The Biofore Company UPM

UPM TILHILL TIMBER BULLETIN

Edition 9
Summer 2010

Trends and influences on the UK standing coniferous timber sales market

Introduction

When considering the introduction to the Timber Bulletin it is always illuminating to review what had been said in the previous year's introduction and compare it to what has actually come to pass in the intervening 12 months. One thing is certain: our industry is cyclical and the cycles are getting shorter!

A trend of rising oil prices was correctly forecast, but conversely the dollar has strengthened, so the oil price impact has increased. The pound remained weak and the exchange rate with the Euro did not return to 2008 levels, but all that may well change in the coming months. Timber prices have recovered well beyond our forecast, largely due to a continued weak position for Sterling. Has the recession bottomed out? All the financial and economic indicators say we have come out of recession, but there still remains a serious concern for the state of the economy.

It is very evident that despite the general downturn and a much overall reduced demand for timber the domestic processing industry has been able to grow its market share for both sawn and board products whilst imports have tailed off dramatically. This effect is driven by the influence of a strong Euro and lower levels of economic activity. This is clearly evidenced in ***fig. 1***. The favourable gap remains between the imported sawn price and domestic sawn prices and this has enabled domestic sawmills to increase their market share. All mills currently have full order books and are having to turn potential custom away. Boardmills have been able to competitively export product to both Europe and North America. This level of activity has meant demand for all round timber specifications has remained exceptionally strong, so much so that there is clear evidence of demand exceeding supply.

The weak pound has also created a renewed interest in log exports from the West Coast of Scotland to both Ireland and more recently Germany. There is no doubt that this demand has contributed to the tightening supply position for sawmills in Scotland. Exports of small roundwood have continued both to Scandinavia and to continental Europe at a similar level to 2009.

Energy wood demand has stabilised for the time being as no significant new biomass energy plants have come on stream in the past year. The main developments have been the start up and commissioning of pellet plants in North and Central Scotland and further developments due to begin on pellet plants in south England and south west Scotland. The regular and continued demand from energy wood users is now a feature of the market. There are a number of factors that continue to cause uncertainty in the development of the biomass renewables sector: the issue of grandfathering rights on ROCs is undoubtedly holding back some investment decisions and the renewable heat incentive (RHI) encouraging smaller scale biomass heat providers.

With market cycle times being compressed it is very difficult to take a firm view of what lies ahead. Whilst full order books and a weak currency assist the domestic processing industry the uncertainty in the Eurozone economies, the change in UK Government and their approach to tackling the deficit problems, will all unquestionably add to the mix of issues that create unpredictability in the market. There is no doubt that the forest industry is a resilient one and demand for wood will continue to grow, so we need to ensure that there is a committed supplier base to provide the timber that the UK's forests have the potential to produce.

Peter Whitfield
Timber Operations Director

Imported sawn softwood

Fig. 1 shows that according to data from Timbertrends, the levels of sawn softwood imports into the UK from major suppliers has decreased by a further 12.8% (702k m^3) from the historically low levels of 2008 with the total volume being imported at 4.785m m^3.

All countries, with the exception of Sweden, reduced imports. The most significant reductions were Latvia 10%, Finland 25%, Russia 31% and Germany 43%.

Sweden however, actually increased imports by 5% (133k m^3) with total imports standing at 2,573k m^3 against a backdrop of a fall of 2.3% in industrial production and a 5% fall in sawn softwood production. The UK remains Swedens largest export market by far.

Because Sweden trades in Swedish Krona, it benefit in 2009 from a relatively stable exchange rate (see also *Fig. 4*) which only weakened in the latter quarter. Of particular note though is the Irish imports that buck the trend despite being affected by the Euro, possibly due to their closeness to the UK and relative ease to respond to demand.

First release statistics from the Forestry Commission on UK Wood Production and Trade indicate apparent consumption of sawn softwood reduced by 8% from 2008 to 7.4m m^3. UK production of sawn softwood did however increase by 2% to 2.825m m^3 representing 38% of the market.

Fig 1. Imported sawn softwood

Source: Timbertrends

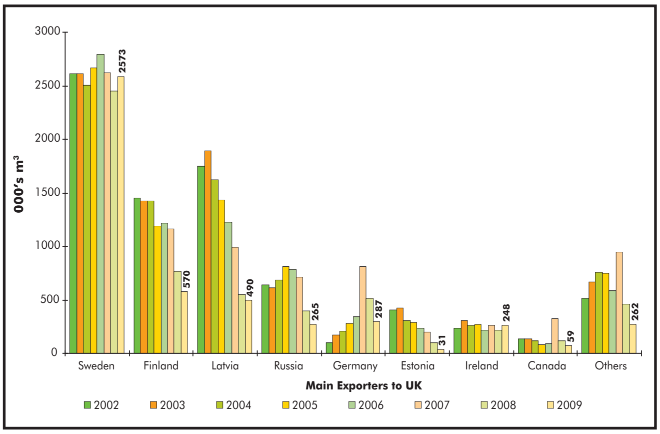


Fig 2. Importers of Sawn Softwood Market Share

Source: Timbertrends

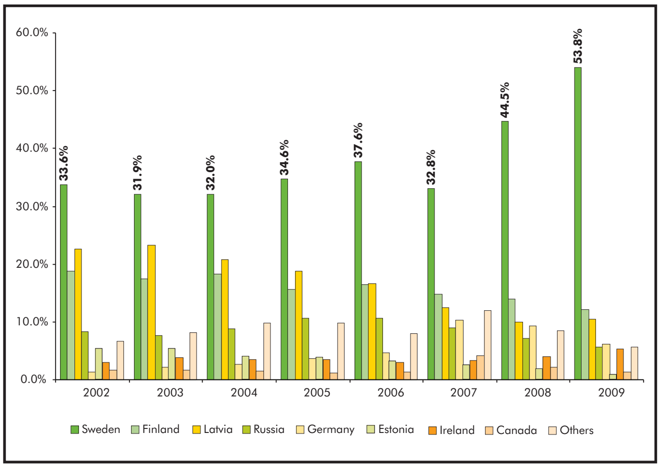


Fig. 2 illustrates the percentage market share each importing country holds over the period 2002 to 2009. Of the major suppliers, Sweden has increased market share significantly by 21% from 44.5% to 53.8% as it increased imports when many others substantially decreased. Finland and Latvia remain at roughly similar levels to 2008, the remaining suppliers being substantially reduced.

This overall fall in imports is due in part to the Europe wide recession and the loss of confidence in construction leading to a reduction in capacity. The very weak pound against the dollar and Euro meant prices were unattractive to importers. In addition, the severe winter in Russia and continuing social and political instability in Latvia adversely influencing investment in new capacity have all contributed to this significant decline.

Sawn timber price vs Exchange rates

In *Fig. 3* we have updated our look at the correlation between sawn timber price and exchange rates.

The exchange rate curve is a mix, weighted by imported volume, of Swedish Krone and the Euro. The chart compares the trend prices for imported sawn timber and the domestic trend price (UCM C16KD mean price trend), against the exchange rate trend (Bank of England).

Historically, as the pound weakens, landed prices rise and the domestic rate tends to shadow the imported price. This behaviour can be seen clearly in the early periods 2002-2006. In 2008 the negative correlation changes due to economic drivers where supply and demand are out of phase. 2009 sees a return to trend with increasing landed prices as the weak pound bites deep. As import volumes fall (see *Fig. 1*), domestic production increased to fill the gap but at stable prices that are attractive to buyers. This trend was largely responsible for the levels of increased sales enjoyed by the domestic producers. We feel the UCM mean British prices for 2010 are conservative and we expect to see significant increases during the first half of 2010 as importers look for further price rises with British timber prices rising proportionately, subject of course, to a continued economic recovery and favourable exchange rates.

Fig 3. Sawn Timber Price and Exchange Rates

Source: Industry Data

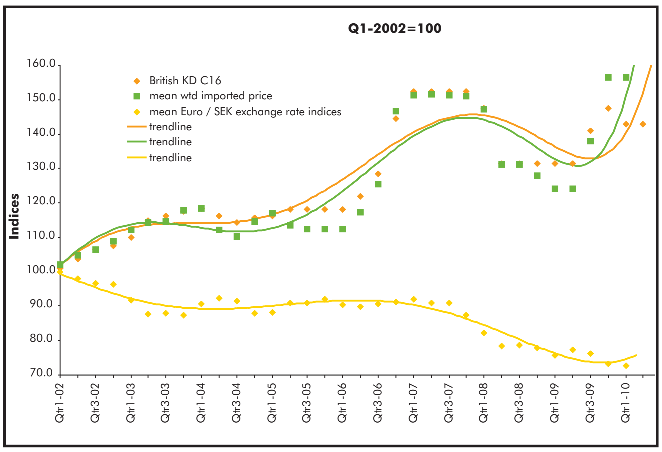
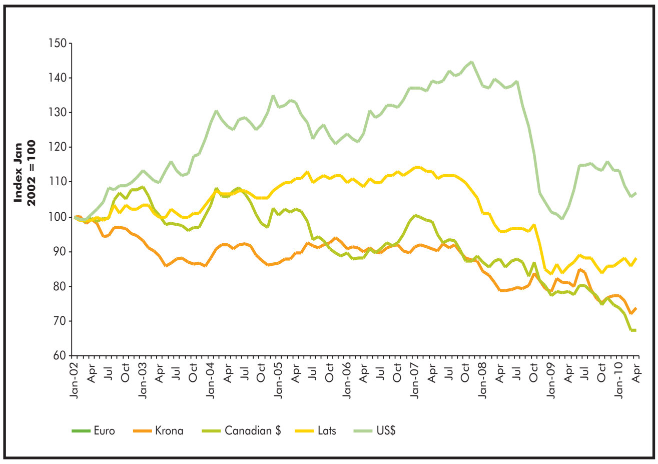


Fig 4. Exchange Rate Trends

Source: Bank of England



Exchange rate turbulence

Fig. 4 continues our annual tracking of the main exchange rates that influence the purchase price of timber.

The severe weakening of Sterling seen during 2008 continued into 2009 notably with the Swedish Krona falling a further nine points from April 2009 to April 2010. The Euro over this period has been quite volatile but the underlying trend is flat.

As discussed in *Fig. 3*, these significant falls have contributed to the rise in landed timber prices over recent months. In the medium term, it is becoming difficult to forecast exchange rates as financial and political upheaval in the Eurozone impacts on the value of the Euro. The fortunes of the British economy will not be known until the new government is established and policies become clear. What is certain is that 2010 will see continued turbulence in exchange rates.

Standing prices increase

Fig. 5 is the most recent published data for competitive standing sales and softwood log indices. For standing sales the relevant indicator is the real Fisher index which is the geometric mean of the Laspeyres (base weighted) and Paasche (current weighted) indices which was introduced in 2009. For historic comparison the Laspeyres indices will continue to be shown until 2014.

Standing sales increased by 5.1% to March 2010 compared with the previous year and the 6 monthly log index moved by 21.9% compared with the corresponding period of the previous year.

The state sector log price movement reflects the positive upward trend of our private sector log price indices in *Fig. 6* and underpins our view that prices are being paid well ahead of the normal 'core' price base.

The state sector standing sales faired less well than logs, the underlying reasons for this may be the quality and character of the parcels put to the market in this period. It is our view that price trends for private sector standing sales have exceeded those implied by the FC statistics possibly due to limited volumes being available in the private sector against a backdrop of strong demand.

Fig 5. Forest Enterprise Price index for GB

Source: Forestry Commission

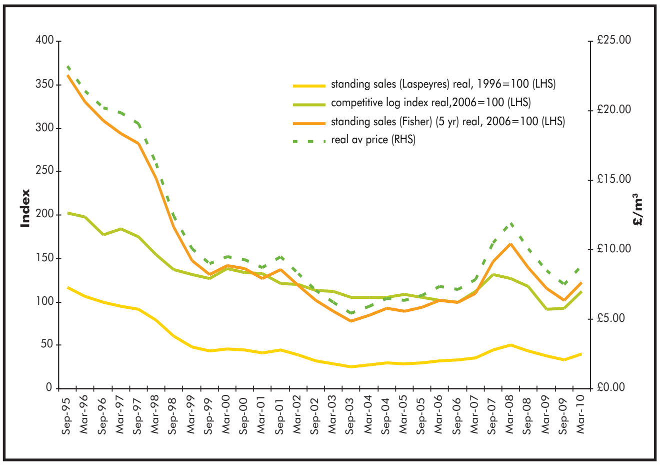
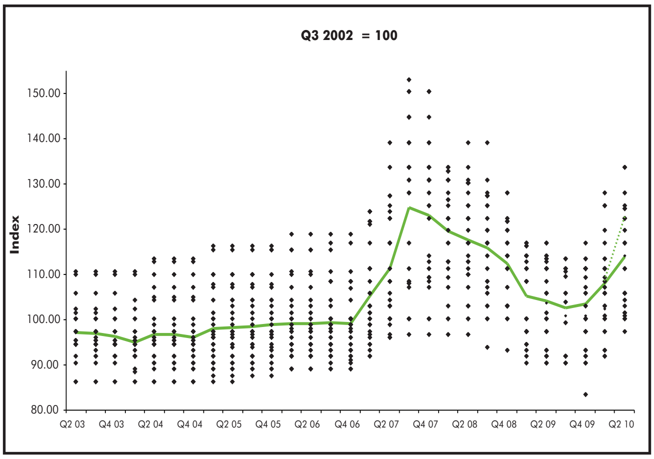


Fig 6. Green Log UK Price Trend

Source: Industry Data



Green logs

Fig. 6 plots a mean GB green log price from a representative sample of the private sector across most markets. The chart plots the mean log price trend and the individual mill price variants. The range in price indices data points is as a result of size, length and location.

The 2009 Bulletin correctly forecast the stabilisation of prices through 2009 and an uplift into 2010, but perhaps underestimated the rate of this increase. There are strong indicators that the market is moving away from core pricing structures and resorting to spot prices as competition increases with demand. The solid line represents core (contract) prices and the dashed line is our estimate of the impact of prices currently paid on a lot by lot basis, commonly referred to a 'specials'.

This peak in prices is a direct result of strong demand due to import substitution coupled with a limited supply of logs. Some of this impact was as a result of the severe winter and normal log extraction being down by 20% in the early part of the year (TTJ).

The price differential (£20-£30m³) between domestic timber and imported as seen in *Fig. 3* is a powerful driver for increased domestic production. It is our view that the base prices will continue to increase but the differential will remain at a similar level whilst economic uncertainty in the UK economy remains.

Sales, costs and stumpage trends

Fig. 7 looks at the trend of harvesting costs and general product sale prices, which are weighted by the product mix, thus deriving the nominal stumpage price paid to growers. The data set is private sector trading, indexed using Fisher geometric mean indices, and represents a significant proportion of the British market.

The relative depression of log prices in 2009 (see *Fig. 6*) has had a significant impact upon the mean parcel value despite strong activity in the SRW and fuel wood markets. This disproportionate mix of product values and high demand for SRW promoted the sales of stands with high SRW content which understandably reduced mean stumpage values.

Fuel cost rises of 12% throughout the year contributed to a 28% fall in stumpage returns to the grower during 2009.

This however, is seen as a short term trough as indications for 2010 and beyond suggest a strong return to stumpage values seen at the peak of 2007 driven by high demand in both logs and SRW as global economic recovery gains momentum and demand continues to outstrip supply.

Fig 7. GB Softwood Timber Sales All Products

Source: UK Forest Industry

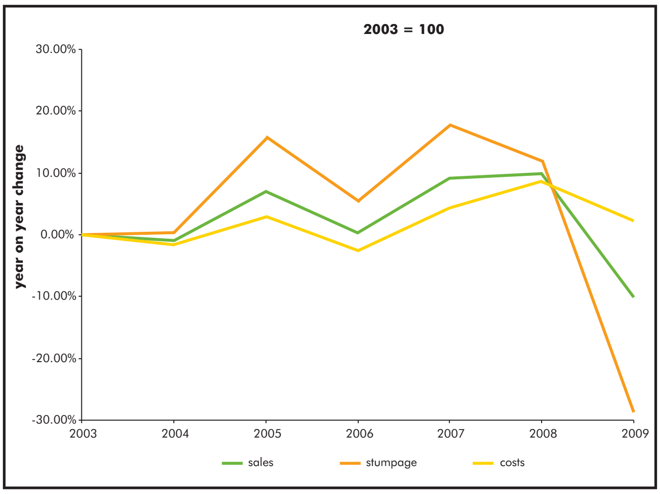
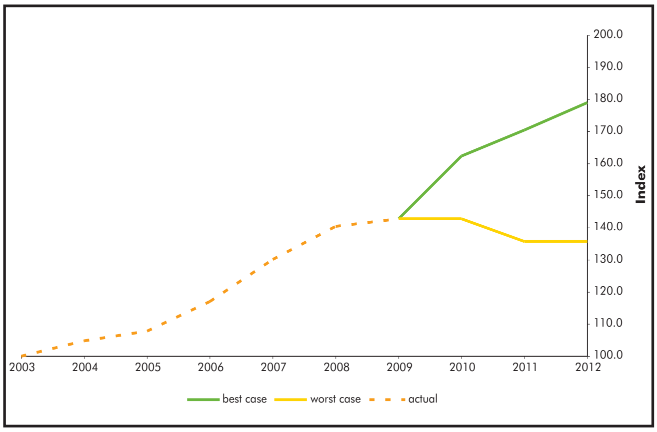


Fig 8. Standard Softwood Log Price Forecast

Source: UK Forest Industry



Log price trends

Fig. 8 the UPM Tilhill 'standard' log forecast tracks the changes in price of all the products produced from converting round logs.

The 2009 Bulletin forecast a 10% drop in log prices as a best case scenario. In reality, prices moved slightly ahead (2%) of the 2008 price. *Fig. 6* illustrates the upturn in the market from Q3 onwards due largely to import substitution, some exports due to the weak pound, growing confidence in a market recovery and marked price increases for other products from the log breakdown process, chiefly co-products for panel board and energy markets.

Looking forward, our worst case scenario is a firming of prices through 2010, thereafter a potential modest fall in prices if the pound strengthens against the SEK and Euro. A more optimistic outlook is for 2010 prices to rise by 13% over 2009 if demand continues to be strong and supply relatively weak, softening to 5% growth per annum as supply and demand return to equilibrium.

SRW price trends

The SRW forecast is an amalgam of the SRW products purchased in the UK weighted by consumption in the paper and board markets.

The 2009 Bulletin again forecast a best case scenario of a 7% decrease for 2009. In reality, prices remained firm at the 2008 level. Our pessimism was due largely to a belief that the recession would bite deeply into the profitability of the SRW market and drive prices down. We did not however, correctly anticipate the extent of the impact of the wood fuel market or the export opportunities for the UK board markets due to the weak pound. Our forecast clearly shows that competition for SRW is driving prices upwards, the difference between the best and worst case being the timing at which the push of the wood fuel market begins to ease and the ceiling at which board markets have the capability to pay.

Not surprisingly, SRW processors in the UK feel under threat from the nascent energy wood market, which is contrary to global pulp and paper industries who have increased their consumption of biomass for energy production by 50% which accounts for 18% of demand (WRI), proving that in global terms at least, the two markets can co-exist.

Fig 9. Forecast of SRW Prices

Source: UK Forest Industry

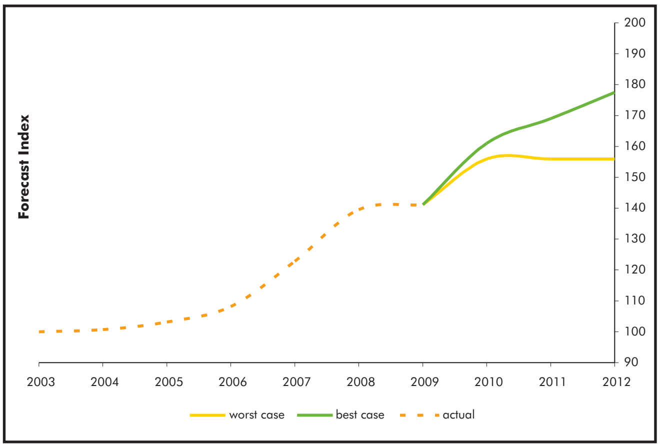
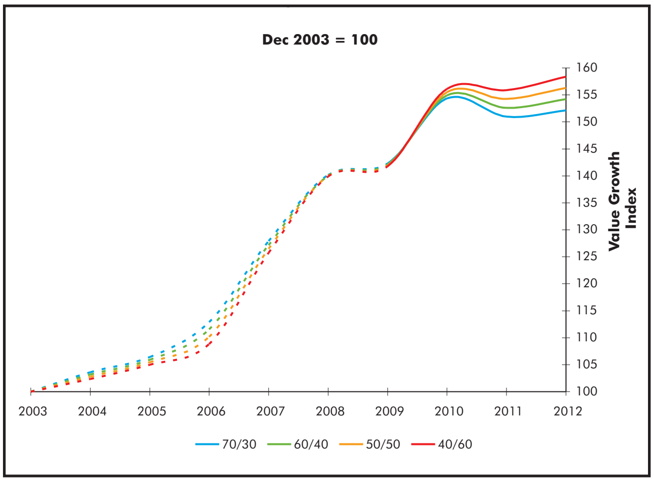


Fig 10. Combined Log and SRW Indices Forecast

Source: UK Forest Industry



Standing sales trends

The standing sale trend is a combination of the log and SRW trend using a mean of the best and worst case scenarios. *Fig. 10* shows the impact of the proportions of log to SRW in a parcel of standing timber.

The model highlights the stabilising of parcel values for 2009 which was a much improved position than our forecast of a 12% drop. It was also clear that there was no differentiation between the parcels of differing log content.

As can be seen in *Fig. 8 and 9*, log prices are subject to greater risk than SRW which will rise in any event. The impact of the mean position of these two components is to value stands of higher SRW content better than those of high log content which is clearly shown in *Fig. 10*. Until such time as the competition for SRW eases and the log market stabilises, we predict that the traditional parcel of high log content will be in strong competition with parcels of smaller tree sizes.

Timber in construction

Fig. 11 illustrates the market share of timber framed houses constructed in the UK over the last 10 years. The country split for 2008/9 was 76% Scotland, 16.7% England, 15% Wales and 10% NI. This must however be seen in the context of the market size in each region which when translated to housing completions in 2008 is England 22,350 units, Scotland 15,983 units and Wales and NI 1068 and 972 respectively.

It is highly likely that Scotland is close to its peak but the huge potential for England is still largely untapped.

With increasing focus on energy conservation and climate change issues, there are encouraging signs that a material increase in the rate of construction of timber frame housing in England will increase consumption of timber products and enhance the prospects for the domestic timber market.

"Action to mitigate climate change has now clear political focus, with timber being the only truly renewable and organic building material." **UKTFA**

Fig 11. Timber Framed Housing Growth

Source: UKTFA

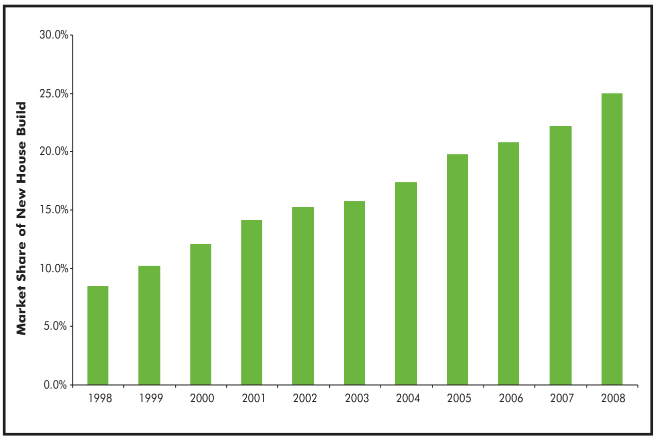
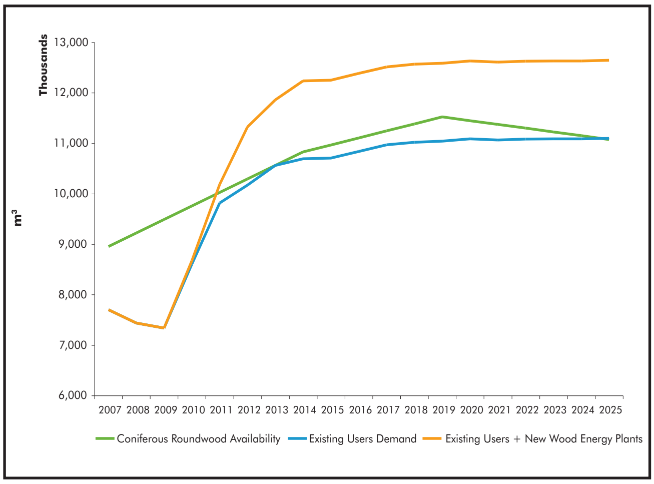


Fig 12. Supply Demand Forecast to 2025

Source: ConFor and UKFPA



Impact of wood energy market development

Fig. 12 is a reproduction of chart 3.1 from the report *'Wood fibre availability and demand in Britain 2007 to 2025'* written by John Clegg Consulting and commissioned by ConFor, UKFPA and Wood Panel Industries Federation.

The forecast of coniferous roundwood availability reflects the Forestry Commission's most recent forecast of 2006 and the demand, both existing and potential, is drawn from 93 companies covering 139 existing or proposed plants who have declared an interest either officially, or unofficially, in using or supplying wood fibre in Britain. There are 33 companies that are operating or have plans to operate 63 wood energy plants and of these 16 larger-scale commercial wood energy plants are operating at the present time.

It is clear there is insufficient fibre to go around if all the planned wood energy plants become operational. The largest energy plants will need to import a large proportion of their requirements as there is insufficient wood fibre available in Britain, but others may well seek to secure a core supply from the UK. For the grower this appears to be good news, as competition drives prices up, but the downside is that displacement of our existing processors by renewable energy markets could lead to an overall reduction in the potential to add value to wood fibre. This in turn could lead to a narrowing of the market with energy plants setting a new benchmark on price. One of the conclusions that the report reaches is that most planned new energy plants will need to secure 7 to 10 year wood fibre supply contracts if they are to attract the necessary investment finance required to build the plant.

The report has raised a number of questions by the industry, in particular, concerning current forest policy which may be counter-productive to the development of the UK forest industry in the context of government policy on renewable energy.

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