Pope Resources

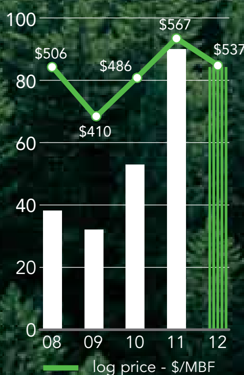
ANNUAL REPORT 2012

Financial Highlights

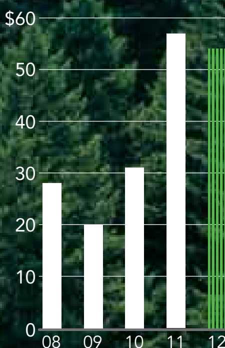
(Thousands, except per unit data)	**2012**	2011	2010
Revenue			
Fee Timber	**$45,539**	$52,729	$27,674
Timberland Management & Consulting	**7**	—	31
Real Estate	**8,497**	4,545	3,487
Total revenue	**$54,043**	$57,274	$31,192
Income (loss) from operations			
Fee Timber	**$11,853**	$16,899	$9,703
Timberland Management & Consulting	**(1,568)**	(1,515)	(1,250)
Real Estate	**(11,099)**	(349)	(809)
Administrative	**(4,170)**	(4,188)	(4,731)
Total income from operations	**$(4,984)**	$10,847	$2,913
Net income (loss) attributable to unitholders	**$(4,709)**	$8,754	$2,038
Net income (loss) per fully diluted unit	**$(1.11)**	$1.94	$0.43
Adjusted cash available for distribution (ACAD)#	**$11,652**	$12,896	$7,594
ACAD per fully diluted unit#	**$2.68**	$2.98	$1.66
Unit price at year-end	**$55.68**	$42.99	$36.80
Distribution per unit	**$1.70**	$1.20	$0.70
Units outstanding at year-end per Nasdaq	**4,412**	4,388	4,328
Total assets	**$267,499**	$230,408	$235,837
Long-term debt, including current portion	**43,835**	45,825	50,498
Noncontrolling interests	**138,418**	101,399	107,817
Partners' capital	**64,223**	75,759	70,990
Partners' capital per unit	**$14.56**	$17.27	$16.40
Fee timber harvest (MMBF)	**84**	90	53

Unaudited

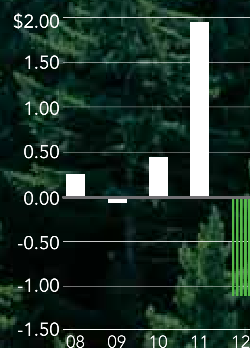
HARVEST VOLUME
MMBF



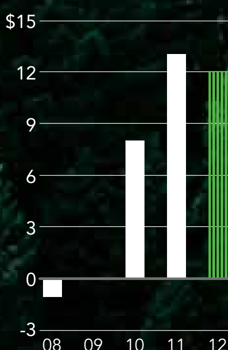
TOTAL REVENUE
MILLIONS



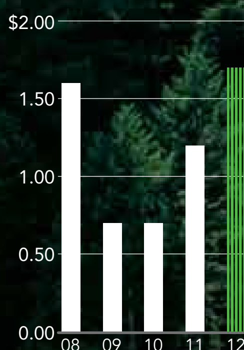
EARNINGS (LOSS)
PER DILUTED UNIT



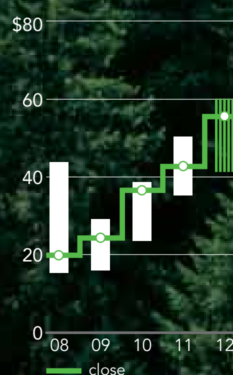
ADJUSTED CASH AVAILABLE
FOR DISTRIBUTION
MILLIONS



DISTRIBUTION
PER UNIT



UNIT TRADING
RANGE



David L. Nunes
President and CEO

Dear Fellow Unitholders:

To the extent the theme of 2011 was aggressively capitalizing on improving market conditions, particularly in China, 2012's story line was one of transitions across all our business lines.

With high log inventories in China in late 2011, we started off 2012 much more cautiously in terms of planned harvest volume. Weaker pricing in China at the outset of 2012 prompted us to shift harvest volume and species mix so as to favor the gradually improving domestic market. As the year unfolded, the domestic market continued to show signs of improvement, due to increasing lumber production driven by both rising U.S. housing starts and strength on the part of selected Pacific Northwest mills targeting Japanese markets for the export of lumber.

An emerging concern in the wake of the recession has been shrinkage in the contractor pool of log harvesters and haulers. We have had to adapt to a world of higher cable logging and hauling costs as a result of a number of contractors exiting the business during the recent recession. I will speak to this in more detail in the Fee Timber section of this letter.

Within our timber fund business, which was established in 2005, 2012 represented a number of transitions. Following the final closing of our third private equity timber fund in the third quarter of 2012, we shifted our efforts from raising capital to finding good timberland investments on behalf of our fellow investors. Fund III has a total of $180 million of committed capital, exceeding the combined size of our first two funds. In December 2012, we placed 25% of the fund's committed capital with a $45 million acquisition of a 19,000-acre tree farm in northern California. The private REIT structure of Funds II and III necessitate, for tax reasons, the suspension of all harvest activities for a year following acquisition. As such, 2012 marked the first full year of having the entire 37,000-acre Fund II portfolio, assembled in 2009 and 2010, available for harvest. Notwithstanding softer export log markets in 2012, our funds contributed 38% of our 2012 total harvest and timber deed sale volume of 84 million board feet (MMBF).

Transitions abounded as well in our Real Estate segment. Conservation sales, whether in fee or involving easements, helped us weather the recent recession, as demand and pricing for sales of developed and undeveloped lands were weak. A combination of improving developed land markets and less funding for conservation is causing us to shift our emphasis away from conservation sales. This shift in the real estate market is most evident within our Gig Harbor project, where we have moved from a multi-year entitlement effort that concluded in early 2011 to an active program of getting properties under contract for sale. Our first residential closing in this project occurred in late 2012 with a $3.3 million sale of an 11.5-acre parcel entitled for 172 multi-family units. We are also under contract on a parcel entitled for the remaining 100 multi-family units in this project, as well as 142 of our 554 single-family lots.

We are looking forward to converting these and other portions of this project into consummated sales over the next several years.

Meanwhile, our Port Gamble property is also undergoing a significant transition. In early 2013, we completed a multi-year planning effort to redevelop this historic mill town by submitting to Kitsap County the master plan for the town's redevelopment. We have also recently concluded negotiations with the State on defining the scope for the final portion of the environmental clean-up effort in Port Gamble, a process that began in 2002. The negotiation of this project definition with the State regulator resulted in a second quarter increase of $12.5 million to our accrual for environmental remediation liability, an expense that dominated our financial results for the year. Lastly, as part of our Port Gamble redevelopment strategy, we are nearing the end of an option agreement with Forterra to sell portions of our 7,000-acre north Kitsap County holdings for conservation.

While 2012 was a transition year which corresponded to 6 MMBF of reduced harvest and timber deed sale volume, we generated $8 million of Real Estate sales and had total revenues of $54 million, nearly reaching the 2011 level of $57 million. However, the aforementioned $12.5 million increase in our environmental remediation accrual swamped our operating results, resulting in a net loss attributable to unitholders of $4.7 million, or a loss of $1.11 per fully diluted ownership unit. Notwithstanding this loss for the year, we are encouraged by the growth potential in each of our three segments. The prospects for future growth give us confidence in the enterprise's cash generating capability and this confidence, coupled with 2012's strong cash flow generation, factored into increasing our quarterly distribution by 29% to $0.45 per unit in the second quarter of 2012.

The balance of this letter will take a deeper dive into the key strategic initiatives within each of our three operating segments, exploring some of the business and market transitions referenced earlier. I will also discuss our capital allocation priorities and how we are positioned to capitalize on future market dynamics.

Significant Shift in Log Market Mix as U.S. Housing Starts Improve

The gradual recovery in U.S. housing starts continued to gain momentum during 2012. With plant curtailments brought on by the recession and a reticence on the part of forest product manufacturers to add capacity until housing starts reach a higher level, the industry saw sharp increases in 2012 for both lumber and panel prices. As of early 2013, the Random Lengths composite lumber price has doubled from its low in 2009. As lumber and plywood prices improved in 2012, we did see a supply response in the form of higher mill operating rates, which in turn translated into greater demand for our logs. We saw particular strength among our customers who produce veneer for plywood and export lumber for the Japanese market.

In contrast to the strengthening domestic log market, the export log market was weaker relative to 2011, pulling down log prices across the quality spectrum. Following explosive growth in the log export market to China in the first half of 2011, we saw the market pull back in the second half of the year as inventories built in China. It took most of the first half of 2012 for these inventories to be worked down before log volumes began to flow to China at rates similar to 2011. These market dynamics translated into 6% lower export prices for 2012 and thus a shift in destinations for our logs from the export to the domestic market, where prices fell by a more modest 1%. Our export mix fell to 25% in 2012 from 45% in 2011 based on the strengthening U.S. market and the weaker Chinese market.

A byproduct of the higher operating rates among our sawmill customers was a dramatic 17% pullback in pulpwood prices. The low cost source of woodchips for pulp mills is typically sourced from sawmill residuals. When lumber operating rates increase, so too does the supply of residual woodchips, thus resulting in lower demand and pricing for whole-log chips.

These various market factors in 2012 combined for a total weighted average log price of $537 per thousand board feet (MBF), which is 5%, or $30 per MBF, below the average

price for 2011. Within this total, we saw a $27 per MBF, or 4%, decline in Douglas-fir sawlog prices and a $46 per MBF, or 8%, decline in whitewood sawlog prices. This differential price performance by species ties back to the weakening of the log export market to China in 2012. Given that China is relatively indifferent to species mix due to the primary end use of wood going into industrial applications like concrete forms, we saw a price compression in 2011 between lower valued whitewoods and higher valued Douglas-fir. As the China log export market cooled in 2012, we saw this price compression relax and thus the poorer year-over-year performance for whitewood relative to Douglas-fir sawlog prices. Our response to this was to slightly increase our mix of Douglas-fir, which grew from 61% in 2011 to 64% in 2012, and to decrease our whitewood mix, which fell from 20% in 2011 to 19% in 2012.

An emerging theme throughout 2012 was the reduced availability of logging and hauling contractors. During the drawn out recession, which resulted in dramatically reduced harvest volumes, many contractors exited the business. As markets have improved over the past year, all landowners have experienced a tighter supply, and thus higher cost, of logging and hauling contractors. While long-term contractor costs have tended to track with inflation, we have experienced significant price increases over the past year, particularly for cable logging harvest units. We have responded in a few ways to this changing dynamic. First, we are working to provide cable logging contractors with larger volume commitments to keep them effectively in our employ for a longer period of time. This goes against the grain of our historic nimbleness of switching harvest units to capitalize on market conditions, but is necessary to retain the best logging contractors. This will also tend to soften our historic seasonal market timing capabilities as we will need to factor in the availability of contractors. We also, for the first time in many years, entered into a timber deed contract on 4.4 MMBF of harvest volume. After having difficulty attracting a cable logging contractor to this harvest unit, we decided to test the timber deed market. This volume was sold to a domestic customer who had access to cable logging contractors used in buying and cutting timber deed sales off public lands. As log markets are expected to stay strong for the next few years, this is a sales opportunity we will continue to monitor.

Including the aforementioned timber deed sale, our total harvest volume for 2012 was 84 MMBF, or 7% below the 90 MMBF harvested in 2011. While harvest volume was down slightly from 2011, we nevertheless dipped slightly into our deferred harvest volume of 34 MMBF as of year-end 2011. We finished 2012 with deferred harvest volume of 32 MMBF. With stronger log prices anticipated in 2013, we will continue to strive to be nimble and look for opportunities to dip further into this deferred volume, which stems from the market downturn in 2009 and 2010. While our overall weighted average log price was down by 5% in 2012 relative to 2011, it is important to remember that this price is 31% above the market low of 2009. This price recovery and the drawing down of deferred harvest volume in 2011 and 2012 certainly validate the decision to defer harvest in 2009 and 2010.

Timber Fund Business Closes Third Fund

In the third quarter of 2012, we concluded our capital raising efforts for our third private equity timber fund since 2005, which has a total of $180 million of capital commitments. Pope Resources is co-investing 5% of the total capital commitments, or $9 million. This fund size is nearly double our initial target size of $100 million and is larger than our first two funds combined. We have a three-year drawdown period within which to make suitable timberland investments in the Pacific Northwest.

In the fourth quarter of 2012, we acquired a 19,000-acre commercial timberland property in northern California for $45 million. This represents the first acquisition for Fund III and brings our total timber fund holdings to 80,000 acres across seven tree farms in Washington, Oregon, and California. This acquisition adds 59 MMBF of merchantable timber inventory from stands age 35 and older. As of December 31, 2012, the three funds collectively have a

total of 385 MMBF of merchantable inventory and $231 million in assets under management based on 2012 year-end appraisals, or $195 million in original acquisition cost. Pope Resources has put $31 million of its own capital to work in the form of co-investments in these three funds, representing 68 MMBF of merchantable inventory on a look-through basis and $39 million of the total assets under management based on 2012 year-end appraisals.

As mentioned above, each of our last two funds are organized as private REITs, and part of securing that tax status means that initial delivered log sales on all newly acquired properties have to be deferred for one year. As such, there will be no harvest activity from Fund III in 2013, unless we elect to sell timber deed sales. With the final two acquisitions from Fund II closing in late 2010, this past year represented the first full year of harvest activity from Fund II. For the year, we harvested a total of 32 MMBF from the first two funds, which represented 38% of the combined harvest and timber deed sale volume for the year. Based on distributions to fund investors, the cash-on-cash yield from our co-investments in the first two funds was 3.0% in 2012. This in turn contributed 11% of the $7.5 million in total quarterly distributions paid to Pope Resources' unitholders during 2012.

Given the current makeup of the timberland portfolio owned by the funds, our planned annual harvest for these properties totals 47 MMBF. In addition, we have a total of 15 MMBF of deferred harvest volume from the funds that we are carrying forward into 2013. While we anticipate that our harvest volume from the fund properties will fluctuate more than that of the Partnership's properties based on multiple overlapping investment terms, we nevertheless expect that our fund business will constitute a greater proportion of our overall harvest volume over time. Thus, as our fund business continues to grow, it will also support, through its distributions to investors, continued growth in quarterly distributions to Pope Resources' unitholders.

In addition to providing an important source of cash flow through our co-investments, the fund business generates a significant source of fee revenue. As a result of being the general partner for Fund I and the managing member for Funds II and III, we are required, for external reporting purposes, to consolidate the performance of the funds within our financial statements. This accounting treatment results in the elimination of all revenue associated with managing the funds, with a corresponding reduction to operating costs within our Fee Timber segment. This external reporting treatment is discussed in more detail within the MD&A section of our Form 10-K filed with the SEC that is packaged with this letter. On an internal reporting basis, the fund business, through our Timberland Management & Consulting segment, generated $148,000 of operating income in 2012 on $2.2 million of revenue. We have thus reached a scale within the fund business where it is positively contributing to the bottom line while at the same time absorbing a larger and larger proportion of allocated costs as we add more properties under management (the internal operating income result cited above is net of $800,000 of allocated costs).

Port Gamble Future Becoming Clearer

This was unquestionably a challenging year for our historic Port Gamble town and the former Pope & Talbot millsite. Our principal challenge has been the protracted negotiations we have had with the Washington State Department of Ecology (DOE) to nail down the details of the remaining clean-up efforts required for Port Gamble Bay. In early 2011, the DOE released for public comment a draft plan to complete cleanup efforts that began in 2002. This 2011 plan, with an estimated cost of $4.5 million, included primarily dredging and capping of the log-handling areas in the bay near the former millsite. Based on extensive comments from a neighboring tribe, the DOE undertook a new round of testing throughout Port Gamble Bay and dramatically increased the scope of the cleanup effort.

In 2012, the DOE proposed elements of a new clean-up plan that was designed to address tribal concerns. This plan called for a number of new elements, including a requirement to remove all the overwater dock structures and old

creosote pilings located around the former millsite. This had the effect of pulling forward in time certain costs that would otherwise be part of our eventual millsite redevelopment plan. The new DOE plan also included much more extensive dredging around the millsite as well as a significantly higher volume of capping with sand in an effort to create new shellfish habitat in the water near the millsite. The plan also includes capping in the central bay, creosote pile removal, and capping in an area where log rafts used to be stored. This new plan has a total estimated cost of $17 million.

The Washington State Model Toxics Cleanup Act (MTCA) provides for joint and several liability, where the DOE can go after a single Potentially Liable Party (PLP) to cover the full cost of a clean-up action. DOE will often do this as a matter of convenience to avoid having to act as arbiter of clean-up cost allocations between PLPs. In these instances where DOE has tagged a single PLP with the obligation to pay the full clean-up cost, that PLP is then free to pursue contribution claims from any other surviving PLPs. The operator who polluted the site, in this case Pope & Talbot, typically bears the brunt of the clean-up liability. But in a case like Port Gamble where the operator has gone bankrupt, the clean-up liability falls to surviving property owners. In Port Gamble, there are two such "orphan" property owners that are thus responsible for the clean-up cost: Pope Resources, who owns the former millsite and tidelands, and the Washington State Department of Natural Resources (DNR), who owns the submerged tidelands in the bay. As described above, DOE is allowed to pursue a single PLP, in this case Pope Resources, to cover the full clean-up cost liability. We will then pursue a contribution claim with the DNR as the other PLP for their share of clean-up costs, which we expect to negotiate concurrent with entering into a consent decree with DOE.

Another element of our negotiations with DOE in 2012 involved an assertion by DOE of potential Natural Resource Damage (NRD) claims against the PLPs. NRD claims are sometimes referred to as the environmental equivalent of "pain and suffering" awards in a civil lawsuit. NRD liability typically is based on causation by the operator, but in this case DOE attempted to bring NRD claims against the two property owning PLPs, Pope Resources and the DNR. Restoration projects are sometimes agreed upon in conjunction with clean-up negotiations as mitigation for NRD claims, but in this case, we agreed with DOE that any potential restoration projects will be part of a separate agreement.

While negotiations with DOE on the clean-up plan and restoration projects continued throughout 2012, sufficient details and cost estimates of the expanded scope of the clean-up effort necessitated an increase in our environmental accrual of $12.5 million to bring it up to $13.9 million as of the end of the year. While the details of the clean-up plan and consent decree are still in the process of being finalized with DOE, as are our negotiations with DNR to set their contribution amount, we believe our current accrual to be adequate to cover our share of costs. We anticipate that the bulk of the actual spending will occur in 2014 and 2015.

In 2012, the State's legislature set aside $9 million of funding to assist in the rehabilitation of Port Gamble Bay. This funding focused on $7 million for the potential acquisition of Pope Resources' timberland either adjacent to the Bay or in its watershed, and $2 million to relocate the Port Gamble sewer outfall. As part of our recently concluded negotiations with DOE on the parameters of the clean-up, they have agreed to allocate $2 million for the removal of Pope Resources' sewer outfall that drains into Hood Canal and will also contribute $1.825 million to assist in acquisition of the 480-acre "Shoreline Block" on Port Gamble Bay. The Kitsap Forest & Bay Coalition has been working to obtain grants to acquire this $4.6 million property. If those efforts are successful, DOE's funding will enable full property acquisition.

On a more positive Port Gamble note, we completed the necessary studies in support of the townsite's redevelopment effort and submitted a master plan application to Kitsap County in early 2013. This plan calls for the

construction of approximately 200 homes within the town and millsite as well as commercial properties including a hotel, restaurant, and additional commercial space. The plan will entail an environmental impact statement and will likely take a few years to reach approval, barring any potential appeals.

Poulsbo Office Move Completed

We completed an unusual office swap in 2012, with the sale to Safeway of our 2-acre corporate headquarters site for $2.9 million. Earlier in 2011, we purchased a 29,000-square foot office building in Poulsbo for $3.2 million from the FDIC. The purchase of this new building was facilitated by a tax-efficient reverse 1031-exchange that allowed us to defer tax on $2.0 million of capital gain realized from a conservation sale plus two other land sales earlier in 2011.

Through this office swap, we took advantage of an opportunity to capture some arbitrage value between the two properties. We sold our 9,800-square foot headquarters site for the price of $296 per square foot, or $33 per square foot of raw land. This exceeded the County's assessed value of $1.6 million by 81%. On the flip-side, we acquired our new building for the price of $108 per square foot, which was 68% of its $4.7 million assessed value. The combined value lift relative to the assessed values was $2.8 million.

The new office building was owned by a failed regional bank, with the entire building under a long-term lease with a new bank that acquired the assets of the failed bank. We restructured the bank's lease and now occupy 40% of the new building. The revised new lease will contribute $182,000 of average annual lease revenue over the balance of the lease, which will pay for all our portion of the net building operating costs and contribute $107,000 of incremental annual cash flow. This incremental cash flow will cover half the required annual debt service costs from a new $3 million mortgage we took out on this building at the end of this past year. Lastly, this new building also provides for some much needed expansion space. We currently occupy 11,000 square feet, with the potential to add another 2,000-square foot section of the building currently leased by the bank.

Capital Allocation Stresses Growth in Distributions and Timber Fund Co-investments

Since closing our first timber fund in 2005, we have endeavored to maintain a balance in how we allocate the cash generated by our various business lines. Our capital allocation priorities have been split among quarterly unitholder distributions, co-investments in our three private equity timber funds, unit repurchases, and opportunistic investments.

In this eight-year period dating back to 2005, we have generated $89 million of Adjusted Cash Available for Distributions (ACAD). We adopted this ACAD measure in 2010 as a metric that helps us to establish the level of quarterly unitholder distributions. ACAD is defined as cash flow from operations, less required principal payments, maintenance capital expenditures, and financed debt extinguishment costs. We also strip out the cash flow from operations attributable to noncontrolling interests in our three private equity timber funds.

Over the same eight-year period, we have invested a total of $97 million across the aforementioned capital allocation priorities, with $42 million, or 43%, to unitholder distributions, $31 million, or 32%, to co-investments in our three private equity timber funds, $19 million, or 20%, in unit repurchases, and $5 million, or 5%, in opportunistic investments in our Real Estate segment.

In the second quarter of 2012, we increased our quarterly unitholder distribution by 29% to $0.45 per unit. This marks the first time since the onset of the recession in 2008 that we have exceeded the quarterly distribution level of $0.40 per unit that was in place that year. As we aggressively cut back our harvest level in 2009, we reduced our distribution by 50% twice to end 2009 at a quarterly distribution level of $0.10 per unit. In each of the ensuing three years, we have increased the quarterly distribution as market conditions have gradually improved. While our quarterly unitholder

distribution has increased significantly the past few years, it is still set conservatively relative to our ACAD level. In 2012, we paid $7.5 million in unitholder distributions, which represented 64% of the 2012 ACAD of $11.7 million. As we see growth in our operating cash flow associated with the gradual recovery in housing starts, we believe we will be well-positioned for corresponding growth in our quarterly distribution.

Since launching our timber fund business, this has been our sole means of growing our timberland base. We co-invested 20% of the paid-in capital in each of our first two funds for a total of $29 million. In our third fund, which had a final closing in the third quarter of 2012 at a total capital commitment of $180 million, our co-investment level was lowered to 5% of committed capital, or $9 million. Of this total, we have invested $2 million and have $7 million of capital commitment remaining over the three-year drawdown period that concludes in mid-2015. Across these three funds, which currently own a total of 80,000 acres, we own 13,000 acres on a look-through basis. This represents a well-diversified portfolio across three states that will contribute 9 MMBF of look-through harvest volume. The cash flow from these co-investments, as represented by distributions to all fund owners, helps to support the growth in Pope Resources' quarterly distributions to its unitholders.

Since 2007, we have had a unit repurchase program in place. This program, while not active in the market at all times, has nevertheless repurchased and retired a total of 255,000 units since 2007. In addition, we had a large unit repurchase in late 2010 that was outside the auspices of this plan for a total of 334,000 units. All told, since late 2007, we have repurchased and retired a total of 589,000 units for $19 million, equating to an average repurchase price of $33 per unit. As part of the large single repurchase transaction in late 2010, we tapped our operating line of credit for $9.6 million. This debt was paid off in 2012.

Our opportunistic investments within the Real Estate segment since 2005, totaling $5 million, have consisted of a 40-acre addition of an adjacent parcel to our Port Gamble project and the purchase of a new corporate headquarters building in Poulsbo, as described earlier in this letter.

With the gradual improvement in U.S. housing starts, we remain optimistic about our ability to generate significant cash flow in the near term from all our segments, notwithstanding the eventual outlays associated with the Port Gamble Bay clean-up effort. This will in turn provide for ample ACAD and continue to provide us with flexibility across our capital allocation spectrum of unitholder distributions, timber fund co-investment, unit repurchases, and opportunistic investments.

Future Outlook Positive Across Business Lines

As we enter 2013, there are lots of reasons for optimism across our various business lines. Unlike a year ago, when we started the year on a cautious note due to high log inventories in China, we are starting this year with much stronger market conditions. The China export log market, which is usually slow this time of year as a result of the Chinese New Year, is currently taking logs at a pace last seen in mid-2011. With the recovery in U.S. housing starts finally starting to show some traction, we are also seeing mill operating rates climb and lumber production increase. West Coast sawmills produced 11% more lumber in 2012 compared to the prior year, a sign that bodes well for our underlying log demand. Looking ahead, the consensus prediction for U.S. housing starts, compiled by the Joint Center for Housing Studies of Harvard University, calls for a 30% increase in 2013 to 1.0 million starts and another 27% increase in 2014 to 1.3 million starts. We are encouraged by these market developments and believe these demand attributes will benefit all three of our segments.

On the supply side, we also have the prospect of less Canadian lumber flowing to the U.S. market. Historically, Canadian lumber has supplied as much as one-third of U.S. lumber demand. However, going forward, Canadian market share will be significantly lower due to the impacts of the mountain pine beetle epidemic in western Canada. In the short term, lumber impacted by mountain pine beetle

mortality is flowing primarily to China. We are in the early stage of seeing reductions in allowable annual cut, which over the longer term will translate to lower harvest levels and less ability to respond to improved lumber market conditions in the U.S. and abroad. Taken in concert with the aforementioned improvements in demand from the U.S. and Asia, some have described this as an ensuing "super cycle." Whether or not such a "super cycle" occurs as some have predicted, we expect these demand and supply dynamics to benefit our log markets.

We are well positioned to capitalize on stronger log markets with both higher planned harvest levels and deferred harvest volume that can be tapped to take advantage of rising markets. With our most recent 19,000-acre Fund III acquisition in late 2012, in which we will begin logging operations in 2014, our planned harvest level will increase by 11 MMBF to 91 MMBF per year. In addition, we have 32 MMBF of deferred harvest volume as of the end of 2012. As we place the remaining $134 million of committed capital in Fund III, our harvest volumes will continue to grow.

Within the Real Estate segment, we have a number of sales in the pipeline that should produce significant cash flow over the next few years. Our Gig Harbor project, described earlier, is expected to generate significant sales over the next few years. This will in turn fund capital expenditures required to complete these and future sales as well as generate free cash flow for investment elsewhere. We also have significant conservation-related sales in the pipeline for potential closing, with the most significant ones connected to our 7,000-acre north Kitsap County exit strategy described earlier and another one that is a subset of our 24,000-acre Swift Reservoir property. These sales, depending on their final form, have the potential to reduce our long-term harvest capability, but will nevertheless generate significant cash flow to reinvest in growth elsewhere. In addition to helping fund our remaining $7 million of Fund III co-investment obligation, we also expect these sales to help fund our Port Gamble environmental clean-up liability over the next few years as that work commences.

As I reflect on the strategies and positioning of each of our three segments, I believe our future is very bright. The combination of our asset base and the market dynamics described in this letter should translate into significant anticipated growth in revenues and cash flow generation over the next few years. I look forward to continuing to lead the excellent management team and employees we have assembled to execute these strategies.

I would be remiss in not mentioning the retirement of Peter Pope, who has served on our Board of Directors for 27 years. I'm a big believer in wisdom gained through the experience of managing through full business cycles. We will miss Peter's steady hand and the wisdom he gained from the many business cycles he experienced during his long career. He was particularly helpful during this most recent recession, which was very challenging for the company and the industry. We look forward to working with his daughter, Maria Pope, who brings deep public company board experience as well as forest products industry perspective to our Board.

One final thanks to our unitholders and your continued faith in our team and our strategies. We appreciate the trust you have placed in us to shepherd your investment in Pope Resources and look forward to rewarding that trust with continued growth in our quarterly distribution and unit value. As always, I welcome your feedback and questions.

David L. Nunes

President and CEO
March 25, 2013

Management's Discussion and Analysis of Financial Condition and Results of Operations

This report contains a number of projections and statements about our expected financial condition, operating results, and business plans and objectives. These statements reflect management's estimates based upon our current goals, in light of management's knowledge of existing circumstances and expectations about future developments. Statements about expectations and future performance are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, as amended, which describe our goals, objectives and anticipated performance. These statements can be identified by words such as words such as "anticipate," "believe," "expect," "intend" and similar expressions. These statements are inherently uncertain, and some or all of these statements may not come to pass. Accordingly, you should not interpret these statements as promises that we will perform at a given level or that we will take any or all of the actions we currently expect to take. Our future actions, as well as our actual performance, will vary from our current expectations, and under various circumstances these variations may be material and adverse. Some of the factors that may cause our actual operating results and financial condition to fall short of our expectations are set forth in that part of our 2012 10-K entitled "Risk Factors." Some of the issues that may have an adverse and material impact on our business, operating results and financial condition include economic conditions that affect consumer demand for our products and the prices we receive for them both domestically and overseas, particularly in certain parts of Asia; government regulation that affects our ability to access our timberlands and harvest logs from those lands; the implications of significant indirect sales to overseas customers, including currency translation, regulatory and tax matters; the effect of financial market conditions on our investment portfolio and related liquidity; environmental and land use regulations that limit our ability to harvest timber and develop property; access to debt financing by our customers as well as ourselves; the impacts of climate change and natural disasters on our timberlands and on surrounding areas; and the potential impacts of fluctuations in foreign currency rates as they affect demand for our products and customers' ability to pay. From time to time we identify other risks and uncertainties in our other filings with the Securities and Exchange Commission. The forward-looking statements in this report reflect our estimates as of the date of the report, and unless required by law, we do not undertake to update these statements as our business operations and environment change.

This discussion should be read in conjunction with the Partnership's audited consolidated financial statements included with this report.

Executive Overview

Pope Resources, a Delaware Limited Partnership ("we" or the "Partnership"), is engaged in three primary businesses. The first, and by far most significant segment in terms of owned assets and operations, is the Fee Timber segment. This segment includes timberlands owned directly by the Partnership and Funds. Operations in this segment consist of growing timber to be harvested as logs for sale to export brokers and domestic manufacturers. Real Estate is our second most significant business segment in terms of total assets owned. Real Estate activities primarily take the form of securing permits, entitlements, and, in some cases, installing infrastructure for raw land development and then realizing that land's value by selling larger parcels to buyers who will take the land further up the value chain, either to home buyers or to operators and lessors of commercial property. Since these land projects span multiple years, the Real Estate segment may incur losses for multiple years while a project is developed, and will not recognize operating income until that project is sold. In addition, within the results for this segment we will occasionally reflect income realized from the negotiation and sale of conservation easements (CE's) placed on Fee Timber properties to preclude future development. Operations in this segment also include leasing residential and commercial properties in Port Gamble, Washington, and leasing out a portion of a commercial office building in Poulsbo, Washington. The objective of our third business segment, which we refer to as Timberland Management & Consulting ("TM&C"), is raising and investing capital from third parties for private equity timber funds, and thereafter managing the acquired assets for the benefit of all investors.

Our current strategy for adding timberland acreage is centered on our private equity timber fund business model, which consists of raising investment capital from third-party investors and placing that capital, along with our own co-investment, in the form of timberland acquisitions. To date, we have raised three timber funds that represent $231 million of assets under management. Our $31 million co-investment, with 20% of Funds I and II, and 5% of Fund III, affords us a share of distributed operating cash flows from the Funds while allowing us to earn asset and timberland management fees. Depending on the overall success of each Fund, we also may be entitled to earn incentive fees. Management believes that this strategy allows us to maintain more sophisticated expertise in timberland acquisition, valuation, and management than would be cost-effective for our timberlands alone. We believe our co-investment commitments boost our credibility with existing and prospective Fund investors by demonstrating that we have a financial as well as an operational commitment to each Fund's success. During 2012, we had the final close of Fund III with $180 million of committed capital, $9 million of which represents our co-investment. The Funds are consolidated into our financial statements, with the income attributable to equity owned by third parties reflected in our Consolidated Statement of Operations under the caption "Net (income) loss attributable to noncontrolling interest—ORM Timber Funds."

As an owner and manager of timberland, we focus keenly on three "product" markets: lumber, logs, and timberland. Each of these markets has unique and distinct attributes such that the respective product prices in each market do not move up or down in lockstep with each other. Generally, the lumber market is the most volatile as it responds quickly (even daily) to changes in housing-driven demand and to changes in lumber inventories. We do not manufacture lumber, but the price of finished lumber affects the demand and pricing for logs. Although the lumber market is volatile, it can provide considerable information about trends that will affect our harvest decisions. Log markets are affected by what is happening in the spot lumber markets, but pricing shifts typically adjust monthly or quarterly rather than daily. Log price volatility is also moderated because logs are used to produce products besides lumber (especially pulp). The market for timberland tends to be even less volatile, with pricing changes that lag behind both lumber and log markets. This is largely a function of the longer time horizons utilized by timberland investors, where the short-swing fluctuations of log or lumber prices are moderated in acquisition modeling. We monitor the lumber market because activity there can presage log price changes. We are constant participants in the log market as we negotiate delivery prices with our customers. The timberland market is important as we are constantly evaluating our own portfolio and its underlying value, as well as the opportunities to adjust that portfolio through either the acquisition or disposition of such land.

Land held for sale in western Washington by our Real Estate segment is suitable primarily for residential and commercial building sites. The markets for these products suffered along with regional and national markets, producing sales declines from their peak in the middle of the last decade. This revenue pattern started to reverse in 2012, with sales nearly doubling from 2011, as a result of selling the land underlying our corporate headquarters and partial recognition of revenue in connection with the sale of a multi-family parcel from our Harbor Hill project in Gig Harbor. The challenges of our Real Estate segment center around how and when to "harvest" a parcel of land and capture the optimum value increment by selling the property, balancing the long-term risks of carrying and developing a property against the potential for income and positive cash flows upon sale.

In July 2012, we entered into a sales agreement with a buyer for approximately 79 units on 22 acres of the single-family residential phase of the Harbor Hill project in Gig Harbor, Washington. The sales agreement provides for four closes between 2013 and 2014. In October 2012, we entered into a purchase and sale agreement to sell 17 acres, also within the Harbor Hill project, where the buyer plans to develop a continuing care retirement community. The agreement gives the buyer up to 45 months to close. With

these signed agreements, all our multi-family parcels in the Harbor Hill project are either sold or under contract. Upon closing, and we conclude we have no material continuing involvement or obligations to the purchasers, revenue will be recognized on both transactions.

Our revenue declined in 2012 from 2011 primarily as a result of lower harvest levels and log pricing. Compared to net income in 2011, we recorded a loss in 2012, which reflects an accrual for environmental remediation of $12.5 million. Notwithstanding the environmental accrual, these year-over-year declines are primarily a result of decreased demand for logs in China, partially offset by increased spot domestic markets and increased real estate revenue. In spite of some domestic demand for wood to be milled for the Japanese market and a gradual U.S. housing market recovery, the 2011 surge in Chinese log markets did not have a corollary in 2012, which translated into overall log price weakness in 2012 relative to 2011. Macroeconomic factors that reflect or influence the health of the U.S. housing market and have a bearing on our business revolve around employment growth, tight credit markets, and the inventory of unsold homes, whether new, existing, or foreclosures. These factors resulted in exceedingly low housing starts in 2009 through 2011, but began to show signs of improvement in 2012. Increases in our Real Estate revenue and healthier domestic log markets testify to this macroeconomic improvement.

Currency exchange rates and ocean freight rates influence the competitiveness of our logs in Asian export markets as well as the competitiveness of our domestic sawmill customers with lumber exports to Asia relative to lumber exported from Canada or Australasia. We sell our export logs to domestic intermediaries who then export the logs. Exchange rates impact the ability of these intermediaries to compete in Asian markets with logs that originate from Canada, Russia, or the Southern Hemisphere. In 2012, the U.S. dollar strengthened against most major currencies. The U.S. dollar strengthening against the Japanese yen and Korean won was not significant enough to affect demand for our logs, owing both to the relatively small fluctuations and to our sales volume into those countries.

Our consolidated revenue in 2012, 2011, and 2010, on a percentage basis by segment, was as follows:

Segment	2012	2011	2010
Fee Timber	84%	92%	89%
Timberland Management & Consulting	—%	—%	—%
Real Estate	16%	8%	11%

Additional segment financial information is presented in Note 11 to the Partnership's Consolidated Financial Statements included with this report.

Outlook

Remaining harvest volume deferred from prior years totaled 32 MMBF as of December 31, 2012 and provides us the flexibility to respond to strength in log markets. In 2013, we expect our harvest level to be between 84–86 MMBF, which includes 35 MMBF from Fund tree farms. Log markets in early 2013 have picked up compared to the demand seen in the fourth quarter of 2012. Trans-Pacific log ship departure levels from the Pacific Northwest, particularly to China, have increased to levels above those of a year ago.

We currently expect improvement in operating results for our Real Estate segment with anticipated closings of properties in 2013, particularly in Gig Harbor.

General & Administrative costs in 2013 are currently expected to be slightly higher than 2012 primarily due to equity compensation costs that are higher due to rising unit prices, and expansion of our insurance programs.

Results of Operations

The following table reconciles net income (loss) attributable to unitholders for the years ended December 31, 2012 to 2011 and 2011 to 2010. In addition to the table's numeric analysis, the explanatory text that follows describes many of these changes by business segment.

Year to Year Comparisons *(in thousands)*	2012 vs. 2011 Total	2011 vs. 2010 Total
Net income (loss) attributable to Pope Resources' unitholders:		
2012 period	$(4,709)	
2011 period	8,754	$8,754
2010 period	—	2,038
Variance	$(13,463)	$6,716
Detail of earnings variance:		
Fee Timber		
Log volumes(A)	$(5,815)	$7,306
Log price realizations(B)	(2,401)	18,076
Stumpage sales	1,026	—
Production costs	674	(9,254)
Depletion	1,739	(6,589)
Other Fee Timber	(269)	(2,343)
Timberland Management & Consulting		
Other Timberland Management & Consulting	(53)	(265)
Real Estate		
Land and conservation easement sales	(351)	554
Sale of land underlying corporate office	2,726	—
Timber depletion on HBU sale	150	(150)
Other Real Estate	(1,752)	158
Environmental remediation accrual	(11,523)	(102)
General & administrative costs	18	543
Debt extinguishment costs	—	1,250
Net interest expense	224	(551)
Taxes	(116)	(526)
Noncontrolling interest	2,260	(1,391)
Total variances	$(13,463)	$6,716

(A) Volume variance calculated by extending change in sales volume by the average log sales price for the comparison period.
(B) Price variance calculated by extending the change in average price realized by current period volume.

Fee Timber

Revenue and Operating Income

Fee Timber results include operations from 113,000 acres of timberland owned by the Partnership and 80,000 acres of timberland owned by the Funds. Fee Timber revenue is earned primarily from the harvest and sale of logs from these timberlands which are located in western Washington, western Oregon, and, when we begin harvesting on the recent Fund III acquisition, northern California. Fee Timber revenue, to a lesser extent, is also derived from the ground leases for cellular communication towers, royalties from gravel mines and quarries, together with the sale of other resources from our timberlands. Our Fee Timber revenue is driven primarily by the volume of timber harvested and the average log price realized on the sale of that harvested timber. Our volume harvested is typically based on manufactured log sales to

customers or exporters. However, during the second quarter of 2012, we sold rights to harvest a defined area of timber (timber deed sale) from the Hood Canal tree farm. In this section of the document, volumes sold and calculations of average price realized during the reporting period exclude the timber deed sale, except where it is called out as included. Harvest volumes are generally expressed in million board feet (MMBF) increments while harvest revenue and related costs are generally expressed in terms of revenue or cost per thousand board feet (MBF). Fee Timber cost of sales, which consist predominantly of harvest, hauling and depletion costs, vary directly and roughly proportionately with harvest volume and the resulting revenues. Revenue and costs related to harvest activities on timberland owned by Funds are consolidated into this discussion of operations.

Revenue and operating income for the Fee Timber segment for each year in the three-year period ended December 31, 2012, are as follows:

	Revenue				
Year Ended *(in millions)*	Log Sale	Mineral, Cell Tower & Other	Total Fee Timber	Operating Income	Harvest Volume (MMBF)
Partnership	**$26.3**	**$2.5**	**$28.8**	**$11.6**	**47.6**
Funds	**16.6**	**0.1**	**16.7**	**0.2**	**32.3**
Total Fee Timber 2012	**$42.9**	**$2.6**	**$45.5**	**$11.8**	**79.9**
Partnership	$29.5	$1.5	$31.0	$13.6	50.7
Funds	21.6	0.1	21.7	3.3	39.5
Total Fee Timber 2011	$51.1	$1.6	$52.7	$16.9	90.2
Partnership	$20.7	$1.6	$22.3	$9.5	42.3
Funds	5.1	0.3	5.4	0.2	10.7
Total Fee Timber 2010	$25.8	$1.9	$27.7	$9.7	53.0

FISCAL YEAR 2012 COMPARED TO 2011. Fee Timber revenue and operating income decreased $7.2 million and $5.1 million, respectively, in 2012 from 2011. The decreases were driven by the combined effect of a 10 MMBF, or 11%, drop in harvest volume from 2011 to 2012 coupled with a $30/MBF, or 5%, decrease in average realized log price. The harvest volume decrease reflects our response to a drop in 2012 log prices from 2011 levels when surging exports to China resulted in price spikes across numerous log sorts. The operating income decrease was accentuated by higher harvest and haul costs across the Combined tree farms, offset in part by a 4.4 MMBF timber deed sale in 2012 which provided $765,000 of operating income. We saw harvest and haul costs rise in 2011 primarily due to high demand for qualified loggers and truckers, many of whom went out of business or converted trucks to haul general freight during the depths of the recent economic downturn. These log and haul cost increases continued in 2012, eroding operating income of both the Partnership and the Funds.

Revenue and operating income for the Funds decreased $5.0 million and $3.1 million, respectively, from 2011 to 2012. A 7 MMBF, or 18%, decline in Fund harvest volume coupled with a $34/MBF, or 6%, decrease in log price were the factors responsible for the decreases. The percentage of Combined harvest coming from Fund properties dropped from 44% in 2011 to 40% in 2012, with the decline resulting from a response to softer export demand and lower prices generally.

FISCAL YEAR 2011 COMPARED TO 2010. Fee Timber revenue and operating income increased $25.0 million and $7.2 million, respectively, in 2011 from 2010. The increases were the result of a 37 MMBF, or 70%, increase in harvest volume from 2010 to 2011 in addition to an $81/MBF, or 17%, increase in average realized log price. The harvest volume increase reflects our response to the improvement in the export market that

began in 2010 and continued through 2011. We harvested 27 MMBF more than the 2011 planned harvest of 63 MMBF in response to stronger export markets, particularly in China. This additional volume was only a portion of the deferred volumes that accumulated during the years 2008–2010 on the Combined tree farms when we held back on harvesting due to very weak markets. The export market to China was the driving force for increases in log prices as the China market purchased logs typically directed to domestic sawmills. The operating income increase was relatively smaller than the revenue increase as a result of a higher proportion of harvest from the Funds and the corresponding higher depletion expenses that come with newly acquired properties. In addition, we experienced increased road maintenance costs, which grew from $812,000, or 21%, of Combined tree farm operating expenses in 2010 to $2.4 million, or 41%, of Combined tree farm operating expenses in 2011 as roads were being prepared for higher levels of future harvest operations.

Revenue and operating income for the Funds increased $16.3 million and $3.1 million, respectively, from 2010 to 2011. A 29 MMBF, or nearly fourfold, increase in harvest volume coupled with a $78/MBF, or 16%, increase in log price were the factors responsible for the increases. The increase in income for the Funds was less dramatic than the increase in revenue would suggest because of the high depletion rates on Fund properties in addition to a $1.1 million increase in road maintenance costs from 2010 to 2011. The percentage of Combined harvest coming from Fund properties more than doubled from 20% in 2010 to 44% in 2011, in response to strong export demand from China and higher log prices generally.

Log Volume

Log volume sold for each year in the three-year period ended December 31, 2012 were as follows:

Volume *(in MMBF)*	**2012**	**% Total**	2011	% Total	2010	% Total
Sawlogs						
Douglas-fir	**51.1**	**64%**	55.2	61%	35.0	66%
Whitewood	**15.4**	**19%**	18.0	20%	7.1	13%
Cedar	**0.8**	**1%**	1.4	1%	0.9	2%
Hardwoods	**2.3**	**3%**	2.4	3%	0.9	2%
Pulpwood						
All Species	**10.2**	**13%**	13.2	15%	9.1	17%
Total	**79.9**	**100%**	90.2	100%	53.0	100%

FISCAL YEAR 2012 COMPARED TO 2011. Harvest volume decreased by 10 MMBF, or 11%, from 2011 to 2012, with 7 MMBF, or 70%, of that decrease attributable to a reduction in Fund harvest. We experienced weaker demand from the China log export market in 2012 relative to 2011. This market softening prompted us to slow the pace of harvest, particularly in the Fund's coastal Oregon hemlock region, which was heavily dependent on the China log export market in 2011. There was very little shift in year-to-date Combined species mix from 2011 to 2012. The most notable shift saw Douglas-fir sawlog volumes increase from 61% in 2011 to 64% in 2012, primarily at the expense of pulpwood volumes, which declined to 13% in 2012 from 15% in 2011.

FISCAL YEAR 2011 COMPARED TO 2010. Harvest volume increased by 37 MMBF, or 70%, from 2010 to 2011 with 29 MMBF, or 77%, of that increase attributable to a boost in Fund harvest. A large percentage of the Funds' previously deferred volume was harvested in 2011 to take advantage of favorable pricing. This elevated the Funds' share of Combined volume mix from 20% in 2010 to 44% in 2011. As described above, the twin decisions to accelerate harvest from both the Partnership's and Funds' tree farms came in response to strong demand from China that took hold during 2010 and continued through 2011. The shift in year-

to-date Combined species mix saw whitewood volume increase from 13% in 2010 to 20% in 2011, primarily at the expense of Douglas-fir volumes, which declined to 61% in 2011 from 66% in 2010. The shift from Doulgas-fir to whitewood can be attributed to the incremental China export demand, which is largely indifferent to species mix. Since the incremental increase in whitewood log prices greatly exceeded the lift in Douglas-fir prices, and we expected that this surge in whitewood prices would be short-lived, we emphasized the harvesting of timber stands with whitewood as the predominant species. This emphasis played well into boosting harvest volumes from the Funds' tree farms where the inventory has a heavier whitewood component. Of particular note, one of the Funds' tree farms is tributary to the new export facility in Astoria, Oregon, which has catered heavily to the China log market. Our cedar and hardwood volumes are minor components of the overall mix and they stayed relatively consistent year over year, while pulpwood saw a slight decline from 2010 to 2011, even as pulpwood prices rose 23% from 2010 to 2011.

Log Prices

Logs from the Combined tree farms serve a number of different domestic and export markets, with domestic mills historically representing our largest market destination. However, this customer mix shifted, in the fourth quarter of 2010 when logs destined for export markets represented the largest share of our total log sales, driven by the China export log market accepting a lower quality product than what has traditionally defined an export log. As a result, significant volumes that theretofore would have been sold to domestic mills instead flowed to the China market beginning with 2010 when our export mix surged to 33% and peaked at 45% in 2011. From 2010 through the third quarter of 2011, the relative strength of the China export market was the driving force for much of our realized log pricing. This dynamic shifted during the fourth quarter of 2011 when oversupply abruptly reduced demand from China. We reacted by shifting a greater proportion of our log supply to domestic mills. In the first quarter of 2012, most of our export volume was comprised of higher-value Douglas-fir logs going to Japan. This mix, however, shifted once again during the second quarter of 2012 with improved domestic lumber demand as a result of higher U.S. housing starts. Additionally, we responded to a new market development with increased sales of high-grade Douglas-fir logs to a limited number of domestic mills capable of cutting high-value Japanese lumber grades. This shift toward domestic customers has continued through the end of 2012 and allowed us to realize equivalent delivered log prices while generating shorter hauls and thus a higher net log realization. Improvement in demand from the domestic market has historically resulted in a compression of spreads between realized export and domestic log prices (hardwood data is excluded from domestic data when calculating export-to-domestic spreads). This pattern held true as we saw the export log premium narrow from $63/MBF, or 11%, in 2011, to $32/MBF, or 6%, in 2012.

We categorize our sawlog volume by species, which is a significant driver of price realized as indicated by the table below. The average log price realized by species for each year in the two-year period ended December 31, 2012 was as follows:

		Fiscal Year						
			Δ from 2011 to 2012			Δ from 2010 to 2011		
		2012	$/MBF	%	2011	$/MBF	%	2010
Sawlogs	Douglas-fir	**$582**	$(27)	(4%)	$609	$81	15%	$528
	Whitewood	**500**	(46)	(8%)	546	100	22%	446
	Cedar	**1,020**	97	11%	923	6	1%	917
	Hardwood	**581**	8	1%	573	71	14%	502
Pulpwood	All Species	**318**	(65)	(17%)	383	72	23%	311
Overall		**537**	(30)	(5%)	567	81	17%	486

The 2012 average log price decreased $30/MBF, or 5%, from the 2011 average log price. This was due primarily to a $37/MBF, or 6%, year-over-year decrease in export price (blended for Douglas-fir and whitewood) in addition to a $65/MBF, or 17%, decrease in pulpwood prices.

The 2011 average log price increased $81/MBF, or 17%, over the 2010 average log price. This was principally due to a $102/MBF, or 19%, year-over-year increase in export price in addition to a $100/MBF, or 22%, increase in whitewood prices, and a $72/MBF, or 23%, increase in pulpwood prices. We targeted some stands with a heavier mix of pulpwood during 2011 to take advantage of this uptick in price which was driven by short supplies of residual chips due to a decline in lumber produced from domestic sawmills.

DOUGLAS-FIR: Douglas-fir is noted for structural characteristics that make it generally preferable to other softwoods and hardwoods for the production of construction grade lumber and plywood. Demand and price for Douglas-fir sawlogs have historically been very dependent upon the level of new home construction in the U.S. The direct link between Douglas-fir sawlog prices and domestic housing starts was pronounced with the housing crash in 2008. The effect of the continued weak domestic housing market was offset in 2011 by strong demand from the export market in China. There was softening in the export market to China during 2012, which along with a moderately stronger domestic housing market, narrowed the differential between export prices and rising domestic Douglas-fir prices. In reaction to this, much of the Douglas-fir volume was re-directed to the domestic market at lower prices but reduced haul costs, resulting in a higher net realization. This shift in end-market destination resulted in a $27, or 4%, decline in Douglas-fir log prices realized from 2011 to 2012.

This decline in Douglas-fir log pricing in 2012 relative to 2011 is not that dramatic a price swing when compared to the $81/MBF, or 15%, increase in Douglas-fir prices from 2010 to 2011 due to strong export markets to China. Douglas-fir sawlogs prices rallied in early 2010 from the lows of 2008 and 2009 with participants in the domestic lumber supply chain increasing demand for logs in response to declining finished product inventories. This increase in domestic demand coincided with an increase in export market demand from China, and to a lesser extent Japan.

WHITEWOOD: "Whitewood" is a term used to describe several softwood species, but for us primarily refers to western hemlock. Though generally considered to be of a lower quality than Douglas-fir, these logs are also used for manufacturing construction grade lumber. Historically, there has been a modest export market for whitewood logs, with most of this volume going to Korea. This changed beginning in 2010 as the China log export market demonstrated an appetite for softwood logs with little apparent regard or discrimination as to species. Beginning in late 2010 through early 2011, weather conditions permitting, we harvested a heavier mix of predominantly whitewood stands to take advantage of the higher relative price lift resulting from surging species-indiscriminant export demand. This strategy benefitted the Funds' tree farms more than the Partnership tree farms because the former contain a higher proportion of whitewood, while the Partnership's whitewood stands tend to be at higher elevations and not easily accessible during winter. In 2011, whitewood prices increased $100/MBF, or 22%, from 2010 due to the export demand for this species. However, substantial pullback in the China market in 2012 served to bring whitewood prices down $46/MBF, or 8%, between 2011 and 2012

CEDAR: Cedar is a minor component in most upland timber stands and is generally used for outdoor applications such as fencing, siding and decking. Although there is a link between demand for these products and housing starts, this link is not as strong as with most other softwood species. Cedar prices increased $97/MBF, or 11%, from 2011 to 2012 in response to a small spike in demand from buyers. Cedar prices remained flat from 2010 to 2011, increasing $6/MBF, or 1%.

HARDWOOD: "Hardwood" can refer to many different species, but on our tree farms, hardwood stands primarily consist of red alder and to a lesser degree bigleaf maple. The local mills that process red alder sawlogs are using the resource to manufacture lumber for use in furniture and cabinet construction. In the

industrial forest sector, little red alder is grown intentionally as a crop tree. Instead, most red alder, and cedar as well, is invasive in otherwise managed conifer stands and is a small incidental component of the commercial species mix. In down-market cycles, users of these secondary species may have relatively better markets for their product than the conifer users, but very short log supply due to the curtailment of conifer log production generally. The result of this dynamic can be countercyclical price spikes for these minor species. Hardwood prices have experienced a gradual increase over the past several years, from $502 in 2010 up to $581 in 2012, with peaks and dips in between. This increasing price trend is due to gradually tightening supply as naturally occurring stands are converted to conifer and better silvicultural practices reduce the invasion of minor species in managed stands. Hardwood prices rose slightly from 2011 to 2012, increasing $8/MBF, or 1%. This modest increase was on top of a $71/MBF, or 14%, year-over-year increase from 2010 to 2011.

PULPWOOD: Pulpwood is a lower quality conifer or hardwood log, unsuitable for the manufacture of lumber, which has value when manufactured into wood chips that are sold to the pulp and paper industry. Sawmills typically provide the bulk of the wood chips used by pulp mills, as they are a low-cost residual by-product from the manufacture of lumber, requiring minimal incremental manufacturing cost and handling. The pulpwood log market has enjoyed relative strength in recent years as a direct result of sawmills taking significant downtime in response to the slowdown in housing starts, thus depriving pulp mills of their traditionally preferred, lowest cost source of raw material. This resulted in a $72/MBF, or 23%, increase in pulpwood prices from 2010 to 2011. However, the closure of a major regional pulp mill in 2012 served to weaken demand and create excess pulpwood inventory. In addition, a gradual increase in sawmill production has helped to push down the demand for, and thus the price of, pulpwood logs sold directly to pulp mills as a primary alternative raw material source. Pulpwood prices were down $65/MBF, or 17%, from 2011 to 2012.

Customers

The oversupply of Pacific Northwest logs in China in late 2011 and early 2012 coupled with an increase in freight costs has slowed demand and decreased pricing to the export markets in China and Korea. As a result, we shifted a greater proportion of our production to domestic mills, which have enjoyed stronger lumber markets as housing starts have improved and, to a lesser extent, found spot markets in Japan for finished lumber.

The ultimate decision on where to sell logs is based on the net proceeds we receive after considering both the delivered log prices from a prospective customer and the hauling cost needed to get logs to that customer. In instances where harvest operations are in close proximity to a mill relative to the export yard of a broker, we may take advantage of a favorable haul cost differential over selling to an export customer at a higher delivered price. The higher net delivered log value earned by selling to the domestic mill will, in such instances, result in sales of logs otherwise intended for Asia being diverted to domestic markets. As such, realized log price movements are influenced by marketing decisions predicated on a net return mentality rather than exclusively focusing on the delivered log price.

Annual harvest volume and average price paid each year in the three-year period ended December 31, 2012 was as follows:

	2012			2011			2010		
Destination	Volume	%	Price	Volume	%	Price	Volume	%	Price
Export brokers	**20.2**	**25%**	**$591**	40.6	45%	$628	17.7	33%	$526
Domestic mills	**49.5**	**62%**	**560**	36.4	40%	565	26.2	50%	520
Pulpwood	**10.2**	**13%**	**318**	13.2	15%	383	9.1	17%	311
Total	**79.9**	**100%**	**$537**	90.2	100%	$567	53.0	100%	$486

FISCAL YEAR 2012 COMPARED TO 2011. Export brokers purchased 25% of total year-to-date volume compared to 45% during the same period in 2011. The loss of volume was made up entirely by the domestic mills that purchased 62% of the 2012 volume versus 40% of the 2011 volume. This swing in product destination was due principally to a weaker China export log market with far less demand in 2012 compared to 2011, which in turn resulted in a $30/MBF, or 5%, decline in prices paid. Notwithstanding gradually improving housing starts and some spot markets for lumber bound for export markets that provided much needed life support to domestic mills, domestic log prices remained flat, losing $5/MBF, or 1%, from 2011 to 2012. Closure of a regional pulp mill and added lumber production served to bring down pulpwood volume 2% from 15% of the product mix in 2011 to 13% of the product mix in 2012. Pulpwood prices also lost $65/MBF, or 17%, between 2011 and 2012.

FISCAL YEAR 2011 COMPARED TO 2010. Export brokers purchased 45% of total 2011 volume compared to 33% during the same period in 2010. In addition, export brokers increased the price they paid by $102/MBF, or 19%, on a year-over-year basis. Nearly all of this increase in volume came at the expense of domestic mills, which purchased 40% of our mix in 2011 compared to 50% in 2010. Notwithstanding the loss in total volume purchased, domestic mills increased prices paid by $45/MBF, or 9%, in an effort to compete with export brokers for logs being sold to the export market. Pulpwood buyers saw a slight decline in logs sold in 2011 compared to the same period in 2010, notwithstanding a $72/MBF, or 23% price increase during the same period. This price increase reflects higher pulp mill demand for whole log chips resulting from sawmill production curtailments.

Harvest Volumes and Seasonality

The Partnership owns 113,000 acres of timberland in western Washington and the Funds own 80,000 acres of timberland in western Washington, western Oregon, and northern California. We are able to conduct year-round harvest activities on the Partnership's Hood Canal tree farm and on 12,000 acres of the Funds' properties because these properties are concentrated at low elevations. In contrast, the Partnership's Columbia tree farm and the 68,000-acre balance of Fund properties are at a higher elevation where harvest activities are generally not possible during the winter months when snow precludes access to the lands. Generally, we concentrate our harvests from the Hood Canal tree farm in those months when weather limits operations on other properties, thus taking advantage of reduced competition for log supply to our customers and improving prices realized. As such, when these various tree farms are combined, we can operate so that the pattern of quarterly volumes harvested is flatter than would be the case if looking at one tree farm in isolation.

The percentage of annual harvest volume by quarter for each year in the three-year period ended December 31, 2012 was as follows:

Year Ended	Q1	Q2	Q3	Q4
2012	**18%**	**38%**	**21%**	**23%**
2011	34%	21%	13%	32%
2010	22%	27%	30%	21%

Harvest activities in early 2012 were approached with caution due to lukewarm demand from the China market during the first quarter of the year and relatively high inventories at domestic customers' log yards resulting from the heavy Q4 2011 production. The second quarter harvest reflects a seasonal bump in spring harvest that was more pronounced this year due to withholding volume during the first quarter and a decision to advance some of the third quarter volume to take advantage of favorable pricing. This resulted in slightly lower third quarter harvest volume, a level we maintained during fourth quarter due to favorable log prices.

We entered 2011 with momentum from the burgeoning Chinese export market that began in earnest in the second half of 2010. As the first quarter progressed, we moved quickly to further ramp up harvest activity to meet the demand from our export customers. We were poised for a seasonal second quarter slow-down that did not come to fruition until the third quarter. We experienced another spike in demand during the final quarter of the year, wherein we cut nearly a third of the annual volume in response to that demand.

We entered 2010 with a plan to defer harvest volume in response to our expectation of continued weakness in log markets resulting from a slowdown in housing. That plan called for no harvest from the Funds. However, as the year progressed and export and domestic markets showed improvement, we gradually increased harvest volume commensurate with the increase in demand, which for us hit its peak in the third quarter. By the third quarter of 2010, we had gained confidence in the impact of the China log market and added volume to meet the surges in export and domestic demand.

The following factors enhance our flexibility in responding to fluctuating markets, whether these fluctuations are seasonally driven or not: we do not own any mills or processing facilities that require a minimum volume; low focus on quarterly earnings fluctuations and our practice of permitting excess harvest units across various species so that we have a ready pool of potential harvest units to draw on for expanded market demand.

Cost of Sales

Cost of sales for the Fee Timber segment consists of harvest, haul, and harvest excise tax costs along with depletion expense. These costs all vary directly with harvest volume. Harvest costs will vary by terrain, with steeper slopes requiring more expensive cable systems with a high labor component, while more moderate slopes can be harvested with mechanized equipment and lower relative costs. Harvest and haul costs represent the direct cost incurred to convert trees into logs and deliver those logs to the point of sale. Harvest excise tax costs in Washington State consist of a 5% tax on the net stumpage value, as determined by the State using an estimation of historical stumpage values. Oregon currently charges a harvest excise tax based on harvest volume with a rate of approximately $4/MBF.

Depletion expense represents the cost of acquiring and growing the harvested timber. Depletion expense is generated from the harvest and sale of timber and periodically from Real Estate sales when land is sold with standing timber. Depletion expense generated from Real Estate sales is typically de minimis and is excluded from the Fee Timber depletion analysis.

The applicable depletion rate is derived by dividing the aggregate cost of merchantable stands of timber (age 35 and older), together with capitalized road expenditures, by the estimated volume of merchantable timber available for harvest at the beginning of that year. The depletion rate, so derived and expressed in per MBF terms, is then multiplied by the volume harvested in a given period to calculate depletion expense for that period as follows:

$$\text{Depletion rate} = \frac{\text{Accumulated cost of timber and capitalized road expenditures}}{\text{Estimated volume of 35-years-and-older merchantable timber}}$$

Because of the relatively recent acquisition dates of the Fund tree farms, and thus relatively higher acquisition costs, the depletion rates associated with harvests from those properties are considerably higher than for harvests from the Partnership's tree farms. Partnership depletion consists primarily of historical timber cost that has been owned by the Partnership for many decades, as well as the Columbia tree farm property that was acquired in 2001.

Each year, the depletion rate is adjusted to account for "layers" of harvest volume exiting the pool and new "layers" of 35-year-old timber volume and cost entering the pool. The depletion rate is then applied to future volume harvested for the coming year to calculate depletion expense for that period.

Fee Timber cost of sales for each year in the three-year period ended December 31, 2012 was as follows:

Year Ended *($ in millions)*	Harvest, Haul and Other	Depletion*	Total Cost of Sales	Harvest Volume (MMBF)
2012	**$17.6**	**$10.0**	**$27.6**	**84.3**
2011	17.8	11.8	29.6	90.2
2010	8.9	5.2	14.1	53.0

*2012 calculation includes 4.4 MMBF from timber deed sale

Cost of sales declined $2.0 million, or 6.7%, from 2011 to 2012 principally as a result of a $1.8 million decline in depletion expense. The decline in depletion expense is a result of an 11% reduction in Combined harvest volume coupled with a shift away from harvest from Funds tree farms, which carry a higher per unit depletion rate, offset by the depletion expense from the 4.4 MMBF timber deed sale. The Partnership tree farms have a lower historic cost and attendant depletion rate, while the Funds' tree farms have a higher depletion rate reflective of a more recent and higher cost basis. In 2012, harvest volumes, including the 4.4 MMBF timber deed sale, were weighted 62% and 38% from Partnership and Fund tree farms, respectively. In 2011, volumes were weighted 56% and 44% from Partnership and Funds, respectively.

Cost of sales more than doubled from 2010 to 2011 primarily as a result of a 70% increase in Combined harvest volume. The increase in costs was compounded by a shift in harvest volume away from the Partnership tree farms that carry a lower historic cost and attendant depletion rate, to include more volume from Fund tree farms that carry a higher depletion rate reflective of more recent acquisition and higher cost basis. In 2011, volumes were weighted 56% and 44% from Partnership and Fund tree farms, respectively. In 2010, harvest volumes were weighted 80% and 20% from Partnership and Fund tree farms, respectively. Harvest, haul, and other costs were also higher in 2011 over 2010 as we included several units in operations that required higher cost cable logging and contractors were successful in negotiating higher prices for their services.

Fee Timber cost of sales, expressed on a per MBF basis for each year in the three-year period ended December 31, 2012, was as follows:

Year Ended *($ in millions)*	Harvest, Haul and Other	Depletion*	Total Cost of Sales
2012	**$226**	**$119**	**$345**
2011	203	130	333
2010	167	98	265

*2012 calculation includes 4.4 MMBF from timber deed sale

Costs of sales per MBF increased $12/MBF in 2012 over 2011 with the increase due entirely to increased harvest-and-haul costs offset by a decline in depletion expense. The per MBF increase in harvest, haul and other reflects increases in harvest from units requiring higher cost cable logging accentuated by competition to hire and retain scarce logging contractors. Cable logging costs in particular experienced a sharp increase in 2011 when demand for experienced contractors exceeded contractor capacity, allowing contractors to demand higher prices for their services that carried over into 2012. Haul costs were also up slightly due to a shrinking contract trucking pool and longer haul distances.

Depletion expense decreased $11/MBF, or 8%, in 2012 compared to 2011. This is attributable to a significant shift in the relative harvest away from Fund tree farms between 2011 and 2012. The Funds' share of the Combined harvest total was 38% in 2012 compared to 44% in 2011.

Costs of sales per MBF increased $68/MBF in 2011 over 2010 with the increase split about evenly between harvest-and-haul costs and depletion expense. As described earlier, cable logging costs were negatively affected by a shortage of contractors in the wake of the industry-wide slowdown of 2008–2010 in which numerous contractors went out of business. During the same 2008–2010 period, many log trucks were converted by their owners to highway freight hauling configuration, creating a shortage of log trucks and thus resulting in slightly higher haul costs when harvest activity rebounded in 2011.

Depletion expense increased $32/MBF, or 33%, in 2011 compared to 2010. This is attributable to a significant increase in the relative harvest from the Funds' tree farms from 2010 to 2011. The Funds' share of the Combined harvest total was 44% in 2011 compared to 20% in 2010.

We use a pooled depletion rate for volume harvested from the Partnership's tree farms that divides the combined book basis of the merchantable timber for both tree farms by the combined merchantable volume for both tree farms. On the other hand, for the Funds we calculate separate depletion rates for each of the six Fund tree farms and then present them for this report in terms of a blended aggregate rate. Depletion expense resulting from timber harvest for each year in the three-year period ended December 31, 2012 was made up of the following:

Year Ended December 31, 2012	Partnership*		Funds		Combined*
Volume harvested (MMBF)	**52.0**	**62%**	**32.3**	**38%**	**84.3**
Rate/MBF	**$59**		**$215**		**$119**
Depletion expense (in thousands)	**$3,083**		**$6,936**		**$10,019**

Year Ended December 31, 2011	Partnership*		Funds		Combined*
Volume harvested (MMBF)	50.7	56%	39.5	44%	90.2
Rate/MBF	$63		$217		$130
Depletion expense (in thousands)	$3,171		$8,587		$11,758

Year Ended December 31, 2010	Partnership*		Funds		Combined*
Volume harvested (MMBF)	42.3	80%	10.7	20%	53.0
Rate/MBF	$62		$236		$98
Depletion expense (in thousands)	$2,640		$2,529		$5,169

*Volume includes 4.4 MMBF from timber deed sale

Operating Expenses

Operating expenses for Fee Timber include management, silviculture and the cost of both maintaining existing roads and building temporary roads required for harvest activities for the 113,000 acres owned by the Partnership and the 80,000 acres owned by the Funds. Operating expenses for the Fee Timber segment declined 3% in 2012 to $6.1 million from $6.3 million in 2011 primarily due to the reduction in road building and maintenance costs which spiked during 2011 to support higher harvest activity. Operating expenses for the Fee Timber segment increased 60% in 2011 to $6.3 million from $3.9 million in 2010. The increase in 2011 expenses over the prior year is attributable to increased road building and maintenance costs to facilitate an increase in harvest levels and to prepare roads for future harvest on newly acquired

Timber Fund lands. Combined road maintenance costs for 2011 were $2.4 million, compared to $812,000 in 2010, or 38% and 21%, respectively, of Combined operating expenses for the two years.

Timberland Management & Consulting

Revenue and Operating Income

The Timberland Management & Consulting (TM&C) segment primarily develops timberland investment portfolios on behalf of the Funds. As of December 31, 2012, the TM&C segment managed three private equity timber funds representing $195 million of acquired commercial timberlands with an appraised value of $231 million. Equity capital in the Funds includes a co-investment by the Partnership in addition to third-party capital. As of December 31, 2012, we have remaining committed capital of $134 million for Fund III, which includes $7 million of remaining commitment on our $9 million co-investment.

See Accounting Matters—Critical Accounting Policies and Estimates—Timber Fund Management Fees for more information on accounting for management fees paid by third-party investors.

Revenue and expense generated through the management of the Funds is accounted for within the TM&C segment. Accounting guidance requires us to consolidate the Funds' into our financial statements because of the governance control the Partnership is deemed to have over the Funds. As such, all fees associated with managing the Funds are eliminated in our consolidated financial statements. The revenue generated from management of these Funds represents an expense to the Fee Timber segment which is also eliminated when the Funds are consolidated into the Partnership's financial statements. The portion of those fees paid by third-party investors is added back to income in the Partnership's consolidated statements of comprehensive income (loss) as a component of the caption "Net (income) loss attributable to noncontrolling interests—ORM Timber Funds".

The Partnership owns 20% of Funds I and II and 5% of Fund III. As a result, in a look-through sense, 80% of Funds I and II and 95% of Fund III management fees are paid by third parties. We generated a total of $2.2 million, $2.4 million, and $1.5 million of management fee revenue in 2012, 2011, and 2010, respectively. At the close of 2012, the TM&C segment was managing 80,000 acres for the Funds compared with 61,000 acres at the end of both 2011 and 2010. Revenue and operating income for the TM&C segment for each year in the three-year period ended December 31, 2012, were as follows:

Year Ended December 31, *(in millions)*	**2012**	2011	2010
Revenue internal	**$2.2**	$2.4	$1.5
Intersegment eliminations	**(2.2)**	(2.4)	(1.5)
Revenue external	**$0.0**	$0.0	$0.0
Operating income—internal	**$0.1**	$0.4	$0.0
Intersegment eliminations	**(1.7)**	(1.9)	(1.3)
Operating loss—external	**$(1.6)**	$(1.5)	$(1.3)
Fund harvest volume (in MMBF)	**32.3**	39.5	10.7

FISCAL YEAR 2012 COMPARED TO 2011. TM&C had $7,500 in consulting fee revenue in 2012 compared with no revenue in 2011 after elimination of $2.2 million and $2.4 million of fees in 2012 and 2011, respectively. The reduction in harvest volume resulted in a decline in management fees earned in 2012 from 2011.

FISCAL YEAR 2011 COMPARED TO 2010. TM&C had no revenue to report in either 2011 or 2010 after elimination of $2.4 million and $1.5 million of fees, respectively. The addition of approximately 25,000 acres under management for Fund II in the fall of 2010 is the primary reason for the increase in revenue eliminated in 2011 over 2010.

Operating Expenses

FISCAL YEAR 2012 COMPARED TO 2011. TM&C operating expenses increased $60,000 in 2012 over the same period in 2011. The increase in operating expense is due primarily to expenses incurred in connection with raising capital and evaluating potential acquisition targets.

FISCAL YEAR 2011 COMPARED TO 2010. TM&C operating expenses increased $234,000 in 2011 over the same period in 2010. The increase in operating expense results from increased costs in connection with higher harvest levels in the Funds, higher personnel related expenses with fund oversight, and administrative costs incurred prior to raising capital for Fund III.

Real Estate

Revenue and Operating Income

The Partnership's Real Estate segment consists primarily of revenue from the sale of land within its 2,900-acre portfolio, sales of development rights, known as conservation easements (CE's), tracts from the Partnership's timberland portfolio, and residential and commercial rents from our Port Gamble and Poulsbo properties. The Partnership's Real Estate holdings are located primarily in the Washington counties of Pierce, Kitsap, and Jefferson with sales of land for this segment typically falling into one of the three general types:

- Commercial, business park, and residential plat land sales represent land sold after development rights have been obtained and generally are sold with prescribed infrastructure improvements.
- Rural residential lot sales that generally require some capital improvements such as zoning, road building, or utility access improvements prior to completing the sale.
- The sale of unimproved land, which generally consists of larger acreage sales rather than single lot sales, and is normally completed with very little capital investment prior to sale and may or may not have a conservation flavor.

In addition to outright sales of fee simple interests in land, such as those three categories enumerated above, we also enter into conservation easement sales that allow us to retain harvesting rights and other timberland management rights, but bar any future subdivision of or real estate development on the property.

As indicated above, conservation sales take two primary forms for us, either a conservation easement sale that extinguishes future development rights on a parcel of timberland but retains the ability to conduct forestry operations or an outright fee simple sale to a conservation entity. In 2012, we sold development rights on nearly 1,900 acres of our Columbia tree farm. In 2011, conservation sales reflected an outright sale of fee simple interest in a 386-acre conservation tract to The Nature Conservancy as well as a sale of development rights on 255 acres to the state of Washington, with assistance from Forterra, previously called Cascade Land Conservancy. In the case of the 386-acre sale to The Nature Conservancy, the Partnership retained no interest in or harvesting rights to the property post-sale. On the other hand, the 255-acre sale of development rights allows us to retain harvesting rights and other timberland management rights, but bars any future subdivision of or real estate development on the property. In 2010, we closed on a sale of development rights that similarly prohibits future development or subdivision activities but permits continuing management of the tracts as timberland, including harvesting of timber. The 2010 development rights sale encumbered 6,886 acres of the Columbia tree farm.

Results from Real Estate operations are expected to vary significantly from year to year as we make multi-year investments in entitlements and infrastructure prior to selling entitled or developed land. In 2012, we reclassified certain costs related to rental revenue. As such, prior period amounts were also reclassified from operating expense to cost of sales to maintain consistency in reporting. Real Estate segment revenue for each year in the three-year period ended December 31, 2012 consisted of the following components:

Description *(in thousands except acres)*	Revenue	Gross Margin	Gross Margin %	Operating Loss	Per Acre Amounts: Acres	Per Acre Amounts: Revenue	Per Acre Amounts: Gross Margin
Land underlying corporate office	$2,900	$2,726			2	$1,450,000	$1,363,000
Development rights (CE)	1,235	985			1,852	667	532
Gig Harbor Residential^	1,553	524			12	129,380	43,667
Unimproved land	1,511	966			444	3,403	2,175
Total land	$7,199	$5,201	72%		2,310	3,116	2,251
Rentals	1,287	50					
Other	11	11					
2012 Total	**$8,497**	**$5,262**	62%	$(11,099)*			
Development rights (CE)	$480	$414			255	$1,882	$1,624
Conservation sale	1,955	1,713			386	5,065	4,438
Unimproved land	417	347			102	4,088	3,402
Residential	484	342			5	96,800	68,400
Total land	$3,336	$2,816	84%		748	4,460	3,765
Rentals	1,195	134					
Other	14	14					
2011 Total	$4,545	$2,964	65%	$(349)**			
Conservation easement	$2,400	$2,244			6,886	$349	$326
Total land	$2,400	$2,244	94%		6,886	349	326
Rentals	1,013	73					
Other	74	70					
2010 Total	$3,487	$2,387	68%	$(829)***			

^Revenue recognized on % complete basis
*Includes $12.5 MM of environmental remediation expense
**Includes $977,000 of environmental remediation expense
***Includes $875,000 of environmental remediation expense

FISCAL YEAR 2012 COMPARED TO 2011. Sales for the Real estate segment in 2012 include the sale of two acres underlying our Poulsbo headquarters building, a sale of development rights on 1,852 acres of our Columbia tree farm for $1.2 million, partial recognition of revenue in connection with a $3.3 million sale of an 11.5-acre multi-family residential land parcel from our Harbor Hill project in Gig Harbor, and four rural land sales totaling $1.5 million for 444 acres. This compares to 2011 when we had one sale of development rights, a fee simple sale to The Nature Conservancy, four unimproved lands sales, the sale of a building on two acres we owned in north Seattle, and one residential lot in Kitsap County.

Operating loss increased $10.8 million from $349,000 in 2011 to $11.1 million in 2012 due to an $11.5 million increase in environmental remediation accruals over the same period in 2011. Notwithstanding the increase

in environmental remediation accruals, operating results improved from 2011 to 2012 due to increased revenue and margin as described earlier.

FISCAL YEAR 2011 COMPARED TO 2010. Real estate transactions in 2011 included a CE sale to the state of Washington funded by Forterra, a fee simple sale of conservation land to The Nature Conservancy, four unimproved land sales, the sale of a building on two acres we owned in north Seattle, and one residential lot in Kitsap County. We benefitted from an increase in real estate activity in 2011 over 2010, when we only closed a single land transaction—a CE sale. Even though we saw an increase in the number of transactions and total revenue from 2010 to 2011, we experienced a slight decline in gross margin as a percent of sales revenue on land sales from 94% in 2010 to 84% in 2011. This gross margin as a percent of sales erosion is primarily attributable to increased professional costs incurred in connection with some of the 2011 transactions.

Operating loss declined $480,000 from $829,000 in 2010 to $349,000 in 2011 due to a $1.1 million increase in revenue offset by $360,000 increase in costs of sales, a $136,000 increase in operating expenses due to an increase in maintenance expenses related to our residential and commercial properties which had been deferred in prior years, and a $102,000 increase in environmental remediation charge over the same period in 2010.

Cost of Sales

Real Estate cost of sales for each of the three years ended December 31, 2012, 2011, and 2010 was $3.2 million, $1.6 million, and $1.1 million, respectively, with these amounts comprised of land basis, legal, other closing costs, and costs incurred in the generation of rental revenue. CE sales, unlike fee simple sales which include land basis in cost of sales, typically have little or no cost basis written off as part of the transaction. Cost of sales doubled from 2011 to 2012 due primarily to 87% increase in sales revenue. Cost of sales increased 44% from 2010 to 2011 due to a 30% increase in revenue.

Operating Expenses

Real Estate operating expenses for each of the three years ended December 31, 2012, 2011, and 2010 were $16.4 million, $3.3 million, and $3.2 million, respectively. Operating expenses significantly increased in 2012, primarily as a result of $12.5 million in environmental remediation charges in addition to expenses incurred in connection with the submission of the Port Gamble master plan and depreciation expense related to the retirement of our previous corporate headquarters. Operating expenses in 2012, excluding $12.5 million in environmental remediation charges, increased $1.5 million over 2011, excluding $977,000 in environmental remediation charges in that year. Operating expenses, excluding environmental remediation charges of $875,000 in 2010 and $977,000 in 2011, were mostly flat, decreasing $5,000.

Basis in Real Estate Projects

"Land Held for Development" on our Balance Sheet represents the Partnership's cost basis in land that has been identified as having greater value as development property rather than as timberland. Our Real Estate segment personnel work with local officials to establish entitlements for further development of these parcels. Project costs that are clearly associated with development or construction of a real estate project are capitalized once entitlement has been obtained.

When facts and circumstances indicate that the carrying value of properties may be impaired, an evaluation of recoverability is performed by comparing the currently recorded carrying value of such property or properties to the projected future undiscounted cash flows of the same property or properties. If it is determined that the carrying value of such assets may not be fully recoverable, we would recognize an

impairment loss, adjusting for the difference between the carrying value and fair market value, and would recognize an expense in this amount against current operations. We have continuously owned most of our land for decades. As a result, the land basis associated with most of our development properties is well below even the off-cycle-peak market values prevalent today. As such, we do not anticipate an asset impairment charge on any of our development projects.

Those properties that are for sale, under contract, and those for which the Partnership has an expectation they will sell within the next 12 months, are classified on our balance sheet as a current asset under "Building and Land Held for Sale". The $1.2 million amount currently in Land Held for Sale reflects our expectation that we will have completed our post-closing obligations related to the December 2012 sale of the multi-family parcel from our Harbor Hill project and this will trigger recognition of revenue currently recorded under "Deferred revenue" in the liability section of our balance sheet.

Environmental Remediation

The Partnership has an accrual for estimated environmental remediation costs of $13.9 million and $2.2 million as of December 31, 2012 and 2011, respectively. The environmental remediation liability represents estimated payments to be made to monitor and remedy certain areas in and around the townsite/millsite of Port Gamble, and at Port Ludlow, Washington.

In the second quarter of 2012, we accrued an additional $12.5 million for Port Gamble environmental liabilities to have an estimated accrual of $14.3 million as of June 30, 2012. This additional accrual is derived prior to the conclusion of negotiations with the Department of Ecology (DOE), but was the result of significant modifications to the draft Port Gamble Baywide and Millsite Remedial Investigation (RI) and Feasibility Study (FS) issued by the DOE in May 2012. From mid-August through the end of December and into 2013, we have been in regular dialogue with DOE Clean-up Action Plan (CAP), coincident with a consent decree that outlines clean-up actions, natural resource damage (NRD) remediation, and potential property sales of land around Gamble Bay by Pope Resources. A short list of unresolved issues remain, principally related to the treatment of existing docks in the southern embayment around the millsite and the degree to which the DNR, the other potentially liable party (PLP) in Port Gamble, is going to participate in funding the costs of clean-up and NRD remediation.

In developing its estimate of the Port Gamble environmental liability, management has employed a Monte Carlo statistical simulation model that suggests a potential aggregate range of clean-up costs from $11.5 million to $16.1 million which corresponds to a two standard deviation range from the mean of possible outcomes.

The environmental remediation accrual also includes estimated costs related to a separate remediation effort within the resort community of Port Ludlow. Early in 2012, soil vapor extraction (SVE) pilot tests were conducted in Port Ludlow with this round of testing producing somewhat inconclusive results regarding the efficacy of SVE as a remediation technique. Over the balance of 2012, representatives of Port Ludlow Associates (PLA) and the Partnership have been in dialogue, along with our respective consultants, to discuss these results and next steps.

The environmental liability at December 31, 2012 is comprised of $750,000 that the Partnership expects to expend in the next 12 months and $13.2 million thereafter. The liability recorded by the Company as of December 31, 2012 is based on the 50th percentile within the range, which management considers to be

their best estimate of the most likely outcome. Activity in the environmental remediation liability is detailed as follows:

Year Ended December 31, *(in thousands)*	Balances at the Beginning of the Year	Additions to Accrual	Expenditures for Remediation	Balance at Year-end
2012	$2,203	$12,500	$761	$13,942
2011	1,933	977	707	2,203
2010	1,269	875	211	1,933

General & Administrative (G&A)

FISCAL YEAR 2012 COMPARED TO 2011. G&A costs were $4.2 million in both 2012 and 2011, with some cost categories up between periods but other offsetting categories down.

FISCAL YEAR 2011 COMPARED TO 2010. G&A costs were $4.2 million in 2011 compared to $4.7 million in 2010. The decline is primarily attributable to development and adoption of a new incentive compensation plan first recorded in 2010 that required a catch-up accrual for multi-year performance cycles and the professional fees incurred in connection with the new plan. Professional and legal service fees were also down between 2010 and 2011 by $450,000. Partially offsetting these cost declines, we experienced a slight increase in taxes on management fees and in necessary repairs made to the corporate building in early 2011.

Interest Income and Expense

Interest income declined from $42,000 in 2011 to $26,000 in 2012 on top of a decrease from $102,000 in 2010. The progressively lower amounts of interest income from 2010 through 2012 are due primarily to lower cash and investment balances coupled with a decrease in average interest earned on the portfolio.

Interest expense, net of interest capitalized to development projects, was $1.5 million in 2012 compared with $1.7 million in 2011 and $1.2 million in 2010. The decline from 2011 to 2012 was due to a decline in weighted average borrowings on the operating line of credit coupled with an increase in interest capitalized to the Harbor Hill project. The increase in interest expense, net of interest capitalized, from 2010 to 2011 was due to a full year of interest on the Fund II mortgage coupled with an increase in interest expense related to higher amounts borrowed on the operating line of credit in 2011 over 2010.

The debt arrangement between the Partnership and Northwest Farm Credit Services (NWFCS) includes an annual rebate of a portion of interest expense paid in the prior year (patronage). This NWFCS patronage program is a feature common to most of this lender's customer loan agreements. The patronage receivable reduced interest expense by $214,000 and $239,000 in 2012 and 2011, respectively.

Debt Extinguishment Costs

In April 2010, we paid off an $18.6 million mortgage with a 7.63% fixed interest rate, one year ahead of its scheduled maturity. The early retirement of this debt resulted in a $1.2 million debt extinguishment charge. The decision to refinance was motivated by the opportunity to reduce cash used for both principal and interest payments, lower borrowing costs, and spread out future refinance risk across a number of years. The early debt extinguishment costs were funded by using new term loans from Northwest Farm Credit Services (NWFCS).

Income Taxes

Pope Resources is a limited partnership and is, therefore, not subject to income tax. Instead, taxable income/loss flows through and is reported to unitholders each year on a Form K-1 for inclusion in each unitholder's tax return. Pope Resources does, however, have corporate subsidiaries that are subject to income tax. The corporate tax-paying entities are utilized for our third-party service fee businesses.

FISCAL YEAR 2012 COMPARED TO 2011. We recorded tax expense of $352,000 and $236,000 in 2012 and 2011, respectively, based on taxable income in corporate subsidiaries and certain discrete items. The increase in 2012 is due primarily to less tax depreciation available for deductions than in the prior year.

FISCAL YEAR 2011 COMPARED TO 2010. We recorded tax expense of $236,000 in 2011 compared to a tax benefit of $290,000 in 2010. The tax expense results from income in the taxable corporate subsidiaries in 2011 as a result of an increase in income from management fees earned.

Noncontrolling Interests—ORM Timber Funds

Noncontrolling interests—ORM Timber Funds represented the portion of 2012, 2011, and 2010 net (income) losses of the Funds attributable to third-party owners of the Funds. The Funds carry a higher depletion cost than the Partnership's timberland and as a result often generate losses during the early years of the Fund life. Included in these results are the management fees charged by ORM LLC to the Funds. The portion of the loss or (income) attributable to these third-party investors is added back to determine "Net income (loss) attributable to Partnership unitholders" as follows:

(in thousands)

Noncontrolling interest—2012	Fund I	Fund II	Fund III	Total
Management fees paid to ORM LLC	$(804)	$(1,321)	$(86)*	$(2,211)
Forest operations	(149)	454	(60)	245
Fund operating loss—Internal	(953)	(867)	(146)	(1,966)
Interest expense	(3)	(535)	—	(538)
Income tax expense	(23)	(55)	—	(78)
Fund net loss—Internal	(979)	(1,457)	(146)	(2,582)
Loss attributed to noncontrolling interest	$783	$1,165	$139	$2,087
Noncontrolling interest—2011				
Management fees paid to ORM LLC	$(847)	$(1,343)	$(200)*	$(2,390)
Forest operations	(143)	3,474	—	3,331
Fund operating income (loss)—Internal	(990)	2,131	(200)	941
Interest expense	(4)	(534)	—	(538)
Income tax expense	(46)	(105)	—	(151)
Fund net income (loss)—Internal	(1,040)	1,492	(200)	252
Loss (income) attributed to noncontrolling interest	$832	$(1,195)	$190	$(173)
Noncontrolling interest—2010				
Management fees paid to ORM LLC	$(827)	$(645)	$—	$(1,472)
Forest operations	22	144	—	166
Fund operating loss—Internal	(805)	(501)	—	(1,306)
Interest expense	(5)	(189)	—	(194)
Income tax expense	(4)	(18)	—	(22)
Fund net loss—Internal	(814)	(708)	—	(1,522)
Loss (income) attributed to noncontrolling interest	$651	$566	$—	$1,218

*Includes $66 and $200 of costs reimbursed to ORM by Fund III in 2012 and 2011, respectively.

Liquidity and Capital Resources

Cash Flows

We ordinarily finance our business activities using funds from operations and, where appropriate in management's assessment, commercial credit arrangements with banks or other financial institutions. Funds generated internally from operations and externally through financing are expected to provide the required resources for the Partnership's future capital expenditures for at least the next twelve months.

The Partnership's debt consists primarily of mortgage debt with fixed interest rates and an operating line of credit. In May 2012, we extended our $20.0 million operating line of credit held with NWFCS. Before the extension, the line of credit had a variable interest rate based on the one-month LIBOR rate plus margins ranging from 2.25% to 3.25%, unused commitment fees ranging from 0.15% to 0.35%, and had a maturity date of August 2013. The ranges for margins over LIBOR and unused commitment are a function of how we measure against covenant tests. Interest payments were required quarterly in arrears. The extension pushed the maturity date out to August 1, 2015 and increased the frequency of interest payments to monthly in arrears. The extended line of credit now carries a variable interest rate that is still based on the one-month LIBOR rate, however, the applicable margins were reduced and range between 1.75% and 2.75% while unused commitment fees remain unchanged at a range between 0.15% and 0.35%. The Partnership had no balance drawn under the line of credit as of December 31, 2012, down from the balance of $5.0 million at December 31, 2011.

In December 2012, we mortgaged the commercial office building on Seventh Avenue in Poulsbo, Washington with a 10-year term loan with a 3.8% interest rate and a 20-year principal amortization. The $3.0 million loan amount was set using a 75% loan-to-value ratio and requires monthly interest and principal payments until January 2023. Loan origination costs of $18,000 will be amortized over the life of the loan.

The Partnership's debt agreements have financial covenants which are measured quarterly. Among the covenants measured, is a requirement that the Partnership not exceed a maximum debt-to-total-capitalization ratio of 30%, with total capitalization calculated using fair market (vs. carrying) value of timberland, roads and timber. The Partnership is in compliance with this covenant as of December 31, 2012 and expects to remain in compliance for at least the next twelve months.

In June 2010, we entered into a $20.0 million term loan agreement with Northwest Farm Credit Services (NWFCS). This agreement was structured with three tranches with terms of 5, 7, and 15 years that collectively have a weighted average interest rate of 5.3%. A fourth tranche of debt with NWFCS had been taken out previously in 2009 in the amount of $9.8 million with an interest rate of 6.4%. The weighted average interest rate for these four tranches of term debt is 5.6%.

Simultaneous with a timberland acquisition during the third quarter of 2010, Fund II closed on an $11 million timberland mortgage with MetLife. This mortgage is a non-amortizing, 10-year loan with a fixed interest rate of 4.85%. The loan agreement allows for, but does not require, annual principal payments of up to 10% without incurring a make-whole premium.

Cash and cash equivalents increased $1.1 million from 2011 to 2012 due primarily to cash provided by proceeds from the mortgage on our new corporate headquarters. Cash and cash equivalents increased $230,000 from 2010 to 2011 due to the increase in cash provided by increased harvest volume and real estate sales, coupled with the absence of a large Fund timberland acquisition that occurred in 2010. During the year ended December 31, 2010, overall cash and cash equivalents decreased $4.8 million resulting primarily from the repayment of long-term debt and the repurchase of a large block of units at a total cost of $11.9 million but $9.6 million of this total was financed by drawing on our line of credit,

resulting in a net $2.3 million drain on 2010 cash balances. The $896,000 and $5.0 million variance in cash flow from 2012 to 2011 and 2011 to 2010, respectively, is broken down in the following table:

(in thousands)	2012	Change	2011	Change	2010
Cash provided by operations	**$16,209**	$(5,451)	$21,660	$12,710	$8,950
Investing activities					
Redemption of investments	**—**	—	—	(1,497)	1,497
Proceeds from sale of fixed assets	**2,873**	2,873	—	—	—
Capital expenditures	**(2,305)**	(394)	(1,911)	(970)	(941)
Acquisition of commercial office building in Poulsbo	**—**	3,210	(3,210)	(3,210)	—
Timberland acquisition	**(45,155)**	(44,996)	(159)	58,047	(58,206)
Cash provided by (used in) investing activities	**(44,587)**	(39,307)	(5,280)	52,370	(57,650)
Financing activities					
Borrowing on (repayment of) line of credit	**(4,957)**	(314)	(4,643)	(14,243)	9,600
Borrowing on (repayment of) long-term debt	**(32)**	(2)	(30)	1,008	(1,038)
Extinguishment of long-term debt	**—**	—	—	18,554	(18,554)
Proceeds from issuance of long-term debt	**3,000**	3,000	—	(31,000)	31,000
Debt issuance costs	**(46)**	(46)	—	283	(283)
Cash distributions to unitholders	**(7,499)**	(2,236)	(5,263)	(2,022)	(3,241)
Unit repurchases	**—**	—	—	12,267	(12,267)
Cash from option exercises, net	**12**	(504)	516	(106)	622
Excess tax benefit from equity-based compensation	**220**	124	96	96	—
Payroll taxes paid upon restricted unit vesting	**(300)**	(66)	(234)	(234)	—
Distributions to fund investors, net of cash to Partnership	**(3,942)**	3,070	(7,012)	(6,206)	(806)
Capital call—ORM Timber Fund II, Inc.	**—**	—	—	(38,800)	38,800
Stock sale—ORM Timber Fund II, Inc.	**118**	118	—	—	—
Capital call—ORM Timber Fund III, Inc.	**42,946**	42,509	437	437	—
Preferred stock issuance (distribution), net—ORM Timber Fund II, Inc.	**(16)**	—	(16)	(126)	110
Other	**—**	1	(1)	(1)	—
Cash provided by (used in) financing activities	**29,504**	45,654	(16,150)	(60,093)	43,943
Net increase (decrease) in cash and cash equivalents	**$1,126**	$896	$230	$4,987	$(4,757)

OPERATING CASH ACTIVITIES. Cash provided by operating activities decreased $5.5 million from 2011 to 2012 due principally to an 11% decline in harvest volume coupled with a 5% reduction in realized average log price. This was partially offset by increased sales from the Real Estate segment but capitalized development activities increased $1.3 million during 2012 in connection with projected sales from the Harbor Hill development.

Cash provided by operating activities increased to $21.7 million in 2011 from $9.0 million in 2010 due primarily to a 70% increase in harvest volumes and a 17% log price increase from the Combined tree farms in addition to a small uptick in Real Estate activity. Capitalized development costs declined slightly to $893,000 in 2011 compared with $1.1 million in 2010.

INVESTING CASH ACTIVITIES. Cash used in investing activities increased $39.3 million from 2011 to 2012 due to the Fund III timberland acquisition in December 2012. This was partially offset by the sale of land underlying our corporate headquarters in the third quarter of 2012 that had no counterpart in 2011 and the acquisition of a commercial building in the second quarter of 2011 that had no corollary in 2012.

Cash used in investing activities declined by $52.4 million from 2010 to 2011 primarily due to the absence in 2011 of a counterpart to the $58 million of timberland acquisitions that were made in 2010. This was

partially offset by a $4.2 million increase in capital expenditures which reflects the $3.2 million acquisition of a commercial office building in Poulsbo in 2011 in addition to an increase in road, timber, and reforestation expenditures in anticipation of planned harvest activity.

FINANCING ACTIVITIES. Cash provided by financing activities increased $45.7 million in 2012 from 2011 due primarily to the Fund III capital call and proceeds provided by a mortgage on the new corporate headquarters. The $0.10 per unit increase in the quarterly distribution beginning the second quarter of 2012 was offset by a decrease in distributions to fund investors.

Cash used in financing activities increased $60.1 million in 2011 from 2010 due to primarily to the non-recurrence of a Fund capital call and net proceeds from the refinance of a mortgage that occurred in 2010. This was offset by an increase in payments on long-term debt in 2011 to pay down the operating line of credit in an effort to keep interest costs low as well as an increase in Fund distributions and Partnership distribution costs reflecting a $0.10 per unit increase in the quarterly distribution beginning the third quarter of 2011.

Expected Future Changes to Cash Flows

OPERATING ACTIVITIES. As discussed above, we currently plan to harvest between 84 MMBF to 86 MMBF in 2013. This plan reflects our expectation that domestic sawmills will gradually increase operating rates and demand for logs in response to improved housing starts.

Based on budget plans, we currently expect our Gig Harbor project's 2013 capital expenditures to total $9.4 million in 2013. The majority of Gig Harbor capital expenditures in 2013 are projected to be for site work, engineering, surveying and overall project management costs following the closing of a multi-family residential parcel and in connection with additional closings in Gig Harbor that are referred to on page 10 and for which we have entered into purchase and sale agreements. In 2010, we reached an agreement with the City of Gig Harbor to allow us to defer construction of certain community-based infrastructure items (e.g., stormwater-retention ponds) until we attained defined sales targets of lots/parcels within the project. In addition, our purchase agreement with the aforementioned multi-family parcel buyer allowed us to delay construction of road improvements until after closing. The closing of this transaction, together with a couple of sales in the pipeline slated to close over the next 24 months, has triggered the need to construct these various infrastructure items. In addition, to bring these future sales to closing, there are required land improvement costs that must be incurred that are also a part of the $9.4 million budget.

INVESTING ACTIVITIES. Management has budgeted $2.0 million of capital expenditures for 2013, excluding any potential timberland acquisitions. These investments are primarily comprised of long-term investments supporting our Fee Timber operations.

FINANCING ACTIVITIES. Management is currently projecting that cash on hand, availability of drawing on the operating line of credit, and cash generated from operating activities will be sufficient to bridge the front-loading of the capital needs for development properties and co-investments in future timber funds.

Excluding noncontrolling interests and debt of the Funds, our debt-to-total-capitalization ratio as of December 31, 2012 was 35% and 9% as measured, respectively, by book value and market value of assets. Should a financing need arise, management is comfortable that there is room to take on additional debt with the ratios at these levels. Portions of the Hood Canal and Columbia tree farms secure the Partnership's current timberland mortgages and, in the case of Fund II, portions of Fund II's tree farms secure the MetLife timberland mortgage. To date, the Partnership's strong financial position has enabled fairly easy access to credit at reasonable terms when needed.

Seasonality

FEE TIMBER. The Partnership owns 113,000 acres of timberland in western Washington and the Funds own collectively 80,000 acres of timberland in western Washington, western Oregon, and northern California. We are able to conduct year-round harvest activities on the Partnership's Hood Canal tree farm and on 12,000 acres of the Funds' properties because these properties are concentrated at low elevations. In contrast, the Partnership's Columbia tree farm and the 68,000-acre balance of the Funds' properties are at a higher elevation where harvest activities are generally not possible during the winter months when snow precludes access to the lands. Generally, we concentrate our harvests from the Hood Canal tree farm in those months when weather limits operations on other properties, thus taking advantage of reduced competition for log supply to our customers and improving prices realized. As such, when these various tree farms are combined, we can operate so that the pattern of quarterly volumes harvested is flatter than would be the case if looking at one tree farm in isolation.

TIMBERLAND MANAGEMENT & CONSULTING. Management revenue generated by this segment is made up of annual asset management and timberland management fees as well as log marketing fees during periods of active harvesting from the Funds' tree farms. These fees, which primarily relate to our activities on behalf of the Funds and are eliminated in consolidation, vary based upon the amount of capital managed, the number of acres managed, and the volume of timber harvested from properties owned by the Funds and are not expected to be significantly seasonal.

REAL ESTATE. While Real Estate results are not expected to be seasonal, the nature of the activities in this segment will likely result in periodic large transactions that will have significant positive impacts on both revenue and operating income of the Partnership in periods in which these transactions close, and relatively limited revenue and income in other periods. While the "lumpiness" of these results is not primarily a function of seasonal weather patterns, we do expect to see some seasonal fluctuations in this segment because of the general effects of weather on Pacific Northwest development activities.

Contractual Obligations, Commercial Commitments and Contingencies

Our commitments at December 31, 2012 consist of operating leases, and other obligations entered into in the normal course of business.

	Payments Due By Period/Commitment Expiration Date				
Obligation or Commitment *(in thousands)*	Total	Less Than 1 Year	1–3 Years	4–5 Years	After 5 Years
Total debt	$43,835	$125	$5,218	$5,233	$33,259
Operating leases	139	85	52	2	—
Interest on debt	18,506	2,319	4,554	4,112	7,521
Environmental remediation	13,942	750	11,518	1,674	—
Other long-term obligations	191	25	50	50	66
Total contractual obligations or commitments	$76,613	$3,304	$21,392	$11,071	$40,846

Environmental remediation represents our estimate of potential liability associated with environmental contamination at Port Gamble and Port Ludlow. Other long-term obligations consist of a $191,000 liability for a supplemental employment retirement plan.

The Partnership may from time to time be a defendant in lawsuits arising in the ordinary course of business. Management believes that loss to the Partnership, if any, will not have a material adverse effect on the Partnership's consolidated financial condition or results of operations.

The impact of inflation on our consolidated financial condition and consolidated results of operations for each of the periods presented was not material.

Off-Balance Sheet Arrangements

The Partnership is not a party to off-balance sheet arrangements other than the operating leases disclosed above and does not hold any variable interests in unconsolidated entities.

Capital Expenditures and Commitments

Projected capital expenditures in 2013 are $11.4 million, of which $9.4 million relates to the Gig Harbor site. These expenditures could be increased or decreased as a consequence of future economic conditions. Projected capital expenditures are subject to permitting timetables and progress towards closing on specific land sale transactions.

Government Regulation

Compliance with laws, regulations, and demands usually involves capital expenditures as well as operating costs. We cannot easily quantify future amounts of capital expenditures required to comply with laws, regulations, and demands, or the effects on operating costs, because in some instances compliance standards have not been developed or have not become final or definitive. Accordingly, at this time we have not included herein a quantification of future capital requirements to comply with any new regulations being developed by United States regulatory agencies.

Additionally, many federal and state environmental regulations, as well as local zoning and land use ordinances, place limits upon various aspects of our operations. These limits include restrictions on our harvest methods and volumes, remediation requirements that may increase our post-harvest reforestation costs, Endangered Species Act limitations on our ability to harvest in certain areas, zoning and development restrictions that impact our Real Estate segment, and a wide range of other existing and pending statutes and regulations. Various initiatives are presented from time to time that seek further restrictions on timber and real estate development businesses, and although management currently is not aware of any material noncompliance with applicable law, we cannot assure readers that we ultimately will be successful in complying with all such regulations or that additional regulations will not ultimately have a material adverse impact upon our business.

Accounting Matters

Accounting Standards Not Yet Implemented

There are no accounting standards not yet implemented that are expected to materially impact the Partnership.

Critical Accounting Policies and Estimates

Management believes its most critical accounting policies and estimates are as follows:

PURCHASED TIMBERLAND COST ALLOCATION. When the Partnership acquires timberlands, a purchase price allocation is performed that allocates cost between the categories of merchantable timber, pre-merchantable timber, and land based upon the relative fair values pertaining to each of the categories. Land value may include uses other than timberland including potential CE sales and development opportunities.

DEPLETION. Depletion represents the cost of timber harvested and the cost of the permanent road system that is charged to operations by applying a depletion rate to volume harvested during the period. The depletion rate is calculated on January 1st of each year by dividing the Partnership's cost of merchantable timber and the cost of the permanent road system by the volume of merchantable timber. For purposes of the depletion calculation, merchantable timber is defined as timber that is equal to or greater than 35 years of age.

To calculate the depletion rate, the Partnership uses a combined pool when the characteristics of the acquired timber are not significantly different from the Partnership's existing timberlands. Depletion rate calculations on Funds timberlands, which are recently acquired, are made on a tree farm specific basis. The depletion cost on timber harvested from the Funds is higher than the Partnership's timberlands and may at times approximate the net stumpage realized on the sale.

Timber inventory volumes include only timber whose eventual harvest is not constrained by the applicable state and federal regulatory limits on timber harvests as applied to the Partnership's properties. Washington's forest practice regulations provide for expanded riparian management zones, wildlife leave trees, and other harvest restrictions to protect public resources including clean water and various fish and other wildlife species. Timber inventory volume is accounted for by periodic statistical sampling of the harvestable timbered acres. Since timber stands can be very heterogeneous, the accuracy of the statistical sampling, known as a "timber cruise", of a timber stand can vary. The inventory system is designed in such a way that the accuracy of the whole is very reliable while any subset, or individual timber stand, will have a wider range of accuracy. The Partnership's standing timber inventory system utilizes annual statistical sampling of the timber (cruising) together with adjustments made for estimated annual growth and the depletion of areas harvested.

The standing inventory system is subject to two processes each year to monitor accuracy. The first is the annual cruise update process and the second is a comparison of the volume actually extracted by harvest to the inventory in the standing inventory system at the time of the harvest. Only productive acres with timber that is at least 20 years old are selected as subject to a cruise. The Partnership cruises 10–20% of its productive acres with 25-year-old or greater timber annually. Specific acres are first selected for cruising with a bias towards those acres that have gone the longest without a cruise and, second, with a bias towards those acres that have been growing the longest. As the cruise is being performed, only those trees with a breast height diameter (approximately 4.5 feet from the ground) of at least 6 inches are measured for inclusion in the inventory. The inventory to harvested volume comparison utilizes subsets of the total inventory which have been sampled sometime in the last ten years and grown annually using yield tables built on more statistical data; due to the nature of statistical sampling the results of the annual timber inventory to harvested volume comparison is meaningful only in the context of accumulated results over several years, and not in the context of a single harvest unit.

A hypothetical 5% change in estimated timber inventory volume would have changed 2012 depletion expense by $224,000.

ENVIRONMENTAL REMEDIATION. The Partnership has an accrual for estimated environmental remediation costs of $13.9 million and $2.2 million as of December 31, 2012 and 2011, respectively. The environmental remediation liability represents estimated payments to be made to monitor and remedy certain areas in and around the townsite/millsite of Port Gamble, and at Port Ludlow, Washington.

In the second quarter of 2012, we accrued an additional $12.5 million for Port Gamble environmental liabilities to have an estimated accrual of $14.3 million as of June 30, 2012. This additional accrual is derived prior to the conclusion of negotiations with the Department of Ecology (DOE), but was the result

of significant modifications to the draft Port Gamble Baywide and Millsite Remedial Investigation (RI) and Feasibility Study (FS) issued by the DOE in May 2012. From mid-August through the end of December and into 2013, we have been in regular dialogue with DOE Clean-up Action Plan (CAP), coincident with a consent decree that outlines clean-up actions, natural resource damage (NRD) remediation, and potential property sales of land around Gamble Bay by Pope Resources. A short list of unresolved issues remain, principally related to the treatment of existing docks in the southern embayment around the millsite and the degree to which the DNR, the other potentially liable party (PLP) in Port Gamble, is going to participate in funding the costs of clean-up and NRD remediation.

In developing its estimate of the Port Gamble environmental liability, management has employed a Monte Carlo statistical simulation model that suggests a potential aggregate range of clean-up costs from $11.5 million to $16.1 million which corresponds to a two standard deviation range from the mean of possible outcomes.

The environmental remediation accrual also includes estimated costs related to a separate remediation effort within the resort community of Port Ludlow. Early in 2012, soil vapor extraction (SVE) pilot tests were conducted in Port Ludlow with this round of testing producing somewhat inconclusive results regarding the efficacy of SVE as a remediation technique. Over the balance of 2012, representatives of Port Ludlow Associates (PLA) and the Partnership have been in dialogue, along with our respective consultants, to discuss these results and next steps.

The environmental liability at December 31, 2012 is comprised of $750,000 that the Partnership expects to expend in the next 12 months and $13.2 million thereafter. The liability recorded by the Company as of December 31, 2012 is based on the 50th percentile within the range, which management considers to be their best estimate of the most likely outcome.

PROPERTY DEVELOPMENT COSTS. The Partnership is developing six master planned communities in Gig Harbor, Kingston, and Port Gamble. Costs of development, including interest, are capitalized for these projects and allocated to individual lots based upon their relative preconstruction value. This allocation of basis supports, in turn, the computation of those amounts reported as a current vs. long-term asset based on management's expectation of when the sales will occur ("Land Held for Sale" and "Land Held for Development," respectively). As lot sales occur, the allocation of these costs becomes part of cost of sales attributed to individual lot sales.

Costs associated with land including acquisition, project design, architectural costs, road construction, capitalized interest and utility installation are accounted for as operating activities on our statement of cash flows.

PERCENTAGE OF COMPLETION REVENUE RECOGNITION. The partnership accounts for revenue recognized from development sales consistent with the accounting standards relating to the sales of real estate. When a real estate transaction is closed with obligations to complete infrastructure or other construction, revenue is recognized on a percentage of completion method by calculating a ratio of costs incurred to total costs expected. Revenue is deferred proportionately based on the remaining costs to complete the project.

IMPAIRMENT OF LONG-LIVED ASSETS. When facts and circumstances indicate the carrying value of properties may be impaired, an evaluation of recoverability is performed by comparing the carrying value of the property to the projected future undiscounted cash flows. Upon indication that the carrying value of such assets may not be recoverable, the Partnership would recognize an impairment loss, for the difference between the carrying value and the market value, and charge this amount against current operations. The land basis associated with most of our development properties is well below current market value; therefore, an asset impairment charge on one of our development projects is not likely. The long-term holding period of

timberland properties makes an asset impairment unlikely as the undiscounted expected cash flows from a timberland property would need to decrease very significantly to not total in excess of the carrying value of a timber property.

CONSOLIDATION OF ORM TIMBER FUND I, LP (FUND I), ORM TIMBER FUND II, INC. (FUND II), AND ORM TIMBER FUND III (REIT) INC. (FUND III). Fund I and Fund II are owned 19% by Pope Resources, A Delaware Limited Partnership, 1% by Olympic Resource Management LLC ("ORMLLC") (a wholly owned subsidiary of the Partnership), and the Partnership owns 5% of Fund III with the remaining owned by third-party investors. ORMLLC is the general partner of Fund I and the manager of Funds II and III. Third-party investors do not have the right to dissolve these Funds or otherwise remove the general partner/manager without cause nor do they have substantive participating rights in major decisions of the Funds. Based upon this governance structure, ORMLLC has presumptive control of the Funds and, as a result, under accounting rules the Funds must be consolidated into the Partnership's financial statements.

TIMBER FUND MANAGEMENT FEES. The Partnership's wholly owned subsidiary, ORMLLC, earns management fees related to managing the Funds. As a result, the Partnership's consolidated financial statements, excluding the Funds, include 100% of these management fees as revenue. The stand-alone financial statements for the Funds include 100% of these management fees as expenses. The dollar amounts are the same, allowing for elimination of these two amounts in consolidation, and initially, no income impact in consolidation. However, Funds I and II are owned 80% by third-party investors, while Fund III is owned 95% by third-party investors, and, as a result, 80% and 95% of these management fees are paid by these third-party investors, respectively. The management fees paid by third-party investors flows to the Partnership's Statement of Operations as a component of the caption "Net (income) loss attributable to noncontrolling interest—ORM Timber Funds," effectively bringing management fees paid by third-party investors back into consolidated income of the Partnership as detailed on page 28.

Total management fees of $2.2 million and $2.4 million were generated in 2012 and 2011, respectively. To summarize the aforementioned consolidation process, these management fees were eliminated from revenue in the Partnership's TM&C segment and from operating expenses in the Partnership's Fee Timber segment. The management fees paid by third-party investors in the funds were added back to consolidated income in the Statement of Operations as a component of the caption "Net loss attributable to noncontrolling interests—ORM Timber Funds."

INCENTIVE COMPENSATION. The Human Resources Committee adopted a new incentive compensation program in 2010. The program has two components—the Performance Restricted Unit ("PRU") plan and the Long-Term Incentive Plan ("LTIP"). Both components have a long-term emphasis, with the PRU plan focused on annual decision making, and the LTIP focused on 3-year performance of the Partnership's publicly traded units relative to a group of peer companies. Compensation expense relating to the PRU will be recognized over the four-year future service period beginning with the date of grant. Approximately $458,000 of equity compensation expense related to the PRU component of this program was recognized in 2012. As of December 31, 2012, we had accrued $2.0 million, with $275,000 of that total attributable to the cash component of the PRU element and the balance of $1.7 million attributable to the LTIP that is paid in cash.

Consolidated Balance Sheets

December 31, *(in thousands)*	2012	2011
ASSETS		
Current assets		
Partnership cash and cash equivalents	$2,517	$249
ORM Timber Funds cash and cash equivalents	1,262	2,404
Cash and cash equivalents	3,779	2,653
Accounts receivable, net	1,208	1,876
Land held for sale	1,179	1,255
Current portion of contracts receivable	13	80
Prepaid expenses and other	1,075	853
Total current assets	7,254	6,717
Properties and equipment, at cost		
Timber and roads, net of accumulated depletion of $82,094 and $71,955	183,287	154,236
Timberland	41,201	34,130
Land held for development	29,039	28,413
Buildings and equipment, net of accumulated depreciation of $6,012 and $6,203	6,154	6,019
Total properties and equipment, at cost	259,681	222,798
Other assets		
Contracts receivable, net of current portion	288	409
Other	276	484
Total other assets	564	893
Total assets	$267,499	$230,408
LIABILITIES, PARTNERS' CAPITAL AND NONCONTROLLING INTERESTS		
Current liabilities		
Accounts payable	$1,673	$1,328
Accrued liabilities	2,866	3,021
Current portion of long-term debt	125	32
Deferred revenue	2,065	447
Other current liabilities	993	468
Total current liabilities	7,722	5,296
Long-term debt, net of current portion	43,710	45,793
Other long-term liabilities	13,426	2,161
Commitments and contingencies		
Partners' capital		
General partners' capital (units issued and outstanding 60 and 60)	902	1,063
Limited partners' capital (units issued and outstanding 4,299 and 4,269)	63,321	74,696
Noncontrolling interests	138,418	101,399
Total partners' capital and noncontrolling interests	202,641	177,158
Total liabilities, partners' capital, and noncontrolling interests	$267,499	$230,408

See accompanying notes to consolidated financial statements.

Consolidated Statements of Comprehensive Income (Loss)

Years Ended December 31 *(in thousands, except per unit information)*	2012	2011	2010
Revenue			
Fee Timber	$45,539	$52,729	$27,674
Timberland Management & Consulting	7	—	31
Real Estate	8,497	4,545	3,487
Total revenue	54,043	57,274	31,192
Costs and expenses			
Cost of sales			
Fee Timber	(27,596)	(29,568)	(14,052)
Real Estate	(3,235)	(1,581)	(1,100)
Total cost of sales	(30,831)	(31,149)	(15,152)
Operating expenses			
Fee Timber	(6,090)	(6,262)	(3,919)
Timberland Management & Consulting	(1,575)	(1,515)	(1,281)
Real Estate	(3,861)	(2,336)	(2,341)
Environmental remediation	(12,500)	(977)	(875)
General & Administrative	(4,170)	(4,188)	(4,711)
Total operating expenses	(28,196)	(15,278)	(13,127)
Operating income (loss)			
Fee Timber	11,853	16,899	9,703
Timberland Management & Consulting	(1,568)	(1,515)	(1,250)
Real Estate	(11,099)	(349)	(829)
General & Administrative	(4,170)	(4,188)	(4,711)
Total operating income	(4,984)	10,847	2,913
Other income (expense)			
Interest expense	(2,077)	(2,158)	(1,815)
Interest capitalized to development projects	591	432	569
Interest income	26	42	102
Net gain on student loan auction rate securities dispositions	—	—	11
Total other expense	(1,460)	(1,684)	(1,133)
Debt extinguishment costs	—	—	(1,250)
Income (loss) before income taxes	(6,444)	9,163	530
Income tax benefit (expense)	(352)	(236)	290
Net income (loss)	(6,796)	8,927	820
Net (income) loss attributable to noncontrolling interests—ORM Timber Funds	2,087	(173)	1,218
Net income (loss) attributable to unitholders	(4,709)	8,754	2,038
Other comprehensive income adjustments	—	—	—
Comprehensive income (loss) attributable to unitholders	$(4,709)	$8,754	$2,038
Allocable to general partners	$(65)	$121	$64
Allocable to limited partners	(4,644)	8,633	1,974
Comprehensive income (loss) attributable to unitholders	$(4,709)	$8,754	$2,038
Earnings (loss) per unit attributable to unitholders:			
Basic	$(1.11)	$1.94	$0.43
Diluted	$(1.11)	$1.94	$0.43
Distributions per unit	$1.70	$1.20	$0.70

See accompanying notes to consolidated financial statements.

Consolidated Statements of Partners' Capital

Years Ended December 31, *(in thousands)*	Attributable to Pope Resources — General Partners	Attributable to Pope Resources — Limited Partners	Noncontrolling Interests	Total
December 31, 2009	$1,089	$82,037	$70,931	$154,057
Net income (loss)	64	1,974	(1,218)	820
Cash distributions	(42)	(3,199)	(821)	(4,062)
Proceeds from option exercises	19	603	—	622
Preferred stock issuance	—	—	125	125
Capital call	—	—	38,800	38,800
Equity-based compensation	22	690	—	712
Unit repurchases	(160)	(12,107)	—	(12,267)
December 31, 2010	$992	$69,998	$107,817	$178,807
Net income	121	8,633	173	8,927
Cash distributions	(72)	(5,191)	(7,028)	(12,291)
Proceeds from option exercises	7	509	—	516
Capital call	—	—	437	437
Excess tax benefit from equity-based compensation	6	90	—	96
Equity-based compensation	12	888	—	900
Indirect repurchase of units for minimum tax withholding	(3)	(231)	—	(234)
December 31, 2011	$1,063	$74,696	$101,399	$177,158
Net loss	(65)	(4,644)	(2,087)	(6,796)
Cash distributions	(105)	(7,394)	(3,958)	(11,457)
Proceeds from option exercises	—	12	—	12
Stock sale	—	—	118	118
Capital call	—	—	42,946	42,946
Excess tax benefit from equity-based compensation	3	217	—	220
Equity-based compensation	10	730	—	740
Indirect repurchase of units for minimum tax withholding	(4)	(296)	—	(300)
December 31, 2012	**$902**	**$63,321**	**$138,418**	**$202,641**

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Years Ended December 31, *(in thousands)*	2012	2011	2010
Cash flows from operating activities:			
Cash received from customers	$56,517	$56,076	$31,289
Cash paid to suppliers and employees	(36,364)	(31,609)	(19,210)
Interest received	26	47	103
Interest paid, net of amounts capitalized	(1,490)	(1,924)	(903)
Debt extinguishment costs	—	—	(1,250)
Capitalized development activities	(2,152)	(893)	(1,075)
Income taxes received (paid)	(328)	(37)	(4)
Net cash provided by operating activities	16,209	21,660	8,950
Cash flows from investing activities:			
Capital expenditures	(2,305)	(5,121)	(941)
Proceeds from sale of fixed assets	2,873	—	—
Redemption of investments	—	—	1,497
Timberland acquisitions	(45,155)	(159)	(58,206)
Net cash used in investing activities	(44,587)	(5,280)	(57,650)
Cash flows from financing activities:			
(Repayment of) draw on line of credit, net	(4,957)	(4,643)	9,600
Repayment of long-term debt	(32)	(30)	(1,038)
Extinguishment of long-term debt	—	—	(18,554)
Proceeds from issuance of long-term debt	3,000	—	31,000
Debt issuance costs	(46)	—	(283)
Unit repurchases	—	—	(12,267)
Proceeds from option exercises	12	516	622
Payroll taxes paid upon restricted unit vesting	(300)	(235)	—
Excess tax benefit from equity-based compensation	220	96	—
Cash distributions to unitholders	(7,499)	(5,263)	(3,241)
Cash distributions—ORM Timber Funds, net of distributions to Partnership	(3,942)	(7,012)	(806)
Capital call—ORM Timber Fund II, Inc.	—	—	38,800
Stock sale—ORM Timber Fund II, Inc.	118	—	—
Preferred stock issuance (distribution), net—ORM Timber Fund II, Inc.	(16)	(16)	110
Capital call—ORM Timber Fund III, Inc.	42,946	437	—
Net cash provided by (used in) financing activities	29,504	(16,150)	43,943
Net increase (decrease) in cash and cash equivalents	1,126	230	(4,757)
Cash and cash equivalents:			
Beginning of year	2,653	2,423	7,180
End of year	$3,779	$2,653	$2,423

See accompanying notes to consolidated financial statements.

Schedule to Consolidated Statements of Cash Flows

Years Ended December 31, *(in thousands)*	2012	2011	2010
Reconciliation of net income (loss) to net cash provided by operating activities:			
Net income (loss)	$(6,796)	$8,927	$820
Depletion	10,019	11,908	5,169
Capitalized development activities	(2,152)	(893)	(1,075)
Equity-based compensation	740	900	712
Excess tax benefit from equity-based compensation	(220)	(96)	—
Depreciation and amortization	1,232	701	642
Gain on sale of property and equipment	(2,753)	—	(11)
Deferred taxes, net	97	90	(252)
Cost of land sold	1,492	112	67
Write-off of debt issuance costs	—	—	32
Increase (decrease) in cash from changes in operating accounts:			
Accounts receivable	668	(1,353)	(282)
Contracts receivable	188	382	174
Prepaid expenses and other current assets	(84)	(10)	(71)
Accounts payable and accrued liabilities	410	921	2,157
Deferred revenue	1,618	(227)	205
Other current liabilities	15	37	(6)
Environmental remediation	11,739	271	664
Other, net	(4)	(10)	5
Net cash provided by operating activities	$16,209	$21,660	$8,950

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

Nature of Operations

Pope Resources, a Delaware Limited Partnership (the "Partnership") is a publicly traded limited partnership engaged primarily in managing timber resources on its own properties as well as those owned by others. Pope Resources' active subsidiaries include the following: ORM, Inc., which is responsible for managing Pope Resources' timber properties; Olympic Resource Management LLC (ORMLLC), which provides timberland management and consulting activities and is responsible for developing the timber fund business; Olympic Property Group I, LLC, which manages the Port Gamble townsite and millsite together with land that is held as development property; and OPG Properties LLC, which owns land that is held as development property. These consolidated financial statements also include ORM Timber Fund I, LP (Fund I), ORM Timber Fund II, Inc. (Fund II), and ORM Timber Fund III, Inc. (Fund III, and collectively with Fund I and Fund II, the Funds). With respect to Funds I and II, ORMLLC is the general partner and owns 1% while Pope Resources owns 19%. ORMLLC is the general partner and owns 1% of Fund III and the Partnership separately has a 4% co-investment in Fund III. The purpose of all three Funds is to invest in timberlands. See Note 2 for additional information.

The Partnership operates in three business segments: Fee Timber, Timberland Management & Consulting, and Real Estate. Fee Timber represents the growing and harvesting of trees from owned properties. Timberland Management & Consulting represents management, acquisition, disposition, and consulting services provided to third-party owners of timberland and provides management services to the Funds. Real Estate consists of obtaining and entitling properties that have been identified as having value as developed residential or commercial property and operating the Partnership's existing commercial property in Kitsap County, Washington.

Principles of Consolidation

The consolidated financial statements include the accounts of the Partnership, its subsidiaries, and the Funds. Intercompany balances and transactions, including operations related to the Funds, have been eliminated in consolidation.

General Partner

The Partnership has two general partners: Pope MGP, Inc. and Pope EGP, Inc. In total, these two entities own 60,000 partnership units. The allocation of distributions, income and other capital related items between the general and limited partners is pro rata among all units outstanding. The managing general partner of the Partnership is Pope MGP, Inc.

Noncontrolling interests

Noncontrolling interests represents the portion of 2012, 2011, and 2010 net income and losses of the Funds attributable to third-party owners of the Funds. In the case of Funds I and II, noncontrolling interests represent 80%, while noncontrolling interests represent 95% of Fund III ownership. To arrive at net income (loss) attributable to Partnership unitholders, the portion of the income attributable to these third-party investors is subtracted from Partnership income (loss) or, in the case of a loss attributable to third-party investors, added back to Partnership income (loss). The Funds are consolidated into Pope Resources' financial statements due to our control over the Funds (see Note 2).

Significant Estimates and Concentrations in Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported

amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expense during the reporting period. Actual results could differ from those estimates.

Depletion

Timber costs are combined into depletion pools based on the common characteristics of the timber such as location and species mix. Each tree farm within the Funds is considered a separate pool and timber harvested by the Funds is accounted for and depleted separate from the Partnership's timberlands due to third-party owners in the Funds. The applicable depletion rate is derived by dividing the aggregate cost of merchantable stands of timber (age 35 and older), together with capitalized road expenditures, by the estimated volume of merchantable timber available for harvest at the beginning of that year. The depletion rate, so derived and expressed in per MBF terms, is then multiplied by the volume harvested in a given period to calculate depletion expense for that period as follows:

$$\text{Depletion rate} = \frac{\text{Accumulated cost of timber and capitalized road expenditures}}{\text{Estimated volume of 35-years-and-older merchantable timber}}$$

Timberland is not subject to depletion.

PURCHASED TIMBERLAND COST ALLOCATION. When the Partnership acquires timberlands, a purchase price allocation is performed that allocates cost between the categories of merchantable timber, pre-merchantable timber, and land based upon the relative fair values pertaining to each of the categories. Land value may include uses other than timberland including potential CE sales and development opportunities.

Cost of Sales

Cost of sales consists of the Partnership's cost basis in timber, real estate, and other inventory sold, and direct costs incurred to make those assets saleable. Those direct costs include the expenditures associated with the harvesting and transporting of timber and closing costs incurred in land and lot sale transactions. Cost of sales also consists of those costs directly attributable to the Partnership's rental activities.

Cash and Cash Equivalents

Cash and cash equivalents include highly liquid investments with original maturities of three months or less at date of purchase.

Concentration of Credit Risk

Financial instruments that potentially subject the Partnership to concentrations of credit risk consist principally of accounts and contracts receivable. The Partnership limits its credit exposure by considering the creditworthiness of potential customers and utilizing the underlying land sold as collateral on contracts. The Partnership's allowance for doubtful accounts on accounts receivable is $58,509 and $14,670 at December 31, 2012 and 2011, respectively.

Contracts Receivable

In the past, the Partnership has occasionally sold small land parcels under contracts that require minimum cash down payments of 20% to 25% at interest rates between 7% and 8.75% per annum. As of December 31, 2012, we held 4 such contracts. While one contract has a repayment term of 15 years, loans are typically structured with repayments based on a 20-year amortization schedule culminating in a balloon payment within 5 to 7 years.

At December 31, 2012, minimum principal payments on contracts receivable for the next five years and thereafter are due as follows (in thousands):

2013	$13
2014	160
2015	9
2016	10
2017	10
Thereafter	99
Total	$301

Income Taxes

The Partnership is not subject to income taxes, but its corporate subsidiaries are subject to income taxes which are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Operating loss and tax credit carryforwards, if any, are also factored into the calculation of deferred tax assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The Partnership has concluded that it is more likely than not that its deferred tax assets will be realizable and thus no valuation allowance has been recorded as of December 31, 2012. This conclusion is based on anticipated future taxable income and tax planning strategies to generate taxable income, if needed. The Partnership is not aware of any tax exposure items as of December 31, 2012 and 2011.

Land Held for Sale and Land Held for Development

Land held for sale and land held for development are recorded at the lower of cost or fair value less the cost to sell. Costs of development, including interest, are capitalized for these projects and allocated to individual lots based upon their relative preconstruction value. This allocation of basis supports, in turn, the computation of those amounts reported as a current vs. long-term asset based on management's expectation of when the sales will occur (Land Held for Sale and Land Held for Development, respectively). As lot sales occur, the allocation of these costs becomes part of cost of sales attributed to individual lot sales. Costs associated with land including acquisition, project design, architectural costs, road construction, capitalized interest and utility installation are accounted for as operating activities on our statement of cash flows.

Those properties that are for sale, under contract, and for which the Partnership has an expectation they will be sold within 12 months are classified on our balance sheet as a current asset under "Land Held for Sale." The $1.2 million currently in Land Held for Sale reflects our expectation of a sale in 2013 of an 11-acre single-family parcel from the Harbor Hill project in Gig Harbor. Land Held for Sale as of December 31, 2011 represented 2012 sales of land underlying our corporate headquarters building in Poulsbo and a 12-acre multi-family parcel from the Harbor Hill project in Gig Harbor.

Land held for development on our balance sheet represents the Partnership's cost basis in land that has been identified as having greater value as development property rather than as timberland. Land development costs, including interest, clearly associated with development or construction of fully entitled projects are capitalized, whereas costs associated with projects that are in the entitlement phase are expensed. Interest capitalization ceases once projects reach the point of substantial completion or construction activity has been intentionally delayed.

Timberland, Timber and Roads

Timberland, timber and roads are recorded at cost. The Partnership capitalizes the cost of building permanent roads on the tree farms and expenses temporary roads and road maintenance. Timberland is not subject to depletion.

Property and Equipment

Buildings and equipment depreciation is provided using the straight-line method over the estimated useful lives of the assets, which range from 3 to 39 years.

When facts and circumstances indicate the carrying value of properties may be impaired, an evaluation of recoverability is performed by comparing the currently recorded carrying value of the property to the projected future undiscounted cash flows of the same property. If it is determined that the carrying value of such assets may not be fully recoverable, we would recognize an impairment loss, adjusting for the difference between the carrying value and the estimated fair market value, and would recognize an expense in this amount against current operations.

Buildings and equipment are recorded at cost and consisted of the following as of December 31, 2012 and 2011 (in thousands):

Description	12/31/2012	12/31/2011
Buildings	$8,512	$8,507
Equipment	3,029	3,083
Furniture and fixtures	625	632
Total	$12,166	$12,222
Accumulated depreciation	(6,012)	(6,203)
Net buildings and equipment	$6,154	$6,019

Deferred Revenue

Deferred revenue represents the unearned portion of cash collected. The deferred revenue balance of $2.1 million at December 31, 2012 primarily represents revenue that will recognized after we complete post-closing obligations related to the 12-acre sale of a multi-family parcel in our Gig Harbor project. Deferred revenue of $447,000 at December 31, 2011 mostly reflects the unearned portion of rental payments received on cell tower leases.

Revenue Recognition

Revenue on timber sales is recorded when title and risk of loss passes to the buyer. Revenue on real estate sales is recorded on the date the sale closes, upon receipt of adequate down payment, and receipt of the buyer's obligation to make sufficient continuing payments towards the purchase of the property and the Partnership has no continuing involvement with the real estate sold. When a real estate transaction is closed with obligations to complete infrastructure or other construction, revenue is recognized on a percentage of completion method by calculating a ratio of costs incurred to total costs expected. Revenue is deferred proportionately based on the remaining costs to satisfy the obligation. Management fees and consulting service revenues are recognized as the related services are provided.

Land and Development Rights or Conservation Easement (CE) Sales

The Partnership considers the sale of land and development rights, or conservation easements (CE's), to be part of its normal operations and therefore recognizes revenue from such sales and cost of sales for the Partnership's basis in the property sold. Cash generated from these sales is included in cash flows from operations on the Partnership's statements of cash flows.

In 2012, 2011, and 2010 the Partnership generated $1.2 million, $2.0 million, and $2.4 million, respectively, from conservation easement sales.

Equity-Based Compensation

The Partnership issues restricted units to certain employees, officers, and directors of the Partnership as part of their annual compensation. Restricted units are valued on the grant date at the market closing price of the partnership units on that date. The value of the restricted units is amortized to compensation expense during the vesting period which can range from two to four years. Grants to retirement-eligible individuals on the date of grant are expensed immediately.

On the date of grant, these restricted units are owned by the employee, officer, or director of the Partnership, subject to a trading restriction that is in effect during the vesting period. As of December 31, 2012, total compensation expense not yet recognized related to non-vested awards was $1.0 million with a weighted average 22 months remaining to vest.

Income (Loss) Per Partnership Unit

Basic net earnings (loss) per unit are calculated by dividing net income (loss) attributable to unitholders, adjusted for non-forfeitable distributions paid out to unvested restricted unitholders and Fund II preferred shareholders, by the weighted average units outstanding during the period. Diluted net earnings (loss) per unit are calculated by dividing net income (loss) attributable to unitholders, adjusted for non-forfeitable distributions paid out to unvested restricted unitholders and Fund II preferred shareholders, by the weighted average units outstanding during the year plus additional units that would have been outstanding assuming the exercise of in-the-money unit equivalents using the treasury stock method, unless the assumed exercise is antidilutive.

The table below displays how we arrived at basic and diluted income (loss) per unit:

Year Ended December 31, *(in thousands)*	2012	2011	2010
Net income (loss) attributable to Pope Resources' unitholders	$(4,709)	$8,754	$2,038
Net income attributable to unvested restricted unitholders	(88)	(341)	(45)
Dividends paid to Fund II preferred shareholders	(16)	(16)	(15)
Net income (loss) attributable to outstanding unitholders	$(4,813)	$8,397	$1,978
Weighted average units outstanding:			
Basic	4,351	4,323	4,554
Dilutive effect of unit equivalents	—	2	24
Diluted	4,351	4,325	4,578
Earnings (loss) per unit: Basic	$(1.11)	$1.94	$0.43
Earnings (loss) per unit: Diluted	$(1.11)	$1.94	$0.43

As of December 31, 2012, there were no outstanding unexercised options. At December 31, 2011, there were 5,500 options to purchase units at prices ranging from $10.75 to $17.40, none of which were excluded from the calculation of dilutive unit equivalents. This compares to December 31, 2010 when options to purchase 47,874 units at prices ranging from $9.30 to $37.73 were outstanding. Of those outstanding options in 2010, 1,464 units at prices ranging from $30.98 to $37.73 were not included in the calculation of dilutive unit equivalents as these were anti-dilutive.

Fund II Preferred Shares

Fund II issued 125 par $0.01 shares of its 12.5% Series A Cumulative Non-Voting Preferred Stock (Series A Preferred Stock) at $1,000 per share for total proceeds of $125,000 in March 2010. Each holder of the Series A Preferred Stock is entitled to a liquidation preference of $1,000 per share. Dividends on each share of Series A Preferred Stock will accrue on a daily basis at the rate of 12.5% per annum. Upon

redemption, the Series A Preferred Shares will be settled in cash and are not convertible into any other class or series of shares or Partnership units. Redemption timing is controlled by Fund II. The maximum amount that the consolidated subsidiary could be required to pay to redeem the instruments upon settlement is $125,000 plus accrued but unpaid dividends. The Series A Preferred Stock is recorded within noncontrolling interests on the consolidated balance sheet and are considered participating securities for purposes of calculating earnings (loss) per unit.

Fair Value Hierarchy

We use a fair value hierarchy in accounting for certain nonfinancial assets and liabilities including long-lived assets (asset groups) measured at fair value for an impairment assessment.

The fair value hierarchy is based on inputs to valuation techniques that are used to measure fair value that are either observable or unobservable. Observable inputs reflect assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources while unobservable inputs reflect a reporting entity's pricing based upon its own market assumptions.

The fair value hierarchy consists of the following three levels:

- *Level 1—Inputs are quoted prices in active markets for identical assets or liabilities.*
- *Level 2—Inputs are: (a) quoted prices for similar assets or liabilities in an active market, (b) quoted prices for identical or similar assets or liabilities in markets that are not active, or (c) inputs other than quoted prices that are observable and market-corroborated inputs, which are derived principally from or corroborated by observable market data.*
- *Level 3—Inputs are derived from valuation techniques in which one or more significant inputs or value drivers are unobservable.*

Reclassifications

Management has reclassified certain prior year operating expenses in the Real Estate segment to conform to the current year presentation. In 2012, we changed the classification of certain Real Estate operating costs related to rental revenue to real estate cost of sales. As such, we have reclassified certain Real Estate operating expenses to cost of sales in the current and all prior periods, with the reclassification having no impact on total expenses for any of the respective periods. Other reclassifications related to intercompany activity were also made that did not change total expenses in any of the reported periods. The table that follows shows cost of sales and operating expenses originally reported in the Form 10-K for the years ended December 31, 2011 and 2010 and the effect of the reclassification on the consolidated statements of comprehensive income (loss):

	2011		2010	
(in thousands)	Reclassified	Reported	Reclassified	Reported
Cost of sales				
Fee Timber	$(29,568)	$(30,042)	$(14,052)	$(14,184)
Real Estate	(1,581)	(522)	(1,100)	(162)
Total cost of sales	(31,149)	(30,564)	(15,152)	(14,346)
Operating expenses				
Fee Timber	(6,262)	(5,788)	(3,919)	(3,787)
Timberland Management & Consulting	(1,515)	(1,515)	(1,281)	(1,281)
Real Estate	(2,336)	(3,395)	(2,341)	(3,259)
Environmental remediation	(977)	(977)	(875)	(875)
General & Administrative	(4,188)	(4,188)	(4,711)	(4,731)
Total operating expenses	(15,278)	(15,863)	(13,127)	(13,933)
Total expenses	$(46,427)	$(46,427)	$(28,279)	$(28,279)

2. ORM Timber Fund I, LP (Fund I), ORM Timber Fund II, Inc. (Fund II), and ORM Timber Fund III (REIT) Inc. (Fund III) (Collectively, "The Funds")

The Funds were formed by Olympic Resource Management LLC (ORMLLC), a wholly owned subsidiary of Pope Resources, for the purpose of attracting capital to purchase timberlands. The objective of these Funds is to generate a return on investments through the acquisition, management, value enhancement and sale of timberland properties. Each Fund is organized to operate for a term of ten years from the end of the drawdown period, with Fund I terminating in August 2017, Fund II terminating in March 2021, and Fund III with an as-yet-undefined term because its drawdown period is still open. Fund III's term of ten years will begin after the capital is fully invested. In July 2012, we completed our final close of Fund III with commitments totaling $180 million, including our co-investment commitment of $9 million. During the fourth quarter of 2012, Fund III acquired 19,000 acres of northern California timberland for a purchase price of $45.1 million which represented a deployment of 25% of the Fund III committed capital. The purchase price was allocated $7.5 million to land and $37.6 million to roads and timber.

Pope Resources and ORMLLC together own 20% of Fund I and Fund II and own 5% of Fund III. All Funds are consolidated into the Partnership's financial statements. The Funds' statements of operations for the year ended December 31, 2012 reflects an operating loss of $2.0 million, operating income of $942,000 for the year ended December 31, 2011 and an operating loss of $1.3 million for the year ended December 31, 2010. These operations include management fees paid to ORMLLC of $2.2 million, $2.4 million, and $1.5 million for 2012, 2011, and 2010, respectively, which are eliminated in consolidation.

The Partnership's consolidated financial statements include Fund I, Fund II, and Fund III assets and liabilities at December 31, 2012 and 2011, which were as follows:

(in thousands)	2012	2011
Cash	$1,262	$2,404
Other current assets	691	546
Total current assets	1,953	2,950
Timber, timberland and roads (net of $20,664 and $13,729 of accumulated depletion in 2012 and 2011)	175,410	136,313
Other long-term assets	111	126
Total assets	$177,474	$139,389
Current liabilities excluding long-term debt	$1,413	$1,525
Current portion of long-term debt	34	32
Total current liabilities	1,447	1,557
Long-term debt	11,002	11,036
Funds' equity	165,025	126,796
Total liabilities and equity	$177,474	$139,389

The table above includes management fees payable to the Partnership of $490,000 and $444,000 as of December 31, 2012 and 2011, respectively. These amounts are eliminated in the Partnership's Consolidated Balance Sheets.

3. Long-Term Debt

At December 31, *(in thousands)*	2012	2011
Pope Resources debt:		
Mortgage payable to NWFCS, collateralized by Poulsbo headquarters:		
Ten-year tranche, interest at 3.80% with monthly principal and interest payments. Matures in January 2023.	$3,000	$—
Mortgages payable to NWFCS, collateralized by timberlands, as follows:		
Five-year tranche, interest at 4.10% with monthly interest-only payments. Matures in July 2015.	4,999	5,000
Seven-year tranche, interest at 4.85% with monthly interest-only payments. Matures in July 2017.	5,000	5,000
Ten-year tranche, interest at 6.40%, collateralized by timberlands with monthly interest-only payments. Matures September 2019.	9,800	9,800
Fifteen-year tranche, interest at 6.05% with monthly interest-only payments. Matures in July 2025.	10,000	10,000
	32,799	29,800
Operating line of credit, variable interest rate based on LIBOR plus margin, with monthly interest-only payments. Matures August 2015.	—	4,957
Total Partnership debt	32,799	34,757
ORM Timber Funds debt:		
Fund I note payable to the City of Tacoma, with interest at 4.5%, with monthly principal and interest payments maturing January 2014.	36	68
Fund II mortgage payable to MetLife, interest at 4.85%, collateralized by Fund II timberlands with quarterly interest payments maturing September 2020.	11,000	11,000
Total ORM Timber Funds debt	11,036	11,068
Consolidated subtotal	43,835	45,825
Less current portion	(125)	(32)
Consolidated long-term debt, less current portion	$43,710	$45,793

The Partnership's debt agreements have covenants which are measured quarterly. Among the covenants measured, is a requirement that the Partnership not exceed a maximum debt-to-total-capitalization ratio of 30%, with total capitalization calculated using fair market (vs. carrying) value of timberland, roads and timber. The Partnership is in compliance with this covenant as of December 31, 2012 and expects to remain in compliance for at least the next twelve months.

Fund II's debt agreement contains a requirement to maintain a loan-to-value ratio of less than 40%, with the denominator defined as appraised value. Fund II is in compliance with this covenant as of December 31, 2012 and expects to remain in compliance for at least the next 12 months.

At December 31, 2012, principal payments on long-term debt for the next five years and thereafter are due as follows (in thousands):

2013	$125
2014	109
2015	5,109
2016	114
2017	5,118
Thereafter	33,260
Total	$43,835

The Partnership's revolving line of credit with NWFCS matures August 2015 and has a maximum borrowing limit of $20 million. This line of credit had nothing drawn as of December 31, 2012, down from $5.0 million as of December 31, 2011. The interest rate under this credit facility uses LIBOR as a benchmark. The spread above the benchmark rate is variable depending on the Partnership's trailing twelve-month interest coverage ratio but ranges from 175 to 275 basis points. As of December 31, 2012, the rate (benchmark plus the spread) was 200 basis points. The debt arrangement between the Partnership and NWFCS includes an annual reimbursement of interest expense (patronage). The Partnership's 2012 interest expense was reduced by $214,000, which reflects estimated patronage to be refunded in 2013 with the related receivable recorded within Accounts Receivable as of December 31, 2012.

Accrued interest relating to all debt instruments was $463,000 and $494,000 at December 31, 2012 and 2011, respectively, and is included in accrued liabilities.

4. Fair Value of Financial Instruments

The Partnership's consolidated financial instruments include cash and cash equivalents and accounts receivable, for which the carrying amount of each represents fair value based on current market interest rates or their short-term nature. Carrying amounts of contracts receivable, although long-term, also approximate fair value given the current market interest rates. The fair value of the Partnership's and Funds' fixed-rate debt having a carrying value of $43.8 million and $45.8 million as of December 31, 2012 and 2011, respectively, has been estimated based on current interest rates for similar financial instruments, Level 2 inputs in the Fair Value Hierarchy, to be approximately $50.1 million and $40.9 million, respectively.

5. Income Taxes

The Partnership is not subject to income taxes. Instead, partners are taxed on their share of the Partnership's taxable income, whether or not cash distributions are paid. However, the Partnership's corporate subsidiaries are subject to income taxes. The following tables provide information on the impact of income taxes in taxable subsidiaries. Consolidated Partnership income (loss) is reconciled to income (loss) before income taxes in corporate subsidiaries for the years ended December 31 as follows:

(in thousands)	**2012**	2011	2010
Income (loss) before income taxes	**$(6,444)**	$9,163	$530
Income (loss) in entities that pass-through pre-tax earnings to the partners	**(6,578)**	8,427	1,408
Income (loss) subject to income taxes	**$134**	$736	$(878)

The provision for income taxes relating to corporate subsidiaries of the Partnership consists of the following income tax benefit (expense) for each of the years ended December 31:

(in thousands)	**2012**	2011	2010
Current	**$(255)**	$(146)	$38
Deferred	**(97)**	(90)	252
Total	**$(352)**	$(236)	$290

For the years ended December 31, 2012 and 2011, the Company also recorded excess tax benefits of $220,000 and $96,000, respectively.

A reconciliation between the federal statutory tax rate and the Partnership's effective tax rate is as follows for each of the years ended December 31:

	2012	2011	2010
Statutory tax on income	34%	34%	34%
Income (loss) in entities that pass-through pre-tax earnings to the partners	(39%)	(31%)	(89%)
Effective income tax rate	(5%)	3%	(55%)

The net deferred income tax assets include the following components as of December 31:

(in thousands)	2012	2011	2010
Current (included in prepaid expenses and other)	$590	$439	$401
Non-current (included in other assets (other long-term liabilities))	(41)	207	335
Total	$549	$646	$736

The deferred tax assets are comprised of the following:

(in thousands)	2012	2011	2010
Compensation-related accruals	$353	$628	$647
Net operating loss carryforward	167	—	—
Depreciation	4	54	38
Other	25	(36)	51
Total	$549	$646	$736

6. Unit Incentive Plan

The Partnership's 2005 Unit Incentive Plan (the Plan) authorized the granting of nonqualified equity compensation to employees, officers, and directors of the Partnership. A total of 1,105,815 units have been reserved for issuance under the Plan of which there are 952,194 units authorized but unissued as of December 31, 2012.

One of the two components of a management incentive compensation program adopted in 2010 (2010 Incentive Compensation Program) is the Performance Restricted Unit (PRU) plan which includes both an equity and cash component. Compensation expense relating to the PRUs will vest 25% per year over a 4-year future service period. The first equity grants pursuant to this program were made in January 2011. The second component of the incentive compensation program is the Long-Term Incentive Plan (LTIP) which is paid in cash. The LTIP awards contain a feature whereby the award amount is based upon the Partnership's total shareholder return (TSR) as compared to TSR's of a benchmark peer group of companies, measured over a rolling three-year performance period. The component based on relative TSR requires the company's projected cash payout for yet-to-be-completed performance cycles to be re-measured quarterly based upon the Partnership's relative TSR ranking, using a Monte Carlo simulation model.

Total equity compensation expense for 2012 was $740,000, of which $458,000 of equity compensation expense was related to the PRU plan. The remaining expense was related to amortization of restricted units issued under the 2005 Plan, but not part of 2010 Incentive Compensation Program. As of December 31, 2012, we accrued $2.0 million relating to the 2010 Incentive Compensation Program, with $275,000 of that total attributable to the cash component of the PRU and the balance of $1.7 million attributable to the LTIP that is paid in cash. This compares with December 31, 2011 when we had accrued $2.0 million for such liabilities, with $220,000 related to the cash component of the PRU and the balance of the $1.8 million attributable to the LTIP that is paid in cash.

The 2010 Incentive Compensation Program does not affect the existence or availability of the 2005 Unit Incentive Plan or change its terms. The 2005 Unit Incentive Plan provides a one-way linkage to the 2010 Incentive Compensation Program because it (2005 Plan) has already established the formal framework by which unit grants, options, etc., can be issued. Upon either the exercise of options or vesting of restricted units, grantees have the choice of tendering back units to pay for their option exercise price and minimum tax withholdings.

Restricted Units

The Human Resources Committee makes awards of restricted units to certain employees, plus the officers and directors of the Partnership and its subsidiaries. The restricted unit grants vest over two to four years and are compensatory in nature. Restricted unit awards entitle the recipient to full distribution rights during the vesting period, and thus are considered participating securities, but are restricted from disposition and may be forfeited until the units vest. The fair value, which equals the market price at date of grant, is charged to income on a straight-line basis over the vesting period. Grants to retirement-eligible individuals on the date of grant are expensed immediately.

Restricted unit activity for the three years ended December 31, 2012 was as follows:

	Units	Weighted Avg Grant Date Fair Value ($)
Outstanding December 31, 2009	56,195	33.76
Grants	26,200	25.15
Vested, net of units tendered back	(16,334)	38.29
Tendered back to pay tax withholding	(1,388)	39.24
Outstanding December 31, 2010	64,673	29.01
Grants	26,500	38.64
Vested, net of units tendered back	(26,431)	32.38
Tendered back to pay tax withholding	(6,242)	31.91
Outstanding December 31, 2011	58,500	31.54
Grants	26,350	42.85
Vested, net of units tendered back	(26,676)	30.15
Tendered back to pay tax withholding	(5,826)	28.60
Outstanding December 31, 2012	**52,348**	**38.09**

Unit Options

Unit options have not been granted since December 2005. Unit options granted prior to January 1, 2006 were non-qualified options granted at an exercise price not less than 100% of the fair value on the grant date. Unit options granted to employees vested over four or five years. Directors had the option of receiving their annual retainer in the form of unit options and those options vested immediately as they were granted monthly for services rendered during the month. Options granted had a life of ten years. As shown below, there are no outstanding options, vested or unvested, at December 31, 2012.

	Options	Weighted Average Exercise Price ($)
Outstanding and Vested December 31, 2009	163,053	15.86
Exercised	(75,692)	14.96
Expired	(2,500)	24.13
Tendered back to pay exercise price and tax withholding	(36,987)	18.46
Outstanding and Vested December 31, 2010	47,874	14.85
Exercised	(39,982)	13.81
Expired	—	—
Tendered back to pay exercise price and tax withholding	(2,392)	12.26
Outstanding and Vested December 31, 2011	5,500	16.35
Exercised	**(3,265)**	**15.63**
Tendered back to pay exercise price and tax withholding	**(2,235)**	**17.40**
Outstanding and Vested December 31, 2012	**—**	**—**

At December 31, 2011, the aggregate spread between the option exercise price and unit market price (intrinsic value) of all options outstanding was $147,000. The weighted average remaining contractual term for all outstanding and exercisable options at December 31, 2011 was 1.9 years.

7. Partnership Unit Repurchase Plans

The Partnership adopted a unit repurchase plan in December 2008 pursuant to which authorization was granted to repurchase limited partner units with an aggregate value of up to $2.5 million. Since that time, we have increased the aggregate value of units authorized for repurchase to $5 million and extended the repurchase plan to allow for repurchases through December 2013. As of December 31, 2012, there remained an unutilized authorization for unit repurchases of $2.5 million.

8. Employee Benefits

As of December 31, 2012, all employees of the Partnership and its subsidiaries are eligible to receive benefits under a defined contribution plan. During the years 2010 through 2012, the Partnership matched 50% of employees' contributions up to 8% of an individual's compensation. The Partnership's contributions to the plan amounted to $141,000, $128,000, and $123,000 for the years ended December 31, 2012, 2011, and 2010, respectively.

9. Commitments and Contingencies

Environmental Remediation

The Partnership has an accrual for estimated environmental remediation costs of $13.9 million and $2.2 million as of December 31, 2012 and 2011, respectively. The environmental remediation liability represents estimated payments to be made to monitor and remedy certain areas in and around the townsite/millsite of Port Gamble, and at Port Ludlow, Washington.

In 2012, we accrued an additional $12.5 million for Port Gamble environmental liabilities to have an estimated accrual of $13.9 million as of December 31, 2012. This additional accrual is derived prior to the conclusion of negotiations with the Department of Ecology (DOE), but was the result of significant modifications to the draft Port Gamble Baywide and Millsite Remedial Investigation (RI) and Feasibility Study (FS) issued by the DOE in May 2012. From mid-August through the end of December and into 2013, we have been in regular dialogue with DOE on a Clean-up Action Plan (CAP), coincident with a consent decree that outlines clean-up actions, natural resource damage (NRD) remediation, and potential property sales of land around Gamble Bay by Pope Resources. A short list of unresolved issues remain, principally related to the treatment of existing docks in the southern embayment around the millsite and the degree to which the DNR, the other potentially liable party (PLP) in Port Gamble, is going to participate in funding the costs of clean-up and NRD remediation.

In developing its estimate of the Port Gamble environmental liability, management has employed a Monte Carlo statistical simulation model that suggests a potential aggregate range of clean-up costs from $11.5 million to $16.1 million which corresponds to a two standard deviation range from the mean of possible outcomes. The liability recorded by the Company as of December 31, 2012 is based on the 50th percentile within the range, which management considers to be their best estimate of the most likely outcome.

The environmental remediation accrual also includes estimated costs related to a separate remediation effort within the resort community of Port Ludlow. Early in 2012, soil vapor extraction (SVE) pilot tests were conducted in Port Ludlow with this round of testing producing somewhat inconclusive results regarding the efficacy of SVE as a remediation technique. Over the balance of 2012, representatives of Port Ludlow Associates (PLA) and the Partnership have been in dialogue, along with our respective consultants, to discuss these results and next steps.

The environmental liability at December 31, 2012 is comprised of $750,000 that the Partnership expects to expend in the next 12 months and $13.2 million thereafter.

Performance Bonds

In the ordinary course of business, and as part of the entitlement and development process, the Partnership is required to provide performance bonds to ensure completion of certain public facilities. The Partnership had performance bonds of $6.1 million and $291,000 outstanding at December 31, 2012 and 2011, respectively. The increase reflects a rise in development activity in 2012 in connection with pending and completed sales from our Harbor Hill project in Gig Harbor.

Supplemental Employee Retirement Plan

The Partnership has a supplemental employee retirement plan for a retired key employee. The plan provides for a retirement income of 70% of his base salary at retirement after taking into account both 401(k) and Social Security benefits with a fixed payment set at $25,013 annually. The Partnership accrued $19,000 and $11,000 in 2012 and 2011, respectively, for this benefit based on an approximation of the cost of purchasing a life annuity paying the aforementioned benefit amount. The recorded balance of the projected liability as of December 31, 2012 and 2011 was $191,000 and $197,000, respectively.

Contingencies

The Partnership may from time to time be a defendant in various lawsuits arising in the ordinary course of business. Management believes Partnership losses related to such lawsuits, if any, will not have a material adverse effect to the Partnership's consolidated financial condition or results of operations or cash flows.

10. Related Party Transactions

Pope MGP, Inc. is the managing general partner of the Partnership and receives an annual management fee of $150,000.

11. Segment and Major Customer Information

The Partnership's operations are classified into three segments: Fee Timber, Timberland Management & Consulting, and Real Estate. The Fee Timber segment consists of the harvest and sale of timber from both the Partnership's 113,000 acres of fee timberland in Washington and the Funds' 80,000 acres in Washington, Oregon, and California.

The Timberland Management & Consulting segment provides investment management, disposition, and technical forestry services in connection with 24,000 acres for Fund I, 37,000 acres for Fund II, and 19,000 acres for Fund III.

The Real Estate segment's operations consist of management of development properties and the rental of residential and commercial properties in Port Gamble and Poulsbo, Washington. Real Estate manages a portfolio of 2,900 acres of higher-and-better-use properties as of December 31, 2012. All of the Partnership's real estate activities are in the state of Washington.

For the year ended December 31, 2012, the Partnership had one customer that represented 20% of consolidated revenue, or $10.6 million. For the year ended December 31, 2011, the Partnership had one customer that represented 28% of consolidated revenue, or $16.2 million. For the year ended December 31, 2010, the Partnership had one customer that represented 24% of consolidated revenue, or $7.6 million.

Identifiable assets are those used exclusively in the operations of each reportable segment or those allocated when used jointly. The Partnership does not allocate cash, accounts receivable, certain prepaid expenses, or the cost basis of the Partnership's administrative office for purposes of evaluating segment performance by the chief operating decision maker. Intersegment transactions are valued at prices

that approximate the price that would be charged to a third-party customer. Details of the Partnership's operations by business segment for the years ended December 31 were as follows:

	Fee Timber			Timberland Management	Real		
(in thousands)	Partnership	Funds	Combined	& Consulting	Estate	Other	Consolidated
2012							
Revenue internal	$29,353	$16,681	$46,034	$2,218	$8,574	$—	$56,826
Eliminations	(495)	—	(495)	(2,211)	(77)	—	(2,783)
Revenue external	28,858	16,681	45,539	7	8,497	—	54,043
Cost of timber and land sold	(13,115)	(14,481)	(27,596)	—	(3,235)	—	(30,831)
Operating, general and administrative expenses internal	(4,183)	(4,166)	(8,349)	(2,070)	(16,361)*	(4,199)	(30,979)
Eliminations	48	2,211	2,259	495	—	29	2,783
Operating, general and administrative expenses external	(4,135)	(1,955)	(6,090)	(1,575)	(16,361)*	(4,170)	(28,196)
Income (loss) from operations internal	12,055	(1,966)	10,089	148	(11,022)	(4,199)	(4,984)
Eliminations	(447)	2,211	1,764	(1,716)	(77)	29	—
Income (loss) from operations external	$11,608	$245	$11,853	$(1,568)	$(11,099)	$(4,170)	$(4,984)
2011							
Revenue internal	$31,429	$21,749	$53,178	$2,390	$4,593	$—	$60,161
Eliminations	(449)	—	(449)	(2,390)	(48)	—	(2,887)
Revenue external	30,980	21,749	52,729	—	4,545	—	57,274
Cost of timber and land sold external	(13,042)	(16,526)	(29,568)	—	(1,581)	—	(31,149)
Operating, general and administrative expenses internal	(4,421)	(4,282)	(8,703)	(1,961)	(3,313)**	(4,188)	(18,165)
Eliminations	51	2,390	2,441	446	—	—	2,887
Operating, general and administrative expenses external	(4,370)	(1,892)	(6,262)	(1,515)	(3,313)**	(4,188)	(15,278)
Income (loss) from operations internal	13,966	941	14,907	429	(301)	(4,188)	10,847
Eliminations	(398)	2,390	1,992	(1,944)	(48)	—	—
Income (loss) from operations external	$13,568	$3,331	$16,899	$(1,515)	$(349)	$(4,188)	$10,847
2010							
Revenue internal	$22,474	$5,370	$27,844	$1,519	$3,535	$—	$32,898
Eliminations	(170)	—	(170)	(1,488)	(48)	—	(1,706)
Revenue external	22,304	5,370	27,674	31	3,487	—	31,192
Cost of timber and land sold external	(9,553)	(4,499)	(14,052)	—	(1,100)	—	(15,152)
Operating, general and administrative expenses internal	(3,265)	(2,177)	(5,442)	(1,464)	(3,216)***	(4,711)	(14,833)
Eliminations	51	1,472	1,523	183	—	—	1,706
Operating, general and administrative expenses external	(3,214)	(705)	(3,919)	(1,281)	(3,216)***	(4,711)	(13,127)
Income (loss) from operations internal	9,656	(1,306)	8,350	55	(781)	(4,711)	2,913
Eliminations	(119)	1,472	1,353	(1,305)	(48)	—	—
Income (loss) from operations external	$9,537	$166	$9,703	$(1,250)	$(829)	$(4,711)	$2,913

*Includes $12.5 MM of environmental remediation expense
**Includes $977,000 of environmental remediation expense
***Includes $875,000 of environmental remediation expense

(in thousands)	2012	2011	2010
Depreciation, Amortization and Depletion			
Fee Timber—Partnership	$3,348	$3,460	$2,883
Fee Timber—Funds	6,950	8,602	2,534
Fee Timber—Combined	10,298	12,062	5,417
Timberland Management & Consulting	4	8	3
Real Estate	854	405	240
G&A	95	134	151
Total	$11,251	$12,609	$5,811
Assets			
Fee Timber—Partnership	$53,090	$52,886	$54,990
Fee Timber—Funds	177,474	139,389	146,803
Fee Timber—Combined	230,564	192,275	201,793
Timberland Management & Consulting	29	3	10
Real Estate	32,909	35,913	31,757
G&A	3,997	2,217	2,277
Total	$267,499	$230,408	$235,837
Capital and Land Expenditures			
Fee Timber—Partnership	$927	$998	$524
Fee Timber—Funds	46,033	837	58,311
Fee Timber—Combined	46,960	1,835	58,835
Timberland Management & Consulting	3	3	2
Real Estate—development activities	2,478	4,104	1,075
Real Estate—other	35	168	185
G&A	136	63	125
Total	$49,612	$6,173	$60,222
Revenue by product/service			
Domestic forest products	$33,577	$27,227	$18,384
Export forest products, indirect	11,962	25,502	9,290
Conservation easements and sales	1,235	2,435	2,400
Fees for service	7	—	31
Homes, lots, and undeveloped acreage	7,262	2,110	1,087
Total	$54,043	$57,274	$31,192

12. Quarterly Financial Information (Unaudited)

(in thousands except per unit amounts)	Revenue	Income (Loss) From Operations	Net Income (Loss) Attributable to Unitholders	Earnings (Loss) Per Partnership Unit: Basic	Earnings (Loss) Per Partnership Unit: Diluted
2012					
First quarter	$8,804	$1,070	$1,206	$0.27	$0.27
Second quarter	17,790	(9,150)	(9,295)	(2.14)	(2.14)
Third quarter	14,595	3,412	3,675	0.81	0.81
Fourth quarter	12,854	(316)	(295)	(0.07)	(0.07)
2011					
First quarter	$17,674	$4,762	$3,680	$0.82	$0.82
Second quarter	14,269	3,460	3,287	0.73	0.73
Third quarter	7,522	(766)	(562)	(0.14)	(0.14)
Fourth quarter	17,809	3,391	2,349	0.52	0.52

Quarterly fluctuations in data result from the addition and/or deferral of harvest volumes as well as the timing of real estate and CE sales, as disclosed in our quarterly filings. Management considered the disclosure requirements of Item 302(a)(3) and does not note any extraordinary, unusual, or infrequently occurring items except as disclosed.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Unitholders
Pope Resources, A Delaware Limited Partnership:

We have audited the accompanying consolidated balance sheets of Pope Resources, A Delaware Limited Partnership, and subsidiaries (collectively, the Partnership) as of December 31, 2012 and 2011, and the related consolidated statements of comprehensive income (loss), partners' capital, and cash flows for each of the years in the three-year period ended December 31, 2012. These consolidated financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pope Resources, A Delaware Limited Partnership, and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Partnership's internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 28, 2013 expressed an unqualified opinion on the effectiveness of the Partnership's internal control over financial reporting.

/s/ KPMG LLP

Seattle, Washington
February 28, 2013

Report of Independent Registered Public Accounting Firm

The Board of Directors and Unitholders

Pope Resources, A Delaware Limited Partnership:

We have audited Pope Resources, A Delaware Limited Partnership (the Partnership), internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Partnership's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in "Management's Report on Internal Control Over Financial Reporting" in the Partnership's annual report on the Form 10-K. Our responsibility is to express an opinion on the Partnership's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Pope Resources, A Delaware Limited Partnership, maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Pope Resources, A Delaware Limited Partnership, and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of comprehensive income (loss), partners' capital, and cash flows for each of the years in the three-year period ended December 31, 2012, and our report dated February 28, 2013, expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Seattle, Washington
February 28, 2013

Results of Operations

(dollar amounts are in thousands except per unit data)	2012	2011	2010	2009
Revenue				
Fee Timber	$45,539	$52,729	$27,674	$14,847
Timberland Management & Consulting	7	0	31	601
Real Estate	8,497	4,545	3,487	5,030
Total revenue	54,043	57,274	31,192	20,478
Operating income (loss)				
Fee Timber	11,853	16,899	9,703	3,724
Timberland Management & Consulting	(1,568)	(1,515)	(1,250)	(375)
Real Estate	(11,099)	(349)	(809)	1,663
General & Administrative	(4,170)	(4,188)	(4,731)	(3,733)
Total operating income (loss)	(4,984)	10,847	2,913	1,279
Depreciation, depletion, and amortization	11,251	12,609	5,843	2,811
Net interest expense (income)	1,460	1,684	1,144	1,007
Income tax expense (benefit)	352	236	(290)	39
Debt extinguishment costs	—	—	1,250	1,137
SLARS impairment and loss or gain on dispositions	—	—	(11)	318
Noncontrolling interests	(2,087)	173	(1,218)	(950)
Net income (loss)	(4,709)	8,754	2,038	(272)
PER DILUTED UNIT RESULTS				
Net income (loss)	$(1.11)	$1.94	$0.43	$(0.07)
Distributions	1.70	1.20	0.70	0.70
Partners' capital	14.56	17.27	16.40	18.17
Weighted average diluted units outstanding (000)	4,351	4,325	4,578	4,539
CASH FLOW				
Net cash provided by operating activities	$16,209	$21,660	$8,950	$662
Distributions to unitholders	7,499	5,263	3,241	3,219
Unit repurchases	—	—	12,267	1,838
Payment (issuance) of long-term debt, excluding debt-issuance costs	1,989	4,673	(21,008)	97
Adjusted Cash Available for Distribution (ACAD) #	11,652	12,896	7,594	(133)
FINANCIAL POSITION				
Land and timber, net of depletion	$253,527	$216,779	$226,678	$171,401
Total assets	267,499	230,408	235,837	187,056
Long-term debt, including current portion	43,835	45,825	50,498	29,490
Partners' capital	64,223	75,759	70,990	83,126
FINANCIAL RATIOS #				
Total Debt to Total Capitalization	35%	33%	37%	26%
Return on Equity	(7)%	12%	3%	0%
Enterprise value/EBITDDA	109	13	26	34
UNIT TRADING PRICES #				
High	$60.39	$50.29	$38.61	$28.98
Low	41.19	35.02	23.32	15.61
Year-end close	55.68	42.99	36.80	24.60
Market capitalization (year end—$millions)	246	189	159	113
Enterprise value (year end—$millions)	252	212	168	121
Fee timber harvest (MMBF)	84	90	53	32
Average per MBF log revenue	537	567	486	410
Employees at December 31 (full time equivalent) #	49	45	45	42

Unaudited

2008	2007	2006	2005	2004	2003	2002
$23,551	$35,514	$35,260	$44,424	$33,571	$22,916	$23,298
944	1,344	3,670	7,764	1,601	2,386	7,295
3,683	15,037	27,320	4,818	4,476	1,734	1,599
28,178	51,895	66,250	57,006	39,648	27,036	32,192
6,294	15,215	14,592	16,320	15,126	9,669	10,199
(543)	(883)	1,266	3,540	(598)	272	919
(1,111)	5,163	13,864	1,270	1,586	(476)	(1,667)
(3,951)	(4,782)	(3,817)	(3,651)	(2,986)	(2,842)	(3,864)
689	14,713	25,905	17,479	13,128	6,623	5,587
4,689	5,549	7,017	11,252	5,752	3,546	3,864
225	(324)	625	2,477	2,952	2,806	2,894
(61)	(69)	439	997	—	242	(788)
—	—	—	—	—	—	—
381	—	—	—	—	—	—
(1,018)	(402)	(69)	321	—	47	147
1,162	15,508	24,910	13,684	10,176	3,528	3,334
$0.23	$3.22	$5.22	$2.88	$2.22	$0.78	$0.74
1.60	1.36	1.06	0.80	0.44	0.24	0.10
18.83	20.48	18.70	14.29	12.01	10.19	9.65
4,661	4,769	4,762	4,753	4,594	4,522	4,520
$3,952	$12,113	$33,114	$23,950	$16,485	$8,029	$8,900
7,444	6,449	4,961	3,701	1,989	1,084	452
3,940	1,374	—	—	—	—	—
1,342	1,481	1,675	1,883	1,979	1,662	1,110
(767)	8,065	29,865	20,270	12,615	4,624	4,847
$137,133	$138,112	$133,731	$78,222	$87,517	$69,003	$70,495
165,411	179,325	180,282	106,358	94,868	86,308	86,788
29,586	30,727	32,208	33,883	35,766	37,745	39,239
87,817	96,644	87,605	66,405	54,533	46,036	43,598
25%	24%	27%	34%	40%	45%	47%
1%	17%	32%	23%	20%	8%	8%
31	9	5	5	7	9	10
$43.81	$50.01	$36.00	$56.85	$25.25	$15.99	$15.50
15.00	34.25	30.00	19.35	15.00	7.00	9.30
20.00	42.75	34.32	31.02	25.00	15.43	10.11
93	202	161	144	113	70	46
153	181	160	154	123	88	92
38	55	55	74	60	45	45
506	607	611	576	529	476	488
51	58	60	65	49	48	79

Definitions

Adjusted cash available for distribution = cash flow from operations less required principal payments, maintenance capital expenditures, and financed debt extinguishment costs. Cash from operations for Funds attributable to noncontrolling interests is stripped out also.

Enterprise value = average of year-end market capitalization less cash plus debt outstanding for current and prior year. Only 20% of Fund debt and cash is included in calculation.

UNITHOLDER INFORMATION

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STOCK EXCHANGE LISTING

Pope Resources' units trade on the NASDAQ Capital Market® under the symbol POPE.

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ANNUAL MEETING

No annual meeting is required for the partnership

FORM 10-K

This report and Pope Resources' Report on Form 10-K are available on the Partnership's website (www.poperesources.com) by clicking on "Investor Relations" and then scrolling to either "Financial Information" or "SEC Filings" on the left-side navigation bar. Additionally, copies of this report and the Form 10-K are available without charge upon request to:

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