The Rumbling Of Timber Bears

by Sam Radcliffe, Vice President

There is a lot of uncertainty in the timberland investment world today, and perhaps not as much excitement as in the late 1990's and early 2000's. An interview with a leading TIMO analyst offers a pretty frank perspective:

Q: You were recently quoted in the Wall Street Journal as suggesting that timberland may be over-priced and that a bubble may be forming. Were you suggesting the market is over-heated?

James Nicol, Chief Investment Strategist for Forest Systems, Inc.: We think the dial has moved past "warm" and is closing in on "hot." That suggests to us that anyone who is thinking about getting into the asset class should be cautious about how, when and where.

Q: Why are timberland values so high right now?

Nicol: There is just too much cash flowing into the asset class from too many sources relative to the supply of investment grade forestland. There are several factors driving this interest, including declining returns across all investment markets, an exploding interest in real assets, and the fact that there is a swarm of new firms out there promoting themselves as forest investment experts.

Q: What factors could lead to a market correction?

Nicol: I could see a scenario where interest rates rise and bond yields increase, drawing capital away from the asset class to more liquid, less risky investments like treasuries. This would also undermine the ready availability of low cost debt, which has been one of the contributors to the run-up in forestland transaction prices. Both changes would diminish the excess demand that is pushing up timberland values as well as mortgage rates. In all likelihood, a material increase in mortgage rates also would have a significant negative impact on housing starts, triggering a reduction in demand for lumber, which would drive down sawtimber stumpage prices.

Many in the timberland investment industry would agree that this is a realistic assessment of today's market. But that interview took place in 2005! More recently, however, some veterans in the industry are sounding similar themes.

Recent Thought

Our friend Scott Sacco of Environs Strategies, a past executive at both Hancock Timber Resource Group and Forest Systems, recently distributed a white paper outlining his thoughts on the current state of the industry. Some extracts:

- *The key messages about the asset class and its fundamental attributes that have been promulgated by TIMOs and others since the late 1980s (healthy long-term returns characterized by cash and appreciation components, portfolio diversification potential, inflation hedging potential and capital preservation potential) continue to be accepted and largely go unchallenged by institutional investors and their investment consultants."*
- *"Overall, discount rate expectations for timberland appear to be poorly calibrated with market realities – with some timberland thought leaders suggesting that a 2 to 4 percent real return on domestic, commodity-based softwood investments is the best investors should expect in the near term. Because of these and related circumstances, investors' continuing use of the NCREIF Timberland Property Index as a benchmark for measuring and evaluating the performance of individual managers and the asset class as a whole presents a challenging conundrum for the TIMO community."*
- *"There are more than 30+ TIMOs competing for access to capital and deals, but there appears to be nominal market differentiation amongst them beyond basic geographic preferences, forest-type specialties, and business models. At present, a large amount of institutional capital is waiting to cash out of the asset class, but some TIMOs appear to be advising their clients that liquidation of their positions does not make sense in the near term because asset values are expected to rise in coming years, which will make it more difficult and expensive for them to re-enter the market in the future."*
- *"The timberland transaction market remains anemic as land auctions characterized by wide bid-ask differentials continue to complicate efforts at deal making. Some market analysts suggest this is tangible evidence that a great deal of the timberland purchased for investors in the mid-2000s was richly acquired."*

At the just concluded *Who Will Own the Forest?* conference sponsored annually by the World Forestry Center in Portland OR, Brookfield Timberlands' Reid Carter's principal message was: "Given the small investable universe the key attribute the timberlands asset class must protect if it is to remain relevant is the reputation of its managers." He suggested the following as key issues to watch:

- How managers "sell" the asset class: Biological growth is often exaggerated – with the exception of fast-grown and greenfield timberland investments, the majority of the present value comes from standing inventory, not biological growth
- Alignment between timberland investors and managers
- Realized versus unrealized returns
- Increasingly aggressive underwriting
- Low discount rates, flat costs, real price increases, etc.
- Unconstrained harvest scheduling models (selective use of growth models/yield curves)
- Stagnant regulatory environment
- Cap rate compression at exit
- Inadequate accounting for risks in less developed markets
- Unrecognized encumbrances and/or counterparty risks
- Short-single round auctions with limited data availability deteriorating quality of information being made available by Timberland Rates of Return sellers

One of the points that "timber bears" consistently make is that "advertised" target rates of return for timberland are too high – that deals are actually being made at much lower discount rates. *A Who Will Own The Forest?* panel session this year was entitled "Discount Rates and Timberland Values by Region". The panelists were all well-respected timberland appraisers and they all agreed that real discount rates for U.S. timberland are now in the 5.8 - 6.0% range. All three of the panelists seemed to support their views with data from the annual discount rate survey conducted by the consulting firm Sizemore & Sizemore (S&S).

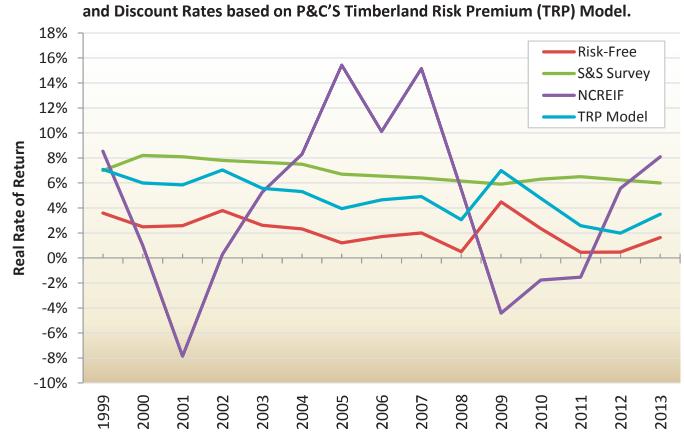
Steve Burak of S&S presented a chart showing the results of that survey over a 15-year period. Based on the survey responses of TIMO's, appraisers, and investors, this is probably a pretty good proxy for the "advertised" target rate of return. Over this fifteen year period, the reported real rates of return showed little volatility, declining very smoothly from about 8% to about 6%. This is actually fairly remarkable, given that the period covered two recessions, two significant stock market downturns, a housing boom and a housing bust. This goes directly to Scott Sacco's point – "discount rate expectations for timberland appear to be poorly calibrated with market realities."

Advertised vs. Actual Rates of Return

Aside from the lack of volatility that would be expected in an otherwise volatile investment world, the survey rates appear to be significantly higher than the fifteen-year record of performance for timberland, as indicated by the widely accepted NCREIF timberland index. Figure 1, below, compares the survey rates with the NCRIEF timberland index, the "risk-free" rate of return (long-term US Treasuries) and rates predicted by Prentiss & Carlisle's Timberland Risk Premium (TRP) Model (see our 2013 Q2 Newsletter). Over this period, the S&S Survey rates averaged 6.9% while the NCRIEF index averaged 4.5% and our TRP Model averaged 4.9% (all inflation-adjusted). But note that the S&S Survey and the TRP Model start at the same point in 1999. The difference over the rest of the period is that the TRP Model adjusts in response to changes in investment conditions, in that it is anchored to the risk-free rate.

Does this disconnect between "advertised" rates as represented by surveys and actual performance as represented by the NCREIF benchmark indicate under-performance or just unrealistic expectations? In our opinion, it is clearly the latter. Only one thing can happen to an asset class that purports

FIGURE 1. Recent History of Long Term Risk-Free Rates, Timberland Discount Rates from the Sizemore & Sizemore Survey, NCREIF Timberland Index Returns, and Discount Rates based on P&C'S Timberland Risk Premium (TRP) Model.



to yield stable above-market returns while at the same time providing inflation hedging and portfolio diversification benefits: its price has to go up until risk adjusted returns settle down to an equilibrium position with other investment alternatives. This is exactly what has happened over the last 15 years.

Perhaps one of the reasons that survey respondents have been unable to admit that expectations for timberland returns have dropped is that without those high expectations, timberland as an asset class loses much of its luster. But that luster was built on a perfect storm in the 1980's and 1990's – inefficient timberland markets, government regulation that greatly diminished timber supply, and mostly strong residential construction activity.

107 Court St. Bangor, ME 04401
www.prentissandcarlisle.com

Bearish?

We have used the term "timber bears" here, but I don't think these individuals are actually bearish on the asset class, and neither is Prentiss & Carlisle. Our point is that investors need to understand that the timberland investment thesis has changed. Out-sized returns on U.S. properties are largely a thing of the past, but direct ownership of timberland can still offer a degree of portfolio diversification, inflation hedging, and stable risk-adjusted yields.

Timberland is not the place to try to hit a home run, but it can be a steady singles producer. Investing in the asset class today requires patience, discipline and recognition of some fundamental guidelines:

- If valuation of a property is built upon a specific value-maximizing strategy, that strategy has to actually be executed in order to realize projected returns.
- Management alpha is largely a function of exploiting niche opportunities in addition to efficiently and stubbornly "sticking to the knitting."
- Properties with a current yield story rather than an appreciation story are less risky in an era of low interest rates.

The most successful timberland investors, including P&C and its clients, have an investment horizon defined not by years but by generations. While that horizon would seem to fit with many institutional objectives (think pension funds), the structure of the institutional timberland market is not designed for multi-generational investment. There are a variety of reasons for this structure, but most have to do with the conventions of both the institutional investors and the real asset managers. There are signs that some players in this asset class are beginning to recognize the mismatch. As timberland returns stabilize at a lower than historical level, we expect the structure of the industry to adjust, but when and how are unclear. Stay tuned.

Learn more about P&C at http://www.prentissandcarlisle.com

Subscribe to our Timberland Investing News Feed at: http://scoop.it/t/timber-invest

107 Court St. Bangor, ME 04401
www.prentissandcarlisle.com