

A Case for Accurate and Transparent Timber Pricing



—Reuben A. Rangel,
Timber Market Analyst
Forest2Market, Inc. (F2M)



History and tradition die hard; nowhere is this more true than in the southern U.S. where the vast majority of timberland is still privately owned. Tens of thousands of small non-industrial timberland owners still tend property that has been in their family for generations. Timberland owners, with a traditional attitude toward ownership, have deep emotional attachments to their land and feel a profound sense of satisfaction and pride in ownership. It is a tradition steeped in practicality however, as the attitude that timberland is an attractive financial investment increasingly joins traditional values in the timberland owner's mind.

Institutional investors, including Timber Investment Management Organizations (TIMOs), were attracted to the strong financial returns from timber many years ago. Pension funds, banks, university endowments, insurance companies, and the like have helped push institutional timberland investment to over \$15 billion¹ worldwide, with a significant portion of that investment occurring in the southern United States. Timberland has historically provided favorable returns with low volatility, making it an attractive vehicle for diversification. Using information from the National Council of Real Estate Investment Fiduciaries Timberland Index² and historic stock and bond prices, average timberland returns beat-out other financial investments significantly. A \$10,000 investment in timberland made in January 1987 would be worth \$168,900 dollars³ today. The same \$10,000 invested in a Standard & Poor's 500-indexed fund would only be worth \$ 61,200 today; 10-year treasuries would have

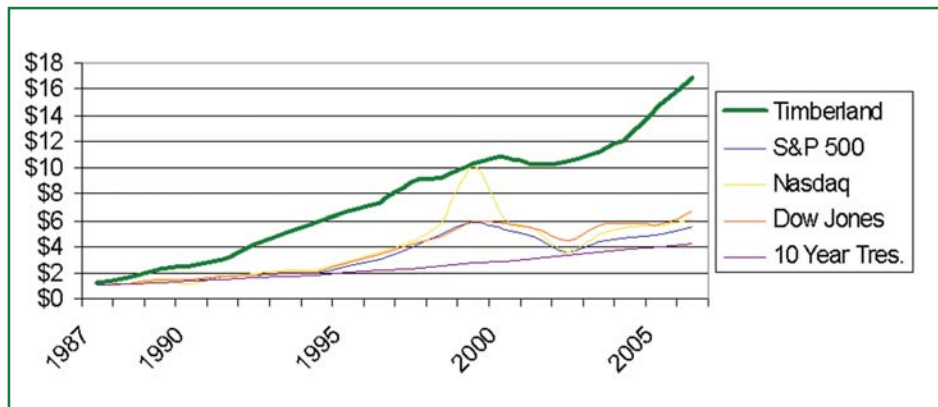


Figure 1: Cumulative value of \$1 invested, 1987–2006 (nonnominal values—unadjusted for inflation).

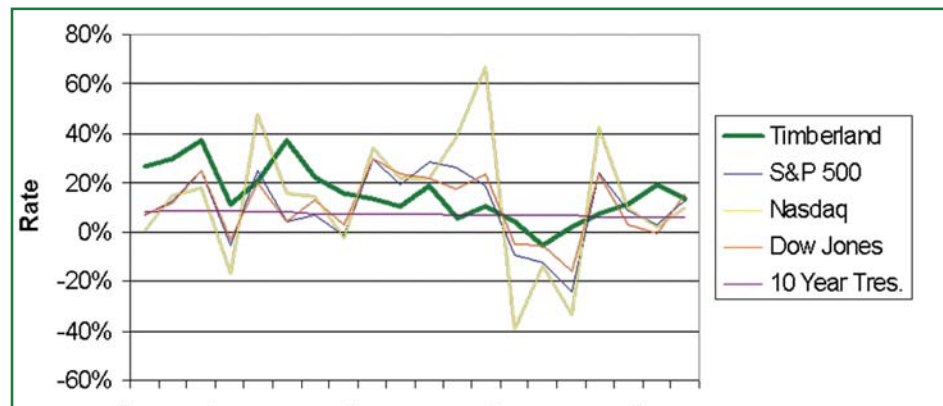


Figure 2: Annualized rates of return.

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returned a mere \$42,100 (Figure 1).

Timberland returns are stable partly because timber continues to grow on the stump regardless of economic downturns or political turmoil. In the last 20 years, the annualized rate of return on timberland has ranged from a high of 38 percent to a low of -2 percent; dropping into negative territory only one time in the last 20 years. Compare this to the extreme volatility of the NASDAQ, which has dropped into negative territory five times in the last 20 years (Figure 2).

Favorable returns and low volatility characterize timber investments in part because standing timber is a working factory increasing in value with the simple input of time and Mother Nature. Timberland owners also have flexibility when it comes to thinning or harvest. If pulpwood prices are depressed, the seller can wait until prices recover or the timber grows into another, higher-priced product class.

Along with favorable returns and low volatility, timberland can provide other financial benefits. Although the final harvest yields the majority of the returns, periodic income is available from thinning and land-use payments from hunting and mineral rights leases. The land itself can change in value and the standing timber increases in value as it grows. Nonetheless, timberland is a long-term investment that does have its associated risks. An uncontrollable occurrence such as a hurricane can destroy half a human lifetime of timber growth. Forest fire, storm, and infestation damage are risks but can be mitigated by good management. The lack of certainty regarding prices also contributes to risk.

Timberland is not a traditional investment and should not be managed as such. A number of factors, including current and future timber market prices and the market principles that govern them, determine the rate of return for timberland. Whether comparing timberland to traditional investments or simply comparing one timber tract to another, an investor's main goal is to determine the asset with the greatest potential return and the least comparable risk. Because of the intricacies of the biological and financial growth and yield of timberland, owners and their agents (consultants, tax advisors, etc.) must have access to

sophisticated financial planning tools and current, accurate pricing information.

Current, accurate price information of a stock or bond is available to anyone with a newspaper subscription or internet connection from nearly anywhere in the world. Unfortunately, for timberland

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owners, this is not the case for stumpage prices, which depend on local conditions and tract attributes. There are two types of pricing services available, but unlike stock price services, they do not report the same price for the same product on the same day.

Some stumpage price services rely on survey methods to collect information and ignore local price variations (which can be significant). Survey-based data collection extrapolates data (in this instance price) from a relatively small number of survey respondents and can have a wide margin of error. In addition, those services report prices averaged over several months, obscuring price trends often to the detriment of the timberland owner.

Transaction-based services, on the other hand, calculate price from a large number of actual sales contracts (closely resembling stock and bond price services, which account for every sale). The sheer number of transactions reported also allows for accurate price calculations in smaller, more relevant geographic areas, taking into account local conditions and even specific tract attributes. Most importantly, transaction-based services can report prices based on the tract attributes that affect sale price: tract volume, acreage, access roads, loggability, distance from tract to mill, product type, and log size. Size metrics, such as diameter at breast height (DBH), in particular have the most profound effect on price. Reliable market analysis shows that changes in log diameter account for roughly 70 to 90 percent of the change in stumpage price, depending on geographic location⁴. For the timberland

owner with land or opportunity in multiple markets, size metrics allow for accurate stumpage price comparisons across geographic regions and through time.

Access to accurate, in-depth, local stumpage pricing and market information is invaluable to any timberland owner or his or her agent, whether planning the timing of harvests and other management activities or in considering timberland investment opportunities. Without accurate, local, current prices and market information, there can be little confidence in price forecasts as well. When making net present value (NPV) calculations, cash flows (related to prices received for future timber harvests) are an important component. With NPV calculations, the sum of all future expected cash flows from an investment are discounted back to the present to obtain the value of an investment beyond the initial capital outlay. Since future cash flows are discounted over many years, even slight inaccuracies in price are magnified as they are compounded over time. Without accurate pricing information, precise timberland investment decision making is ultimately a futile exercise.

Viewing timberland ownership purely as a financial investment vehicle is not a novel idea. As local timber pricing and market information becomes more transparent and potential investors become aware of the paramount providers of this information, the notion of timberland as an investment among private timberland owners can only gain in popularity.

About Forest2Market, Inc. (F2M)

Forest2Market, Inc. (F2M) provides products and services that allow participants in the forest and wood products industry—including individual landowners as well as the largest wood products companies in North America—to make better business decisions. We provide data-driven informational tools supported by actual market transaction data.

References

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