

Timberland Reconveyance Fees: An Introduction

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Introduction and Overview

Recent events in the financial markets generated questions from current and potential timberland investors regarding traditional and alternate opportunities for generating cash in the short-term and securitizing assets for the long-term. One tool under consideration by institutional and corporate timberland owners is reconveyance fees.

Reconveyance fees give the holder the right to receive 1% of the sales price with any future transfer of title to real property for, as currently defined, 99 years. Freehold Timber Group, LLC currently estimates that the present value (PV) of this future stream of income, net to the owner, is worth approximately 7% of the appraised value of the timberland property.

Reconveyance fees have been applied to real estate classes including residential and office developments. Specific, potential applications for timberland reconveyance fees include, but are not limited to:

- Short-term cash generation through the sale of reconveyance fees;
- Long-term financing of obligations tied to the property (such as mitigation banks, easements, right-of-ways or other legislated or mandated property attributes); and
- Long-term securitization of timberland investments.

In exploring opportunities for applying reconveyance fees to timberland assets, Freehold Timber Group commissioned Forisk Consulting to research the process for estimating the values of reconveyance fees associated with timberland properties. Key challenges associated with this research revolve around the data required to value these fees over a 99 year time horizon. The key inputs are estimates of a suitable discount rate, expected rate of appreciation, expected turnover rate (sale frequency) of timberlands, and the expected value (price) of timberland assets in each region.

Key findings from this research included:

- At this time, approximately 17% to 19% of forested acres in the Pacific Northwest, South, and Northeast represent a reasonable estimate for the “investable universe” of US timberlands. TIMOs and REITs are, and will increasingly be, the leading or primary owners of investment grade properties.
- Reported cash returns from timberlands across the US are converging, which supports the case for applying one appreciation rate for the timberland asset class in the US. Based on available data and Forisk analysis, 8.09% nominal was proposed as a reasonable, expected long-term appreciation rate on timberlands.
- Emerging trends within the current timberland investment environment include:
 - Timberlands are becoming a national market.
 - Interest in US timberlands from international investors continues to grow.
 - Timberland transactions increasingly occur between TIMOs.
- Based on publicly-available data, weighted average per acre prices for US timberlands in region-specific transactions exceeding 100,000 acres each from 2005 through 2008 were:
 - Northeast: \$460 per acre;
 - Northwest: \$2,251 per acre; and
 - South: \$1,384 per acre.
- Direct research on investment-grade timberland turnover is limited. Using four approaches and data sources to study this area, a turnover rate of 10.9 years was identified as a reasonable estimate of turnover from “investment-grade” properties.
- Estimated suitable current discount rates for long-term US timberlands: 7% nominal.

Reconveyance fees appear to represent a viable instrument that could be strategically applied, implemented, and allocated for timberland investment, financing, and conservation management purposes. The balance of this document summarizes key insights and assumptions from the research associated with understanding and considering the application of reconveyance fees to timberland assets.

Summary of Current Timberland Investment Environment

Recent timberland investment trends indicate that transactions have slowed as buyers and sellers appear to readjust their forward looking portfolio allocations and appear to prepare for an adjustment in timberland prices. Evidence includes the slowing of transacted acres and the pulling from the market of three large, potential deals (Table 1).

Table 1: Announced Timberland Offerings Removed from Market, 2008

Seller	Acres	Location
Forest Capital Partners	1.84 million	LA, OR, WA, ID
GMO Renewable Resources	326,000	Southeast US
St. Joe Company	67,365	Florida

According to Timber Mart-South, a preliminary estimate of industrial and institutional timberland transactions in 2008 total 3.85 million acres in the US relative to a five-year annual average of 5.4 million acres.¹ Overall, the current timberland investment environment appears to be taking on the following characteristics:

Timberlands are becoming a national market. While timber markets are uniquely local and timberland ownership patterns vary widely by region, the asset class has become national. Investors increasingly recognize that:

- Timberland diversification can be achieved within a given region – i.e. within the South, Northeast, or within the Pacific Northwest; or
- Diversification is increasingly driven at the portfolio level, which includes all invested assets held by the client.

In addition, rates of return and discount rates applied to potential investments appear to be converging across the country. The most compelling evidence comes from both the converging cash returns of timberland investments and the converging discount rates applied to timberland assets across regions in the US. This trend reflects, in part, a “return to fundamentals” in timberland investing where potential buyers are refocusing on potential returns and cash flows from growing and selling trees rather than depending on development values over the next decade.

Interest in US timberlands from international investors continues to grow. Foreign investors increased their holdings of US real estate assets from 2006 to 2007.² 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% increase in foreign ownership since 2006. Of that, 13.6 million acres,

¹ Timber Mart-South, 4th Quarter 2008.

² Mendell, B.C. 2009. Divest and conquer: exchange rates, the political environment, and the nature of the asset are all factors behind foreign investment in US forests, *Industry Today*, 12(1): 6-7.

or 64%, were classified as forest lands.³ Factors driving foreign investor interest in US timberlands include exchange rates, the political environment, and the nature of the asset.⁴

Timberland transactions increasingly occur between TIMOs. In 2001, TIMOs became the dominant buyers of investment grade timberlands in the US; in 2008, TIMOs also became the primary seller of investment grade timberlands in the US. Timberlands have become a subset of the overall private timberland universe, and turnover is expected to increase within this subset.⁵ While turnover may fall in the short-term, the characteristics of the institutional timberland investment sector indicate a steady churn of properties over the longer turn converging to, approximately, 10 years.

Average turnover of investment grade properties in US regions

To date, the turnover of timberland properties – the resale rate – has not been widely or rigorously tracked in regional or national databases by public or private data providers. As such, Forisk identified and pursued four approaches for quantifying and estimating the turnover of investment grade timberland properties in the United States:⁶

1. Average acres sold per year based on industrial/institutional transactions to estimate the frequency with which a given acre changes hands;
2. Timberland parcel turnover rate based on county tax roll data;
3. Literature reviews and research interviews to aggregate expert opinion and published research on timberland ownership tenures; and
4. Exploration into the details and data underlying the NCREIF Timberland Index.

For small and family-owned timberland properties, Forisk suggests the average turnover of 26 years from the National Woodland Owner Survey conducted by the US Forest Service.

However, a turnover rate of 10.9 years is a reasonable estimate of turnover from investment-grade properties. This is a blended average of 10 (85%) and 16.05 (15%) years – the average of the most common fund holding and Forisk's estimate of the ceiling of the turnover rate, which is based on analysis of actual large-scale transactions.⁷

Estimating discount rates for investment grade timberlands

The challenge with discount rates is that they are not directly observable; they must be estimated.⁸ The challenge in estimating discounts rates in the current business climate is the extreme effects recent market returns have had on traditional measures of long-term investment performance, such as the S&P 500, ten year bonds, and borrowing rates. As such, a longer term view of key measures is required in applying traditional approaches, extending traditional 10-year windows to 20 years for incorporating longer-term perspectives.

³ Foreign buyers of agricultural land must register their purchases with the United States Department of Agriculture (USDA), which in turn publishes an annual report, *Foreign Holdings of U.S. Agricultural Land*.

⁴ Mendell, B.C. 2009. Divest and conquer: exchange rates, the political environment, and the nature of the asset are all factors behind foreign investment in US forests, *Industry Today*, 12(1): 6-7.

⁵ As opportunities present themselves for realizing returns exceeding agreed to client benchmarks, TIMO managers often have the latitude to sell or liquidate timberland investment portfolios. As such, several TIMOs indicated that timberland funds are rarely held to their 10 or 12 year planned maturities.

⁶ Each approach is detailed in “Freehold Timberland Reconveyance Fees” by Forisk Consulting, April 2009, 29 pages.

⁷ The 85/15 ratio is an estimate of the breakdown between true institutional/industrial acres and individual/family acres in the estimated and relevant investable universe of 60 million acres.

⁸ Mendell, B.C. 2006. Discount rates and timberland investments. *Timberland Report*, James W. Sewall Company, 3rd quarter, 8(3): 1-7.

Using quantitative approaches, estimated long-term nominal discounts for US timberlands moving forward range from 4.96% to 8.78%. Discussions with practitioners indicated real rates ranging from 5% to 8%. In our professional opinion, nominal discount rates below 6% nominal are unreasonably low as they imply investors should prefer long-term bonds. **As such, 7% nominal was recommended**, which is the midpoint of 6% to 8%, while remaining consistent with the quantitative estimates. It also represents the low end of those applied by current practitioners.

Conclusion

Reconveyance fees appear to provide a viable instrument for strategically generating short-term cash flows, financing long-term property-specific obligations, and securitizing a portion of one's timberland investment portfolio. As such, reconveyance fees may present timberland investors and managers with additional means for meeting their specific investment, financing, and property management objectives.