Indexing Timber REIT Performance: Weyerhaeuser, Where Art Thou?

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About Forisk Equity Research
Forisk’s Equity Research Program supports investors, analysts, and executives interested in publicly-traded timberland-owning real estate investment trusts (REITs). Quarterly coverage emphasizes:

- NAV and cash flow-based valuations;
- Forest economics analysis of timber and timberland market fundamentals; and
- Potential impacts on timber REIT valuations from evolving markets such as wood bioenergy.

Forisk has provided Executive Education and published seminal timber REIT equity research since 2007. In 2008, Forisk initiated the Forisk Timber REIT (FTR, “footer”) Index to track the timber REIT sector and provide a benchmark for comparative analysis. To subscribe to the free weekly FTR Index Summary, or to obtain historical FTR Index data in an Excel format, contact Neena Mishra, nmishra@forisk.com.

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Executive Summary

Weyerhaeuser’s (WY) December 2009 announcement regarding its board’s approval for conversion to a real estate investment trust (REIT) drew attention to the timber REIT sector, its financial performance through the economic cycle and its investment potential moving forward. This technical note is in response to questions received from subscribers and clients regarding the conversion of Weyerhaeuser and its inclusion in the FTR (“footer”) Index, the longest continuously published index for the timber REIT sector.

Questions arose regarding the adding of Weyerhaeuser to the Index because the timing and nature of its REIT conversion differed from all previous cases. Unlike previous timber REIT conversions, Weyerhaeuser converts retroactively to tax year 2010. We detail our thinking for when to index Weyerhaeuser as a REIT to optimally satisfy investor needs related to benchmarking timber REIT financial performance.

Initiated in 2008, the Forisk Timber REIT (FTR) Index is a market capitalization weighted index of all publicly-traded timberland-owning REITs. The Index which presently includes Plum Creek (PCL), Rayonier (RYN) and Potlatch (PCH), provides a benchmark for a subset of institutional and retail timberland investors, particularly interested in tax efficient REIT structures.

With the payment of the special dividend in September 2010 and announcement of dividend guidance for 2011 in December 2010, Weyerhaeuser effectively completed all steps required for conversion to a REIT. The company has (1) operated as a REIT, with the ability to satisfy the IRS income and asset tests requirements for REITs, since January 1, 2010 and (2) provided dividend guidance as a REIT for the year 2011. Investors buying shares of Weyerhaeuser today now have better visibility about their investment and tax planning. Though there is no guarantee that the IRS will accept Weyerhaeuser’s REIT qualifications upon electing REIT status on its 2010 tax return in early 2011, we believe that company has established its ability to satisfy the asset and income tests for this year and, barring unforeseen complications, the company’s conversion remains a foregone conclusion. Thus the company is now a REIT from an investor’s perspective.

We therefore include Weyerhaeuser in the FTR Index on the first trading day of the new year on January 3rd, 2011.
Introduction

Weyerhaeuser’s REIT conversion draws attention to timber REITs and the FTR Index.

Weyerhaeuser’s (WY) December 2009 announcement regarding its board’s approval for conversion to a real estate investment trust (REIT) affirmed the expected restructuring of the 109-year old forest products company. The subsequent shareholder approval in April 2010 of this decision, and continued interest in timberland investment vehicles generally, draws attention to the timber REIT sector, its financial performance through the economic cycle and its investment potential moving forward. From an investor’s perspective, key benefits of investing in timber REITs include strong relative dividends taxed primarily at capital gains tax rates.

Currently, three timberland-owning REITs trade publicly in the US: Plum Creek (PCL), Rayonier (RYN) and Potlatch (PCH).¹ The timber REIT sector market cap of $11.65 billion comprises 52% Plum Creek, 36% Rayonier and 12% Potlatch. In aggregate, this sector constitutes 2.99% of total public REIT capitalization. Weyerhaeuser, with a market cap exceeding $10 billion, increases the sector by 85%.

“When will the FTR Index include Weyerhaeuser?”

Our subscribers and clients have asked this question since Weyerhaeuser announced its intent to convert to a REIT. However, the conversion timetable and, critically, the Earnings and Profit (E&P) payout remained unknown until July 11, 2010, when the company announced the required “special dividend,” which paid out on September 1, 2010. While technically a REIT only after electing the REIT status in its tax filing for 2010, Weyerhaeuser effectively operates as a REIT today. Subsequently, the timing and nature of its REIT conversion differed from all previous cases. Weyerhaeuser’s conversion will be retroactive to tax year 2010, while previous conversions were forward looking. In this technical note, we detail our thinking for when to index Weyerhaeuser as a REIT to optimally satisfy investor needs related to benchmarking timber REIT financial performance.

Investor Interest in Timber REITs

First peer-reviewed study of timber REITs conducted in 2007, published in 2008

In 2007, Forisk conducted the first peer-reviewed research evaluating timber REIT performance.² The study, published in 2008, analyzed equity market responses to announcements by forest industry firms of their decisions to restructure from traditional C-corporations to real estate investment trusts (REITs). Our research found that all four announcements were associated with significant abnormal increases in the stock prices on the day before, day of or day after each firm announced the conversion. On average, shareholders showed a 5.2% paper gain in share value one day following the announced intent to convert. The analysis concluded that investors prefer holding industrial timberlands within a REIT – with its tax efficient structure and distribution requirements – rather than traditional C-corporation.

¹ Longview Fiber (LFB) traded publicly as a timber REIT temporarily in 2006 prior to its acquisition by Brookfield Asset Management in 2007.
Figure 1 summarizes the relative performance in 2010 of the three currently-available public timber REITs and Weyerhaeuser.

Figure 1: Indexed Returns of Public Timber REITs, 2010 (January 4, 2010 = 100)

Forisk Timber REIT (FTR) Index

The Forisk Timber REIT Index, commonly called the “footer” index, is a market capitalization weighted index of all publicly-traded timberland-owning real estate investment trusts (REITs). Initiated in 2008, the FTR Index assigns a weight to each of its constituents based on its individual market share.

In addition to the market cap weighted index, Forisk publishes the FTR Total Return Index and FTR Equal Weighted Index. The Total Return Index assumes the reinvestment of dividends on a daily basis; the Equal Weighted Index assumes that an equal dollar amount is invested in each security (Figure 2).

Any publicly-traded US company operating as a REIT that owns and/or manages timberland is eligible for inclusion into the FTR Indices. All eligible companies should be listed on either the NYSE or NASDAQ. In the past, we included the timber REITs, with effect from the date on which they became a REIT.4

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3 Weyerhaeuser’s share price has been adjusted to account for the special dividend.
4 For a copy of “FTR Indices Calculation Methodology”, which details the process followed for Index maintenance, and to be added to the FTR Weekly Summary distribution, which summarizes timber REIT performance relative to US benchmarks and alternative asset classes, please contact Neena Mishra, nmishra@forisk.com.
Weyerhaeuser Converts

“What did Weyerhaeuser do to qualify for REIT status? What is the company’s status?”

On December 15, 2009, Weyerhaeuser announced that its board decided that (1) a REIT conversion best supports the company’s strategic direction and (2) that the conversion would likely occur in 2010. Requirements for conversion included that the company pay a special dividend, by the end of the year of conversion, of its previously undistributed earnings and profits (E&P), attributable to the taxable periods prior to the effective date of conversion.\(^5\)

Prior to the 2009 announcement, Weyerhaeuser had taken significant steps to prepare itself for the conversion. In 2007, Weyerhaeuser named Debra Cafaro, a well-regarded REIT executive, to its board. The firm sold its Containerboard, Packaging and Recycling business to International Paper and combined its Fine Paper Business in a spinoff transaction with Domtar. Additionally, the company has divested or closed multiple wood products manufacturing plants in the last three years.

Organizationaly, Weyerhaeuser’s changes included:
- Fiscal year end changed to the calendar year.
- Non-qualifying assets and associated liabilities were transferred to taxable REIT subsidiaries (TRSs).
- Timberland business divided into “qualifying” and “non-qualifying” businesses:
  - Owned and leased timberlands with Weyerhaeuser (REIT qualifying).

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\(^5\) E&P is required to be measured at the beginning of the year of election, but can be paid till the end of the election year.
Logging operations, oil and gas leases moved to Weyerhaeuser NR Company (TRS).

- “Higher-and-better-use” (HBU) lands and non-strategic timberlands moved to Weyerhaeuser Real Estate Development Company (TRS).
- Weyerhaeuser’s Wood Products manufacturing, Cellulose Fibers business and the Weyerhaeuser Real Estate Company reside within TRSs.

In view of the organizational changes made through 2008, the company could have elected REIT status for the year 2009. However, the company delayed this decision for the following reasons material to shareholders:

- REIT status would have precluded the carryback of 2009 operating losses.
- REIT qualifying timber income for 2009 was low due to harvest deferrals in a down housing market. As a result, the tax benefit gained in 2009 would have been small relative to the E&P payout.
- Weyerhaeuser had a substantial profit associated with the sale of the Containerboard Business in 2008 and the net operating losses (NOLs) in the year of conversion are required to be carried forward against future income and not backward, whereas Weyerhaeuser wanted to carry the NOLs of 2009 backward against the gains made in 2008.

Further Weyerhaeuser anticipated that the IRS would extend its ruling for 2009 that enabled firms to pay the special dividend in 90% stock and 10% cash for the year 2010. In the past, the IRS allowed REITs to payout up to 80%, rather than 90%, stock and 20% cash.

After shareholders’ approval, Weyerhaeuser declared a special dividend of $5.6 billion. The dividend (stock and cash), taxable for 2010 federal income tax purposes, was paid on September 1, 2010 to shareholders of record on July 22, 2010. On the ex-dividend date (July 20, 2010), the share price adjusted to reflect the special dividend as follows:

- Closing price per share on July 19, 2010: $41.83
- Special dividend per share: $26.47
- Adjusted share price ex-dividend: $15.36

On December 13, 2010, Weyerhaeuser announced that it anticipates an annual dividend payment of $0.60 per share in 2011. The first quarterly dividend payment of $0.15 per share is expected in March 2011. Management also stated its intent to target a dividend payout ratio of 75% of FAD (Funds Available for Distribution, defined as cash flow before debt repayments and dividends) over the cycle. However, in 2011, the payout approximates 100% of FAD as Weyerhaeuser does not expect significant improvement in the housing markets and economy in general in 2011.

**Adding Weyerhaeuser to the FTR Index**

**Weyerhaeuser joins the FTR Index on January 3rd, 2011, the first trading day of the year.**

With the payment of the special dividend in September 2010 and announcement of dividend guidance for 2011 in December 2010, Weyerhaeuser effectively completed all steps required for conversion to a REIT. However, prior to Weyerhaeuser, all timber REITs announced their conversions prior to the effective realization of REIT status and their addition to the FTR Index. Uniquely, Weyerhaeuser’s conversion will be retroactive to tax year 2010.

In adding Weyerhaeuser to the FTR Index, we considered the following dates:
1. January 1, 2010 (effective date for conversion, retroactive upon filing 2010 tax returns in 2011)
2. July 20, 2010 (Ex-dividend date for payment of special dividend)
3. January 3, 2011 (the first trading day of 2011)
4. Actual date Weyerhaeuser files its tax return in 2011 and elects REIT status

For the benefit of the timberland and timber REIT investors that currently apply the FTR Index as a benchmark for their portfolios, we decided not to add Weyerhaeuser retroactively in the Index. Further, many clients benchmarking with the FTR Index already invested in Weyerhaeuser shares after the company paid the special dividend and announced its guidance for the 2011 dividend as a REIT. To minimize the tracking error between the investment performance of our clients’ portfolios and the FTR Index, we felt it imprudent to wait for “technical” completion of the conversion farther into the future.

The company has (1) operated as a REIT, with the ability to satisfy the IRS income and asset tests requirements for REITs, since January 1, 2010 and (2) provided dividend guidance as a REIT for the year 2011. Investors buying shares of Weyerhaeuser today now have better visibility about their investment and tax planning. Though there is no guarantee that the IRS will accept Weyerhaeuser’s REIT qualifications upon electing REIT status on its 2010 tax return, we believe that company has established its ability to satisfy the asset and income tests for this year and, barring unforeseen complications, the company’s conversion remains a foregone conclusion. Thus the company is now a REIT from an investor’s perspective.

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