Forest Research Group

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TIMOs and REITs: Pizza and Beer?

Analogy Needed

Timberland investors in the United States can choose private equity investment through many different Timberland Investment Management Organizations (TIMOs) or three (currently) publicly-traded timberland Real Estate Investment Trusts (REITs) and some private REITs.

The REITs usually convey the idea that they are an *alternative* to private equity investment in timberland, and note particularly that investments in a timberland REIT are more liquid than a private equity investment in timberland.

We suggest that they are not an *alternative*: your portfolio might benefit from one or the other or *both*. The characteristics of timberland as a private equity investment differ from those of timberland in a REIT.

So they may be like pizza and beer. You can consume one without the other, but they also go well together. But this analogy implies they fit very well together all the time, and that is not quite what we mean to say. Perhaps they are like coffee and tea: some people drink one, some people drink the other, and some people drink both. It all depends on your portfolio.

Private Equity and Liquidity

TIMOs have been marketing the benefits of private equity investments in timberland for institutional investors in the United States for over twenty years. Individuals and small partnerships have been pushing timberland investments for wealthy individuals for much longer than that.

One of the perceived disadvantages in private equity timberland investment is a lack of liquidity. The liquidity issue has two pieces: the investment vehicle and the underlying asset.

Investment Vehicle Liquidity

Some investments are through commingled funds which have finite life spans. It is very difficult to get out of such an investment before the end of the term, and it is very difficult to extend the life of the investment if things are going well. But this is illiquidity based on the investment vehicle, not the underlying asset.

One way of getting around the finite life of a commingled fund investment vehicle is to invest via a separate account. A separate account has no termination date: investors can sell whenever they want (or buy whenever they want).

Underlying Asset Liquidity

Both commingled funds and separate account investments are subject to the other timberland liquidity issue. It takes ***time*** to sell a sizeable timberland property. The great International Paper timberland sale of 2006 took most of a year from the time the sale was officially kicked off until most of the transactions closed.

OK, that was 6.5 million acres or so. But that year does not include the time International Paper spent deciding how and when to sell, setting up the sale and finding investment bankers to help. Even smaller sales of "only" tens of thousands of acres or hectares can take a year from the time the decision is made to sell until the deal is closed.

It is also difficult to rebalance a timberland investment. How do you reduce your timberland portfolio by 10%?

Do you sell a single property (assuming you have one that accounts for 10% of your timberland portfolio)? What will the sale of that property mean to the performance of the remaining timberland portfolio? Will it leave you over-allocated in New Zealand (or Alabama or British Columbia)

Do you sell 10% of each property? That can be a very expensive proposition and may be impractical for many properties. (It is easier to sell 10% of a timberland property than it is to sell 10% of a hotel or a warehouse or apartment complex, but still not easy).

REITs to the (Liquidity) Rescue

The liquidity problem is alleviated by REIT ownership of timberland. Investors can sell shares of the timber REIT at any time. It is certainly easier, quicker and cheaper to sell a few hundred REIT shares than it is to sell a few acres of a private equity investment. It is also easier to buy a few hundred REIT shares than it is to add a few acres of timberland to an existing investment--while the wholesale discount for buying very large timberland properties has all but disappeared, very small retail lots (e.g., 10 or 40 or 80 acres) are still far more costly than, say, 10,000 acre parcels.

(However, it is unlikely that large investments in REITs are "perfectly" liquid. While $100 million of REIT shares may be more liquid than $100 million of private equity investment, can you unload $100 million of any stock in any company in a single day? Won't that drive the share price down?)

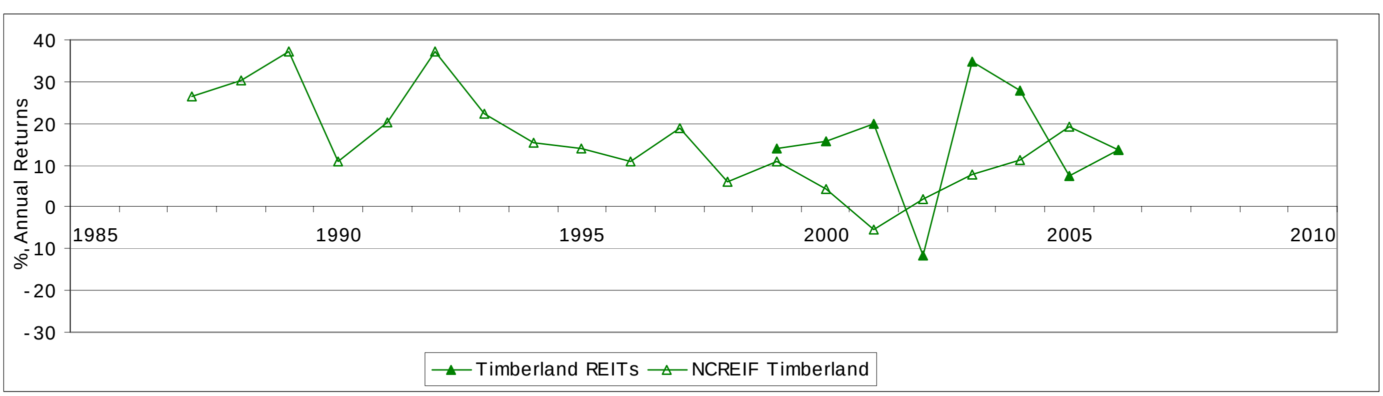
Another advantage to the REIT structure—from the timberland manager's point of view—is that the underlying asset does not need to be sold. It is nearly impossible for a TIMO to transfer(/sell) a property from one investor-client to another. When a private equity investor wants to reduce its timberland investments, it is almost always necessary to sell some timberland. With REITs, however, investors can adjust their timberland investment allocation as needed without disturbing the management organization and the assets it is managing. The manager does not have to deal with big swings in the number of acres being managed and related over- and under-staffing issues.

Data history on publicly-traded timber REITs is limited (Figure 1). Plum Creek converted to a REIT in 1999, Rayonier in 2004 and Potlatch in 2006. The return shown in the chart is a market value-weighted return, where the 2006 market value for each company is used for all years. Table 1 shows that, over the eight years of available data, the REITs had higher returns and higher volatility than the TIMOs, and the two asset classes were very poorly correlated

Table 1. Return Statistics for Timberland REITs and Private Equity Investments

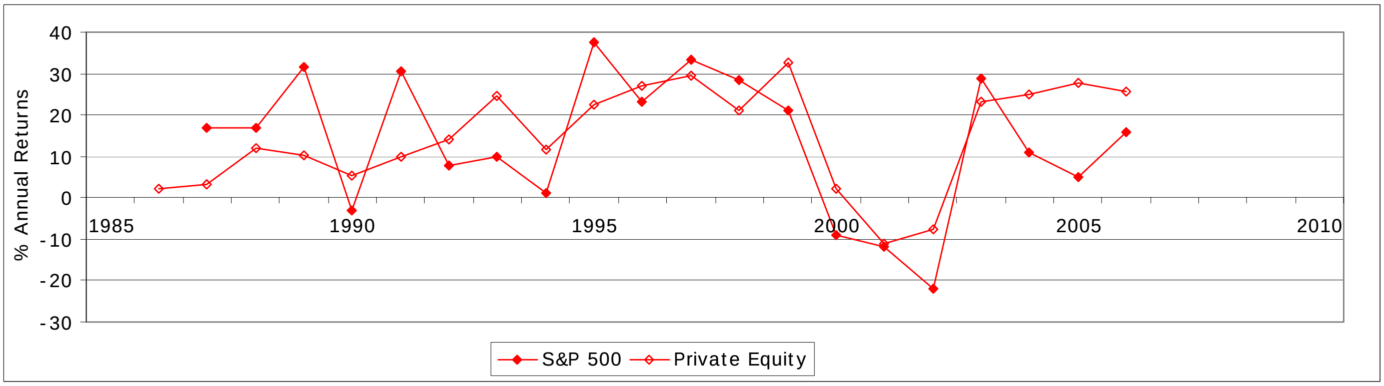
	Timberland REITs	NCREIF Timberland
Annually Compounded Returns	14.5%	7.7%
Standard Deviation	13.9%	7.6%
Coefficient of Variation	95.8%	98.3%
Correlation Coefficient	1.0000	0.0406

Figure 1. Timberland REIT and Private Equity Investment Returns



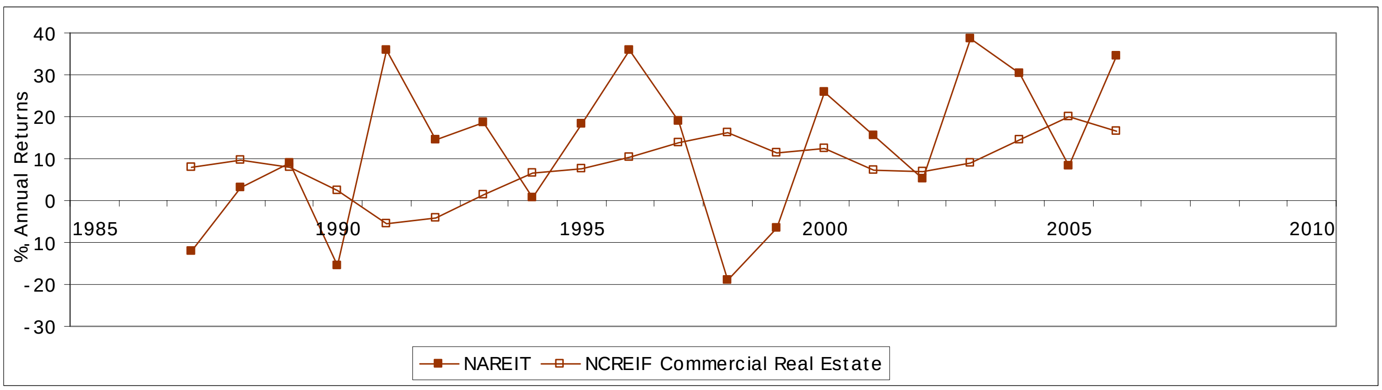
Sources: National Council of Real Estate Investment Fiduciaries and Forest Research Group

Figure 2. Publicly-Traded Stocks (S&P 500) and Private Equity Investment Returns



Sources: Ibbotson Associates and Cambridge Associates

Figure 3. Commercial Real Estate REIT and Private Equity Investment Returns



Sources: National Association of Real Estate Investment Trusts and National Council of Real Estate Investment Fiduciaries

Table 2. Return Statistics for Publicly-Traded and Private Equity Investment Returns, 1999-2006

	General		Commerical Real Estate		Timberland	
	S&P 500	Private Equity	NAREIT	NCREIF Commercial Real Estate	Timberland REITs	NCREIF Timberland
Annually Compounded Returns	3.4%	13.4%	18.0%	12.1%	14.5%	7.7%
Standard Deviation	17.7%	17.4%	15.8%	4.6%	13.9%	7.6%
Coefficient of Variation	516%	129%	88%	38%	96%	98%
Correlation Coefficient	1.0000	0.8768	0.3169	0.3490	0.6626	0.5922
"Paired" Correlation Coefficient	1.0000	0.8768	1.0000	0.1184	1.0000	0.0406

Public vs. Private Investments

We looked at other publicly-traded/private equity investment pairs to see how they compare. Figure 2 shows the S&P 500 and Cambridge Associates' Private Equity index. Figure 3 shows commercial real estate returns.

Table 2 provides some statistics for the returns, but only for the time timberland REIT returns are available: 1999-2006.

The commercial real estate and timberland REITs provided higher returns than their corresponding private equity investments. The publicly-traded assets had higher standard deviations than their private equity counterparts (but the coefficients of variation for the two timberland assets are nearly identical).

Over the past eight years, the general private equity investment returns have been highly positively correlated with large cap stocks, timberland somewhat less so, and commercial real estate much less so.

When correlations are calculated for the paired assets, we find private timberland and real estate investment returns are not correlated with timberland and real estate REIT returns.

Summary

Our analysis shows that private equity investments provide different returns than investments in publicly-traded assets of the same kind. This means timberland REITs are not necessarily an alternative to (or a substitute for) private equity investments in timberland. They may be an appropriate investment whether there is private equity timberland in the portfolio or not.

Update

In Volume 1, Number 4, *The Anti-Correlation Heresy*, I wrote about the apparent correlation between the Super Bowl winner and the performance of the stock market, but had not been able to cite the source. While cleaning out some old files early this year, I found the original article. It appeared in the Wall Street Journal on January 12, 1998, was written by William Power, and was entitled *Friday's Stock Drop Isn't the Big Worry: Broncos' Victory Is.*

The Super Bowl Predictor is a little more complicated than I described back in 2004. The Dow Jones Industrial Average will rise if a team that was a pre-merger National Football League team wins the Super Bowl, and will fall if a team that was originally an American Football League team wins. What complicates the analysis is that some former National *League* teams were moved into the American Football *Conference* after the merger. The Dow Jones should do well this year, because *both* teams in the 2007 Super Bowl were originally from the National Football League (the Indianapolis Colts were part of the original NFL).

So it is not as simple as which *Conference* wins the Super Bowl—what is important is which pre-merger League the winning team came from.

This Super Bowl Predictor is tracked by Robert Stovall at Wood Asset Management. It was mentioned again in an unattributed Wall Street Journal article on January 23, 2007. The Predictor has been slipping of late: in 1998, it was 90% accurate, but by 2006 it was only 80% accurate. That is in part because the New England Patriots have won a few Super Bowls and the market did not crash.

An explanation for our international readers

We are talking about "real" football here, not that game the rest of you play with the round ball and the nets and the kicking and the no helmets (Canada has a game that comes close, but they play it on a field of a different size up there.) The National Football League merged with the American Football League in 1970 to form the National Football League with two conferences: the National Football Conference and the American Football Conference. You don't need to understand the game to know which way the Dow Jones average will move, you just need to know which pre-merger league each team was in. You can find more information at the official NFL web site: www.nfl.com.

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