

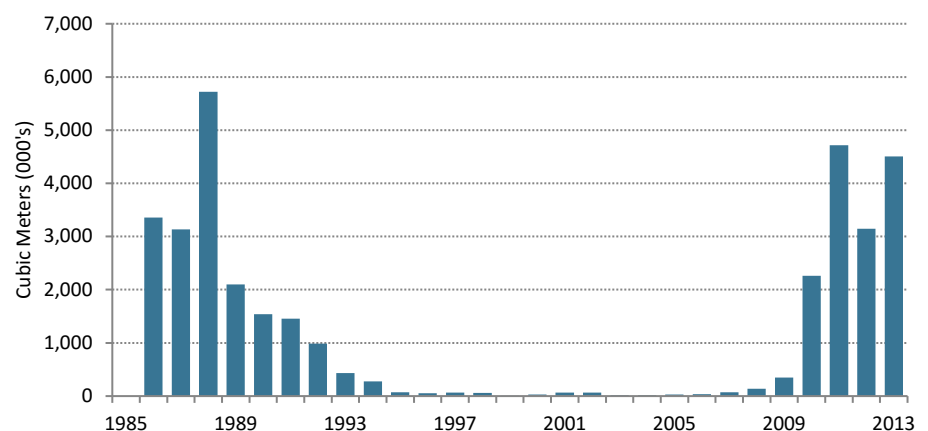
U.S. Timber Exports to China

Timberland investors are well positioned to benefit from the uptrend of sawlog prices that is currently underway in many parts of the world. In the U.S., demand for softwood sawlogs has been steadily increasing since 2009 and fundamentals support a positive long-term outlook. While the outlook is positive across the U.S., the Pacific Northwest has outpaced other timberland regions in terms of softwood sawlog demand growth. This is due to demand from China and other Asian countries such as Japan for west coast sawlogs and lumber. We would like to take the opportunity to comment on these market trends and highlight the importance of a geographically diversified timberland portfolio in order to participate in multiple forest products markets.

Introduction

Since the well documented downturn of the U.S. housing market, the recovery of U.S. forest products demand since 2009 has varied by region and market segment. The largest contributor to the variation of recovery has been the sharp increase in softwood sawlog shipments to China from the Pacific Northwest (Fig. 1). With domestic softwood lumber markets still recovering, the recent increase in exports to China has largely benefited Pacific Northwest timberland owners. In the past, from 1986 to 1992, China has been a significant destination for Pacific Northwest softwoods. However, exports tailed off due to rising prices, China's increased production of domestic forests, and the development of new sources of supply from countries like Russia and New Zealand. But beginning

Figure 1. Pacific Northwest Softwood Sawlog Exports to China



Source: U.S. International Trade Commission

in 2009, softwood sawlog exports from the Pacific Northwest to China have risen from 351,000 cubic meters to more than 4.5 million cubic meters.

When Pacific Northwest exports to China began to rise rapidly in 2009, China held a relatively small overall share of the west coast export market (Fig. 2). Now China is clearly the primary destination for Pacific Northwest soft sawlogs, even though volumes exported to Japan may have been more consistent in the recent past.

What has encouraged the surge in exports?

The answer is threefold. One, demand for forest products in China is growing. New construction activity in China posted a full recovery from the decline in 2012. On top of this growth in residential and non-residential construction starts, the Chinese government

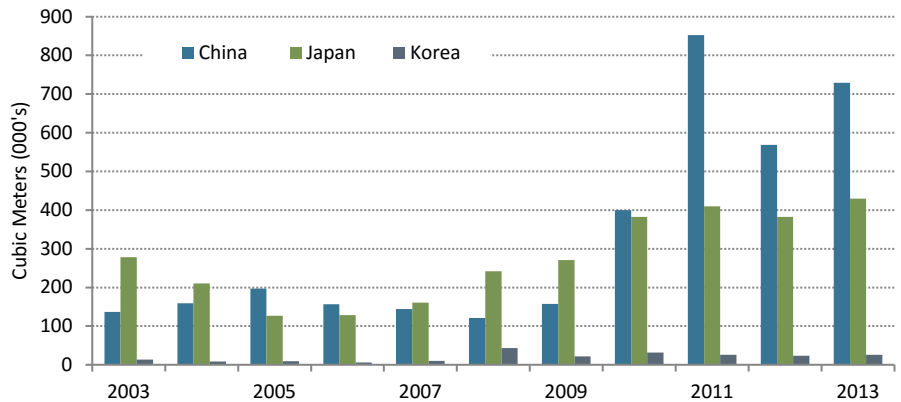
has a social housing unit program that has been building to increase the supply of affordable housing. The program calls for 36 million units to be built between 2011 and 2015. As of November 2013, China started construction of 6.7 million social housing units for the year, with 5.4 million completed.¹ On the supply side, China has a widening fibre deficit with softwood harvests expected to decline further in the future and domestic production biased towards hardwoods.

Two, the sharp decline in U.S. housing starts, between 2005 and 2009, dramatically reduced the demand for softwood lumber in both the U.S. and Canada. With U.S. lumber demand low, opportunities for China to increase their imports of U.S. softwood sawlogs became increasingly attractive.

And three, the log export tariff imposed by Russia significantly reduced their volume of sawlog exports to China due to the significant increase in delivered costs of their sawlogs. Prior to 2008 when Russia began imposing export tariffs, they supplied China with 85-90% of their softwood sawlog imports. But when Russia joined the World Trade Organization in 2012 they were forced to take steps to reduce trade restrictions on export sawlogs to which heavy tariffs had previously been applied. In spite of reduced restrictions and the expected reduction of costs, however, their industry has suffered from rising logging and transportation costs and is faced with a growing need for major investments in infrastructure. Recent reports now put Russia's market share of logs to China at less than 30%.²

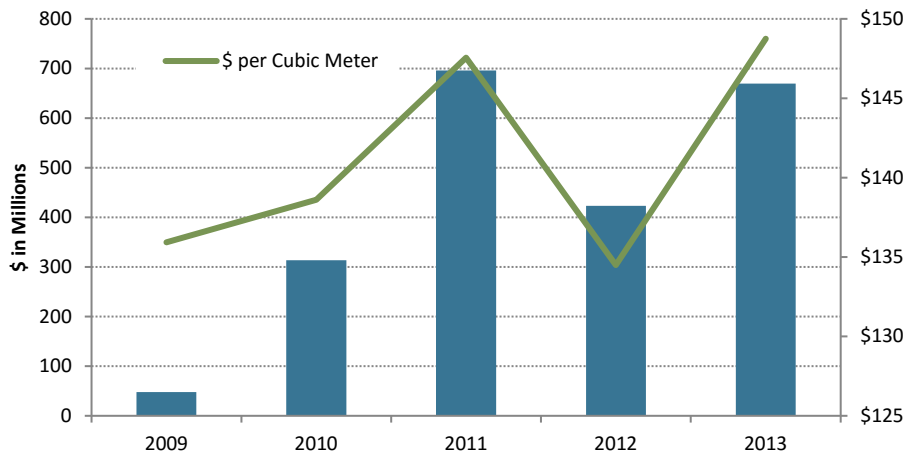
Much of China's softwood sawlog shortfall has been made up by the U.S., New Zealand, and to a lesser extent Canada. In general, sawlogs from public forests in Canada cannot be exported. Since the vast majority of the

Figure 2. Pacific Northwest Sawlog Exports by Destination



Source: U.S. International Trade Commission

Figure 3. Value of Pacific Northwest Softwood Sawlog Exports to China

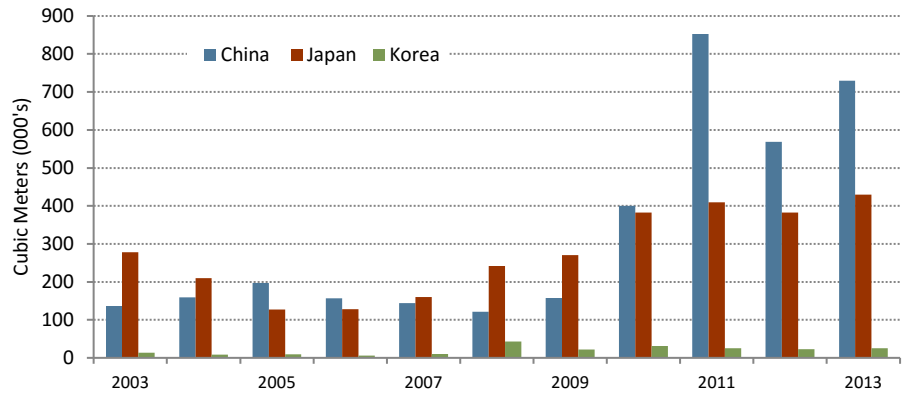


Source: International Trade Commission

timber in Canada is from provincial forestland, Canadian exports to China are mostly in the form of softwood lumber. Canada will be further constrained by the reduced availability of timber killed by the mountain pine beetle, which had been in high demand in China due to its attractiveness from a cost standpoint.

This may further shift the supply burden onto the U.S. and New Zealand. Though the volume of Pacific Northwest sawlogs exported to China in 2013 did not surpass the previous high water mark of 2011, the value per unit exported exceeded that of 2011 as the total value of sawlog exports approached \$670 million (Fig. 3). New Zealand has likewise experienced an increase in the value of sawlog exports to China since 2009. In 2013, New Zealand sawlog exports to China totaled \$1.4 billion (US\$).³

Figure 4. Pacific Northwest Softwood Lumber Exports by Destination



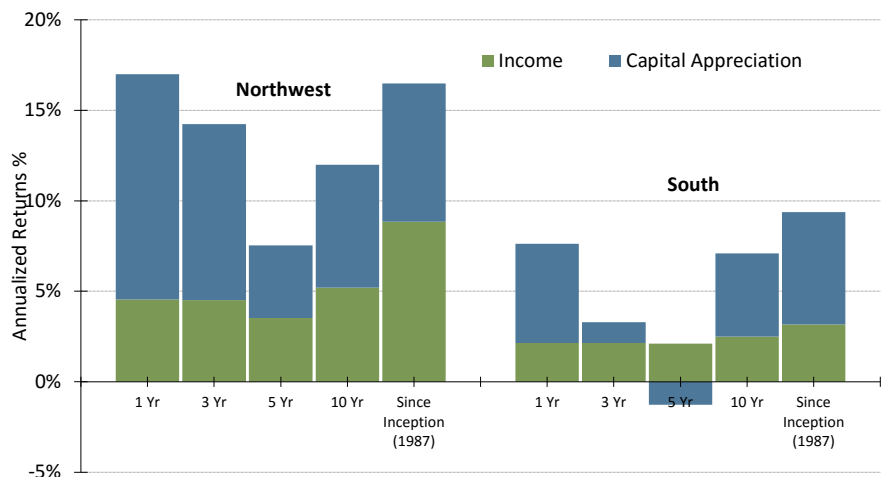
Source: U.S. International Trade

A parallel story is true for Pacific Northwest softwood lumber exports to China, albeit on a smaller scale. Despite China’s widening fibre supply gap, China is reported to have some of the world’s lowest cost sawmills, and consequently can be very competitive for sawlogs and at times softwood lumber as well. Figure 4 shows the increase from 2009 and softwood lumber exports from the Pacific Northwest topping 700,000 cubic meters in 2013.

Timberland Returns Inherently Impacted by Export Demand

The geographical location of timberland investments is obviously the primary component of the overall impact of the rise in exports to China. This is evident by comparing the recent regional timberland returns reflected in the National Council of Real Estate Investment Fiduciaries (NCREIF) Timberland Index. The latent effect of the rise in Pacific Northwest softwood sawlog exports to China is a significant reason why the one and three year annualized returns are significantly higher in the Northwest region than that of the South (Fig. 5). Given that the South is more dependent on domestic softwood sawlog demand, the South will continue to benefit from the continued, but more sluggish growth in U.S. residential construction markets.

Figure 5. NCREIF Timberland Index, Annualized Rates of Return through December 31, 2013



Source: NCREIF

Sawlog exports to China from the Pacific Northwest may not sustain the rapid growth rate since 2009. However, there are several factors that may cause them to remain elevated and point towards continued tailwinds from China:

- Urbanization rate equal to the migration of roughly 10 million rural residents per year;

- Aforementioned social housing unit program calling for 36 million units of affordable housing by 2015;
- Architects in China are increasingly using wood in non-residential construction projects; and
- Growing attractiveness of wood as a renewable green building product.

In addition, it is worthwhile to reiterate that the timber supply from Canada will continue to be constrained and Russia will not play a significant role in the near term due to the needed capital investment necessary to increase production and reduce costs.

Summary

The recovery of softwood sawtimber demand from the 2009 low point is well underway and has certainly been buttressed by export markets. Pacific Northwest timberland owners have benefited whether they are selling sawlogs to exporters or to domestic mills, which then ship lumber overseas or supply the domestic market. Either way, the demand for sawlogs has increased and export demand results in domestic mills having to be more competitive for their sawlogs. All the while, the U.S. housing market recovery will continue to benefit timberland owners across all regions. Taking into account export markets and other secular trends, regional variation will most likely exist in an additive manner and further highlight the paramount importance of a geographically diversified timberland portfolio.

¹ National Bureau of Statistics of China, ERA Research

² NZX AgriFax, Forestry Market Report

³ NZX AgriFax, Special Report, January 2014

About the Author

Bill Turner, PhD is the Director of Timberland. He is responsible for asset class research, investment strategy, and reviewing prospective acquisitions. As the Director of Timberland, he oversees the timberland valuation process and works as a liaison with our strategic partners. Dr. Turner has over fifteen years of timberland investment experience; including portfolio management, forest management operations and planning, and timberland transactions. Prior to joining Silver Creek in 2013, Bill was a director at Forest Legacy Investments. Earlier in his career, he worked with Olympic Resource Management, a Pope Resources Company, which managed over 650,000 acres of timberland and served as the western timberland manager for the Hancock Timber Resource Group. On behalf of institutional and private investors, Dr. Turner has led the valuation analysis of over \$3 billion of timberland assets. Dr. Turner holds a PhD in Forest Resource Economics from the University of Washington, a Masters in Applied Economics, and a B.A. in Business Administration with a concentration in Finance.

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