viewfromthetop

Big sawmill investments for West Fraser

Logging and Sawmilling Journal is introducing a new feature in 2011: View from the Top. In this series of interviews with the CEO's of Canada's major forest companies, we'll look at the opportunities that lie ahead for the industry, and the challenges as the industry pulls itself out the worst downturn since the Great Depression.

In our first interview, Logging and Sawmilling Journal Editor Paul MacDonald talks with Hank Ketcham, Chairman, President and CEO of Vancouver-based West Fraser Timber, about the company's recently announced $230 million capital spending program, his outlook for lumber markets, and how West Fraser is going to deal with the mountain pine beetle situation in the B.C. Interior, going forward.

Logging and Sawmilling Journal: What is your outlook for 2011 and going into 2012? A lot of people are talking about 2012 in particular being a better year for lumber markets and U.S. housing starts.
Hank Ketcham: Well, I wouldn't predict 2012 myself. Every year for the last few years, we've thought that the next year was going to be better, and it hasn't been—it's been worse as a matter of fact, progressively worse.
The last quarter of 2010 picked up a little bit. But U.S. housing starts are still in tough shape—they've continued to be at the lowest levels since World War II. The exchange rate is close to par. And I don't think anybody that I've heard of can accurately quantify the effect the existing foreclosures and the pending foreclosures in the U.S. are going to have on housing inventory in the next year or two.
So I think it's really hard for anyone to get a handle on what the next 12 to 18 months are going to look like in this business. But it's really the same thing—you've got to have well-capitalized, low-cost sawmills to survive in this climate.

LSJ: The foreclosure situation in the U.S. seems to be this huge cloud hanging over the economy and the lumber business.
HK: It sure seems like it to me. But a lot of the fundamentals are right for renewed housing starts—interest rates and affordability, for example. Again, it's hard for us here in Canada to get a handle on this foreclosure situation in the U.S. and how it's going to materialize over the next couple of years. It's obviously had a very depressing effect on the market up to this point. And some people are saying we still have a lot more to come.

LSJ: Are you cautiously optimistic going into 2011, compared with what it has been like the last few years? It's been such a wrenching time for the forest industry.
HK: It's important to remember that it just hasn't been the last couple of years that it's been bad for the industry—it's been the last four years.
It started in the latter half of 2006 for the forest industry. When you really think about the depression for our business, it's been unprecedented. In terms of being cautiously optimistic going forward, I would say for our industry, the optimism relates to the fact that we have to be closer to the end than the beginning.
I don't think that anyone can see the light at the end of the tunnel yet, and increased lumber consumption—but that is obviously going to come.
For our company, I'd say that I'm quite optimistic. I think if you have a good strong balance sheet, if you have well capitalized mills, if you have a low cost structure, you can come through this pretty well. All the high cost production has been taken out of the system now, and that's what's giving us some semblance of supply and demand in the market. Though it's hard for me to understand how prices are where they are—at $300 a thousand board feet at the end of 2010—given the

state of the housing market in the U.S.

LSJ: What has it been like for West Fraser over the last four or five years? What has the company had to do to make sure that it comes through the downturn?
HK: We've always had an ability to go into the downturns feeling pretty confident. We have very modern, very efficient sawmills in Canada. And we've always endeavoured to maintain a strong balance sheet because you really don't know when a negative surprise is going to hit you. And when you are a highly capital intensive industry in a commodity product, you can go underwater really quick if you don't have a balance sheet that gives you staying power.
Due to our cost structure, we have been able to significantly reduce our debt right through this recession to the point where we have an extremely strong balance sheet today. And we have plants that don't need a lot of capital. We have a big capital program going forward, the biggest in our history—$230 million on the wood products side. But we see these as great opportunities—if we did not do them, we would still have a strong, well capitalized group of mills here in Canada.
Our issue is with West Fraser operations in the U.S. South, where we bought a bunch of mills from International-Paper in 2007, knowing full well that we had to spend money to get them modernized and efficient. We closed that deal right when the recession hit hard and we have not spent the money down there, so we are going to be embarking on solid capital programs down there in 2011.

LSJ: There's been a lot of talk about the lumber market in China, especially for B.C. producers. What are your thoughts on the Chinese market, does it have legs long term?
HK: I think it is a developing market that does have legs long term. We were skeptical of that three or four years ago. But I think a lot of credit has to go to B.C. Premier Gordon Campbell and B.C. Minister of Forests Pat Bell for an outstanding job of working with the forest industry, working with the Canadian government to promote our wood products over there, and it's really had a major effect.
On the margin, China's significantly growing consumption has had some effect on North American lumber prices for SPF, so that has really helped us out with the dependence on the U.S. market. It also looks to me that the momentum is gaining for more wood use in China; they've never had codes and standards for wood construction, and they do now, with the help and encouragement of the B.C. and Canadian governments. We have customers that we are working with to develop new markets, and they are starting to build some homes out of wood there.
We're looking at programs to get wood into four, five and six storey apartment buildings there. There is a lot happening. We're very optimistic about China.

LSJ: A lot of the lumber exports have been lower value wood. Is there a way to move that up the value chain?
HK: I think so. It started out being construction concrete framing, that kind of product. I think there we are starting to get into market niches; it's a slow process but it's happening. With a country that big, with such an explosive internal economy, I think once they start moving into a product like our lumber, it's going to continue growing. We don't know how it's going to go, whether it's houses or what, but with 1.3 billion people, who are now starting to ask for our wood and are getting used to using it, I think it has tremendous potential.

LSJ: How do you see the Chinese lumber market as part of the mix going forward? Traditionally, the U.S. market has been the main market for Canadian lumber.
In the past, the industry has paid attention to overseas markets, and when the U.S. market recovers, there is less interest in

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these markets, and they become an afterthought.

HK: We have a little bit of a market in South Korea and Taiwan, China is growing pretty rapidly, we have a strong base in Japan that has been a great market for us—and it will continue to be well into the future.

There is also potential in the North American market. We have let the commercial/light industrial market slip away on us over the years. We can start getting market share there, just as we have in China, if we put the same effort into building our reputation in those markets.

And the home building business in North America is going to come back, big time. It was overbuilt, and now it is significantly being underbuilt, just to get the inventories in line. When it comes back, we'll get back to a trend in housing starts that will make lumber production a very good business to be in. I think, when things turn around in the U.S., we'll end up with a very strong U.S. market, with offshore opportunities that weren't there when we went into this downturn. So I think it's going to result in a very strong market down the road.

LSJ: What do you see U.S. housing starts rebounding to?

HK: Based on some of the independent forecasts, we've always looked at 1.6 million housing starts annually as the trend. Maybe it's 1.5 million or 1.7 million housing starts. Either one would be fine. The industry will adjust to whatever number that is.

The other factor is a reduced timber supply. Canada is not going to be shipping as much wood into the U.S. in the future because we won't have the timber assets. There is the mountain pine beetle in British Columbia, there is reduced supply out of eastern Canada. And I think we are going to get to a tipping point at some point where the North American market is going to need more lumber than we can supply.

LSJ: As the North American lumber market recovers, how can Canadian companies deal with the competition from other countries?

HK: Well, Europe was making significant inroads into the North American market prior to the downturn. And they are probably thinking of getting back into this market when prices get to a certain point. Certainly, if the Euro is devalued significantly, that would make their product more affordable.

The fast growing plantation regions also have economies that are starting to grow, and use their wood internally. But it's a different species—I think that SPF out of Canada is always going to be a preferred species for what it's used for, construction products.

LSJ: Going forward, how is the mountain pine beetle going to impact the market, the B.C. Interior and West Fraser in particular?

HK: It's had a huge impact on the industry in two ways up to this point. There's been more wood available than the AAC can accommodate. So the industry has moved from average B.C. Interior lumber production of 10 billion board feet a year to 15 billion board feet a year because we were trying to liquidate the dead pine. What happens when you do that, though, is you're really cutting stands of timber that 10 years ago you would have said there's no way you could make any money at it. It's a very, very tough wood profile that we're dealing with that has a significant impact on mill nets, grade percentage, productivity and lumber recovery factors.

We've been able to develop and install technology that's really helped us deal with the significantly declining wood profile. But eventually, we're going to get to the point where the wood is just not going to be there, economically or physically, to get the cut at the level that it is at now. So we'll drop back, over time to the cut levels that we saw in the B.C. Interior more in the 1980s, or the early 1990s.

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LSJ: There may not be opportunities in other areas of Canada, but where does West Fraser go from there when it has to take a step back in the B.C. Interior, due to impact of the pine beetle?
HK: Everyone is going to struggle to keep their operations going in the B.C. Interior—and some are not going to make it. It's going to be a real fight in B.C. for a while.
That's one of the reasons we moved as aggressively as we did into the U.S. South, to offset the effects of the eventual beetle falldown for our company. We're a significant player in the U.S. now. And we're a significant player in Alberta. We're just going to keep looking for opportunities around North America that make sense to us, where we think we can add value and make money.

LSJ: West Fraser has now launched the biggest capital spending program in its history, with $230 million. Where will that be going?
HK: At our September board meeting, we approved an interim capital spending program of $125 million. We did not want to get stuck in a cycle where we had to wait until the end of the year until we started spending money. We presented projects to the board at that point in time, of $125 million. We went back to the board in December with a program significantly higher than that, to $230 million. Although our industry is still in a fairly fragile state, we believe that this is the time to focus on improving our current operations.
The $230 million will be spent in all three areas, B.C., Alberta and the U.S. South. We will be doing high payback projects, going through all of our mills where we get the best payback, the most return, and are the most strategic.

LSJ: You talked about getting through the last four or five years with the company's solid financials. Can you talk about the importance of being resourceful at the mill level and the importance of the company's people?
HK: We've been very fortunate—we have long term employees at the staff level who really understand the culture of the company, who really understand our strategy to get through tough times, great leadership, great continuity, we have virtually no turnover at our senior levels. Our management group is all pulling in the same direction.
With our hourly employees, we have great people, people who have 35, 40 and 45-years' service with West Fraser.
We have great employees who understand the industry, who understand what is going on in the economy, who understand that to win in the commodity game, you've got to be low cost. Our employees have been through many recessions before, and we've always come out of them stronger than our competitors.

LSJ: There are all kinds of things that contribute to being a low cost producer. What are the particular things that West Fraser does to help it be a low cost producer?
HK: I think there are three things. You've got to have modern and efficient sawmills. This company has always made sure that it spent its cash flow re-investing in our plants and equipment, and people. We've always gone into downturns with no real requirement to spend a lot of money on our plants to get them set up for the downturn. In other words, if you re-invest your money every year in efficiencies, when the downturn does come, you don't have to do much. In the past, we've never curtailed capital spending in any recession we've gone through, in the 1970s, 1980s or 1990s. But this time we did curtail capital spending because the recession was so severe. But when we did that, it did not really have much of an effect on our Canadian sawmills because we had spent so much money on the mills up to the downturn.
Number two is we have just had a culture of cost control since 1955, when West Fraser was founded by my Dad and his two brothers. There's a real sense of frugality and it really started with the three brothers who started the company. We're very frugal, low key and modest—and we try not to let that change.
You can go down to the mills and our people know that we stand for low cost, efficient production and our people buy into it. How does that manifest itself in better margins? Well, when we get into a downturn, we really have not had to do much in terms of how our employees do their jobs. We work really hard on working capital and some other things during the

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recession. But essentially, we have not had to change our operating mode much at all.
Finally, you have to have a strong balance sheet going into a recession which we did. And we had relatively strong cash flow right through the downturn, so we were able through the recession to pay down a significant amount of debt. Through the worst recession this industry has ever known, we've produced significant cash and come out with a very strong balance sheet.

LSJ: It seems to be a hallmark of the company that, good times and bad times, it works away at being a solid producer.
HK: We try not to change much. You always get a bit fat and sassy when things are better. But we talk costs all the time around here. The only way you can make margin in a commodity business is to be lower cost than the other guy.
We all sell the same product for the same amount of money. When the market needs over 100 per cent of what you all make, you're going to do fine. But when it only needs 65 per cent of what you all make, someone is going to be in trouble, and someone is going to be OK.

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