

## Forest Products

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Industry Brief

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### Building Materials

#### Forest Products: Remain Cautious on Continued Weak US Housing Starts

Consistent with our Mar-21-11 building materials note, “Lumber Co Valuations Fully Reflect Japan Rebuild; Downgrading to Market Perform” we are cautious on near term prospects for Western lumber producers Canfor (CFP-TSX), West Fraser (WFT-TSX) and Interfor (IFP.A-TSX). In fact, we expect negative 1H11 earnings momentum as a result of lower realized lumber pricing, logistical shipping issues, and the higher C\$. While robust Chinese demand is very encouraging, without greater demand from the key US lumber market we expect lumber prices could slide over the next 2 quarters. Further, we expect the market has been too optimistic on the prospects of near-term earnings potential associated with rebuilding Japan’s earthquake damaged regions. Given our expectation for no recovery in US lumber markets this year we continue to advocate a seasonal trade and encourage investors to take profits with the potential to buy back in at lower levels during 3Q11. Longer term, we remain very bullish on lumber pricing and see the potential for 1) mountain pine beetle related supply restrictions, 2) incremental Asian demand and 3) an eventual return to normalized US housing starts as leading to an extended “Peak Lumber Super-Cycle” with dramatic valuation implication for Western lumber producers.

US housing starts for Mar-11, released today, revealed 7.2% mth/mth increase to a 549K annualized pace from an upwardly revised 512K starts in Feb-11, coming in above consensus expectations of 520K starts while forward looking housing permits of 594K, also came in above expectations of 540K. Despite the favourable mth/mth comps, these housing starts levels remain depressed and we note the breakdown between lumber intensive single family units (which totaled 422K) vs. multi-family units (127K) remains decidedly negative for B.C. based lumber producers. In fact, Mar-11’s 422K single family starts were well below the 2010 average of 472K starts and roughly in-line with the trailing 6 month average of 429K starts reflecting meager demand for new single family dwellings (note: the 2010 average was likely skewed upwards by the US home buyer’s tax credit during 1H10). In addition, April’s reading of the National Association of Home Builders/Wells Fargo Housing Market Index of just 16 (down from 17 in March) is comparable to recession lows and also reflective of current depressed market conditions (recall a reading of above 50 indicates a generally positive sentiment among builders). The 1Q11 average housing start pace of 563K is 13% below our RJ US Housing Model 1Q11 estimate of 650K starts but within 3% of our recently downwardly revised annual forecast of 580K starts as our model does not forecast an improvement in housing starts until 2H12.

Company	Ticker Primary	Ticker Secondary	Current Price	Rating
<b>Building Materials</b>				
Canfor Corp.	CFP-TSX		C\$12.69	3
Interfor	IFP.A-TSX		C\$6.20	3
Norbord Inc.	NBD-TSX		C\$13.07	3
Sino-Forest Corporation	TRE-TSX		C\$23.96	1
TimberWest	TWF.UN-TSX		C\$6.53	2
West Fraser Timber	WFT-TSX		C\$53.05	3

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### Raymond James & Associates (U.S.) definitions

**Strong Buy (SB1)** Expected to appreciate, produce a total return of at least 15%, and outperform the S&P 500 over the next six to 12 months. For higher yielding and more conservative equities, such as REITs and certain MLPs, a total return of at least 15% is expected to be realized over the next 12 months. **Outperform (MO2)** Expected to appreciate and outperform the S&P 500 over the next 12-18 months. For higher yielding and more conservative equities, such as REITs and certain MLPs, an Outperform rating is used for securities where we are comfortable with the relative safety of the dividend and expect a total return modestly exceeding the dividend yield over the next 12-18 months. **Market Perform (MP3)** Expected to perform generally in line with the S&P 500 over the next 12 months. **Underperform (MU4)** Expected to underperform the S&P 500 or its sector over the next six to 12 months and should be sold. **Suspended (S)** The rating and price target have been suspended temporarily. This action may be due to market events that made coverage impracticable, or to comply with applicable regulations or firm policies in certain circumstances, including when Raymond James may be providing investment banking services to the company. The previous rating and price target are no longer in effect for this security and should not be relied upon.

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**Growth (G)** Low to average risk equities with sound financials, more consistent earnings growth, possibly a small dividend, and the potential for long-term price appreciation.

**Aggressive Growth (AG)** Medium or higher risk equities of companies in fast growing and competitive industries, with less predictable earnings and acceptable, but possibly more leveraged balance sheets.

**High Risk (HR)** Companies with less predictable earnings (or losses), rapidly changing market dynamics, financial and competitive issues, higher price volatility (beta), and risk of principal.

**Venture Risk (VR)** Companies with a short or unprofitable operating history, limited or less predictable revenues, very high risk associated with success, and a substantial risk of principal.

## Rating Distributions

	Coverage Universe Rating Distribution		Investment Banking Distribution	
	RJL	RJA	RJL	RJA
<b>Strong Buy and Outperform (Buy)</b>	69%	53%	60%	24%
<b>Market Perform (Hold)</b>	30%	41%	32%	10%
<b>Underperform (Sell)</b>	2%	6%	0%	9%

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### Risks - Canfor Corp.

Forest product prices are cyclical, worse than expected economic conditions could reduce our price forecasts. ii) As sales are typically denominated in U.S. dollars, a depreciation of the U.S. dollar could negatively affect earnings. iii) Canfor operates on Crown land. Government policy changes could negatively affect operating margins. v) Forest product markets are global in nature issues affecting transportation or market access could impact earnings. vi) Extreme weather conditions or fires could impact harvesting plans and hence earnings.

**Risks - Interfor**

Some of the specific risk factors that pertain to the projected 6 to 12 month stock price target for Interfor are as follows: i) Lumber prices are cyclical, slower than expected economic growth or higher mortgage rates could reduce our price forecasts. ii) As sales are denominated in U.S. dollars, a depreciation of the U.S. dollar could negatively affect earnings. iii) Interfor's logging operations are primarily on Crown land. Government policy changes could negatively affect operating margins, iv) Forest product markets are global in nature issues affecting transportation or market access could impact earnings.

**Risks - Norbord**

Some of the specific risk factors that pertain to the projected 6 to 12 month stock price target for Norbord are as follows: i) Wood based panel products are highly cyclical, slower than expected residential construction rates, economic growth or plywood substitution rates could reduce OSB demand, pricing and earnings. ii) Additional announced capacity increases or a faster ramp up of existing projects could reduce our commodity price forecasts and earnings. iii) A reduction in the availability or an increase in price of raw materials such as fibre (e.g., related to market conditions or weather) and resin (e.g., related to oil prices) could negatively affect operating margins iv) Forest product markets are global in nature, trade issues affecting market access could impact earnings.

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**Risks - West Fraser Timber**

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**Risks - Sino-Forest Corporation**

The key risks to our target price include: 1) cyclical nature of forest products industry and fluctuations in the prices of logs and other wood products 2) any delays/issues in executing growth initiatives and eventual execution of perpetual rotation business model 3) instability in the political climate in China 4) inclement weather/ droughts impacting tree growth 4) FX risk including potential weakening of the Renminbi 5) the threat of new competitors 6) reliance on key executives and members of management and relationships with government officials 7) rising input and labour costs 8) the potential reduction in the growth of China's economy and demand for wood products

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