

Timberland Market Update

Global Consulting Alliance

Quarterly Edition - September 2019

Economic Developments

- Although US economic growth slowed considerably in Q2 2019 to approximately 2.1% (down from 3.1% in Q1 2019), there are few signs that the economy is heading for a near term recession as consumer spending remains strong. In the longer term, increasing consumer debt and diminished trade due to tariffs is expected to continue to slow economic growth rates. Aggressive interest rate cuts may be in the future from the Federal Reserve as recently seen in other countries. This may keep the US out of an “official” recession, but in an environment of declining economic growth, nonetheless.
- Despite the US economy’s current momentum there are risks. During May 2019 the yield curve, measured as the gap between the 3-month and 10-year US Treasuries deeply inverted pointing to the likelihood of a global recession within the next ~18 months. Morgan Stanley in late May indicated that an “adjusted” yield curve that accounts for quantitative easing and tightening has been persistently inverted for the past six months. During the month of August, the spread between the two-year and ten-year yields also inverted. Analysts flag that significance given that two years is the shortest-dated US Treasury note, and the most sensitive to rate movements.
- Australia and New Zealand (NZ) have dropped their interest rates from 1.5% to 1.0% during the quarter. Vietnam, Brazil, South Africa, South Korea, Chile, Indonesia and Malaysia have also cut their interest rates and/or are contemplating a rate-cut.
- The Australian economy has been flagging in the first half of 2019 with alarm bells of imminent recession becoming louder. Slowing GDP growth (negative GDP growth per capita was recorded in the March quarter), low inflation, low wages growth and low consumer confidence (as evidenced by very low new car sales) were experienced, all indicators of a tough economic environment. Consumer sentiment has picked up more recently and it appears falling property prices have bottomed out in Sydney and Melbourne owing to tax cuts, lower interest rates and a relaxation of lending standards. Despite these positives record high household debt, weak wage growth and a continued slowdown in construction activity weigh the economy down. Inflation picked up in the June quarter from March’s deceleration, but the latest reading is still below the Reserve Bank of Australia’s (RBA) 2-3% target range.
- Based on 2018 World Bank data, the exports of goods and services accounts for 19.5% of China’s GDP, 12.1% for the USA, 14.8% for Brazil and 21.0% for Uruguay. Australia and NZ’s economies are significantly more exposed to global trading conditions, with the exports of goods and services accounting for 21.7% and 27.6% of their GDPs respectively.
- Growth in the Euro area remains weak. Economic problems have not gone away - the most significant being the trade war between China and the US, Brexit, and signs of Germany's weakening economy. However, the positive development of the internal market, and the decline in the Euro area unemployment rate is creating some positive momentum. The ECB's interest rate expectations remain low.
- The Brazilian economy remains at a standstill. From January to August, the GDP annual growth rate forecast reduced from 2.5% to 0.8 % even with the Selic rate at a record low of 6.0% and inflation at 3.2%.

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The short-term outlook is negative, mainly due to the internal political and economic turmoil and the expected global economic decline.

- Shipping costs are expected to be higher in 2020, in part due to the new sulphur content regulation impacting ship fuel charges. Margules Groome expects the cost increase to be in the region of USD4-5/JAS m³ but will likely be shared through the supply chain.

Asia-Pacific

- Chinese import of hardwood woodchip in Q2 2019 increased to 3.6 million BDMt from 3.2 million BDMt in 2018, i.e. an 11% volume increase. Vietnam increased its export woodchip volume by 8% over this period while Australian export volumes remained flat. Vietnamese CNF prices increased by 13% over the same period and Australian prices by 11%.
- Japanese import of hardwood chip in Q2 2019 declined to 2.63 million BDMt from 2.78 million BDMt in 2018, a 5% drop. Japanese CNF import prices increased by 9% over the same period.
- Bleach hardwood kraft pulp, BHKP prices dropped from highs around USD750 per air dried tonne (ADt) to less than USD 500/ADt and in the case of Brazil, sales of around USD470/ADt. Some reports even suggest spot prices as low as USD460/ADt. We believe these price levels to be below the cost of production for the Chinese mills. Some Australian woodchip exporters are staring port inventories and a softening market.
- In our view, the decline in BHKP prices is not only attributable to the China-US trade war with excess production capacity playing a role, exacerbated by softening global demand. The pulp sector has significant exposure to global trade through demand for packaging materials.
- NZ market share of softwood imports into China increased from 41% to 43% in H1 2019 from H1 2018, mainly at the expense of Russia and the USA. For H1 2019 NZ log exports to China increased 8.5% in volume terms from 16.1 million to 17.6 million. Both Korea and India saw significant reductions (11% and 9% respectively) while Japan showed a modest 2% increase.
- Total Australian softwood log exports increase 8.8% in H1 2019 with China showing a similar increase. The China market for Australian softwood log is expected to slow in the second half of 2019.
- Radiata log prices crashed at the end of May by 16%-20% and remain depressed with a very minor increase in August. Softwood log inventories in China have remained relatively stable over the last several months at high levels (~4.0 million m³). A minor 2.4% increase occurred in July.
- There is a massive lift in Chinese log imports from Germany in 2019 taking advantage of (a) the large quantities of discounted logs now available from production forests in Europe (Germany, Finland, Czech Republic, Italy and France) impacted by windstorms, drought and beetle infestations, and (b) the ability to backhaul logs from Germany to China by rail more cheaply and in less time than ocean freight as a result of the 'Belt and Road' initiative creating and improving overland freight links with the support of Chinese government subsidies.
- The ongoing dwelling construction market slump in Australia is not having a major impact on sawnwood prices yet as most of the decline appears to be in the multi-story apartment sector and not in the detached housing sector where most of the sawnwood is used.

Europe

- Global uncertainty is dampening the outlook for the wood industry in Europe. While demand for sawn timber has remained relatively strong, signs of a slowdown are beginning to be evident and the market outlook is uncertain for the second half of the year. Log prices for pine, spruce and beach logs have been falling, mainly as a result of increased sanitation harvesting from last season's forest fires, drought and the bark beetle damaged forests in Central Europe.
- The rapid drop in pulp prices due to a slowdown in Chinese demand and high inventory levels will impact on industry performance during the latter part of this year. Weaker European paper demand has also had a negative impact on the market. There is a high level of uncertainty related to the market development for the latter part of 2019 and early 2020. The development is very much up to how radical market downturns will be taken by the industry.
- Wood markets in the Nordic countries have managed to remain relatively stable. In the Baltic countries, the balance between supply and demand has improved rapidly. The situation in Sweden is gradually improving after the imbalance arisen by massive forest damages caused by spruce bark beetles this year. Latest estimates indicate damage of a similar magnitude to last year (approx. 3-4 million m³ of wood). Markets in Germany and Poland continue to be impacted due to increased quantities of damaged wood (estimated to be >40 million m³ in Germany, Austria and the Czech Republic). In the UK domestic log prices have decreased significantly due to cheaper lumber imports (increased central European wood supply) and weaker domestic lumber demand as a result of Brexit uncertainties. In Russia, the winter harvesting conditions were good, having a positive impact on wood supply.
- The increasing interest towards investments in the Baltic countries by Finnish and Swedish financial and industrial investors mainly driven by gradually tightening wood supply and high land valuations, has triggered several forestry transactions in 2018-2019:
 - SCA acquired 10 300 ha of forest land in Estonia from Forestum Group AB in May 2019
 - United Bankers acquired 22 000 ha forest land in Finland from UPM in December 2018
 - Seafarers' pension fund acquired 17 000 ha of forest land in Finland from UPM and private individuals throughout the year 2018
 - Tornator acquired 20 000 ha of forest land throughout the year 2018, the largest single acquisition being 5 300 ha from Vapo.
- In addition to these transactions, the Swedish Forest Holding company Bergvik Skog AB, who owned 2.3 million ha of forest in Sweden and another 0.1 million ha in Latvia, has undergone a full ownership restructuring. The company was split into two parts: Bergvik Skog East and Bergvik Skog West. The Eastern part was sold as a whole to BillerudKorsnäs. West was split into 7 parts and sold to different buyers, the biggest buyer being Stora Enso. The Latvian forests were sold to Södra.
- The continued strong development of the industry is welcomed by forest owners. In addition to several announced investments in new bioproduct mills, more sawmilling capacity will come on stream in the Nordic countries. We expect the current bark beetle problems to affect wood supply and contribute to intensified forestland transaction activity.

North America

- Forest product markets in the US generally remain in a surplus supply situation, as demand from housing and household formation remains far below long-term trend levels. Housing starts for July 2019 were reported at approximately 1.2 million starts – the same level as in July 2018. Historically low mortgage rates have not translated into increased housing starts as many Americans are saddled with debt, and challenges of affordability.
- Softwood lumber prices have gradually fallen through 2019 but reversed that trend in July as a result of continued mill closures in western Canada due to reductions in log supply from Provincial forests. Softwood lumber prices remain ~35% below mid-2018 levels and are in the range of USD 200-225/m³.
- The trade war with China has had a significant impact on US log and lumber exports, with 1H 2019 exports of softwood logs down 34%, and softwood lumber exports down 25% from 1H 2018 levels respectively. China has been the largest export market for both US softwood and hardwood log and lumber exports in recent years. Exports remain a very small percentage of the US roundwood market, but impact prices within export regions.
- Stumpage prices remain flat in the US South with TimberMart South reporting an average pine sawlog stumpage price in Q2 2019 of USD 27.00/green metric ton, compared to USD 26.00/GMt in Q2 2018, and approximately USD 29.40/GMt in Q2 2009. Stumpage prices in the US Northwest continue to fall in response to lower lumber prices and reduced export trade. Washington State timber sale prices were down 20% in July 2019 from 1 year earlier.
- Timberland transaction volume has increased slightly in 2019 but remains below historical levels and continues to be hampered by book values that remain above market prices. JW Sewall reports that average discount rates fell very slightly between 2017 and 2019 and are now in the range of 5% real for average transactions. Discount rates are a function of the supply and demand of capital looking at the timberland asset class, and alternative investment returns. Relatively stable discount rates in recent years likely reflects an equilibrium between capital looking to enter and exit timberland assets.

South America

BRAZIL

- Pulp Industry: after two years of high economic return, with average EBTIDA ranging from 50% to 60%, this industry is facing a significant setback due to the international pulp prices that fell around 35% in the last nine months, from USD750/ADt to an average of USD470/ADt CIF China. Recently, in an attempt to recover prices, the Brazilian industry reduced production by approximately 2 million ADt/year, equivalent to 11% of its 18.1 million ADt capacity. The scenario in the short-term is uncertain. Prices are likely to remain flat.
- Charcoal Industry: despite the sharp production and price increase verified from 2Q 2018 to 1Q 2019, the charcoal industry was unable to maintain momentum. From Q2 2018 onwards, charcoal prices started to decline, from BRL170-190/MDC to BRL110-130/MDC currently. Due to the negative context and trends of the Global economy, and the Mercosul specifically, it is not expected this industry will recover its profitability in the short-term, negatively impacting Eucalypt forest growers, mainly in Minas Gerais state.

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- **Composite Panel Industry:** although panel prices are increasing since mid-2018 albeit at a slow pace, this industry will only completely recover its performance to 2015 pre-crisis when the housing construction segment recover, perhaps in one or two years.
- **Sawmills and Plywood Industry:** prices dropped by 20% to 30% in the last 12 months because of their current dependency on an oversupplied external market, and their core low-bargaining power regarding the wood suppliers and primary consumers. The current context of the Brazilian economy also has negatively impacted the performance of these industries. No economic improvement is expected in 2019.
- **Wood Prices:** in general, Eucalypt wood prices in almost all forestry clusters do not offer a proper economic return and have not done so since 2014. In real terms, prices have depreciated in the 2015-2019 period. The main reasons for this poor performance have been the almost 5-year economic crisis and the high-bargaining power of the pulp and MDF/MDP industries, which own enough planted forests to effectively regulate the wood prices in their favour. In the case of pine, the small-log prices have not appreciated in real terms since 2015, providing a weak or negative economic return. On the other hand, despite the economic crisis, the sawlog assortments had real appreciation in the same period (1% to 3% per year), mainly because of the diversified and resilient forest-based industry in southern Brazil.

URUGUAY

- **Pulp Industry:** last month UPM announced that the company has made the investment decision to construct a 2.1 million ADt/a greenfield eucalypt pulp mill near Paso de los Toros in central Uruguay. The USD2.7 billion investment will grow UPM's current pulp capacity by more than 50%, resulting in a step change in the scale of UPM's pulp business as well as in UPM's future earnings. Additionally, UPM will invest USD350 million in port operations in Montevideo and local facilities in Paso de los Toros. The mill is scheduled to start up in the second half of 2022.
- Both UPM 1 and Montes del Plata (MdP) pulp mills continue to operate at full capacity despite the downwards international pulp price cycle over the last 9 months. Both pulpmills continue to drive demand for Eucalypt pulplogs from all Uruguayan regions.
- **Woodchip Exports:** demand from Portugal remains strong, and Uruguay will export around 900 000 m³ of *Eucalyptus globulus* woodchips during 2019. FOB price for this product is USD160/BDMt (~USD91/m³).
- **Plywood Industry:** during 2018, Uruguay's plywood exports were close to 240 000 m³. As mid-2019, exported volume was less than 90 000 m³. The FOB price for this product is around USD280/m³. During August 2019, Lumin, the only plywood manufacturer in the country, announced an investment of USD30 million to build a second line in their plywood mill located in Tacuarembó (in northern Uruguay).
- **Green Log Exports:**
 - Eucalypt sawlog and plywood log exports: even though FOB price remains high (between USD130 and 140/m³), demand is lower than 2018. Total 2019 exported volume will be half of what Uruguay exported during 2018.
 - Pine sawlogs exports: As of mid-2019, total exported volume was ~ 1 million JAS m³. The Chinese market has slowed dramatically in mid-2019, and most of the vessels expected for the 2H 2019 were cancelled.

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