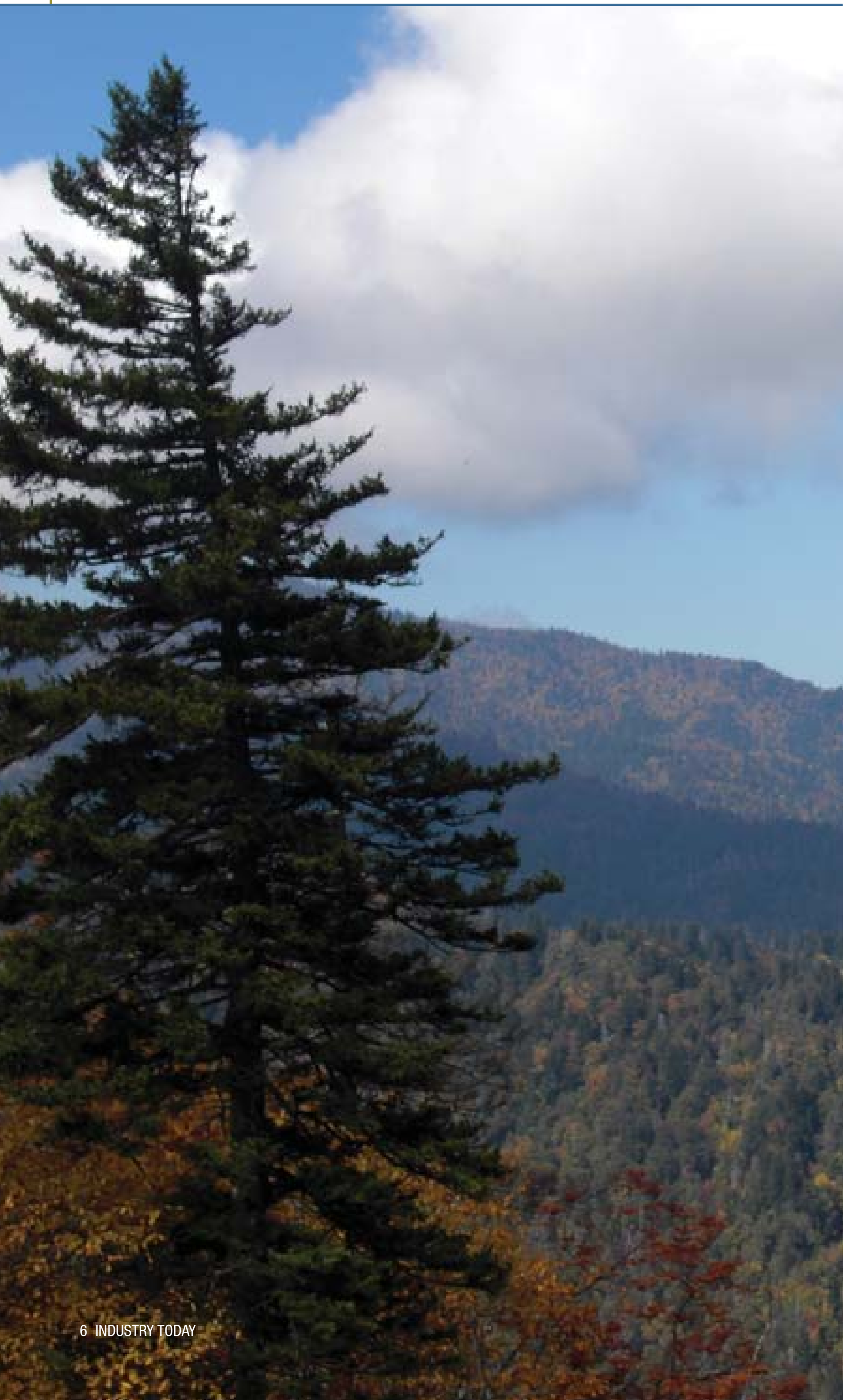
FEATURE

Divest And Conquer



FOREIGN INVESTORS CONTINUED TO increase their holdings of U.S. real estate assets from 2006 to 2007. Individual and corporate investors – mostly from Canada and Europe – owned more than 21.2 million acres of agricultural land across the United States, an increase of over 5.3 million acres since 2006. This represented a 33.6 percent increase in foreign ownership since 2006. Of that, 13.6 million acres, or 64 percent, were classified as forest lands. As in 2006, Maine and Texas led all states in foreign-owned land in 2007. Foreign ownership in Maine decreased 8 percent to 3.3 million acres, 15.7 percent of all foreign-owned U.S. agricultural land. Foreign ownership in Texas increased 11 percent to 1.9 million acres, 8.9 percent of all foreign-owned agriculture land in the U.S.

John Hancock Life Insurance and several subsidiaries have contributed the most to the increase in foreign timberland ownership, according to researchers at the Real Estate Center at Texas A&M University. Manulife Financial owns John Hancock and is a Canadian-based company that specializes in financial services. The group purchases timberlands primarily through its timberland investment management organization (TIMO) based in the United States: Hancock Timber Resource Group, one of the leading timberland investors in the country.

THE ECONOMICS OF TIMBER

This appetite for timberlands has been fed by the continued divestitures of industrial-grade timberlands by traditional vertically integrated forest industry firms in the U.S. Why has the forest products sector divested its timberlands? Operational, regulatory, and financial reasons encouraged a shift away from direct ownership by the forest products industry. Timber markets have become more liquid, permitting wood using facilities to satisfy their raw materials needs without actually owning timberlands. Regulations, in the form of tax laws, put traditional C-corporations at a tax disadvantage relative to real estate investment trusts (REITs) and the single-taxed limited liability corporations (LLCs) and S-corporations of private investors. C-corps

EXCHANGE RATES, THE POLITICAL ENVIRONMENT, AND THE NATURE OF THE ASSET ARE ALL FACTORS BEHIND FOREIGN INVESTMENT IN U.S. FORESTS.

face "double-taxation" as they pay federal income taxes and their shareholders pay personal income taxes on dividend distributions. Alternately, REITs, LLCs and S-corps do not pay taxes at the corporate level and are thus more attractive to shareholders. In addition, rising property taxes and disparate property tax policies raised the operating costs of owning timberlands. Increasing land values near population centers such as Atlanta and recreation centers such as Florida complicated the economics of growing timber for corporate managers.

This reality of the tax code and poor forest industry performance relative to broader measures of stock market performance created pressure on industry executives at firms such as Georgia-Pacific, International Paper, Louisiana-Pacific and Boise Cascade to improve financial returns. Divesting timberlands provided a ready means for generating cash to pay down debt and "unlock" shareholder value. Today, these firms and others own little to no timberlands, having sold them to institutional investors and TIMOs – such as Hancock Timber Resource Group in Boston (mentioned earlier), Forest Investment Associates in Atlanta, and The Campbell Group in Portland – and publicly-traded timber REITs – such as Plum Creek, Potlatch, and Rayonier.

While small portions of these timberland sales have gone to developers plugged into the housing markets who planned to build subdivisions, the vast majority of these acreages are being bought by investors who intend to manage them for the long-term and keep them as income-producing forests. These investors include a range of foreign pension funds, institutional investors and multi-national corporations. Foreign investors in U.S. timberlands typically maintain a long-term perspective, working with investment horizons of one to two decades rather than one to two years.

FOREIGN INTRIGUE

While vertically integrated U.S. timber firms divested their timberland because of tax inefficiencies and poor market performance, why are foreign investors intrigued by U.S. timberland? The answer is threefold: exchange rates, the political environment, and the nature of the asset.

First, favorable exchange rates can increase the attractiveness of a foreign investment. The weakened U.S. dollar in the past few years incented foreign investors to revisit and acquire U.S. land and real estate assets.

Second, the U.S. has a stable political environment that is favorable for timberland investment. Research interviews we conducted in 2007 with 13 U.S.-based firms and institutions directly involved in executing timberland investment strategies highlighted critical factors affecting international timberland investment decisions. These executives identified key risks and concerns associated with investing overseas. The top five were:

- political stability;
- markets for wood;
- property rights;
- legal structure/contracts;
- tax regulations.

The interview responses are also instructive when viewed from an international investor perspective looking into the United States. The identified factors are currently associated with U.S. timberland investments; they represent standard, assumed characteristics and components of participating in the asset class domestically. As such, the favorable U.S. profile of timberland investments along these dimensions help explain the international interest in owning U.S. timberlands.

The third reason foreign investors are interested in timberland is that it is a hard asset class that will remain in demand. One investment thesis pursued by foreign-based investors (with longer term investment horizons) and US-based hedge funds: the U.S. is ultimately resource constrained and any investment in land and the assets required to produce food, buildings materials, packaging and bioenergy will ultimately be successful and profitable in the long-run. From this perspective, timberlands represent an attractive sector of the land space in that they are often located in the "path of growth," have the proven ability to generate commercial in-demand products, and may be acquired at (relatively) attractive prices. In addition, they are a hard asset that may provide an investment portfolio with a hedge against inflation and diversification benefits during a period of relative market turmoil.

The U.S. may be a favorable place to own timberlands in the global marketplace, but is foreign ownership of U.S. timberlands favorable for U.S. citizens? It's understandable that the turnover of significant industrial timberland acres by traditional, U.S.-based forest-products firms to, in cases, foreign owners generate concerns. It appears more unpredictable when the owners are not household names. However, the reality of maximizing value and returns of U.S. timberlands, regardless the owner, depends on strong U.S. demand and localized markets for wood, forest products, homes and, in the future, forest bioenergy. Strong interest in U.S. timberland investments support and imply long-term strength in and commitment to domestic economic performance.

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