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231x earnings value play

Evan Lorenz writes:

Still-punitive mortgage rates, a collapse in lumber demand and the threat of a tariff war with Canada constitute the back story to the bullish analysis of West Fraser Timber Co. Ltd. now unfolding. The essential argument is that things will sooner or later get better and that West Fraser will flourish all the more on account of today's rough patch.

The company's founding brothers—Sam, Bill and Pete Ketcham, of Seattle, Wash., sons of Hank Ketcham, star Yale football center, class of 1914—started with $60,000 they scraped together in 1955 to buy a 12-employee planing mill in Quesnel, British Columbia. They named it West Fraser because their timber rights were situated west of the eponymous river. Their acorn of a mill has grown into the oak of lumber, the No. 1 producer in North America, bigger than Weyerhaeuser Co., Interfor Corp. and Canfor Corp.

In Canada and the United States, West Fraser (WFG on Toronto and New York) operates 34 mills, two pulp and paper locations and 20 engineered-wood-products manufacturing facilities—examples of engineered wood include oriented-strand board, plywood, medium-density fiberboard and laminated-veneer lumber. In the United Kingdom and Europe, West Fraser operates three additional EWP factories. The company divides itself into four units: lumber (which delivered 40% of sales in the 12 months ended Sept. 27), North American EWP (45%), pulp and paper (8%) and European EWP (7%).

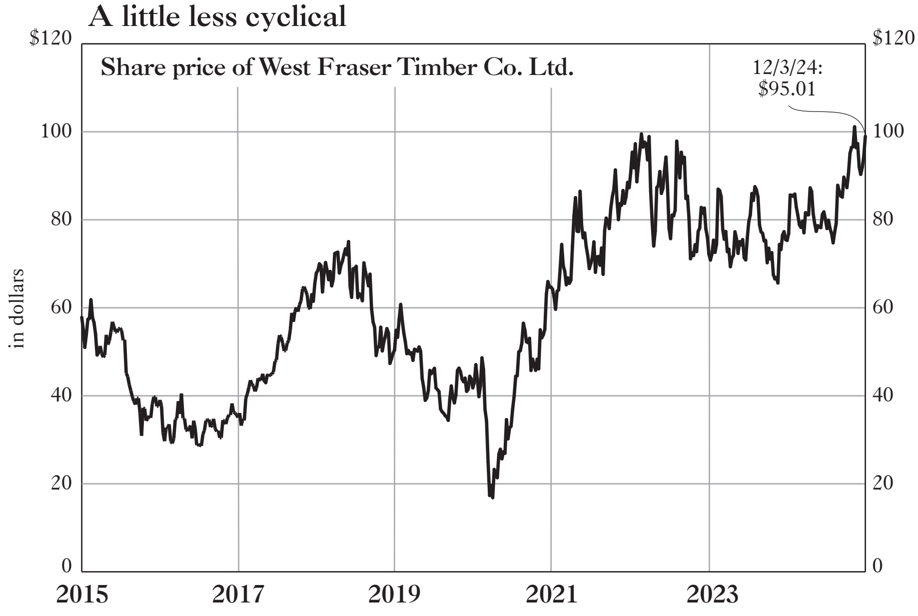
The lumber industry is almost indistinguishable from the housing industry. Some 31% of lumber is earmarked for new residential construction, 41% for residential repair and renovation. Most of those R&R outlays take place around housing transactions, either when owners make repairs to prepare a home for viewing or when new buyers remodel after closing.

"If you step back a little bit to when Covid first hit, everyone thought that housing was going to get crushed and the world was going to come to an end," Ketan Mamtora, who rates West Fraser a buy for BMO Capital Markets Corp., tells me. "So all the mills, both on the lumber side and on the OSB side, really pulled back on production."

In other words, the lumber business was flabbergasted by the home-improvement boom that stimulus checks and low mortgage rates sparked. Before you knew it, by May 2021, the price of 1,000 board feet of lumber had soared to an all-time high of $1,670.50 from an average of $356.47 in the five years ended 2019. Timber producers reaped record earnings in 2020 and 2021.

The Federal Reserve put a stop to the festivities with its belated raising of short-term interest rates in early 2022. New housing starts have since declined to an annualized 1.3 million in October from a post-virus peak of 1.8 million in April 2022. Many households took advantage of borrowing costs as low as 2.82% on 30-year fixed-rate mortgages in 2021 to buy a

A little less cyclical



source: The Bloomberg

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larger home or refinance their current mortgage. As rates have more than doubled, to 7.11% as of today, many Americans are choosing to stay put. Their implantation has led to a collapse in the sales of seasoned (i.e., existing) homes, to a 3.96 million pace in October, lowest since 2010 and down from an average of 6.1 million in 2021. The plunge in resales has proven no help to the remodeling business.

It's Canadian timber that builds new American homes and repairs existing ones, and U.S. lumber mills resent the competition. They call it unfair: Canadian pines grow on government-owned land, American pines on private property. The mills claim that the Canadian government subsidizes production through below-market stumpage rates. Washington's import duties on Canadian pines date from the Reagan administration.

Last week, President-elect Donald Trump threatened to slap a 25% tariff on all goods shipped from Mexico and Canada unless each nation halts the flow of illegal immigrants and drugs entering the United States. If he follows through, the new tariffs would piggyback on the anti-dumping and countervailing duties already in force on Canadian timber. In West Fraser's case, in the third quarter, such levies summed to 11.3%.

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The collapse in housing activity has weighed so heavily on the lumber business that companies like Interfor and Canfor generated negative Ebitda in the 12 months through Sept. 30. The cash hemorrhage means that "about 10% of industry capacity has been removed," Interfor CEO Ian Fillinger told his Nov. 7 earnings-call audience, and he reckoned that one-half of those shutdowns are permanent.

Nevertheless, because building over the past decade has failed to keep pace with population growth, America needs houses. According to a new Freddie Mac analysis, the national shortfall reached 3.7 million units at the end of the third quarter. Households had been deferring home refurbishments, too, though that, at least, may be changing. Borrowings on home-equity lines of credit, a typical funding source for repairs and a leading indicator of the happy sound of hammers banging nails, rose by 10.9% year over year in the third quarter.

West Fraser Timber Co. Ltd. at a glance

all figures in $ mns except per share data

	TTM*	2023	2022	2021	2020
revenue	$6,283	$6,454	$9,701	$10,518	$4,373
adjusted Ebitda	630	561	3,212	4,569	1,043
net income	-96	-167	1,975	2,947	588
earnings per share	-1.13	-2.01	20.86	27.03	8.56
shares outstanding	80.3	83.2	93.2	109.6	68.9
cash	997	900	1,162	1,568	461
debt	500	499	499	499	507
total assets	9,243	9,415	9,973	10,433	4,178

*12 months ended Sept. 27, 2024.

sources: company reports, the Bloomberg

Has the demand for lumber bottomed? "I'm not saying that we are going back to 1.6 million housing starts," says Mamtora. "That's not my base case. What I think is we will see some modest improvement in demand, both on new residential construction and on R&R. So between supply cuts and demand improving, that should help lumber prices and boost Ebitda."

The scale of the aforementioned reductions in lumber production capacity has "prompted a number of customers to express concern on supply of some products for next year," Bart Bender, senior vice president of Interfor, said on the November call. Some concerned buyers are entering into forward purchase agreements, he added: "I can tell you that we have entertained new inquiries and new programs and secured new programs in areas that we haven't been active in [before]."

It's to West Fraser's credit that it's remained profitable through the downturn. "On a trailing four-quarter basis, adjusted Ebitda was $630 million, which is an improvement from the $561 million reported at year-end 2023," CEO Sean McLaren crowed on the Oct. 24 earnings dial-in. "We've now been able to maintain a trailing four-quarter Ebitda above $500 million throughout this latest down cycle that started back in late 2022, aided by actions we have taken, including acquisitions, strategic initiatives to optimize our mill portfolio and a relentless focus on cost and margin opportunities."

The purchase of Norbord, Inc. in 2021 is a big contributor to this outperformance. Norbord boosted West Fraser's sales of oriented-strand board (OSB), a type of engineered wood product made from compressed layers of wood flakes and adhesives. The boards have a multitude of uses, from flooring to wall sheathing. Thanks to its strength, resistance to rot and affordability, OSB has pulled ahead of plywood in the competition for builders' dollars.

From a competitive standpoint, the OSB market is nicely concentrated: The top-five players control 80% of capacity in North America, and West Fraser leads this quintet with a 31% share. For comparison, the top-10 lumber companies control 52% of industrywide capacity. As a result, West Fraser's North American lumber operations produced an average Ebitda margin of 19% over the past decade versus 28% for the North American EWP division (including Norbord's historic results).

West Fraser bought Norbord for C$4.2 billion in an all-stock transaction that caused the acquirer's share count to bulge by 54.5 million, to 121.6 million. As West Fraser has remained in the green through the post-Covid slump, it has used its free cash flow to repurchase 43.1 million shares at a cost of $3.6 billion since closing on the acquisition.

Trump's tariffs, if imposed, would complicate, though not prevent, a lumber recovery. Tariffs, with apologies to the imminent new administration, are taxes that raise the price of imported goods; and by providing domestic producers room with a pricing umbrella to exploit, they propagate more taxes. It's

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some comfort, at least, that trade disputes are nothing new for the lumber industry.

Neither are pine beetles. As they continue to ravage British Columbia's forests, West Fraser has turned to American timber. In 2004, it procured just 11% of its lumber from American forests. Last year, 52% was so sourced. While builders would prefer to pay less, not more, for lumber and OSB, these products account for only 3% of the total costs of a new house. It follows that a 25% tariff could be covered by a less-than-1% hike in new-home prices.

Adjusting for a bond repayment after the close of the third quarter, West Fraser carried $200 million in debt versus a cash position of $697 million, and even those striking figures may understate the strength of the balance sheet. As of Sept. 27, the company had deposited $880 million, or $10.97 per share, with the Department of Commerce to satisfy U.S. import duties. In the past, West Fraser has appealed these charges and recouped a portion of them. "It's never the full amount but, in the past, it has been a decent amount," David Kessler, a senior investment associate at Robotti & Co. Advisors, LLC, which holds a position in West Fraser, tells me. Moody's Ratings and S&P Global Ratings, a little less impressed than we are, rate the debt Baa2/triple-B-minus, or lower investment-grade.

If, say, an upside lurch in mortgage rates delays the recovery of the timber market, West Fraser would have less reason than most to worry. Its strong financial position will allow it to pounce on the distressed assets of its encumbered competitors. James Pattison, the nonagenarian Canadian billionaire, seems well aware of these facts, since he has discussed combining West Fraser, in which he holds 11.5% of the outstanding shares, with Canfor, the fourth-largest lumber producer, which he controls via a 53.8% stake.

"We don't want to grow our capacity for growth's sake," Robert Winslow, West Fraser's director of investor relations, tells me. "That's not what we're interested in. We'll grow as long as it makes us better. We're in a commodity business. We will buy assets that will lower our cost or improve our margins. It's almost a perverse thing, but if the cycle recovers too quickly, the distressed assets, like the jewels that fall into distress, may not be available to us."

As it is, the North American lumber industry is becoming more concentrated. The top-10 producers, as noted, account for 52% of capacity, up from 43% a decade ago, and there's no sign of a countertrend. "If you look at Builders FirstSource, they've been rolling-up the distribution segment," Mike DeRop, a senior investment associate at Robotti, tells me. So is Home Depot, which bought SRS Distribution, Inc. earlier this year.

"Our hope is that lumber mills will see what's happened in the OSB industry and see what's happened among their customers, and they are going to have to respond to that," DeRop continues. "The mom and pops—that is, companies with only one or two mills—are going to have a really tough time in terms of logistics, increased costs and things of that nature. We do hope that there's a setup here for additional consolidation in lumber." It would bring higher and more stable returns, DeRop says.

West Fraser's share price itself may provide some downside protection if the lumber business goes pear-shaped. In summer 2022, Kronospan, Europe's largest OSB manufacturer, weighed a buyout of West Fraser. Banasino Investments Ltd., an affiliate of Kronospan, holds a 10.7% stake.

West Fraser trades at 231 times the estimate of adjusted 2024 earnings—a fact attributable not to an overzealous fan base but to the plunge in earnings, in the context of an industry-wide profits famine. Assume a gradual recovery over the next two years, and that multiple falls to 19.3 times 2025's earnings and 11.4 times the guesstimate for 2026.

On Bay Street, six of the seven analysts on the case say buy while the dissenter says hold. Short interest amounts to a diminutive 1% of the equity float. Over the past year, insiders have purchased 24 shares—exactly 24 shares—at a cost of $1,836.

In a highly cyclical business, West Fraser has proven itself to be an all-weather competitor. It will prosper if the housing market picks up, and it has the balance sheet to prosper from its competitors' distress if the bad times drag on.

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