RE: The Valuation of Forests – Exposure Draft

This comment letter refers primarily to Question 7 and secondarily to Questions 3 and 4 of the Exposure Draft.

The purpose for this discussion concerns primarily the cost approach (paragraphs 51-56) as presented in the Exposure Draft. Paragraph 52 states that the cost approach is most applicable to recently planted forests and Paragraph 53 states that the cost approach is generally less applicable to established forests. Based on those statements and the other paragraphs in the cost approach section, it seems that you are providing justification for appraisers to not conduct the cost approach unless the forest being valued is very young. I do not agree with this premise and I present my reasoning for considering the cost approach to be appropriate for valuing timberland properties containing all ages of timber.

BACKGROUND

To provide some background on this topic, it is important to consider the mindset of typical timberland investors. I believe the typical timberland investor considers at least the following three factors when deciding on a timberland purchase:

1) How much can I expect to pay for the property?
2) What is the cash flow and return to be expected from the property?
3) What is the value of the property considering the current values of the individual assets?

In answering Question 1, the sales comparison (market) approach is most helpful. The sales approach analyzes similar market transactions and, with applied adjustments, provides an indicated value of the subject property. Using a market-derived discount rate, timber growth projections, and other income and expense projections specific to the property, Question 2 is addressed through the income approach. Question 3 is answered by following the overall concept of the cost approach in which the values of the individual assets are estimated separately and then summed into a total property value estimate. Aspects of the sales comparison, income, and cost approaches may be used to estimate the individual asset values.
**Income Approach**

In practice, the concept of the income approach as presented in the Exposure Draft is pretty well accepted, although I sometimes encounter the use of a capitalization approach of a single year’s income expectancy instead of a discounted cash flow methodology.

**Sales Approach**

Concerning the sales approach, I am seeing a slightly increased use of the methodology presented in the Exposure Draft in which adjustments are made to the asset components of entire sales to derive indicated values for the subject property. However, I sometimes encounter what I consider to be a misrepresentation of this approach. Although acceptable based on previous practices and peer acceptance, these questionable practices include:

1) Adjusting the sale’s timber value to the pre-derived subject’s timber value with the “adjustment” being nothing more than the difference between the sale’s and subject’s timber values. This is in contrast to what I consider to be the preferred method of using timber prices derived from each sale applied to the subject’s timber volumes.

2) Using aspects of the sales approach to derive individual prices from separate markets for the subject’s assets, applying those prices to the assets, and then summing the asset values into an overall value estimate. Sometimes the income approach may be used for some assets, however, since the sales approach is used for most of the individual assets, some appraisers consider this overall methodology to be the sales approach.

**Cost Approach**

For the cost approach, I generally see what I described above in Bullet 2 of the sales approach labeled as either the cost approach or the sales approach. When labeled as the sales approach, then generally no cost approach is presented. When labeled as the cost approach, then usually either a true sales approach is conducted or the sales approach is omitted justified by not having enough information from the sales. However, I do encounter some instances in which the appraiser may conduct both examples described in Bullets 1 and 2 of the sales approach, with the former labeled as the sales approach and the latter labeled as the cost approach. In these cases, as would be expected, the values indicated from the two approaches are nearly identical since the subject’s timber value is derived in identical manner for both approaches and the land is valued very similarly between the two approaches.

The cost approach is also the approach that allows “quick” valuations in the market. It is the “cost” or price of each unit of the assets. During the overall reconciliation process, the cost approach allows for the reconciled value to be prorated to the individual assets. Similarly, when verifying and reconciling comparable sales, the cost approach applied to the sale’s assets allows for the purchase price to be allocated to the sale’s assets; which also facilitates the sales approach. So the cost (or sum-of-the-parts) approach can be a very reliable means of estimating the probable sales price of a forested property. It also provides a means to perform more reliable, transparent comparisons between appraisals.

The cost approach also typically supports cost basis establishment for tax purposes.
Summary

I agree with the overall descriptions of the income and sales approaches presented in the Exposure Draft. Although I agree that the cost approach as presented is most applicable to young forests, I disagree with the premise presented for the cost approach that it is generally applicable to only young forests.

As appraisers, our mission is to model the typical behavior of market participants. Above, I presented what I consider to be three primary questions asked by investors concerning timberland investments. The income and sales approaches each address one of these questions. However, the third question would remain unanswered under the assumption that the cost approach is inappropriate for natural forests or forests older than a few years. I present the following discussion for consideration that a cost approach modified for the uniqueness of forested properties is applicable to all investment-grade timberland properties.

DISCUSSION

Comparisons between Traditional and Timberland Investment Properties

Traditional improved properties consist of land and some kind of man-made structure. Forested properties consist of land and standing timber; the timber can be established artificially (i.e., planted) or naturally. Beginning with bare land for both types of investments, the cash flows of these investment types can be considered opposite of each other. The traditional investment consists of an immediate large outlay of capital for constructing the improvement, deriving regular (generally monthly or annual) incomes, and periodic costs for maintenance. In contrast, the timberland investment consists of a relatively small immediate outlay of capital to establish the forest and then deriving incomes from one or two intermediate thinnings and a final harvest of the timber. A primary objective of the traditional investment after constructing the improvement is to maintain the improvement’s income potential for as long as possible. For the timberland investment, the primary objective after stand establishment is to optimize the harvest value in as short a time as possible, in essence converting the timber into individual forest products.

Cost Approach Comparisons

The purpose of the preceding comparison of the investment types is to illustrate that the primary uses for the cost approach are quite different between a traditional investment and a timberland investment. In the traditional investment, the investor wants to know the value of the property considering reconstructing the improvements, whereas in the timberland investment, the investor wants to know the value of the property in deconstructing (harvesting) the timber. Additionally, for the traditional investment the improvement is generally considered as one unit for marketing purposes. For the timberland investment the market for the timber can be quite varied with different timber products going to different markets. It is important that the quantities and values for the various subject timber products be easily tracked and updated at regular intervals throughout the investment cycle.

Considering the differences between the traditional investment property and the timberland investment property, it is important to recognize corresponding differences in the purpose and application of the cost
approach between the investment types. While maintaining the overall premise of the cost approach by summing the values of various assets to derive an estimate of the total property value, the following are the differences in deriving the improvement or timber values:

1) The improvement asset value is the replacement cost of the improvement under the assumption that the improvement is being reconstructed as of the valuation date.
2) The timber asset value is the value of the timber under the assumption that the timber is being harvested or sold as of the valuation date.

SUMMARY

Considering the uniqueness of timberland investment properties and the necessity to know the values of the individual assets, I believe the concept of the cost approach is applicable to all timberland properties regardless of the age of the forests. The premise of the principle of substitution holds true for both traditional and timberland investment properties, however, it is important to understand the assets being substituted. In a cost approach for a traditional improved property, the substitutable assets are the land and the building, with the building value being measured by its current replacement cost (less depreciation). In a timberland property’s cost approach, the substitutable assets are the land and the timber, with the timber value being measured by the cumulative value of the standing convertible raw timber products (as pulpwood, sawtimber, etc.).

It should be noted that in appraising a traditional improved property, the actual cost of construction may not necessarily be used; the current cost of construction should be used. This is especially true for older special-use properties, such as a church, in which the cost approach is generally deemed to be the most applicable approach. This illustrates the applicability of the cost approach for a unique property that would at first seem not-applicable due to the age of the improvement.

This discussion does not address the actual valuation methodologies of the timber assets. However, I believe the proposed standards should address an important issue concerning inconsistent valuations between premerchantable timber and merchantable timber, particularly at the ages at which premerchantable timber is transitioning into merchantable timber assets. If the appraiser does not adequately consider this transition period between asset classes, there could be significant increases or decreases in the asset’s value that are not appropriate in the market. To the extent possible, it seems that the optimal procedure is for all three approaches to be conducted as stand-alone approaches and then the final value reconciled considering the appraiser’s reliability of the inputs to each approach and market participants’ reliance on the various approaches when conducting transactions. As described earlier, since the individual assets would have been valued separately within the cost approach, these values could serve as a basis for allocating the reconciled value to the various assets.

Sincerely,

Keith Ward, RF
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