



March 13, 2007

Paper & Forest Products

Sector Weighting:  
**Underweight**

## Russian Log Export Tax

### Update #1: Further Thoughts On How The Tax May Be Implemented

- In addition to stimulating greater investment in the Russian wood processing sector, it appears that the desire to reduce illegal logging is also a major motivator for the dramatic increase in log export taxes announced in early February.
- In addition to the log export taxes, it is reported that various incentive programs are being offered to encourage investment. These include the ability to export some logs at a reduced tax rate if a certain amount of the harvest is processed. Large investors seem to be getting preference.
- The share prices of public companies with a positive exposure to the Russian announcement have generally outperformed the overall market over the past 15 months. China-based plantation companies such as Sino-Forest and Cathay Forest appear to have reaped the largest benefit thus far.
- Although we expect the Russian log export tax to be an "evolving story" in terms of implementation, we continue to think the Feb. 5 announcement by the Russian government signals a fundamental structural change in the global market for logs. It is most positive for foreign timberland owners.

*All figures in Canadian dollars, unless otherwise stated.*

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This report is an update to our initial report on this issue published on February 22, entitled *Russia Plans To Dramatically Increase Its Export Tax On Logs: A Structural Change In Global Wood Markets*.

As time progresses, we are getting further color on how the Russians are likely to implement the new export tax regime. This is clearly an evolving situation, and we suspect that further updates will also be warranted. In this update, we briefly focus on five issues:

1. Implementation of the tax;
2. Government structure;
3. Sources of capital for new investment;
4. Log market response; and
5. Additional "winners" and "losers."

## 1) Implementation Of The Tax

During the first week of March, the Forest Bureau Chief of Khabarovsk met with prospective strategic investors from Russia and China. (Khabarovsk is located southeast of the Russian Far East Federal Okrug, just north of the Chinese border.) Two of the key messages reportedly coming out of these meetings are:

1. In addition to encouraging greater domestic processing, a key objective of the export tax is to weed out the small operators that are primarily responsible for illegal logging (i.e., those that export less than 50,000 m<sup>3</sup> a year). Note that the issue of illegal logging was addressed in the Appendix in our initial report.
2. To encourage the bigger operations to develop their processing capability, various incentive programs are being offered. These programs include:
  - For operations that process more than 35% of their harvested timber, there would be a preferential rate for the export tariff for timber for the remaining balance of the timber harvested. This rate may be determined locally and on individual cases.
  - The local State Forestry Bureau has the authority to set the rate, and it is expected to be about 30% of the regular rate.
  - In order to support the larger operations and encourage them to develop the wood processing industry, the large operations will be given preference in applying for concessions (and the granting of concessions does not have to go through the auction process).
  - In order to encourage plantations to develop renewable forestry programs, the leasing period of the forestry concessions will be extended to 99 years from its present 50 years.

The second point provides a considerable incentive to invest in new processing facilities since it allows the investor to capture some of the positive impact resulting from a higher expected international price of logs.

Note that we are somewhat skeptical that the local State Forestry Bureaus will in fact be given the kind of discretion suggested in these meetings. This is a claim we will continue to try to verify.

Generally speaking, measures related to international trade are a federal responsibility. As a result, even if the State Forestry Bureaus have a say in the level of the tax, we fully expect the Federal Russian government to closely monitor the situation to ensure its objectives are not undermined. While the new Forest Code, which is currently being implemented in Russia, entails a shift in the ownership of Forest Management Units from the federal authorities to the regions, this is generally occurring in the context of an increasingly centralized bureaucracy.

Also note that to discourage companies from doing just a low level of processing to avoid the export tax on logs, export taxes have also been announced for "lightly processed" commodities. For example, the ganben grade of lumber sold into the Japanese market (which is not very different from a cant) will be subject to an export tax rising to 50%.

## 2) Government Structure: Background

Several years ago, Russian President Putin divided Russia into seven Federal Okrugs that are headed by the President's Plenipotentiaries, who are virtually Governor Generals. Almost 60% of Russian log exports are shipped to Pacific Rim markets (i.e., China, Japan, South Korea), and almost all of this volume originates in the two Federal Okrugs of Siberia and Russian Far East (RFE).

The RFE is made up of 10 provinces, while Siberia has 13. Khabarovskiy Krai in the southeastern corner of the RFE is the most important province in terms of logging production, and the Forestry Bureau of Khabarovsk discussed above is located in that province. Researchers at the Economic Research Institute in Khabarovsk—part of the Russian Academy of Sciences—estimate that illegal logging currently accounts for over 50 percent of the RFE's forest sector's output. However, our understanding is that this estimate is disputed by the Federal Forestry Agency.

## 3) Sources Of Capital

Consistent with its approach in other resource sectors (and the apparent bias to providing long-term leases to larger enterprises), it appears that the Putin government is in favor of creating "national champions" in the Russian forest industry. We think the Russian industry will primarily be looking to Western sponsors for their capital equipment and operating expertise.

It is likely that the capital required to modernize and expand the Russian wood processing sector will primarily be sourced from profits generated in the Russian energy, steel, and chemical sectors. As a result, the need for foreign capital could well be lower than many pundits think. (The implication is that the development of the Russian wood processing industry may occur quicker than generally expected.) Having said that, we do expect an inflow of mainly Scandinavian capital west of the Ural Mountains, and mainly Chinese capital east of the Urals.

A range of European and Japanese companies already have joint ventures in the Russian solidwood industry. In the pulp and paper side of the industry, the highest profile deal is the proposed JV between International Paper (IP-SO) and Ilim Pulp & Paper, which was announced October 26, 2006. Ilim currently accounts for about 60% of the pulp and 50% of the boxboard capacity in Russia.

We expect a number of new solidwood-oriented JV opportunities with foreign companies to be explored in the coming year. For example:

- Midway United is a joint venture between the private U.S. wood products company Murphy Timber and a Russian company led by the founders of Evraz Holdings (EVR-L), one of the largest steel companies in Russia. The JV is looking at an investment in two large North American style solidwood complexes in Siberia.
- Cathay Forest (CFZ-V) is in the process of setting up a 51%-owned JV with one of the larger timber harvesters in the Khaboriski region of the Russian Far East. Our understanding is that the JV involves developing a 270,000 hectares concession under a 50-year agreement with an annual harvest of 300,000 m<sup>3</sup>. In anticipation of the log export taxes, the potential Russian partners are already constructing a sawmill with Finnish equipment (to be completed in 2008). The plan is to operate the sawmill with a portion of the harvest, and then export the remaining timber volume at a favorable preferential rate.

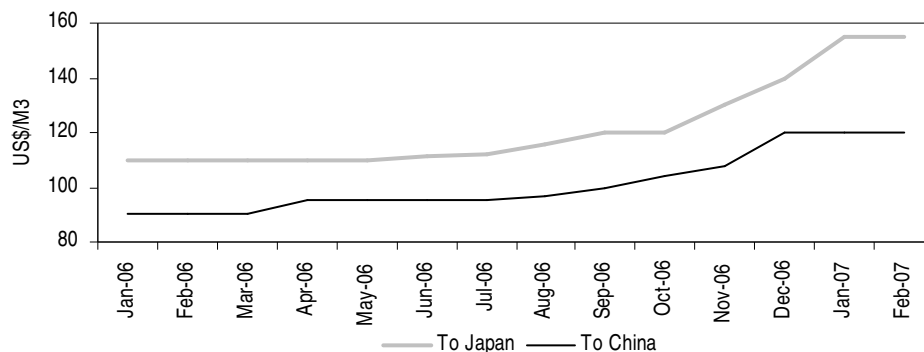
In our view, given the general concerns with illegal logging and environmental performance, it is imperative that the forest resource be managed in a sustainable manner. Especially in the context of all the other uncertainties, we think investors would be ill advised to become involved with ventures whose forestry operations are not third-party certified for sustainability. Our preference in Russia is for certification from the Forest Stewardship Council (FSC).

We still think it will be five to seven years before Russia becomes a meaningful player in the international market for paper and forest products. This is especially true if Russia's domestic consumption continues to expand at its recent growth rates.

## 4) Log Market Response

Exhibit 1 illustrates the changes in the export price of Russian logs since the beginning of January 2006. We have focused on spruce logs in the various markets, with prices up roughly 50% in Japan and 30% in China. In general, we attribute the higher prices in Japan to the higher quality logs going into this country.

**Exhibit 1. Representative Russian Log Export Prices**



Source: DALEXPORTLES, CIBC World Markets Inc.

Interestingly, most of the rise in log prices occurred in the fourth quarter of last year, before the official announcement of the tax increase on February 5. There is a range of reasons for this movement.

- First, as argued in our initial report, there were numerous signals from the Russian government in the second half of last year that it was going to make a significant move in this direction. It is possible that the market simply responded in anticipation of the actual announcement.
- Second, some observers note that last year the Russian log exporters started having difficulties keeping up with demand. Various reasons for this have been cited, including:
  - Crackdown on illegal logging;
  - Excessively mild or extremely cold weather—depending on the region—which made logging difficult;
  - Lack of transportation infrastructure—shortage of rail cars; and, in Irkutsk region, limitations on the number of sidings at which logs could be loaded on rail cars.

We will continue to monitor the export price of Russian (and other) logs as the higher export taxes begin to be actually levied.

## 5) Additional “Winners” And “Losers”

In our initial report, we identified some 27 publicly traded companies that would be affected by the export taxes announced by the Russian government.

In our haste, we neglected to identify at least two other publicly traded potential “winners” (i.e., Samling Global and CMPC).

### Samling Global

Ticker: 3938–HK (Hong Kong Stock Exchange)

- The company went public on the Hong Kong exchange earlier this month, with a US\$280 million offering for roughly 25% of the company.
- Samling Global has almost 4 million hectares of timberland under management, of which over 75% is in the form of concessions in Malaysia and Guyana. The company is a major exporter of logs, with annual log production capacity of roughly 3.2 million m<sup>3</sup>/year.
- In terms of installed hardwood plywood capacity, Samling is also the fifth largest in the world with over 800,000 m<sup>3</sup>.
- Although sawn timber comprises only a small part of Samling’s current business, the company plans to expand capacity in hardwood sawn timber in Malaysia and softwood sawn timber in New Zealand.

### CMPC

Ticker: CMPC–CL (Santiago Stock Exchange)

- Empresas CMPC is a Chilean-based forest products company. CMPC has operations in the forestry, pulp, paper, folding boxboard, tissue products, newsprint, multi-walled paper sacks, corrugated cardboard boxes, and stationery businesses.
- The company owns over 420,000 hectares of planted pine and eucalyptus in Chile and is also developing 100,000 hectares of pine forestlands aimed at the pulp market in Argentina.
- Despite its significant timber resource, the company does not export raw logs.
- CMPC owns three sawmills in Chile with a production capacity of over 1.1 million m<sup>3</sup>/year of radiata pine. CMPC exports 77% of its production globally to over 20 countries. It also owns a remanufacturing plant in Los Angeles that produces 110,000 m<sup>3</sup>/year of products made from dry sawn wood (finger joint panels, moldings, and laminated products), which are exported mainly to the United States, Japan, and Spain. CMPC also operates a 120,000 m<sup>3</sup>/year sawmill, a pole facility, and a remanufacturing plant located in Chile.
- Sales mix: 17% forestry, 28% pulp, 26% papers, 20% tissue, and 9% paper products.

If we were to focus on private organizations, some of the biggest potential “winners” would be the large Timber Management Organizations (TIMOs). The largest of the TIMOs are Hancock Timber, Resource Management Service and Forest Capital Partners. Among the other private companies, Arauco in Chile would likely be among the other the biggest winners.

In our initial report, among the public companies, we identified Sumitomo Forestry (1911-T) as arguably the biggest potential “loser” from this shock. However, in absolute terms, the biggest losers are almost certainly the private Chinese plywood and lumber companies that depend almost exclusively on imported Russian logs.

Exhibit 2 shows the stock market performance of our focus group of equities looking back across several recent time periods.

**Exhibit 2. Global Stock Price Performance**

	Price			Stock Performance Since		
	Mar. 12, '07	Ticker	Exchange	Jan. 2, '06	Aug. 31, '06	Jan. 2, '07
<b>Canada (C\$)</b>						
Acadian Timber	10.33	AND.UN	TSX	-	14.8%	11.7%
Canfor	11.75	CFP	TSX	10.2%	20.0%	8.9%
Canfor Pulp	14.66	CFX.UN	TSX	-	21.7%	18.8%
Cathay Forest	0.77	CFZ	TSX-V	-1.3%	28.3%	26.2%
Interfor	8.00	IFP.A	TSX	11.1%	11.9%	11.3%
Sino Forest	10.10	TRE	TSX	104.5%	124.4%	29.0%
Timberwest	17.10	TWF.UN	TSX	11.0%	22.6%	13.5%
Western Forest	2.20	WEF	TSX	35.9%	33.3%	14.6%
West Fraser	43.33	WFT	TSX	5.1%	16.8%	4.7%
TSX Index	13,065.15	TS300		15.9%	8.2%	1.2%
TSX Paper & Forest Products Index	771.97	STPAFO		13.1%	28.8%	6.9%
<b>USA (US\$)</b>						
Mercer	12.13	MERC	NASDAQ	54.3%	28.4%	2.2%
Plum Creek	38.90	PCL	NYSE	7.9%	11.7%	-2.4%
Pottlatch	45.27	PCH	NYSE	-11.2%	18.2%	3.3%
Rayonier	43.39	RYN	NYSE	8.9%	9.8%	5.7%
Temple Inland	58.59	TIN	NYSE	30.6%	31.6%	27.3%
Weyerhaeuser	80.88	WY	NYSE	21.9%	30.5%	14.5%
S&P 500 Index	1,406.60	SPX		12.7%	7.9%	-0.8%
S&P Paper & Forest Products Index	167.35	S5PAFO		10.8%	15.9%	8.0%
<b>Chile (Pesos)</b>						
CMPC	17,800.00	CMPC	CE	41.3%	19.1%	-0.6%
Santiago Stock Index	2,912.25	IPSA		50.1%	32.0%	8.1%
<b>Australia (A\$)</b>						
Auspine	3.75	ANE	AUS	8.7%	-10.7%	-10.9%
Boral	8.39	BLD	AUS	3.6%	23.4%	10.0%
Great Southern Plantations	2.20	GTP	AUS	-25.2%	-20.0%	-22.0%
Gunns	2.78	GNS	AUS	-14.5%	0.7%	-6.1%
Timbercorp	1.96	TIM	AUS	-34.7%	-28.7%	-34.7%
Willmott Forests	1.47	WFL	AUS	-18.3%	9.7%	0.7%
ASX Index	5,899.90	AS52		24.0%	15.4%	3.9%
<b>New Zealand (NZ\$)</b>						
Tenon	3.05	TEN	NZ	-13.8%	-7.3%	1.7%
NZ Index	1,149.83	NZSE		12.7%	14.6%	0.0%
NZ Forest & Forest Products Index	535.47	NZFRST		0.6%	-7.3%	1.7%
<b>China (HK\$)</b>						
Samling Global*	2.54	3938	HK	-	-	22.1%
Hang Seng Stock Index	2,715.85	HSCI		39.4%	18.5%	-3.1%
<b>Japan (Yen)</b>						
Sumitomo Forestry	1,250.00	1911	T	5.9%	12.5%	-3.1%
Tokyo Stock Index	173.70	TOPIX		5.5%	7.7%	3.3%
<b>Malaysia (Ringgits)</b>						
Leweko Resources Berhad	1.66	8745	KL	18.6%	36.1%	-1.8%
Kuala Lumpur Stock Index	173.03	KLSI		36.1%	25.4%	10.0%
<b>Finland (Euros)</b>						
M-Real	5.19	MRLAV	HE	20.4%	26.6%	7.9%
Stora Enso	12.72	STERV	HE	11.1%	7.3%	6.0%
Helsinki Stock Index	10,130.40	HEX		23.4%	13.8%	5.2%

\*Since IPO - March 6, 2007

Note: These results cannot and should not be viewed as an indicator of future performance.

Source: Bloomberg and CIBC World Markets Inc.



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