Address to the American Loggers Council National Meeting
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Thank you Danny, Travis and to all of you for inviting me here today. I know that many of you are among the most successful logging contractors in the country and it's an honor to have the chance to share some of my thoughts with you.

I'm going to make some broad generalizations about the current state of the logging industry and how it might evolve over time. But before doing so, I thought I would start by giving you some background on my experience and by making a disclaimer about the limits of my knowledge.

First, my background. Although my primary work is with The Lyme Timber Company, a timberland investor, I started my career in the logging industry 16 years ago when a Vermont logger named Russell Barnes recruited me during my last semester of college to help start a workers' compensation safety group for loggers. We formed an organization, engaged an insurance company, and got OSHA funding for safety training. The organization had some initial success, but even with lower workers' compensation rates, we couldn't recruit enough contractors with bona fide employees to make the program viable.

The organization wound down after a few years, but having been exposed to the logging industry, I and another partner decided to help Russell organize and grow his business. We raised $90,000 of equity from friends and family, got financing from Farm Credit, bought a new Rottne forwarder, and formed Long View Forest Contracting. We started out with two cut-to-length crews and our work concentrated on non-industrial private lands in southern Vermont and New Hampshire.

My focus was, and still is, on the business side of the business, but during the first few years I also worked in the woods felling trees with a chainsaw – an experience that has proven invaluable to everything I've subsequently done in logging and timberland investing.

Long View has grown to six logging crews today – three fully mechanized and three hand felling - along with a forest management division and some side businesses. It has become one of the larger logging contractors in New Hampshire and Vermont. I am now less involved in the day to day operations, but remain engaged as an owner and part of the management team. I continue to analyze the numbers each year and this gives me a perspective on the financial challenges and opportunities facing logging contractors.

My primary work for the past eight years has been with The Lyme Timber Company where I am a Managing Director. We are a so-called TIMO – timberland investment management organization. This basically means that we raise capital from investors – endowments, pensions, high net worth individuals – to purchase and manage timberlands. Right now we own about 500,000 acres of land –our large holdings include 240,000 acres in New York, 72,000 acres in Wisconsin, 80,000 acres of timber rights in Tennessee, and as of this December, we will own an additional 46,000 acres in Florida and 50,000 acres in Quebec Canada.

We have a unique strategy among TIMOs in that we tend to focus on relatively large timberland properties where we can sell working forest conservation easements. The easements restrict development, but allow for ongoing timber harvesting and management. We like easements, as well as long-term timber deeds, because they concentrate our investment on the timber resource rather than some of the more speculative aspects of owning timberland – conversion to other uses and breakup value.

With this focus, we tend to be fairly involved in forest management and operations – we set up log concentration yards to sort and merchandize logs and we sell delivered logs to mills. We engage logging contractors primarily through service contracts.

Now let me share a disclaimer: I have little direct experience with logging outside the Northeast and the regions where Lyme Timber has owned timberlands for some time. What I do know from my travels is that there is a lot of regional variation in the size, profitability, and overall health of logging businesses across the country. So I hope you will forgive any generalizations I make that don't make sense for the region in which you operate.

With that, let me shift gears to some of the issues that I see facing logging contractors and the forest products industry more broadly.

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There's been a lot of talk about the so-called "logging capacity shortage". It's a concern that mills, landowners and others have raised for some time, but the concern has been more pronounced in recent years following the housing bust and economic downturn.

In 2011, Rick Holley, the CEO of Plum Creek, the owner of 7 million acres of timberland in the US, said that he regards logging capacity as the <u>number one issue</u> facing the industry.

University of Georgia studies have indicated a 15-20% decrease in logging capacity in the US South since 2007 and some have suggested that capacity reductions are greater than 25% in some regions. According to a recent RISI/ Wood Supply Research Institute study, capital expenditures by logging contractors dropped in half during the period from 2008 to 2010 relative to pre-recession levels. The authors predict that capital expenditures on logging equipment will need to increase by 50% in the next three to four years to meet fiber and roundwood demand from mills.

In my own experience investing in timberlands, I can tell you that we have lowered our stumpage expectations in some regions and therefore the price we will offer for land, based on what we think will be the challenges and higher costs necessary to ramp up production and recruit logging capacity to areas where it has been lost.

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In my view, however, talking about logging capacity obscures a more fundamental issue, and that issue is <u>logging business profitability</u>. No one talks about contractor capacity issues in the oil fields of the Bakken Shale – the main shortage there is housing because they can't build the houses fast enough to support the influx of contractors and workers.

When people talk about "logging capacity," what they really mean is a lack of incentive for contractors to expand their existing businesses, or for would-be logging contractors to start new businesses. And this comes down to that simple issue of profitability.

Why personally guarantee hundreds of thousands of dollars of debt to replace aging equipment without confidence in future business opportunities? Profitability is the deciding factor between contractors seeking a future in the logging business, and planning an exit strategy.

Profitability is also the critical ingredient to recruiting new and talented workers into the logging industry.

To be blunt, logging profitability is the elephant in the room.

If that's the case, the next question is: how do contractors - and the logging industry more broadly - become more profitable?

The solution that many have pointed to for years is for loggers to become more efficient and productive – to produce more wood at a lower cost. But while increasing efficiency and reducing costs are worthy goals, I don't see increased productivity and lower costs as the starting point to higher logging profitability.

Contractors have become a lot more productive over the past thirty years with mechanization and experience.   It is true that additional productivity gains will come from further investments in people and equipment, but those investments will only be made if existing businesses are profitable and provide a platform for expansion and growth.

At the contracting business I co-own, we keep track of and analyze nearly everything.   I've spent more time than I care to admit designing information systems to track job costs and profits– labor inputs, machine hours, margins by product, fuel and labor costs per production unit, etc. We have analyzed literally hundreds of logging jobs over the past 15 years and we pay particular attention to the 5-10% of jobs that lose money. On these jobs, it's rarely the case that we lost money because of crew inefficiency or low productivity. Rather, the jobs lost money because we mispriced them – we under-estimated costs, or didn't get the delivered log prices we expected, or the job didn't cut out the way we anticipated.   In most cases, any additional margin we could have realized from working more efficiently would not have been enough to make the job profitable.

In short, *the price* we charged for our services, rather than the cost of providing those services, was the deciding factor on profitability. While understanding costs and productivity can help you better manage costs and productivity, an equally important benefit to understanding these factors is to help you figure out how to price products and services for a profit.

With that in mind, let me address the ways that logging contractors "price" their services to the two parts of the supply chain they serve: mills on the one hand and landowners on the other. Can logging contractors increase profitability by getting mills to pay more or provide a more consistent market for logs? Can logging profits be increased by structuring better contractual arrangements with landowners?

*** *Mill relationships* ***

I'll deal with the mill relationships first. As a starting point, let me say that I don't see mills returning to the kinds of steady procurement relationships that some contractors enjoyed years ago.

There will be periods of time – perhaps now is one of them – when mills need wood and suppliers are in a good position to negotiate price, but over the long-term mills will continue to be focused on their bottom-line procurement costs, and the delivered log price is going to be set based on the simple economics of supply and demand.

Most mills have sold off their land, and they no longer employ foresters who have exposure to managing lands and working directly with landowners and contractors. This is a profound change that resulted from the massive timberland divestiture by industrial companies over the past 15 years, including International Paper's 5 million acre land sale in 2006. Wausau Paper Company's 72,000 acre sale to us in 2011 was one of the last of these paper company divestitures.

I think the loss of a land base has and will continue to affect the culture and attitudes within mill organizations. Without a land base, mills and their staff are more removed from land management, and fiber is regarded almost exclusively as an input cost. Fiber and wood procurement are no longer part of a broader land management strategy. On top of this, mills are in an increasingly global business where managing input costs is critical to their survival. Finally, paper mills, in particular, are facing the headwinds of shrinking overall demand for their products.

So, in short, I think the logger and landowner relationship with mills will continue to be a price driven buy-sell relationship with price dictated by week to week mill demand.

With this dynamic, the main opportunity for an individual logger is to get bigger, control a lot of supply and be in a better position to negotiate price in exchange for volume commitments. This is basically what large landowners do and it's one of the reasons why we, Lyme Timber, like to own large tracts of timberland within a particular wood basket.

Some of the most profitable logging businesses and wood dealers have followed this path as well. In some regions, we are seeing some of the larger contractors adding crews, and they are doing so because they've been able to get the commitments and margins necessary to justify the investment. But getting bigger in order to negotiate more favorable pricing with mills may not be the right strategy for many logging contractors. And it comes as no surprise to anyone that smaller contractors with one or two crews have relatively little leverage in price negotiations with mills.

Although I've just said that I don't see mills returning to the kinds of steady procurement relationships that some mills followed years ago, I do believe that the consuming side of the industry should be pushed to pay a premium to consistent suppliers – even smaller suppliers - who operate at the highest standards of professionalism. Mills do in fact have a stake in contractor and landowner environmental compliance as well as the public's perception of forest management and logging, and the best way to raise the bar and ensure that certification and state environmental standards are being met is to reward those contractors who are consistent and who go above and beyond the minimums.

I would challenge organizations like the American Loggers Council and the Forest Resources Association to take this issue on and promote preferred supplier programs as a best practice for mills and the consuming side of the industry.

**** Landowner Relationships ****

Now let me shift to the relationship between the logging contractor and the landowner. Whether the contractor is purchasing stumpage or being paid to cut and haul timber, the landowner logger relationship is more of a service relationship than a supplier relationship. And in my opinion, this creates more opportunity, even with large, industrial landowners like Lyme Timber and others who are focused on maximizing their stumpage margins.

Here's why.

First, on industrial TIMO and REIT ownerships, investors are getting tired of watching the trees grow and waiting for stumpage prices to come back. To varying degrees, they did this from 2008 to 2012, and now even if prices don't fully recover, many are deciding that they need to generate some yield on their investment. At the same time many TIMOs and REITs recognize how difficult it is to find quality contractors to ramp up production.

Last week I attended the annual "Who Will Own the Forest" conference in Portland, Oregon, which is basically a gathering of all the TIMOs and REITs in the US. I conducted an informal and unscientific poll of my peers - executives at other TIMOs and REITs. I asked whether they were having trouble recruiting contractors and whether they thought the rates and contractual arrangements would need to be more favorable to loggers in the future. While I got some different perspectives on the extent of the problem from region to region, I can tell you that there was broad agreement that quality contractors are in a position to negotiate more favorable contracts and there was a genuine commitment to exploring new approaches to help these contractors expand capacity.

So there's an opportunity for logging contractors. And I think at least some TIMOs and REITS will be receptive to new approaches to supporting contractors who wish to add crews and capacity.

At Lyme Timber, we've tried to create strong, long-term relationships with logging contractors by paying fair rates and providing steady and consistent work.

We look for three things in contractors: 1) we want contractors who are highly productive and can help us meet our annual harvest goals; 2) we look for contractors who are committed to quality work – not only compliance with BMPs, but also concern for the residual stand conditions and overall professionalism; and 3) we want to partner with contractors who require little supervision because we think supervision is expensive. We're happy to pay premium rates to contractors who can perform well on all three of these dimensions.

We also try to do other things to help contractors be productive and profitable. Our foresters set up jobs so that the contractor can move right on and we don't add in things like road work without providing additional fees. During the 2008-2010 recession, we kept our production levels up because we wanted to keep our core group of contractors going. As a major landowner in New York and Tennessee, we knew that cutting back would have a big impact on contractors' businesses and potentially our ability to ramp up production when markets recovered. During that time, we implemented a fuel surcharge program that was and is independent of the price we are paid by the mill, and this meant that in some quarters we actually had negative stumpage margins on pulpwood.

Despite lower margins during some quarters and some of the extra harvesting costs we incur, I believe that over the long-term our strategy has served us and our investors very well. We've not scrambled for contracting capacity over the past two years as our markets have improved, and this has allowed us to benefit from stronger markets in ways that some other landowners have not. In the long-term, we believe that the benefits of a stable contracting force that is investing in people and equipment outweigh the short-term gains we could realize from modestly higher stumpage margins.

**** Contracting Relationships with Non-Industrial Private Landowners ****

I would also like to speak briefly to contractor relationships with landowners on the non-industrial forest – the smaller family ownerships. This is the world that I inhabit when wearing my logging business hat. In this context, the jobs are smaller and often less production oriented than jobs on large ownerships, and this means there's even more opportunity for contractors to increase margins through a focus on quality and service.

Study after study has shown that stumpage value ranks relatively low on the list of non-industrial private landowner priorities, but too often that is the way contractor selection is made.

In the future, I believe that contractors who find ways to build trusting relationships *directly* with landowners will be the most profitable. They will also be in a position to provide better and more comprehensive services to landowners. In our contracting business, this has meant hiring a forestry staff and creating a forest management division.

**** Conclusions ****

The common theme here is that contractors have the greatest opportunity to increase profitability and remain profitable by <u>focusing on service</u>. When the customer is a mill with a strict focus on managing input costs, the service opportunity is relatively limited unless you are a large supplier whose supply can't be replaced. When the customer is a landowner who has to a wide variety of interests - silviculture, residual stand conditions, consistent production, BMP compliance, wildlife, and easement requirements, you have many more opportunities to deliver service and secure contract terms that reward you for that service.

It would be nice if mills and landowners simply took all of this on - through preferred supplier programs, premiums for master logger certifications, long term contracts, and lower stumpage expectations. But unfortunately, and despite landowner and mill recognition of the problems, I don't see these things happening without logging contractors playing a bigger role to make them happen. Individual logging contractors are going to need to stay disciplined on their pricing and find ways to communicate the value they provide to landowners and mills.

In addition, I think organizations like the ALC and the Forest Resources Association can raise the profile of these issues. I would challenge these organizations and others to find ways to shift the dialogue about logging capacity to a dialogue about contractual arrangements that create greater opportunities for profit in the logging business.

The "logging capacity" issue will be solved, and the entire supply chain made more efficient, by logging businesses investing capital in new equipment, people and systems. But logging businesses won't do this unless they see a pathway to profitability.

Let me close by saying that I think that logging business profitability is critical not only for the success of individual contractors, but also for the entire forest products industry, rural communities and land conservation generally.

I would challenge other large landowners and the consuming side of the industry – mills - to recognize that profitable and successful logging contractors living in rural communities are ambassadors for the industry and the best defense against negative public perceptions of logging and the forest products industry. Successful logging contractors are often leaders in their communities – providing tours to school groups, speaking in legislatures, and doing all sorts of things that present the industry in a positive light. If their businesses are successful and growing, they will be in a position to provide a level of positive public relations that cannot be matched by even the most ambitious marketing budget.

I would challenge the environmental community to recognize the importance of successful and profitable logging contractors as well. These are the businesses that have the capacity to continually raise the bar and do quality work that causes the least damage to soils, streams, and habitat.

Finally, and perhaps most importantly, profitable logging businesses will be able to pay the kinds of wages necessary to recruit talented young people to the industry and to rural communities, many of which have lost this talent and wage base, and are struggling in a variety of ways.

In short, profitable logging businesses, along with globally competitive mills and responsible landowners, are critical to sustainable forestry and the long-term health of the entire forest products industry.

Thank you.