COPING WITH CHANGE - AN INDUSTRIAL PERSPECTIVE

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As we approach the end of the 1980’s, and consider the economic events of this decade and their effect on the American business scene and the forest industry in particular - it’s been a real party. Massive, rapid changes have forced a reexamination of the basic forest investment rationale. I don’t think that it is an overstatement to say that the events of the 80’s put industrial forestry (as we know it) on trial.

The history of the forest industry, and its involvement in forestry, provides a snapshot of changes. Our beginnings in the logging camps of the 40’s slowly progressed to establish primitive forestry programs in the 50’s. Major land acquisitions by forest products companies were for the purpose of satisfying the bankers’ and lenders’ need for security in developing the forest industry. By the late 50’s to early 60’s full scale forestry programs were accepted and the forest land base began to be recognized as a valuable asset to the company.

During the late 60’s the economy was strong and demand for wood products took off. The largest and fastest growing forest based companies were extremely profitable, mostly from wood products manufacturing, and their timberlands enhanced both profit and cash flows. Capital gains tax treatment further augmented cash flow, which served as a major source of capital needed to build paper manufacturing capacity. Growth in the 70’s saw high inflation rates which enhanced corporate ownership of real assets such as land and rising stumpage rates. Wall Street loved us and couldn’t write enough good about us and our "green gold" timberlands.

Then, in 1979 and 1980, the bubble burst. A severe recession pulled the fuel out of the economy and the forest industry was hit harder than many other business sectors. Markets went sour for both paper and wood products, which in turn devalued the timber assets with severe drops in land and timber prices. To add to our woes, the dollar strengthened. We found foreign products eating market share and fully realized the meaning of being a world economy. Stock prices dropped and Wall Street made noises about timberlands being dead, non-efficient assets. Then came massive consolidation and restructuring of the industry as takeover artists saw opportunities aplenty and made their moves. Other, smaller companies

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moved boldly to acquire mills that were sold off as several large companies were broken up after takeovers. The result was several small companies becoming major corporations with the timberlands often left to someone else.

All of this change caused widespread corporate soul-searching as to what the proper competitive strategy and attitude should be in holding and investing in the timberland assets. Most projections suggested that the severe shortages in wood supply so often forecasted in the past, really were in pretty good shape. The "market" did not seem to recognize the value of the timberlands asset in its stock pricing. Corporations also had a need to monetize that asset in the redeployment moves of restructuring.

Some decided to just get out of the forest industry, others sold their timberlands (if they could find a buyer). Others decided to uncouple from the asset with limited partnerships, thus monetizing the timberlands while attempting to retain control of the resource.

Others of us kept the faith. We bucked conventional wisdom and ignored the financial guys and said "we are going to keep the timberlands because they have been good to us, and helped to build the company. Our gut feeling is that they will be good to us again in the future". In economic terms that would be called irrational behavior.

The Present

Over the last two to three years, the overall economy has recovered and prices for wood products, though sporadic, are not terribly depressed. Paper prices are at record levels. Stock prices are still undervalued, but not to the extreme. On the timber side, prices have strengthened significantly over the last two years. We are still not back to 1979 prices, but it has been steady, and more in tune with reality. We now see a gradual positive change of investment interest in Timberlands from both foreign and domestic sources. Most companies have held their reforestation and silvicultural programs intact and have maintained the lands in good shape. The severe recession of the early 80's made us reevaluate our forestry and wood procurement systems and make structural and attitudinal changes. We are better than we were before. Our operations are cost controlled, and capital use is much more pragmatic and efficient. Staffs are much leaner, almost to a fault, and we intend to keep it that way. We are not at our peak performance yet, but we are getting there and do not intend to let up.

The dawn of the 90's is moving the U.S. forest industry into the realm of world markets and world competition. To travel down this road forest managers must be innovative and improve on the traditional concepts used to determine the investment quality of
a forest products company. It means that the forest land base that is owned or controlled by a corporation (publicly traded) must provide a solid competitive advantage and therefore contribute to the corporation financially and strategically much more than it ever has before. You may think "that is fine to say, but how can we do it ...?"

Time will not permit me to adequately cover an in-depth review of what we can do to make the timber management or wood procurement functions contribute more to the corporations. However, permit me to throw out a few random thoughts.

Start with the people. The most intelligent and innovative plans will never get implemented unless you have people capable and willing to make it work. Traditional organizations and relationships with people will not work in the future. People have to be full participants in decision making at all levels in the organization and to feel ownership of both responsibility and results. They have to think of themselves as part of an enterprise, as opposed to thinking of themselves as employees of an institution.

This industry depends heavily on contractors to do the bulk of its woods work. The question we should ask ourselves is do we treat them like partners or vendors? I'm afraid that the IRS and the legal profession have had an inordinate influence on us in that regard. These people must not be alienated from the enterprise or we will be in big trouble economically.

Then we look at the land base. Begin by thinking about it as something that can be refined, moved, traded or even disposed of if it does not strategically support the goals of the company. The economics of moving a land base 20 to 50 miles closer to your primary manufacturing location are astounding. Capital investments in the land should be much more site specific than in the past. We've been guilty of too many blanket prescriptions for regeneration and silvicultural activities.

Thirdly, there remains much more to be done to reduce costs in our wood procurement systems. We traditionally design for overproduction and many times have inadequate wood receiving capabilities at the mills. The impact on the contractors and their efficiency is tremendous. Add to that our propensity to have off-site inventories or what I refer to as "hedge points". We add handling and inventory costs that are often redundant. The logging systems seem to be locked into power "rip & roar" equipment when we are entering a time when we need more low power and high-tech maneuverability in the plantation forest.

The last thing I want to throw out that we can look at to improve timberlands' financial performance involves the revenue enhancement area. From the timber, we have to extract more, higher value products from the forest by better separation and salesmanship in the woods. A tremendous potential is developing
to identify and market these materials, if our people aggressively seek them out. In addition, the non-timber revenue prospects continue to improve as public acceptance of paying for recreation grows, especially in the South.

One thing that has bothered me for a long time is how industry thinks about its timber investments. Timber investments defy standard business analysis and even standard accounting practices. We traditionally have calculated the reforestation and current market land cost and carried all that forward to final harvest to measure net present value. Speaking as part of a large, forest-based corporation, I think that we should look at that from another angle. First, we have to assume that we have made a basic decision that we will own the land as a part of the total manufacturing capital investment and, therefore, really have no opportunity to sell the land. Secondly, we assume that the reforestation cost is really a cost of harvesting and, therefore, we will consider it an expense at the time of harvest regardless of how IRS looks at it. Therefore the only costs we apply time value to to the point of harvest are management costs with ad valorem taxes and any other holding costs. Now, you may say "he's been smoking something", but it obviously makes a dramatic difference in how timber investments are evaluated when the reforestation costs are not carried through the rotation and beyond. As responsible land stewards, we really don't have a choice if we liquidate a timber stand but to apply a reasonable, minimum regeneration cost. In fact, in many states, you are required to do so by law. The only thing you could really debate is the degree of incremental capital for higher regeneration intensity above a minimum expenditure to meet minimum standards. Let me illustrate the difference with the following slides.

I fully realize that this is a radical departure from the standard economic approach. Application of this approach can only be made if the owner is strategically committed to timberland ownership. The main point here is to make us think about the investment in a more positive and competitive way.

Thus far I have dealt with the plight of forest ownership and investments in industry owned lands. When we examine the other 60% of our wood supply for the future, we see a mix of good news and bad news.

One half of the nation's softwood supply is standing on the national forest, mostly in the west. The new forest plans call for 1 billion board feet annual reduction in the harvest planned. There is a serious question as to the Forest Service's ability to offer sale volumes called for in the plan given the escalation of public pressure to reduce or eliminate timber harvesting.

Over the next decade and maybe beyond, the environmental movement will gather strength and move to even more extreme positions and pressures. The large environmental organizations will expand their revenues through well-financed crusades
designed to create public hysteria about imminent and irreversible environmental damage being done to the nation's natural resources: forest, water and air.

The coalition with the news media is already well established and has business and the federal government under fire. Lawsuits and appeals are increasing the stranglehold on the Forest Service and BLM timber sale programs. It is only a matter of time before this will spill over to private lands.

The country cannot take large chunks of this supply out of availability without serious impacts on the timber economy. The irony of all this is where will the wood have to come from? Within this country, the shift will be an increased pressure on the South to supply the nation's need. It will be a mixed blessing to Southern forestry, but on balance it should enhance increased investments in both silvicultural and manufacturing activities.

If not this country - it will come from Canada, USSR, or the Amazon basin, where forestry is either primitive or non-existent. Environmentally, from a world view, who lost? Why not obtain the supply we need in this country, which has a demonstrated willingness to spend the capital and has the know-how and technology to do an excellent job in reforestation. Not to mention keeping the jobs and communities alive in our own country. It is an inescapable fact that the drive to stop harvesting from the public lands in the U.S. makes no sense at all, either economically or environmentally. There are major efforts underway on both a regional and national level to communicate to the public an appeal to reason and balance. However, I must tell you that irreversible damage has already been done.

Now some good news. A more difficult trend to evaluate is the health of the largest forest landowner in the American scene, which is unique in the world - that being what we affectionately call the "non-industrial private landowner"; or NIPL. In 1983 Dr. Yoho of Purdue University classified the NIPL in what I think is a very useful way to think about them. He classified them as follows:

1) **Custodial** - become forest owners by default - limbo (10-20%)

2) **Sideline** - semi-accidental owners - appendage to other investments - fragmentation occurs

3) **Speculators** - hedge inflation

4) **Hobby investors** - small, managed forest - for heirs

5) **True investors** - behavior economically rational - sophisticated - growing
One thing for sure about the NIPL is that there is constant change and diversity among those owners. Yoho points out that while there is a certain amount of fragmentation going on, there also seems to be some consolidation among the investor classifications. There seems to be growing evidence that the investor-type NIPL is expanding and adding acreage. This is mainly through pension funds, insurance portfolios, partnerships (including foreign investors) and just plain individuals who are looking for good, long term investments. This is a very positive trend for the forest industry in that it will result in larger, more efficient ownerships and management intensity should rise. Dr. Yoho states that these people recognize that capital investments in the forest have current market value even though the actual income from harvest is many years away. One must worry, though, that the loss of capital gains treatment on those owners will have a major negative impact. While the NIPL will continue to be the industry’s major wood supply source and must be encouraged if we are to survive, it will continue to be very sensitive to tax policy and market forces.

Let me now summarize what all these observations might mean to the American forest economy and the forest industry in the 90’s. The easiest and quickest way to convey this will be to list a few assumptions - economists always want assumptions:

1) Paper demand will continue to grow at a modest rate but additional capacity will moderate price increases.

2) Wood Products overall U.S. demand will be level, but there will be major production shifts to the South.

3) Environmental pressures will further constrain saw-timber supply, mainly in the west, and will have significant activity in the south vis-a-vis wetlands—biodiversity—wildlife habitat.

4) Takeovers and consolidation of the forest industry will continue, but at a more moderate pace.

If you accept these as valid assumptions along with the normal economic cycles, then the implications for industrial forest investment follow.

Solid wood products will become more profitable in the 90’s than generally expected. Paper, especially in the higher, value-added grades, will do well over the decade. These two factors, along with the uncertainties in the public and NIPL timber sectors, will bring the management of corporate owned timberlands back into favor. To solidify the confidence in timber and timberland as a sound investment, the forest manager must capture the eye of the investment community with innovative, sound, economic and market strategy. Investors, either individuals or institutions, will then want to participate not
only through direct ownership but through partnerships and even in favoring corporations that have large, well-managed ownership. My prediction is that we will see an improved and healthier forest industry in the U.S. and allow us to move into the world market as a strong and qualified competitor. Foresters and forest managers in general must break the chains of conservatism and manage the lands much more aggressively than we have in the past.

That's our challenge.