September 29, 2011

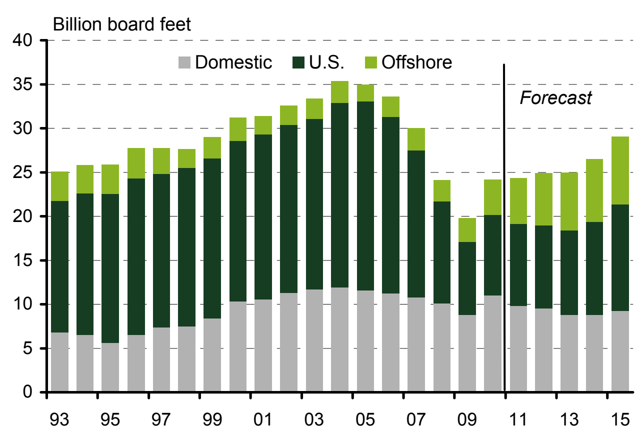
PATIENCE IS A VIRTUE FOR CANADA'S LUMBER SECTOR

Highlights

- Unlike the cyclical gains seen in other resource sectors, the lumber industry still faces prices 36% lower than previous cyclical highs, and a much-needed recovery in U.S. homebuilding is seemingly nowhere in sight.
- However, patience is a virtue for this beleaguered sector. An eventual recovery in U.S. housing starts, and continued demand growth from China is set to drive an upswing in lumber demand late in 2013.
- That demand recovery will occur against a far leaner capacity backdrop at the mill level, setting the stage for a notable rally in lumber prices.
- Furthermore, Canada's lumber sector has undergone significant restructuring over the past 10 years in the face of daunting competitive pressures. But, producers who can hang on through more near-term difficulties should see profits greatly improve.

Many of Canada's resource-based sectors have seen impressive cyclical gains during the current economic recovery, but when it comes to Canada's lumber industry, patience will remain a virtue. There has been some firming in lumber prices and production since the worst of the recession – driven largely by demand from China – but times are still tough in this important sector. Lumber prices remain 36% lower than their previous cyclical highs, and capacity use rates in the industry are running below levels considered consistent with profitability. However, patience will be rewarded. By late 2013, improved demand from the United States, Canada's biggest customer, will add to already rapidly growing demand from China, to produce a significant cyclical upswing in demand for lumber (Chart 1).

CHART 1. CDN SOFTWOOD LUMBER DEMAND



Source: RISI, TD Economics
Forecast by TD Economics as at September 2011

Moreover, after considerable restructuring over the past ten years, the lumber sector is leaner and more competitive. We expect further capacity reductions this year, setting the stage for an upswing in prices once U.S. demand starts coming back on stream. However, that improvement is still a ways off, and we don't see prices topping US$300 (as measured by the Random Lengths Framing Composite, in US$/thous. board feet) on a sustained basis until 2013.

Demand from China Lends Much-Needed Support

The pick-up we have seen in lumber output from the depths of the recession has been largely due to demand from China growing by leaps and bounds. Canada's lumber exports to China were up over 100% in 2010, and 140% so far in 2011. China's share of

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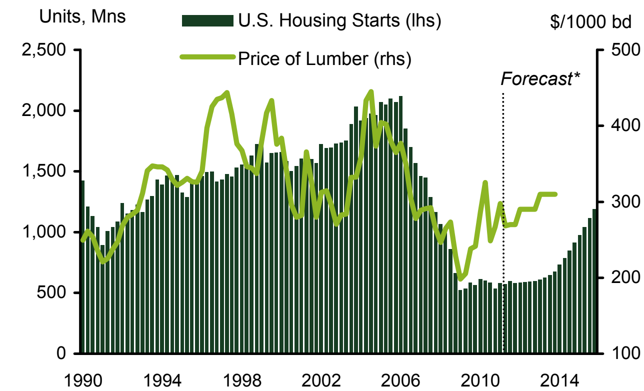
Canada's lumber exports has risen from only 1.0% in 2006, to 20% for 2011 year-to date. China is now the second biggest market for Canadian lumber (after the U.S.), having surpassed Japan at the end of last year (Chart 2).

The increasing importance of China in lumber markets can be seen in the recent breakdown between the historically tight relationship between U.S. homebuilding and the price of lumber (Chart 3). The effect of increased demand from China has raised prices for North American lumber higher than underlying demand from the U.S. would have suggested historically. Some have referred to the gap between current prices and demand from the U.S. as "the China effect". Put another way, were it not for surging demand for lumber from China, prices would probably be much lower than they already are.

British Columbia is home to the lion's share of Canada's lumber industry, and it is the most export-oriented province (Chart 4). Given its location on the Pacific Rim, it's not surprising that almost three-quarters of Canada's lumber exports to China are coming from B.C. In May of this year, lumber exports to China surpassed exports to the U.S. in dollar terms (the U.S. still imported more by volume).

Over the past five years, the B.C. industry and government have been very proactive in marketing wood for use in construction in China, opening up new markets there. Thus far, marketing efforts by Canadian lumber producers and governments have helped Canada become the major beneficiary of strong wood imports growth into China. In fact, Canada recently overtook Russia as the largest supplier of softwood lumber to China. China now imports more lumber from B.C. than from the United States. Anecdotally,

CHART 3. U.S. HOMEBUILDING RECOVERY DELAYED



Forecast by TD Economics as at Sept. 2011
Source: FIBER, U.S. Dept of Commerce, TD Economics;

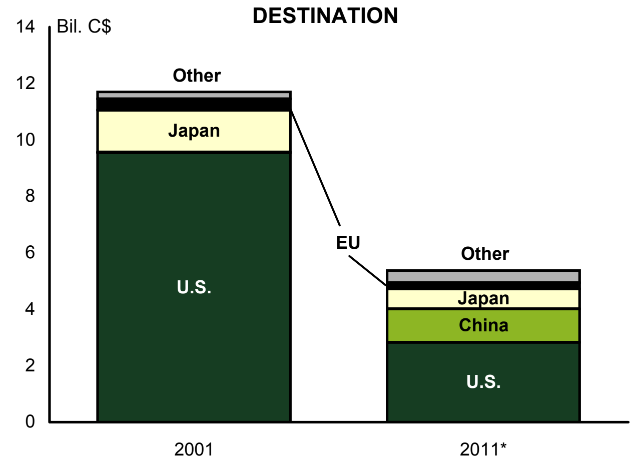
the B.C. government estimates that in production terms, both the U.S. and China each equal about 40% of the province's lumber production.

Healthy demand growth from China is expected to continue over the medium term. Analysts expect China's imports of wood products to grow at 10% per year through 2015, and those are deemed conservative estimates[1]. We expect Canada to continue to benefit from this robust growth in Chinese demand and our forecast assumes offshore demand – driven largely by China – to expand by 30% this year, before cooling slightly to 15% in 2012, and 10% in 2013 (Chart 1, front page).

Recovery in U.S. Demand Not Expected Until 2013

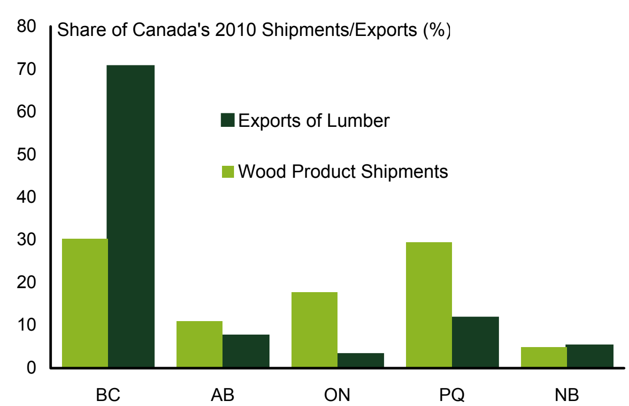
The fortunes of Canadian lumber production are closely

CHART 2. CDN LUMBER EXPORTS BY DESTINATION



Source: Industry Canada; *Year-to-date exports, annualized

CHART 4. CANADA'S KEY LUMBER-PRODUCING PROVINCES

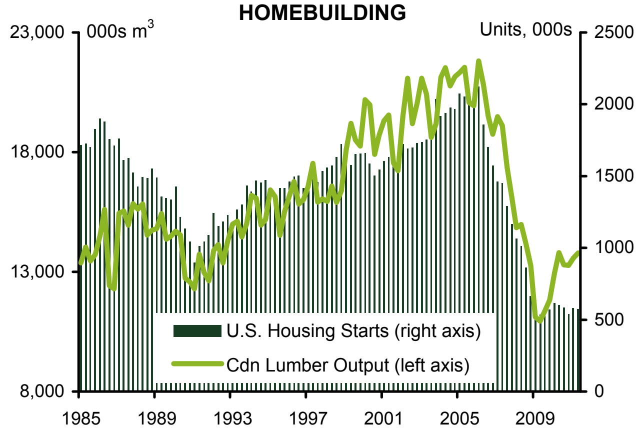


Source: Statistics Canada, Industry Canada tied to the trend in U.S. homebuilding, and its collapse hit the industry hard (Chart 5). Chinese demand may have kept mills running, but low capacity use rates mean there is little scope for higher prices until improved demand from our biggest customer starts filling order books. The U.S. is still our number one market, accounting for roughly 60% of Canadian lumber exports in 2010 despite the housing downturn. The share has fallen from a recent peak of 83% in 2005, but the importance of a recovery in U.S. demand to Canada's lumber industry remains crucial.

However, the U.S. housing market is still in the dumps, and the level of single-family starts remains depressed. Amid falling home prices and an ample supply of existing homes, there is little impetus for new home construction. Moreover, a "shadow inventory" of distressed and foreclosed homes still looms on the horizon, and needs to be worked through before demand for new homes can pick up. With significant bottlenecks in the foreclosure process in many parts of the U.S., there is a great deal of uncertainty surrounding how long it will take for the inventory overhang to be worked through.

A key determinant of housing demand, and hence the pace of inventory correction, is the rate of household formation. It is currently running below trend, but once they return to a more normal level, significant pent-up demand for housing could be unleashed. Conditions in the job market are a key driver of the household formation rate, and the outlook for employment has grown gloomier in recent weeks. Given our current outlook for U.S. job growth (*see U.S. Quarterly Economic Forecast*), we expect home sales to rise enough to absorb the excess inventory of existing homes by the end of 2013. Once that hurdle is cleared, new home

CHART 5. LUMBER OUTPUT TIED TO U.S. HOMEBUILDING



Source: U.S. Dept. of Commerce, Statistics Canada

sales should begin to trend upward, boosting construction.

Our outlook for U.S. housing starts is reasonably conservative (Chart 3). We do not expect starts to get back to the over 2 million units per year pace that prevailed during the last housing boom, which represented a period of overbuilding both in the size and number of new homes. But, a pick-up in housing starts in late 2013, and gathering steam in 2014 should drive an improvement in U.S. lumber demand.

Little Support from Domestic Demand Expected

Canada is a major exporter of lumber on the world stage, but domestic demand still accounts for roughly 45% of the market. We do not see any significant growth in domestic demand for lumber in the near term. With heavily-indebted households weighing on the housing market, housing starts in Canada are forecast to decline over the next few years. That means very limited increases in demand from Canadian homebuilders. We also expect growth in the economy as a whole to moderate, led by cooler consumer spending, so we don't foresee any great pick up in renovation spending to spur domestic lumber demand either. But, nor do we subscribe to the view that Canada's housing market is severely overbuilt and poised for a dramatic correction.

Capacity Constraints to Boost Prices Beyond 2013

The final factor underpinning how high lumber prices could go in an eventual cyclical upswing is capacity constraints at the mill level. The Canadian lumber industry has met the huge decline in lumber demand from the U.S. with significant cuts to capacity. Canadian capacity is approximately 15% lower than it was at its peak in 2005, and reductions continued in 2010, despite improved demand. One measure of the demand-to-capacity ratio for Canada currently stands at around 67%, still well back of the over 90% rate at the height of the housing boom, but it has been improving, particularly in Western Canada. With capacity use rates still low there is little pressure for price increases, and further shutdowns are likely this year.

Once demand from the U.S. does pick up, however, the demand-to-capacity ratio should cross the key 80% threshold[2] (cited as key for industry profitability and for generating significant pricing pressures) in 2013. Increasing capacity use rates will become a big positive for prices in 2013-2014.

Canada's lumber industry faced significant competitive challenges over the past ten years, even before slumping U.S. demand felled production. The greatest challenges faced were export duties imposed by the U.S., and an appreciating Canadian dollar. Those pressures resulted in productivity gains from 2001 to 2005 five times faster than the manufacturing sector as a whole[3]. These improvements were due to closures of the least productive plants, rather than the addition of better equipment. We don't have actual productivity data for the most recent years, but we can see that output has increased in the industry since the recession, but employment has fallen off slightly, suggesting even further productivity improvements. These difficult changes have resulted in an industry that is far more competitive than it was before.

That is a good thing considering the Canadian dollar is expected to remain elevated over the forecast horizon. A high Canadian dollar is a negative for profits, but the industry is much better placed to cope with it after years of restructuring. Add it all up, and the combination of firmer prices and a more competitive industry in Canada paints a very positive picture for profits in 2013 and beyond.

How are Different Regions Faring?

Canada's lumber industry can be found in nearly all regions of the country, but its performance varies. The top five provinces (B.C., Quebec, Alberta, Ontario and New Brunswick) accounted for 93% of shipments and 98% of exports last year. Ontario and Quebec's lumber sectors saw the greatest production declines during the U.S. housing downturn (Chart 7).

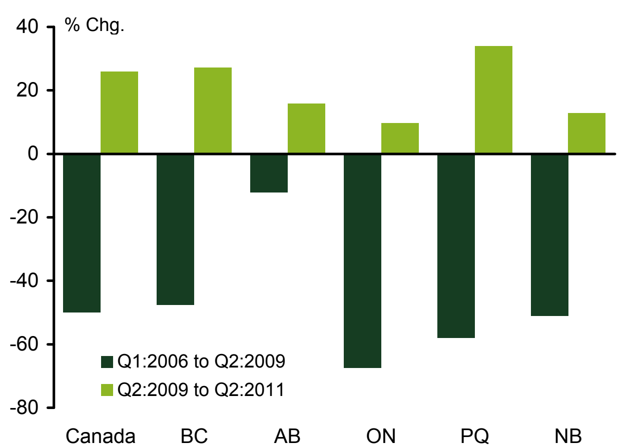
As discussed earlier in this report, growth in exports driven by demand from China has been concentrated in B.C. The impact of that growth can be seen in capacity use rates that are faring slightly better in B.C. (77% so far in 2011, versus 73% over the same period in 2010) than east of the Rockies (74% year-to-date in 2011, versus 75% in 2010). Eastern Canadian producers are also higher cost producers on average, compared with producers in Western Canada who are cited as among the lowest cost producers in North American, and among the lowest globally[4]. B.C.'s proximity to Asian markets has also helped it have the most diverse export base compared to the rest of Canada, who are still heavily weighted to the U.S. (Chart 8). B.C. should continue to benefit from strong demand growth from China, with U.S. demand adding further momentum in 2013.

Once U.S. demand finally picks up, regions that have been lagging behind B.C. should see their fortunes improve. New Brunswick and Ontario have the greatest shares of U.S.-bound exports, so stand to benefit the most, followed by Quebec then Alberta. Moreover, as of July 1, 2011 a 10% additional export charge (under the current Softwood Lumber Agreement) that had been affecting producers in Saskatchewan, Manitoba, Ontario and Quebec was removed, a positive development for these regions. An added benefit of higher prices is that duty rates fall.

Disputes under the SLA remain a challenge for the industry. No sooner has the additional export charge in one region ended, than another complaint filed by the U.S. alleging the low prices charged for pine-beetle timber from Interior B.C. amounts to a subsidy. This matter is currently before the courts, and presents another uncertainty for B.C. producers, on top of dealing with the mountain pine beetle infestation itself.

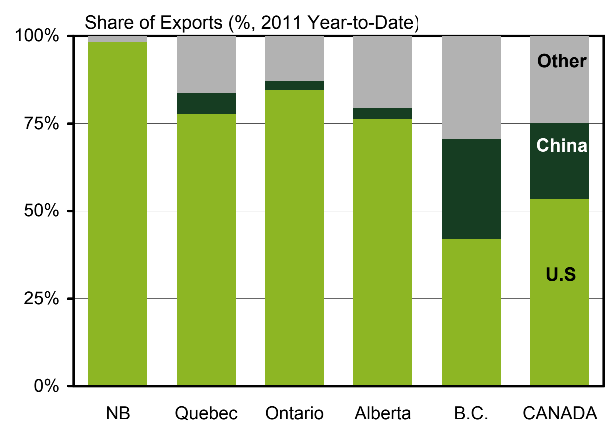
The province of B.C. estimates that the pest will have killed 80% of the merchantable mature pine in BC's Cen-

CHART 7. LUMBER PRODUCTION BY PROVINCE



Source: Statistics Canada

CHART 8. DESTINATION OF PROVINCIAL LUMBER EXPORTS



Source: Statistics Canada

tral and Southern Interior by 2013[5]. For starters, it's worth pointing out that the wood that is killed by the beetle is not unusable, and significant investments in innovations have resulted in many novel uses for beetle wood. Moreover, this is not a new crisis, the effects have been highly anticipated by the industry, and industry players have worked hard to maximize the harvest and use of the wood.

However, the longer-term impact on the B.C. industry will be significant. Even though beetle-affected areas are being re-forested, with so much pine being harvested on an accelerated timetable, there will be a reduction in the annual allowable cut in B.C. over the next 10-15 years, reducing the available supply of pine. This presents a significant challenge to B.C.'s lumber industry over the longer term, and one that the province has been working to mitigate for some time now.

The Bottom Line

A meaningful improvement in Canada's lumber output awaits a recovery in U.S. homebuilding. However, with the considerable structural problems in the U.S. housing market that seems quite far off on the horizon. Once an upswing in U.S. demand can be seen more clearly, a leaner capacity backdrop could produce a significant rally in lumber prices. Lumber prices averaged \$269/1000 Bd Ft in August, and we don't see them rising above \$300 until 2013 when U.S. demand improves. For producers who can weather continued weakness in the medium-term, higher prices will greatly improve profitability in an industry that has endured ten very difficult years.

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Endnotes

1 "Special Report: News and Statistics about China" RISI. April 2011.

2 "North American Lumber" Peter Barynin, RISI. June 2011.

3 "The Canadian Lumber Industry: Recent Trends" Daniel Dufour, Statistics Canada. June 2007.

4 "Industry at a Crossroads: Choosing the Path to Renewal" Forest Products Industry Task Force. May 2007

5 "Mountain Pine Beetle Action Plan, 2006-2011"