

# Challenging Times

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## Introduction

This paper describes changes in the forest industry's operating and trading environment since the start of this year, the industry's response to those changes, and gives some views on future prospects.

## Trading Conditions

The forest growing industry enjoyed favourable trading conditions in 2002. Prices for logs in Asian markets were stable for most of the year, the \$US exchange rate was favourable, and bulk freight rates were at near record lows. The domestic market was strong on the back of strong housing and general construction activity in Australasia and the US. New Zealand's overall harvest maintained its year on year rise with continued growth in export volumes into Asia, particularly to new markets in China and India.

Early signs of a change in conditions, driven by a number of factors, appeared in the fourth quarter of 2002:

- Prices for export logs to Korea in USD fell rapidly as exporters pushed volume into the market despite high inventories in discharge ports.
- Prices for appearance grade lumber in the US began to fall in the face of expanding supply from South American producers
- In December the NZD began its rapid appreciation against the USD.
- Freight rates, which had been at near record lows, began to show signs of upward pressure.
- However Australasian market conditions remained strong.

The combination of rising freight rates and falling export log prices culminated in a dramatic drop in average sales realisations in December, the impact varying across the industry according to relative exposure to the export and domestic markets. Log exporters were able to lift prices in the first quarter of the year to partially offset currency appreciation and freight, however domestic mills targeting customers in the US market were coming under increasing pressure from:

- Rapidly changing relative currency values between the USD and the NZD, Chilean peso, and the Brazilian real.
- Deteriorating prices in the US market.
- Highly competitive manufacturing costs from Chilean and Brazilian producers.

The net effect of these factors was a rapid deterioration in the ability of New Zealand producers to profitably service the US which resulted in significant falls in prices

for pruned logs in the first quarter, with further easing as the year has progressed.

The pattern established in the first quarter has continued through the year, however September has seen a degree of improvement in USD export log prices. Fig. 1 shows movements in the NZD/USD exchange rate and freight rates to Asia from January 2002.

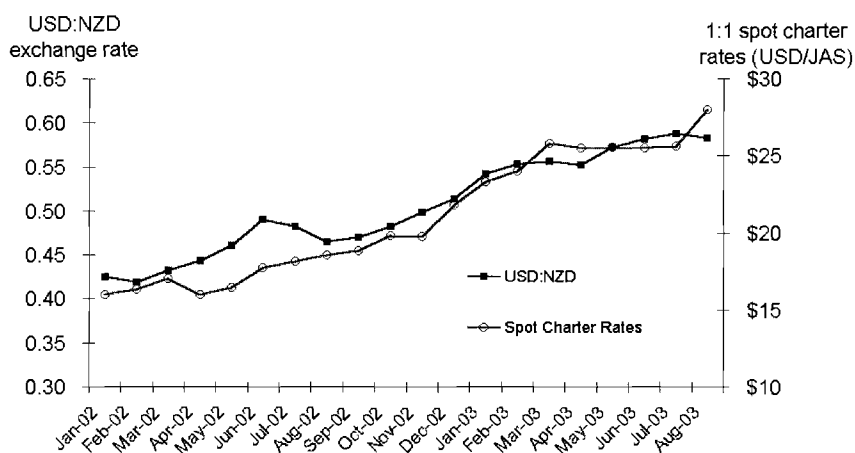


Fig.1: Trends in USD:NZD exchange rate (left hand scale) and freight rates (right hand scale) since January 2002.

A number of points are worth noting:

- The exchange rate at USD 0.58 is close to its long run level. Rates experienced last year, in the USD 0.40 to 0.45 range, were abnormal.
- Freight rates experienced during 2002 were USD 10-12/JAS<sup>1</sup> below historic levels.
- Both factors combined resulted in NZD receipts for export log sales to Asia that were out of line with historic experience given the selling price for logs in our major markets in Korea and China. The movement in prices that New Zealand exporters have experienced has been driven by currency and freight as much as by conditions in the market. Fig. 2 shows the movement in NZD receipts on an FOB<sup>2</sup> basis against the USD CFR<sup>3</sup> price for a notional K grade log since January 2002.

The Australasian market for structural timber has remained strong on the back of buoyant economies in both New Zealand and Australia, and a comparatively stable NZD/AUD exchange rate. Prices for structural logs in the domestic market have eased slightly over the second and third quarters but have basically held steady during the year. Prices for industrial grade logs have eased as processors have dealt with the impact of the rising exchange rate on net realisations from sales into Asia

<sup>1</sup> JAS = m3 scaled according to the Japanese Agricultural Standard

<sup>2</sup> FOB = free-on-board (price at the port of origin)

<sup>3</sup> CFR = cost, freight (price at port of destination)

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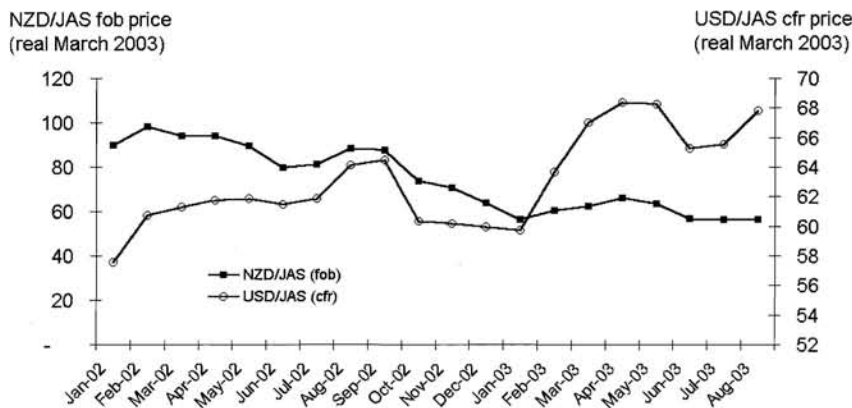


Fig. 2: Although USD prices of K grade logs delivered to Korea have increased, the real NZD price of these logs free-on-board at the New Zealand port has decreased.

and other USD denominated markets.

Overall the combination of factors described above has seen a rapid and substantial deterioration in terms of trade for forest owners to the point that average sales realisations are at historic lows. Fig. 3, which tracks a log price index representing export and domestic prices in inflation adjusted NZD, clearly illustrates the challenge that the industry faces.

**Industry Response**

The first point to make is that the “industry” has not responded, rather each participant has made decisions based on their own circumstances. The industry position is the accumulation of participants’ individual decisions that reflect their relative exposures to the underlying factors that are driving change. The emerging short term picture appears to be:

- Domestic processors that have been focused on the US appearance market have reduced their exposure

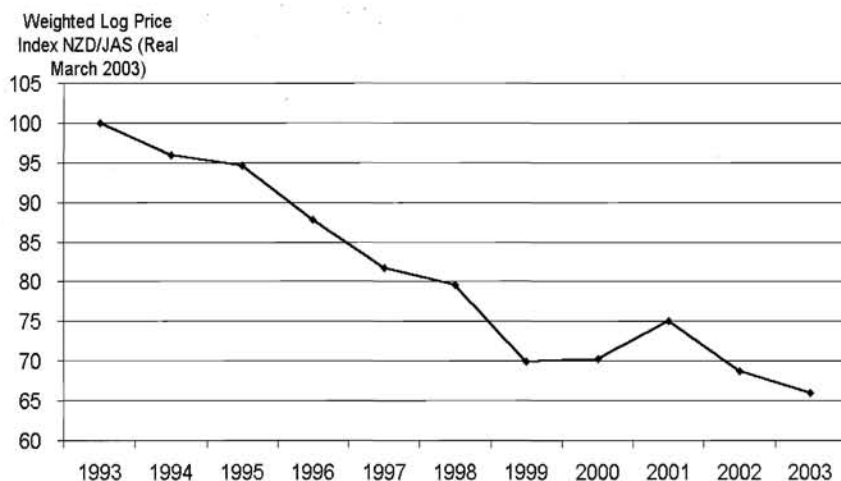


Fig. 3: There has been a downward trend in a log price index representing export and domestic prices in inflation adjusted (March 2003) NZD.

by reducing capacity, diverting capacity into the domestic structural market and negotiating down log prices to maintain viability. In some cases mill closures have occurred.

• The reduction in NZD receipts from export log sales has lowered stumpage returns from high cost sources (forest on steep country with long lead distances to port) with a high exposure to export log markets, to the point where deferral of harvest makes more economic sense than continued harvesting. Volumes offered into export markets have fallen in the third and fourth quarter as forest owners have cut back on harvest levels. The flow on impact of these decisions has been a reduction in required harvesting and distribution capacity in Northland, the East Coast and in the Central North Island. The

cumulative reduction in harvest constitutes something less than 10% of the national harvest, i.e. we are seeing the elimination of highest marginal cost sales to lowest marginal revenue customers.

- The reduction in capacity has resulted in layoffs across the industry that are estimated at 2700 people.
- All forest owners will be evaluating options to reduce costs to improve returns and to create greater resilience to income volatility.
- Forest owners have maintained supply to domestic processors with some increase in competition for available demand, given diversion from export log markets and the diversion of processing capacity from the US to the Australasian market. The cost of marginal log supply to domestic processors has fallen over the past 9 months.
- It is worth bearing in mind that the industry has increased output year on year since the mid 1990s and has developed markets to absorb in the order of 23 million m<sup>3</sup> of radiata pine each year. Short term perturbations in returns and production levels are inevitable in an industry that is expanding at such a rapid rate.

**Short Term Prospects**

At the fundamental level there is little prospect for short term improvement in forest owners terms of trade:

- The currency is unlikely to depreciate substantially over the next twelve months. Most commentators are picking the NZD/USD rate to lie above USD 0.55 with the balance of view favouring USD 0.58 to 0.60.

• Freight rates are likely to hold around USD 30–34/JAS for some months given a general shortage of bulk shipping tonnage in the class of vessels used by the New Zealand log trade to Asia. This short-

age is driven by demand for capacity into China and North Asia and a reduction in capacity, i.e. scrapping exceeding new construction, that will take some time to rectify. In the longer run rates will fall as supply and demand come into balance, however it is unlikely that rates will fall to the levels experienced in 2002.

- Demand from China, and to a lesser extent Korea, will continue to grow.
- Reduction in supply by New Zealand forest owners and demand growth create some prospect of price rises to offset cost increases. The initial price gains have been achieved in September and October but not sufficiently to fully offset cost movements. Continued supply constraint should create the opportunity to stabilise and possibly lift NZD receipts during 2004.
- The Australasian domestic economy is forecast to remain robust over the next 12 months which should allow domestic prices to remain stable.
- Prices in the US market should continue to respond to increasing activity in the US housing market.

Given these circumstances it is likely that the national harvest will stabilise during the next 12 months, but that forest owner's returns will continue to be constrained.

### Long Term Outlook

The current situation reinforces the need for forest owners to be highly proactive, through initiatives such as the Wood Quality Initiative, in supporting continued expansion of the domestic processing industry, which will lead to:

- Reduced direct exposure to volatile externals such as exchange rate and freight will assist in reducing income volatility.
- Reduced exposure to traded commodity prices for logs in North Asia will reduce income volatility.
- Reduced exposure to commodity log markets will assist in reducing volatility in demand driven by traded log stocks into China and Korea.
- Overall reduction in the volatility of marginal revenues will assist owners to maintain greater stability in actual and forward harvest volumes which will flow through into (amongst other things):
  - more certain environment for supplier businesses;
  - an environment that will allow forest owners and suppliers to increase productivity, reduce cost and improve profitability;
  - greater stability of employment;
  - greater stability in asset values;
  - greater incentive for local and central government to continue investment in essential infrastructure.

Forest owners must also take advantage of the current situation to increase the level of cooperation between suppliers to Asian log customers with a focus on achieving greater control over revenue streams in the future.

Some forest owners have already taken steps to move in this direction. Carter Holt Harvey has put in place plans to:

- Delay the increase in harvest from its Northland forests to:
  - Improve the quality and suitability of the harvest for domestic processing by lifting clearfall ages above 25 years.
  - Introduce a steady increase in harvest levels post 2006 to a long run sustainable level that will provide the stability of supply to support major investment in processing.
  - Create demand for harvest and distribution capacity that will rise steadily to a long run steady state that will generate higher levels of employment than previous plans that had envisaged a rapid build up in volume followed by an equally rapid reduction.
  - Allow for completion of critical infrastructure development in conjunction with harvest volume increases.
- Bring forward its planned reduction in harvest from Kinleith forest but to reduce the size of the reduction and plan for a steady increase to the long run sustainable yield for the estate.
- Combine its export log volumes with other exporters, initially CNIFP, through the formation of Silva Forest Products.

The significant movement in forest ownership from vertically integrated public corporation ownership to private and investment fund ownership in recent years and the likely continuation of this trend is positive for the industry. A greater spread of ownership and investment motivations is likely to have a moderating effect on industry response to changing market conditions. The willingness of investors to introduce new capital supports an optimistic view of the long run prospects for the industry.

Long run prospects for the forest owner remain optimistic. It is essential that the industry and its suppliers do everything possible to achieve a position of international cost competitiveness from growing cost through to final consumer. Increased investment in value added processing is part of the answer, however achieving maximum productivity across all forest based operations is just as critical.

Looking further ahead it is possible to see the opportunity for a general rise in real prices for radiata pine (logs or finished products) based on rising marginal costs for our competitors. For example, the marginal cost of supply from the Russian far east into Asia will inevitably rise as investment in infrastructure is required to access more remote supply sources on more difficult terrain. The challenge for New Zealand forest owners and our suppliers is to ensure that we do not let this emerging cost advantage erode through rising domestic cost or falling fibre quality.