Despite the current slowdown in the U.S. housing sector, private timberland investments returned a strong 18.4 percent during 2007. Timberland appraisal gains are boosting near-term timberland returns as timberland buyers seem to be looking through the current cyclical weakness in markets for timber and wood products, using lower discount rates to value future timber cash flows.

As in prior years, we devote one quarterly issue of our Hancock Timberland Investor to a review of investment performance of U.S. private timberland properties.

Our measure of timberland performance is the NCREIF (National Council of Real Estate Investment Fiduciaries) Timberland Property Index (See HTI 3Q2000 for a description of the Index), which reports returns for institutional investments in timberland properties throughout the United States.

NCREIF timberland properties numbered 305 as of fourth quarter 2007. These properties contained over 8.6 million acres of timberland in the United States, with a combined market value of $14.8 billion. Seventy-three percent of the Index value was in the South, 22 percent in the Pacific Northwest and the remaining 5 percent in the Northeast.

**Performance Results**

The total return for the Timberland Index during 2007 was 18.4 percent. NCREIF separates timberland returns into a property-level operating income or EBITDDA component and a capital appreciation or depreciation component. The EBITDDA return at 3.1 percent is a 30 percent drop from 2006. The capital return at 15 percent is a rise of over 6 percent from 2006.

Regionally, timberland properties performed similarly, with increases in 2007 total returns compared to 2006. Likewise, capital appreciation combined with falling income in both the US South and the US Pacific Northwest. (See Table 1 on page 2) In the South, income returns of 2.5 percent were the lowest returns in 6 years.

**What drove Timberland Performance?**

NCREIF timberland market values, as measured by appraisals and actual timberland sales, have risen during the past two years. Our “fully-regulated” forest calculation, based on NCREIF returns, isolates the effects of changing market values from the effect of timber inventory growth and changes in the sample of properties in the Index (See HTI 2Q 2002 for a full description of our methodology). Inflation-adjusted (Continued on page 2)
market values for U.S. timberland in 2007 rose $204 per acre over values in 2006, to average $2,300 per acre.

Regionally, timberland values in the Pacific Northwest have climbed at a greater rate and for a longer period of time than timberland values in the South. From 2004 through 2007, inflation-adjusted timberland values in the Pacific Northwest have risen by $1,072 per acre, averaging $3,503 per acre at year-end 2007.

In the South, timberland values gradually turned upward in 2005 after falling for six consecutive years. At year-end 2007, inflation-adjusted southern timberland values averaged $1,534 per acre, a rise of $185 per acre over the past three years.

Together, changes in operating revenues—largely driven by timber prices—and changes in the real discount rate, explain movements in timberland values.

As shown in Figure 1, page 3, timber prices in the U.S. have fallen by a marked amount over the past five to six quarters. First quarter prices for domestic grade Douglas-fir sawtimber in the Pacific Northwest dropped $120 per MBF or 40 percent below prices one year ago.

Timberland owners in the U.S. South have seen less of a decline in prices, although southern pine sawtimber prices have fallen 15 percent from levels last year.

Timberland appraisal gains are boosting near-term timberland returns, as evidenced by the rise in timberland values despite the fall in timber prices.

Comparative Cash Yields

Rates of operating cash yield for a fully regulated U.S. timberland property—an estimate of expected real return—were relatively stable from 1996 through 2005. Beginning in 2006, discount rates used to value timberland properties compressed in
Despite steep production cuts at North American lumber mills—some regions slowing to 30 year lows—slack demand for manufactured wood products in the U.S. has pulled prices down substantially for domestic logs first quarter. Softwood sawtimber prices in the Pacific Northwest sold domestically were off $90 per MBF from last quarter, a full 40 percent below prices one year ago. Southern pine timber prices, although down 15 percent from year ago prices, held up better first quarter averaging $201 per MBF.

Despite modest seasonal increases in southern pine lumber demand combined with extensive mill curtailments have kept prices flat to rising through last year and into 2008. Delivered log prices, known to lag price movements for lumber, are still working their way down from the steep drop lumber prices experienced in 2006.

Western U.S. wood product markets continue to be beaten by the persistent slack domestic demand for new housing material. Adding to domestic woes, North American total wood product exports to offshore markets have turned downward despite anomalies like last year’s first, year-over-year increase in US log exports to Japan since 1999. First quarter total exports of wood products overseas retreated 13 percent. A bright spot for some lumber producers has been South Korea and Taiwan, as demand for North American style wood-framed single-family and small multi-family housing has fueled sales of treated hemlock lumber.
The lack of sawmill residual chips and continued strength in global markets for pulp and paper have maintained demand for pulpwood in all regions. First quarter prices for pulpwood rose again, an upward trend since mid-2006.

Prices for market pulp rose for the tenth consecutive quarter to average $880 per metric ton. Global demand for market pulp rose 4 percent through April, with Western Europe and China making up one quarter of the growth in world pulp demand. U.S. markets for delivered pulpwood continue to be strong—with prices rising in both the West and the South—although western pulpwood prices have exhibited three times the volatility over the past ten quarters as pulpwood prices in the South.

First quarter private timberland values, as reported by NCREIF, averaged $1,568 per acre in the South and $2,940 per acre in the Pacific Northwest. Both regional averages rose just over twenty percent from levels one year ago.
Figure 7. U.S. Timberland Valuation Multiples in Private Property Markets
Trailing multiples to operating EBITDDA rose again in both the U.S. Pacific Northwest and South first quarter as market values lifted while trailing fourth quarter income per acre fell.

Figure 8. Hancock Securitized Timberland Index
Share prices for the individual timber-intensive companies we track for our Securitized Timber Index bounced around during the first quarter, ending up at quarter-end just about where they settled at year-end 2007. Overall, the Index reflects an upward trend since the Fall of 2006, with real estate sales at Rayonier and Plum Creek boosting performance during falling markets for wood products.

Figure 9. U.S. South Timberland Values in Public Equity and Private Property Markets
Southern timberland values in private and public markets moved in opposite directions first quarter after four consecutive quarters of parallel upward movement. Public timberland values gave back most of last quarter’s gain, falling $146 per acre to average $1,267 per acre. In comparison, private timberland values rose $76 per acre to average $1,568 per acre for the quarter. Private timberland values, as provided by the NCREIF timberland index, are measured by appraisals or actual timberland sales. Public timberland values are derived by HTRG Research.
Cash yields for timberland declined by about 200 basis points over the past three years, during the period when timberland property values rose despite a drop in operating cash flow. Expected real returns for commercial properties appear to have dropped by similar amounts over the past decade.

Timberland buyers seem to be looking through the current cyclical weakness in timber markets, using lower discount rates to value future timber cash flows.

**Expected Performance**

U.S. timberland property returns should be robust during 2008, despite any cyclical weakness in timber markets, as appraisals continue to catch up to higher transaction values reflective of compressed discount rates.

Timberland values are anticipated to remain at current levels, as strong flows of financial capital to timberland properties continue, augmented by a modest near-term recovery in timber markets.

**NOTES:**

References to expected investment performance in this newsletter are based on historical information and are based on management's projections. Potential for profit as well as for loss exists.