UNLOCKING THE MYSTERY:
UNDERSTANDING TIMBERLAND INVESTMENT MANAGEMENT FEES

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Introduction

One common mistake investors make when studying TIMO fees is focusing their attention primarily on direct comparisons of asset management and incentive fees while generally ignoring or overlooking how seemingly routine operational and asset management costs are handled.

When investors explore the timberland investment asset class, they will eventually examine the different fee structures of timberland investment management organizations (TIMOs). One potential mistake investors could make when studying TIMO fees is focusing their attention primarily on direct comparisons of asset management and incentive fees while generally ignoring or overlooking how seemingly routine operational and asset management costs are handled. This is problematic because these additional fees and expenses can represent a sizable portion of the overall cost of operating a timberland investment portfolio. Furthermore, while some TIMOs cover many of these costs in their base asset management fees, others pass through some or virtually all of them to their clients, sometimes without fully explaining or quantifying their scope up front. From an investor's standpoint, not knowing how these additional expenses are handled can significantly influence whether a TIMO is perceived as having an expense ratio that is better or worse than its peers. Furthermore, the degree to which such fees and expenses are absorbed by a TIMO or passed through to its clients can have an impact on future incentive fee calculations.

Because of these factors, conducting an "apples-to-apples" comparison of TIMO fee structures is not a simple or straightforward affair. The key to making sense of the inherent ambiguities requires understanding the types of expenses that are universally incurred in the process of building and managing a timberland portfolio and then recognizing how the various business models TIMOs use tend to influence how they charge for their own services and cover related portfolio expenses.

The purpose of this paper is to provide a measure of transparency on these subjects so investors can conduct more effective due diligence on candidate managers. We also hope the information helps investors guide and incentivize their managers once they have been hired by supporting their efforts to shape collaborative relationships that result in win-win outcomes.

Types of Fees Employed by TIMOs

We begin with an overview of the fees and expenses that are typically charged by TIMOs. Although this is not an exhaustive list, it does represent most types of fees that are currently in use within the timberland asset management space.

Recurring Fees

Fees and expenses that are applied on a periodic basis, usually by quarter, include asset management fees, property-level expenses and fund-level expenses. Timberland investment managers most commonly charge such fees in arrears, but some do charge them in advance.

Asset Management Fee

Other names for this fee include *annual management fee* and *manager fee.* It should not be confused, however, with the *property management fee.* The asset management fee compensates the TIMO for servicing and administering the client's timberland portfolio.

The management fee is a rate based on either (a) committed capital, (b) invested capital, (c) net asset value (NAV) or fair market value (FMV), or (d) some combination of the three.

The management fee is a rate based on either (a) committed capital, (b) invested capital, (c) net asset value (NAV) or fair market value (FMV), or (d) some combination of the three. For example, the asset management fee may be assessed on committed capital at the onset of a fund or investment program, then on invested capital after all the allocated funds have been been placed. Later in the life of the fund or program, the fee structure may convert to one based on net asset value. Most asset management fees in the timberland investment space fall between 70 and 200 basis points (0.70 to 2.00 percent) on an annual basis.

The argument for charging management fees on committed capital is based on the notion that the TIMO should be compensated for setting up the client's account and for performing the research and analysis necessary to execute the investment strategy. The counter argument to charging fees on committed capital is that the practice does not incentivize the manager to actively pursue acquisitions and the protracted placement of capital has the potential to erode an investor's net return.

The more frequently utilized approach to charging asset management fees is to assess them based either on invested capital or the net asset value of the portfolio. Some investors prefer to pay fees on invested capital because it eliminates the risk that a manager might "game" the valuation process to draw higher fees based on the higher valuation of an acquisition. Other investors see benefit in paying fees on the net asset value of the portfolio because the approach produces an inherent alignment of interest. In short, the TIMO is rewarded, presumably, for creating value for the investor. This argument pre-supposes that higher-valued acquisitions often require more effort on the part of a TIMO, which therefore should be compensated accordingly. From an operational standpoint, this approach also gives the manager more incentive to push for higher timber productivity or to develop ancillary sources of revenue to enhance the overall value of the timberland asset.

Property-Level Expenses

Also known as the *property management fee*, *operating expenses* or *forest management fees,* these are direct expenses associated with the ground-level management and operation of the client's forests. Among other things, it includes all silvicultural activities such as planting, fertilization and herbicide treatments. It also includes harvest supervision, forest inventory management, property security and road building and maintenance.

Fund or Account-Level Expenses

Depending on the TIMO, fund-level or account-level expenses that are not covered by the asset management fee are often charged directly to the client. These can include *administrative and professional fees as well as legal* and *organizational costs.*

Event Based Fees

Some TIMOs charge fees for specific types of investment or management activities. Some fees are more common than others. These include the following:

Acquisition Fees

An acquisition fee is a fee charged by a TIMO based on the transaction value of a timberland acquisition. Its purpose is to cover many of the costs (but not necessarily all) related to an acquisition. It also is meant to compensate the manager for the time and resources used to seek, identify and perform due diligence on the prospective acquisition.

Disposition Fees

As with acquisition fees, some TIMOs charge disposition fees to cover land sale costs such as updating forest inventories, obtaining appraisals and performing associated legal work. Theoretically, disposition fees also can be substantiated as providing managers with an incentive to sell assets rather than allowing them to remain in the portfolio so that the manager may continue collecting asset management fees.

Sales Commissions

Some TIMOs use a variety of terms to describe activities associated with the provision of certain operationally-focused transaction services for which they charge discrete fees (such as *harvesting supervision), -* but such fees might best be categorized as sales commissions. For instance, a portion of the revenue generated from a timber harvest or land sale may be collected by the TIMO for services associated with initiating and managing the transaction. Other activities, such as the sale of recreational licenses, conservation easements, wetland mitigation banking credits, and carbon offset credits also may be subject to such fees.

In the timberland investment sector, the most common strategy for structuring incentive compensation is to offer the manager a share of the net proceeds above a preferred investment return.

Organizational or Set-Up Costs

Again, TIMOs use a variety of names for such expenses, but *Organizational* or *Set Up* costs are charges related to the development and creation of the fund or account that will house the investor's timberland portfolio. This can include expenses related to the creation of appropriate legal entities. Although a TIMO may absorb some of these costs, the remainder are often charged to the timberland fund or client account.

Incentive Fees

Charging incentive performance fees is a well established method for aligning a TIMO's financial interests with those of its clients. In the timberland investment sector, the most common strategy for structuring incentive compensation is to offer the manager a share of the net proceeds above a preferred investment return (i.e., *hurdle rate* or *target rate*). That share is known as a *carried interest*. The formula used to calculate the preferred return and the carried interest varies by TIMO. Incentive fee payout schedules also differ, with some firms adopting a schedule of periodic payouts over the life of the portfolio, and others choosing a single final payout at termination. When a periodic payout schedule is employed, an investor may seek to withhold some of the incentive fees a manager has earned. Alternatively, a *claw back* option may be used to ensure that the client does not pay any excess incentive fee at the end of the investment period.

For portfolios that target established timber markets, like the United States, hurdle rates for incentive fees typically fall between 6 and 10 percent on a nominal basis and 4 and 8 percent on a real (inflation-adjusted) basis. For portfolios focused on emerging timberland markets, like those in Latin America or Central Europe, hurdle rates are correspondingly higher. In either case with established or emerging markets, TIMO carried interests commonly fall in the range of 15 to 30 percent.

Summary of Fees

To summarize, Table 1 illustrates a concise list of the fees commonly utilized by TIMOs while Table 2 shows the arguments for and against each of the three means of assessing the asset management fee.

Again, understanding TIMO fee structures requires knowledge of their component parts and how they are arranged by each manager. However, to fully appreciate and evaluate a TIMO's fee structure, it is essential to understand how its business model influences how it charges for its services. The next section of this paper addresses the linkages between two primary fee structures and the three primary business models employed by most TIMOs.

Table 1. Fees in use by timberland investment managers for institutional investors.

	Description		Frequency	Typical Rate
Recurring Fees	Asset Management Fee	Fee to the manager to administer the portfolio.	Near Universal	70 to 200 bps of committed/invested capital or net asset value
	Property-Level Fees or Expenses	Operating expenses accrued from the management of timberland assets in the portfolio	Near Universal	Direct charge through of expenses incurred
	Fund / Account-Level Expenses	Costs of servicing a portfolio not absorbed by the asset management fee	Near Universal	Direct charge through of expenses incurred
Event-Based Fees	Acquisition Fee	Compensation for identifying and acquiring timberland properties for the investor	Rare	Up to 5% of transaction value
	Disposition Fee	Compensation for the preparation and sale of timberland properties for the investor	Rare	Up to 5% of transaction value
	Sales Commission	Compensation for the administration of a timber sale, land sale, or other forms of income	Rare	Up to 8% of proceeds
	Organizational Costs	Expenses related to setting up the timberland fund or investor account	Near Universal	Varies based on complexity of investment vehicle
Incentive Fees	Preferred Return or Hurdle Rate	The rate of return above which an incentive fee is earned	Common	6-10% nominal IRR
	Carried Interest	Share of earnings above the preferred return	Common	15-30%

Table 2. Pros and cons of using different bases for calculating the asset management fee

Base for Calculating Asset Management Fees	Argument For	Argument Against
Committed Capital	Manager can maintain investment discipline and not be pressured to place capital too hastily	Fee structure could reward a long placement period, which might erode returns.
Invested Capital	Manager is more likely to stay focused despite large swings in timber and land markets that can impact the value of the portfolio	Manager may lack commitment to build value for the portfolio.
Net Asset Value (NAV) or Fair Market Value (FMV)	An incentive exists for the manager to maximize value of the timberland portfolio	Temptation exists for the manager to try to influence portfolio valuations.* There also could be pressure to hold on to assets for too long during strong markets.

**Note: For TIMO's that are members of NCREIF, which is moving to a mandated annual appraisal cycle, this issue is tempered by the appraisal cycle and standards (including the standard that appraisers must be rotated at least once every three years).*

Two Primary Fee Models Employed by TIMOs

Most TIMOs employ one of two base fee structures. The first is the *cost pass-through* model. As is shown in the Figure 1, with this model, most high-level and administrative services are provided directly by the TIMO and are covered by the asset management fee. All other routine services are performed by third-party contractors and their costs are *passed through*, dollar for dollar, to the investor. The second model that is commonly used by TIMOs is the *internalized fee* structure (Figure 2). Under this model, the TIMO has a subsidiary or affiliate that provides property management services for the investor. The subsidiary, however, may itself employ third-party contractors to perform some routine services. For instance, contractors may be used if the property management subsidiary or affiliate determines that it is not economical to provide certain services and functions directly. These services can include specialized capabilities such as remote sensing and fire management and suppression. Contractors also may be used if an independent party is required under the terms of the investment management agreement (IMA) to perform the service. Some examples of such services can include property appraisals, wetlands mitigation banking credit verification and certification for forest sustainability.

The second model that is commonly used by TIMOs is the internalized fee structure. Under this model, the TIMO has a subsidiary or affiliate that provides property management services for the investor.

With the *internalized fee* model, the investor contractually agrees, normally in the context of the IMA, to employ the TIMO's property management subsidiary or affiliate through the life of the investment. Only under special or extenuating circumstances will that contractual relationship be broken. In return, the TIMO typically agrees that its subsidiary or affiliate will charge for its services at a market-based, competitive rate. How that market rate is established varies from TIMO to TIMO because there is no standard procedure for fee verification.

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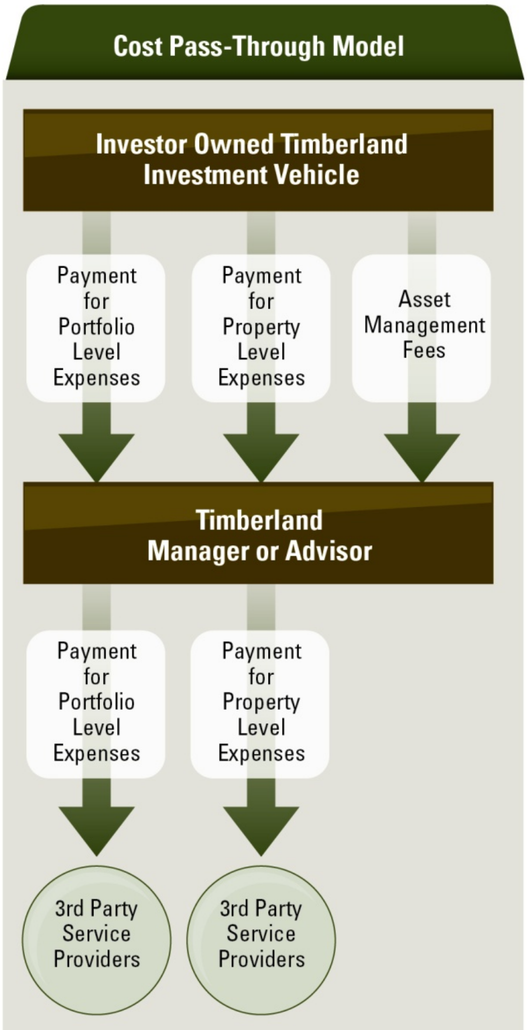
While the *pass-through* and *internalized cost* models are the two dominant approaches employed by TIMOs, the decision to utilize one or the other is not a black or white choice. Some TIMOs, for instance, have in-house staff who perform services on behalf of clients as if they were contractors. The cost of these services then is charged back to the client. Some TIMOs also employ affiliated firms that work exclusively or predominately with them to provide selected services. These can include sales and marketing, real estate, and forest-planning services.

Three Business Models against the Two Fee Models

As we previously mentioned, there are effectively three operational business models employed by TIMOs and each tends to cause an organization to gravitate toward the use of a particular type of fee structure.

1. ***Outsourced / Contractor-Based Business Model***
   In the contractor-based model, most functions related to the operation of a portfolio, with the exception of portfolio management and client service, are outsourced. This includes activities such as economic and market research, accounting, transaction management (acquisition and disposition support as well as timber and land sales) and forest operations.



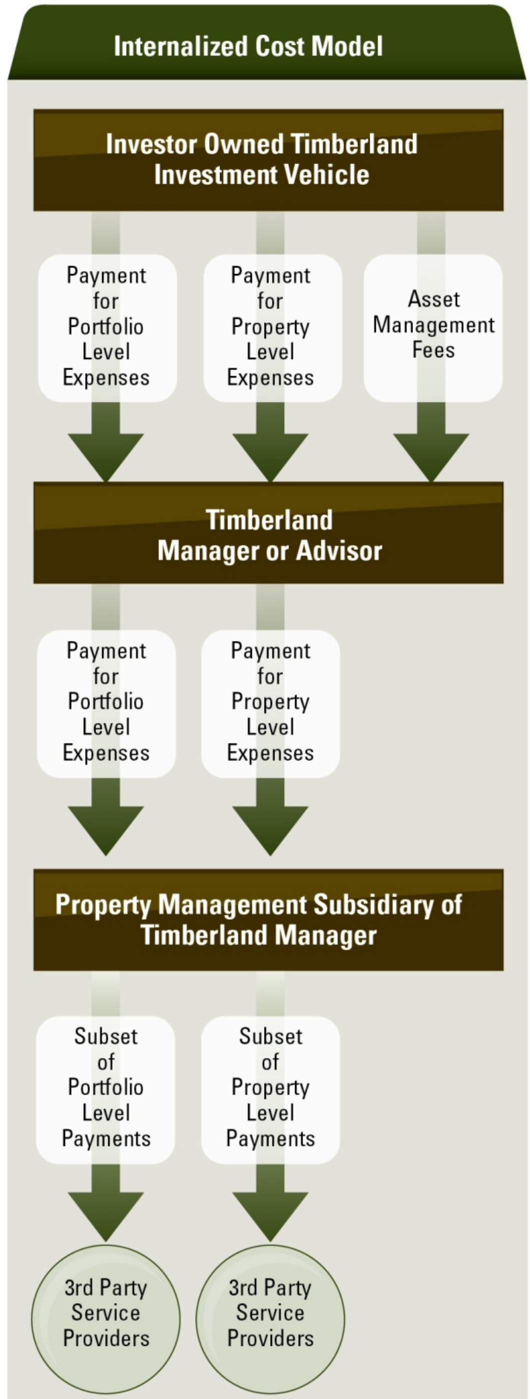


Figure 1. Pass-through structure for recurring maintenance fees of a timberland investment vehicle.

Figure 2. Internalized cost structure for recurring maintenance fees of a timberland investment vehicle.

TIMOs that use the Outsourced and Hybrid models normally employ the cost pass-through fee structure. In contrast, Vertically-Integrated TIMOs use the internalized cost model.

2. ***Vertically-Integrated Business Model***
   With this approach, the TIMO provides an all-inclusive set of services for the investor through its internal staff of managers, foresters and specialists. Most vertically-integrated TIMOs have wholly-owned subsidiaries or affiliates that provide ground-level property management services.

3. ***Hybrid Business Model*[1]**
   Between the two ends of the business model spectrum there exists a hybrid model in which many higher-level services and functions are maintained in-house and performed directly by the TIMO, while others, particularly ground-level technical forestry services, are outsourced. Hybrid TIMOs for instance, can have in-house staff performing acquisitions, portfolio management and dispositions. They also may have their own regional foresters who are responsible for supervising forest operations (which are typically executed by contract foresters). Nevertheless, unlike vertically-integrated managers, TIMOs that utilize the hybrid business model generally choose not to maintain property management subsidiaries.

TIMOs that use the *Outsourced* and *Hybrid* models normally employ the *cost pass-through* fee structure. In contrast, *Vertically-Integrated* TIMOs use the *internalized cost* model. Table 3 breaks out the allocation of expenses between the two fee structures and three business models.

[1] The Hybrid model is a generalized description that includes a “middle” range of business models between the outsourced and vertically-integrated models. However, there also are a range of hybrid models. The most basic hybrid model maintains portfolio management functions in-house while regional foresters supervise day-to-day forestry operations, which are performed by contractors. The most comprehensive hybrid model is referred to as a Horizontally-Integrated model. To be considered a Horizontally-Integrated TIMO, in addition to portfolio management and regional foresters, a firm must maintain the spectrum of research, analysis and decision expertise, such as: 1) economic research; 2) biometric and forest science research; 3) real estate; and 3) accounting and client reporting. For a more comprehensive discussion on these business models, we suggest reading the TIR white paper, “Timber Investment Styles: What they Mean for an Investor,” by Tom Johnson.

Table 3. How fees and expenses are charged based on the fee structure and business model of the timberland investment manager.

TIMO Business Model Fee Model	Outsourced Model Cost Pass-Through Model	Hybrid Model Cost Pass-Through Model	Vertically Integrated Model Internalized Cost Model
Core Advisor Level Costs • Principals and Directors • Portfolio / Account Management • Client Service • Advisor Level Administrative Costs	**Internalized** Covered by the asset management fee	**Internalized** Covered by the asset management fee	**Internalized** Covered by asset management fee
Portfolio-Level Expenses • Accounting • Acquisition • Disposition • Legal (Structure, Governance and Transactional) • Economic Research • Biometric Research • Forest Planning & Harvest Scheduling • Real Estate • Regional Forest Management	**Contracted Out** Services (if provided to the client) are performed by third- party contractors and are directly charged to the client account or fund	**Partly Internalized, Partly Outsourced** Services performed in-house are covered by the asset management fee. The remainder are outsourced to third-party contractors and are charged to the client account or fund	**Internalized** Most functions are the responsibility of the TIMO's property management subsidiary and are charged to the client account or fund. Any remaining functions fall back to the parent TIMO and are covered by the asset management fee
Property Level Expenses • Forest Operations • Appraisals • Timber Inventory • Remote Sensing & Geographic Information Systems (GIS) • Security and Monitoring • Risk Management and Fire Control • Recreational Management	**Contracted Out** Services performed by third-party contractors are directly charged to the client account or fund	**Contracted Out** Services performed by third-party contractors are directly charged to the client account or fund	**Internalized** The TIMO-owned property-management subsidiary charges the client account or fund for all property level services. The subsidiary itself may hire subcontractors.

TIMO Basis for Fee Model Choice

At first glance, the differences in fee structures appear academic and superficial. However, how these fees are segregated, and the business model a TIMO employs, are of significance to the investor because they can influence if and how a manager is incentivized. This, in turn, can alter the manager's strategy and behavior and impact a timberland portfolio's investment performance. To understand the relationship between fees and managers' actions and performance, it is necessary to understand the rationales that often drive TIMOs to choose one fee model over the other.

TIMOs that utilize a contractor-based model argue that they have the capacity to make portfolio management decisions without having to consider the implications an acquisition or disposition will have on its own in-house property-management staff.

Contractor-Based TIMO with Cost Pass-Through Model

TIMOs that utilize a contractor-based model argue that they have the capacity to make portfolio management decisions without having to consider the implications an acquisition or disposition will have on its own in-house property-management staff (the need to hire or fire staff to service the client). In addition, the model creates inherent transparency that is beneficial to the client because contracted services, which are passed through, are acquired using competitive-bid processes that ensure that rates and fees are competitively priced to market. Consequently, there is little opportunity for the TIMO to "game" the process to retain profit internally.

…vertical integration allows a TIMO to retain home-grown talent and expert knowledge, which, theoretically, can provide additional "alpha."

Vertically-Integrated TIMO with Internalized Cost Model

A vertically-integrated TIMO is likely to offer three primary arguments for employing a fully internalized fee structure. First, integration and coordination of portfolio and forest management activities improves when all functions are being managed within the same organization. For instance, practices such as quality control and cross functional integration are easier to implement. Likewise, having a unified corporate culture has intangible benefits. Together, these attributes can have a positive influence on investment performance. Secondly, vertical integration allows a TIMO to retain home-grown talent and expert knowledge, which, theoretically, can provide additional "alpha." Finally, it is easier to motivate and directly align the interests of the client with those of property-level personnel if those individuals providing ground-level management are employees of the TIMO rather than third-party contractors.

Hybrid TIMO with Cost Pass-Through Model

Like the contractor model, the hybrid TIMO outsources non-core functions like certain administrative and forest-management activities. This reduces operating costs and prevents investment decision-making related to buying, holding and selling clients' assets from being compromised by internal business considerations. However, hybrid TIMOs retain and ensure cross-functional integration of core value-adding functions like portfolio management, forest operations planning, accounting and research.

Choosing the Right Fees

Which fee model or TIMO business structure should an investor pick? In the end, the choice may come down to a matching the client's philosophy and style with those of the TIMO. As is illustrated in Table 4, there are a number of advantages and disadvantages associated with the *pass-through* and the *internalized cost* fee models. In the end, investors might be well advised to take a holistic approach – to evaluate TIMO fees based on the degree to which they are fair and competitive; provide alignment of financial interests; and, incentivize a manager to make investment decisions that are clearly in conformance with its fiduciary obligation to operate in its clients' interests.

Application for the Investor

With the information provided above as a background, there are three practices that investors should adopt when evaluating a manager and its fees:

Recognize the incentives (and disincentives) that particular fee structures provide and, if necessary and possible, adjust them with the TIMO in advance of establishing a relationship

1. Consider the full range of fees and expenses likely to be incurred and try to understand the tradeoffs between lower costs and enhanced services provided by the TIMO.

2. Recognize the incentives (and disincentives) that particular fee structures provide and, if necessary and possible, adjust them with the TIMO in advance of establishing a relationship to ensure that only superior effort and performance are being suitably rewarded.

3. Over the course of the investment, monitor and confirm that the fees and costs being incurred are consistent with initial expectations and do not accept a TIMO's fees or pass-through charges without first analyzing and validating them.

Making a Fair Comparison of Fees between Managers

Even though it is virtually impossible to make an "apples-to-apples" comparison of TIMO fee structures, when evaluating firms, investors should make their best effort to understand how their approaches to fees are similar and different. This process should not focus exclusively on one or two aspects of the fee structure, the asset management fees and incentive fees, for instance, but rather on the full range of fees and expenses likely to be incurred during the process of building and managing the portfolio.

The simple worksheet provided in Figure 3 is a tool that may be helpful in this regard. It enables one to isolate and calculate asset management fees as well as estimated pass-through costs on a property and portfolio-level so an educated cost comparison can be made. By highlighting the different aspects and features of a TIMO's operational approach, an investor can gauge if the range of services being provided are worth the additional costs likely to be incurred.

To illustrate, Figures 4 and 5 are hypothetical total-fee analyses of two different TIMOs. Figure 4 features TIMO A, a firm that has adopted a minimalist business model that entails outsourcing most of its functions. In contrast, TIMO B in figure 5, provides a number of additional capabilities internally, including accounting, real estate planning expertise and research. TIMO A's asset management fee is 85 basis points while TIMO B's is 100 basis points. However, after the costs of the additional services are accounted for, the net adjusted fee burden of 175 is actually lower than that of its counterpart. In this case, an investor choosing between the two firms would have to decide if those additional in-house capabilities in research and real estate offered by TIMO B warrant paying the higher upfront costs represented in the firm's base asset management fee. If not, TIMO A's lower nominal fees may be a better fit with the investor's needs and expectations.

Fee Compilation Worksheet

Management Fee ______ bp

Property-Management Costs*

Average Forest Operating Cost per Acre x Total Acres in Portfolio / Total Placed Capital = ______

Pass-Through Portfolio-Level Expenses

Accounting ______
Acquisitions ______
Audit ______
Legal ______
etc. ______

NOMINAL TOTAL COST: ______ bp

Subtract Extra Services Included in Asset Management Fee

Economic Research - ______
Biometric Research - ______
Real Estate - ______
etc. - ______

ADJUSTED TOTAL COST: ______ bp

Figure 3.

* *Include separate estimates for property management costs for each physiographic region or type of forest investment in the portfolio, as average operating costs will very across different wood baskets. Typical per acre costs can be provided by forestry consulting firms in the industry.*

Illustration 1: Heavily Outsourced TIMO A

Management Fee			85	bp
Property Management Costs				
$10.00 / acre x 36,000 acres / $50 million =			72	
Pass-Through Portfolio Level Expenses				
Accounting			5	
Audit			3	
Legal			5	
Recreational License Management			3	
Forest Sustainability Certification			7	
	NOMINAL TOTAL COST:		180	bp
Subtract Extra Services Included in Asset Management Fee				
(none)		-	0	
	ADJUSTED TOTAL COST:		180	bp

Figure 4.

Illustration 2: More Service Inclusive TIMO B

Management Fee			100	bp
Property Management Costs				
$10.00 / acre x 36,000 acres / $50 million =			72	
Pass-Through Portfolio Level Expenses				
Audit			3	
Legal			5	
Recreational License Management			3	
Forest Sustainability Certification			7	
	NOMINAL TOTAL COST:		190	bp
Subtract Extra Services Included in Asset Management Fee				
Accounting		-	5	
Biometric Research		-	4	
Economic Resarch		-	3	
Real Estate Planning and Management		-	3	
	ADJUSTED TOTAL COST:		175	bp

Figure 5.

Understand and Manage how Fees Shape TIMO Incentives

In establishing working relationships with TIMOs, it is advisable for investors to understand how a firm's fee structure can create certain incentives for it to work towards (or against) its clients' investment objectives. A TIMO with a property-management subsidiary, for instance, may agree to set fees for forest operations based on industry averages. However, such an approach may provide little incentive for the TIMO to pursue efficiencies or quality controls that exceed industry norms.

It also is prudent to be wary of fee arrangements that are atypical and could lead to a misalignment of interests. For established markets like the United States, we suggest an investor be cognizant and wary of event-based acquisition fees, disposition fees and commissions tied to other transactional activities, like the harvesting and sale of timber. Be sure to confirm that such fees are justified and that "double-dipping" is not occurring. This most often happens when costs that should be covered by the base asset management fee are being inappropriately passed through to the client.

Although options for influencing investment terms are limited when one is investing through a commingled fund product, an investor that plans to establish a separate account with a TIMO should be in a good position to shape and influence the proposed investment management agreement (IMA) to ensure its terms are consistent with the investor's goals and objectives. It may prove to be beneficial to be proactive from the outset in establishing a fee structure that aligns the financial interests of the investor and the TIMO and that ensures proper safeguards and incentives are in place.

Monitor and Confirm Fees

Finally, after selecting a manager, we recommend that the investor monitor the manager's fees, operating rates and costs on a regular basis. This can include calculating the net expense rate as is shown earlier in Figure 3. Also consider engaging an independent, third-party forestry consulting firm to assess whether the fees being charged or passed-through by the TIMO are reasonable and consistent with industry norms. This will not only ensure cost competitiveness, it also will assist the investor in developing a better understanding of the timberland portfolio and how it is managed.