SHOP TALK

with Rachel Speirs

A Conversation with Howard Kaplan

When the Employee Retirement Income Security Act (ERISA) passed in 1974, it opened the door for pension fund investing in alternative assets. Among those new alternative assets were agricultural land and timber, which investors identified early on as a steady, relatively safe long-term investment that could deliver equity-like returns with bond-like risk. Today, with the growing momentum behind biofuels and continuing demand coming from emerging markets, timber and agricultural land investments are once again proving their strength as alternative core investments.

***Howard Kaplan,** president of ORG Natural Resources, recently spoke with **Rachel Speirs,** editor of* The Institutional Real Estate Letter — North America, *about the latest trends in timber and agriculture industries and what it all means for natural resource real estate investments.*

Howard Kaplan

The big question on investors' minds these days is how to deal with deleveraging prices and constricted credit markets. How has land been affected by the most recent downturn?

The downturn has actually not had much of an impact on land in the United States, at this point, but we are seeing its impact a bit more in South America. In general, timber and agricultural assets have variable annual cash flows and, therefore, should not use much leverage. Owners without debt do not have to deleverage.

That said, in some offshore assets, such as farms in Brazil, local operators are being affected by reductions in operating credit and are under pressure. Demand for timber, primarily, but also to some extent agricultural products, is being dampened by the credit crisis, resulting in lower product prices, but the impact is through a reduced demand mechanism not because of deleveraging directly. Our evaluation of funds looks at leverage closely. We believe risk goes up faster than return with excess leverage.

During the past 20 years, you've made the case for timberland and farmland investing. What, in particular, makes timber and agriculture good options in today's investment environment?

All of the same reasons as before: It's an inflation hedge; It offers competitive risk-adjusted returns and provides diversification. It also gives investors an opportunity to find alpha, since it's an asset class that is really underinvested in because institutional investors lack familiarity with it. In the United States, only 1 percent of agricultural land is owned by institutions, while 8 percent of commercial high-quality timberland is owned by institutions.

At ORG Natural Resources you help institutional investors evaluate managers and give them advice on emerging opportunities. Where do you see the opportunities in land today?

There are great opportunities in both the Northern and Southern Hemispheres due to the continuation of rapid economic growth by emerging economies. A large percentage of world population will demand increasing supplies of natural resources, and what better source than renewable resources? These assets are a safe harbor for that growth.

We see land opportunities in: 1) high productivity assets with high growth rates or yields that are low-cost producers; 2) where infrastructure expansions will reduce time and cost of getting products to market such as in Brazil; 3) where productivity can be upgraded through value-added activities; 4) in permanent plantings of fruit and nut trees and vineyards; and 5) in greenfield

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developments with state-of- the-art technology.

The demand for agricultural products by the growing middle class in China and India will be difficult to meet without higher prices than historical and that will affect all productive lands. In timber, the current situation of distress and uncertainty, in some cases, are putting pressure on owners to monetize a quality of assets that in ordinary times they would not want to sell.

Prices are holding up fairly well at this time, but the quality of assets that are trading hands is very high. These are long-term assets, and when pricing returns to or exceeds trendline levels, we believe these will turn out to be very valuable holdings. Furthermore, today's acquisitions have optionality on potential energy values without paying for it.

What about the critique of agricultural/timber investing that says there is perpetual oversupply because of increasing competition from foreign producers?

That is too myopic. It used to be that world population was growing, but the emerging economies were not growing effective demand. Developed economies were mature, meaning their marginal demand for these basic food and forest products was much lower. Now, emerging economies' effective demand is growing rapidly where marginal demand is much higher. It will be very hard for production to keep up with demand.

In addition to the deflating markets, there has been another notable trend for more "green" or environmentally friendly business practices. How has this environmental awareness impacted the investments you deal with? What opportunities and risks does this trend pose?

In some cases, environmental awareness has increased operating costs or restricted supplies by making environmentally sensitive areas off-limits. We believe these issues can be made opportunities by recognizing environmental values and monetizing them. In other cases, a little extra operating effort to obtain environmental certifications improves product-marketing opportunities.

Let's shift gears away from the trends for a moment and talk about timber and agricultural land from a portfolio perspective. Where do these asset types fit?

Timber and ag are good diversifiers in core and core-plus real estate portfolios. They also fit well in a real assets portfolio or where long-term inflation hedging is a key objective. They are equity and provide competitive risk-adjusted equity returns. They fit in defined benefit plans where liabilities have inflation risk. They also fit in portfolios that are more risk sensitive.

There are many different vehicles for investing in timber and agriculture: commingled funds, separate accounts, REITs, etc. Which are most popular among institutional investors and why?

The most popular are commingled funds and separate accounts. There are currently no U.S. REITs in agriculture, but there are some publicly traded companies in Europe that invest in Russian farmland. There are also some timber REITs and TIMOs [timber investment management organizations] in the U.S. In fact, timber represents about 5 percent of the REIT universe.

How are timberland and agricultural land valued?

There are two primary ways that investors value timber and ag lands: 1) comparable sales and 2) capitalizing net operating income (NOI). Most properties have relatively unique value characteristics, so it

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is difficult to find timely and truly comparable sales. Comparable sales do allow an appraiser to establish market discount rates to use for comparing similar properties with different NOI expectations. If the land is leased, then both are valued

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on recent rental income at current cap rates. This is quite similar to "traditional" real estate.

Timber properties are subject to a depletion expense, which is the recognition of costs into standing trees realized at time of harvest. Farmland improved with irrigation systems and/or permanent plantings, such as fruit and nut trees or vines, are subject to an allowance for depreciation of the improvements. However, there is no depreciation on the land assets as land is productive in perpetuity. This is why the cap rates and discount rates are lower for timber and ag than for urban real estate, which experiences much more depreciation over time.

You mentioned earlier that the current economic downturn, and subsequent decreased demand for agricultural and timber goods, has somewhat depressed the market. What other risks do investors need to consider?

The overall risk is that demand does not materialize as expected or technology improves productivity faster than demand growth. Local risks such as pests, fires, weather, etc. can often be diversified to a point that they become *de minimis,* at least over a few years time as opposed to a single year impact.

Other risks are all the things that affect NOI, prices and expenses. There are cross-currents that impact both timber and agricultural investments. Fuel prices have been up, increasing costs of operations, harvest and transport, but these have also now declined. Locations closer to market suffer less from increasing transport costs than locations further away. Certainly, the lumber demand is tied to housing. However, this has always been a cyclical industry. Housing is now going through a significant adjustment due to recent overbuilding.

Timber is a long-term asset and is more dependent on long-term demand not short-term cycles. Biological growth continues even during periods of slack demand, so when the markets do recover, there will be more wood to sell. Harvests from federal lands have been down and are expected to stay down.

In all cases, one needs to buy assets right and not overpay. That said, buying highly productive assets means that they are the low-cost producers, always an important consideration when acquiring commodity-producing assets. These will be the strongest market participants.

What other trends do you see on the horizon for timber and agricultural land?

In ag, we will find that market distortions due to subsidies will decrease and there will be increased emphasis on productivity and efficiency. Importing nations will take a larger role in providing storage. In timber, we will see more "greenfield" investments, meaning new plantings. We're also seeing more plantations of rainforest species to substitute for natural rainforest harvests.

In both cases, there is an emerging linkage to energy through biofuels. We already see it in Brazil, with sugarcane used for ethanol production, and in the United States, where mills are being constructed that use wood to generate energy. New technologies are under development that will significantly improve the transformation process efficiency. ❖