COVID-19: Impacts Across the Forest Sector

COVID-19: Impacting U.S. Forest Product Markets
With North American markets for forest products and timber rapidly adjusting to the sweeping changes precipitated by the COVID-19 crisis, HNRG and other timberland managers are reviewing and revising short-term return expectations and operational plans. The impact of the COVID-19 crisis on specific properties will vary considerably based on the composition of the markets to which they are delivering timber, as the various segments of the forest product sector are experiencing different degrees of vulnerability to the pandemic. Headwinds are already being felt in the underlying markets for softwood sawtimber, as construction activity is in retreat due to COVID-19 restrictions and falling consumer confidence. Concurrently, segments of the pulp and paper industry such as tissue and packaging are experiencing strong demand as a result of changing consumer behavior. Even with some positive market segments, the scope of the current economic shut-down in the U.S., coupled with the increasing weakness in the construction sector, will represent significant headwinds to timberland investments in 2020.

Solid Wood Product Markets
Lumber, plywood, and other structural and non-structural wood panels represent the largest single component of U.S. wood demand by volume, and an even greater proportion of total timber value, due to the higher per unit value of sawlogs (larger, more mature trees) compared to pulpwood (smaller, less mature trees). Consequently, the impacts of the COVID-19 crisis on solid wood product markets will be key in determining potential changes in timberland revenue streams over the next 18 months.

Housing starts and repair and remodeling are the key drivers of solid wood product demand globally (lumber, wood panels, molding and millwork, wood flooring, and cabinetry). Underlying fundamentals in U.S. construction markets were strong heading into 2020, as the U.S. reached a cyclical high in new home construction at 1.63 million units (SAAR) in December 2019.

U.S. residential construction demand in early 2020 drew solid support from
strong employment and wage growth and improved affordability, as mortgage rates dropped to record low levels.

Based on the robust performance of construction markets

Although forestry and wood products processing has
demand and prices to trend higher, but this
 optimum outlook was stopped short by the emergence of
cost contagion in the U.S. in early March.1

Consumer confidence took a series of blows as the U.S.
stock market crashed and job losses surged, crushing the
purchasing intentions of potential home buyers. Monthly
U.S. housing starts in March turned down, an early
indicator of a likely significant correction in the second
quarter.

Another moderating force to deteriorating demand
conditions for timber managers can be wood supply
agreements with local mills. These agreements can
include specified schedules of delivered timber volumes.
Likewise, wood supply agreements might also include a
known price for the timber harvested, typically indexed
through a backward-looking average of prices of logs or
backward-looking calculations of the final product price.

The exact timing of a bounce back in housing remains
highly uncertain and will depend on consumer confidence
and when businesses can resume operations and
workers can return to their jobs.

1 https://www.whitehouse.gov/wp-content/uploads/2020/03/03.16.20_coronavirus-guidance_8.5x11_315PM.pdf
3 Random Lengths Weekly, April 21, 2020
4 RBC Capital Markets, April 12, 2020; Random Lengths Weekly, April 21, 2020, HNRG April 12, 2020
Monetary and fiscal policy responses have been significant and will be a huge plus in supporting a recovery in construction activity, particularly historically low interest rates and the potential for further rounds of fiscal packages targeting infrastructure construction.

Yet, risk-aversion moves by financial institutions could curb some of the potential boost of the Federal Reserve’s aggressive actions. Recently, JP Morgan in the face of a developing major recession implemented new home lending policy changes requiring borrowers to have a credit score above 700 and 20 percent down in response to COVID-19. A current bright spot for solid wood product demand has been home improvement activity, indicated by strong sales at big box home-improvement stores. Repair and alterations of existing homes has over the past decade accounted for approximately one half of U.S. consumption of softwood lumber. Current spending on home improvement may see a benefit from much of the population being bunkered at home with time to initiate deferred home projects. Any bump-up in home improvement activity could be short-lived particularly if business closures persist and uncertainty surrounding household income restrains spending decisions.

**Pulp and Paper Markets**
The U.S. pulp and paper sector is a major consumer of wood fiber and is a multi-faceted industry, spanning a range of end-use markets, each with its own dynamics. Key segments include market pulp (not integrated with paper or paperboard capacity); graphic papers which are used for printing purposes including newsprint; packaging and board; tissue and hygiene products; and specialty papers. Wood pulp (market pulp) and packaging and board products are globally the largest end uses.
Graphic Paper Printing and Writing

The measures that have been generally adopted to contain the spread of COVID-19 have created a dramatic fall-off in graphic paper demand. Closures of schools, offices, retail stores, and cancelled conferences and meetings has resulted in less printing, less dollars spent on advertising by print media, and an acceleration in the on-going shift away from print media to online. The life-style changes necessitated by the COVID-19 crisis such as social distancing are likely to continue to have a moderating influence on graphic paper demand, by boosting the shift to on-line services and shopping which are less dependent on print media and paper than traditional schools and brick and mortar retail commerce. Global demand for graphic paper fell 5 percent (6 million tonnes) last year while capacity only retreated 2.7 million tonnes, resulting in historically low producer operating rates. As COVID-19 has pushed demand even lower in 2020, market imbalances have been exacerbated. In North America, several producers had already implemented extended downtimes. Domtar and PCA, representing about 3 percent of North America graphic paper capacity, have announced additional mill shutdowns for mid-April and May.

Paper Packaging and Board

Although demand for packaging will be moderated by the slowing economy, COVID-19 related quarantines and stay-at-home policies are changing consumer behavior and generating expanded at-home shopping which generates demand for paper boxes for shipping. The surge in consumer buying of products shipped in corrugated packaging both to homes and to grocery stores helped push up U.S. paper and paperboard production 2 percent year-to-date in February (to 12.5 million tons) compared to the same period last year and is expected to show stronger increases for March and April as consumers have dug in at home. Linerboard used in the manufacture of corrugated boxes, led the increase. Linerboard production makes up over half of the paper and board production in the U.S.

Tissue and Specialty Pulp

Consumer panic buying of tissue products as cities rolled out stay-at-home orders, and increased use of tissue products for health care at homes, clinics and hospitals resulted in a 6 percent gain in production for the first two months of 2020 (to 1.3 million tons) compared to the same period last year. Tissue mills - where workers are healthy and allowed to work – are running close to full capacity. Georgia Pacific, one of North America’s top three tissue

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6 Fastmarkets RISI Viewpoint, March 19, 2020
7 Fastmarkets RISI PPI, Pulp and Paper Week, August 23, 2019
8 RBC Capital Markets, April 12, 2020
9 Fastmarkets RISI, April 3, 2020
11 Fastmarkets RISI, April 3, 2020
producers, reported production for the week of March 16th to be at 120 percent of capacity, while smaller independent, America Paper Converting reported to be running around the clock and has increased its work force at its Woodlands, WA and Richmond, VA tissue facilities.\(^\text{12}\)

The at-home stocking of tissue products and associated panic buying triggered by the COVID-19 outbreak is a temporary phenomenon, and could be followed by a period of de-stocking as the crisis abates.

U.S. timberland investors should expect to see reduced cash flows in 2020 as a result of disruptions in the forest product sector and depressed demand, particularly in the highest-value market segments, solid wood products. Despite a few healthier market segments, the overall forest sector will be contending with a pronounced setback in demand in 2020. These weaker market conditions will translate into increasingly competitive timber markets and downward pressure on sawtimber prices. The ability of individual timberland properties to weather the significant headwinds in 2020 will depend on the composition and depth of their local markets, and the competitive position of their key customers in their respective market segments. A timberland owners’ position as preferred supplier based on their scale and track record of dependably delivering quality timber will be key to navigating these unique, challenging, and hopefully temporary market conditions.

\(^{12}\) Fastmarkets RISI, March 27, 2020
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