Timber in Transition: Tax Designation Created Opportunities

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When Plum Creek Timber Co. was looking for ways to grow about 10 years ago, it hit upon the idea of forming a real estate investment trust, or REIT, a tax designation that promised to increase the publicly traded company's share value, making it easier to raise capital to buy more land. In 1999, Plum Creek formed the first publicly held timber REIT. The groundbreaking move proved highly successful and sparked a firestorm of interest in timber REITs. REITs were created in 1960 as a means of allowing individuals to invest in the real estate market, explained Ron Kuykendall, vice president of communications for the National Association of Real Estate Investment Trusts, of which Plum Creek is a member.

Through REITs, individuals can own a stake, or share, in a publicly traded company that buys, sells or manages real estate on their behalf, Kuykendall explained. Commercial real estate otherwise tends to be much too expensive for the average individual investor. “It's important to understand that investing in commercial real estate is different from owning real estate in the form of a home or other personal real property,” he added. “The critical difference is that commercial real estate is an asset that produces continuing rent income from tenants.” Commercial real estate - including apartment buildings, shopping centers and office complexes - tends to attract long-term leases that provide a relatively stable, consistent revenue stream. REITs pass along those rents to their shareholders in the form of dividends, Kuykendall said. And REITs tend to pay rather high dividends. NAREIT recently reported that REITs outperformed all other major U.S. equity benchmarkets in 2006, clocking a total return of 34.35 percent. The Dow Jones Industrials, in comparison, drew total returns of 16.29 percent. Qualified companies find REITs attractive because the tax designation allows them to forgo paying any corporate tax on dividends they distribute to shareholders. REITs are required to pay out at least 90 percent of their taxable incomes, but most REITS pay out 100 percent to avoid paying any corporate tax, Kuykendall said. Instead, shareholders shoulder the tax burden, just as they would if they owned the building directly, he said.

However, not just any company can become a REIT. By law, 75 percent of a REIT's assets must be in the form of real estate. “So it has to be a true real estate company,” he said. The number of publicly traded REITs in the U.S. has remained relatively steady, at about 190, for the past decade or so, Kuykendall said. The total assets of these REITs exceeds $400 billion. Another 800 or so REITs are privately held and are not required to list their assets. According to the Securities and Exchange Commission, there are three kinds of REITS: n Equity REITS, which invest in or own real estate and make money for investors from the rents they collect. This is the most common type of REIT. n Mortgage REITS, which lend money to owners and developers or invest in financial instruments secured by mortgages on real estate. n Hybrid REITS, which are a combination of equity and mortgage REITS. This is the smallest category and includes only a handful of companies. Equity REITs can be further divided into specialty designations. There are industrial REITs, retail REITs and residential REITs, for instance. And there are timber REITs. Plum Creek (listed as PCL on the New York and Pacific stock exchanges) is a timber REIT.

Since Plum Creek entered the market, timber REITs have proved so successful there's been talk about tracking them as their own category, rather than as a specialty REIT. Timber REITs are different from other equity REITs because trees don't pay rent, at least not in the traditional sense. While timber REITs provide the same kind of reliable income as commercial real estate, their asset is forestlands - not office buildings. “Timber, of course, is a very long-term asset because it takes years to grow,” said Kathy Budinick, Plum Creek's director of communications. Budinick explained that timber is also an attractive investment because it self-renews over time - unlike, say, an apartment building, which requires additional investment to upgrade. In 2001, the REIT Modernization Act allowed REITs to expand beyond their traditional landlord services to provide more specialty services under subsidiaries. Most of Plum Creek Timber Co. now operates under taxable REIT subsidiaries. It has a manufacturing subsidiary and a development subsidiary, for instance. Plum Creek's shareholders reap the benefits from the company's various subsidiaries and their divergent missions as land managers, Budinick said. Some of them, she added, are going to see value in developing a portion of those lands. Other timber companies adopt REIT structure Plum Creek (PCL on the New York Stock Exchange) was the first publicly traded timber company to become a REIT, but not the last. In the years since, a handful of other companies, including Longview Fiber (NYSE: LFB), Potlatch (NYSE: PCH) and Rayonier (NYSE: RYN), have made the transition. Potlatch Corp. is one of the most recent, having formally converted to a REIT on Jan. 1, 2006, said the company's vice president of public affairs, Mark Benson. Before the change, Potlatch had operated as a traditional c-corporation. Potlatch manages 1.5 million acres of forestland in five states - Idaho, Arkansas, Minnesota, Oregon and Wisconsin - and has non-timber operations in other states, including Nevada and Illinois. While it, like Plum Creek, has undertaken some real estate development, the company's focus has remained on “traditional outputs,” Benson said. “Our decision to convert to a REIT was driven by our desire to gain the tax efficiency of a REIT,” he explained. “It had nothing to do with real estate.” These days, there aren't many c-corporations left that own forestland, he said. That traditional corporate structure just isn't as tax efficient.

Weyerhaeuser is one of the few major forestland holders that hasn't converted to a REIT. The fully integrated international forest-products company manages 35 million acres of timberland worldwide, about 7 million of which are within the United States. While it has sold some residential real estate since the 1960s and has a number of real estate subsidiaries, “our real estate company really has nothing to do with our timber business,” said Frank Mendizabal, a spokesman for Weyerhaeuser. In Weyerhaeuser's case, the REIT designation simply doesn't apply, he said. The REIT structure isn't for every timber company, but it is an undeniably attractive option for those who qualify because it “minimizes tax leakage,” said Steven Chercover, a paper and forest products analyst with D.A. Davidson. “It's very tax efficient,” Chercover said. “The companies that haven't (converted to REITs) yet are under tremendous pressure to do so.” Weyerhaeuser, for example, is paying 37 percent corporate tax. REITs like Plum Creek don't pay any, because the tax burden is passed on to shareholders along with their dividends, he said.