

Pacific Northwest Log Markets and the Changing Role of Chinese Demand

China's growing appetite for log and lumber imports has changed the dynamics of timber markets in western Oregon, Washington, and British Columbia over the past few years. Rising volumes of log exports to China from the U.S. West Coast and lumber from BC has increased market tension, supporting higher timber prices. Yet, last year's slowdown in China highlighted concerns about the sustainability of China's recent growth trajectory and questions about its future needs for imported logs and lumber.

The performance of timberland assets in North America's Pacific Northwest has benefitted significantly from the robust expansion in exports of softwood logs and lumber to China. Between 2008 and 2011, West Coast softwood log exports to China increased 80 percent, while shipments of Canadian lumber to China increased 118 percent. Canada is now the number one supplier of imported softwood lumber to China with a market share of 44 percent. The U.S. is currently the third largest supplier of imported softwood logs to China with a market share of 13 percent, trailing behind New Zealand at 32 percent and Russia with a market share of 38 percent.

In 2011, U.S. softwood log exports to China peaked at 1.5 BBF, which represented 25 percent of the total softwood sawlog harvest in western Oregon and Washington that year. In BC, softwood lumber exports to China reached a high of 5.21 BBF that same year. As a result of the growth in shipments to China, BC has become less dependent on demand from the U.S. In 2011, B.C. softwood lumber exports to the U.S. accounted for just 43 percent of total production in the province, down from the typical 70 percent in past decades.

Boosted by robust export markets, West Coast hemlock delivered sawlog prices rose 64 percent between 2009 and 2011. In marked contrast, timber prices in regions with limited access to the Chinese markets (U.S. Inland

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Chart 1: U.S. West Coast Softwood Log Exports

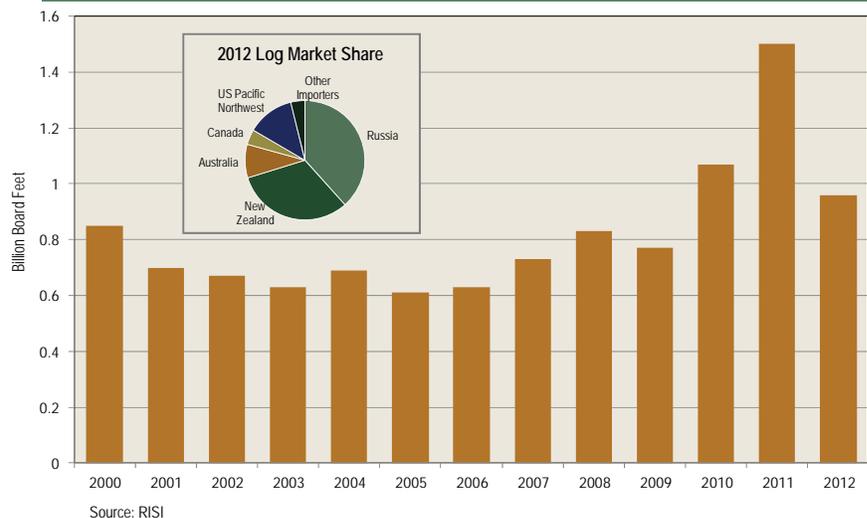
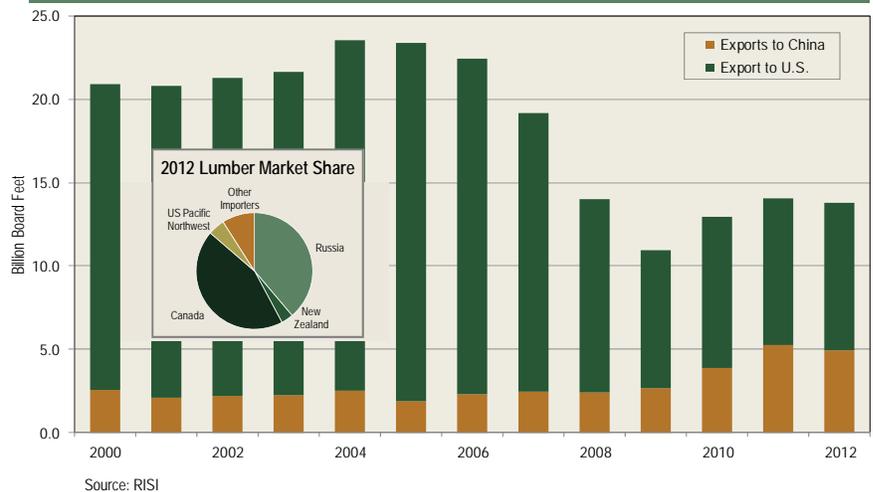


Chart 2: Canadian Softwood Lumber Exports by Destination



West and South) did not experience corresponding gains (see *Figure 3*, this page).

Last year, the pace of China’s growth in GDP slowed to 7.8 percent (down from an average of 10.9 percent in the period 2006 -2011), and construction activity was restrained by the government in an effort to avoid the formation of a housing bubble. As a result, U.S. log exports to China slipped 36 percent from their 2011 peak. Softwood lumber exports from BC to China also reacted to the softer demand in China, with an 8 percent downward correction from its 2011 highs. The weaker offshore demand from China translated into lower sawtimber values, with West Coast hemlock delivered sawlog prices declining 6 percent compared to the previous year.

A Downside Scenario

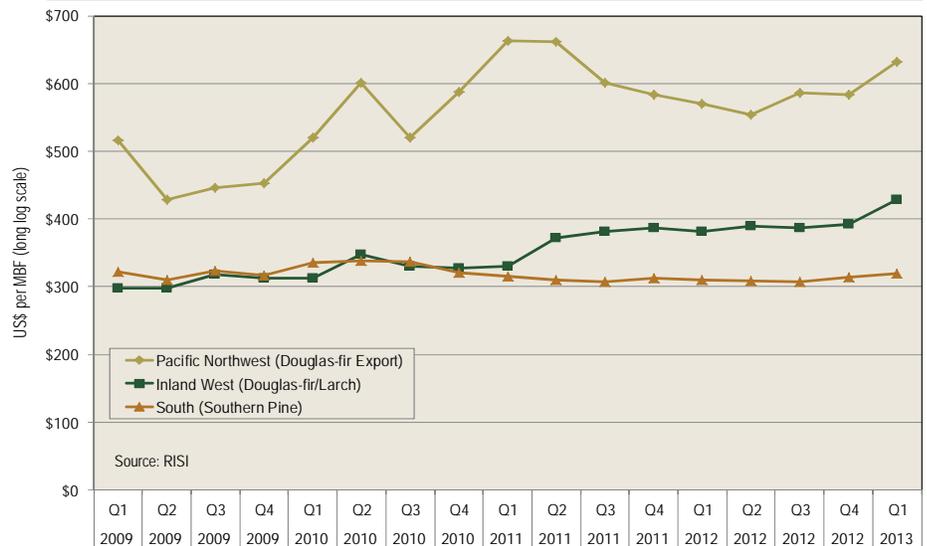
In light of last year’s reversals in North American trade in softwood logs and lumber, we have tried to evaluate some of the potential impacts that would be associated with a further slowdown in Chinese log and lumber demand.

China’s government has recently addressed the need for a major rebalancing of their economy, particularly in a global environment where lackluster growth in the advanced economies is no longer able to support export driven growth.

Other economies, such as the former Soviet Union, Japan, Korea and Brazil, that enjoyed extended periods of strong economic growth during their development, eventually reached periods when their economies lost momentum and in some cases stalled.

In March, China lowered its official economic growth target for the first time since 2005, from 8.0 to 7.5 percent. If growth in China’s GDP missed this target and instead slipped to an annual rate between 5.0 – 6.0 percent in the coming decade, what changes could we expect to see in the volume of logs and lumber

Chart 3: U.S. West Coast Softwood Log Exports



exported from North America’s West Coast?

If we assume that a 25 percent reduction in activity in China’s general economy was accompanied by a corresponding contraction in construction, a decline (at least initially) of a similar magnitude could occur in the volume of softwood logs and lumber imported from North America.

Based on the West Coast hemlock price correction experienced in 2012, where a 63 percent drop in export volume led to a 13 percent drop in the price of hemlock saw logs, we’d expect the initial price response to be proportionately smaller. Lower western sawlog prices would improve the competitive position of U.S. West Coast lumber and plywood mills, boosting domestic sawlog demand, particularly in light of the continuing recovery in U.S. housing demand. Consequently, the initial downward price response to a downshift in Chinese log exports should moderate over time.

In this scenario, Canadian softwood lumber exports to China would also slip. Yet, given China’s increasing preference for lumber imports over logs, the drop

expected would be more moderate, at about 15 percent, or approximately 0.9 BBF. Given the large proportion of lower grade economy lumber exported from B.C. to China, only a portion (approximately 40 percent) of this material could be redirected to the U.S. market. This 0.40 BBF of additional softwood lumber available to the U.S. market would represent just over 1.0 percent of the total U.S. softwood lumber demand for 2012.

The additional 0.40 BBF of Canadian softwood lumber available for shipment to the U.S. would more likely displace non-Canadian imports rather than production from U.S. sawmills. U.S. softwood lumber imports from non-Canadian suppliers were 0.3 BBF in 2012 and are projected by RISI to expand to 3.0 BBF by 2017. This forecasted increase in U.S. imports of non-Canadian lumber would be reduced in the event of a contraction in Chinese demand for Canadian softwood lumber.

Under a Slow Growth China scenario, the redirection of Canadian softwood lumber from China to the U.S. market would

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Quarterly U.S. Housing Starts (1,000 units) and U.S. Softwood Lumber Composite Price Index (USD per MBF)

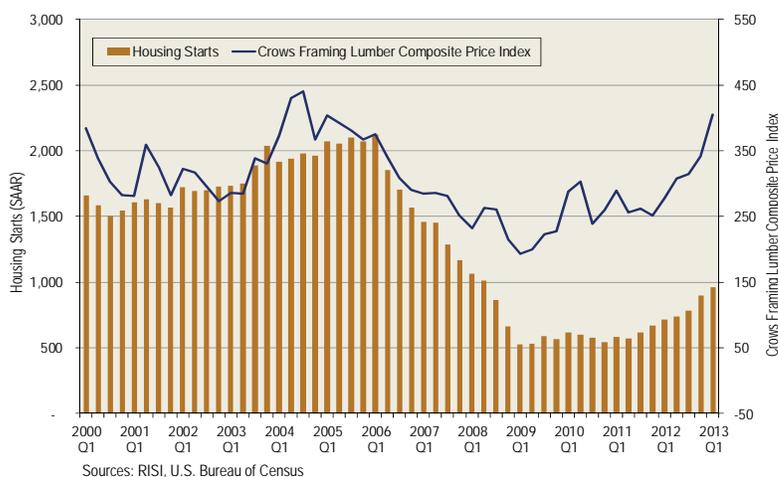


Figure 1. North American Softwood Lumber Prices and U.S. Housing Starts

Prices for North American softwood lumber as measured by the Crows Framing Lumber Composite Index surged in the first quarter, gaining 18 percent over the previous quarter and 46 percent over the first quarter of last year. The rally in softwood lumber prices was supported by stronger U.S. residential construction activity and improved expectation for lumber demand. In the first quarter of 2013, U.S. housing starts averaged 963,000 units (SAAR), 35 percent above the same period a year earlier. Purchases of lumber and wood panels leading up to the peak summer construction season have been supported by declines in the unemployment rate, strengthening consumer confidence and record low-mortgage rates.

Quarterly Australian Dwelling Unit Approvals (1,000 units), Australian Softwood Lumber Composite Price Index and Softwood Stumpage Log Index

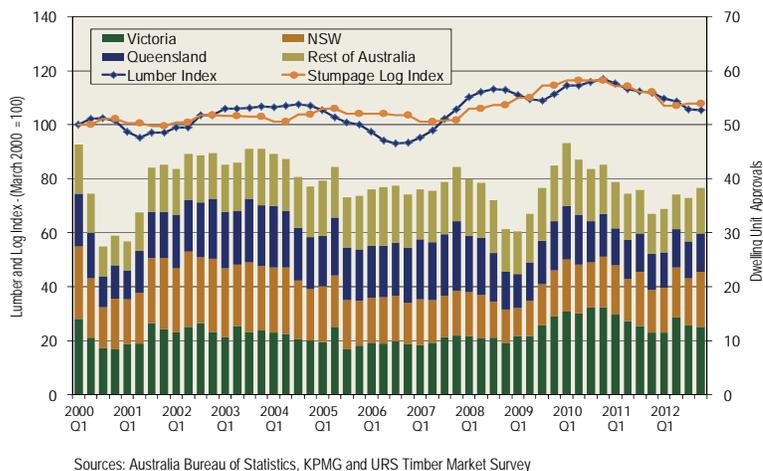


Figure 2. Australian Softwood Lumber, Timber Prices, Dwelling Unit Approvals

Lumber and stumpage prices in Australia seem to have reached a bottom in the second half of 2012, finding support in modest improvements in construction activity. Dwelling construction approvals for all of Australia, as reported by Australian Bureau of Statistics, have maintained a choppy upward trend since hitting a low-point at the end of 2011. In the first quarter of 2013, dwelling approvals totaled 37,330 units, a 7 percent increase over the first quarter of 2012, but down 3 percent from the previous quarter. The slow-down in the Australian mining sector continues to restrain the pace of recovery in Australian residential construction. Responding to the still anemic home construction activity, Australian softwood lumber prices and stumpage index in the first quarter are anticipated to achieve at most modest gains over the last half of 2012 (the most recently reported information).

Quarterly New Zealand softwood log export volume to China (million m3) and New Zealand radiata pine log import price (USD/m3 cif China)



Figure 3. New Zealand Log Exports

In the first quarter of 2013, New Zealand exports of pine sawlogs experience an 8 percent drop from the previous quarter, but remained at historically high levels, and were 40 percent higher than the first quarter of last year. New Zealand continues to increase its share in the key China market, at 66 percent of log exports in 2012, close to overtaking Russia as the number one supplier of softwood logs to China. In the first quarter of 2013, New Zealand accounted for 33 percent of China's imports of softwood logs, up from 25 percent in the first quarter of 2012. Over the same period, Russia's share of China's softwood log imports dropped to 34 percent from 46 percent.

Monthly exchange rates between USD and Commodity Currencies



Figure 4. Exchange Rates

In early 2013, currencies in Australia, Canada and New Zealand have felt downward pressure from a softening in global demand for commodity products and have lost ground against the U.S. dollar. The U.S. dollar has also benefitted in the first quarter from a better than expected pick-up in economic activity, despite higher taxes and reduced federal spending. The currencies of Australia, Canada and New Zealand have all corrected from the near historically high levels reached in 2012, and have continued to edge lower in recent months with both the Australian and Canadian dollars trading below parity with the U.S. dollar. Brazil's exchange rate stabilized in the first quarter, but is down 12 percent from the same period a year ago, reflecting the still sluggish growth in the Brazilian economy.

Quarterly Average Regional Composite Prices for Softwood Sawtimber Stumpage (USD per m3)

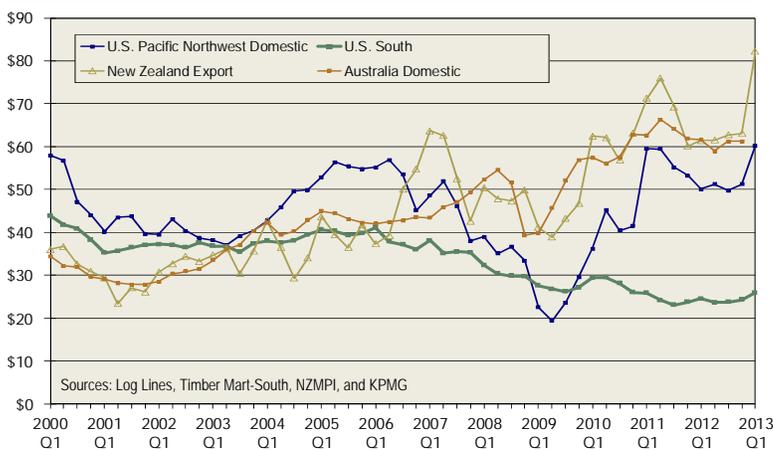


Figure 5. Regional Softwood Sawtimber Stumpage Prices

In regions with access to Asian export markets, softwood stumpage prices made significant gains in the first quarter of 2013. In New Zealand, softwood sawtimber stumpage prices jumped 30 percent from the previous quarter, responding to continuing strong export log demand from China, as competing suppliers in North America were shifting their focus towards recovering domestic markets. Prices for domestic sawlogs in the U.S. Pacific Northwest also rose strongly, responding to a rally in lumber and plywood markets and continuing competition from export log demand in China. Stumpage prices in the U.S. Pacific Northwest increased 18 percent over the previous quarter. Compared to New Zealand and the U.S. West Coast, the sawtimber markets in the U.S. experienced only modest gains, with pine sawtimber stumpage in the South rising 7 percent in the first quarter compared to the previous quarter.

Quarterly Prices for market pulp and fiber (USD per metric ton)

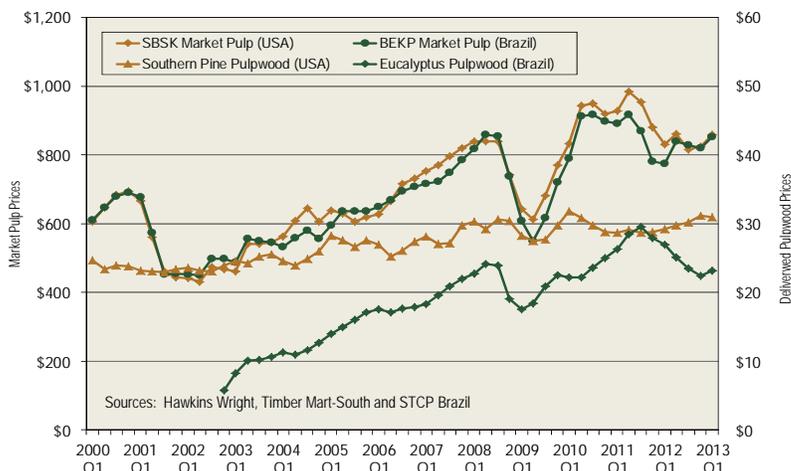


Figure 6. Pulp and Pulpwood Prices, U.S. South and Brazil

Market pulp prices in the first quarter of 2013 jumped over \$30 per tonne from last quarter's price, with U.S. southern bleached softwood kraft (SBSK) and Brazilian eucalyptus kraft pulp (BEKP) trading at nearly the same price (SBSK = \$858/tonne, BEKP = \$852/tonne). The price of U.S. Southern Pine pulpwood in the first quarter of 2013 dipped slightly from last quarter, yet improved six percent over prices in the first quarter of 2011. In Brazil, Eucalyptus pulpwood prices turned upward first quarter, at \$27/tonne following a five quarter slide but is still 14 percent behind first quarter's price of 2011.

U.S. Timberland Annualized Operating Cash Yields (percent per year)

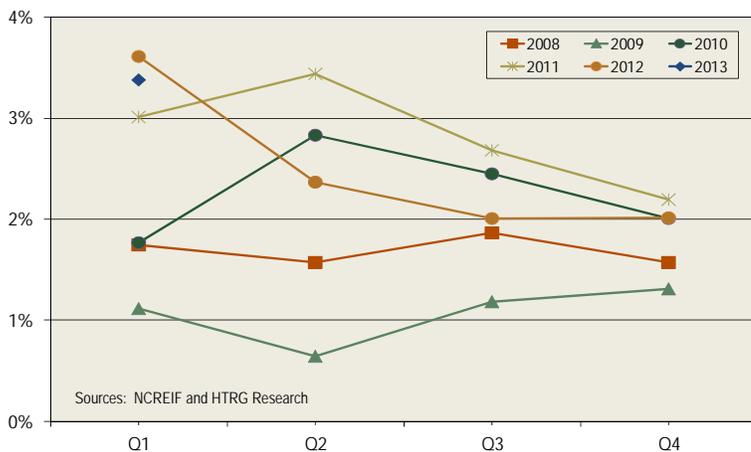


Figure 7. U.S. Timberland Annualized Operating Cash Yields (percent per year)

The annualized cash yield in the first quarter registered improving prices for timber – as timberland managers respond to increased demand for timber losing as construction improves. First quarter 2013 cash yields moved toward historical first quarter average yields near 3.0 percent for the U.S. South and 5.5 percent for the U.S. Pacific Northwest.

Monthly Securitized Timberland Share Value (Indexed to 100 at start date)

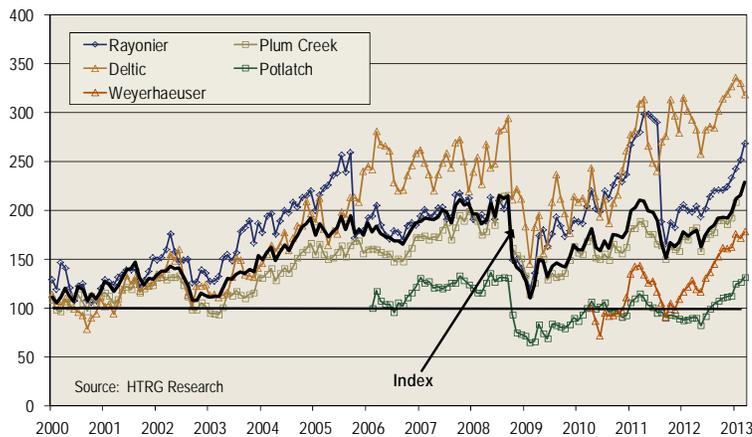


Figure 8. Hancock Securitized Timberland Index

The Hancock Securitized Timberland Index increased by 20 percent during the first quarter of 2013. Plum Creek and Weyerhaeuser were the main drivers behind the increase, as their values rose by 24 percent and 22 percent, respectively. Potlatch and Rayonier both increased by 11 percent. Deltic, faring the worst in the first quarter, lost seven percent of its value. Timber REIT's benefited from improved housing demand – showing strong performance in their wood products segment first quarter.

Quarterly U.S. South Timberland Values (\$ per acre)

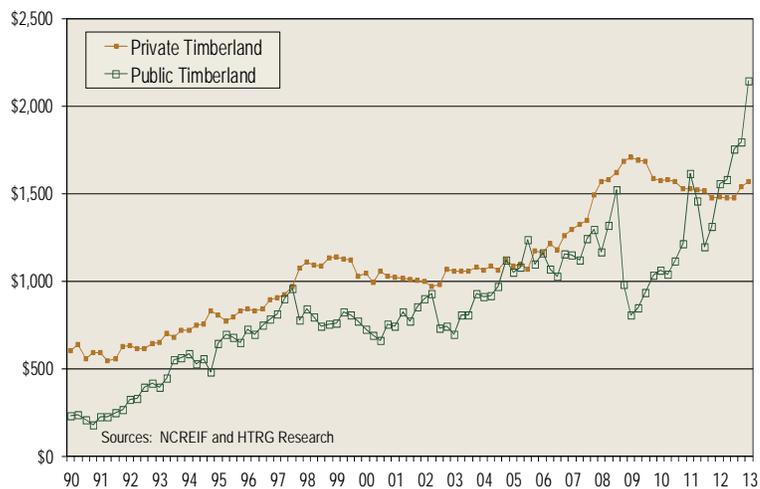


Figure 9. Timberland Enterprise Value

The gap between private and public timberland values in the U.S. South widened in the first quarter of 2013, as privately held timberland – measured by the NCREIF Timberland Index - remained essentially flat during the quarter, while public timberland increased 22 percent from the start of the year. Strong performance in wood products markets transferred quickly to public company valuations.

have only a marginal impact on the production levels at U.S. sawmills, and a relatively modest dampening effect on western timber prices.

Summary

A moderation in China's economic growth rate is a strong probability as China adapts to challenging conditions in the global marketplace and addresses problems in its current development policy. However, China's ability to sustain solid economic performance over the past two decades and successfully navigate through the Global Financial Crisis provides a degree of confidence that China will be able to engineer a successful transition to a more domestically-driven economy.

Consequently, the probability that a sharp and protracted set-back in the Chinese economy would result in significant negative impacts to timber markets is assessed to be low. 

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NOTES:

Figure 1. The source for the U.S. Housing Starts is U.S. Bureau of Census. The Housing Starts data includes Single-family and Multi-family starts. Crows Framing Lumber Composite Index data is RISI.

Figure 2. Quarterly Australian Dwelling Unit Approvals is published by the Australian Bureau of Statistics. The Lumber Index is published by URS Timber Market Survey using Softwood Structural lumber prices (Blended Price - 60% MGP 10 90x35x4800, 40% MGP 10 70x35x4800). Log Price Index is calculated using the (APLPI) Radiata Pine Domestic Stumpage prices. The log price is an average of Intermediate and Medium sawlog prices

Figure 3. Quarterly New Zealand softwood log export volume to China and China Import prices are published by the RISI International Timber Service.

Figure 4. Monthly average Exchange Rates are published by the Pacific Exchange Rate Service.

Figure 5. Quarterly Softwood Sawtimber Stumpage Prices for the U.S. Pacific Northwest is reported in Loglines published by RISI. The weighted index is made up of 50% Domestic Douglas-fir (47% #2 and 53% #3 Sawmill sorts) and 50% Whitewoods (47% #2 and 53% #3 Sawmill sorts). U.S. South prices are published by Timber Mart-South (60% Southern Pine Sawtimber and 40% Chip-n-Saw). Australian domestic prices are calculated using the KPMG Australian Pine Log Price Index (APLPI) Radiata Pine Domestic Stumpage prices. The log price is an average of Intermediate and Medium sawlog prices converted to USD/m³. New Zealand radiata pine export log prices are a blend of A,K and J sort logs published by New Zealand Ministry of Primary Industries converted to USD.

Figure 6. Quarterly Market Pulp prices are published by Hawkins Wright. U.S. Southern Pine Pulpwood prices are published by Timber Mart-South. Brazil Eucalyptus Pulpwood prices are published by STCP Engenharia de Projetos Ltda.

Figure 7. Annualized Operating Cash Yields are published by National Council of Real Estate Investment Fiduciaries (NCREIF). Yields are calculated using 60% U.S. South and 40% U.S. West.

Figure 8. The Hancock Securitized Timberland Index (HSTI) uses a base-weighted aggregate methodology (similar to that used to construct the S&P 500) to calculate a market capitalization-weighted value for five publicly traded timber-intensive forest products companies. Base weights were adjusted for the emergence of new companies or at the beginning of each year. Dividends are not reinvested. The companies included in the HSTI have no investment relationship with Hancock Timber Resource Group.

Figure 9. Public equity values are derived from our Timberland Enterprise Value per Southern Equivalent Acre (TEV/SEA) calculation for five timber-intensive publicly traded companies as compared to southern timberland values per acre calculated from the NCREIF database. TEV is a quarterly estimate based on total enterprise value (total market equity + book value debt) less estimated value of processing facilities, other non-timber assets and non-enterprise working capital. SEA uses regional NCREIF \$/acre values to translate a company's timberland holdings in various regions to the area of southern timberland that would have an equivalent market value.

References to expected investment performance in this newsletter are based on historical information and are based on managements projections. Potential for profit as well as for loss exists.