at all; loss or restriction of development and subdivision rights; conveyance of public recreation rights; requirements for habitat preservation or enhancement; special silviculture mandates such as stocking guidelines, preference for uneven-aged management, restrictions on clearcutting or intensive practices (e.g., planting, non-native species, herbicides); etc. The appraisal must also recognize the extent to which the liquidity of the property is impaired. All these features reduce value, but risk and uncertainly often comprise the greatest component of value loss.

When applying transaction analysis in the after value, the appraiser should use comparable sales in which conservation easements were already in place at the time of sale. Unfortunately, the U.S. Northeast is the only region where there is a readily available supply of such data, so appraisals in other regions must use less than ideal transaction data to generate after values.

With discounted cash flow analysis, cash flow inputs must reflect the terms of the easement, and project what (in the eyes of a prudent investor) the easement holder will enforce in terms of easement compliance. The discount rate in the after situation will be greater than in the before situation due to increased uncertainty associated with co-managing a property with the easement holder, loss of "option value," and decreased liquidity of the asset. It is not uncommon to see the discount rate increase by 150 to 200 basis points or more in the after valuation.

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[4] Kirkland, Stephen D. Benefits of conservation easements. Southern Lumberman. January 2006. p. 35
[5] Small, Stephen. Appraising Easements, Third Edition. Land Trust Alliance, 1999, p. 23.

Are conservation easements always perpetual? No. They can have limited terms, but it is harder for ENGOs to raise funds, and term limits obviate the potential for charitable donations. Moreover, there are two ways in which a perpetual easement can be extinguished. One is for circumstances to radically change such that it becomes impossible for the easement to meet its stated objectives (e.g., all viable forestry markets disappear, or the property is condemned for other uses). Another is via the doctrine of merger – for instance, where the holder of the easement acquires the underlying fee interest.

The 1990 Farm Bill introduced the Forest Legacy Program (FLP), designed to protect lands from conversion to non-forest use. To date, over 1 million acres have been protected nationwide, with tract sizes ranging from 4 to 218,547 acres in size, with an average of 3,900.[6] Table 1 summarizes FLP activity in the timberland regions of the Southeast, Northeast and Pacific Northwest.

Table 1. Number of tracts and acres by selected regions in the FLP through 2005[7]

Region	States	Tracts	Acres
Southeast	7	37	65,688
Northeast	8	109	677,753
Pacific Northwest	5	33	45,005

Industrial, institutional, and private investors all use conservation easements to develop lands,[8] pursue certification, and establish public access. ENGOs and large timberland investors have partnered in some of the largest transactions in the U.S. In a typical scenario, the ENGO buys forestland in fee, sells a conservation easement to a public agency, and sells the underlying fee to a pure timber investor. This enables the timber investor to stick to its core business without having to generate returns on non-timber assets. A variation is where ENGOs and timber investors submit a joint bid, with the seller conveying easements directly to a public agency or ENGO, and the underlying fee to the timber investor. In other deals, the timber investor acquires fee simple interest with the intent of conveying easements to an ENGO or public agency.

Working forest conservation easements have been common throughout New York and New England since the 1970s and 80s. Several years ago we began seeing working forest easements in the Lake States, Inland West, and Pacific-Northwest, and to a lesser extent in Appalachia and the Southeast. Some easements have been very large, like the 750,000-acre Pingree easement in northern Maine, or the pending 250,000-acre International Paper Company easement in northern New York. With the huge amounts of capital chasing timberland deals, we can expect more and more investors to ultimately hold easement-laden properties.

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[6] Greening Forest Investment Panel: Forest Legacy. 2005. Draft document distributed by Liz Crane, Legacy Program Manager for the South, USDA at Society of American Foresters National Convention, Fort Worth, TX, October 2005.

[7] Southeast: AL, FL, GA, NC, SC, TN, VA; Northeast: CT, MA, ME, NH, NJ, NY, RI, VT; Pacific Northwest: AK, CA, CO, ID, WA, Of the remaining 12 states and territories, Montana features the greatest number of acres (154,579) in the FLP, Minnesota has the largest number of tracts (17), and New Mexico has the fewest of both with one tract of 132 acres. Wisconsin and Utah also have significant numbers of acres in the program with 36,009 and 47,967 respectively.

[8] Planning agencies sometimes require landowners to place undeveloped acres in conservation easements.

WOOD SUPPLY AGREEMENTS

Wood supply agreements have been used by forest industry managers to help manage the costs and flows of wood raw materials to manufacturing facilities, and to mitigate operational impacts of timberland divestitures by integrated forest products firms.[9] A typical agreement comprises a contractual obligation by a supplier to provide agreed-to volumes of wood to a buyer, who commits to purchase this raw material at the contract price.

Historical examples of wood supply agreements include major mergers, international operations, and industrial divestitures. When Plum Creek merged with The Timber Company in 2000, it assumed responsibility for a 10-year wood supply agreement between The Timber Company and Georgia-Pacific to supply Georgia-Pacific mills. An announced deal in 2004 combining the Swedish forestlands of Stora Enso and Korsnas into a forest-owning firm called Bergvik Skog AB included a 15-year wood supply agreement for Stora Enso and Korsnas manufacturing facilities. The Cerberus Group dispositions in Michigan and Ohio are encumbered by long-term supply agreements. Over 2 million acres of U.S. timberlands have traded hands in the past several years with wood supply agreements ranging from 20 to 50 years. Offshore, Stora Enso recently signed an agreement to purchase timber and land-use rights on 34,000 hectares in China to secure wood supplies for a new forest industry project.[10] Supply agreements are commonplace in South America and Australasia, where wood processing facilities are being constructed under the promise of sustained raw material supply. They help participating parties minimize operational impacts, facilitate the transition of ownership and control, and satisfy financing objectives.

To support an appraisal, pending transaction, or buy-out or dissolution of an existing supply agreement, one must assess the economic impact of its terms. Most agreements reflect a tradeoff between security and flexibility. Securing a market for the timberland owner and securing a supply of raw material for the wood user provides a set of predictable incoming and outgoing wood flows and cash flows, which must be evaluated against operational opportunity costs.

A key feature of any wood supply agreement is its pricing mechanism. Many older agreements index to a base like the Producer Price Index. Today, agreements commonly call for annually or semiannually marking prices to the market, using independent surveys of stumpage or delivered prices as a base. This has the advantage of ensuring that neither party will gain a clear price advantage. Many pricing approaches exist, and they can provide substantial security to both sides of the deal.

With large transactions, supply agreements often identify a core acreage capable of producing volumes required under the agreement. Non-core acres may be transferred to other parties with no strings attached. This outside acreage may be land with substantial non-timber value. Supply agreements can thus limit the liquidity of a property, particularly where the agreement prohibits subdivision and sale of core acres to parties not named in the agreement.[11]

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[9] Yin, Runsheng and Bob Izlar. 2001. Supply contract and portfolio insurance. Journal of Forestry. May 2001: 39-44.
[10] Stora Enso In Deal To Buy Timber, Land Use In China. *Dow Jones Newswires*. November 10, 2005.
[11] Mills prefer to limit the number of parties on the supply side of a wood supply agreement.

Regional timber markets feature increasing separation between timber producers (timberland owners) and wood consumers (mills), increasing the demand for wood supply agreements. Of the 6.86 million acres of U.S. timberland transactions summarized in the previous three issues of this newsletter, 5.23 million acres (76%) reflect divestitures by industry. Table 2 summarizes transactions exceeding 100,000 acres. This does not include those industrial timberland assets that are currently on the market, such as International Paper's entire 6.8-million acre forestland portfolio.

Table 2. Timberland transactions exceeding 100,000 acres with wood supply agreements, 2004-2005

Seller	State(s)	Acres	Buyer(s)
Domtar	NY	104,400	Lyme Timber Co, The Nature Conservancy
Fraser Papers	ME	240,000	The Forestland Group, LLC
Irving Woodlands	ME	230,000	Timber Star LLC
International Paper	ME, NH	1,100,000	GMO Renewable Resources LLC
Boise Cascade	Northwest, LA, AL	2,200,000	Forest Capital Partners
TOTALS		**3,874,400**	

Sources: Paperloop, Timber Mart-South, James W. Sewall Company

These transactions included a range of supply agreements:

- Domtar sold its northern New York lands while retaining a long-term fiber supply agreement supporting its papers mills in Quebec.
- Fraser Papers sale in Maine to The Forestland Group involved assets once held by James River, and is subject to a long-term wood supply agreement.
- Irving Woodlands, among the last of industry stalwarts committed to strong vertical integration, sold 230,000 acres to TimberStar. The deal was encumbered by a long-term supply agreement.
- International Paper's transaction with GMO renewable resources includes a long-term fiber supply agreement.
- Boise's 2.2-million acre sale for $1.65 billion to Forest Capital Partners – the single largest deal of 2004 – includes long-term wood supply agreements for the former Boise plants.

Internationally, wood supply agreements have been associated with satisfying forest certification requirements. For example, managers of certified forest plantations in Uruguay have been pursued by Vietnamese buyers seeking long-term fiber sources. Vietnamese manufacturers are unable to access certain foreign export markets (e.g., the European Union) where domestic sources of wood raw materials lack certification by a recognized international standard, such as the Forest Stewardship Council.

GREEN CERTIFICATION REQUIREMENTS

Green certification, such as under the Forest Stewardship Council (FSC) or the Sustainable Forest Initiative (SFI), is generally not a legal requirement of investment or land ownership. However, timberland deals increasingly involve certification as either a desirable option or a requirement.

Sewall clients have been involved in several conservation easements requiring the underlying fee owner to either: (1) submit fairly prescriptive forest management requirements, complete with oversight by the easement holder; or, (2) maintain the property under green certification. In most cases, the land was certified prior to the transfer of the easement, so the fee owner opted for certification instead of inviting yet another layer of forest management oversight.

Clients have also required help in analyzing the impact of wood supply agreements that require green certification. This requirement may reside within a conservation easement that stands alongside the supply agreement; other times it is a stand-alone requirement of the supply contract. Usually, an industrial owner is green certified from the mill to the woods, and wants to ensure that, when a major block of land crucial to mill supply is sold, certified wood will still be available from the land base. Green certification is generally voluntary aside from market inducements. However, in the context of conservation easements and supply agreements, it can become a legally binding requirement that runs with title to the property.

Where it is legally required, most investors believe that certification does more to detract from timberland value than add to it. They reason that the costs of compliance exceed the tangible benefits of upgraded management systems. In rare instances, modest market premiums are available for select forest products, but this remains uncommon. Access to specialty markets requiring green products is perhaps its greatest benefit. The *intangible* benefits of positive image and improved customer relations are what drive many decisions to go the certification route. We would be remiss to underestimate the real market influence that large customers like Time-Warner are wielding by requiring large to use high percentages of green certified wood in their production processes. However, many institutional investment managers have foregone certification because of the lack of tangible benefits accruing to the investor.

One concern commonly expressed by landowners is that certification groups inconsistently apply standards from owner to owner. This has caused many investors to avoid certification, and others to drop it. Consistency, predictability, and equity across owners would probably result in more private non-industrial owners certifying their lands. However, in the short-term we may see a decrease in the total U.S. acres under certification as the IPCo lands (SFI certified) fall into non-industrial hands.

CONCLUSION

Forewarned is forearmed. Conservation easements, wood supply agreements, and green certification complicate deals, but also provide opportunities for addressing specific concerns and mitigating risk. Business practices change, and the market place is becoming increasingly adept at adjusting and accounting for the impacts of these instruments. They provide certain buyers with niche opportunities, and the hope that returns will result from the market becoming more comfortable with these provisions.

Use of these instruments – particularly easements and certification – is not limited to large investments. According to Connie Best of Pacific Forest Trust, 100 million acres of forestlands are owned by individuals 65 years of age and older. As these owners sell or bequeath their lands,

they increasingly seek to formalize in contracts their wishes for the future of these lands. And communities concerned about future development have taken active interests in new institutional owners. The resulting contractual innovations will raise further questions about who actually "owns" the forestland.

Timberland Report VOL. 8, NO. 1
The *Timberland Report* looks at the timberland investment industry with an emphasis on the United States. The opinions expressed may not reflect the opinions of James W. Sewall Company.

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