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Mendell looks to local factors for timberland valuations

By Curtis Seltzer

Brooks C. Mendell, Ph.D., is president and founder of Forisk Consulting, a Georgia-based firm that specializes in forest-industry, timber-REIT, bioenergy and timber-market research ([!! HYPERLINK "http://www.forisk.com/" ¶ www.forisk.com⁺](http://www.forisk.com/)). Mendell has nearly 20 years of consulting, operating and equity research experience in these areas.

He approaches timberland investing as an exercise in thoroughly researching the site-specific characteristics of a property's timber, its local market, investor priorities and "knowing what is knowable" in using projected revenue models.

Mendell is a scheduled speaker at the first Land Think Summit ([!! HYPERLINK "http://www.getlandsmart.com/" ¶ www.getlandsmart.com⁺](http://www.getlandsmart.com/)) to be held at the Gwinnett Center in Duluth, Ga., on September 30, 2010. Following work with Weyerhaeuser, Accenture and the University of Georgia, he started Forisk in 2004.

His unedited answers to my questions appear below:

1. Do you think timberland is currently priced above, at or below market in terms of its intrinsic values (defined however you want), and why? What's driving current valuations? Do you see a change in valuation drivers in the future?

I worry less about regional or asset class-specific values and much more about individual properties and local timber markets. Timberland price-to-value metrics depend critically on the local wood basin and forest stocking level of the given property. Broad-based per-acre values used to evaluate regional averages can mislead investors into thinking they are performing at, above or below expectations. Over the past two years, key changes in valuation drivers include (1) the approach to building in HBU (development) opportunities into valuation models and (2) the selection and application of the discount rate. Today, rather than sifting through timberland properties seeking to find suitable development potential, investors are taking a forest-centric approach to evaluating timberland properties and asking "what is this asset worth to me, assuming it will generate returns primarily from growing and selling trees?"

2. Do you use or recommend a general valuation formula for determining which investments to make, such as x% of acquisition cost in merchantable timber or a projected 10-year pay off of acquisition cost? When using DCF analysis, what minimum target do you use? Do you have non-revenue hurdles against which you measure timberland investment performance?

No. In supporting valuation work, we focus on two things. First, we clarify, possibly to the point of annoyance, the priorities of the investor. Being specific on this point is critical to any valuation efforts as it affects assumptions, investment periods and negotiations. For example, a client whose objective is to own forestlands solely from a "maximizing long-term returns" perspective differs from maximizing annual cash flows which differs from clients who own forests to help source a wood-using mill or bioenergy project to clients who prioritize recreational potential. We find, in cases, the clients themselves may not be clear on their own priorities, so we work through this to bring clarity to any valuation and due diligence work.

Second, we attempt to "know what's knowable" with respect to data for the DCF model, local wood markets, and client hurdle rates. We have the opportunity to review valuation models from a range of investors and analysts and find that, typically, ~30% have a math or Excel error, and most have made assumptions about costs, volumes or prices that could be strengthened with minimal work. So, in the DCF, we want, to the extent possible, "know what's knowable" and get it right relative to the investor's priorities. If we're not clear on what the investor values, the DCF can provide a valuation inconsistent with the true ownership objectives.

3. Do you anticipate any significant shifts in the market (either positive or negative) for timber fiber/logs during the next 15 years? Do you anticipate any technology change, shift in end uses, environmental issues, trade restrictions/expansion etc. that would positively or negatively affect

current production trends and markets for timber products?

The biggest downside risk for timberland owners may be unintended, negative impacts from legislation that narrowly defines wood-related raw materials that could qualify for bioenergy markets or subsidies, if there are any.

4. How would you advise small timberland investors to analyze an investment? How should they determine a buyer's price?

The recipe for analyzing timberland investments is straightforward, though it requires discipline and patience. First, understand the local wood market. Timber markets are uniquely local. The same timberland property in two different baskets will have two different values. In understanding the local basket, this goes beyond knowing all of the wood outlets into which you might sell trees. It includes knowing in advance how you will access these markets. Will you work through a forestry consultant? If so, who? Will you work directly with loggers? If so, who?

Second, question your forest data. In forestry, we have a somewhat bizarre relationship to data as compared to data for other assets such as bonds, equities or even commercial real estate. In forestry, everything is a sample. A forest cruise, which estimates the volume and value of the standing forest on a given property, is a sample of what's out there. If we use data from the US Forest Service, it's based on samples. If we use a timber pricing service, whether public or private, all reported prices are based on samples, not all transactions. So ask questions about the data.

Third, and repeating a theme, know what's knowable. In evaluating the value to you, the investor, you want to nail down, to the extent possible, what's left over each year after revenues are generated and bills paid. That means being specific about what exactly will the property taxes be for THIS property, what are the annual management costs for THIS property, and what are the fees paid to consultants, accountants and lawyers to acquire and manage THIS property. Plus, fully explore the revenue potential for the timberland property, above and beyond forestry. Cell towers? Mineral rights? Kaolin? Hunting? Spiritual retreats?

We recommend to investors that they become familiar with their local markets first, and then patiently seek and evaluate timberland investment opportunities. This approach leads to building solid models with tested assumptions for buying properties. Then, when the numbers look good, move fast.

5. Are there any game-changers in the future that you've identified, such as a short-rotation species (6-7 years to dimension), coming infestation, coming market sector, declining market sector, production technology, etc for timberland?

We conduct a fair amount of in-house timber market and forest economics research to try and understand what makes timberland markets dance. Two areas continue to tickle our research funny bone. One, new seedlings could become forestry's "arms race." If clonal and related seedlings do in fact represent a leap in forest productivity, they could become a de facto requirement for competitive timberland returns. This has yet to be determined. Two, ethanol and biodiesel subsidies could further drive up agriculture land prices, putting pressure on forestry-uses and timberland values. If you believe that ethanol markets are here to stay, and if you believe federal mandates – which currently dictate ethanol use – will continue to remain in place and may increase, and if you look at and believe the data linking ethanol production to food prices and supplies, then this is a plausible and supportable long-term investment thesis.

Curtis Seltzer is a land consultant who works with buyers and helps sellers with marketing plans. He is author of How To Be a DIRT-SMART Buyer of Country Property at www.curtis-seltzer.com where his weekly columns are posted.

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