

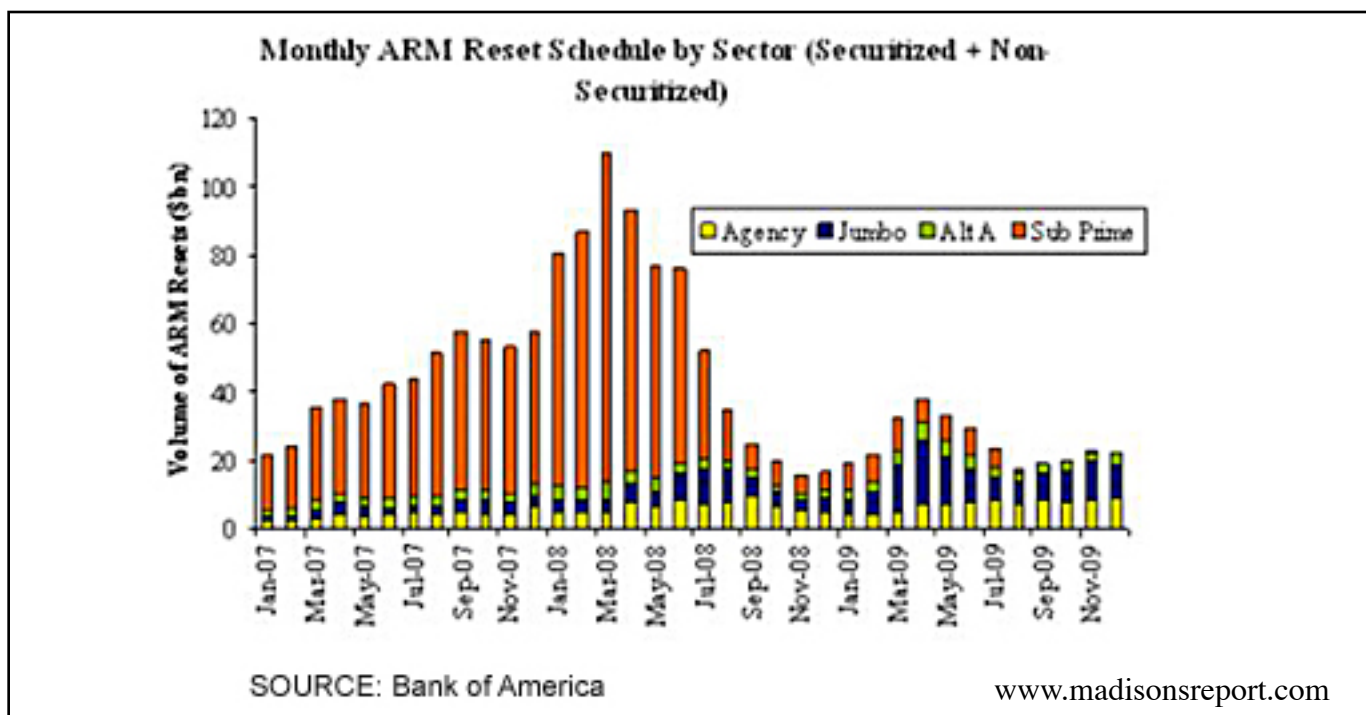


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Canada's historic reliance on the US housing market for lumber customers has always been unpredictable. Domestic US lumber producers have never wanted their Canadian colleagues to have more than a 33 per cent market share. When home building in America is going strong, producers north of the border can hardly keep up with the orders. But when the housing market slows down, or grinds to a standstill as it is now, US lumber wholesalers slam the door on Canadian wood products. "Protectionism" is perhaps not a strong enough description.

While at a timber investment conference recently in Portland, OR, Madison's came across the exact mentality that is currently killing North American lumber producers. A conversation with a timber salesman from Alabama brought this comment, "My daddy ran a sawmill, his daddy ran a sawmill, and his daddy before him." Replace the southern twang with an interior BC accent, or one from small town Quebec, and you have the Canadian lumber producer in a nutshell.

When it became obvious in 3Q 2006 that all was not well in the lumber game, rather than look forward and change their business model, Canadian producers - especially in BC - simply ramped up production in an attempt to drive their competition out of business. Dimension lumber flowed across the border as if home building was continuing at a record pace, which it no longer was. Now mill curtailments and closures are magnified due to previous overproduction, and renewal of production will be delayed until the bulk of wood oversupply available has been absorbed.



There are two possible obvious solutions to rectifying this old, stale mindset: 1) put more focus on added-value and secondary manufacturing rather than just chopping raw logs into basic pieces as quickly as possible, and 2) looking for new markets. While Japan is still by far the main customer for lumber coming out of the west coast, Chinese demand is growing exponentially every quarter. Meanwhile Europe is hungry for all manner of

remanufactured products of high quality, from laminated to veneers, furniture stock and trim. The difficulty with exporting remanufactured wood products into Europe is that they are actually trying to sell into North America. The difficulty with breaking into China as a market for primary products is that there is already a strong exporting contingent in North America that has spent the past two years building a customer base in that country. Chinese lumber exporters in North America are highly motivated to maintain a strong hold on their market share, going so far as to buy lumber on this continent at a premium and sell into China at a discount just to prevent anyone else from gaining a foothold.

Europe has easy access to high quality hardwoods both internally and from Africa, as well as potential sources in New Zealand. With a long tradition of managed silviculture and reforestation, there is a lot of competition to the sale of North American home building components on the European continent. The latest figures from the Food and Agriculture Organization of the United Nations show that in 2006 Europe, including the United Kingdom, exported 72 per cent of its domestic forest products while importing a quantity matching 35 per cent of domestic production. The total value of forest product export for that year was US\$111.4 billion, while import value was US\$89.8 billion. In 2005 European Union countries imported US\$2.31 billion in softwood lumber (up 35 per cent), while in that same year China imported US\$317 million (up 250 per cent).

Russia almost doubled its softwood lumber exports into Europe in 2005 from 2001, shipping US\$713 million worth of wood for a 31 per cent market share. Russia grew its softwood exports into China to \$116 million during the same time period, which represents 37 per cent of the Chinese imported softwood market. China also increased its softwood imports from Canada to \$52 million in 2005, up from \$9 million in 2001. Canada's market share of Chinese imported softwood stood at about 16 per cent in 2005.

Exports of raw logs out of Russia have declined dramatically since that government's announcement early this year of an 80 per cent export tax. To date the tax on raw log exports has been set at 15 per cent, and is expected to reach the maximum by February of 2009. Some analysts are skeptical that the full 80 per cent levy will go through. However just the perception of such a high tax has already served to decrease demand for Russian logs in Japan, China and Europe. China will have to source this fibre somewhere, and is already looking to New Zealand and other parts of Asia. Timber producing countries and regions have their own restrictions on raw log exports, like British Columbia's moratorium on cedar, which is forcing Chinese importers to modify their demand for raw logs and timbers only.

Current wisdom for anyone wanting to send wood products into Europe is that they must be value-added or secondary remanufactured in some way. Slicing up a bunch of 2x4's is not going to garner a lot of demand. European importers are most interested in veneer sheets, panel, including particle board, and chemical wood pulp. There is also significant demand for industrial roundwood and sawnwood in some countries (Austria, Belgium, Denmark, Finland, Italy, Norway, Spain, and the UK) but generally speaking these items are brought in from other European countries rather than being shipped all the way from North America.

In China the situation is quite different; that country's producers would prefer to do all the mill work, remanufacturing and assembly themselves. However the Chinese economy is growing at such a rate, and to such a degree, that the government and agencies are not able to ensure policy is being followed. Chinese delegates from industries related to forestry and wood products are travelling the world to gain new contacts, while at the same time groups and delegations are touring China trying to get new business.

Keta Kosman  
Publisher  
Madison's Lumber Reporter  
[www.madisonsreport.com](http://www.madisonsreport.com)  
604 984-6838