<u>News Release</u>

Russian Log Exports & Lumber Production Soaring

'Gold Rush' in Western & Eastern Russia Yields New Investments & Huge Increases in Timber Harvest & Lumber Output

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Vancouver, B.C. — The current and future status of Russia's timber and wood products industry has been investigated by consultants Gerry Van Leeuwen and Russell Taylor of R.E. Taylor & Associates Ltd. (Vancouver, BC) following various field trips in the second half of 2002 to Russia and its neighboring countries. What the consultants saw and learned are not the typical media reports that westerners are used to reading about on growth prospects and developments related to Russia's wood products industry.

Their findings and analysis will be published in an extensive multi-client study, *The European & Russian Wood Products Sectors* to be released in May. Two summary reports have been published in the February and March issues of ***WOOD Markets Monthly newsletter***, Vancouver, B.C.

"The opening of the Russian wood products trade to international market forces and the availability of lucrative export destinations has attracted the attention of many Russian wood product producers", explains Russell Taylor, Publisher of ***WOOD Markets*** and co-author of the report. "The most profitable logging and wood product manufacturing companies in Russia today are those exporting as much of their production as possible. These are the companies that are, in turn, reinvesting export-earned profits into new logging and manufacturing equipment/technology, to support the process of modernizing and expanding the forestry and manufacturing sectors."

The low cost structures of the timber industry coupled with increasing investments in automation are new trends in Russia. "The ability to produce higher quality products combined with the superior qualities of Russian fine-grained pine, larch, and spruce logs virtually guarantees Russian log and lumber exporters excellent selling opportunities to buyers throughout western Europe and Asian markets (especially China and Japan)", stated Gerry Van Leeuwen, co-author of the report. "With the ability to significantly expand its annual log harvest and with about 50% of the world's temperate forest area, Russia remains one of the biggest supply threats to upset the world's existing balance between producers and exporters to global wood markets."

During the second half of 2002, consultants Gerry Van Leeuwen and Russell Taylor of R.E. Taylor & Associates spent a total of ten weeks visiting logging operations and sawmilling and secondary processing plants in the Russian Far East, Siberia, Western and Northern Europe, the Baltic States and Northern China. "The results of our travels show clearly that the Russian timber industry has been expanding its log and lumber exports rapidly, even though overall log and lumber production has been growing at only a modest pace since the mid 1990s," commented Van Leeuwen. High export prices (ruble basis) for logs and lumber during the last five years have shifted the production focus to export-quality products. In turn, export products are producing much-needed profits to reinvest in plant replacement, modernization and expansion — to facilitate even more exports. Growing log and lumber exports are impacting Asian (especially China and Japan) as well as European markets by increasing the supply of low-cost, high-quality wood to markets that are already oversupplied. This is occurring, and will continue to occur, at the expense of traditional, higher-cost suppliers throughout the world.

The main export markets for logs from eastern Russia are China, Japan and South Korea. China is by far the major market for central Russia, while Japan and South Korea are the chief destinations for logs from the Pacific region of Russia. Added Taylor, "Many Russian log exporters prefer to sell to the Chinese because they buy all grades of logs (i.e., 70%–80% of a Russian operators'sawlog production) and will pay cash. This is in contrast to Japanese buyers, who buy only the highest quality logs and usually require payment terms."

Log exports to China have grown rapidly due to an explosion in the number of individual log exporters who have jumped into what is a very profitable business. From traveling along the Trans-Siberian railroad, Van Leeuwen observed that in Irkutsk and Krasnoyarsk States many new log export rail sidings are under construction. "The large railcar sidings are more elaborate, and consist of large log-sorting yards and numerous overhead, gantry-style cranes for unloading incoming logs and loading up to twenty outgoing railcars per day," said Van Leeuwen. Smaller railcar sidings that can load two or three railcars per day are easily and inexpensively constructed, consisting simply of log bulkheads and mobile cranes. Many old and abandoned railcar sidings that once serviced state-owned manufacturing plants along major railroads have been taken over by log export entrepreneurs. These facilities have been quickly adapted to log-sorting, storage and railcar-loading operations.

Consequently, log export profits have become the catalyst behind expanding log exports. The introduction of new, low-cost, made-in-Russia mechanical harvesters is expected to reduce logging costs even further over the next few years. "It has become very obvious", commented both Taylor and Van Leeuwen, "that the fine-grained, old-growth, superior quality of Russian pine, larch and spruce logs virtually guarantees the log producer the ability to find an export market buyer that offers Russian producers generous margins."

Federal and state authorities are changing forestry regulations to allow allocation of large-scale timber harvesting and leasing rights for longer periods of up to 49 years (special exemptions for even longer periods have been granted in Siberia). State governments are increasingly supporting auctions of timber-cutting rights. These changes are expected to support major investments by the large forestry companies for construction of new and upgraded manufacturing operations.

In western Russia, a gold rush mentality is occurring as Scandinavian and western European companies appear to be aggressively staking out timber concessions, joint ventures or acquisitions of Russian companies to get positioned for the next wave of wood products investments and exports from Russia's high quality wood basket. "The fact that the incremental availability of private timber from Western Europe is normally only available at higher prices," explained Taylor, "has driven the industry to search new areas of Europe for lower cost supplies." Russian timber that is located a thousand miles or more away is routinely purchased by sawmill companies in Sweden, Finland, the Baltic States and Germany to feed their mills and to also send signals to local timber owners that alternative high-quality log supplies are available (where the final delivered price for Russian timber is normally, but not always, lower). New sawmills or sawmill expansions in Western Europe are occurring where logs are more plentiful, raw material and labor are lower cost, and where political risk can be managed. New investments are scattered across Central Europe (Austria) with some going into Eastern Europe (Czech Republic, Romania, Poland) as well as the Baltic States and many regions in Russia.

With low domestic delivered log costs and low sawmill conversion costs in many of the newer sawmills, export market lumber prices for kiln dried, high quality appearance and small knotted structural lumber are very attractive for Russian operations as compared to domestic prices for green, rough lumber of only US$40 to $85/m3 (US$100 to $200/Mbf - net) fob mill. Russian solid wood product manufacturers are discovering that the high quality, old growth, fine grained appearance of their softwood and hardwood species is highly valued in export markets when manufactured to export quality standards. A number of wood product companies visited are planning (or already have installed) new lumber production equipment, dry kilns and secondary processing equipment. Almost every company visited in the Russian Far East was looking for information on how to produce and market export products and/or are actively expanding current operations to increase production of export quality products to Asia.

Western media often give the impression that only a few Russian companies are reinvesting to modernize or expand operations. Impressions gained during our travels in Russia do not support this view. Many of the companies visited (large and small) appear to be reinvesting whatever investment capital they can obtain (i.e., from both log export and sawmilling profits or small loans) in efforts to expand and improve their lumber manufacturing operations with the sole objective of increasing capacity to produce more export quality products.

The potential to earn sizable export profits has doubled sawn wood exports in the last five years and, in turn, has created a major investment surge in the construction of new and expanded sawmill capacity. We have compiled a list of 23 announced sawmilling investments in Russia involving 3.5 million m3 of sawn wood production (1.5 billion bf – net count; approximately 2.3 billion bf – nominal count) to be operational between 2002 and 2004. Approximately 65% of the new investments are by foreign companies that are joint venture partners with Russian companies. Northern European, Japanese and Chinese companies are the major joint venture investors. Foreign investment that is based on 100% equity ownership is still rare in the Russian wood products manufacturing sector. Another 11 larger sawmill projects are planned for the Baltics and Eastern Europe involving 2.2 million m3 of sawn wood production (1.1 billion bf – net count; 1.6 billion bf – nominal count), many involving Russian timber. “This amounts to almost 4 billion bf (nominal count) of new lumber capacity,” commented Taylor, “at a time where there is about 4 billion bf of excess capacity in North America. The potential of a global over-supply of logs and lumber and all of the mystery surrounding Eastern Europe and Russia was a key reason for conducting our investigations.”

Russia’s official harvest of just over 100 million m3 (the unofficial harvest is 10% to 30% higher due to illegal logging) is currently an astonishingly low proportion (16%–20%) of its apparent sustainable annual cut. Consequently, a huge surplus of mature wood exists in Russia. European associations believe that the harvest could be expanded to 250 million m3 within ten years if the necessary government and industry changes are implemented. Growing log export markets in China and Europe — and the profits they generate — are presently pushing the issues of institutional change. Although questions remain about the overall economic health of the forest industry, the amount of Russian corruption, and its need for capital investment, it’s obvious that profitability on the export front is the driving force behind Russian-financed investments in forestry and logging.

Legal and political uncertainty still makes foreign investment in Russia high risk. This is not likely to change significantly in the next two or three years. Much of the Russian legal and bureaucratic system is administered by state and local authorities. Great concern has been expressed by foreign investors about the discriminatory and unpredictable actions taken by local and regional authorities against foreigners and foreign owned manufacturing plants. These actions vary by state and region but have been a major reason why some foreign owned companies have decided to sell or even abandon their Russian investments.

During the next five years, Russian log exports are projected to continue to increase and, in the Russian Far East, are predicted to easily double due to the large volumes of high quality, mature timber available and growing demand in China. Russian log export profits are expected to finance the construction of the required forestry infrastructure and construction of new mills. Due to the major investments required for new or improved sawmill capacity to replace the old, inefficient and abandoned mills of the Soviet era, sawn lumber production in Russia is expected to increase by about 20% during the next two to three years. Investments being made in Russian wood product manufacturing plants are based mainly on lucrative export markets in Asia and Europe. It is likely that lumber exports will increase by at least 50%, based mainly on the number of announced capacity expansions in 2003 and 2004. This could increase Russian lumber exports by about 2 million m3 by 2005 (i.e., a 25% increase over 2002 lumber export volume of 8.4 million m3)

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For more information, including a brochure on multi-client study on The European & Russian Wood Products Sectors, please contact:

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