



TIMBERLAND INVESTMENT RESOURCES_{LLC}

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TIR

HAS THE OTHER SHOE DROPPED?

ASSESSMENT OF A CORRECTION IN TIMBERLAND MARKETS

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Economic Research and Analysis

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Introduction

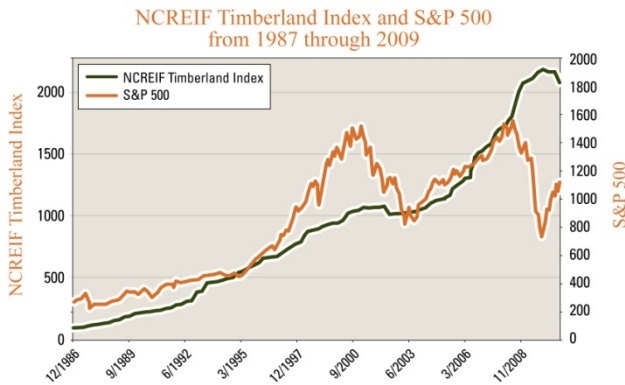


Figure 1. NCREIF Timberland Index and the Standard & Poor's 500 Index from 1987 through 2009.

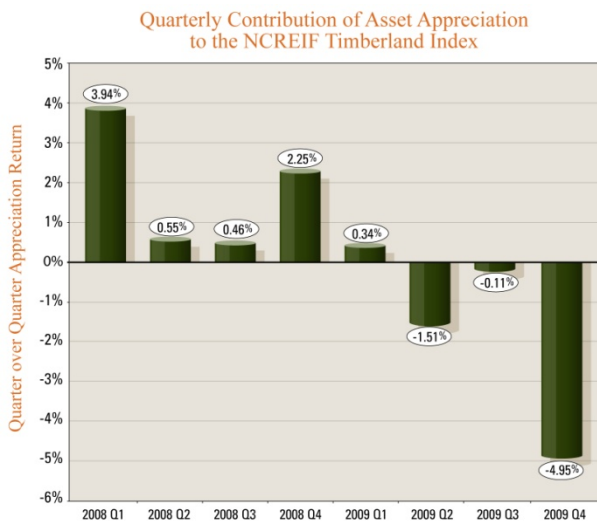


Figure 2. Quarterly contribution of asset appreciation to the NCREIF Timberland Index. Total return for the NCREIF Timberland Index consists of (1) income and (2) asset appreciation. The latter is also known as returns from capital gains.

A look at the NCREIF Timberland Index could cause one to conclude that the timberland asset class has survived the recent financial market turmoil and global recession relatively unscathed. At the end of the fourth quarter of 2009, the S&P 500 was down 28.75 percent from its peak closing value of 1,565.15, which was reached on October 9, 2007. However, by comparison the NCREIF Timberland Index was only off 5.43 percent from its peak, which was reached during the first quarter of last year (see Figure 1).

The reason timberland returns appear to have held up so well is that, unlike many other investment markets, forestland values seemingly have not faced a wholesale correction. Based on the contribution of asset appreciation to the total return of the NCREIF Timberland Index (Figure 2), timberland appears to have escaped the 30 percent or greater declines experienced by asset classes such as commercial real estate, equities, hedge funds and corporate bonds. In fact, according to NCREIF, losses in market value have been held to a very modest -6.49 percent from the high experienced during the first quarter of 2009.

Under these circumstances, it is no surprise that some industry observers believe that the timberland asset class is facing an eminent asset pricing bubble. In other words, they believe a market correction in timberland values is overdue. Given the weakness in real estate markets and the major contractions paper and wood product markets have experienced, it is natural to think that "the other shoe is waiting to drop." However, the question is: should a prudent timberland investor withhold capital and wait for a market-wide adjustment to occur?

At TIR, we believe the answer is no. Contrary to some interpretations of the NCREIF data, we think the correction already has occurred. In fact, from our standpoint, now is as opportune a time to invest in timberland as we have seen. While favorable investment opportunities have always existed in U.S. timberland markets, even during the height of market cycles, timberland values have improved to the point where diligent and discerning investors can find some



Total Acres of Major Timberland Sales in the United States (2000 – 2009)

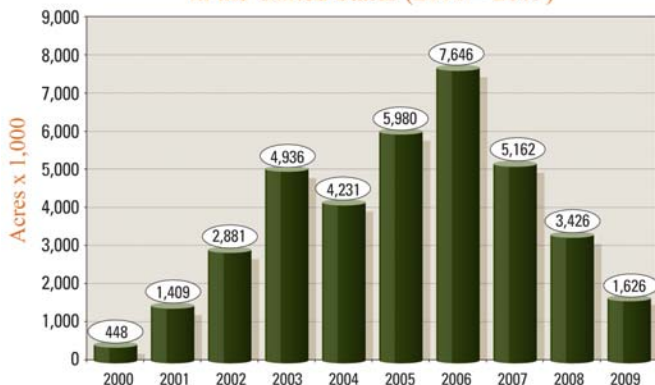


Figure 3. Total acres of major timberland sales in the United States, 2000-2009. Source: RISI Timberland Sales Database, *Timberland Markets Report*.

Acres Weighted Average Price of Major Timberland Sales in the United States (2006 – 2009)

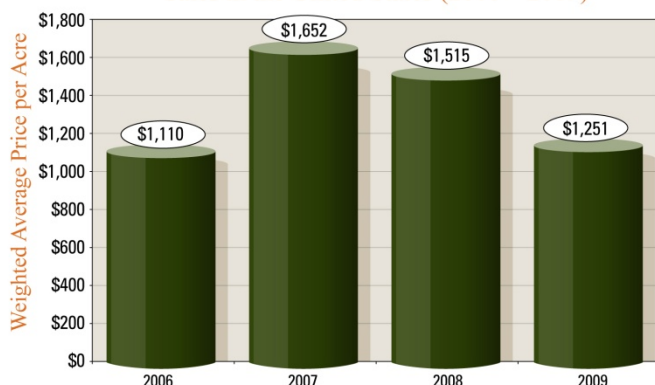


Figure 4. Average price of major timberland sales in the United States on an acres weighted basis from 2006 through 2009. A major timberland sale is recognized as a transaction greater than 5,000 acres. Source: RISI Timberland Sales Database, *Timberland Markets Report*.

very attractive acquisition opportunities with excellent long-term risk and return fundamentals.¹

It is important to recognize that timberland is an inefficient and highly diversified asset class. Unlike stocks, bonds and commodities, timberland is not a fungible asset. No two pieces of timberland are exactly alike, as each offers very different characteristics and features based on its geographic location, surrounding demographics, climate conditions, timber age profile and species composition. Such variability requires investors to carefully evaluate each timberland opportunity based on fundamental analysis of value and return – irrespective of whether the general market environment is strong or weak.

Knowing that the market is heterogeneous and inefficient, we can nevertheless still assert that as a whole, the current timberland market is offering buyers some excellent investment opportunities – even if that assessment is not fully reflected in the values reported by NCREIF.

Since early 2009, timberland sellers have been facing softer demand and pricing for their properties. The number of acres sold in 2009 was 52 percent lower than 2008 levels (Figure 3). Likewise, the total value of major timberland transactions consummated during that same period was 70 percent below 2008 levels. In such a thin market, those transactions that were completed were executed at values measurably below the record levels seen in 2007, when the average (acres weighted) price of timberland in the U.S. was \$1,652 per acre.² Since that market high, the average price year-to-date through 2009 was \$1,251 per acre, representing a decline of 24 percent (see Figure 4). Such price drops are comparable with other price corrections seen in other asset classes during this recession.

In short, from our standpoint, the shoe has dropped in timberland markets. Nevertheless, many in the investment community failed to take notice of the adjustment. One reason the correction has not been fully recognized by the NCREIF Timberland Index is because of the way net asset value (NAV) is calculated

¹ For further discussions on timberland investments under the current difficult economic and financial environment, see the TIR white paper, “Timberland in the Eye of the Financial Storm: The Short and Long-Term Outlook for Timberland in Today’s Economic Environment” (February 2009).

² Source: RISI Timberland Sales Database and *Timberland Markets Report*



SIDEBAR

Will the correction hurt investors who entered before the market correction?

If a market correction has indeed occurred, a relevant concern of existing timberland investors is the harm it may have done to their portfolios, primarily due to the prices that were paid to acquire land on their behalf prior to the downturn. In hindsight, the concern some investors may be having is whether they entered the market at the wrong time. The answer is based on whether investors must liquidate their holdings in the current market environment or whether they have the capacity to hold their assets through a full investment cycle.

If near-term liquidation is a necessity, then investors may be disappointed with the performance of their portfolios. On the other hand, if they are not pressed to sell their holdings and can wait until timber and rural land markets improve – and they eventually will – then there is nothing to be concerned about.

The biological characteristics of timber allow growth even if harvests are withheld. As a result, the opportunity costs associated with foregone harvest income are minimal. Land is a limited resource within a growing economy and its value is influenced by ongoing population growth. Consequently, throughout history it has consistently returned to trends of long-term appreciation following periods of decline or negligible growth. This means that as long as investors purchase timberland using conservative NPV and IRR analytics, the odds are good that fundamentals will redeem those investments if investors are able to wait out down cycles.

by those who contribute data. Most timberland investment managers use third-party appraisals to value their clients' timberland holdings. However, these appraisals are performed no more frequently than once a year, with some managers even choosing two or three-year appraisal cycles. In between those periodic appraisals, the investment manager relies on an internal estimate of value. In such cases, that internal valuation is typically adjusted based on timber prices. However, land prices are held consistent with those reflected in the manager's most recent appraisals. Given the valuation processes employed by NCREIF's data contributors, it is not unusual to see a lag of a year or longer between timberland market performance and NCREIF performance. Consequently, the drop in timberland prices during the past two or three quarters may not have been fully reflected in the NCREIF Timberland Index.

In conclusion, for investors interested in committing capital to the timberland asset class, there is no need to wait for a market correction. In our view, the correction already has occurred. We strongly believe it is a buyer's market right now and we are seeing many opportunities to acquire some outstanding lands that can serve as the foundation of a strongly performing portfolio in the days to come.