



CIBC
World Markets

Sector: Paper & Forest Products

Sector Weighting: Underweight

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Russia's Planned Export Tax On Logs: Global Implications

2007 British Columbia

See "Price Target Calculation" and "Key Risks to Price Target" sections at the end of this report, or at the end of each section thereof, where applicable.

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The Event

- In 2005 Russian introduced a 6.5% export tax on logs.
- On Feb. 5, 2007, Russia announced that it plans to dramatically raise the export tax over the next two years:
 - July 1, 2007: 20%, but not less than 10 euros/m³
 - April 1, 2008: 25%, but not less than 15 euros/m³
 - Jan. 1, 2009: 80%, but not less than 50 euos/m³.

The intent is to stimulate the domestic processing of timber.

The Russian Perspective

What is the context?

- **Russia is a minor player in global paper & forest product markets, but a powerhouse in the log trade.**
- **The government wants this to change – right up to Putin's level.**
- **The announcement should be seen in the context of Russia becoming more aggressive in asserting control over its natural resources in general.**

The Russian Perspective

What are the empirical facts?

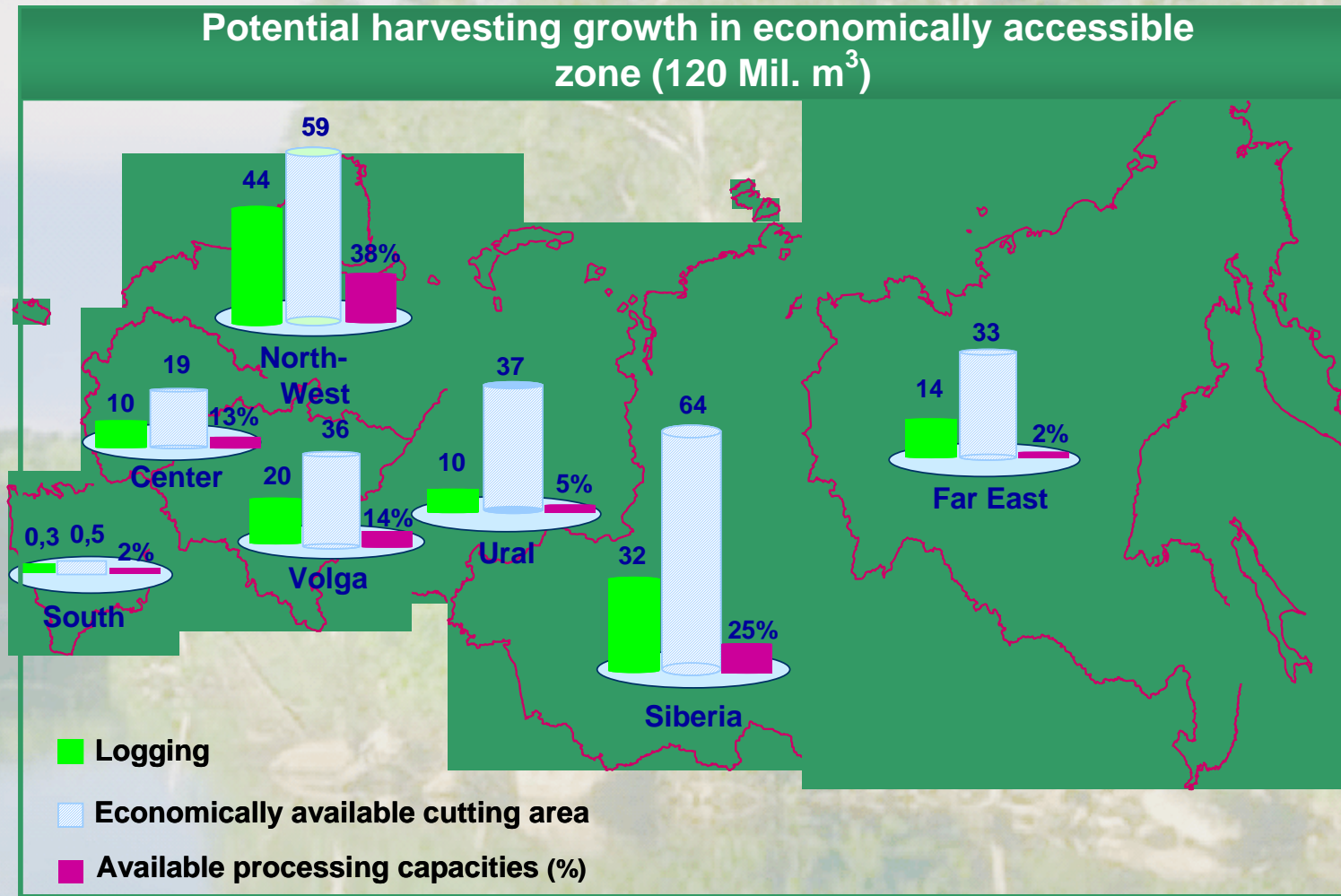
- **Russia contains over 20% of the world's timber resource – more forest cover than Canada + Brazil – but much is uneconomic.**
- **Actual harvest of 132 million m³ is far smaller than the AAC of 564 million m³, but govt. still estimates the economically available harvest is 250 million m³. Implies potential incremental increase of 120 million m³ – 90% more than current harvest, or about 60% of Canada.**
- **World's largest exporter of logs – 40% of the total softwood exports.**
- **Provides over 80% of the logs imported into Finland and China, and a high % imported in Japan and Korea.**

The Russian Perspective

- **Russia's log exports have risen by more than 2.5x over the past 10 years – roughly 53 million m³ in 2006.**
- **Imports of wood and paper products have been steadily growing – currently worth \$3 billion.**
- **On April 6, 2006, at a meeting on forestry sector and wood industry development, President Putin noted in his opening remarks:**
 - **"Our neighbors continue to make billions of dollars out of Russia's forests. We, meanwhile, are doing little to develop our own wood processing industry."**
 - **... "By the way, our products are not easily allowed to the markets. Non-tariff constraints, administrative barriers and ever newly invented pretexts are being used to keep our products out of the markets."**

The Russian Perspective

Disproportion of harvesting volumes and timber processing capacities.



The Russian Perspective

Bottom line?

- **Only a small fraction of Russian harvest is processed domestically.**
- **At least according to the govt., there is significant room to economically expand the current harvest level.**
- **If no action were taken, an even greater exploitation of Russia's timber resource by foreigners is expected over time.**

The Economic Impact

Magnitude of the tax increase

+ Russia's large share of the global market

= higher global price of logs

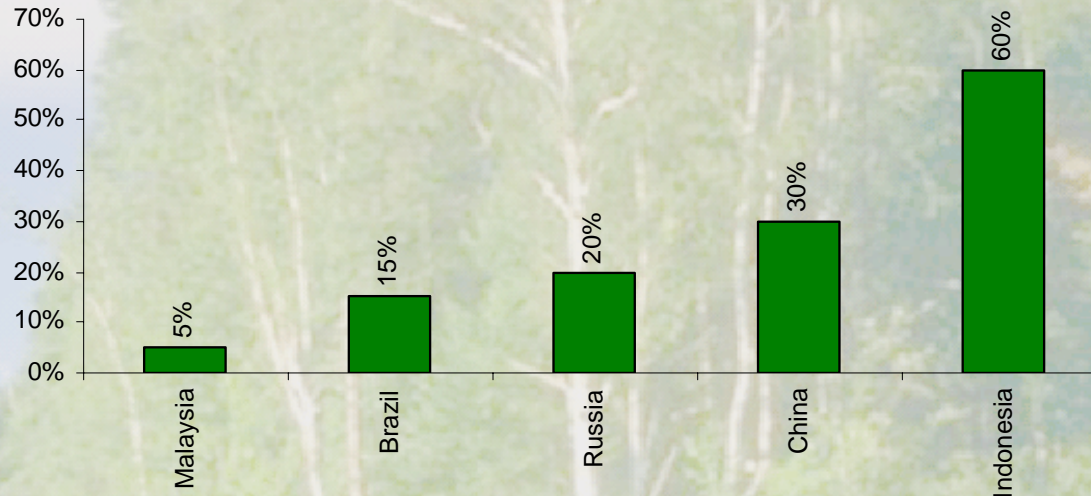
Biggest national winners are the other major log exporters:

- U.S. is 2nd (but only about 1/4 of Russia)**
- Germany, N.Z. and Canada round out the top 5**

Domestic Russian processing sector is also a winner due to lower domestic log prices (but the harvesting sector is a loser)

The Economic Impact

Estimated Percent Of Log Production Illegally Harvested



Source: Seneca Creek Associated, Wood Resources International.

- **Illegal logging is a significant problem, with the government itself estimating it to be 10%-15% of the total harvest. Independent estimates are even higher.**
- **The export tax will arguably result in a lower level of illegal logging in Russia (but a higher level in other countries.)**

The Economic Impact

Biggest losers are the major log importers:

- **China**
- **Japan**
- **Finland**

Dependence on Russia has increased significantly in recent years. Imports have doubled for Finland since 1997, and China since 2001.

Initial reaction in Japan is a rising preference for domestic species, and reconsideration of N. American species in light of decreasing confidence in future supplies from Europe.

The Economic Impact

Also expect upward pressure on the prices of those processed commodities for which logs are a high % of variable costs and in which the “losers” specialize.

Plywood:

- **logs ~ 65% of AVC**
- **China is the world’s biggest producer**
- **Temporary life-line for N. American producers**
- **Given underlying economics, catalyst for OSB “going global”**

The Economic Impact

Softwood Lumber:

- **Logs ~ 65%-75% of AVC**
- **Higher-quality product will fill the vacuum in Japan and Korea**
- **Lower-quality product will fill the vacuum in China**
- **Given the complex distribution channels in these countries, companies with an established presence will benefit the most**

The Economic Impact

Market Pulp:

- **Wood fiber ~ 45%-55% of AVC**
- **Europe accounts for roughly 30% of the world's total market pulp, and about 50% of the NBSK**
- **In Europe, the Russian supply shock is being reinforced by the "bio-energy" demand shock. Pulp mills are getting squeezed on fiber costs, and more closures can be expected.**

The Economic Impact

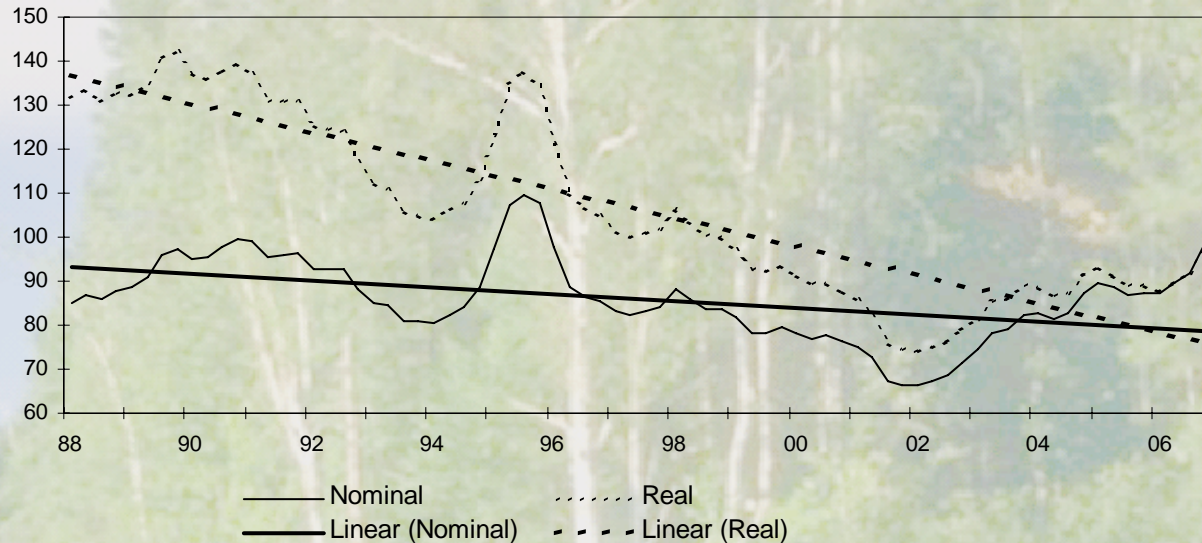
Log and product prices in Asia are already moving up.

For example:

- **Russian spruce (ezo) logs in Japan are now going for \$155/m³-160/m³ – 50% higher than 1 year ago.**
- **Japanese sawmillers of Russian wood have increased their price for ezo-spruce by 35%+ since this time last year.**

The Economic Impact

Global Average Price Of Softwood Fibre: Real And Nominal US\$



Source: Wood Resource Quarterly, CIBC World Markets.

Perceptions of scarcity change over time:

- **1985-1995: wood is relatively scarce**
- **1996-2006: wood is relatively abundant**
- **2007 + ?**

The Economic Impact

We are likely at an inflection point regarding the perception of scarcity. In 2007, the “Russian shock” will be reinforced by two other developments:

(1) Bio-energy demand for wood fiber.

- **Already a big concern for the European industry**
- **Driven by concern about GHG emissions, but also security of oil & gas imports from Russia**

(2) Mountain Pine Beetle.

- **Conventional wisdom is 25%-35% drop in the Interior’s AAC in 8-10 years**
- **Increasing focus on economic wood supply, and the decline may be closer to 50% in 3-5 years.**

Why Do Logs Get Exported?

- **Relative to the cost of shipping lumber, plywood or pulp, it is expensive to transport logs.**
- **Lumber extracted from a log is generally only about one-half of the total volume of the log. Lumber is also much lighter if it is kiln-dried.**
- **Significant log exports are “not normal” in a competitive market... so why are they occurring in Russia?**

Why Do Logs Get Exported?

- **There are several reasons why foreigners may be willing and able to pay more for Russian logs than can Russian processors**
 - **Foreign barriers to forest product exports from Russia**
 - **Foreign subsidies for log processing**
 - **Uncompetitive manufacturing costs in Russia.**
- **The first 2 reasons provide some intellectual justification for the Russian exports tax – it “levels the playing field”**
- **The third reason is likely the main reason for large Russian log exports. Log exports are likely a symptom rather than the problem.**

Why Do Logs Get Exported?

The dramatically higher log export taxes will help subsidize the domestic Russian processing industries through a reduction in the cost of fiber.

However, in our view, the ability to attract new capital investment will still be impeded by a number of other factors:

- **The general hosting conditions**
- **Need for a complete forest sector complex**
- **Declining labor supply**
- **Prospective appreciation of the ruble exchange rate.**

Why Do Logs Get Exported?

Investors want a stable, predictable, rule-based business and investment climate. This should be augmented by an internationally competitive tax regime.

Hosting Conditions:

- **Underdeveloped infrastructure**
- **Little transparency in the ownership of the forest resource**
- **Inadequate system of governance... the “rule of law” in Russia is sometimes locally interpreted as meaning “those who rule, are the law.”**

New Forest Code may help (or make things worse)

Why Do Logs Get Exported?

Projected annual growth (%) of working age population between 2003 - 2015

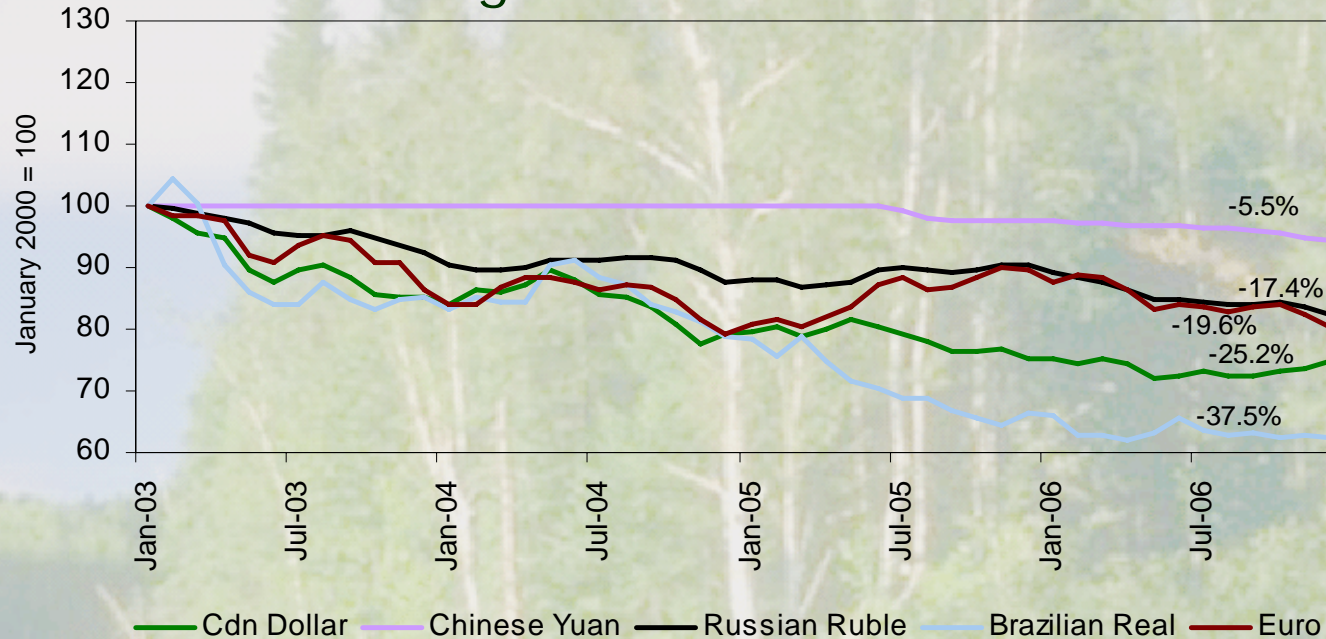


Source: McKinsey & Co, Emerging Global Labor Market, 2005

- **Except Japan, no other major country faces the same kind of decline in its working age population as does Russia.**
- **Russia will be open to China's capital, but probably not its labor.**

Why Do Logs Get Exported?

Exchange Rates To The U.S. Dollar

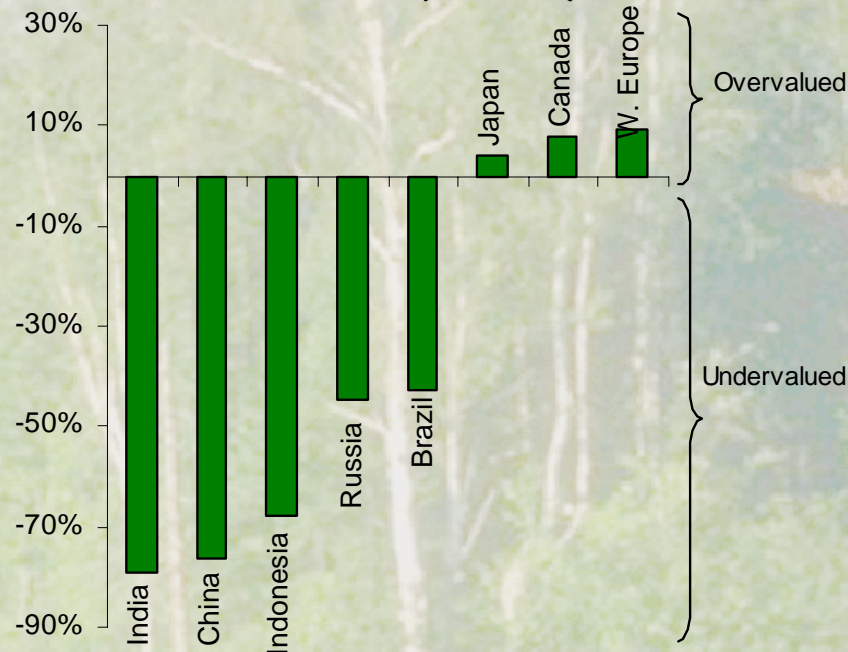


Source: Bloomberg, CIBC World Markets.

The Russian ruble has been appreciating against the US\$ (and yuan), decreasing its relative cost competitiveness.

Why Do Logs Get Exported?

Percent Change From The Current To The PPP Implied Exchange Rate (2006)



Source: International Monetary Fund, CIBC World Markets

- **It is always difficult to forecast the long-run exchange rate, but it is still required when assessing investments.**
- **In our view, all of the "BRICs" are expected to experience stronger currencies against the N. American, European and Japanese currencies.**

Why Do Logs Get Exported?

Bottom line?

- **A number of obstacles must be overcome before the desired capital investments are made in Russia.**
- **In our view, it will be 5-7 years before meaningful volumes of Russian plywood, lumber and/or pulp show up in international markets.**
- **In the meantime, there is a “window of opportunity.”**

The Stock Market Implications

Provided they can sell into the global market at the higher prices, the primary beneficiaries of the Russian export tax are the owners of timberland outside of Russia.

In the United States:

- Plum Creek, Rayonier, Potlatch & Weyerhaeuser

In Canada:

- TimberWest & Brookfield

In Australia/N.Z.:

- Gunns, Willmott Forests, Auspine & Great Southern Plantations

The Stock Market Implications

In South America:

- **Arauco**
- **CMPC**

In Asia:

- **Samling Global**

The Stock Market Implications

In Europe, SCA and Holmen are the two largest private timberland owners (after the Catholic Church). However, the capital gains on the land will be at least partly offset by higher wood costs.

In China, Sino-Forest and Cathay Forest manage plantations and harvest logs, but they don't own the land.

- In the absence of concrete stumpage formulae, expect the governments to act opportunistically**
- We take some comfort from the 14-year fixed price contracts associated with Sino-Forest's recent expansions in Hunan Province.**

The Stock Market Implications

Other companies that stand to capture some of the rent created by the Russian tax are those which:

- **Produce grades of lumber, plywood and pulp that are already well established in the Asian market.**
- **Have those products contributing a meaningful share of the companies overall business.**

In Canada: Interfor and Western F.P. (and to a lesser extent Canfor, West Fraser, Canfor Pulp, SFK Pulp)

In New Zealand: Tenon

In Australia: Boral

The Stock Market Implications

The biggest losers?

Sumitomo Forestry in Japan:

- One of Japan's largest log importers, with about 35% from Russia.

M-Real in Finland:

- Arguably the European company with the greatest historical dependence on imported wood fiber from Russia.



THANK YOU