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Does Your Client Own Timberland?

IT USED TO BE THAT INVESTORS thought that adding an integrated forest products company like International Paper was the way to add timber to their portfolios. Those days are gone. Most of the traditional forest products firms have divested themselves of timberland.

There are 514 million acres of timberland in the United States. About 31% of that is publicly owned and nearly half is in non-corporate holdings, leaving about 90 to 100 million acres of forest industry and investment timberland. In the past five years, 28 million acres of forest industry timberland have changed ownership in the United States. These acres were mainly sold by traditional forest products companies and bought by institutional investors and REITs. It is predicted these parties will purchase another 10 to 15 million acres in the next decade.

Many financial advisors are not aware that clients may hold significant financial positions in timber via direct investments. There are just over 10 million individual and family forest owners in the United States. These family forests occupy about 252 million acres of timberland. Most family forests are small tracts, as nearly three-quarters of them are less than 20 acres in size. But over a half million owners control 100 acres or more. At the other end of the spectrum, about 20,000 owners have tracts of over 1,000 acres in size.

Seventy-two percent of family forests are in the eastern United States, where the productive timberland and private ownership is located. The states with the greatest area of private forestland, each with more than 15 million acres, are Alaska, Geor-

gia, Alabama, Mississippi, Maine, Texas, North Carolina and Arkansas. The states with the greatest number of private owners, each with more than 500,000 owners, are New York, Tennessee, North Carolina, Georgia and Florida.

Financial advisors should be aware timber assets could be a large component of an investor's portfolio and the client may not even think of this timber as an asset. Below are some of the major considerations that will affect forest owners who reforest or sell timber.

Fundamentals

What ingredients make up a timberland investment? It has a rate of return just like any investment, but several characteristics make it unique. Its main cash flows come from timber sales and those are impacted by current timber prices. But what makes it special?

First, while timber can be purchased as a stand-alone entity, most forest owners own both land and timber as a combined production unit. So it becomes a two-component investment, or two sub-investments. Second, there are potentially large initial purchase costs. Site preparation and tree planting is often required on bare land. Third, long time periods are involved in forestry. A full growing cycle (rotation) for southern pine is 25 to 35 years. Fourth, cash flow will be determined by the age structure of the forest. This defines when harvest will occur.

Fifth, forests are subject to physical risks, like wildfire, insects and disease. Fortunately, these risks are small on a well-managed forest. Sixth, the forest is both a factory and

Over ten million individuals and families own timberland. Is it a neglected aspect of your client's portfolio?

By Thomas J. Straka

a storehouse. A forest produces the product and at the same time serves as the storehouse for the product. As wood grows it is stored on the stump. If timber markets are down, the forest allows for self-storage.

Seventh, the two components of a timber investment often react to inflation and price appreciation differently. Land and timber are often subject to different price change pressures. Eighth, land costs are an issue. Some timber investment analysts ignore land opportunity cost (you have to own or lease land to grow timber). Land cost is a relevant cost in timber investment analysis. Ninth, timber offers tax advantages. Tenth, timberland is a rare investment that allows for enjoyable side benefits (e.g., hunting and recreation) that are often not part of the investment analysis. Lastly, price information is difficult to obtain. Timber prices differ by region and tree species. Average investors would need a forester to value timber investments.

Institutional Investors

Certain financial characteristics of timberland make it attractive to investors. Timber and timberland investment opportunities go beyond the United States and are global. Institutional investors target countries like Australia, New Zealand, Chile, Uruguay and Brazil. The top ten institutional investors own over 20 million acres of timberland.

There are three elements that drive a timberland investment: biological tree growth, timber price changes and changes in land value. Biological tree growth simply means that as trees get older they increase in both volume and value and move through three product classes (trees grow from pulpwood size, to small sawtimber size, to large sawtimber and plywood log size). Biological growth accounts for 65% to 75% of investment growth because increasing volume and value over time are independent of financial market conditions. Timber price changes account for 25% to 30% of investment growth and result from several economic factors such as population growth, interest rates, GDP per capita, construction rates

and overall economic activity level. Typically, land value only represents a small percentage of timberland investment growth and is related to local market conditions.

Four main themes dominate the discussion about what makes timberland an attractive investment: its strong historical risk-adjusted returns; its limited volatility; its negative or low correlation with other traditional asset classes such as stocks and bonds and even commercial real estate; and its apparent positive correlation with inflation, which makes it an inflation hedge. Timberland has shown low and negative correlations with other asset classes. The correlation between timberland and the Consumer Price Index is -0.07 over the last 20 years, making timberland a partial hedge against inflation.

Institutional investors continue to increase acres of timberland owned, buying hundreds of thousands of acres at a time. Prices are in the range of \$1,500 to \$1,900 an acre. Keep in mind this is for land and timber (much of the timber mature) and involves a “quantity discount” for large acreages.


TIMOs, REITs and ETFs

A TIMO is a management group that assists institutional investors in locating, evaluating and acquiring timberland. Once it is acquired, the TIMO actively manages the investment. This is how pension funds, endowments and foundations invest in timberland. Pension funds usually do not pay taxes, so taxes are not an issue for many TIMO owners. Private owners would pay capital gains tax rates like other timber owners.

REITs and ETFs should not need an explanation. There is a tax advantage that encouraged the conversion of forest industry lands to timber REITs. A REIT can distribute significantly more cash directly to its investors in the form of a tax-efficient dividend. This is because REIT earnings are exempt from corporate income taxes and the REIT must pass on to its shareholders

90% of earnings in dividends. An additional advantage is that most REIT income from the sale of standing timber under contracts is treated as long-term capital gains by the shareholders. So REIT dividends tend to be large and reliable, and better yet are taxed at the long-term capital gain rate.

Plum Creek is the largest and most geographically diverse private landowner in the nation; it is also the first and largest publicly traded REIT. It owns 7.4 million acres. Two other national timberland REITs are Rayonier and Potlatch. They both earn significant income from manufacturing, so they don't represent as much of a pure timber investment as Plum Creek. Rayonier controls 2.2 million acres and Potlatch controls 1.6 million acres. All three REITs trade on the New York Stock Exchange. Wells Real Estate Funds recently launched the first public, non-traded REIT investing in timberland.

The first-ever timber ETF made its debut late in 2007 and is offered by Claymore Securities. The Claymore/Clear Global Timber Index ETF is listed on the American Stock Exchange as CUT and invests primarily outside the United States. It is not strictly a pure timberlands investment since it is based on forest products companies that own and manage significant timberland. But to be included in the index, the company must harvest the timber use in its business. An investor can now buy an ETF that will produce results that correspond to the S&P 500 Timber and Forestry Index. The iShares Global S&P 500 Timber and Forestry ETF promises exposure to the shares of approximately 25 leading forest products firms worldwide. Both these ETFs are similar in that their exposure to timber is global and indirect through the forest industry. Two other ETFs are Phaunos Timber Fund and Cambium Global Timberland. 

Thomas J. Straka is a forest economist at Clemson University in South Carolina. Another article by Straka that discusses the tax advantages of timber investing can be read at www.fa-mag.com under the November issue.

Wells Timberland REIT, Inc. Risk Factors:

Institutions often invest on terms and conditions different from individual investors, particularly with regard to fees and expenses.

Consider investment objectives, along with a product's fees and expenses, before investing. Please read the prospectus carefully to learn about potential risks, such as:

- Illiquidity. Not publicly traded; if shares can be sold, they may be worth less than what was paid for them.
- Dependence on the Advisor.
- We may pay cash distributions from offering proceeds or borrowings, which may reduce amounts available to acquire properties. We have not paid any cash distributions to date to our stockholders as a result of restrictions resulting from our credit agreements. Once we are able to make cash distributions, our cash distributions are not guaranteed and may fluctuate.
- Regulatory, economic, and environmental changes that may impact real estate, forestry, and/or tax legislation.
- Conflicts of interest facing the Advisor and its affiliates.
- Regardless of fund performance, considerable fees and expenses are paid to the Advisor, its affiliates, and broker/dealers.
- May not meet the offering's stated investment objectives.
- **Product not FDIC or NCUA/NCUSIF insured, not bank or credit union guaranteed, and may lose value.**

This investment is not suitable for all investors; see the prospectus for state suitability standards.

Wells Timberland REIT, Inc. (Wells Timberland) has not yet elected nor qualified to be taxed as a REIT. Wells Timberland has a limited operating history and to date has made only one acquisition, Mahrt Timberland, a collection of timberlands in Georgia and Alabama. Wells Timberland may not achieve the level of diversification described in the prospectus.

As of February 15, 2010, Wells Timberland's total borrowings were approximately 124% of net assets and 52% of the cost of the timber assets before adjustments for depletion and amortization. Wells Timberland is prohibited from making distributions or redeeming shares under its share redemption program (except for qualified disabilities and death) until certain loans and financial targets are satisfied.

This material contains forward-looking statements, which generally can be identified by our use of words such as "may," "will," "expect," "intend," "anticipate," "estimate," "believe," "continue," or other similar words. Factors that could cause actual results to vary materially from those expressed in forward-looking statements include fluctuations in interest rates, demand risks, and lack of availability of financing.

As of March 29, 2010, the Wells Timberland follow-on offering is not yet effective in Alabama, Maryland, Michigan, Ohio, or Tennessee. Please visit www.WellsTimberland.com for more details.

Wells Timberland REIT, Inc. is sponsored by Wells Real Estate Funds, Inc. Wells Real Estate Funds, Inc. is affiliated with Wells Investment Securities, Inc. – Distributor – Member FINRA/SIPC.

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