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MARKET REPORT

IN THE FIRST OF A REGULAR SERIES OF TIMBERLAND INVESTMENT AND WOOD MARKET REPORTS, FORISK'S BROOKS MENDELL AND TYLER REEVES LOOK BACK AT 2022 AND EXAMINE 2023'S EARLY RETURNS.

BY BROOKS MENDELL AND TYLER REEVES

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At Forisk, our analysis emphasizes relative performance over absolute results. How will "this" timber market perform relative to "that" market across a series of scenarios? This approach also extends across forest industry sectors where we look for constraints or excess margins that might lead firms to restructure or correct.

In this article, we begin by reviewing timberland returns and values, which surged in 2022, and the associated timberland investment deal flow. Then, we look at forest industry curtailments. Together, these dynamics raise questions about what to watch in 2023.

TIMBERLAND RETURNS AND THE CASE FOR CAUTION

In late 2022, we noted the following:

> "…the story for timberland moving forward remains compelling… Even with the headwinds of uneven inflation, interest rates, and economic growth, timberland has positive exposure to multiple attractive theses."

These exposures include long-term demand for solid wood products to rebuild and grow the U.S. housing stock in an ESG-friendly way and the concept that forestlands offer investors a "safe haven" during turbulent times. In other words, timberland can provide welcome stability when the world is bouncing around.

That said, how did timberland investments perform in 2022? According to the Forisk Timber REIT (FTR) Index, timber REITs as a sector returned -22.75% based on appreciation and -18.51% on a total returns basis (versus 25.09% on appreciation and 30.12% for total returns in 2021). How did this compare to private timberland investments? Timberlands returned 12.90% in 2022 (versus 9.17% in 2021).

While the strong 2022 private timberland returns catch the attention of private forest owners and investors, the 31.4% gap (12.9% for timberland vs. -18.50% for timber REITs) between those and the total returns for timber REITs generates questions. The last time private timberlands and public timber REITS moved so strongly apart was in 2008 when NCRIEF gained 9.5%, and the FTR Index fell 20.4%, a gap of 29.9%.

The U.S. South provides a useful case for considering timberland returns relative to a softer economy. From 2005 through 2008, the National Council for Real Estate Investment Fiduciaries (NCREIF) reported double-digit returns before three consecutive years of negative returns from 2009 through 2011, driven by the Great Recession and over-allocations to real estate in timberland portfolios. The wild change in the market is reflected in the peak-to-trough returns for Southern timberlands, which went from 18.8% in 2007 to -4.3% in 2009.

Timberland valuations also swung during this period. Private timberlands in the South approached $1,100 per acre in early 2005 and, by early 2009, hit $1,700 before correcting below $1,500 over the next three years.

How do recent trends in the U.S. South compare? In 2022, NCREIF reported double-digit returns of 13.4% for the South, the highest rate of return since 2007. Private timberland market values in the South stabilized around $1,800 per acre since 2019 before rising above $2,000 to close 2022. In Q4 2022, average per acre timberland values increased by $160 year-over-year (8.7%). The core driver of strong returns in 2007-2008 and 2022 was appreciation (not cash flow).

As an analyst and investor advisor, my questions focus on "what are your objectives?" and "what are you buying?" Investors acquire an asset with a model of how they expect it to generate cash and returns. Fifteen years ago, before and during the Great Recession, those models included assumptions related to real estate (HBU). Today, the higher valuations include models for forest carbon, real estate, and traditional forestry activities. While timberland remains a reliable cash-flow-generating asset, the prices paid for those cash flows should correspond to underlying and measurable sources of demand and production.

With respect to valuations, timberland investors and timberland-owning REITs are testing the limits and opportunities of forest carbon markets. One CEO said, "With forest carbon, we believe it's about quality. So, we're looking at projects with bankable partners that don't overly restrict our ability to manage and harvest if carbon markets go belly up." This general sentiment was consistent across firms and institutions we've talked to over the past six months, which continue looking for the right balance of traditional forestry models that generate cash from harvesting trees with evolving markets associated with ESG, solar panels, and real estate.

Seller	Buyer	Location	Acres	Price ($MM)	$/ac
The Forestland Group	Bluesource Sustainable Forests	Eastern U.S.	1,700,000	$1,800.0	$1,060
-	Campbell Global	AR,OK, MS	250,000	$500.0	$2,000
Greenfirst Forest Products	Perimeter Forest	ON	203,000	$49.3	$250
Manulife (Hancock)	Rayonier	TX,AL,GA,LA	137,800	$454.0	$3,300
Lyme Timber Company	Manulife (Hancock)	FL	90,000	$111.0	$1,230
Green Crow Corporation	Nuveen	WA/OR	47,751	-	-
Green Diamond Resource Company	Southern Pine Plantations/RMS	AR	45,795	-	-
The Rohatyn Group	The Nature Conservancy	MI	32,600	$43.2	$1,320
Lyme Timber Company	Bluesource Sustainable Forests	MI	29,000	-	-
Private	Bluesource Sustainable Forests	TN,AL	27,000	$27.5	$1,020
Molpus	Idaho Department of Lands	ID	18,000	-	-
Lyme Timber Company	-	OR	16,981	-	-
Sleepy Creek Land	Private	FL	12,712	$37.6	$2,953
Nuveen	The Conservation Fund	OK	11,332	-	-
Resource Management Service	Domain Timber Advisors	AL,AR	11,000	-	-
Rayonier	Ecotrust Forest Management	WA	10,981	$30.6	$2,800

Figure 1. 2022 Q4 – 2023 Q1 Completed Timberland Transactions Data Source: March 2023 Forisk Market Bulletin

TIMBERLAND DEAL FLOW

Timberland transaction volumes increased by approximately 1.7 million acres in 2022. This represents a 61% year-over-year increase and comes after a 61% increase in 2021. The more than 4.4 million acres sold in 2022 represent the second highest level in a decade, topped only by 2016, the year of the Weyerhaeuser/Plum Creek merger.

Despite the increase, much of the volume came from a handful of large deals. These include, for example, Bluesource's purchase of 1.7 million acres from The Forestland Group and the merger between PotlatchDeltic and CatchMark, which saw the newly integrated REIT assume ownership of CatchMark's 350,000 acres across the Southeast. Figure 1 includes details associated with over 2 million acres of closed, larger timberland transactions in the U.S. for the six months, including the fourth quarter of 2022 and the first quarter of 2023.

While current activity occurs in all U.S. regions, the U.S. South continues to dominate most "institutional" timberland acres on the market. Project Verde, offered for bid by Conservation Forestry, represents 93,223 acres spread across four states, Alabama, Arkansas, Florida, and Virginia. Also in the South, Valley Creek timberland, a collection of 27,469 acres across Central Alabama, is being offered by bid sale. Lastly, Forest Investment Associates is offering their ~14,000-acre package, Osceola Timberlands, for sale. The properties are spread across South Georgia and North Florida.

LOG PRICES, HOUSING MARKETS, AND MILL CURTAILMENTS

In mid-2021, after lumber prices peaked in June and corrected sharply in July, Forisk examined the potential impacts on delivered softwood log prices in Pacific Northwest. As with the 2018 log price boom – where domestic #2 Douglas-fir exceeded $850 per MBF before dropping below $650 per MBF within three quarters – we assessed how log prices might correct and estimated 2022 delivered log prices in line with the pre-COVID five-year average for 2016 to 2020 in our Base Case scenarios.

As we enter 2023, the market provides a strong, two-part case for a robust log price correction in the Northwest. The first part focuses on the potential of softening housing markets in the U.S., which continued to contract through the close of 2022. High mortgage rates continue to hamper housing affordability, and builder sentiment remains low. The NAHB/Wells Fargo Housing Market index, a monthly sentiment survey among builders of single-family homes, fell 57.8% year-over-year.

Housing starts fell again in December, marking the fourth consecutive month of declines. Seasonally adjusted starts fell 1.4% to a rate of 1.382 million starts. Despite widespread consensus across independent forecasters from the housing industry that housing starts will be lower for 2023, estimates vary widely for 2024. For example, KPMG forecasts a bearish 2024 with an estimated 1.134 million starts. Meanwhile, MBA posits a much more bullish 2024, rising back to 1.541 million starts. This represents a range of 407 thousand starts across market watchers and analysts.

Part two for a potential log price correction in the Northwest captures the associated decline in wood demand and the recent wave of curtailments across forest industry sectors, which lower production levels and reduce the demand for wood. Announced sawmill curtailments and closings are increasingly common since widespread flooding in Western Canada in late 2021 disrupted road and rail transport for sawmills to deliv-

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er products to market. The story changed from infrastructure damage to a lack of available and affordable fiber as we moved through 2022 and into 2023. During this time, we saw regional lumber prices retreat, log prices increase, and harvest restrictions become more common.

Since December 2022, announcements for curtailments and/or closings have directly named 20 mills in Western Canada (Alberta and British Columbia) and removed over 900 MMBF of capacity from the sawmill sector. Firms including Aspen Planers, Canfor, Conifex, Interfor, Sinclair, Skeena, Tolko, West Fraser, and Western Forest Products have announced curtailments as of January 26, 2023, for Western Canada alone.

In total, firms in Western Canada in 2022 announced sawmill capacity reductions totaling over 1.8 BBFT, or roughly 11% of the total sawmill capacity in the region. By the end of January 2023, roughly 1.1 BBF, more than 6% of 2023 sawmill capacity for this region, announced closures or curtailments with more in the queue. While Western Canada accounts for most of the reductions, other regions, including the U.S. South, also took production offline.

The pulp and paper sector also announced significant downtime, primarily in Western Canada and the U.S. South. Lower demand for finished goods and downstream impacts on raw material supplies from fewer available manufacturing residuals for pulp and paper mills are affecting firms, especially in Western Canada.

An executive at a forest products manufacturer emphasized to us the "interdependence" of the industry. "People don't realize how connected the industry is. When a market for hardwood fiber goes down, it affects softwood mills, too." This theme repeated itself in conversations with timberland investors, as well as with manufacturers across regions. In short, declining production at sawmills affects the feedstock reliability and viability of regional wood-using pulp mills.

For the Northwest, there is a potential upside. A heavy portion of the curtailment activity occurs in BC, which could boost the need for regional production in the United States in Oregon and Washington, and incremental capacity increases in the U.S. South.

In 2008, Forisk registered the FTR ("footer") Index to benchmark the timber REIT sector. To subscribe to the free one-page weekly FTR Index Summary and to obtain historical FTR Index data in an Excel format, please contact Pamela Smith at psmith@forisk.com.

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