Canfor Corporation First Quarter 2010 Conference Call

Operator - Good morning, ladies and gentlemen. Welcome to the Canfor Corporation's first quarter results 2010 conference call. A recording of the call and a transcript will be available on Canfor's website.

During this call, Canfor's Chief Executive Officer and Chief Financial Officer will be referring to a slide presentation that is available in the Investor Relations section on their website. Also, the company would like to point out that this call will include forward-looking statements. So, please refer to the press release for the associated risks of such statements.

I would now like to turn the meeting over to Mr. Jim Shepard, President and Chief Executive Officer of Canfor Corporation. Please go ahead, Mr. Shepard.

Jim Shepard - Thank you operator. Good morning everybody and welcome to Canfor's conference call to discuss the company's first quarter results for 2010. I am joined here today by Tom Sitar Canfor's Vice President of Finance and CFO. Don Kayne – Vice President of Marketing and Sales and Mark Feldinger – Vice President of Manufacturing. I will give a brief overview of the quarter and then Tom will speak to our financial results.

The combination of our intense focus on cost containment, productivity improvement, and customer service now complemented by a rising market price is starting to show we have some traction, at last.

This time last year, with reference to the severe economic downturn, I said that we were not at the beginning of the end but we, at least, may be at the end of the beginning. Today, I would like to say we are at the beginning of the end. But that remains to be seen. I do, however, genuinely feel that we are past the worst of it and we came through it in one piece and in good shape.

We have a strong balance sheet that will enable us to modernize our facilities to further improve our competitiveness and to take advantage of growth opportunities that are complementary to our focus on becoming the dominant supplier of wood product solutions to our highly-valued customers.

We have a highly-qualified work-force that is aligned with our shareholders through incentive plans that are focused on shareholder returns. This, I might add, includes all of our hourly people in British Columbia with the signing of a ground-breaking agreement with the United Steel Workers that provides for cost reduction elements complemented by a profit incentive program.

We are pleased to report that in the first quarter of 2010, we reported positive net income. While these results are encouraging and the market looks favourable for the moment, we are still cautious about the immediate future. There may be rays of sunlight shining right now, but there are still some clouds on the horizon, particularly in the United States, like the expected continuation of home mortgage foreclosures and the continuing high unemployment numbers. For these reasons we continue to be focused on growing our off-shore markets and on cash conservation with prudent capital investment that will enable us to become even more competitive in the future.

That's not to say we are not optimistic about the future of Canfor and for the lumber industry. In our view, there is a scenario unfolding globally that will see a worldwide shortage of SPF lumber leading to a strengthening of the lumber price base that will make this industry a good place to invest. The question at this moment of time is whether or not this current strong lumber price caused by supply constraint will hold up until the long term reality of the global shortage takes hold. So the good news is that a good lumber market lies ahead, we are just not sure if it's here yet permanently or if we have to wait a little longer.

One positive impact of the US housing downturn is that it provided the stimulus to focus on the evolving market of China. The exponential growth that we've seen in our shipments to China is only one part of the story. We are also seeing a growing Asian appetite for higher grades of lumber, with an increasing percentage of our shipments to China in Q1 being our construction grade lumber (2&Btr). In Japan, which has been an important market for us for many years, we were successful in increasing our market share of prime lumber products.

To further ensure our ability to supply our customers with the lumber products solutions they need, we added a second shift at our Mackenzie sawmill in February. We will also be reopening our Chetwynd sawmill next month. An incentive program at these operations will engage the efforts and ideas of our hourly workforce and empower them to share in the success of their operations in the future.

As I previously mentioned, we are pleased to say that we have also reached agreement with the United Steelworkers (USW) on a 4 year agreement that will reward our hourly employees in British Columbia with profit based incentives and reinforce the teamwork necessary for high performance at all our mills.

I am cautiously optimistic as I look into the near future. We do believe that prices have firmed and we hope this trend continues. However, we continue to be cautious about bringing on new capacity. We do not see robust demand coming from US housing starts at this time. We believe most of the upward pressure on prices is related to inventory replenishment and increasing demand offshore. One thing I can say for sure is that we strategically reduced production throughout this downturn and we will strategically increase production as we see evidence of sustained demand.

For more details of our financial results in the first quarter, I would now like to turn the call over to Tom Sitar.

Thank you, Jim. My comments this morning will focus on our financial results for the first quarter of 2010 and identify those items that affect comparability with other quarters and those factors that contributed significantly to our results.

During my comments I will refer to our Q1 overview slide presentation which is on our website, in the Investor Relations section, Webcasts tab. I will refer to it periodically. Also note that for ease of reference I will refer to all dollar amounts rounded to the nearest million, except of course the per share amounts.

Before I report the net income numbers, please take note that we have adopted a new accounting standard. This change has re-located the non-controlling interest account from liabilities to shareholders equity, a change that moves our balance sheet closer to how it will look under International Financial Reporting Standards or IFRS. An effect of this change is that we now disclose net income as attributable to equity shareholders and that attributable to non-controlling interests. The net income attributable to equity shareholders is comparable to net income reported in prior periods and is the one also reported on a per share basis.

Wednesday evening, we reported first quarter net income of $33 million, compared to a loss of $9 million in Q4 2009 and a loss of $70 million in the first quarter a year ago. The first quarter equity shareholder net income was $16 million (or 11 cents per share). This compares to a net loss of $17 million (or 12 cents per share) for the fourth quarter of 2009, and a net loss of $59 million (or 41 cents per share) in the first quarter of 2009.

On slide 4 of our presentation we have highlighted the current quarter's unusual items and I will detail them now. Please note that the amounts I refer to are on an after tax basis.

First, a gain of $6 million (4 cents per share) due to the effect of translation of our US dollar denominated debt, net of investments, as the Canadian dollar strengthened during the quarter.

Second, a loss of $1 million (1 cent per share) on derivative financial instruments, related to our hedging positions on US currency, natural gas, diesel and lumber.

After taking account of these items, the first quarter adjusted net income is $10 million ($0.07 per share) compared to an adjusted net loss of $24 million ($0.17 per share) for the fourth quarter of 2009, or an improvement of $34 million.

Slide 5 shows the history of US housing starts and SPF lumber prices, clearly showing the rapid rise in lumber price in the first quarter, with only a slight move up in housing starts. This would suggest that current lumber prices are not driven by any strength in the U.S. house construction activity.

Turning to our operating performance, Slide 6 of our presentation, total gross sales were $28 million higher than the prior quarter. The Company generated positive EBITDA of $78 million, an increase of $63 million from the prior quarter. If you remove the effect of recovering inventory devaluations reflected in each quarter's results, EBITDA in the first quarter was positive $55 million, an improvement of $40 million from the $15 million dollar EBITDA in the fourth quarter of 2009. Lumber & pulp prices increased significantly in the first quarter of 2010, and were the major reason for improved results.

Looking at each of our business segments in turn….

Slide 7 of our presentation is lumber. The Lumber segment had positive EBITDA of $34 million in the first quarter of 2010, compared to negative EBITDA of $9 million for the previous quarter. We had an inventory valuation recovery of $22 million recorded in Q1 compared to a negligible amount reported in Q4 2009.

When these items are adjusted out, EBITDA in Q1 was $12 million, which represented a $20 million quarter over quarter improvement. I certainly hope that this is the last quarter in which we have to comment on inventory valuation. The improvement in lumber results is primarily due to improved SPF and Southern Yellow Pine lumber prices. This is evidenced in the increase in average benchmark prices of 31% and 42% respectively. These price increases were partially offset by the rising Canadian dollar. Offshore prices lagged those of North America.

Lumber shipments were reduced by about 110 million board feet from the fourth quarter, reflecting a significant drawdown in finished goods inventory in fourth quarter of 2009.

And now turning to the Pulp and Paper segment on Slide 8……

The first quarter results reported for the pulp and paper segment include Canfor's Taylor Pulp Mill together with Canfor Pulp Limited Partnership. The first quarter EBITDA was $46 million and was up by $16 million compared to the fourth quarter of 2009 again principally from improving pulp prices due to low global inventory levels and continued strong demand.

Results for Canfor Pulp Limited Partnership, of which we own 50.2%, were discussed in the Canfor Pulp Income Funds' news release and conference call earlier this week.

Other comments, for the quarter, our capital expenditures were $13 million, which was comprised of $11 million for the solid wood lumber business and $2 million for Canfor Pulp.

Going forward, we expect that in the lumber business, our capital spending for full year this year will be about $85 million.

At the end of the quarter, Canfor, excluding Canfor Pulp, had cash of $59 million and unused lines of credit of approximately $384 million. Our net debt to total capitalization, excluding Canfor Pulp was 10%, and on a consolidated basis it was 14%.

And Jim, with that I would like to turn the call back over to you.

Thank you, Tom.

Operator, I would now like to ask that we take questions from the telephone lines.

Thank you we will now take questions from the telephone lines. (Operator instructions)

Our first question is from Daryl Swetlishoff from Raymond James. Go ahead Mr. Swetlishoff.

Daryl Swetlishoff – Good morning guys. Uh, Jim, could you expand on your China market strategy? Just give us a sense of your commitment to that market longer term. I mean obviously it weighed on your results in the first quarter even though it was good for the North American industry. What are you seeing in that market longer term and what role will Canfor plan in it?

Jim Shepard – Well, quite frankly, I see China emerging as the, you know, they say China will pass the US within 10 years, and I don't think there is any doubt on the basis of my visits there of the last couple years. Every time I go back after 6 months I'm astounded by the growth I have seen. When we first started to sell into China, quite frankly, we just saw opportunity but we didn't know what the opportunity looked like. Initially we were selling low grade lumber, 2 things, basically the low grade lumber for forming for concrete, which in a way is like feeding the enemy, but also the low grade went into remanufacturing billets for finished furniture and interior furnishings that got shipped back around the world. That was the initial, but then along came that disastrous earthquake in Sichuan a couple of years ago which was a disastrous event but what it did was really illustrated the safety advantages of wood frame construction because after that disaster was evaluated there were some wood frame homes that stood up to the quake very well. They were undamaged, quite frankly, that revelation was not unlike what happen in Kobe many years ago in Japan which really opened the pathway for wood frame construction in the Japanese market. So that was another opportunity that we saw but as we've gone back over there we're seeing opportunities, for example, in infill walls, even in the reinforced concrete office buildings.

Just to give you an example, we were over there visiting with Minister Bell, the first time we were over there we toured the Sichuan area and we drove through these cities, they called them towns, quite frankly, they were cities of 1, 2 and 3 million people. We'd drive through these streets and there'd be these, as far as the eye can see, we'd see these buildings of 6, 8 or 10 story's high and they'd stop the bus and we got out because they wanted us to walk along the street so we could see the impact of the earth quake. It was eerie because we realized that all of these buildings, the widows were open and the curtains were blowing in the wind. It became evident that there wasn't a soul in any of these buildings. The reason was because they were all condemned.

And when you'd look closely and you'd see these cracks going up the side of the building. Without exaggeration we saw hundreds of building like that and they will all need to be replaced. So the construction needs for China, not just for that, that's just an example of that earthquake but the other example is that there is an estimate of 20 million people moving into the urban part of China every year. That's 2/3rd the size of Canada, it happening. There are so many opportunities in China it really stretches the imagination and quite frankly we continue to focus on where the most opportunistic place for shipping our product there but while we're doing that, the net effect we're taking a considerable amount of volume off the North American market and that's certainly having a positive impact on the lumber prices today and that will continue.

Daryl Swetlishoff – Thanks for that Jim, that's a very fulsome answer. Thank you.

Operator – Thanks you. Our next question is from Paul Quinn from RBC Capital markets. You can go ahead.

Paul Quinn – Thank you. Good morning guys. Couple questions. One, just in terms of your product mix or shift in geographies, can you sort of give us a breakdown of Q1 in terms of what you want in what you ship to the US, Canada and Asia?

Jim Shepard – I'm going to pass that one over to Don Kayne, he'll be more adapt to give you an answer on that.

Don Kayne – Hi Paul, Don here. Basically we're about 25% overseas in total for the first quarter. And that will likely go down maybe a little bit in the second quarter but certainly in the first quarter 25%, and about 20% into Canada and the balance US.

Paul Quinn – And that overseas split between China and Japan is?

Don Kayne – A bit over half of that would be China.

Paul Quinn – Wow. Ok in terms of lots has been talked about this demandless recovery and lumber prices, and it's really supply related, what's your sense of the inventory in the distribution channels?

Don Kayne – Definitely low across the board everywhere but I think that has been going on for the last 2 years but a steady reduction in overall inventories in all areas in the supply chain and that would apply basically globally. So with all of that production that's come off the market over the last couple of years combined with everyone focusing hard on reducing working capital overall, I think that has really contributed a lot to what we've been seeing here recently that quick spike up in prices.

Paul Quinn – Alright, just so I understand this, it's still characterized as low even though they've somewhat done some rebuilding?

Don Kayne – Oh Absolutely, no question. This has been going on for such a long time, this reduction, I mean there has been some increase for sure but we still believe there is a still a very tight inventory situation across North America even to some degree overseas and particularly in Japan.

Paul Quinn – Ok, in terms of the labor agreement, first congratulations, second, if you can give us some high level idea of what the incentives are within the deal?

Jim Shepard – Well, basically what is does is it involves and investment by the hourly workers of the steelworkers. Which basically is a reduction of wage costs to Canfor of 7% for 2 years, that's one. Another highlight, and this is most important, is that there is a provider there for profit sharing to the hourly workers of the steelworkers now in the company. And that's hugely important, because what that really does is that it aligns the hourly workers with objectives for our shareholders just as we have a bonus plan for our salary people. Basically it means everybody that is employed at Canfor now, whether it's me, the executive, management, salary or hourly, we're all aligned to do the best we can to get a return on our investment.

Paul Quinn – Ok, now that profit sharing, is that based off of the specific mill economics? Or is it overall?

Jim Shepard – Yes, and its return on capital employed, mill by mill…oh sorry, it's not mill by mill, it's by the whole company, I'm sorry, it's by the lumber business by the company. We do have a couple of mills that are specifically mill by mill but those were agreements that were basically a foreshadowing what we concluded but those were mills that were shutdown for an extensive period of time.

Paul Quinn – Ok and just lastly, Noticing your very strong balance sheet, and then trying to reconcile the vision of being the dominate supplier of wood with the world-wide shortage of SPF lumber, you have a majority of operations in MPB BC, What's the vision going forward here?

Jim Shepard – We said the dominate supplier of wood product solutions to our highly valued customers so we're not just a manufacturing company we're a marketing company. But we are very strategic and deliberate about where we sell our products and what grades we produce from the logs that we have to cut.

Paul Quinn – Alright, thanks guys.

Operator – Thank you. Our next question is from John Collar from Oppenhiemer and Close. Go ahead Mr. Collar.

John Collar – Good morning gentlemen. I'd like to know what your capacity utilization in the quarter was? For lumber.

Jim Shepard – 60%

John Collar – Ok, great and looking at the rise in price on lumber now on the lower US tax, I know it's a bit up in the air, but do you expect to be over that limit say in Q3 or Q4?

Jim Shepard – Over the 355, you mean?

John Collar – Right, exactly.

Jim Shepard – Well I don't think so.

John Collar – Ok thanks.

Operator – Thank you. Our next question is from Pierre Lacroix from Desjardins Securities. Please go ahead.

Pierre Lacroix – Thanks, Can you remind us what your long term commitment is to the pulp business and talking about the assets as well, maybe you could remind us what is your strategic view on the USB assets and also on the Howe Sound if there is any progress on that side to eventually looking at maybe divesting these assets?

Jim Shepard – As far as the Pulp business is concerned, through the last 3 years we went through absolutely the worst lumber markets that anyone can ever remember, the cash distribution from the Pulp was a very nice outrigger for us to have so it was a welcome source of cash. So it served us very well. And it continues to do so and certainly as you can see the Pulp business is just as good if not better than lumber pricing these days and those cash distributions are continued to be welcomed. So as far as we're concerned our relationship and our investment is a good one and we haven't got any plans to do anything about it at this point.

I'm sorry and you asked a question about OBS and Howe Sound, well as far as OSB is concerned we continue to be in the OSB business from the point of view that we are a 50% partner with Louisiana Pacific at our plant up in the Peace River country and it's yielding a nice return for us. PolarBoard is a facility that we shut down a couple of years ago and it has been for sale and continues to be for sale. So, our long time approach to OSB, it's not been a strategic prime business for us. And Howe Sound…there's no change in our status at Howe Sound.

Pierre Lacroix – Otherwise said, its still and asset that is Non-core for you and might be divested over time?

Jim Shepard – It's Non-core.

Pierre Lacroix – Thank you very much.

Operator – Thank you. We will now take questions from the media. Our first question is from Dave Barry from CKPG news. Go ahead Mr. Barry.

Dave Barry – Morning, you talked about possible expansion with the situation not being what it is, can you enlighten us a little bit about that and maybe specifically talk about plans in Northern BC?

Jim Shepard – Possible expansion…I'm not sure…are you thinking of mill start-ups? Is that what you're thinking of?

Dave Barry – Ah…well you did talk about modernization and possibly expanding business's which I sort of took as possible purchases of other companies.

Jim Shepard – Well, I didn't say that…I did say modernization and that is something that is ongoing. We have done some but on a limited basis over the last couple of years because we have been constrained with our focus on cash to make sure our balance sheet remained healthy. But we have introduced and built energy systems at Fort St. John and just completing at Mackenzie right now. We certainly will be looking at the modernization of our mills not only in BC but in also in Alberta and North and South Carolina and we'll be picking those locations that the best economic equation. But certainly BC will see some definite investment as we go forward.

Dave Barry – Just to follow-up, can you give me anything specific on Northern BC or are we not that far down the road yet?

Jim Shepard – We're not at the point where we're going to making any announcements but we certainly will be looking at Northern BC but lets face it, it's the bulk of our operations here in BC. There will be some announcements in the months ahead. Stay tuned on that.

Dave Barry – Thank you.

Thank you. There are no further questions registered. I will now turn the meeting back over to Mr. Shepard.

Jim Shepard – Well, if there are no more questions, I wanna thank you for your interest and we'll speak to you all next quarter.