

Hancock Timberland Investor



A Manulife Asset Management Company

Third Quarter 2015

Expiration of Softwood Lumber Agreement (SLA) with Canada: Potential Impacts on U.S. Timber Markets

Will unrestricted trade of Canadian softwood lumber reduce demand for U.S. sawlogs?

History

Since the 1840s, the U.S. has periodically imposed various taxes on the imports of Canadian softwood lumber. The latest version, the Softwood Lumber Agreement (SLA), signed and implemented in October 2006, imposed a 34% limit on Canadian softwood lumber imports as a share of total U.S. consumption by applying a variety of export taxes and quotas on individual Canadian provinces (exempting the Maritime provinces). The export tax rate schedules were tied to the Random Lengths Composite Index of North American softwood lumber prices, and the tax rates were structured to progressively phase-out as the lumber price index moved higher. The main features of the SLA export taxes are summarized in Table 1.

Table 1: Canadian Softwood Lumber Export Tax Levels

Prevailing Monthly Price*	Option A: Export Charge	Option B: Export Charge
>\$US 355	No export charge	No export charge and no volume restraint
\$US 336-355	5%	2.5% export charge + maximum export volume cannot exceed the region's share of 34% of expected U.S. Consumption for the month
\$US 316-335	10%	3% export charge + maximum export volume cannot exceed the region's share of 32% of expected U.S. Consumption for the month
< \$US 315	15%	5% export charge + maximum export volume cannot exceed the region's share of 30% of expected U.S. Consumption for the month

*Four-week average of Random Lengths Framing Lumber Composite Price.
Option A: BC and Alberta.
Option B: Quebec, Ontario, Manitoba, and Saskatchewan.

Sources: Random Lengths

The Effective Operation of the Agreement

The recently expired SLA began operating in September 2006, shortly before U.S. housing markets collapsed and sent the U.S.

forest products sector into its deepest and most protracted downturn since the Great Depression of the 1930s. During the extremely challenging period 2007-2011 when North American softwood lumber prices were severely depressed, the export tax on Canadian softwood lumber stayed consistently at its maximum levels (15% for B.C. and Alberta), with the exception of three months in 2010 when softwood lumber markets bumped-up as a result of a Federal incentive program for first-time homebuyers. During this four year period, the combination of quotas and export taxes afforded a modicum of relief to U.S. sawmills, helped limit Canada's share of the U.S. lumber market, and provided a strong motivation for Canadian sawmills (particularly in British Columbia) to actively develop alternative off-shore markets, such as China.

As U.S. residential construction activity recovered in 2012-2014, softwood lumber prices rose to levels triggering the reduction or suspension of the tariff from its maximum levels. In 2013, the tariff on Canadian softwood lumber dropped to zero for nine months of the year, and stayed at zero for all 12 months of 2014. By the second quarter of 2015, declining softwood lumber prices once again triggered the activation of the export tax at varying levels (5%, 10% and 15%) from April through mid-October when the SLA terminated.

Shipments of Canadian lumber to the U.S. did not change dramatically following the lifting of the trade sanctions, and lumber prices actually moved higher into mid-November 2015. In the five weeks after the expiration of the SLA, the Random Lengths Composite Index increased 7%, rising from \$305/MBF to \$326/MBF, discrediting fears that stockpiles of wood were waiting just north of the U.S. border for shipment after the expiration of the SLA. However, the question remains whether or not unrestricted Canadian access to U.S. softwood lumber markets over the next few years will compromise prospects for U.S. sawmills, and result in reduced demand and lower prices for U.S. softwood sawlogs.

Probability and Timing of a New Agreement

The passage and implementation of a replacement to the SLA is unlikely to occur over the next couple of years. A provision of

(Continued on page 2)

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(Continued from page 1)

the agreement put a 12 month hold on the U.S. from pursuing any new trade litigation on Canadian softwood lumber shipments to the U.S. Negotiating a new softwood lumber trade agreement in the coming months will be difficult. National elections just occurred in October for Canada, ushering in a new administration and the U.S. presidential elections will take place in November 2016. In addition, both the U.S. and Canada are focused on the politically charged authorization of the recently finalized Trans Pacific Partnership (TPP). Negotiating a new version of the SLA could be viewed as a distraction from the implementation of the wider-reaching and higher-profile TPP.

If a serious effort were to be applied to constructing another softwood lumber trade deal with Canada, an agreement is not likely to be concluded quickly. When Canada withdrew from the Memorandum of Understanding regulating softwood lumber trade with the U.S. in 1991, the next five-year trade agreement was not signed until 1996. When the 1996 agreement expired in 2001, it wasn't until 2006 that the recently expired SLA was put in place.

Canadian sawmills will likely show caution in moving wood aggressively into the U.S. market over the next year. Given the long history of regulated trade in softwood lumber between Canada and the U.S., Canadian producers will be expecting a new agreement to eventually be enacted and will be cognizant that a surge in exports to the U.S. may be used as possible evidence of dumping. A surge in Canadian lumber exports to the U.S. could provide the basis for the U.S. government to impose retroactive duties on current and future lumber shipments from the day the SLA expired.

Market Changes since the last Softwood Lumber Agreement

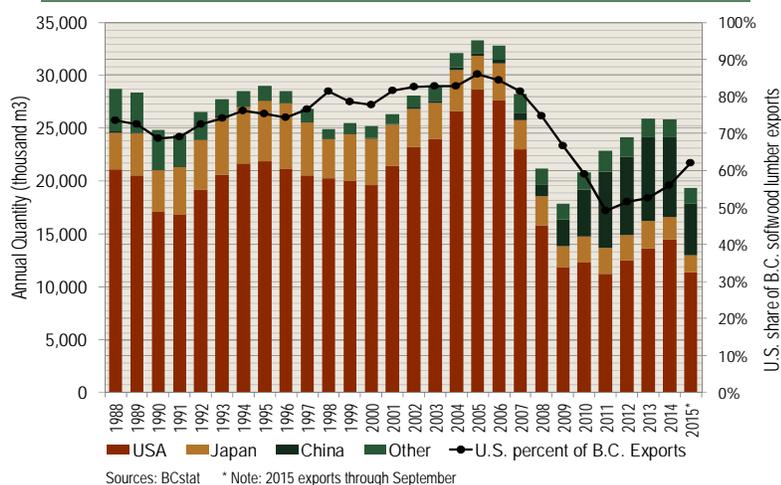
Assessing the potential threat to U.S. timber markets requires considering some of the major changes that have occurred in the North American softwood lumber markets since 2006. The two most prominent changes are the reductions in the timber supply in B.C. as a result of the winding down of salvage operations for the Mountain Pine Beetle infestation, and B.C.'s expanded trade in softwood lumber with China. In 2006, B.C.'s forests were in the midst of a Mountain Pine Beetle infestation, which resulted in a surge in tree mortality and a significant increase in the province's overall harvest levels to accommodate the salvage of the dead and dying trees. At the time, the U.S. was the destination for 84% of B.C.'s softwood lumber exports and the glut of salvage material represented a significant threat to U.S. softwood lumber producers. Between 2000 and 2005, BC exports to the U.S. increased 46%, rising from 19 million cubic meters to 28 million cubic meters.

Compared to ten years ago, the current market conditions are substantially different: B.C. is in the process of winding down its beetle salvage operations; timber harvest levels set by the B.C. government are projected to trend lower; and B.C. has

significantly diversified its exports of softwood lumber. In 2015, B.C. softwood lumber exports to China are estimated (based on actual shipments in the first 7 months) to be 27% of B.C.'s total softwood lumber exports, while the U.S. will account for 62% (Chart 1).

Reductions in B.C. timber harvests along with the development of China as a destination for its softwood lumber have significantly reduced the capability of Canada to flood the U.S. softwood lumber market. In the period 2011-2014, despite U.S. softwood lumber demand improving, lumber prices recovering, and the tariff on B.C. softwood lumber exports being eliminated for most of 2013-2014, exports from B.C. only increased at a

Chart 1: BC Softwood Lumber Exports by Destination



moderate rate, and are still well below the peak levels shipped in the mid-2000s (Chart 2 on page 6).

Another difference in the North American softwood lumber market today compared to when the SLA was enacted in 2006, is the more extensive Canadian ownership of sawmill capacity located in the U.S. *Random Lengths* reports that Canadian sawmillers (primarily B.C. based Canfor, West Fraser and Interfor) now own 30% of the total sawmill capacity in the U.S. South. Canadian companies have invested in expanded capacity in the U.S. in response to anticipated reductions in Canadian public timber supplies as well as to mitigate risks associated with the possible imposition of a new set of trade restrictions limiting their access to U.S. markets.

Post-Expiration of SLA

Looking out over the next five years, a major ramp-up in Canadian shipments is not anticipated to occur for several reasons:

1. B.C. producers will be facing timber supply constraints that

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

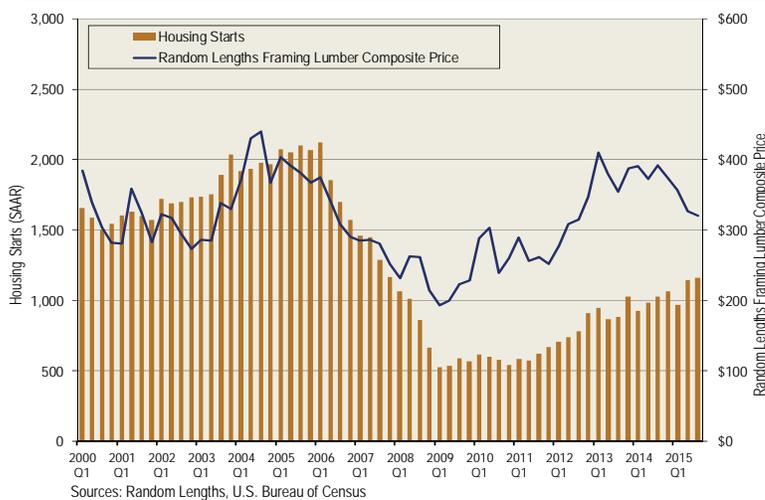


Figure 1. North American Softwood Lumber Prices and U.S. Housing Starts

In the third quarter, U.S. residential construction edged higher to an average of 1.16 million units (SAAR), up 2% from the previous quarter and a 13% increase over the same period a year ago. Even with a modest gain in housing activity, prices for lumber and wood panels slipped a bit further. The Random Lengths Framing Lumber Composite Index dropped 2% from the previous quarter and was down 18% year over year. The positive impacts of higher housing starts was offset by increased U.S. imports of softwood lumber from Chile, Sweden and New Zealand.

Quarterly Australian Dwelling Unit Approvals (1,000 units), Softwood Lumber Composite Price Index (AUD based) & Softwood Stumpage Price Index (AUD based)

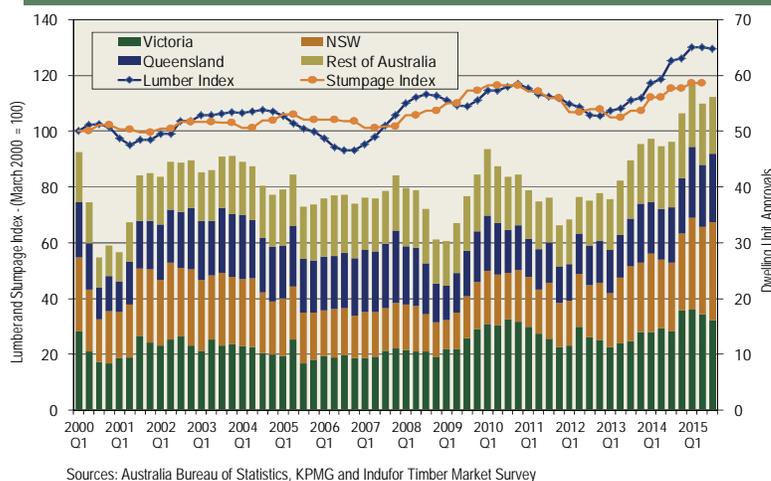


Figure 2. Australian Softwood Lumber Prices, Timber Prices, and Dwelling Unit Approvals

Australian dwelling approvals (a key indicator of residential construction activity) regained forward momentum in the third quarter after slipping 6% second quarter, now reaching just 4% under the first quarter's record peak. Australian residential construction activity has remained strong despite GDP slipping to 2.0% in the second quarter, reaching a two year low. The strong housing markets have supported increases in Australian structural lumber prices, rising 22% from third quarter 2012 to third quarter 2015. Lumber prices in 2015 have flattened, dipping 0.4% third quarter from peaking in the first quarter of this year. Sawlog prices, reported every 6 months, are benefiting from domestic lumber market demand and the development of export log markets in China.

Quarterly New Zealand Softwood Log Export Volume to China (million m3) and Price (USD per m3 CIF) to China



Figure 3. New Zealand Log Exports

New Zealand sawlog exports to China are experiencing a volatile year in 2015, dropping back to 2.6 million cubic meters in the third quarter, a 17% decline over the previous quarter. For the first three quarters of 2015, log exports were 8% below the same period in 2014, reflecting the on-going slow-down in China's economy and construction activity. The price of New Zealand sawlogs in China denominated in U.S. dollars has responded and moved down to \$95 per cubic meter in the third quarter, 41% below the high-point of \$161 per cubic meter set in the first quarter of last year. New Zealand sawlog prices are now approaching (just 12% above) the cyclical low reached in the second quarter of 2009 following the Global Financial Crisis.

Quarterly Exchange Rates Between USD and Commodity Currencies

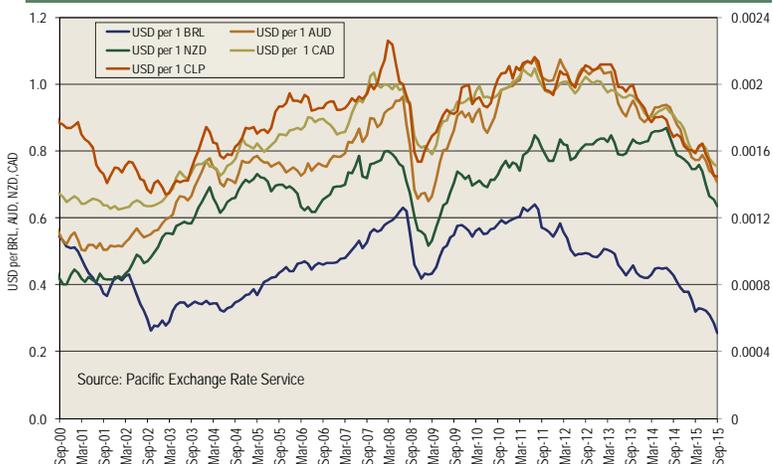


Figure 4. Exchange Rates

The currencies of Australia, Brazil, Canada, Chile and New Zealand all lost ground relative to the U.S. dollar in the third quarter of 2015. Compared to the previous quarter, the Australian dollar lost 10% against the U.S. dollar, while the New Zealand dollar was down 11%, the Brazilian real 13%, the Canadian dollar 3% and the Chilean peso 9%. Compared to the same period a year ago, the Australian dollar has depreciated 22%, the New Zealand dollar 23%, the Brazilian real 35%, the Canadian dollar, 17% and the Chilean peso 15%. All of these currencies have been impacted by soft commodity prices and the set-back in Chinese import demand. The more pronounced drop in Brazil's currency over the past year is tied to the country's negative economic performance, rising inflation, and the unsettled political situation.

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

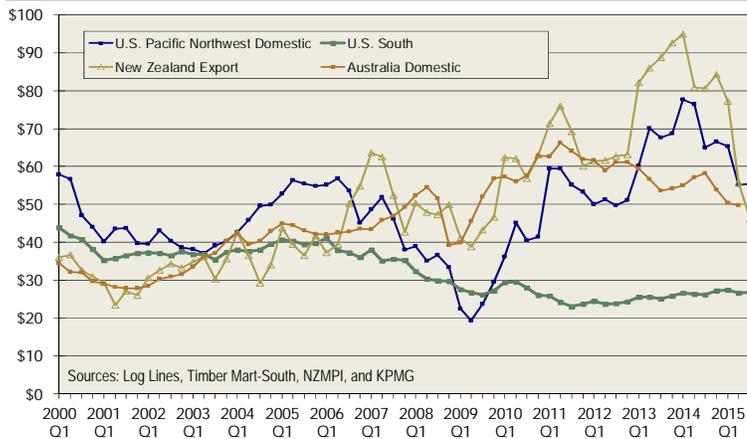


Figure 5. Regional Softwood Sawtimber Stumpage Prices

Softwood sawlog stumpage prices denominated in U.S. dollars made modest gains in U.S. markets and declined in New Zealand during the third quarter. New Zealand export sawlog stumpage prices were down 17.1% in the third quarter, mainly as a result of New Zealand currency depreciation against the U.S. dollar. Prices in NZ dollars declined just 1.9%. Stumpage prices in the U.S. Pacific Northwest increased 0.6% from the previous quarter, while timber prices in the U.S. South increased third quarter by 0.5% from second quarter levels, and are up 2.5% from third quarter prices last year.

Quarterly Prices for Market Pulp and Delivered Pulpwood (USD per metric ton)

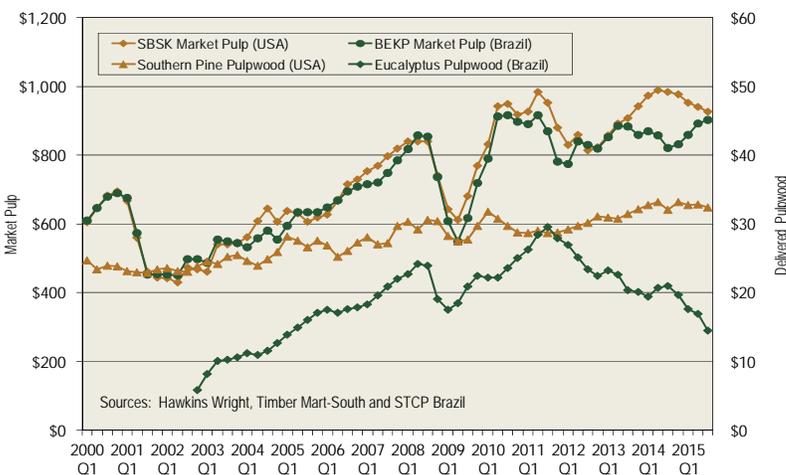


Figure 6. Pulp and Pulpwood Prices, U.S. South and Brazil

Bleached Eucalyptus Kraft Pulp (BEKP) continued on an upward trend in the third quarter of 2015, gaining 1.1% over the previous quarter. At US\$902, BEKP was up 9.8% from the third quarter of last year. BEKP prices have climbed US\$70 over the past three quarters, finding continued support from strong export demand based on Brazil's low-cost position as a producer, which has been supported by the substantial correction in the Brazilian real. Brazilian eucalyptus pulpwood prices fell 14.2% in U.S. dollars compared to the previous quarter, but in local currency terms prices were nearly flat. Southern Bleached Softwood Kraft (SBSK) prices fell again third quarter, at US\$927 per tonne, a US\$63 per tonne fall from the last cyclical peak of US\$990 second quarter last year. Pine pulpwood delivered prices in the U.S. South moved little third quarter, at US\$29.40 per tonne.

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

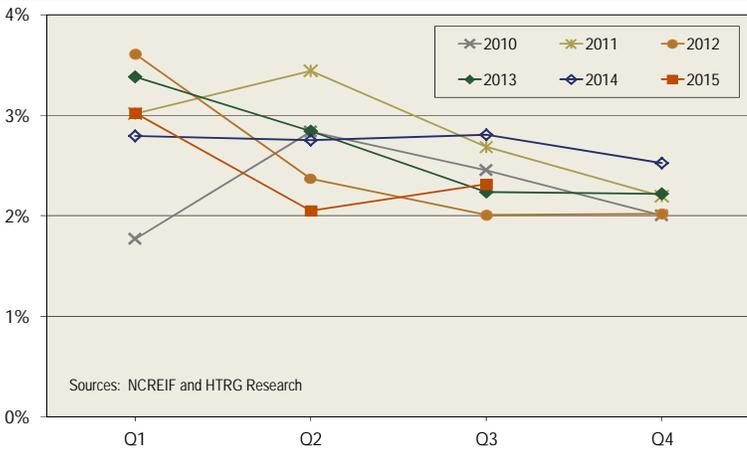


Figure 7. U.S. Timberland Operating Cash Yields
 Third quarter U.S. cash yields from timberland operations, as reported by NCREIF, were 2.3%, a modest improvement over the previous quarter’s 2.0%. The increase in third quarter cash yield was driven by better results from southern timberlands, reflecting improved demand and modest gains in timber prices. Cash returns on western timberlands remained close to the levels experienced in the second quarter, as western timber production was constrained by fire-related harvest restrictions.

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

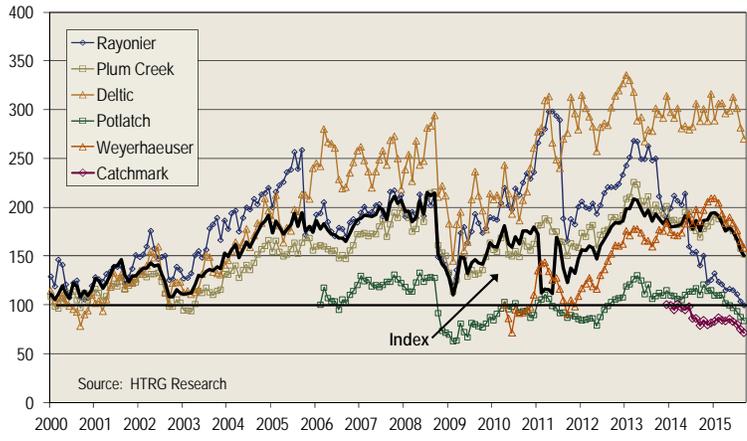


Figure 8. Hancock Securitized Timberland Index
 The Hancock Securitized Timberland Index, a market-capitalized weighted performance Index of timberland held in public market ownership dropped 10.5% in the third quarter from second quarter. Decreasing share prices for the six REITs in the index and reduced shares outstanding contributed to the fall. Weyerhaeuser, the largest contributor to the Index, lost 13.9% of market value and the next largest contributor, Plum Creek, declined by 3.3%. Potlatch lost 18.5% of market value; Rayonier lost 1.7% and CatchMark Timber Trust lost 12.4%. CatchMark was included in the HSTI after its successful REIT conversion in December 2013, and contributes 1.5% of the total weight of the Index.

Quarterly U.S. South Timberland Values (USD per acre)

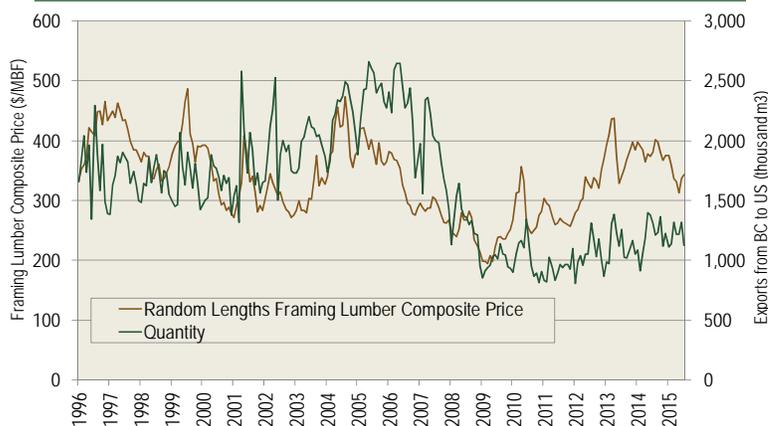


Figure 9. Timberland Enterprise Value
 In the third quarter, estimates of Southern U.S. timberland per acre values for publicly traded REITs decreased compared to timberland values held by private institutions, with the value spread dropping to a \$170 per acre discount compared to properties held by private institutions. Public timberland, measured by the Timberland Enterprise Value per Southern Equivalent Acre (TEV/SEA), fell \$499 per acre over the past four quarters. In contrast, timberland held by private institutional investors – representing the properties contributing to the NCREIF Timberland Property Index in the U.S. South – rose \$23 per acre over the same time period.

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(Continued from page 2)

Chart 2: BC Monthly Softwood Lumber Exports vs Framing Lumber Composite Price 1996 - 2015 (July)



Sources: BC Stats and Random Lengths

will limit their ability to ramp-up production on a sustained basis at their B.C. mills. The assessment of constrained timber supply in B.C. is corroborated by the modest gains in B.C. softwood lumber production in the first half of 2015 (2%) and the continuing investment by B.C. lumber producers in the U.S. South (Canfor's recent acquisition of Anthony Forest Products, which has six facilities producing lumber, engineered wood products, and wood chips in

Arkansas, Louisiana, and Georgia).

2. B.C. softwood lumber producers are not likely to abandon the market presence in China that was developed with considerable effort over the past decade, and which now provides Canadian sawmills important market diversification and reduced dependency on U.S. markets.
3. Canadian softwood lumber companies now have significant production based in the U.S. and these operations would be negatively impacted by depressed lumber prices resulting from a spike in Canadian exports to the U.S.

The end of the SLA is not likely to substantially slow the ongoing shift in the North American softwood lumber industry from British Columbia to the U.S. South. Over the next decade, the softwood lumber sector in the U.S. South, benefitting from infusions of new capital from Canadian companies, will become a bigger and more cost-efficient consumer of the region's pine sawlogs. In addition, the exposure to open-market competition in the absence of trade protection should drive the South's sawmills to greater operating efficiencies and an improved cost position in international markets. A rejuvenated southern pine lumber industry with an improved ability to participate in global markets should benefit the region's timberland owners with more stable and secure markets. 🌲

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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. Random Lengths Lumber Composite Index data is used for lumber prices.

Figure 2. Quarterly Australian Dwelling Unit Approvals is published by the Australian Bureau of Statistics. The Lumber Index is published by Indufor Timber Market Survey using Softwood Structural lumber prices (Blended Price - 60 percent MGP 10 90x35x4800, 40 percent 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 percent Domestic Douglas-fir (47 percent #2 and 53 percent #3 Sawmill sorts) and 50 percent Whitewoods (47 percent #2 and 53 percent #3 Sawmill sorts). U.S. South prices are published by Timber Mart-South (60 percent Southern Pine Sawtimber and 40 percent 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 percent U.S. South and 40 percent 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 six 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.