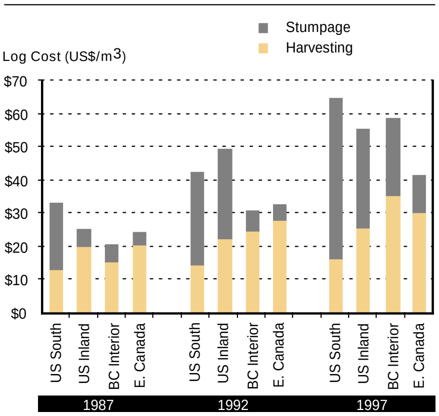
Timber & Lumber Costs

Who's Got The Competitive Advantage Now?

Understanding cost-side dynamics has become even more important over the last year in the face of sustained financial and lumber market volatility. Costs in the various producing regions continue to change as a result of both local and global conditions.

The question that continually confounds the industry is, Does any one producing region have a competitive advantage on costs? In an attempt to answer this important question, a summary of cost data compiled from various producing regions in mid-1998 has been analyzed (using average costs for the period in U.S. dollars).

Figure 1
COMPARISON OF NORTH AMERICAN DELIVERED LOG COSTS



Source: IWMRI

NORTH AMERICAN REGIONAL COSTS

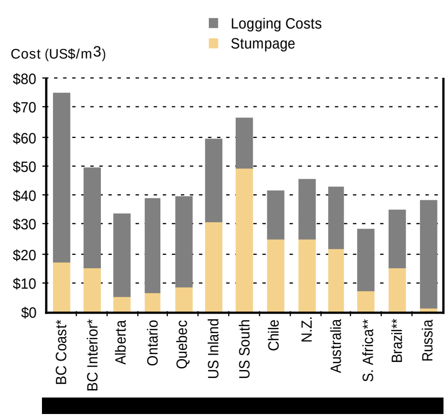
Timber Costs

There appear to be many myths surrounding the cost structure of the "dimension lumber" producing regions in Canada and the U.S. However, one main trend has been evident — log costs have been rising in all areas over the past 10 years (figure 1). Although the U.S. South has generally had the highest delivered log costs on the continent, other regions' costs have also been escalating. But the biggest cost change over the last ten years has been the dramatic increase in timber stumpage rates (figure 1):

- From US$20/m^3 to \$50/m^3 (US \$90 to \$225/Mbf, Scribner scale) in the U.S. South;
- From US$5/m^3 to \$30/m^3 in the U.S. Inland; and
- From under US$5/m^3 to over \$20/m^3 in the B.C. Interior.

When logging costs are considered, the B.C. industry moves to the top of the cost curve. Provincial government stumpage and environmental poilices have caused B.C. to become one of the highest-cost log producers in the world, a far cry from its position as one of the most competitive just five years earlier (figure 2).

Figure 2
REGIONAL DELIVERED LOG COSTS (MAY '98)

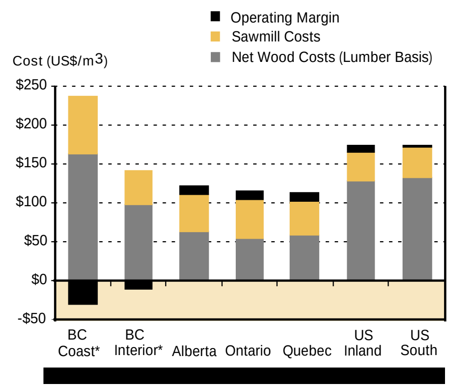


Source: IWMRI
Note: *June '98 **Estimated

Sawmill Margins

Based on mid-1998 regional average timber and sawmilling costs, and FOB lumber revenues, North American lumber producers have managed to squeeze out only small margins during the weak market conditions of second quarter, 1998 (figure 3).

Figure 3
NORTH AMERICAN LUMBER MILL COSTS & MARGINS (MAY '98)



Source: IWMRI
Note: *June '98

The only exception to this rule, however, is the B.C. sawmilling industry, which has posted significant financial losses averaging in excess of US$20/m^3 (US\$45/Mbf) on the Coast and up to US$10/m^3 (US\$20/Mbf) in the Interior SPF region. Ironically, these losses in lumber manufacturing come <u>after</u> the inclusion of the B.C. government's June 1 stumpage rate adjustment — which the U.S. Coalition claims violates the Softwood Lumber Agreement!

Since the "operating margin" potential is the ultimate barometer for comparing costs and revenues between regions, it is apparent B.C. has the greatest cost disadvantage (stumpage as well as increased fixed costs from mill curtailments) and the worst operating margin in comparison to all other producing regions in North America. Although the other three Canadian provinces recorded moderate margins of up to US$10/m^3 in May of 1998 (similar to the U.S. Inland but slightly above the South's US$5/m^3) — these regions are not able to participate in achieving further margins from timber (as stumpage), since the provincial goverments own the timberland.

U.S. companies, on the other hand, are able to earn additional margins on lumber through stumpage returns on private timberlands; this occurs in the U.S. South and, to a lesser degree, in the Inland region. Consequently, the real or aggregate operating margins from processing logs into lumber can often be much higher (or are understated in simple comparisons) for U.S. producers compared to those in Canada. The issue of how Canada's provincial governments price their timber (in sharp contrast to what is closer to a free-market system in the U.S.) appears to be somewhat of a moot point from this analysis.

Although figure 3 indicates that the calculated margins look slightly higher in Central and Eastern Canada, the competitive advantage among North American producers — at least before the Canadian dollar collapsed in July/August — may actually lie more on the U.S. side than the Canadian side!

SOUTHERN HEMISPHERE COSTS

The main softwood plantation-growing countries — Australia, New Zealand, Chile, Brazil and South Africa — all harvest pine as the dominant species. Although New Zealand, Chile and, to a lesser degree, South Africa, manage a moderate amount of their lands on a pruned regime for clear lumber production, most of these forests have not yet matured.

Timber Costs

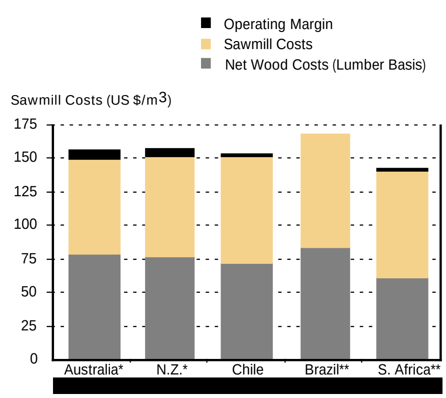
When the average delivered timber costs are compared, small regional variances occur between these regions. These variances depend on the relative strength of their respective domestic or export markets, or on timber qualities (figure 2). While stumpage costs are similar between Australia, New Zealand and Chile, both Brazil and South Africa enjoy much lower stumpage prices. Logging costs, however, remain close between these regions, as was the general case in North America.

Sawmill Margins

When logs are converted to lumber in these five regions, two similar cost themes emerge for the period reviewed (figure 4):

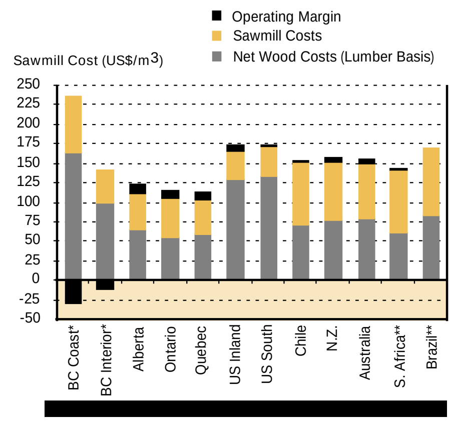
- Net wood costs (logs to lumber less income from residuals) and sawmilling costs were fairly consistent as measured in U.S. dollars; and
- Although driven by different forces, the average operating margins remained similar, ranging from slightly above zero at sawmills in Chile, Brazil and South Africa, to US$6-$8 per m^3 (US$15 to $20/Mbf) in Australia and New Zealand.

Figure 4
SAWMILL COSTS & NET MARGINS: PLANTATION PINE (MAY '98)



Source: IWMRI
Note: *July 1998, **Estimated

Figure 5
SUMMARY OF SAWMILL COST & MARGINS BY REGION/COUNTRY (MAY '98)



Source: IWMRI
Note: *June 1998 **Estimated

Each of these countries have both local and export market issues to account for the costs between countries.

SUMMARY

When the seven North American and five Southern Hemisphere regions are compared (figure 5), it becomes clear regional timber costs reflect a variety of supply, demand, regulatory and log quality issues. One significant likeness exists between all regions: sawmillers have been able to achieve relatively low operating margins that average well under 5% (a range of -10% to +10%) of sales in the 12 regions. Although weak markets can be blamed in part, the sawmill owner is still the one being squeezed between a wary marketplace and aggressive timberland owners. As a result, no single producing region appears to have the edge in terms of competitive advantage. Consequently, trying to make money on a consistent basis in the lumber business can be one of the toughest challenges in the entire wood products industry! ■

Summarized from recent conference presentations made by Russell E. Taylor in Chile, New Zealand, Australia and the U.S. Full copies of these presentations are available at a nominal cost.