ARE BC MILLS POISED FOR LONG-TERM SUCCESS?

By Jim Girvan

It has been a wild ride in the North American lumber markets over the past few years. Since 2019, we have seen lows below $300 per thousand board feet for spruce-pine-fir (SPF) lumber and highs of close to $950, with specialty grades and species way off the scale. Looking forward, analysts seem to believe prices will remain strong but in a commodity market, things don't always stay strong for long.

This leads to the question, are BC's SPF-producing mills presently poised to remain competitive compared to their Western Canadian counterparts when the inevitable fall in prices comes?

To answer this, we updated a Western Canada sawmill cost model for 2019 circumstances. We configured a sawmill margin curve that included all of the 70 remaining structural SPF sawmills in the BC Interior, Alberta and Saskatchewan that produce North American structural grade lumber and factored in all others from 2019's 20.2 per cent US import tax rates. Of note, BC coastal mills and all mills in the Interior that produce primarily cedar products were excluded from the analysis.

This approach provided a quantitative—albeit relative analysis—of log and sawmill costs, revenues, earnings and, in the end, relative mill rankings. It also included our insights into the structure of the industry as a predictor of which mills could be potentially shut down or curtailed due to poor competitiveness in the event markets fall.

Quartiles were assigned to each mill for the following key indicators: percentage shipments to US, delivered log cost, lumber from log recovery, sawmill cost, lumber revenue, and residual fibre value.

Each mill attribute was put into five categories in terms of their relative rating from one being the best performance or lowest cost to five being the worst performance

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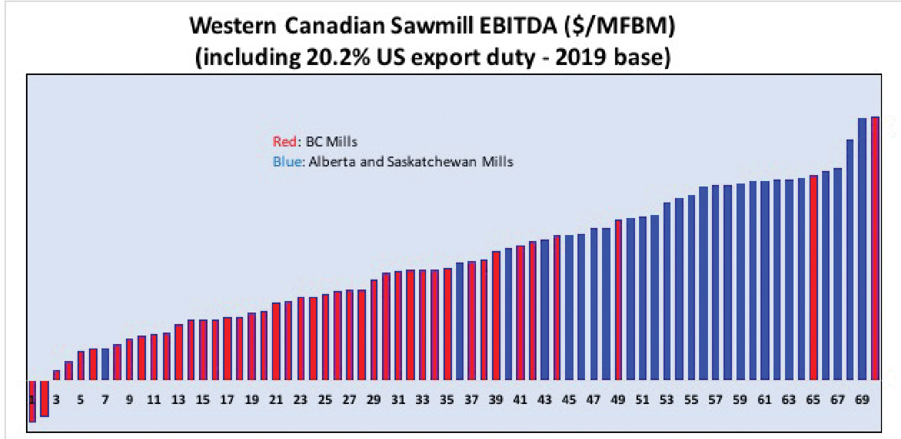
or highest cost. The rankings from one to five were then assigned cost values based on cost and revenue data that were based on the team's best estimates. The data was extrapolated from the best sawmill down to the worst sawmill over the five cost categories with some specific individual mill data used to generate the benchmark results. The weighted costs and revenues derived from the quartile assignments then yielded an earnings before interest, taxes, depreciation, and amortization (EBITDA) calculation. The mills were then ranked according to their EBITDA.

The assessments of EBITDA results are the average for the year 2019. The lumber market prices in 2019 were relatively stable for lumber prices: W-SPF ranged from $315 to $385/mfbm. The results represent a relative ranking, assuming average annual prices, for both lumber and residual fibre during the year.

It is also important to recognize that given the methodology employed using averaged categories by sawmill attribute, the resultant EBITDA calculation for each specific mill may not match with actual mill results, as the analysis is relative to the large group of mills assessed. That said, in mid-2019 most BC Interior mills demonstrated a range of EBITDA between $25 and $60/mfbm while Alberta mills tended to show an EBITDA range of between $50 and $90/mfbm. This suggests that both the relative mill ranking and the overall assessment appear reasonable. Given that mill curtailments did not occur in Alberta or Saskatchewan in the second half of 2019, the rising costs of logs in the BC Interior in the second half of the year resulted in many mills being curtailed due to negative margins, suggesting that the competitiveness of BC mills was very fragile.



Courtesy of Jim Girvan

The figure on page 29 depicts the results.

In 2019, generally speaking, Alberta and Saskatchewan mills appear to be consistently more profitable than mills located in BC, primarily as a result of lower delivered log costs and more exposure to US and Canadian markets.

Why is this the case?

While it is important to review each of the five cost or revenue variables used to assess EBITDA, one only needs to look to delivered log costs differences between the three jurisdictions to find the key answer.

BC's log costs are consistently higher, on average, than in other jurisdictions. Together with continued changes to forest policy in areas such as waste utilization (fibre recovery zones), a shrinking working forest due to habitat conservation, loss of timber from forest fires and beetle infestations and, of course, high stumpage, it is not likely that BC's relative position in Western Canada will change much. And, in 2021, we have also been warned that BC stumpage charges will be moving much higher to reflect the strong lumber prices in the second half of 2020 and so far in 2021.

How can we ensure BC's mills move up the cost curve to be in the top quartile category in Western Canada?

Sawmill costs are already the lowest (on average in Western Canada, let alone the world!) so log costs and exposure to the US market are key. The good news is the US lumber import taxes have recently dropped to around 9 per cent from 20 per cent, but these will be reviewed by the US once again later in the year. Therefore, the focus needs to be on log-related cost reductions, something that is directly tied to BC forest policy.