December 5, 2023

Agricultural Finance

U.S. Timberland Discount Rates, Revisited

Summary

In our 2020 report, we noted a trend of timberland discount rate compression in the U.S. South, particularly in states with increasing sawmill capacity. Since then, the Federal Reserve significantly raised the federal funds rate from near zero to 5.25– 5.50% to combat inflation. As a result, the yield on a 10-year U.S. Treasury Bond, often used in capital asset pricing models as a proxy for the risk-free rate, increased from less than 1% at the end of 2020 to nearly 5.0% in the fourth quarter of 2023 and approximately 4.4% as of this writing (Figure 1). Under normal circumstances we would expect this rise in rates to put upward pressure on timberland discount rates and downward pressure on property values. However, MIM's tracking of appraisal data shows the opposite to be occurring, underscoring the durability and strength of the asset class amid recession concerns and economic volatility.

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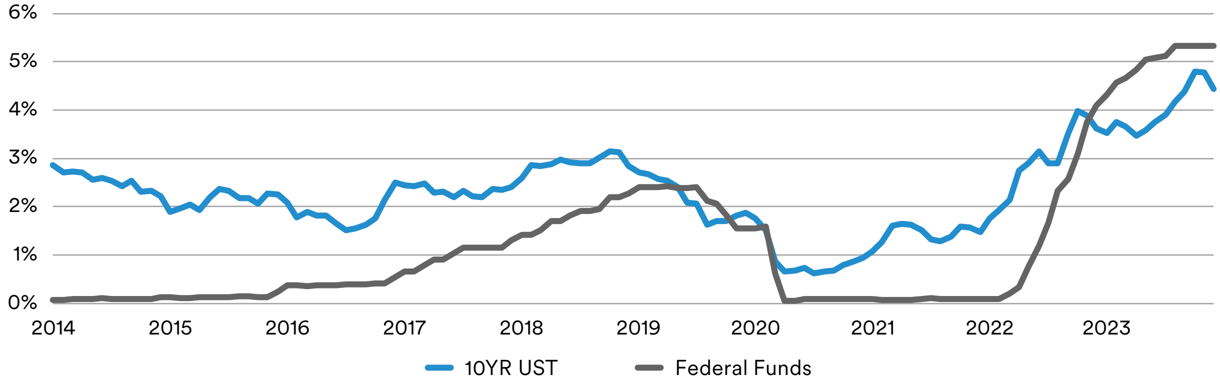
Figure 1 | Federal Funds Rate and 10-Year U.S. Treasury

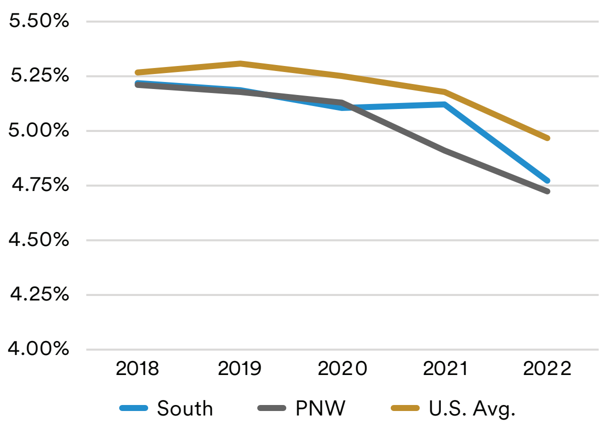


Source: Federal Reserve Bank of St. Louis (11/17/2023)

Discount Rate Compression and Elevated Timberland Values

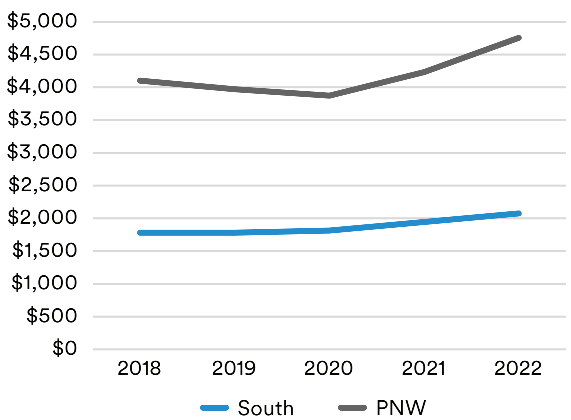
Despite the rapid rise in interest rates, the average U.S. timberland discount rate in MIM's debt portfolio decreased by approximately 34 basis points since 2019. The trend was more pronounced in the timberland investment regions of the Pacific Northwest and U.S. South, where discount rates declined by over 40 basis points (Figure 2). Largely as a result of the decline in discount rates, the average per acre appraised value of timberland assets securing MIM's debt portfolio increased by over 15% between 2019 and 2022 (Figure 3).

Figure 2 | Average Timberland Real Discount Rates



Source: MIM

Figure 3 | Average Per Acre Appraised Timberland Values of Assets Securing MIM Debt



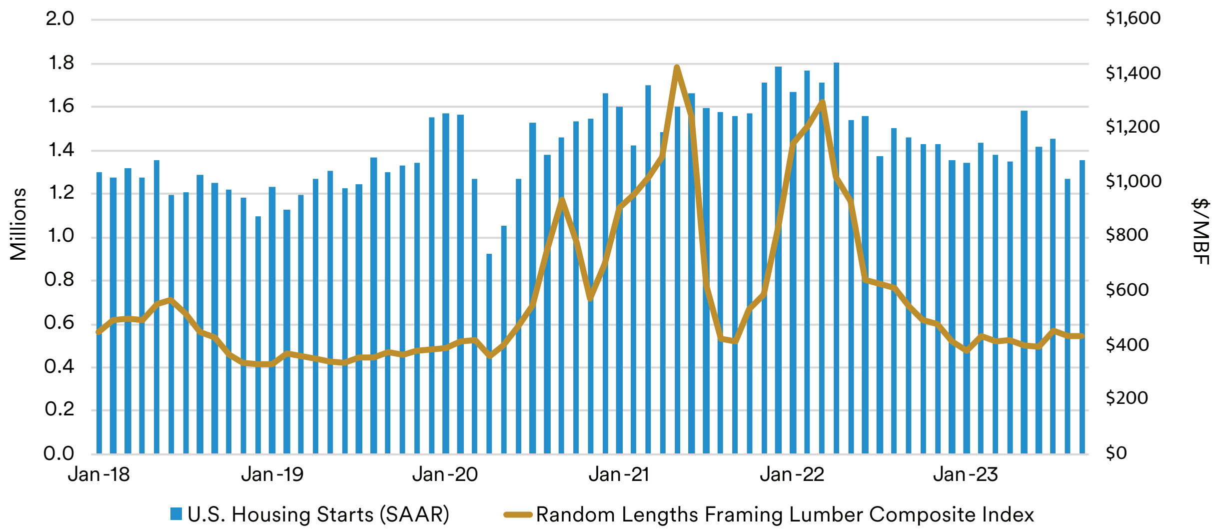
Source: MIM

Competitive Environment for Timberland Assets

We believe one of the primary reasons discount rates have declined is growth in the number of investors seeking timberland's inflation-hedging attributes. Timberland values have historically maintained a reasonably strong correlation with inflation. The increased interest in timberland as a potential inflation hedge has led to a competitive acquisition environment for timberland assets, which has been further exacerbated by existing timberland investors being reluctant to divest due to the difficulty of redeploying capital in the asset class. Net-zero carbon goals and enhanced demand for ESG (environmental, social, and governance) friendly assets have also increased interest in timberland as an asset class, further supporting values.

Another contributing factor is the record high wood products prices experienced during the peak pandemic years, partially attributable to upticks in new home construction and residential improvement expenditures (Figure 4). This left forest product manufacturing companies and timber REITS with an abundance of cash, positioning them well to compete on timberland offerings. Demographic tailwinds, including millennials aging out of apartments, are putting further pressure on the underbuilt single-family home stock and could drive positive housing market fundamentals during the remainder of the decade. Although the higher interest rate environment is causing many millennials to be unable to finance a home purchase, build-to-rent single family homes is a quickly growing strategy amongst institutional investors, as well as one that will require more wood products.

Figure 4 | U.S. Housing Starts and Framing Lumber Composite Price



Source: U.S. Census Bureau (October 2023), Random Lengths (September 2023), FEA (September 2023)

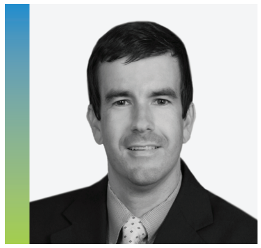
Impacts of a Potential Recession on Timberland Valuations and Discount Rates

Due to a combination of factors including student loan repayments resuming and consumer credit measures, MIM expects an economic recession to begin in 2024 and that the Federal Reserve will transition to a rate cut cycle. As a result, MIM forecasts the 10-year U.S. Treasury rate to have peaked in 2023 and finish 2024 near 4.0% at the same time as the headline consumer price index falls to 2.8%. If true, we would also expect discount rates to remain low, although a softening investor appetite for inflation-hedging assets or a temporary lull in new housing construction brought on by a recession could prevent discount rates from going even lower.

Regardless of whether a recession occurs and rates begin declining, the push for carbon credits and ESG-focused investments is likely to be a durable one. However, the perception of risk associated with carbon projects continues to evolve as their impact on forest operations and valuations becomes better understood. While fluctuations in interest rates and the exact pace and evolution of carbon markets may be difficult to predict, the demographic trends pushing a further shortage in housing should drive demand for timber, providing a solid foundation for timberland valuations that is supported by the recent downward trend in timberland discount rates.

Authors

WILLIAM PATTISON
Head of Real Estate Research



HUGH LENTILE
Director
Timberland and Forest Products

ANDREW CAREY
Director
Timberland and Forest Products

TOM KARMEL
Director
Agricultural Strategies Group

PERRY HUMPHREYS
Associate
Timberland and Forest Products

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