

FOREX, L-P DEAL CASTS LIGHT ON OSB MARKET/CAPACITY SITUATION

World's leading OSB producer hasn't lost appetite for expansion, especially of the overnight variety.



HENRY SPELTER
FOREST PRODUCTS LABORATORY
E-MAIL: hspelter@facstaff.wisc

When is a used car more valuable than a new one? That question came to me following the recent forest industry takeovers, the most interesting of which was the purchase of Quebec-based OSB and lumber producer, Le Groupe Forex. This offers a good context in which to take a forward glance at structural panel prospects in North America.

On June 28, 1999, Louisiana-Pacific initiated a bidding contest with Boise Cascade that saw L-P's initial bid of \$600 million (Canadian) escalate to Boise's \$740 million by August 6. Although the L-P people could have bowed out and claimed as a consolation prize a pre-arranged break-up fee that by this time had risen to \$27 million, they chose not to exercise that option and instead raised the ante to \$760 million. Boise gave up and L-P consummated its merger with Forex on September 10.

By adding to the price the debt inherited from Forex and subtracting the value of the sawmills, the approximate cost of the deal's OSB component comes to around \$780 million. Converting that to U.S. dollars and dividing by capacity gives a cost of capacity of about \$365 per m³. Comparisons with recent installations and buyouts show that the Forex deal was head-and-shoulders above all previous transactions (Figure 1). In that light, why would L-P pay about a 35% premium for existing capacity that it could have gotten brand new for less?

The explanation may partly lie in the answer to the question posed at the beginning. One of the few things that some of my relatives, who lived most of their

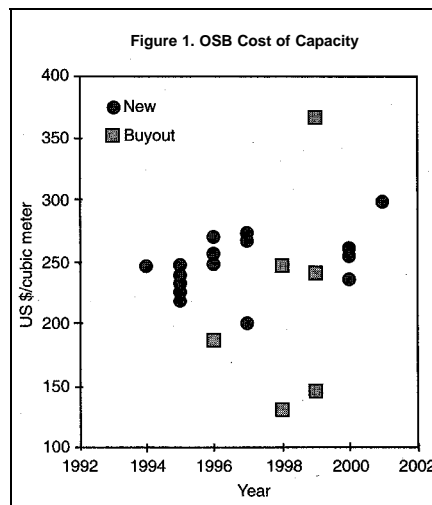
lives in socialist economies, recalled with fondness about that system was how they were always able to resell their used cars for more than they paid for them new. The reason why was found in the vehicle marketing system. To buy a new car, you had to go to an office and place your order along with depositing the full purchase price. Then you had a two to three year wait before your car arrived. If you had a strong urge to drive immediately, your only option was the used car market where demand often boosted prices sharply.

Ordering a new capital intensive industrial plant is somewhat similar. It takes a long time to find a site, obtain permits, order equipment and assemble the pieces before a desire to make boards is realized. A period of two years is not unusual for panel installations. This mattered in 1999 because the OSB markets in North America were extremely favorable. Prices were heading into record high territory when Forex became available and the only way to strike while the iron was hot was by acquisition.

This approach also allows a company to grow without growing the industry, a strategy urged on forest products firms by analysts who saw excessive capacity growth as a cause of poor financial results. So paying a premium for existing assets can make sense if the profits generated during the waiting period to build equivalent capacity are big enough to offset the overpayment.

Let's stipulate that period as two years and the overpayment as \$160 million. Then, with 1.45 million m³ of annual capacity, the margin for those two years would have to average over \$55/m³. How realistic that is can be guessed at from Figure 2, which shows estimated historical margins for OSB. These have been fairly rich in recent years and seemingly trending higher although that is mostly an artifact of inflation. A margin of \$55/m³ is well below the average for 1999. After the bidding climaxed, OSB prices hit an air pocket and margins shriveled by more than 50% in four weeks. But even then they were almost twice the \$55/m³ level and prices have recovered somewhat since.

In terms of raw probabilities, the odds in the first year (i.e. 2000) are pretty good. By inspection of Figure 2 we can see that when margins rise into the zone more than one standard deviation above



the trend, they seldom collapse the following year. In 80% of the cases they remain there or at least above trend.

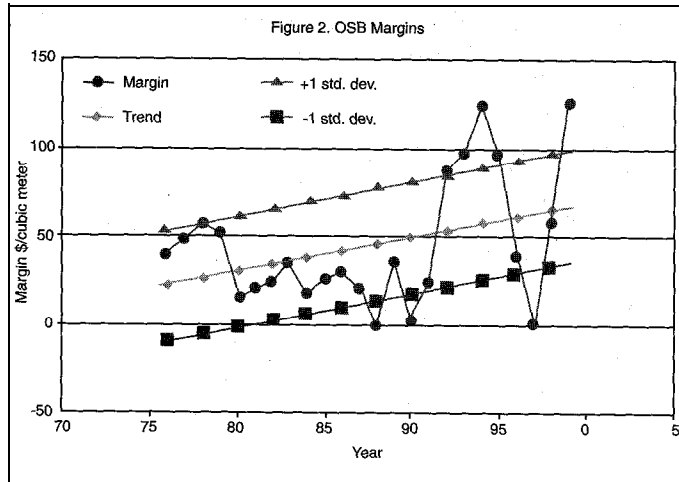
Going out two years is more uncertain. In examining past behavior one notices a tendency for periods of high margins relative to replacement cost of capital (the recent situation) to be echoed two to three years later by a surge in capacity. I list the currently known projects that have a high probability of being realized during the coming three years in Table 1. They follow past patterns with a large increment of capacity looming in 2001-02. More may be announced as time passes. What is its likely impact?

Table 1. Announced and likely new OSB capacity expansion (thousand m³)

Company	Location	2000/2001-2002
Louisiana-Pacific	Chile	133
Norbord	N. Carolina	443
Ainsworth/Grant	Alberta	531
Ainsworth/Norsask	Saskatchewan	440
Boise Cascade	Chile	398
Forex (now L-P)	Quebec	531
Georgia-Pacific	Arkansas	363
Louisiana-Pacific	British Columbia	443
MacMillan Bloedel (now Weyerhaeuser)	Saskatchewan	504
Trillium	Venezuela	301

One high probability outcome for which the industry might as well brace itself is an outpouring of tongue clicking, finger wagging and hand wringing from the analyst community. Phrases like "irrational exuberance," OSB capacity surge" and "marketing challenge" are likely to be tossed around as freely as cabers at a Highland festival. I confess to having used such phraseology freely myself, but I am not inclined to join the chorus this time, yet.

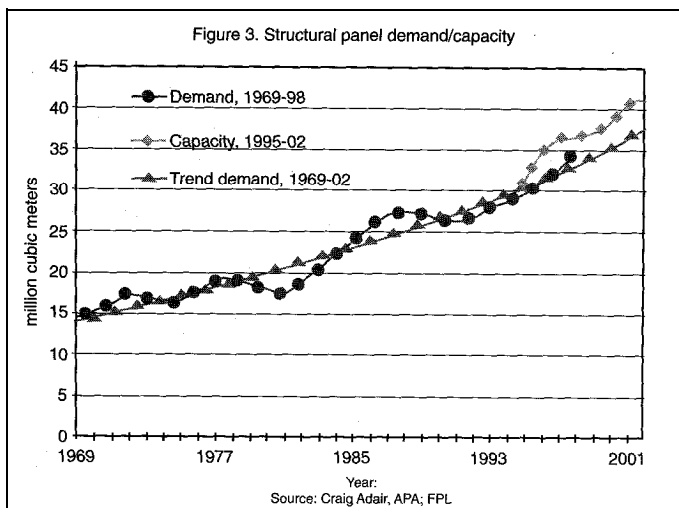
In the first place, the above capacities represent gross increases. In the inventory of structural panel plants, there are many old, depreciated, high-cost facilities that could be terminated at little cost when prices weaken. For example, when the MacMillan



Bloedel (Weyerhaeuser) plant is built, it will likely result in the closure of two small capacity lines in the same area. Likewise, both Louisiana-Pacific and Georgia-Pacific have a number of OSB plants that are small by today's standards and are candidates for closure should prices weaken significantly. These will tend to moderate the growth impact of the new capacity.

In the second place, to get an extended profit meltdown, a downturn in demand is generally needed. While a recession is possible, it does not seem imminent in the current low-inflation, low-interest rate environment. Demand ebbs and flows, but over the last three decades its growth has averaged about 3% per year (Figure 3). There is no compelling reason to expect this to change.

If we postulate that the growth to meet this demand will come from OSB, which currently accounts for half of the structural panel universe, then the trend OSB growth rate doubles to 6%. If we further



take into account the growing volumes of plywood that are being directed toward LVL and assume a 1% yearly gain in OSB panel market share, then the trend growth rises to 7%. With a current base of 19 million m³, these translate to annual capacity increases of about 1.3 million m³, or 4 million m³ over the period 2000-2002. That's about equal to the gross capacity growth embodied in the above announcements.

Put another way, if we figure future capacity based on current announcements, less the likely closures of high-cost plants, the demand/capacity ratio, based only on trend demand, would be 92% in 2002. Although that is down from about 95% currently, it is above 1996-97's level of 90% when margins hovered around zero.

These, of course, are forward looking assessments subject to change and different interpretations. Based on what I know today, within the short-term parameters laid out above, the L-P deal strikes me as being a reasonable bet. Margins should remain high enough at least through the first half of 2001 so that recouping the premium seems a fair expectation. Beyond that the issue changes to whether taking a stake in a commodity-based business is the right move in the long-term, but I defer that for another day.

For now, let us acknowledge and salute the accomplishments of the Forex principals. The company started in the '60s as a lumber producer, then sold those assets in the '80s to Domtar.

They returned to the forest products industry in 1993 by acquiring two distressed OSB operations at St. Michel and Chambord. If memory serves me right, the latter was shut down at the time. They refurbished those plants, placing them on a sound economic footing, then built a modern mill at Maniwaki for an exceptionally low capital outlay. They placed these assets on the market and sold them within one week of an all-time record high for prices. Now that's how to execute the dictum "buy low, sell high." PW