

Maine Policy Review

Volume 16

Issue 2 *Maine's North Woods*

2007

Seeing the Forest for the Trees: The Future of Timber Investing in the North Woods -- A Conversation with Clark S. Binkley

Peter Howell

Open Space Institute

Follow this and additional works at: <https://digitalcommons.library.umaine.edu/mpr>



Part of the [Natural Resource Economics Commons](#), and the [Real Estate Commons](#)

Recommended Citation

Howell, Peter. "Seeing the Forest for the Trees: The Future of Timber Investing in the North Woods -- A Conversation with Clark S. Binkley." *Maine Policy Review* 16.2 (2007) : 38 -43, <https://digitalcommons.library.umaine.edu/mpr/vol16/iss2/6>.

This Interview is brought to you for free and open access by DigitalCommons@UMaine.

Seeing the Forest for the Trees: The Future of Timber Investing in the North Woods

A Conversation with Clark S. Binkley

by Peter Howell



In this conversation with Peter Howell, Clark Binkley draws on his long-term experience as a timberland investment manager to give his analysis of and forecast for timber markets and timber investing in the Northern Forest. While he is not optimistic about the current prospects for such investments, he does believe that there are some opportunities in conservation easements, residential development, and possibly biofuels and carbon credits. 🐉

Dr. Clark Binkley, former chief investment officer of Hancock Timber Resource Group, was responsible for timberland investments totaling \$3.5 billion during his eight-year tenure with Hancock. Hancock, which once owned a large portfolio of properties in the Northern Forest, sold its entire portfolio in the region between 2003 and 2004. Binkley left Hancock in 2005 to start International Forestry Investment Advisors, LLC (IFIA) to develop and implement innovative, socially responsible timberland investment strategies. At the moment, IFIA manages just under a half billion dollars of investments in two funds, one related to intensively managed hybrid poplars in Oregon and Washington, and the other focused on emerging markets. Just back from a trip to Asia, Binkley sat down with Peter Howell recently in New Hampshire to offer his perspective on timber markets and timber investing and what the future might hold for both in the Northern Forest.

Question: So what's so interesting about Southeast Asia that you can't find in Maine?

Binkley: Low-cost land, fast-growing trees, and good access to the rapidly expanding markets in Indonesia, Vietnam, and China.

Question: So if you could, would you buy timberland in Maine?

Binkley: No, probably not.

Question: So you're still less than sanguine about your backyard. Why?

Binkley: There are three key problems:

1. I think you're going to see continued downward pressure on the forest products industry in the region due to more competitive mills elsewhere in the world. At its factory in Old Town, Bounty is producing paper towels from processed eucalyptus pulp that is shipped up from South America—a classic coals to Newcastle story. But it's cheap, and it's great pulp. Timberland owners need markets for their

pulpwood and logs, and if the forest products manufacturing base deteriorates then the risks of holding timberland increase.

2. Land costs have risen to the point that returns have fallen to levels that cannot justify ownership for timber production.
3. There is little opportunity to leverage forestry biotechnologies such as the use of elite varieties and intensive management to offset higher land costs.

Traditionally, high-quality hardwoods have paid much of the freight for timberland ownership in the region. To grow high-quality hardwoods, you have to have something to do with the very large quantity of low-quality materials that you are producing along the way, and historically, the pulp mills in the region have performed that function. I don't think you'll see a new pulp mill in Maine. With their decline, this is becoming more difficult. And high-quality hardwoods increasingly are grown in fast-growing plantations.

We are going into a major housing slump. Timber prices in some cases have fallen and in other cases are going to have to fall just to come down to be in line with lumber prices. So you are going to look at a couple of years of probably pretty poor operating economics. It's a very tough time in the lumber business right now. Single-board-foot prices are at their lowest level in 40 years.

The hardwoods business isn't terribly strong either, and historically that's been the great strength of the Northeast. The United States furniture industry has fallen by about 50 percent, and most of the loss has gone to China, Vietnam, and Indonesia. The furniture manufacturers in Southeast Asia do need wood, and some wood from the United States that might have gone to U.S. manufacturers will go there instead. But firms in these countries are also sourcing their wood from a much broader and closer supply chain than the United States. And also there are getting to be substitutes for native hardwoods from plantation-grown hardwoods. All this translates into a lot of negative pressures on cash flows in timber industry in the Northern Forest.

Question: You sound like a real Dr. Doom and Gloom. Any bright spots anywhere?

Binkley: Well, there are some positives. The biofuels business might replace pulp markets. But it's a tough business. There's a lot being said about cellulosic ethanol, which would create demand for pulp. But most of the business plans for these things show the price of their inputs—wood—as zero. That doesn't help us much. Carbon credits could also play a role. If you assume, perhaps a little rosily, that forests in the Northeast might grow perhaps two tons per acre per year and that carbon credits will fetch \$25 a ton, that's a lot of money. But it's completely a function of regulation: will we get a legal framework to capture this value? Within the environmental community there are highly mixed views about whether you should get credits to grow natural forests. But in my view, carbon could become the largest market for forests in the Northeast.

On the timber-supply side, one of the underappreciated phenomena in North America is the impact of the mountain pine beetle in British Columbia. It is basically killing every single pine tree in British Columbia. The industry is doing as much salvage logging as it can so there's a lot of supply on the market right now, but that is a relatively temporary phenomenon. In maybe 10 to 15 years, supply is going to fall off fairly dramatically in British Columbia. This could reduce the wood supply in North America by 20 to 30 million cubic meters of wood. Just to give that a kind of point of reference, New Zealand cuts about 20 or 25 million cubic meters annually. So, in the longer term, that should be favorable for timber prices in the United States.

And finally, one bright side for the industry is, ironically, the prominence of so called higher and better use (HBU), or sale of timberland for development. You have seen that in New England, but it is also a broad phenomenon in North America. The timber REITS (real estate investment trusts) (including Plum Creek) and the TIMOs (timber investment management organizations) now make about a third of their cash flow from land sales.

Question: So why are investors buying land specifically in northern New England?

Binkley: That's a good question. Many of them bought in the past on the basis of bullish predictions of future value. I don't think you'll see a lot of large institutions buying in the region for a while. Smaller investors, real estate developers and loggers are likely to make up the bulk of the purchasers. Prices are simply too high for the traditional, classic timberland investor to make good returns.

Question: Timberland prices remain strong. How do you square your pessimism with what seems like continuing optimism on the part of many investors?

Binkley: As economists are fond of saying, "optimists control markets!" More seriously, in valuing timber, there are two questions: what are the cash flows over time? And what discount rate do you use to bring those cash flows back to the present? The reason that timber asset values have stayed high is a curious blend of the two. Generally, cash flows have dropped overall rather significantly, suggesting valuations should have fallen. But, the discount rate has also fallen, from perhaps eight percent to 4.5 percent. The impact of reductions in discount rates has more than offset the reductions in expected cash flows, so timberland asset values have risen in the face of deteriorating fundamentals.

Will the discount rate continue to fall? I just don't think it can. One benchmark, 10-year U.S. Treasury bonds, is at a cyclically low level already. If the discount rate doesn't fall, or if it begins to increase, it seems to me that asset values will have to fall at some point. Of course, timberland prices may not fall a lot and may not fall quickly. Prices may be a bit "sticky" downwards in part because appraisals tend to look backwards rather than forwards, and the past has been full of high prices. And, timberland asset values may be propped up by development or carbon values. I just think the future may look different from the past.

Question: Yet there still seems to be a lot of money going into timber investment?

Binkley: Yes. There is a great deal of money coming into the asset class looking for land that, after the last big sell-off by industrial companies, is relatively scarce. There are several very large European pension plans that have decided that they want to invest in timberland and a couple of very large Canadian ones. These funds may be worth \$100 billion to \$200 billion, and they typically are looking to place perhaps one to three percent of their value in timber to diversify their holdings. A billion dollars may not be much to them, but it's a lot of timberland!

Question: But what effect has the credit crisis and the meltdown on Wall Street had on timber investing?

Binkley: The recent turmoil in capital markets has meant two things for timberland. First, borrowing has gotten a lot more expensive for everybody. If you wanted to buy timberland and do it with lot of debt, you probably won't be doing that anymore. Recently, TimberStar bought a lot of forestland in Texas, and they did it with a debt structure that looks a lot like the debt structures that have all collapsed around us in the mortgage business. Second, it means that returns on U.S. Treasury bonds have fallen a good deal, and this will cause people to look for higher yields elsewhere. Timberlands historically have offered reasonable returns so I imagine the credit crisis has re-emphasized the low risk of timberland.

Question: So, one trend seems to maybe slow aggressive investment and the other would seem to favor timberland vis-à-vis other assets?

Binkley: That's right. Historically, people have invested in timber as an asset because it wasn't correlated with the stock market. But what's unclear is what will happen in the future. Right now forward-looking returns—that is, what investors think the future return will be—have fallen about 300 to 400 basis points

(that is three to four percentage points) in the last three years. The question is: are investors really going to be interested in investing in timberland when they are generating only 200 basis points above real treasuries? It just seems to me that the bloom is a little bit off the rose with conventional U.S. timberland investments.

Question: How will all this affect the timber investors' approach to timber harvesting and to conservation?

Binkley: Well, you may see more pressure on some investor landowners to cut harder to increase cash flow. As for conservation, that's the really interesting question. Easements have helped timberland investors by reducing their cost on the front end and thus increasing their internal rate of return. Lyme Timber, a TIMO, has done magnificently well with their investments by partnering with conservation groups on easements.

Question: What about development? Aren't investors betting on increased returns through development?

Binkley: Historically, many timber investors have. Since about 2000, a lot of timber investors have included a premium for development in their business plans for timberland acquisitions. But I think many have realized their rural real estate development is far riskier than the timber business and that they may have mis-valued that element of the timberland asset.

Question: But isn't there growing development pressure in the region? If they weren't right then, aren't they now? Isn't this Plum Creek's business model?

Binkley: It is, and it may be a winning one. Plum Creek clearly is further ahead of other timber investors in thinking about HBU (highest and best use). But I think the picture is much more complicated. There surely is a lot of heterogeneity in land in the Northeast. There's a lot of timberland, particularly in Maine, that just does not now have and is not likely to ever have any material HBU. development value because it is too distant or it lacks any distinguishing characteristics. I shouldn't

say that it will never have it, but it might only have it in the context of being part of a 10,000-acre kingdom lot or something like that. There is only so much waterfront, there are only so many prime lakes and hills, etc. So, both the amount and kind of economic productivity of the land varies tremendously.

Question: Many observers have commented that even if there isn't immediate development, land sales are likely to lead to greater parcelization? Do you see that, and is it a concern?

Binkley: It absolutely is occurring as larger ownerships become divided into smaller ones. But, until the land use changes, all you have is more landowners. Fragmented ownership does not necessarily mean a fragmented forest. What does fragmented ownership mean ecologically, economically? There's a great deal of fuzzy thinking, and little empirical work, to answer this question.

Question: Are there any structural limits for investors to capturing real estate value?

Binkley: Yes, a potentially very significant one. If a timberland investor repeatedly makes HBU sales, the IRS considers that investor to be in the business of dealing in land. This activity then becomes a business unrelated to the timberland business, and is taxed at ordinary income, not capital gains tax rates. Plum Creek has appropriately gotten around this problem by creating a separate, taxable subsidiary for its real estate activities, but not all timberland investors have done so. I am frankly a bit surprised that there has not been more tax-related concern about the amount of real estate sales being made by traditional timber investors.

Question: If you were a policymaker, what policies would you pursue to ensure the continued health of the forest in northern New England?

Binkley: I think that one of the most effective tools is continued funding for conservation easements. Conservation easements take out the development value

without having to do the development. This increases an investor's return and keeps the land from being developed. Carbon credits also can play a role. I would have thought that given all the concern about forestry and forests in New England the Regional Greenhouse Gas Initiative (RGGI) would have a strong program that would have linked accounting for carbon credits as part of a conservation program. This could have been another way to fund conservation easements. The RGGI rules are still in flux, but to date have not been very positive for forestry. If structured correctly, I think that carbon credits could be a very powerful lever for protecting forestland. 🐼



Peter Howell is the executive vice president of the Open Space Institute where he oversees the conservation research and finance programs. Previously he designed and implemented national grant-making programs focused on wildlife habitat conservation at the Doris Duke Charitable Foundation and on urban park creation and restoration at the Lila Wallace-Reader's Digest Fund.



Clark S. Binkley is managing director of International Forestry Investment Advisors (IFIA), a firm he founded to develop and implement innovative, socially responsible timberland investment strategies. Prior to founding IFIA, he was managing director and chief investment officer of the Hancock Timber Resource Group, the world's largest timberland investment advisory firm serving private-equity clients. Before joining Hancock, he was dean of the Faculty of Forestry at the University of British Columbia, and from 1978 to 1990 was on the faculty at Yale University. He has written more than 100 books and articles on forest economics and is known worldwide for his research on timberland investments.