



Legislative Fiscal Bureau

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July 23, 2019

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Natural Resources: Stewardship Forest Legacy Easement Acquisition from Keweenaw Land Association -- Agenda Item V

REQUEST

On March 8, 2019, the Department of Natural Resources (DNR) requested approval under s. 23.0917(6m) of the statutes to purchase a conservation easement from Keweenaw Land Association, Ltd., on 14,352 acres in Iron County for \$4,841,000 in 2018-19 from the land acquisition subprogram of the Warren Knowles-Gaylord Nelson Stewardship Program. The project, to be known as the Great Northern Conservation Easement, is located in the Towns of Knight, Carey, and Mercer, in Iron County. Notice of an objection to the proposed acquisition was made on March 28, 2019.

ANALYSIS

Background

On March 8, 2019, DNR submitted the Keweenaw acquisition to the Joint Committee on Finance. The purchase price for the easement is \$4,841,000, with appraisal fees of \$18,750 and estimated closing costs of \$6,300. The Department would pay the total project cost of \$4,866,050 from stewardship bonding authority.

The proposed project would acquire a perpetual conservation easement on 14,352 acres divided between two tracts located in the Forest Legacy project boundaries. To the west, the proposed properties abut the 13,805-acre Twin Lakes Forest Legacy easement. The northern tract is contiguous on its northern and eastern borders with Iron County Forest land and contains or abuts several properties owned by the Board of Commissioners of Public Lands (BCPL). The southern tract is surrounded on much of its northern, eastern, and southern boundaries by county forest lands. To the property's southeast is the Moose Lake State Natural Area. DNR contends that the Keweenaw properties are critical to connect existing public lands and will prevent future forest fragmentation.

Additionally, the terms of the easement dictate that the properties would be managed according to sustainable forestry guidelines.

DNR reports the project area contains a total of 13,847 acres, or approximately 90%, of productive forest, including 8,878 acres of upland woodlands and 4,969 acres of lowland woodlands. The remaining acreage includes wetlands, lakes, and streams. A 2017 analysis of timber on the properties, as reported in an appraisal, indicates the properties are estimated to contain approximately 216,500 cord equivalents of timber, including 71,300 cords of sugar maple, 31,200 cords of red maple, 22,600 cords of hemlock, 19,900 cords of white cedar, and 71,500 cords of other northern hardwood and swamp conifer species. The properties contain an estimated 163,400 cords of pulpwood, 26,000 cords of boltwood, 11,800 thousand board feet (MBF) of saw timber, and 500 MBF of veneer-quality wood. Approximately half of the properties' areas are well-drained, making them suitable to future saw timber production.

The easement would provide public access and guarantee that the entire property would not be subdivided and that no developments or buildings would be constructed. The project is a part of the state's long-term Forest Legacy program, which seeks to preserve environmentally important private forestlands in long-term or perpetual forestry uses. DNR notes that the properties contain Class I, II and III trout streams, as well as several scattered wetlands and unnamed lakes. In total, the properties contain 17.15 miles of stream and lake frontage.

Under the proposal, the Keweenaw Land Association, a timber investment management organization (TIMO), would manage the properties, be responsible for paying taxes and assessments, and receive revenues from timber harvests. Currently, the entire property is enrolled as open acreage under the managed forest law (MFL). The tracts were enrolled between 1999 and 2002 and pay acreage share payments of 74¢ per acre, or \$10,620 annually. The terms of the easement dictate that if MFL orders, which expire between 2024 and 2027, are not renewed, Keweenaw must manage forestry activities according to the DNR-approved forest management plan. Agricultural uses, mining, quarrying and mineral exploration would be prohibited on the properties under the easement. The terms of the easement provide public access, including reasonable use of motor vehicles, and nature-based outdoor activities such as fishing, hunting, trapping, hiking, and skiing.

Furthermore, the Keweenaw Land Association would set aside \$400,000 from the purchase price in a permanent endowment for road maintenance on 16.45 miles of interior roads to guarantee public access. Keweenaw is required to write a road management plan, outlining current road condition and maintenance activities. Keweenaw is required to update the plan every five years and submit the updates to DNR for approval.

Appraisals

Section 23.0917(7)(e)1. of the statutes requires DNR to receive at least two appraisals for any land acquisition project that is estimated to be above \$350,000. DNR received two appraisals for the Keweenaw project that estimated fair market value based on comparable sales. These appraisals estimated the value of the easement to be between \$5,740,800 and \$6,459,000, or between \$400 and \$450 per acre. DNR requested a consultant provide a third estimate for the value of the properties

based on the net present value of the income that could be derived from timber harvests. The third opinion estimated the value of the easement at \$4,341,000, or approximately \$300 per acre. DNR's acquisition price represents the reconciliation of these estimates.

Market Approach. Two appraisals estimated the value of the easement based on a comparable sales, or market approach, which examines recent sales of similar properties to determine fair market value. (For purposes of this analysis, appraisals will be referred to by the names of the firms that conducted them: Stone, Steiro, and Compass). A conservation easement cedes the right to develop on or subdivide a property and therefore limits the potential future uses of a property. The appraised value of an easement is based on the difference between the appraised value of a property as if it were to be sold in fee title (the before condition) and the appraised value of the property if it were to be sold encumbered by the easement (the after condition). Therefore, the fair market value of the easement is the appraised before condition less the after condition.

Appraisals noted that the use of the Keweenaw parcels is legally constrained through zoning. The parcels are located entirely within areas zoned for forestry, which limit the commercial uses of the land. For instance, most quarrying and mining operations are prohibited, and residential development is limited to cabins and recreational properties. Lot subdivisions may be no smaller than 60,000 square feet. Utilities, private wells, and septic systems have not been installed on either property. While the properties' zoning allows agricultural uses, appraisers noted that the land cover would preclude most farming. Additionally, the parcels are enrolled in MFL, which further restricts future uses to silvicultural activities. Given these conditions, appraisers note that the highest and best use for the properties would be industrial forestry.

To estimate the fair market value of the pre-easement condition of the land, appraisers analyzed a total of six sales of comparable land. These parcels sold for between \$787 and \$1,070 per acre. All comparable sales were of smaller tracts than the Keweenaw project. The Stone appraisal notes that, in general, for large timberland acquisitions (typically those over 5,000 acres), timber quality is a greater factor in setting the market price for a parcel. However, as there may be more uses for smaller parcels, including recreation and residential, demand tends to be greater, which inflates the price per acre. Of the comparable sales, all sales of less than 5,000 acres had the highest price per acre (ranging between \$977 and \$1,070). The Stone appraisal estimated the pre-easement price of the Keweenaw properties at \$12,917,000, or \$900 per acre.

Additionally, both appraisers analyzed the prior sale of the project properties. Keweenaw Land Association purchased the project properties on March 1, 2017. The appraisals, which were conducted in early 2018, less than a year after Keweenaw acquired the land, determined that the prior sale of the properties for \$12,800,000 was a reasonable comparison for setting the current market value. The Steiro appraisal noted that the price per acre paid by Keweenaw Land Association (\$892) would be higher than more recent sales of large timber tracts and may reflect past market conditions, rather than the present fair market value. The Steiro appraisal estimated that under current market conditions, \$12,558,000, or \$875 per acre, would be a more accurate estimate of fair market value.

The addition of the proposed easement, which would be a permanent encumbrance on certain

uses of the properties, would reduce the potential future sale price of the properties. Appraisers noted that the restrictions on permanent development and lot subdivision would limit future purposes for the properties to industrial forestry. The appraisers note that the prohibition on subdivision would likely preclude smaller timber investors from seeking to purchase the properties. This, compounded by recent actions by TIMOs and other large timber companies to reduce their forestland holdings, would reduce the future purchase price of the property.

Both appraisals estimated the fair market value of the Keweenaw project with the easement in effect based on analyzing comparable easement sales. It should be noted that most comparable sales were between a private seller or a non-profit conservation organization (NCO) to DNR for the purposes of establishing a conservation easement. Comparable sales needed to be scaled based on the size and locations of the properties. The scaled value of the sales ranged from \$440 to \$693 per acre. The Stone appraisal estimated the after condition of the Keweenaw parcels at \$6,458,000, or \$450 per acre. Therefore, the value of the easement would be \$6,459,000. The Steiro appraisal estimated the value of the after condition of the Keweenaw parcels at \$6,817,200, or \$475 per acre. Therefore, the Steiro appraisal estimated the value of the easement at \$5,740,800.

Income Approach. DNR requested a consulting report (Compass report) on the Keweenaw project that could account for future income that Keweenaw could derive from the timber on the property. This appraisal method is called the income approach and it is typically used for those properties that are being acquired to produce income. It seeks to calculate the discounted, or present value, of all future income that could be derived from a property. Factors that may contribute to a property's income appraisal value include harvestable timber, as well as opportunities for leasing or subdivision of the land.

Both the Stone and Steiro appraisals noted that the highest and best use for the property would be industrial forestry. They further noted that many timber companies seek to estimate the future earnings that could be received from a property in setting the purchase price. However, both the Stone and Steiro appraisals rejected taking an income approach, citing a difficulty to accurately account for the value and amount of timber on the Keweenaw property, as well as fluctuating timber markets that may alter the future stumpage values on the properties.

The Compass report estimated the discounted cash flow attributable from timber harvests over a 10-year period, which the reviewer estimated to be a typical term of ownership in large industrial timberlands in the area. Further, Compass assumed that 3% of the properties' timber, beginning at approximately 6,300 cord equivalents in the first year (5,500 cords of pulpwood and 360 MBF of saw timber), could be sustainably harvested in a given year. The Compass report assumed that pulpwood would be sold for \$30 per cord and saw timber would sell for \$335 per MBF, based on the average stumpage value in the region as of March 31, 2018. At these rates, the stumpage value of properties' pulpwood would total \$165,000 and the value of saw timber would total \$120,600 per year beginning in the first year, for a total value of \$285,600.

To estimate the fair market value of the before condition of the Keweenaw properties, the Compass report assumed that the Keweenaw Land Association would seek to reduce costs of property management by subdividing and selling unproductive forest land each year. Under this

assumption, the Compass report estimated that the Keweenaw Land Association would sell approximately 500 acres of land each year at a value of \$1,000 per acre. (A reduction in acreage and available timber is assumed to reduce annual timber harvests accordingly, to maintain a harvest of 3% of available timber each year.) Land management, legal services, and MFL acreage share payments would offset these income streams. The Compass report estimated that the cost of management activities on the properties between \$105,000 and \$135,000 annually.

Under these assumptions, the Compass report estimated the net annual income derived from the property between \$592,400 and \$653,700. The Compass report also assumed a sale of the property after 10 years, with proceeds of approximately \$8.2 million. Annual income, combined with the final sale proceeds and a 5% annual discount rate applied, yielded an estimated fair market value of the before condition of the Keweenaw properties at \$9,889,000.

Under the easement, the land could not be subdivided, meaning no income is assumed for sales of portions of the property. The Keweenaw Land Association also would be required to maintain and pay MFL acreage share payments for the entirety of the 14,352-acre property. Therefore, costs associated with the properties' after condition would be higher while timber income would remain comparable to the pre-easement scenario and consistent over the 10 years. Furthermore, the road endowment requires Keweenaw to maintain 16.45 miles of internal access roads such that they are passable by a pickup truck. The Compass report estimated the cost of road maintenance at \$10,000 per year. Finally, Compass applied the same 5% annual discount rate as under the pre-easement condition and assumed a sale of \$7.2 million at the end of the 10-year holding period.

Under these assumptions, the Compass report estimated the fair market value of the after condition at \$5,548,000. Therefore, the value of the easement was estimated at \$4,341,000. Table 1 summarizes the estimates of the Compass report.

TABLE 1

Compass Income-Estimated Values

	<u>Average Annual Income</u>	<u>Average Annual Cost</u>	<u>Average Net Revenue</u>	<u>Income at Final Sale</u>	<u>Discounted Ten-Year Revenue Stream</u>
Before Condition	\$744,150	-\$121,214	\$622,936	\$8,200,000	\$9,889,000
After Condition	289,454	-143,520	145,934	7,200,000	<u>5,548,000</u>
Easement Value					\$4,341,000

DNR requested a review of the two appraisals and the Compass report to reconcile the comparable sales and income approaches. The review noted that the timber industry typically relies on the income approach to price land acquisitions. Therefore, the reviewer placed greater weight on the estimate derived through the income approach. However, the review noted that timber markets fluctuate frequently and that an estimate of the 10-year harvest value is highly speculative. DNR's

proposed project cost of \$4,841,000 represents the weighted average of the income approach and the comparable sales appraisals. Table 2 summarizes the estimated before, after, and project values contained in each appraisal.

TABLE 2

Summary of Appraised and Estimate Values

<u>Appraisal/ (Valuation Method)</u>	<u>Before Condition Value</u>	<u>After Condition Value</u>	<u>Project (Easement) Value</u>	<u>Price per Acre</u>
Stone (Market)	\$12,917,000	\$6,458,000	\$6,459,000	\$450
Steiro (Market)	12,558,000	6,817,200	5,740,800	400
Compass (Income)	9,889,000	5,548,000	4,341,000	302
DNR (Market/Income Reconcile)	\$10,896,000	\$6,055,000	\$4,841,000	\$337

While the Compass report is not a formal appraisal, one could argue it uses a valuation approach more indicative of the parcels' intended long-term use in industrial forestry production. Under this perspective, the \$4,341,000 value calculated by the Compass report could be considered the most appropriate estimate of fair market value. The Committee could consider approving \$4,341,000 for the Keweenaw project, plus transaction costs, to reflect the income-estimated value of the properties [Alternative 2].

The Committee could also consider denying the request [Alternative 3]. As the Keweenaw properties are enrolled in MFL through at least 2024, there is unlikely to be an immediate effect. The Keweenaw Land Association would still be responsible for sustainable forest management and acreage share payments. After MFL orders expire, the land could be subdivided and sold to recreational users. However, as the tracts are in an area zoned exclusively for forest management, it may be unlikely that residential and commercial buyers would purchase significant portions of properties.

ALTERNATIVES

1. Approve the Department of Natural Resources request to purchase a conservation easement of 14,352 acres in the Towns of Carey, Knight, and Mercer in Iron County. Approve a total obligation of \$4,866,100 in stewardship bonding authority (land acquisition subprogram), including a purchase price of \$4,841,000 and transaction costs of \$25,100.

2. Modify the request and approve a total obligation of \$4,366,100 to reflect the lowest estimated value of the property of \$4,341,000 and transaction costs of \$25,100.

3. Deny the request.

Prepared by: Eric Hepler