



MADISON'S TIMBER PREVIEW

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Interest in forest industry investment is resurging, with analysts and economists of all flavours beginning to express opinions and forecasts. Market pulp prices were not hammered as badly as solid wood during the economic downturn, but paper and board prices suffered quite badly. Now that manufacturing shipments are rising to pre-recession levels, as is newspaper advertising and circulation, its time to take a look at the scope of that recovery.

Last week Skot Kortje, financial analyst for the Globe and Mail, wrote a piece titled, "*TimberWest shares ready for lift-off*".

"The past year has seen a surprising renaissance for timber and pulp stocks. A combination of supply factors has ignited bullish forestry product commodity price trends as lumber and pulp prices have risen substantially since the market bottom," wrote Kortje. "Investors trading a rally from trend-line support can look to a \$6 objective, a 30-per-cent move. Long-term investors may see the bullish trend extend beyond resistance at the March peak."

TimberWest shares were trading at \$4.80 on April 14, when Kortje's piece was published. At market close on Thursday this week, shares were up to \$5.38 with no sign of slowing their rise.

Raymond James analyst Daryl Swetlishoff coined the phrase 'peak lumber' in a report published March 31, recommending that investors build positions in British Columbia lumber stocks in anticipation of a lumber 'super cycle.'

Despite market pulp prices holding firm through 2009, due in part to reduced inventories as chips from sawmills became scarce and further to sustained demand out of China, pulp producer share prices are just now beginning to reflect the strength of the pulp industry. Preliminary printing and writing paper shipments for March were released April 16 by the American Forest and Paper Association and showed continued improvement on both a monthly and year-over-year basis. The only exception was uncoated free sheet which remained flat compared to the same time last year. US total printing and writing paper shipments in March 2010 were at 1.565 million tons, 11.7 per cent higher than February, and 12.9 per cent above year-earlier levels. This demand will push common pulp grades to over \$1,000 per metric ton, a height not seen since 1995, according to the AF&PA.

Meanwhile, US box shipments continued to show cyclical recovery, inventories dropped further from already lean levels, and operating rates remained high. If industry price hike initiatives of US\$60 ton on containerboard and 10 per cent hike on boxes go through, industry margins are expected to expand sharply in the second half of the year. Higher prices may combine with falling fibre costs and improving volumes, according to Deutsche Bank.

Mercer International Inc., a market pulp producer with two mills in Germany and one in western British Columbia, share prices have shot up 679 per cent since one year ago. Mercer shares were at \$0.68 on April 22, 2009 and were selling for \$5.30 on April 22, 2010. By comparison the Dow Jones rose only 36 per cent in the same time period.

SFK Pulp Fund operates a market pulp mill in Quebec, and one recycled fibre and one recovered fibre pulp mill in the US. SFK share prices have experienced a 457 per cent rise in the past year, compared

to the S&P TSX index's rise of 32 per cent. On April 22, 2009 SFK shares were selling for \$0.39, shooting up to \$1.76 Thursday. SFK generated \$389 million in 2009 revenues on curtailed production, versus \$532 million in 2008. The company received \$20.9 million in Green Energy Transformation funding from Canada. After several equity raises in the past at higher prices, the SFK restructured its debt covenants and survived, and is now converting to a corporation. The company is running at capacity in Quebec.

Tembec, Inc. has operations in the solid wood, pulp, and paper sectors. The pulp and paper segments of Tembec consist of 12 operations, including two pulp mills in France which the company has just sold. Tembec shares have risen 187 per cent in the past year, going from \$0.88 on April 22, 2009 to \$2.82 Thursday. Most of those gains began on March 2, 2010.

None of these companies have made any extraordinary measures in the past year to enjoy such a healthy rise in stock prices. They are simply being carried along by a perception of a strengthening industry. Tembec had \$490 million in debt and \$200 million in underfunded pension liability, as of December 31st. The funds from the French mills will be used to reduce debt and fund capital expenditures. Tembec generated revenues of \$1.8 billion in the year ended September 30, 2009, down from \$2.4 billion for the predecessor company. More than half its revenues are from paper pulp.

Chris Damas of SeekingAlpha wrote on April 16, 2010 "*Paper Stocks Poised to Rally*".

"These small cap names [Tembec and SFK] have only now begun to react positively to the ongoing boom in pulp and paper pricing. Clearly the exchange rate is a negative if the Canadian dollar continues to rise above parity with the USD. I have chosen companies that have at least some US operations or debt funded in USD. It is likely more pulp and paper supply will come back on line if demand continues to build and prices continue to rise. However, I expect the industry will show some production discipline, as the weaker names were rooted out during the 2008/2009 downturn."

Deutsche Bank analysts released their 1Q paper and packaging estimates and revisions note on April 14, finding that in almost every paper grade, significant price hikes are in the market. The most prominent is the US\$60 per ton containerboard initiative for April, but prices are also rising on other paperboard grades, as well as uncoated free sheet. At the same time, the 1Q spike in fibre costs appears to be easing. Combined with the usual seasonal, as well as potentially cyclical, boost to volumes, the sequential earnings lift between 1Q and 2Q should be impressive when revealed.

The global pulp market remains tight, says another Deutsche Bank note. Major producers have now announced \$30-50 per metric ton price increases for May across key markets. Domtar, Canfor and Mercer International have slated North American market pulp prices at US\$1,000 per metric ton for May, up US\$40 per metric ton. If implemented, North American market prices will be up approximately 13 per cent from the July 2008 cyclical high and up approximately 57 per cent from the May 2009 cyclical low.

Global pulp and paper price tracker FOEX.fi concurs that US market pulp list prices currently stand at "a full US1000 per metric ton".

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