

DBRS Canada Newsletter

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HEAD FAKE – NOT OUT OF THE WOODS YET (PART II)

The North American economy ended its decline in mid-2009, and ensuing economic indicators have offered optimism of a possible turnaround in the battered forest product industry. GDP has seen positive sequential growth since Q2 2009, and most economic forecasters expect the positive trend to continue. However, the strength of the recovery is weaker than expected due to the impact of persistent high unemployment in the United States and the associated drag on consumption. Boosts from one-off factors such as re-stocking and government stimulus created early strength in the recovery; however, the positive impact of these factors appears to be fading, along with the momentum of the North American economy.

DBRS has already expressed reservations about the durability of the recovery (See DBRS Canada Newsletter dated November 11, 2009) but we still expect the forest product industry to strengthen in line with the positive developments in the general economy. In fact, subsequent performance in some sectors has exceeded expectations. Unusually tight inventory conditions have given an extra push to prices, particularly in pulp, lumber and oriented strand board (OSB). Most forest products companies tracked by DBRS reported good results for Q1 2010, and DBRS expects solid results for Q2 2010 as well. However, the latest economic indicators seem to suggest that the general economy is sputtering, especially in the housing sector. Some segments in the forest products industry appear to have gone into reverse. DBRS still believes that the worst is over for the forest product industry for this cycle but the recent favourable performance in the industry is not sustainable. In view of recent developments, DBRS expects that a full recovery for the industry will be further delayed. Additionally, DBRS notes that this brief positive operating performance window, although beneficial, is not strong enough to restore the weakened financial profile of most companies that were under stress during the down cycle. The renewed softness in the industry increases the likelihood of negative rating actions on forest products companies in the coming months.

To date, the pulp segment has fared the best coming out of the recession, and the near-term outlook is still positive although momentum appears to be waning. Pulp producers have been disciplined in managing supply by shutting capacity and curtailing production. Strong demand from China and tight supply has led to a good recovery in pulp prices. In addition, the earthquake in Chile earlier this year disrupted supply, further exacerbating the demand/supply imbalance. Pulp prices have risen uninterrupted since May 2009 from below \$650 to above \$1,000 in June 2010. However, recent unfavourable developments have tilted the demand/supply conditions, signalling that pulp prices may be peaking: (1) Demand from China is slowing as the country has finished re-stocking; (2) Supply is on the rise because high prices have encouraged producers to restart their shuttered mills; and (3) Chile has restored its production capacity adding to supply. Nevertheless, the near-term outlook for pulp producers remains positive despite the risk of softening pulp prices (from a high base). However, the large amount of idled capacity on the sidelines adds to the risk and limits the pulp segment's upside.

Uncoated free sheet (UFS) prices are also trending higher, in line with the improving economy. Rising pulp prices and supply management by producers have also contributed to UFS price increases. Despite the worry of a secular decline in demand due to the displacement of paper by the electronic medium, shipment of UFS in 2010 actually increased slightly compared with 2009, an unexpected positive development. Near term, DBRS expects demand and pricing of UFS to remain steady, in line with the growth in the general economy. The bad news for paper producers is that the trend of electronic medium usage in place of printing materials remains strong. This structural change will limit the benefit of an improving economy to paper producers, whose operating profit is expected to remain under pressure.

Newsprint prices have been on a steady rise since mid-2009 after key industry players – AbitibiBowater in particular – sharply reduced their production capacities. However, newsprint continues to have the worst long-term fundamentals within the forest products industry, and prospects for producers are dismal. Ongoing supply curtailment is necessary to support prices until a balance is reached between supply and

lower but sustainable level of demand, reflecting structural changes in newspaper readership and print advertising. Operating performance at newsprint producers remains under pressure and further rationalization is needed to stabilize profitability and limit ongoing losses at companies in this sector.

The wood product (lumber, oriented strand board, logs, etc.) sector has been on a roller coaster ride over the past few months. Lumber prices (Western SPF) rose from just above \$170 in July 2009 to a peak of more than \$300 in April 2010 before falling to \$200 in June 2010. OSB showed similar price movement, rising from just above \$170 in July 2009 to a peak of just under \$400 in April, decreasing to just over \$200 in June 2010. Prices for lumber and OSB rose sharply in early 2010 due to one-off factors such as tight inventory conditions, re-stocking demand, limited log supply due to wet weather conditions in the southeast, etc. However, the optimism of a recovery in the housing sector has proven to be unfounded. Although residential construction activities (as measured by new housing starts) were showing improvement in early 2010, the recovery was weak. In addition, activity levels have stalled in the last few months, and are well below those necessary for producers to be profitable. As supply increased when weather improved and re-stocking ran its course, the demand dried up and prices retreated. Recent economic indicators do not support a meaningful increase in residential construction anytime soon. There are still significant headwinds facing the construction industry and hence, the demand for building materials. (1) The boost from the homebuyer tax credit in the United States expired at the end of April 2010. The lack of stimulus and the negative impact of pulled forward sales could dampen the demand for the rest of 2010 and possibly into early 2011, as evidenced by recent softening housing demand and prices. (2) The persistent high unemployment rate in the United States and its resultant impact on the confidence of potential homebuyers could continue to dampen demand and further delay a meaningful recovery in the housing market despite favourable mortgage rates. (3) A major contributing factor to the current slow residential construction activities is the availability of credit to home builders. With most financial institutions still in a tightening mode, the lack of credit weighs on construction activities. DBRS expects that operating results at companies with large exposure to building products will remain challenged until the residential construction sector shows a meaningful improvement, now expected in mid- to late-2011. However, timberland operators will fare better even in the current weak industry conditions.

As well as the mixed fundamentals facing forest product companies, the recent weakness in the U.S. dollar poses another challenge to companies with extensive operations in Canada. Companies are vulnerable to sharp movements in currencies because they cannot adjust their operations fast enough to counter the changes. Companies with a large cost base in Canada are going to be impacted by the renewed strength in the Canadian dollar since a lull in Q2 2009. The near-term outlook for the Canadian dollar is continued strength with a target of parity or higher against the U.S. dollar. The rise in dollar-induced production costs would put the Canadian operations at a distinct disadvantage against their U.S. competition.

The current ratings of most forest product companies rated by DBRS remain under pressure despite recent improving results. Companies that continue to report weak margins, and/or incur deficits in free cash flow, remain vulnerable. Capital expenditures at most forest products companies were sharply reduced during the severe downturn and DBRS believes this low level of spending is not sustainable. Companies still suffering from a free cash flow deficit are likely to increase leverage in order to fund the necessary spending to maintain equipment in reasonably good operating shape.

In conclusion, DBRS believes that the recent improved operating performances at the forest product companies may not be sustainable, and that the financial profile of most companies in this sector remains under pressure. In particular, the continued weakness in the construction sector and a strengthening Canadian dollar has put even more pressure on some Canadian building products producers and may lead to negative rating actions. For those companies, the recent improvement is more of a head fake rather than a sustainable trend. They are not out of the woods yet.

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Note: All figures are in U.S. dollars unless otherwise noted.