

Forest ownership by corporates - a thing of the past?

Dennis A Neilson*

The formal announcement by Fletcher Challenge Forests in late March 2003 that it is to "reduce investment in trees to focus investment into high-margin processing, distribution and marketing"¹ is yet another example of international forestland³ owning corporations reversing course in recent years to sell forests they have often owned for decades.

So how does the Fletcher strategy fit into international trends? Well, it is actually a late starter in the corporate forestland exit stakes, if we examine what has been happening in North America and Europe recently. But let us first summarise some history of corporate forestland ownership.

Corporate ownership of forests is a relatively recent phenomenon, and only in selected regions. On a large scale it probably stretches back only 100-130 years, and coincides with the rise of large corporations that were formed to expand into wood processing. Initially this was sawmilling, but in the early 20th century many expanded into very highly capital-intensive pulp and paper manufacture.

Initially, native forests became "corporatised" following the inexpensive purchase of government land and trees. The United States corporate giant Weyerhaeuser is probably the best example of a company that grew rapidly after purchasing large tracts of forestland handed out in "square miles" in the 19th century, mostly to railroad companies.

Another feature of corporate ownership was the use of subsidies to encourage planting. Even the ability to cross-deduct earnings from other businesses is considered by some to be effectively a subsidisation. Subsidies and tax credits by themselves, however, did not guarantee the growth in corporate forestry. In many European countries, for instance, corporate ownership is very small or non-existent. In Austria the largest private owner holds only about 30,000 hectares, in the Czech Republic 12,000 hectares, in the UK 10,000 hectares, and in France we could not identify a single owner with more than a few thousand hectares.

Only in the United States did many corporations end up owning large tracts of forestland - in 2002 some 14 companies each owned more than 300,000 hectares. In Finland one of only two very large owners - Stora Enso

with 600,000 hectares - held forestland assets until 2002, but it has since decided to exit its forestland investments in both Finland and the USA. In 2003 merchant bankers are busily implementing schemes to quit Stora's assets to non-traditional investors. Its USA assets have already been sold to a Real Estate Investment Trust (REIT) in 2003.

Actually much of the "subsidisation" for forestland development in the 1950s to the 1980s was cross-government department fund allocation and went into the government expanding its own forestland - with national wood self sufficiency and employment in rural areas being a major motivation. Where subsidies were paid to private companies, e.g. in New Zealand in the 1960s and 1970s, in Chile from 1970-1993, in Brazil in the 1960s-1980s, and more recently in Argentina and Uruguay, corporations have expanded holdings.

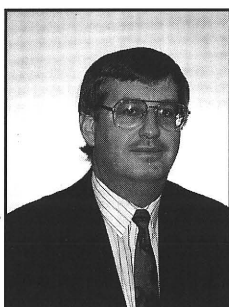
Notably, immediately after the Chile corporate subsidy ceased after 20 years, the two major Chilean corporates, Arauco and CMPC, stopped expanding their pine estates in Chile and moved east to gain subsidy advantages in Argentina and Uruguay. Indeed, most corporate growth in forestland has been a result of government assets being handed for free or cheaply to private corporations, or because of subsidies. An absence of generous subsidies often equates to little or no corporate forestland expansion, especially in softwood species.

In addition to subsidisation help, corporate expansion had another fillip from government privatisation. This occurred in Chile in the 1970s and in New Zealand, Australia and South Africa in the 1990s and later. But, by 1996, we might have seen the peak of global corporate ownership.

Reasons for corporate disinvestment in forestland

So, if corporate forest expansion in a number of countries was such a good thing in the 100 or more years to 1995, what has happened since? We think a combination of several or all of the reasons below have caused this strategy shift.

1. Up to 1990, generations of corporate executives in what were mostly pulp, paper and forest owning companies were schooled into the axiom of fibre security. By 1990, however, the time was fast approaching when traditional engineer and forester CEOs were being replaced by financially trained CEOs, who did not have the same fibre security conviction.



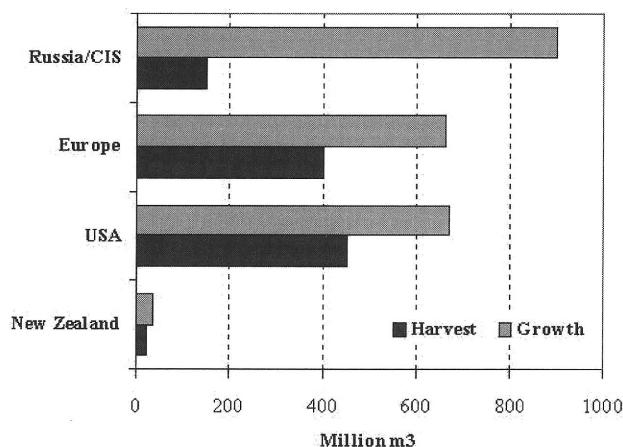
* Dennis Neilson is Director of DANA Limited¹. He is a Registered Forestry Consultant.

¹ In 2003 DANA published a 550 page Review "The Global Tree Farm and Management Forest Industry, on which this article is based.

² New Zealand Herald.

³ Forestland is used to describe commercial managed native forest and tree farms.

Fig. 1: Growth versus harvest balances in selected regions and countries.



2. In any event, fibre security was a fine policy only until the profitability of the pulp and paper sector started a decade-long nosedive, which continues. So the pressure was on to search for ways to reduce capital.

3. A consequence of this low profitability has been a consolidation binge amongst existing players. We think about 40 corporate mergers have occurred in the Northern Hemisphere in the last decade.

Many of these "mergers" were actually highly leveraged buyouts, which significantly raised debt levels. As forest product prices have declined, high debt has in some cases become debt distress. So, again the pressure increased further on forest product corporates to sell down assets. These include previously sacrosanct forestlands.

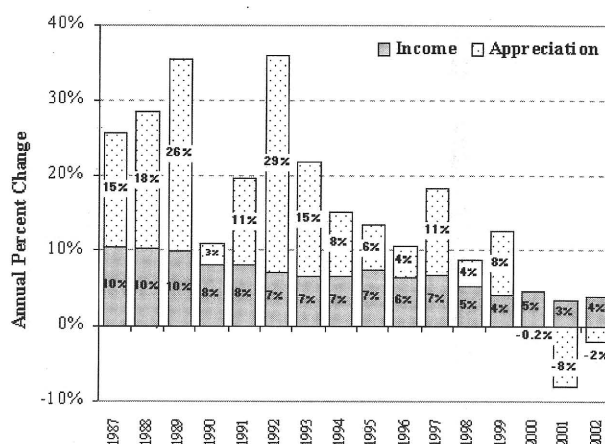
4. In the 1990s, a paradigm shift occurred in company attitudes toward future regional and global wood supply balances. Prior to this, most executives believed in the doctrine of future wood shortages. This justified controlling forestland. But 10-years on, most regions and countries now seem to be falling over themselves to exaggerate their surpluses, just as they exaggerated their looming shortages late last century. Recently published data suggests that the annual growth of wood just in Russia, the EU and USA now exceeds annual harvest by over 1,000 million cubic metres. If we believe the data in Fig. 1, no one should rationally want to own the forests.

The point is that now corporates everywhere seem to believe there will be a wood surplus for all time. Time to get out - or is it too late?

5. Forestland returns have fallen during the 1990s,

⁴ Not quite as bad as the price trend for the UK Forestry Commission which is reported to have an average real reduction in conifer stumpages of 8.6% per year from 1974 to 1999.

Fig. 2: North American REIT Returns 1987-2002



as log prices continue to slide in real terms. We do not have specific US corporate data details, but the graph of USA Timberland REIT returns (Fig. 2) is self-explanatory⁴.

There have been some sophisticated analyses recently produced in the United States to try to explain this trend as a "normal" result of changing age classes, stocking, growth rates and harvest strategies of acquired assets - and nothing to be inherently concerned about. At the end of the day, however, forestland returns for all but the most spectacular initial bargains cannot beat reducing real wood prices over 5-10 years.

6. In the USA anyway, accounting standards do not allow forest-owning companies to write up forestland assets. They are held in the accounts at cost. With many companies owning forestland for decades, an easy way to release cash flow, and profits, has been to sell these assets.

7. Subsidy payments have reduced or stopped.

8. A new, ready-made market for forestland sales developed from the late 1980s. This was a steadily increasing number of institutional fund management organisations whose rule changes allowed investment in forestland.

Some of the forestland managers of pension fund assets are now very large. Hancock Natural Resources Group (HRNG), for example, manages over one million hectares of forestland for investors. A single pension fund, CalPERS⁵, recently had US\$1.2 billion of its US\$132 billion fund in forestland (some 370,000 hectares).

So, during the 1990s, institutional forestland investment (mostly via Timber Investment Management Organisations or TIMOs, and REITs) turned from a trickle to a flood to a crescendo - from only US\$1.5 billion in 1990 to US\$11 billion in 2002⁶. Most was purchased

⁵ California Public Employees Pension Fund.

⁶ UBS Timberland Investors, Forest Investment Associates.



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from corporates. From 1998/9-2001, corporates sold almost 2.5 million hectares of forestland in the USA, and fund managers acquired a similar amount.

In early 2003, almost 1.0 million hectares of US forestland is "in play" including for sale signs hanging on assets of corporate owners International Paper (IP), Louisiana Pacific, Rayonier, Smurfit Stone, Bowater and Weyerhaeuser. A further 700,000 hectares is classified as "potential offerings"⁷. The crescendo seems to have become a rout.

Three of the above companies, International Paper, Rayonier and Weyerhaeuser have subsidiary forestland companies in New Zealand. One, International Paper (IP), announced in early April that it would sell 600,000 hectares of forestland in the US South over five years. IP has more than 3.6 million hectares of forestland in the United States and claims that it, "*routinely sells and buys forestland in the ordinary course of (its) business*"⁸. There has, however, been much more buying than selling in recent years. The company's subsidiary in New Zealand, CHH has to date not made any announcement about major forestland sales.

The second, Rayonier purchased more than 100,000 hectares of forestland from the Crown in 1992. But it has been selling down New Zealand assets for some years and now owns a little more than 50% of its original holdings. Its most recent sale has been its 33,000 hectare forest in the East Coast, sold to Chinese buyer Huaguang in 2002. This sell down may be more a result of unsolicited offers that Rayonier chose not to refuse, rather than a result of a long-term exit strategy. It is unlikely, however, that returns enjoyed by Rayonier in the 1990s will be repeated again in the foreseeable future. There is no indication yet that Weyerhaeuser is considering a reduction of its joint venture US TIMO-Company forest holding in Nelson.

One major reason for the change in ownership class is that REITs and TIMOs have significant tax advantages over corporate investors. In the USA, for instance, gross earnings of \$100 earned by a forest products company would be taxed at the corporate and shareholder level to reduce the net shareholder earnings to only \$37. In contrast, an aggregate REIT tax is only 20%, leaving 80% available for investors.

In New Zealand, however, there are no "special" tax advantages afforded to institutional investors (all TIMOs at this time) that are not open to any other private or corporate overseas investors. All have vehicles available to structure their businesses to minimise New Zealand and home country tax. Thus it would be reasonable to assume that any overseas owner pays less tax here than would a kiwi investor. By how much is debatable, and is not public knowledge. Whatever the final TIMO tax position on New Zealand assets, it has certainly not prevented, and has probably encouraged a major TIMO move into New Zealand. In fact TIMO purchases in the last three years have probably accounted for 70% of all transactions. This trend from corporate to fund

manager ownership has also occurred recently in South Africa, e.g. Mondi to Global Environmental Fund; and in Latin America, e.g. Klabin to Boise to UBS Timberland Investors.

The future

So where to from here? Who will be the next generation of forestland purchasers, now that corporates are well through their global asset sell-down to TIMOs and REITs? Well this is a worry. Already in 2002-03 we see institutional (pension fund) investors actually starting to offer for sale forestland in areas so large that it cannot be just for regional repositioning. In early 2003, half of the forestland for sale in the USA was actually being offered by TIMOs or REITs. This is a new development. There are just too many sellers and not enough buyers.

In 2003 the world's largest single pension fund investor CalPERS (mentioned above) confirmed that it is downsizing its forestland asset. Its average "since inception" return of 13% p.a. had been whittled away to just 0.2% in Q3 2002.

New Zealand forestland corporate returns have also recently been very disappointing to shareholders. In its 2002 results, Carter Holt Harvey stated that its forest return was only 3%, compared with its Australian processing Division return of 10%, and its weighted average cost of capital (WACC) of 11%. Fletcher Challenge Forest returns have rarely, if ever, exceeded 3%, and it has a similar WACC as CHH.

[We might have expected that WACC would reduce with the fall in interest rates worldwide. But it appears that this is not the case as risk-free premiums for industrial lending have increased. We would note also however that the calculation of WACC can be as much an art as a science].

Buyers in New Zealand continue to seek near 10% after-tax returns, or more. We think this would also apply to United States based TIMOs here, as they must take into account country and exchange rate risk. So how can buyers achieve a 10% return when existing owners can only get 3%⁹? There are a few ways, but none of them are sustainable in the long run. One is to buy really cheaply from distressed sellers. But New Zealand sellers appear not to be as distressed as their North American counterparts.

Another appears to be by offering a short-term

⁷ *Timberland Markets Feb. 2003.*

⁸ *Paperloop 31 March 2003.*

⁹ *It is often difficult to directly compare returns, as different organisations commonly use their own return formulae. So, the "post-tax" returns for a TIMO may be calculated using a different formula than post-tax returns for CHH, and the Fletcher formula will be different again. However, for the purposes of this paper it is reasonable to assume the numbers used here are for "post-tax" returns and WACC.*



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purchase of selected assets. The most recent New Zealand forestland sale at the time of writing was the 8,940-hectare sale by Fletcher Forest to UBSTI, which now has partial or total ownership over about 110,000 hectares of forestland in New Zealand. UBSTI acquired "partial rotation" cutting rights over only the older age classes in Tauhara and Tahorakuri forests. Thus it can enjoy the cream of the cumulative return curve at the top end, but leave the seller with the milk, and re-establishment/management costs.

So, are we headed for the end of global corporate forestland ownership? In the Northern Hemisphere at least, this ownership class now looks decidedly unstable. But corporate ownership can only fully disappear if there are buyers for several millions of hectares around the world. What if the TIMOs and REITs start to leave the table?

The recent CalPERS decision to reduce ownership is probably not yet the tip of a forestland fund sell-down iceberg. But most individual investment contracts with TIMO managers are only for 5-10 years. Many of

these are approaching the first option-call to exit. If too many individual pension funds decide not to rollover their contracts, there could be an excessive area of forestland on the market, with too few buyers.

Maybe we will see Governments getting back into the business? This is perhaps feasible in the Central North Island to get present players out of a dilemma. In some countries, indigenous people will become owners when they receive settlement forestland over time. But they are not corporate forestland buyers. Indeed in New Zealand Ngai Tahu has already on-sold much of its forestland assets awarded as part of a Treaty settlement.

The ownership Ferris Wheel will continue to turn. Is it possible just possible that forestland values again become so attractive that at some future date we will read that Fletcher Challenge Forests has announced a new strategy that includes, "selling down processing distribution and marketing assets to focus investment in high-margin forestland ownership"?

TIMOs have landed!

Colin R McKenzie*

What is a TIMO?

Timber Investment Management Organisation's - TIMOs - have been active in New Zealand since the early 1990s when investors advised by UBS Timber Investors purchased a joint venture interest in the Nelson forest which prior to the sale was wholly owned and managed by Fletcher Challenge¹. TIMOs are on a course for continued growth as the managers of New Zealand's plantation forest estate. Who are the TIMOs? What are the drivers of their dramatic growth? What are the implications for the New Zealand forest industry?

Simply, a TIMO is an investment advisor who manages funds that focus exclusively (or very predominantly) on generating investment returns from timberlands. As such, they provide an alternative management entity to the more traditional government or corporate ownership of large forest estates. TIMOs are generally focused on just timberland ownership and sell their product as either stumpage or as logs to their customers for processing. Some TIMOs have a level of vertical integration, often resulting from the activity of the previous owner of the forest or through a joint venture relationship with a processing company, but the primary focus is pure timberland investment.

* Colin McKenzie is Director of UBS Timber Investors which is headquartered in West Lebanon, New Hampshire. The company was founded in 1982 and as of December 31, 2002 managed USD1.2 billion of forestry investments in seven countries on behalf of over eighty clients. The views expressed in this article are solely those of the author and are not attributable to UBS Timber Investors.

Emergence of TIMOs

Institutional investment in timberlands emerged in the United Kingdom in the 1960s and 1970s, but since the 1980s the industry has been dominated by the United States. Hence the use of the word "timber" in reference to forests rather than "plantations", a more familiar word choice for New Zealanders. The emergence of TIMOs is due to two coincident trends in separate industries. Firstly, previously integrated forest products companies are now moving to "unlock" value by separating tree ownership from their processing and marketing activities. Secondly, investment managers in the financial sector are creating sophisticated structures to achieve specialisation in all asset classes. Timber has now emerged as an increasingly important asset class in diversifying the portfolios of the major institutional investors. The TIMO industry has grown dramatically during the past fifteen years and now manages some USD10 billion of assets. It is also globalising, with 15% of the assets under management currently outside the United States.

TIMOs facilitate timberland investment by bridging between the forest industry sector and investor entities that control and manage large amounts of capital (Chart 1). The investors, who are the clients of the TIMOs, are public and private sector pension funds, foundations, endowments and high net worth individuals. These clients may invest individually as separate accounts, or the TIMOs may arrange co-mingled accounts where the capital of perhaps five to twenty unrelated investors may

¹ In 1997 Fletcher Challenge sold its interest in the venture to Weyerhaeuser Company, which remains our partner today.