

SUMMARY

- Canada's sawmilling industry is in decline
- Insect infestations have ravaged the forests
- Punitive US tariffs have damaged the industry
- Sawmillers are hoping for a belated recovery in US housing demand

TURBULENCE AND DECLINE

Canada's sawmillers face a range of challenges, from massive insect pest damage in the forest, to increased competition from Europe and trade tariffs in their biggest export market, the US. They are having to explore new strategies to find the answers. Building materials and real-estate consultant **Robert Woodbridge** reports



Above: Sawlogs from pine beetle-killed trees await processing at a BC Interior sawmill

Canada's sawmilling industry is big and powerful, but declining. The pace of the decline varies geographically – led by British Columbia, which once boasted a seemingly endless supply of low-cost wood. In recent years, western Canada's spruce-pine-fir (SPF)

forests have been ravaged by insect infestations; the profitability of its sawmills has been wiped out by rising wood costs, sharp declines in log supply, punitive 20% US tariffs and mill closures.

Two decades ago, Quebec, Ontario and the Atlantic Provinces also experienced traumatic market changes, timber supply reductions and cost-driven downsizings. Substantially reduced in aggregate volume of output, their surviving sawmills are in a stabilisation phase – struggling currently with low North American lumber prices and dismal levels of US new housing demand.

Active property markets in Canada have generated a lot of domestic demand for building materials. But Canadian markets can't compare with the size and importance of the US housing industry. For Canada, despite substantial diversification into other markets, notably China, lumber and wood product exports to the US remain vital.

Canadian success in China was serendipitous, but it also reflected smart marketing by BC sawmillers. The Chinese construction industry's need for huge supplies of low-cost lumber for concrete forms exactly matched BC's otherwise unsaleable supply of degraded pine dimension lumber production. Without China, BC's SPF industry would have collapsed. However, like Japan's imports, China's manufacturing industries increasingly require higher grades of lumber – a need welcomed by price competitive sawmills in eastern Russia.

Canadian sawmills are technological leaders, at the cutting-edge of efficient lumber recovery and milling practices. Large-scale plants historically have provided significant economies of scale. The sector is also focused on development of new wood products, such as cross-laminated timber (CLT) – used increasingly for tall wood buildings and systems building. Even so, it currently remains dependent on commodity framing grades.

SOFTWOOD LUMBER PRICES

Volatility in lumber prices is particularly harsh on commodity grade producers and their customers. Over a two-month period in 2018, benchmark North American prices jumped 19% (see graph). Over the next year, they fell dramatically. By May 2019, prices were 40% lower than the peak a year earlier.

The impacts of sharply reduced softwood lumber prices also hit Canadian sawmilling operations much harder than lower cost mills operating in the US South. The latter enjoy abundant wood supply, lower log prices and a locational advantage, close to large and growing markets.

Having enjoyed strong Q3 and Q4 2018 sales revenues and earnings, North American sawmillers were forced to adjust to lumber prices that eventually dropped below trend levels. As a result, by Q1 2019, Canadian mills began to take substantial downtime. In British Columbia, with a six-month lag in its government-administered stumpage formula for public timber, many SPF mills were paying more for their log supplies than they received for finished lumber.

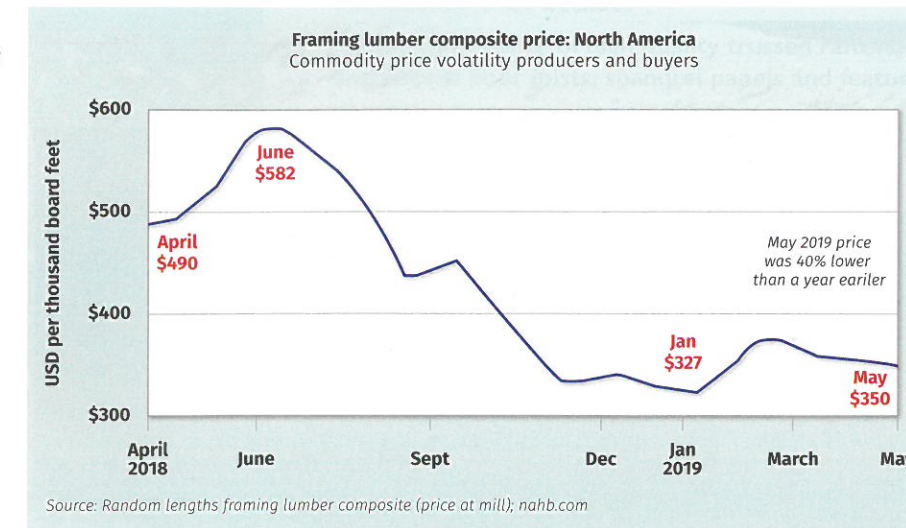
An upward blip in lumber prices occurred around March, reflecting better weather and the spring site-built construction cycle. But this petered out as US housing starts failed to recover as expected.

US MARKETS

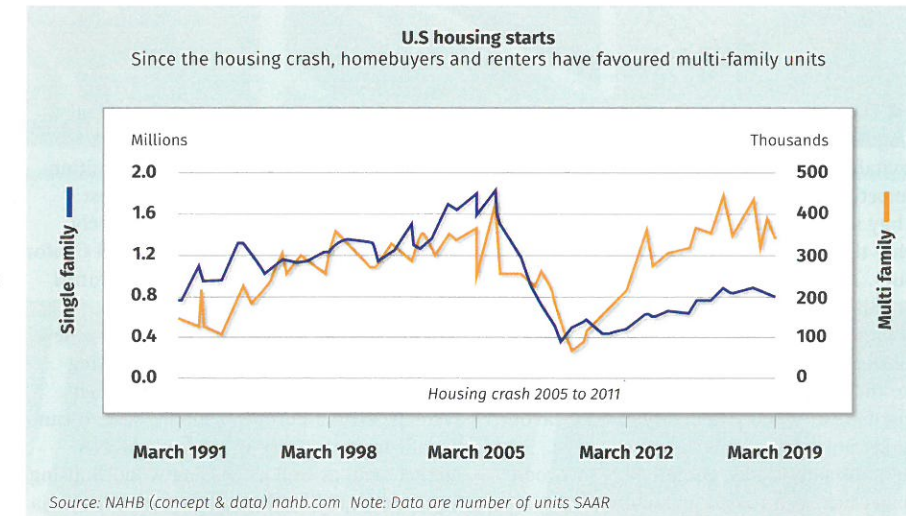
Over 70% of Canadian lumber exports are sold to major markets in the US, where Canada has roughly a 25% market share. One-fifth of exports are sold to China and the balance primarily to emerging Asian markets.

Consumption of softwood lumber in the US is still well below previous levels. During the construction boom in the early 2000s, almost 50% of all softwood lumber consumed in the US went into new-build housing. After the market crash, this declined sharply, as home renovations took an increasingly larger percentage share. By 2018, only about 30% of US consumption went to homebuilding. Even so, new housing starts remain a primary driver of overall demand and North American lumber prices.

During the US housing slump of 2005 to 2011, fundamental changes in demand took place. Prior to the crash, home ownership rates were rising and demand for suburban



Above: Over a two-month period in 2018, benchmark North American prices jumped 19%



Above: Single-family unit construction has lagged behind multi-family

single-family homes was buoyant. The mix of single and multi-family housing generally was in balance (see graph). Since the crash, home ownership rates have declined; more people are renting and single-family unit construction has lagged sharply behind multi-family.

The graph also shows that the US homebuilding industry's pace of new construction peaked during 2018. So far in 2019, it shows a concerning flat-to-declining trend. Forecasts by industry analysts, such as the National Association of Home Builders, anticipate only a modest improvement over the next few years.

This is not good news for North American lumber producers because single-family homes consume three times the volume of softwood lumber as multi-family units.

It demonstrates an enforced supply

discipline on homebuilders. That's key to any future substantial recovery in US housing starts, which encouragingly remains supported by fundamentally strong demographics.

The DIY home renovation market bounced back quickly following the US housing crash. It accounted for a record 40% of the country's overall consumption in 2018 and is associated with a highly efficient retail and pro-builder supply-chain (such as Home Depot, Lowes, Menards and 84 Lumber).

This market is also of considerable interest to offshore suppliers of softwood lumber to the US, such as the Baltics, Chile and Brazil. But collectively, they still hold only a small share of the US market. It's a demanding customer, requiring higher grades of square-edge (ie no-wane) lumber typical of European sawmills. ▶



Above: BC Interior pine sawlog showing beetle infestation

◀ The western Canadian industry, recognising very early the realities of the inevitable decline in their mills' competitiveness and supply capability, began to buy sawmills and make timber deals in the richly timbered, lower cost forests of the US South. Through aggressive acquisitions, Canadian firms now account for one-third of US lumber capacity.

European pine and spruce lumber suppliers into the US are sensing the game has changed – permanently and potentially in their favour. Market pulp always has been an internationally traded commodity; softwood lumber has been traded regionally. Smart firms know that's no longer the case. The

lumber game has changed, and the global supply chain is becoming sophisticated.

With its recent majority-share acquisition of Vida Group, Sweden's seventh largest sawmilling group and its largest privately held operator, BC-based multi-national Canfor is positioning itself as a globally diversified channel partner to existing US retail customers. It's well positioned to serve a new generation of global homebuilders buying factory-built components and engineered systems. With a European supply base, it can benefit from recovery in the huge MENA market area, as well as chasing wood-housing and taller-building demand prospects in India and other parts of emerging Asian markets.

North America's DIY home renovation markets are predicted to continue to grow. If housing starts recover more strongly than currently predicted, the volume of lumber imported by the US from offshore seems likely to grow – perhaps substantially.

US MORTGAGE FINANCING

Still shell-shocked by widespread foreclosures and loss of home values during and following the 2005-2011 housing crisis, US new homebuyers, and those trading up, remain wary of the future.

The mortgage finance industry remains in a spooked and defensive posture – despite extensive financial reforms. Three decades ago, prior to the recovery in US housing demand, mortgage rates were a hefty 10%. Today, equivalent rates (including points) are just above 4% – slightly higher than recent lows, but still a great deal for homebuyers, if they can qualify, and if they have confidence in the future.

Many do not. Further structural reforms in the US mortgage financing industry (for example, Fannie-Mae and Freddie Mac) are essential before the housing market can be regarded as being healthy. That's some time away yet.

CYCLICAL COMEBACK FOR CANADA?

For the 2019 earnings season, it's already late in the game for BC and Canada. Producers are holding large inventories of unsold, and high production cost, SPF. They are taking substantial downtime at BC sawmills. They're betting on a belated recovery in this season's so far lack lustre US housing market demand, and a big recovery in lumber prices.

With further, most likely significant, downsizing in BC's SPF lumber capacity, stock investors are rightly concerned. The prospects for growth in 2020 are not looking optimistic.

Deep structural issues remain in Canada's forest economy. Many will take generations to resolve. New commercial threats, such as BC's Bill 22, may involve government policy changes unfavourable to large commodity lumber producers.

Canada's forest sector is not alone in facing significant operating challenges. Based on history, however, it would be unwise to underestimate Canadian sawmillers' ability to innovate and compete. ■

FURTHER INFORMATION

Robert Woodbridge is principal of a building materials and real-estate consultancy based in the UK and Canada. He is a former market analyst in Canada's wood products and pulp and paper sectors. Contact robertwoodbridge@gmail.com



Above: Pine beetle infestation kills the trees, leaving blue stain and extensive cracking

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