



MADISON'S TIMBER PREVIEW

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North American lumber demand and prices ended so strongly in 2012 that everyone wants to know: Is this a real recovery? Are higher lumber prices here to stay or is this a temporary spurt of demand which will die off soon? A lot of the strength behind the improving lumber market is coming from better numbers in US home building. US house prices stopped falling and home sales perked up a little bit here and there in 2011 and 2012, then a little bit more. By the second half of 2012 there was more building of new US homes than most people thought there would be, with those figures getting only better as December rolled around.

Still, as January wanes, people are asking if there will be another downturn. This question was at the very top of peoples' minds at the *IQPC 11th Global Timberland Investment Summit* in New York City this week. Investment funds, analysts, fund managers, advisors, US and international timberland sellers, the US Forest Service, and more gathered to exchange the latest information and ideas about the current state of global timber stocks.

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Kenneth Brown, Founder and Managing Partner at LionChase Holdings gave a talk on the "Private Equity Approach to Timberland Investment Analysis". Brown scoffed at the idea that anyone could plug data into a model which would then predict what is going to happen in the lumber industry in the next five years.

"There is no way anyone could possibly predict an event with a model because this situation has never happened before," said Brown. "So how can it be in your model?"

This sentiment is exactly correct, and was echoed strongly in *Madison's* own speech later in the conference.

Next spoke Manish Kapoor, Managing Principal at West Wheelock Capital.

"Don't just invest in timberland," began Kapoor. "Expand to natural resources. Compare timberland to other assets. The case for timber looks better now than it did two years ago. For example; a year and half ago, junk bonds were paying 8.5 per cent now they are paying 6.4 per cent. But timber is a relatively low correlation asset, it correlates to other criteria than the S&P, the Dow Jones, and such. Timber actually correlates more to real estate. However timber is susceptible to macro economic events."

During this session there was also some interesting discussion about US inflation, with many agreeing that 'real' inflation -- if gas and food prices are put back into that index -- is about 5 per cent.

"So if you are getting a 6 per cent return on your investment," said Kapoor. "You are really making 1 per cent."

The second day started with the topic everyone wanted to know more about: US housing market projections. The first session was a panel, which included Daniel DiMartino, Financial Analyst for the Federal Reserve Bank of Dallas, Jeremy Bach of Bach Capital Advisors, and Mark Kennedy, Executive Director of Equity Research for Paper and Forest Products at CIBC.

DiMartino provided some excellent projections for the US real estate market, including starts, foreclosures, and home buying trends. Unfortunately, after being extensively quoted by *Madison's* a few years ago DiMartino since always stipulates that her comments are off the record. Suffice to say there was a significant adjustment over her projection last year. Not a significant adjustment, a complete reversal. While certainly not having the most glowing expectations of the three panelists, DiMartino's estimation of the next two to five years of US home sales and building was much, much more positive than it was at the January 2012 IQPC conference.

Bach started out by saying he views the housing market as upside. Bach's company raises funds for capital investment, of which a lot of focus lately has been on pooling loans -- specifically mortgages -- to sell to lenders.

"Has there been too much of a flood of houses on the market lately?" asked Bach rhetorically. "No. It takes us three months to put out a pool of loans, and there are only so many real buyers. However the credit market is getting better, banks try to refinance people every day. Two years ago they couldn't get anyone refinanced, we are hearing anecdotally that it is much easier now.

"The new rules about qualifying for a mortgage will ease liability in the short term and allow banks to keep lending."

There was a question from the floor about the shadow inventory. Bach and DiMartino together answered that investor sales have been about 30 per cent of that market, that there has been a change in the complexion of the shadow inventory. The worth of those homes has gone up to an average of US\$250,000, which puts the speculative buyer looking for a second investment property out of the game.

Kennedy was more specific about his outlook for the US housing market.

"In total there were 780,000 housing starts in 2012," began Kennedy. "This figure surpassed all analysts expectations, including my own, some by a large degree. In 2013 I expect 950,000 starts, and in 2014 it will be 1.15 million.

"This is not a normal housing recovery. It is going at a very gradual, slow rate. And the annualized numbers are still a long way from normal, which is 1.5 million starts annualized. Since 2008 the US was underbuilding so severely that it will take a few years to catch up to the 50 year average."

"There will be a deficit of almost 3 million new homes in the US by the end of 2014," detailed Kennedy. "In order to revert to the mean, there will need to be 1.8 million new US homes built every year for the next ten years."

The mean line for annualized housing starts in the US has been incredibly strong for over 75 years, it is a trend that has never been broken over the medium term. When a downturn and recovery, or uptick and correction, are taken together, the mean has never deviated from 1.4 million annualized.

"In 2005, lumber demand in the US was 30 billion board feet, in 2012 it was 10 billion board feet, in 2014/15 it will be 18 billion board feet," explained Kennedy. "The North American lumber system is stretched, it is at the verge of running out of wood. In certain regions there are significant supply constraints coming, particularly in BC with the mountain pine beetle and Quebec with the reduction in the AAC.

"We must not forget about China, as a customer. That market for North American wood is not going away. North America exported 6 billion board feet of lumber in 2012. It will take four years for the supply-demand balance to get back to normal, so the tone for lumber demand therefore timber is positive."

In answer to a question about Canadian market share, Kennedy said that Canada won't be able to return to the approximately 33 per cent it has historically enjoyed in the US.

"At most Canada will make up 25 per cent of wood in the US. The void will be filled by European wood imports into the US."

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