The Role of Master Limited Partnerships in Forest Industry Restructuring

Thomas G. Harris, Jr. and Michael S. Reddick
School of Forest Resources
University of Georgia
Athens, GA

Introduction

The Master Limited Partnership is a recently evolved form of public ownership of assets. Like the familiar limited partnership, there are two classes of partners; general and limited. The general partner is responsible for the business, takes actions which are binding on other partners, and has unlimited liability for the debts of the partnership. The limited partner, by comparison, takes no action on behalf of the partnership and their liability is limited to the amount of their investment in the partnership. The partnership does not pay income taxes, but instead passes income, deductions, losses, and gains to the partners. Partners report these items on their personal income tax returns.

Master limited partnerships differ from the limited partnership in that the shares or units issued to limited partners in an MLP are publicly traded. This gives investors in an MLP the liquidity that was not previously available in pure timber investments.

The MLP structure was first utilized in 1981 by the oil and gas industry. There are two primary methods to form an MLP. The "roll up" in which many illiquid limited partnerships are merged into an MLP with one managing general partner. Apache Petroleum was the first to do this in 1981 and the term "Master Limited Partnership" was coined. The
second method is the "spin off," accomplished by the contribution of corporate assets followed by the public offering of units. This was first done in 1983 by Transco Energy Company and has been the structure of most MLPs since. The "spin off" has been the structure of all forestry MLPs to date.

Forestry MLPs

Four forestry MLPs currently are traded. Rayonier Timber and IP Timber, formed by ITT Rayonier and International Paper. Timber Realization formed by the Masonite Corporation and Pope Resources formed by Pope and Talbot.

ITT Rayonier and International Paper (IP) put almost all of their timberland holdings into limited partnerships. The structure of the two partnerships are almost identical and offer cash flows to investors for 14 years in the case of IP and 15 years for Rayonier. In return for transfer of timberlands to the partnership IP and ITT received 100% of class A and class B depository units. Both corporations act as general partners and control the lands. The class A units are publicly traded and class A unit holders receive and are responsible for 95% of the revenues and costs of timber harvest during the initial period, which ends in 1999 for IP Timber and 2000 for Rayonier Timberlands. Class B unitholders receive 4% and the general partner receives 1 percent. Both corporations currently plan to hold 100% of the class B units. After the initial term class A holders receive 4% of such revenues and class B unitholders receive 95 percent. Costs for reforestation that can be allocated to timber that will be harvested after the initial term

64
will be allocated to the class B units, along with costs and revenue which are associated with the land.

Pope Resources was formed when Pope and Talbot distributed its timberlands and other lands in the state of Washington. There is only one class of units and these were distributed to shareholders in Pope and Talbot based upon the number of common shares owned. Unitholders will receive distributions for a longer period than those owning units in IP Timberlands or Rayonier Timberlands. Land distributed to the partnership are operated on an ongoing basis for timber production and sale for real estate development. Pope and Talbot retain control of the land as general partner. In exchange for the lands, Pope and Talbot received the proceeds of a $22.5 million mortgage on the timberlands which is the responsibility of the partnership.

Timber Realization was the first forestry MLP, formed in 1982. Masonite Corporation distributed its timberlands, ten sawmills, and treating plant to stockholders. Stockholders received units in a one-for-one trade in exchange for 67% of Masonite common stock. The partnership is to hold and liquidate its assets by August 1987. Upon completion the units will have no value.

Use of the MLP

The MLP structure can be used to achieve a variety of ends. The structure can be used as a source of equity by the parent. Or, in the case of Masonite and Pope and Talbot a reasonable way to monetize timberland assets at a time when prices are depressed.

Limited partnerships can also be used to avert hostile takeover attempts. Timberlands are carried on company books at a value typically
far below market value. The ability to finance a takeover by divesting the company of these undervalued assets is a strong motivation. The transfer of lands to a partnership makes this more difficult and may force the market to attach a reasonable value to the lands. Given this structure the parent company is no longer burdened with owning timberland assets, but is assured its continued timber production, and can exert some control over the asset.

Investors in the MLP in some cases avoid double taxation. When timberlands are held by a corporation, capital gains tax is paid on the gain from the harvest of timber, and investors pay tax on any dividends they receive. An investor in a limited partnership avoids this double taxation as all tax items flow directly to the investor.

**MLP Disadvantages**

The MLP structure is not without disadvantages, however. The MLP structure is complex and expensive to put in place. Rayonier paid seven percent of the proceeds of its placement for underwriting. The creation of the timber partnership also adds extra administrative and transaction costs because timber is no longer sold within the corporation. The MLP structure is also expensive because the proceeds from an MLP may cost the corporation more than an equal amount of debt. Tax timing is also an issue. The corporation receives the proceeds of the offering in lieu of the stream of future cash flows. In this sense the corporation accelerates the timing of its tax liability.

Conflict of interest between the parent corporation and the limited partners is a serious issue in the cases of IP Timberlands and Rayonier Timberlands, and to a lesser extent in Pope Resources. The parents
control the partnership, and depend on timber from the partnership for use in their manufacturing facilities. Conflicts will arise in determining the price paid to the partnership for stumpage, scheduling timber sales, selecting the timber to be cut, and the acquisition or sale of timberlands. Conflicts also arise in the allocation of land management and administrative costs between class A and class B units in the case of IP and Rayonier Timberlands.

**Best Potential Uses**

The MLP may have its best strategic fit when the parent company finds that one or more of the following scenarios are true:

1) The parent wishes to liquidate a timber asset larger than the local market can absorb.

2) The timber can generate a high cash flow or after-tax return.

3) The asset is not of strategic importance to the parent.

4) Taxes on the immediate sale or distribution are acceptable to shareholders or unitholders.

5) Timber can be used as equity for a new venture.

**References**


<table>
<thead>
<tr>
<th></th>
<th>IP TIMBERLANDS</th>
<th>RAYONIER TIMBERLANDS</th>
<th>TIMBER REALIZATION COMPANY</th>
<th>POPE RESOURCES</th>
</tr>
</thead>
<tbody>
<tr>
<td>PARENT</td>
<td>INTERNATIONAL PAPER</td>
<td>ITT-RAYONIER</td>
<td>MASONITE CORP.</td>
<td>POPE AND TALBOT</td>
</tr>
<tr>
<td>ISSUED</td>
<td>JAN '85 AND OCT '86</td>
<td>NOV '85</td>
<td>AUG '82</td>
<td>DEC '85</td>
</tr>
<tr>
<td>EXCHANGE/SYMBOL</td>
<td>NYSE/IPT</td>
<td>NYSE/LOG</td>
<td>PHILADELPHIA/TRX</td>
<td>PACIFIC/PRP</td>
</tr>
<tr>
<td>INITIAL DISTRIBUTION</td>
<td>SALE TO PUBLIC</td>
<td>SALE TO PUBLIC</td>
<td>NONTAXABLE DISTRIBUTION TO SHAREHOLDERS</td>
<td>TAXABLE DISTRIBUTION TO SHAREHOLDERS</td>
</tr>
<tr>
<td>ACRES TRANSFERRED (000)</td>
<td>6,363</td>
<td>1,189</td>
<td>467</td>
<td>78</td>
</tr>
<tr>
<td>INVENTORY (MMBF)</td>
<td>35,030</td>
<td>7,763</td>
<td>1,871</td>
<td>862</td>
</tr>
<tr>
<td>CAPITAL RAISED FOR PARENT ($ MILLIONS)</td>
<td>152</td>
<td>94</td>
<td>-</td>
<td>21</td>
</tr>
<tr>
<td>PARENTS CONTROL</td>
<td>YES</td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
</tr>
</tbody>
</table>