TIMOs & REITs
What, Why, & How They Might Impact Sustainable Forestry

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Introduction

Forestland ownership patterns can have a significant impact on the long-term continuance of large tracts of forestland as diverse natural forests. In recent years, there has been something of a perfect storm impacting forestland ownership. Increased demands for liquid capital for core operations, rising Wall Street pressures to improve returns, and a realization that many timberland assets have been undervalued have combined with an increased willingness by the financial sector to invest in forestland. This combination has caused millions of acres to change hands from large integrated forest product companies to investment management vehicles such as TIMOs and REITs. The jury is still out as to the long-term impact of this ownership shift on forest management activities; however there are growing concerns about the commitment of these ownership entities to forests in general and to sustainable forests (e.g. certified) specifically. This report provides a brief overview of TIMOs and REITs and those policies and pressures that have been driving their growth. This report also provides information about how TIMOs and REITs are currently impacting sustainable forestry and how these impacts may evolve.

Background

Of the approximately 749 million acres (277 million ha.) of forest land in the U.S., about two thirds, or 504 million acres, are classed as timberland (forests that are available for periodic timber harvest). The forest industry, along with various institutional investors, has traditionally owned about 12 to 13 percent of the timberland (approximately 60 million acres) within the United States. In recent decades, ownership of forestlands, and particularly of this 12 to 13 percent of timberland, has increasingly shifted to "TIMOs[1]" and "REITs.[2]" The land transactions of TIMOs, REITs and other financial buyers have been significant in recent years and accounted for about 60% of all publicly reported timber transactions in the U.S. from 1995-1999[3], with acreage growth in TIMOs and REITs being 22% annually between 1987 and 2003[4]. In 2006, TIMOs and REITs were involved in transactions amounting to more than 7 million acres of timberland - the highest level of activity since 1999. By the end of 2006, TIMOs owned approximately 20 million acres of U.S forestland (a 283% increase since 2002) and REITs owned a bit less than 15 million acres[5]. In total, these two ownership categories control nearly 5% of the total forestland in the U.S. and about 7% of the timberland.

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[1] Timber Investment Management Organizations (TIMOs): Private companies acting as investment managers for institutional clients, primarily pension funds, endowments and wealthy individuals. Timberlands are owned as illiquid direct investments or partnership shares, generally in separate accounts, but frequently in pooled funds.

[2] Real Estate Investment Trusts (REITs): Companies focusing mostly or exclusively on real estate and timberland ownership with a high degree of liquidity through the public trading of shares on a stock exchange.

[3] http://environment.yale.edu/documents/downloads/0-9/05.03.pdf

[4] http://www.sfasu.edu/forestry/services/proceedings/carlton_owen_key_learnings.pdf

[5] Timberland Markets. February 2007. Vol. 5, No. 1. RISI. www.risiinfo.com/tsd

Historical Context

Official federal ownership of land in the United States began around the end of the 18th century, when the original colonies ceded their "western" lands to the government. In 1803 the government acquired the lands that comprised the Louisiana Purchase, resulting in a significant increase in the government stock of property. Ultimately it was decided that the land would better increase in value and productivity if distributed to private interests. In 1812 the General Land Office was established with the purpose of overseeing disposal of public lands through land sales, homesteading, grants to railroads, and other methods. The transfer of land ownership also served to help finance the government and expansion into new territories, along with trading posts, and the military locations necessary to support that expansion.

Nearly half a century later, the US government passed the Homestead Act of 1862 to help speed up the dispersal of land into the private sector. Although federal disposal of public lands into private ownership was done primarily through the Homestead Act, the government also disposed of land by giving away parcels as payment to veterans or selling land at public auctions. Reconstruction following the Civil War included significant land ownership changes as well. It was through these means that private industry throughout the United States was able to expand its forestland ownership.

Over the past three decades or so, consolidation of forest products companies through mergers and acquisition, combined with the globalization of the forest sector and fiber supplies (and the poor financial performance of the pulp and paper industry), has caused a reevaluation of forestland as a strategic asset and increased the importance of demonstrating a greater return on capital investments. In this context, companies began divesting their timber holdings in order to reduce debt or focus on generating quarterly returns. This activity, in turn, stimulated the interest of a certain group of professional investors – TIMOs and REITs.

TIMOs and REITs Defined

The acronyms "TIMO" and "REIT" refer to two distinct types of investment structures that are used to manage economic returns from land ownership.

TIMOs

A Timberland Investment Management Organization (TIMO) is an investment management tool where the focus of management is primarily on maximizing the growth in the value of timberland assets. Investors in TIMOs are interested in total return and capital appreciation (i.e., growth in the value of the land from the time of purchase to sale and increased timber volume); capital appreciation typically accounts for 2/3rds of the total return for a TIMO. Generally, TIMOs are not as concerned as other land managers might be about annual cash flows from activities such as timber sales and are in a better position to time their activities and investments to respond to market conditions.

Investors in the TIMO actually become the owners of the forestland and a role of the TIMO management team is to advise these investors. Participating in a TIMO usually requires a minimum investment of $100,000. Therefore, owners of TIMOs tend to be pension funds, insurance companies, corporations, foundations, financial institutions, universities, endowments, and occasionally, individual investors. In the United States, TIMOs currently advise on the management of approximately 20 million acres of land with a total value of more than $19 billion[5].

There are two primary types of investment models for TIMOs. The "separate accounts" model involves an individual investor or financial entity that purchases timberland and intends to manage it for returns over an indefinite term. In contrast, "closed-end funds" involve multiple investors who purchase timberland jointly and intend to hold it for a set period, such as 10 to 15 years, before selling it.[6] Estimates are that TIMO investments are fairly evenly split between these two models, with about half of all investments in each category. Over the past 30 years, TIMOs have typically held lands for 7 to 15 years before selling, with sales most often to other TIMOs, conservation groups, or timber companies.

For much of the twentieth century timberland had been considered a secure and stable, but low yielding investment. Thus it has often been a component of insurance company portfolios. Recent growth of TIMOs has been driven in part by the creation and subsequent changes to the Employee Retirement Income Security Act of 1974 (ERISA).[7] This federal law aimed to provide protections for individuals enrolled in various retirement plans. The act includes requirements for institutional investors such as health and pension plans, endowments, and foundations to diversify their portfolios to

For-sale signs pop up on U.S. timberlands
By Laura Mandaro, MarketWatch
Last Update: 11:59 AM ET Mar 31, 2007

SAN FRANCISCO (MarketWatch) -- If Paul Bunyan were chopping logs today, he'd probably be working for a retirement fund.

The nation's 504 million acres of timberland, home to wildlife and the source of everything from deck frames to copy paper, have been the focus of a massive multi-year auction, the outcome of which is set to change the rules for wood companies and conservationists alike.

"In the last 10 years, there's been an explosion of interest in timberlands," said Bob Izlar, director of the University of Georgia's Center for Forest Business.

One such sale is going on now. Paper and wood maker Temple-Inland, Inc. has said it is seeking buyers for most of its 1.8 million in Southern U.S. timberlands. The acquirers are likely to be financial investors that include insurance companies and specialized asset managers. And while these types of investors continue to log, their growing role in the industry has cast a long shadow over what happens to these forestlands 10 or 15 years from now, when some timber-oriented funds are scheduled to wind down their investment.

"There's an uncertainty in the general conservation community about the long-term predictability that [these lands] will stay in timberland and won't go into a golf course," said Izlar, who is considering a study on the impact of ownership changes.

http://www.marketwatch.com/news/story/private-investors-gobble-up-us/story.aspx?guid=%7BE750A6A9-5A46-4E41-AB86-9ED7C6B80DFF%7D

6 http://www.safnet.org/archive/1204_ownerships.cfm
7 http://www.dol.gov/dol/topic/health-plans/erisa.htm

minimize the risk of large losses. This act provided a legal mandate for pension funds with large amounts of capital to diversify away from traditional fixed income securities. At the time ERISA was enacted, timberlands were selling at bargain prices, and to respond to ERISA's requirements, timberland investment management organizations (TIMOs) were developed to diversify, organize and manage institutional investments in these lands. In the mid-1980s, investment opportunities were further enhanced by changes to ERISA to allow investments in private equity markets and reductions in the capital-gains tax rate.

Tax issues loom large in the growth of TIMOs and divestiture of timber holdings on the part of the forest products industry. If a corporation owns timberland, and is set up as a C-Corp, any profit generated from timber or other resources on that land is subject to income tax. Then, tax is levied again when dividends are transferred to shareholders. In comparison, shareholders in a TIMO (or REIT) are taxed only once (like an S-Corp), and benefit further in being taxed at a lower rate on any capital gain that may have occurred; corporations are not eligible for capital gains treatment. Further disparity may occur if an investment group qualifies as a retirement trust, as there may be no tax liability at all. The net effect of these provisions of the tax code is that forest products corporations may face taxes of two to three-times and more that of a TIMO engaged in the same business activity.

Several trends within the forest products sector have also contributed to the growth of TIMOs. Inefficient mills, industry overcapacity, increasingly capital-intensive operations, and rising raw material costs have all contributed to the overall poor financial performance of integrated operations. All these trends have placed substantial capital demands on forest products companies at a time when much of their capital was relatively inaccessible as it was tied up in timberland. TIMOs and REITs provide a way that raw materials can remain accessible while at the same time freeing the capital assets.

The total assets under management by TIMOs have grown rapidly in the last 20 years, with much of that growth occurring in the past five years. In 2001, a survey of TIMOs in the southern U.S found that their plans included expanding from their existing 4.2 million acres of forestland ownership to 12.2 million acres by 2010. If this growth is realized, TIMOs will represent 6% of southern forestland[8]. The growth of TIMOs could continue to be significant if existing industrial and non-industrial land ownerships continue to become available.

[8] http://www.treesearch.fs.fed.us/pubs/7176

REITs

A Real Estate Investment Trust (REIT) is defined as a company that owns and may operate income-producing real estate. Commonly, REITs manage apartment buildings, shopping centers, offices, hotels or warehouses. REITs are unique in that their primary business is managing groups of properties to produce income, and they are required to distribute most of their profits as dividends. A REIT can be either a publicly or privately held company. Publicly traded REITs are managed by corporate officers and professionals that are accountable to a board of directors as well as their shareholders and creditors. The board of directors or trustees determines the investments of the REIT and these directors are elected by and responsible to the shareholders. The directors, analysts, auditors, and the business and financial media monitor the performance of the REIT. A REIT is required to have a minimum of 100 shareholders, and invest at least 75% of its total assets in real estate. There are approximately 200 publicly traded REITS in the United States, with a collective worth of more than $500 billion.

A REIT is required to distribute at least 90% of taxable income to its shareholders annually. A REIT is permitted to deduct dividends paid to its shareholders from its corporate taxable income. In practice, most REITS remit 100% of their taxable income to shareholders and thus owe no corporate tax. Shareholders are required to pay taxes on the dividends received and capital gains. Most states honor this federal tax treatment and do not require REITs to pay state income taxes. A REIT is not allowed to pass any tax losses through to its investors.

Requirements for REIT status in the United States

U.S. REITs must pass four tests in order to retain their special tax status:

1. REITs must distribute at least 90 percent of their taxable income, excluding capital gains, as dividends to its shareholders.

2. REITs must have at least 75 percent of their assets invested in real estate, mortgage loans, shares of other REITs, cash, or government securities.

3. REITs must derive at least 75 percent of their gross income from rents, mortgage interest, or gains from the sale of real property. At least 95 percent must come from these sources, together with dividends, interest and gains from security sales.

4. REITs must have at least 100 shareholders with less than 50 percent of outstanding shares concentrated in the hands of five or fewer shareholders.

Source: Tischer, Chad A. "International REITs." Dimeo Schneider & Associates, LLC Oct. 2006. 23 April 2007 http://www.dimeoschneider.com/documents/InternationalREITs.pdf

Because REITs are essentially in the real estate business, their performance is affected by the same market trends that impact the supply of and demand for property, including population trends and job growth, changes in interest rates, and capital market conditions.

Similar to TIMOs, REITs have also grow significantly since the 1970s to take advantage of the low prices of timberland and to organize and manage partnerships for institutional investors. However, the modern idea of a REIT originated in 1960 with the establishment of the real estate investment tax provision, which reestablished special tax considerations for distributed income. The motivation for this provision was to make investments in large-scale, income-producing real estate accessible to small investors through the purchase of equity.

Investment in REITs increased throughout the 1980s, and the Tax Reform Act of 1986 allowed REITS to directly manage properties. This change provided several advantages in terms of engaging experienced property management professionals and diversifying the portfolio of properties. There are at least three publicly traded REITs that were previously traditional forest industry operations: Plum Creek, Rayonier, and Potlatch.

Global Trends and Impacts

The development of TIMO and REIT investments has been unevenly distributed around the United States. Some individual states have been particularly heavily impacted, such as in Maine where more than 7 million acres, representing a full one-third of Maine's forestland, has changed hands since 1998[9]. The Midwest has also seen significant activity with nearly 5 million acres changing hands between 1992 and 2006.[10] Investment in timberlands continues to be financially attractive. The National Council of Real Estate Investment Fiduciaries (NCREIF) has reported five-year timberland returns of 10.6% and one and three-year returns near 14%.[11]

There is also significant investment activity occurring in Canada, various countries in South America, New Zealand, and other parts of the world. There is speculation that the boom in timberland sales in the United States has likely hit its peak and timberland investors will be increasingly looking offshore for future investment opportunities.[12] It is estimated that a dozen or more countries have either legalized or are in the process of legalizing REIT-like structures. Predictions are that international REIT transactions could increase significantly and add increased complexity to the overall trend of timberland and real estate investment.

Currently, Europe and Asia appear to have the highest immediate growth potential for international REITs. Should REIT development occur within Europe most growth would likely be within city limits; due to government restrictions on development across Europe, real estate companies there will most likely be constrained to focusing on the changing ownership of developed properties and the rebuilding of old city infrastructures. Among those countries interested in the global market are Germany and Britain (that are expected to establish some form of REIT legislation within the next year). Countries that have recently passed REIT legislation include Japan, France, Singapore, Hong Kong and South Korea. As more developing and forest resource rich countries begin to participate in REITs, the impacts to the forest sector will likely be more significant.

[9] http://www.nrcm.org/land_sales.asp

[10] http://www.forisk.com/UserFiles/File/Vol8%20No2.pdf

[11] http://www.marketwatch.com/news/story/private-investors-gobble-up-us/story.aspx?guid=%7BE750A6A9-5A46-4E41-AB86-9ED7C6B80DFF%7D

[12] http://www.timberlink.net/forestland-timber-investment-funds-advice.php

Today, it is estimated that 12 major American TIMOs, REITs, and other types of funds are interested in (or are already invested in) managing overseas investments, including Hancock Timber Resources Group, Wagner FM Group, Fountain Forestry, and Global Environmental Fund. It is these large institutional investment managers that have shown the most interest in international REITs so far, but activity may also be seen on the part of smaller investors who are looking to expand overseas. Investments in New Zealand, South American and Australia totaled about $2 billion by the end of 2006 (compared to the $7.3 billion in the Southern U.S. alone). Although analysts are expecting investments to increase outside of the U.S., especially if land prices in the U.S. continue to rise, there is also an expectation that the long-term effect will be to bring increased foreign investment to the U.S. where the market opportunity is most developed and where risk is lower.

To help support the global competitiveness of U.S. timberland investments, the American Forest and Paper Association (AF&PA) is pushing for Congress to pass H.R. 1937, known informally as the Timber Revitalization and Economic Enhancement (TREE) Act of 2007. The TREE Act, introduced in April 2007, would reduce barriers to REIT timberland ownership and cap the tax on timber gains at a maximum rate of 14 percent (a 60-percent deduction for qualified timber gain).

Environmental Considerations

The purchase of forestland by a TIMO or REIT can represent a fairly significant change in the nature of ownership. Such a change can raise concerns about potential environmental impacts of the new management regime. In addition, there is concern about forestland conversion or that the forested resource will be "parcelized" or fragmented through future land sales and real estate development activities. These concerns and the associated environmental impacts can be addressed to some degree through the use of tools such as conservation easements and forest certification.

Conservation Easements

A number of TIMOs and REITs have embraced land conservation tools such as conservation easements[13]. In 2002, The Nature Conservancy and its partners purchased nearly 45,000 acres from Hancock Timber, a TIMO. Under the terms of the agreement, GMO Renewable Resources, another TIMO, has management responsibilities and is subject to the terms of a conservation easement.[14] A similar project was completed in April 2007 between the State of New York, The Conservation Fund, and Lyme Timber Company (a TIMO) for a total of 257,000 acres of conservation easements in Adirondack State Park. The terms of this agreement include management practices that adhere to the standards of the Sustainable Forestry Initiative (SFI).[15]

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[13] For more information about conservations easements, please see the Dovetail Report: *Conservation Easements to Protect Working Forests*, February 2006. Available at: http://www.dovetailinc.org/reports/pdf/DovetailEasements0206lg.pdf

[14] http://www.nature.org/pressroom/press/press673.html

[15] http://www.conservationfund.org/node/318

Conservation easements can reduce the forest management changes resulting from forest ownership changes. Easements can be a valuable tool for resource protection, risk reduction and asset enhancement; however, the provisions of conservation easements can also severely restrict real estate and development potentials and obligate an organization to restrictive forest management practices and monitoring and reporting requirements. Because each conservation easement is individually negotiated, the specific impacts of a conservation easement will depend on the details of the agreement. A conservation easement can provide significant benefit to investors by providing an early influx of capital and an opportunity to focus investment management on timberland values.

Forest Management and Certification

Because TIMOs and REITs are obligated to manage their properties for the benefit of their investors, this priority is reflected in the type of forest management that is practiced. Studies in the southern United States have documented that TIMOs (that make up the bulk of forest investment trusts in this region) tend to manage their lands with an intensity that is similar to industrial lands and that the focus is on planted pine and high yield management practices. In 2000, 69% of TIMO managed lands in the South were in planted pine and 56% were in high yield operations[16]. By 2010, these numbers are predicted to rise to 81% and 70%, respectively[17].

Forest management practices can be limited through both voluntary and regulatory measures. In the absence of high levels of forest regulation, voluntary forest certification can establish a baseline for acceptable management practices and provide the added assurance of annual audits and public reporting. Less than half of the TIMOs and REITs with forestland ownership in the United States are currently participating in third-party certification programs (Table 1). The level of participation may increase as market demand for certified products and raw materials develops or other economic returns from certification can be more clearly communicated to investors. Certification interests may also grow as investors increasingly look overseas for forestland opportunities. Internationally, forest certification and the assurances it can provide in sensitive regions could serve to help evaluate and reduce risk.

Table 1. TIMOs and REITs Participating in Forest Certification

Name	**Certification(s)[18]**
Plum Creek Timber Co., Inc.	SFI
Hancock Timber Resource Group	SFI, FSC
The Forestland Group	FSC
Forest Capital Partners	SFI
Rayonier	SFI, FSC
Potlatch Corporation	SFI, FSC
Lyme Timber	SFI, FSC

[16] High Yield is defined as including chemical or mechanical site preparation, improved seedlings for planning, herbicide treatment in the first and second growing seasons, fertilization at age eight on about 50% of the acres, and pre-commercial or commercial thinning.

[17] See Resource listing for Siry, 2001.

[18] SFI: Sustainable Forestry Initiative, www.sfiprogram.org; FSC: Forest Stewardship Council, www.fscus.org

Forest Conversion

The greatest concern raised with the growth of TIMOs and REITS has been the potential for an increase in forestland conversion to other land uses including subdivision and development. One recent report projects dramatic housing development over the next three decades on 44 million acres of what is now commercial timberland as a result of shifts in ownership.[19] Subdivision is often viewed as undesirable even if not accompanied by development, as small landowners are much more likely to restrict access than a larger landowner. For instance, a 1997 USFS survey of private landowners in Wisconsin showed that only 20% make their land available for public recreation; in contrast, almost all corporate forestland owners in Wisconsin allow public access.[20] Also, small landowners may be less likely to practice timber management and harvesting of forest products. The leading drivers for forestland conversion and increased land development are likely to continue to be the relative costs and benefits of forestland ownership and the policies governing land development. In the context of TIMOs and REITs, the obligation to investors remains a priority, and their decisions to develop or convert forestland will reflect the extent to which keeping forestlands intact and well-managed results in competitive economic returns for their investors.

Future Considerations

TIMOs and REITs are attractive to investors because of the combined cash flow that can be gained from timber sales and the security and stability of land value appreciation. Unfortunately, these factors do not account for the various environmental and social considerations involved in the management of a natural resource. However, the economic drivers for timberland investments may expand significantly if environmental and social concerns are included in the process. Specifically, if predictions for the development of the bio-economy are realized (i.e. should plant resources become an important source of energy and industrial chemicals) or should developments in markets for ecosystem services occur, TIMOs and REITs could have a whole new set of investment opportunities. If cellulosic energy and fuels continue to develop, the value of wood products and forestland may increase and drive additional investments. The market for biomass could also impact what types of lands TIMOs and REITs are seeking and the type of land management that is practiced. Similarly, if payments for carbon sequestration, watershed protections, or other ecosystem services become more common and more lucrative, these markets could also impact investments and land management practices.

[19] Stein, S., McRoberts, R., Alig, R., Nelson, M., Theobald, D., Eley, M., Dechter, M., and Carr, M. 2005. Forests on the edge: housing development in America's private forests. U.S. Forest Service, General Technical Report. PNW-GTR-636.

[20] Davies, P. 2007. Not out of the woods yet: the consequences of commercial timberland sales may not be as dire as some fear. Federal Reserve Bank of Minneapolis. FedGazette (January). (http://woodrow.mpls.frb.fed.us/pubs/fedgaz/07-01/forests.cfm?js=0)

The Bottom Line

The sale of large tracts of forestland by forest products companies to financial interests both creates opportunities and raises concerns. The concerns rest in the unclear commitment of ownership groups to long-term sustainable forest management and the role these groups might play in parcelization of forestland and associated development. The opportunities lie in the potential for increased investment in forest management and productivity, and in the access of new ownership groups, e.g. environmental organizations, socially responsible mutual funds and other concerned groups, to these properties and the control and influence that could entail. In reality, TIMOs and REITs are market-based tools that will impact forests primarily based on the goals of those organizations and investors that choose to participate in them.

Resources

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