



MADISON'S TIMBER PREVIEW

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Wily investors are hanging back, watching the lumber industry very carefully to determine when the market will hit bottom so they can start buying under-valued Wall Street stock. No need to look any further for proof than this week's purchase of the idled Fort St. James sawmill (formerly owned by the bankrupt Pope & Talbot) by the brand-new Conifex company.

Comprised of a group of former lumber industry big-wigs, and chaired by a director of Raymond James, Conifex intends to buy curtailed sawmills over the next couple of years. With one of its members able to provide large amounts of capital, Conifex will go so far as to upgrade the woefully out-of-date mills in order to make them competitive in the future, once the lumber market turns around.

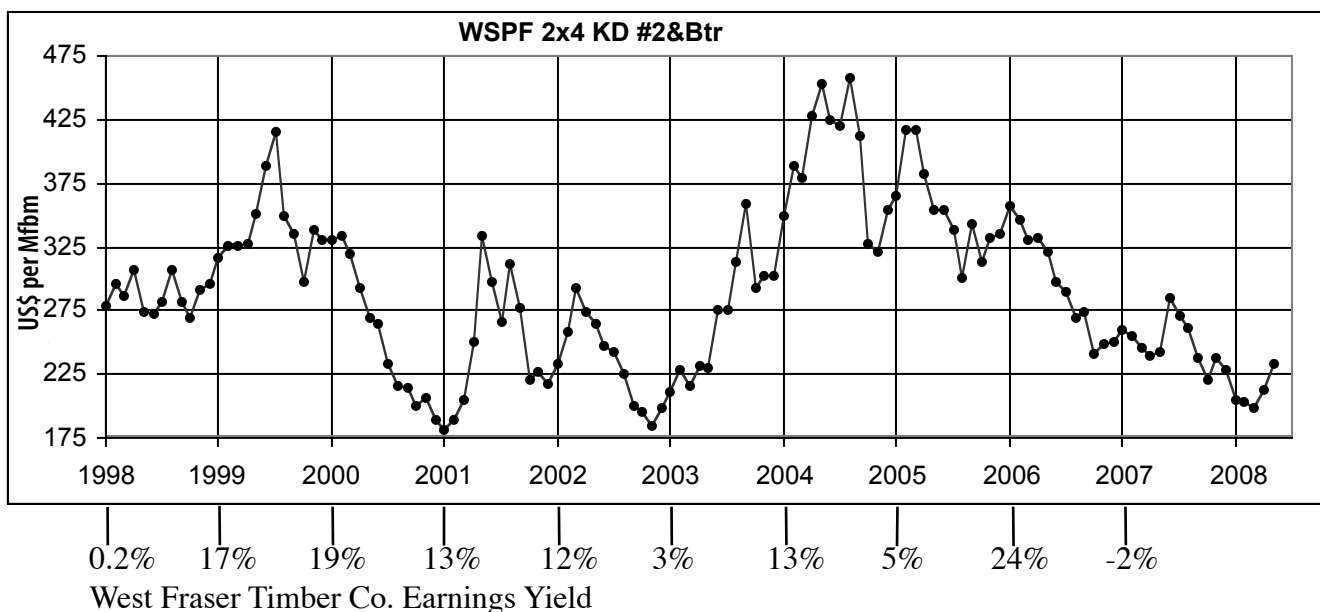
But when will that be? Not for two years at least (barring a major natural disaster or other emergency). The United States, the world's largest lumber consumer by far, needs to complete the agonizing throes of the zero-interest mortgage and asset backed paper fiascos. Once the foreclosures run their course, and the glut of unsold homes are digested through the resumption of sales, home building in the US will resume. This can not possibly be before mid-2010, at the very soonest. Of course it all depends on how the US economy goes; if there will in fact be the slowdown that many analysts are predicting, the housing market recovery will take even longer.

Which makes this a perfect time to invest in wood products companies, provided one can wait out the downturn. I am going to focus on Canadian stock, because that economy is currently stronger than America's and is facing less uncertainty in the near future.

Applying the methods of a very successful modern investor, Warren Buffet, I analyzed the historical return of a Canadian lumber company. I chose West Fraser Timber Co. (WFT-T) as the example, because it is a Top Ten North American lumber producer, and because the head office is situated in Quesnel, British Columbia, the centre of the beetle-kill disaster and heavily impacted by the current lumber market downturn.

Using the vital commodity price data and information gathered from the mills and wholesalers every week by *Madison's Lumber Reporter*, I will provide insight into the economic health of the industry.

Benchmark Random Length Lumber Prices 1998-2008



Through a simple calculation, Mr. Buffet determines the earnings yield (earnings per share divided by share price) of a company over ten years. I will qualify this by saying the Mr. Buffett would never invest in the forest industry because it is not "simple". I intend to demystify some of the confusion revolving around this very complicated business.

The graph on the previous page tracks the benchmark dimension lumber price (WSPF KD 2x4 #2&Btr) over the last decade; and shows the yearly earnings yield for West Fraser below. There doesn't seem to be a direct relationship, clearly there are explanations besides simple market conditions for the earnings yield of wood products companies. Knowledge of the industry can help explain some things. For example, in 2006 a large portion of the duties from the Softwood Lumber Agreement that had been collected by the US Dept. of Commerce since mid-2002 were returned to Canadian lumber companies. This influx of cash raised the return to investors.

Similarly, although the lumber market was strong and prices high in 2005, the earnings yield was relatively low. This is because West Fraser embarked on a couple of very ambitious sawmill building projects, one of which has since been completely abandoned.

In mid-2003 there was a terrible forest fire in the Kelowna, BC area, causing a perceived threat to timber supply. And, in fact, to mill operations, given that the Tolko mill at Barriere literally melted into the ground.

Despite things looking very dire for West Fraser's bottom line, the company is embarking on an exciting new venture. There are opportunities for future development of the wood products industry besides simply pumping out two-by-fours, and West Fraser recognizes that. The most likely of these to see profit in the near future are wood pellets, already in enormous demand in Europe and parts of Asia, and bio-fuels.

Wood residue, until recently termed 'wood waste', is a bonanza of fibre supply for ethanol. Currently the only difficulty is the process of breaking down the wood cellulose, which is significantly tougher than that of, say, corn. Two methods are being actively researched internationally. It's only a matter of time before a technological breakthrough is made. When that happens lumber companies all over North America are going to rush out to their timberlands to recover the fibre littering the forest floor.

A May 23, 2008 press release by West Fraser announced a new venture, together with EPCOR, to develop the use of "sawmill waste, forest residuals from harvesting activities such as slash and tree limbs, and low-grade beetle-killed wood" to "explore the potential of a biomass fueled 50-70 megawatt power generation facility in the area of Houston, BC." The feasibility study is not expected to be complete until late 2008.

Despite the dire economic reality right now, there is clearly HUGE potential for future growth and profit earnings in the timber business. I will be keeping a close eye on any developments.

Next time . . . panel (OSB and Plywood) producers.

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