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Forest Products

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Industry Comment

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Forest Products

China Forest Products Markets: Long Term Bullish Trend Intact

Event

Over the past few years China has had an increasingly material impact on global forest products shipments and commodity pricing. This, plus the negative attention associated with the Sino Forest (TRE-TSX, Under Review) fraud allegations has sharpened investor focus on the Chinese outlook. In an effort to keep abreast of developments we attended the 2011 China Forests, Policy, Markets, & Practice conference in Shanghai, on June 22 and 23. We would like to acknowledge the assistance of Dr. Wenran Jiang, Professor of Political Science at the University of Alberta and Raymond James China Consultant, for his assistance in preparing this research note in addition to arranging meetings with Chinese contacts during the trip and providing his considerable expertise on the country from a political and economic perspective.

Action

The evolving Chinese market is a key tenet of our long-term bullish Peak Lumber thesis. That said, with weak expected 2Q11 earnings and cautious management guidance on US markets we currently rate Canfor (CFP-TSX), Interfor (IFP.A-TSX), and West Fraser (WFT-TSX) Market Perform. China has also boosted demand for NBSK and dissolving pulp, pushing both commodities to new highs this year. Despite recent softening we remain constructive on both pulp grades and highlight Strong Buy rated Fortress Paper (FTP-TSX) and Domtar (UFS-NYSE), along with Outperform rated Canfor Pulp (CFX-TSX) and Mercer (MERC-NASDAQ). Sino Forest's target and rating remain Under Review pending the findings of the Independent Board Committee's internal review.

Analysis

Our takeaways from the conference, augmented by other data collection and news analysis, lead us to maintain our positive outlook on Canadian forest products companies servicing the growing Chinese market. This bullish outlook rests on our expectation of strong Chinese demand for forest products being driven by macro themes including the large scale urban migration of the country's rural population (estimated at between 10 mln and 15 mln people annually), rising living standards for growing middle classes fueling increased per capita consumption of wood fibre, and a shortage of natural domestic forest resources, resulting in steadily rising demand for Canadian building materials and pulp products. The emergence of the Chinese market bolsters our medium to long term view on forest products commodity supply demand balance. Pulp and lumber prices both rallied this past year – despite tepid demand from traditional western markets. Under a coordinated recovery scenario it is not difficult to see forest product commodity prices surpassing historical peak levels, in our view.

Company	Ticker Primary	Ticker Secondary	Current Price	Target Price (6-12 months)	Dividend Yield	Total Return To Target	Rating
Building Materials							
Canfor Corp.	CFP-TSX		C$10.65	C$12.50		17%	Market Perform 3
Interfor	IFP.A-TSX		C$5.09	C$6.00		18%	Market Perform 3
Norbord Inc.	NBD-TSX		C$12.81	C$14.00		9%	Market Perform 3
Sino-Forest Corporation	TRE-TSX		C$4.75	UR		NM	Under Review
West Fraser Timber	WFT-TSX		C$51.36	C$54.00	1%	6%	Market Perform 3
Pulp & Paper							
Canfor Pulp Products Inc.	CFX-TSX		C$18.58	C$21.00	9%	22%	Outperform 2
Domtar	UFS-NYSE	UFS.T-TSX	US$98.10	US$125.00	1%	28%	Strong Buy 1
Fibrek Inc.	FBK-TSX		C$1.34	C$1.60		19%	Market Perform 3
Fortress Paper	FTP-TSX		C$37.21	C$60.00		61%	Strong Buy 1
Mercer International Inc.	MERC-NASDAQ	MRI.U-TSX	US$10.87	US$17.00		56%	Outperform 2

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Sino Forest Update – A discussion of the Chinese forest products outlook without at least mentioning Sino Forest would be incomplete. In our view, two recent events have contributed to extreme volatility in the stock: 1) Wellington's announcement of an 11.5% position, and 2) Sino's cancellation of a mid-July investor tour of some of its Chinese assets. While the stock tumbled intraday on the news, we regard the cancellation of the tour as a non-event as we consider any tours ahead of the release of the report by the Independent Board Committee/PricewaterhouseCoopers as premature.

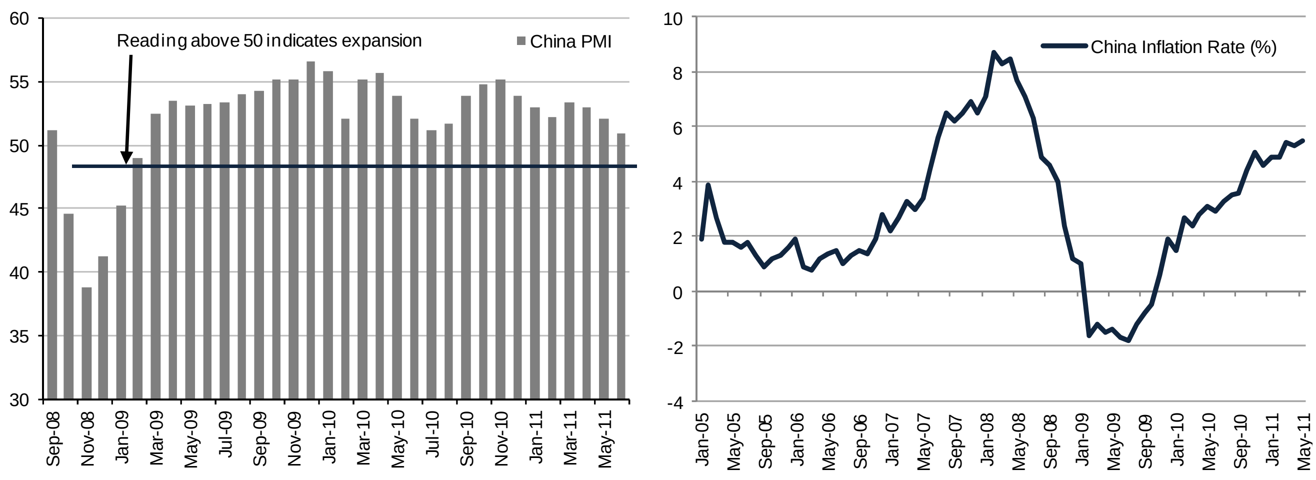
To reiterate our position, on June 6 we placed Sino's target and rating Under Review pending the release of the findings of the Board's internal review of basic corporate data, the ownership and valuation of assets, revenues, and other key items included in the short sellers' original allegations. It is our understanding that the review is progressing and is expected to be complete within a 2 to 3 month timeline. We stress that we are not in a position to conduct a forensic audit of Sino's assets and financials and hence cannot speculate on the outcome of the review. We underscore our belief, however, that even if the review refutes the allegations of impropriety, we expect returning investor confidence to be vulnerable to any potential irregularity uncovered; even issues unrelated to the short sellers' original allegations.

Even assuming the allegations prove unfounded we expect the distraction and new higher risk profile associated with companies with Chinese assets will likely limit near to medium term access to Western capital markets. As such, even under the best case scenario we expect Sino to have much slower growth potential, restricted to internally generated cash flows and a US$1.5 bln debt facility provided by the China Development Bank. Assuming existing hectares under master agreement are purchased, plus the replanting of 200,000 ha of eucalyptus, we believe a theoretical share price value of $13 - $17 is possible applying a discount rate in our DCF model of 15% - 17%, compared to 13.4% previously. We highlight this analysis is sensitive to the discount rate used and, in light of the current confidence issues, an appropriate level for this particular input is difficult to determine. We reiterate this is a theoretical valuation based on the assumption that the allegations prove unfounded, and note that equity value could evaporate should the major allegations prove accurate. Lastly, we underscore our belief in a large and growing Chinese wood fibre deficit. To the extent that Chinese timber plantation owners' ability to grow is reduced, we see more opportunity for Western Canadian lumber producers such as Canfor, Interfor, and West Fraser to make up the difference.

China Forests, Markets, Policy & Practice Conference 2011 – In our efforts to stay abreast of ongoing developments in the Chinese market for Canadian lumber and pulp exports we attended the 2011 China Forests, Policy, Markets, & Practice conference in Shanghai, on June 22 and 23. Our takeaways from the conference, augmented by other data collection and news analysis, lead us to maintain our positive outlook on Canadian forest products companies servicing the market. This bullish outlook rests on our expectation of strong demand for forest products in China being driven by macro themes, including the large scale urban migration of the country's rural population (estimated at between 10 mln and 15 mln people annually), rising living standards for growing middle classes fueling increased per capita consumption of wood fibre, and a shortage of natural domestic forest resources, resulting in steadily rising demand for BC lumber and pulp products, in our view.

China economic update – While growth in China remains strong by global standards, the government's recent efforts in curbing inflation, as well as softening global demand for the country's exports, appear to be taking a toll on the economy's pace. In fact, China's manufacturing PMI, a measure of the country's factory output levels, fell to 50.9 in June, below consensus expectations of 51.3 and down from 52 in May, marking the index's third consecutive month of decline and a 28 month low according to China's Federation of Logistics and Purchasing (a reading above 50 indicates economic expansion – see Exhibit 1, LHS). While Chinese inflation hit a 34 month high of 5.5% in May (see Exhibit 1, RHS), well above the government's 4.0% target, Premier Wen recently indicated policies aimed at combatting inflation such as increases to banks' required reserve ratios and benchmark interest rates are working, with overall price levels now within a "controllable range". While we do not speculate as to whether inflation in the country is truly under control, we believe economic conditions in China will remain sufficiently robust to support continued growth in demand for wood products – particularly if the Chinese Premier's comments represent a signal the country's tightening cycle is coming to an end. With a recent 25 bps hike to China's benchmark 1 year interest rate (bringing it to 6.56%), we acknowledge the potential for cooling China's hot real estate market; however, we expect price any declines will be limited to the large coastal cities. Lastly, even if GDP growth in China comes in at the low end of the 8-10% estimated range (it was 9.7% in 1Q11), a report by the McKinsey institute suggests growth of the country's middle class from current levels of 170 mln to 350 mln and continued increases in the country's urbanization will give rise to a per capita GDP growth rate approaching 20%, as it moves from a low income nation (GDP/capita in the $1,000 - $4,000 range) to middle income (GDP/capita of $4,000 - $9,000). Chinese State Forestry Administration officials believe growth in China's wood products sector will materially outpace the overall economy, growing by double digits for the foreseeable future.

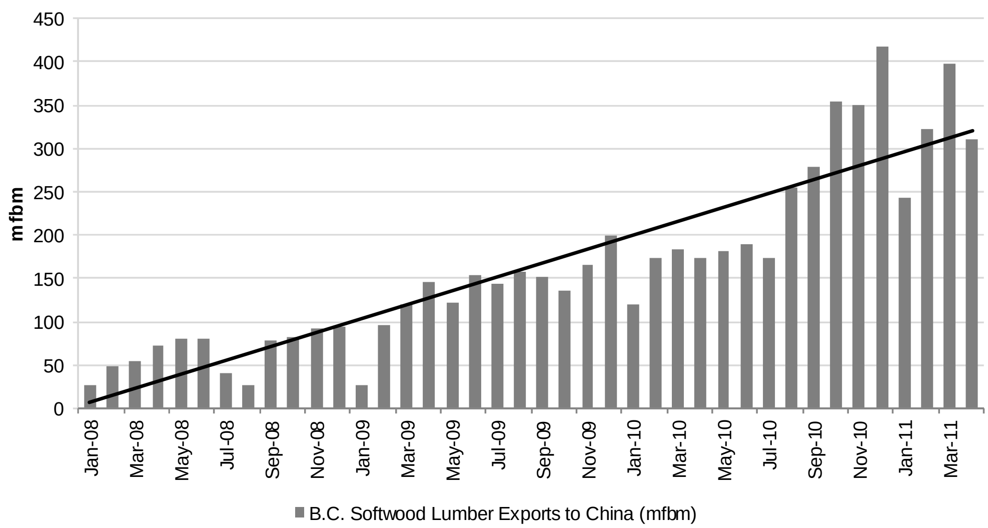
Exhibit 1: China Purchasing Manager's Index & Inflation Rate



Source: China Federation of Logistics & Purchasing, Bloomberg

BC softwood lumber shipments to China still posting big increases YTD – Referring to Exhibit 2 below, we highlight BC softwood lumber shipments continue to post big y/y increases with YTD shipments for Jan - Apr 2011 up 96% over the comparable period in 2010. In fact, if we annualize shipments for the first 4 months of 2011, which totaled 1.28 bln fbm, we arrive at an annual figure approaching 4 bln fbm of lumber going to China this year – in-line with the BC Ministry of Forests' "stretch" goal. While data for BC lumber exports to China in May is not yet available, we note the port of Shanghai reported softwood lumber imports of 540K m^3 during the month, up 87% y/y. We attribute the strong growth in shipments to burgeoning demand for wood used in concrete forming driven by factors including China's mass urbanization, significant infrastructure expenditures, and government support for affordable housing, while rising trade and domestic consumption of remanufactured wood products such as furniture, interior decoration materials, doors, and flooring also make a significant contribution. The uses for Canadian lumber in China are essentially evenly split between these two primary end-uses with a small but briskly growing wood frame residential construction niche.

Exhibit 2: B.C. Softwood Lumber Exports to China

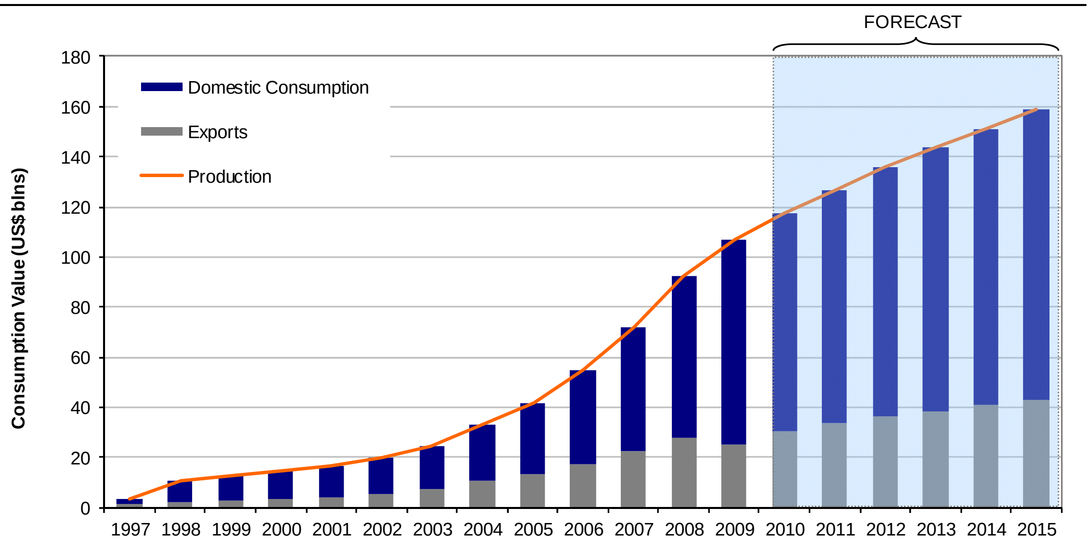


Source: BC Stats

Wood frame construction market small but growing quickly – There are currently 20,000 homes, primarily consisting of high end residential villas, under planning or construction in China which feature wood frame construction ("WFC"). While this is an extremely small amount in relation to China's overall housing market it is twice what it was a year ago, reflecting the increasing acceptance of wood frame construction in the country. Anecdotally, our conversations with those close to the Chinese construction market indicate WFC is gaining traction due to benefits in the areas of cost, earthquake durability, energy efficiency, and environmental impact. Furthermore, in the traditional Chinese 6-story walk-up apartment building, the use of wood in roofing and interior walls represents a massive market, currently in the early stages of acceptance. In fact, lumber use in roofing may not be limited to new construction as we understand the market for re-roofing of existing structures with wood will also be significant, as many of the residential buildings in China feature flat concrete/steel roofs which are prone to leaking.

Chinese consumption of wood furniture exhibiting robust growth – As per data from International Wood Markets, Chinese domestic consumption of wood furniture has grown rapidly over the past 5 years with an average growth rate of 30% (see Exhibit 3). While this growth is expected to moderate somewhat going forward, at an average of 6% over the next 5 years (Wood Markets forecast), this remains a positive for BC lumber exporters as furniture represents a significant end-use of BC lumber in China. We also highlight that, of the total amount of furniture produced in China, exports account for only ~30%, meaning demand for BC lumber eventually used in furniture is driven primarily by domestic demand, as opposed to the relatively uncertain economies of key export markets such as the US, Europe, and Japan. As an example of this trend, Guandong Yihua Wood, one of China's largest producers of wood furniture and flooring, recently announced plans to raise approximately US$130 mln to expand its domestic presence around first and second tier cities by establishing 31 retail outlets and over 1,000 distributors. We believe this strategic plan is indicative of the overall wood products industry's plans for expansion.

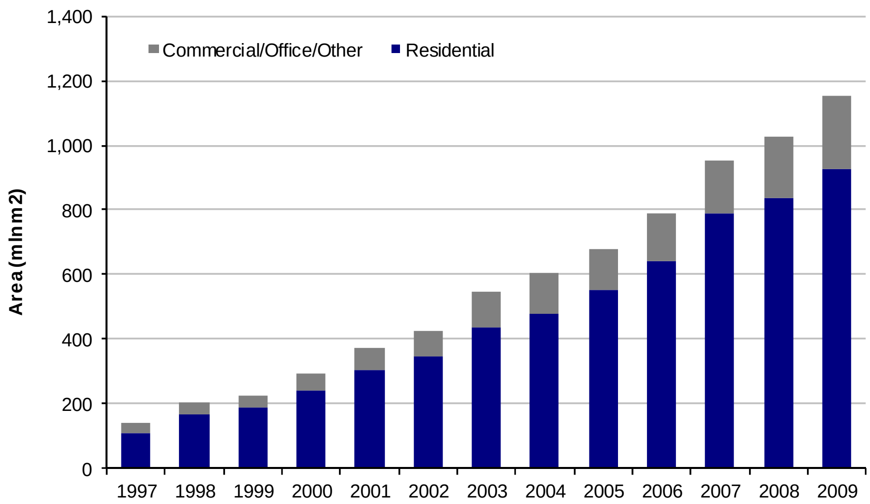
Exhibit 3: China Wood Furniture Production, Consumption & Exports



Source: International Wood Markets

Residential and commercial construction also going strong – Another key driver of Chinese demand for lumber is the country's booming construction industry. Each of the residential and commercial construction sectors has exhibited strong growth over the past decade, averaging 18% and 20% respectively. This equates to an overall growth rate of over 18%, driving significant demand for lumber used in concrete forming (see Exhibit 4). More recently, the construction industry's PMI for June came in at 65.6, well above the 50 benchmark indicating expansion and the highest among all of the PMI sub-sectors, while the forward looking construction business expectations PMI sub index registered a reading of 72.7 (also the highest among all sub-sectors), indicating a positive outlook. While concerns that China's construction sector is overheating certainly exist, we believe the Chinese central government will continue to pursue policies which support the industry, including the construction of 36 mln affordable housing units by 2015, which in combination with the aforementioned economic shifts will outweigh the negative potential impact of falling home prices in first tier cities, in our view.

Exhibit 4: China Commercial and Residential Construction



Source: International Wood Markets

Insufficient domestic supply leads to dependence on imports – China's National Forest Protection Plan was enacted in 1998 in the wake of massive flooding in the middle reaches of the Yangtze River, which was partially attributed to deforestation in the river's upper reaches. These developments led to a drastic reduction in the country's domestic commercial timber production and availability. As a result, despite a large government investment in reforestation, domestic supply of wood fibre is insufficient to keep pace with the country's growing demand. After spiking in 2008 at 81 mln m^3 (artificially high due to recovery efforts to clear out damaged forest materials after the Sichuan earthquake), commercial timber production in China declined 14% in 2009 to 69 mln m^3 – approximately in line with 2007 levels, despite growing demand from rapidly expanding construction and wood processing/manufacturing sectors.

On the import side, timber supply is also constrained by the Russian log export tariff which increased to 25% (or at least 15 Euros per m^3) on unprocessed logs effective Apr-08. These tariff increases have resulted in Russia's share of China's log imports falling from 68% in 2007 to 41% in 2010 and down to 36% for 2011 YTD (Jan - Apr). While we acknowledge pressure from Scandinavian countries (whose sizable wood processing industries suffer cost inflation due to the tariff) and Russia's desire to join the WTO could potentially cause the tariff to decline, we believe the Russian government will continue to pursue policies which limit the degree to which logs can be exported in the hopes of encouraging the development of a larger wood processing industry. In addition, we note significant required expenditures in infrastructure, including logging equipment and roads, will limit the degree to which Russia's vast forests can be harvested as areas close to transportation hubs are increasingly depleted.

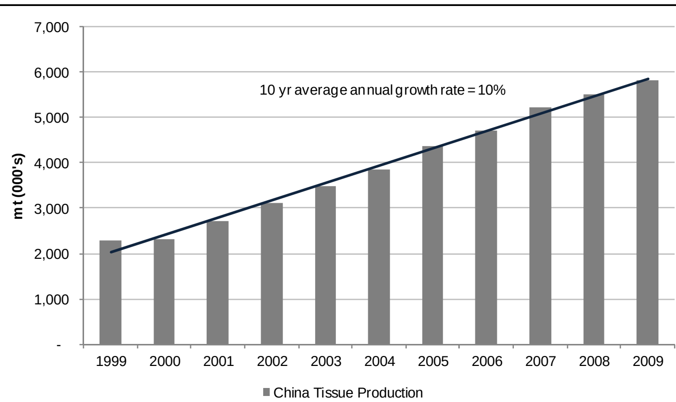
In addition, while China does boast an estimated 62 mln ha of forest plantations (the largest in the world), these plantation lands are largely state-owned and yield actual harvests well below potential. The government is increasingly looking to privatize these plantation lands; however, in the wake of several scandals in the Chinese forestry sector including companies such as Sino-Forest (TRE-TSX, Under Review), Cathay Forest Products (CFZ-TSXV, Not Rated), and China Forestry Holdings (930-HK, Not Rated), we believe access to Western capital to these firms is limited, thus reducing the growth of this sector for the foreseeable future. Given these supply constraints we believe the rapid growth in Chinese demand for lumber YTD is sustainable, particularly with depressed US demand keeping prices low. In our view, Western Canadian lumber producers are extremely well positioned to benefit.

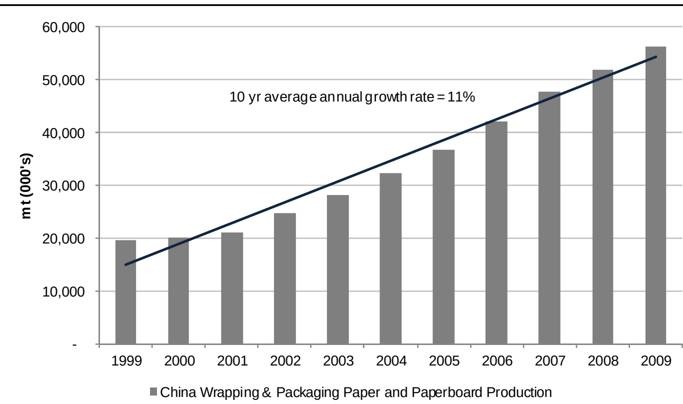
Pulp & Paper

The Chinese pulp and paper industry is characterized by rapidly growing consumption and the parallel transformation of a high number of small, inefficient, highly polluting mills to larger, modern, more environmentally viable mills. RISI currently estimates China's paper and paperboard consumption per capita at 70 kg annually, as compared to developed nations such as the US at over 200 kg/yr. Thus, we adopt a favourable long term outlook towards China's demand for pulp and paper particularly in light of strong growth in end markets (detailed below). We underscore our top Pulp & Paper picks, including Strong Buy rated Fortress Paper and Domtar and Outperform rated Canfor Pulp and Mercer International.

Tissue, packaging, and paperboard demand growing quickly – Having closed many small, inefficient, highly polluting mills and investing heavily in capacity additions in recent years, China now boasts one of the world's most modern tissue production industries. Last year, half of the new tissue machines installed globally were located in China and, with Chinese society increasingly viewing tissue as a standard everyday item, multiple new tissue lines are required each year to keep up with the rising demand. Chinese buyers previously accustomed to basic tissue now expect a quality of virgin-fiber based tissue on par with products sold in North America or Europe. Anecdotal reports indicate demand for tissue is spreading beyond the major coastal cities as well with paper napkins now widely used even in China's relatively poor inland areas. In fact, over the past 10 years growth in tissue production in China has grown by an average of 10%, well above the 4% global average (see Exhibit 5 LHS). We regard the positive implications for Canada's NBSK producers of these trends as three-fold. First, evolving preferences with respect to higher quality tissue augur well for NBSK pulp, which features the greater reinforcement strength and absorbency required for these products. Second, higher machine speeds involved in increasingly modern paper machines also necessitate more NBSK usage. Lastly, the increasing usage of tissue per capita and rising population in Asia bodes well for healthy increases in tissue capacity going forward. While some new tissue and coating technologies allow for the greater usage of southern pulp and/or reduced softwood pulp requirements in general, we expect the aforementioned positive trends to outweigh these negative ones. Similar to tissue, packaging papers and paperboard exhibited strong growth over the past decade with production more than doubling and an average annual growth rate of 11% and surpassing the US as the world's largest producer in 2008 (see Exhibit 5 RHS).

Exhibit 5: China NBSK Pulp Demand Drivers: Tissue Production (LHS), Wrapping, Packaging & Paperboard Production (RHS)

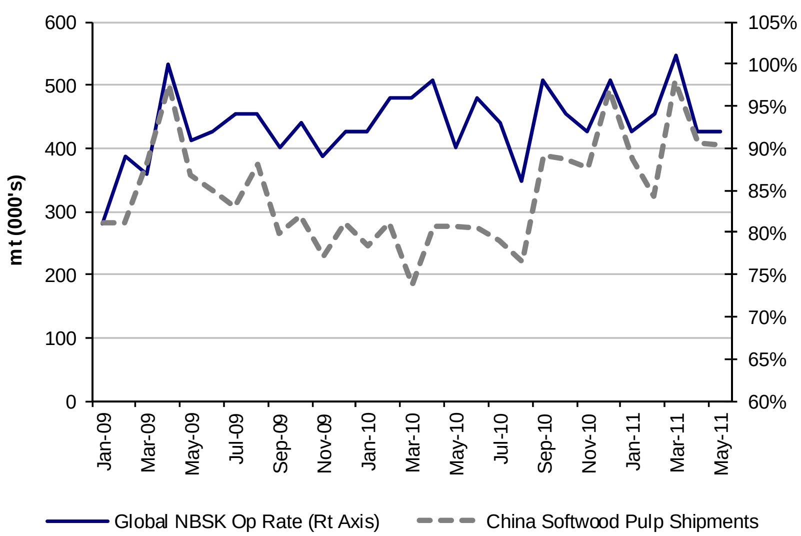




Source: FAO

Rising demand in end markets drives increased pulp purchases – As per the most recent set of industry stats from the Pulp and Paper Products Council, YTD shipments (Jan - May) of softwood pulp to China are up 62% y/y, particularly impressive given the high and rising price levels in the commodity over this period. As is evident from Exhibit 6 below, Chinese demand exerts a material influence over global operating rates and, while a smaller market than Western Europe, is now approaching North America in terms of importance as an end market for softwood pulp. While global NBSK markets appear to be headed for a seasonal slow-down with announcements of reduced July list prices by several major producers in North America and reports of rising inventories and spot discounting in China, we believe this dip in demand will be transitory given current fundamentals. Specifically, we see low global inventories (26 days seasonally adjusted) resulting from a heavy spring downtime season and the return of strong Chinese purchasing in the late summer/early fall limiting the downward pressure on prices. Longer term, the foregoing commentary regarding end markets for pulp in China benefitting from increased paper usage per capita will result in continued growth, in our view.

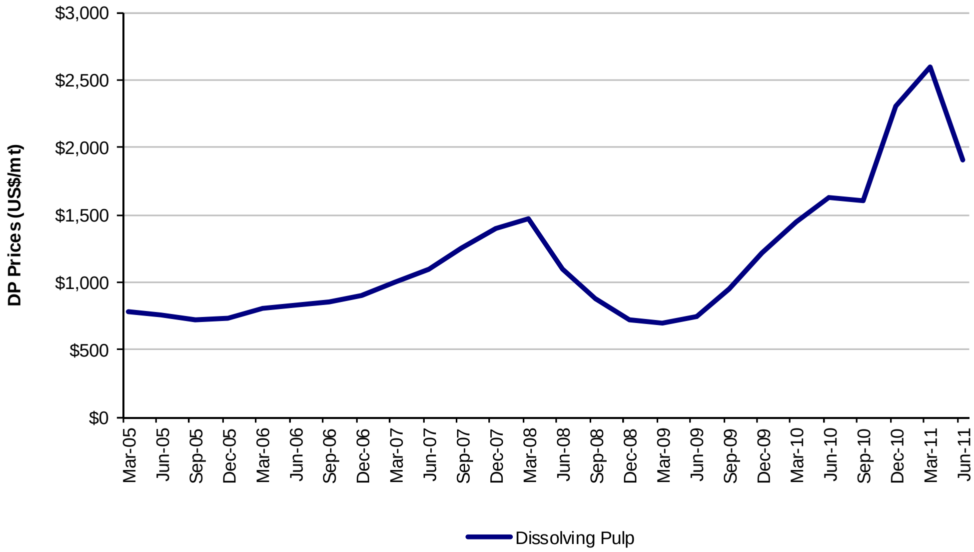
Exhibit 6: China Softwood Pulp Shipments and Global Operating Rates



Source: Pulp and Paper Products Council

DP outlook also buoyed by China prospects – Similar to the trend seen in tissue consumption, we believe the developing middle class in China will spur considerable increases in demand for textiles such as rayon. As rayon, produced primarily in China, is the key end-use for dissolving pulp, we expect Strong Buy rated Fortress Paper will benefit greatly from the bullish themes discussed herein. While DP prices are down to US$1,900/mt from highs of US$2,600/mt (see Exhibit 7) due to a slowdown in textile markets and falling cotton and rayon prices, we foresee rayon capacity additions in China continuing in anticipation of this rising demand, contributing to the long term upward trend in DP. We highlight the expected low cost position of FTP's Thurso mill at approximately $675/mt as providing extremely healthy margins even if prices continue to decline in the short-run, and note we see resistance to DP prices falling below US$1,800/mt as this is the point where substitution of NBSK into textile end uses is no longer economic.

Exhibit 7: Dissolving Pulp Price Chart



Source: Poyry, CCF Group

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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.

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	Coverage Universe Rating Distribution		Investment Banking Distribution	
	RJL	RJA	RJL	RJA
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Underperform (Sell)	2%	6%	0%	0%

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