

Getting an edge on the competition

There are opportunities for forest companies to better manage risk—and gain a competitive advantage—by using financial tools, such as hedging, that can help smooth out the large swings in both revenues and costs.

By Craig Hamanishi

The Canadian forest products industry has been fighting what many are calling a “perfect storm” as rising costs, coupled with weak commodity prices, have severely strained operating margins. The pulp and paper sector has witnessed closures, both temporary and permanent, of numerous operations across the country. Now many lumber producers are approaching or have fallen below breakeven levels, and temporary shutdowns throughout North America have been announced. Logging contractors and trucking firms have also been affected due to soaring diesel fuel prices.

What’s causing the pain? Recent press releases and earnings reports from the forest companies typically focus on a small group of culprits:

- rising energy costs;
- strengthening Canadian dollar;
- soft markets for finished products.

Commodities, by nature, are cyclical and forest products are among the most cyclical and volatile of the world’s traded commodities.

to page 32



from page 31

Factor in exposure to equally unstable energy and foreign exchange rates and you have the makings of tremendous earnings volatility.

Boom and bust years are characteristic of the industry and the impacts are not limited to producers. Companies handling lumber, particularly those carrying inventories, often face similar uncertainties.

Risk management involves using financial instruments, such as futures and options, to manage and reduce exposure to volatile commodity prices. Managing risk implies reducing the possibility of adverse price movements. While some mistakenly view hedging as “risky,” taking no action to manage your exposure is a far more perilous course of action.

Many textbooks cite the primary reason for managing risk as “protection from large or catastrophic losses.” Most would agree that closing a facility and the associated impacts on the balance sheet and, perhaps more importantly, the lives of their employees, qualifies as “catastrophic.”



What about the impacts of missed budgets on the overall health of the firm? Since most companies aren't fortunate enough to have unlimited capital, budget deficits are often felt throughout the organization. As one senior industry manager noted, “If we exceed budget targets in one area, it has to be made up in others.”

Although many in the forest industry have been reluctant to embrace risk management as a fundamental business strategy, a number of entities are taking a proactive approach to controlling this uncertainty. Many of the larger, integrated

companies are hedging currency, interest rate and, in some cases, commodity prices. Among the wholesale/distribution crowd we're seeing a handful of companies using futures for strategic purposes—to both enhance profit and create business opportunities. Even end-users can manage their risk and build protection against rising prices. The more innovative companies have learned to successfully manage margins and smooth out the large swings in both revenues and costs.

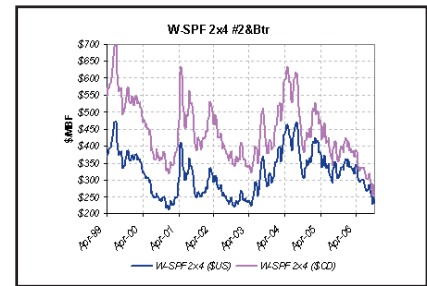
How does it work? Simply, financial tools are available to help lock in a fixed price on a specific product for an extended period of time. For example, if a lumber mill expected continued appreciation in the Canadian dollar, it could buy contracts to lock in a fixed exchange rate. If the currency did strengthen, the mill would be insulated from further foreign exchange losses due to the hedge. Similarly, a distribution yard carrying a large lumber inventory could protect itself from falling lumber prices by hedging against price declines. If lumber prices fell, the yard would be protected.

Once hedged, the yard wouldn't be



concerned about price direction; rather it could focus on servicing its customers and earning normal margins.

To be effective, a risk management plan must be tailored to each organization's specific goals, risk tolerances and market biases. Companies with



Lumber prices are notoriously volatile (above), exhibiting deeply cyclical tendencies. When fluctuating exchange rates are factored in, volatility increases. Note the shrinking premium of Canadian dollar adjusted lumber prices due to strengthening currency values. (Source: Random Lengths, US Federal Reserve)

limited cash flow and liquidity issues may hedge more aggressively to ensure, at worst, they have locked in sufficient cash flow to keep the doors open. Others may be more selective about the risks they manage. Those forecasting a weakening Canadian dollar may choose to let foreign exchange float but actively manage their energy and lumber price exposure.

Determining the most appropriate tools to achieve the objectives is one of the most important considerations. Futures, options, highly structured over-the-counter (OTC) contracts and cash based strategies are among the choices.

If you're new to financial instruments, it's essential to have a knowledgeable advisor to help assess market conditions and determine the best strategy as futures and options trading involves various degrees of risk. New participants in the

commodity markets should recognize that in addition to volatility in the marketplace, futures and/or short options positions will require margin deposits, long options positions require payment of a premium, and over-the-counter

transactions may require some type of credit negotiation.

But many firms decide that these risks are offset by the benefits associated with implementing a hedging strategy.

It's important to have realistic expectations and understand the relation-

ship between your cash positions and hedge products. Simply checking monthly account statements for a credit or debit isn't good enough. Consider the sales manager that hedges 15 per cent of a mill's production at very favourable levels but doesn't pick the exact market top. Should he be fired for losing money in the hedge account or promoted for ensuring the company has locked in favourable operating margins on a portion of their production?

Why isn't the forest industry taking a more proactive approach to managing risk? We believe complacency and lack of education are contributing factors. The forest products industry is mature and somewhat reluctant to change. There simply hasn't been sufficient pressure to change.

If no one hedges, then there is no competitive advantage and everyone suffers together. This is changing, however, as many organizations have realized that managing risk is essential to secure their future and are currently working to develop and implement programs.

Education has also been lacking. Understanding the intricacies of hedging requires engaging an experienced consultant to help avoid the pitfalls. For many, risk management is a new concept and reflects an area where they've had little prior experience.

Companies like FCStone place a strong emphasis on education and ensure clients fully understand the process prior to implementation. It is vitally important that the products and strategies are fully understood to ensure they are objectively evaluated and receive the necessary support from senior management.

Many think risk management limits profit potential, asserting, "Without risk there's no reward." While there may be some truth to the statement, it's important to note that risk management is not an all-or-none proposition. If a lumber distributor has a yard full of inventory and a strong bias towards an improving pricing environment then there may be no need to hedge. However, through the spring/early summer of 2006, nearly every individual we contacted had a very strong opinion that the lumber market was oversupplied and prices were bound to fall. In hindsight, they were exactly right—prices fell dramatically.

Many of these same companies were carrying large, unhedged inventories and, although their forecasts were correct, they did little more than watch as the value of their inventories declined.

Others resist engaging in a risk management program because they don't feel they have sufficient time to devote to the project. Understanding and managing risk can be a complex undertaking and does require an upfront investment to fully understand and appreciate the procedures and tools available.

Remember, this is an investment in the long-term health, viability and profitability of your company. However, once the plan has been developed, implementation is relatively straightforward. While hedging requires day-to-day-position monitoring, it is neither advisable nor necessary to be glued to your quote screen, neglecting other aspects of your business.

Risk management in the forest products industry is in its infancy, but examination of other commodity-based industries illustrates the potential.

Progressive companies in the forest products industry have a tremendous opportunity to be ahead of the curve and gain competitive advantage over their rivals by becoming early adopters of risk management.

Consider the grain industry which in the last couple decades has evolved from limited participation to currently boasting some of the most sophisticated hedgers of any commodities market.

Today the grain industry is extremely advanced in its approach to risk management and many are 100 per cent hedged at all times.

What caused this change? Simply, change came from within. As competition pressured margins, companies were forced to manage risk to remain competitive. Those that refused lost their edge and many were either bought out or failed during difficult years. Progressive companies in the forest products industry have a tremendous opportunity to be

ahead of the curve and gain competitive advantage over their rivals by becoming early adopters of risk management.

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FCStone is the premier commodity risk management firm with roots dating back to 1924. With unparalleled experience in the commodity markets, FCStone provides unique market intelligence and innovative financial solutions to manage commodity price volatility, protect budgets and secure margins. Our mission is simple: to add bottom-line results for our customers.

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