Forest products stocks are well off their highs as lumber prices remain sky high. Time to buy the dip?

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PUBLISHED 22 HOURS AGO

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A worker controls a hopper full of cedar lumber at Interfor's Hammond Cedar Mill in Maple Ridge, B.C. on July 17

A worker controls a hopper full of cedar lumber at Interfor's Hammond Cedar Mill in Maple Ridge, B.C. on July 17, 2003.

CHUCK STOODY/CP

If your instinct is to sell Canadian forestry stocks out of concern that record-high lumber prices can't possibly be sustained, you're not alone: The stocks have fallen about 15 per cent as a group over the past three weeks.

But should you tame that instinct?

Weaker stock prices for West Fraser Timber Co. Ltd. WFG-T (/investing/markets/stocks/WFG-T/) -1.83% ▼ , Canfor Corp. CFP-T (/investing/markets/stocks/CFP-T/) -0.35% ▼ and Interfor Corp. IFP-T (/investing/markets/stocks/IFP-T/) -1.02% ▼ are reflecting a couple of concerns now facing the forestry sector. A recent report showed that U.S. single-family housing starts – a key source of lumber demand – fell 13.4 per cent in April, from March, even as the number of building permits remained relatively steady.

The setback suggests to some observers that sky-high lumber prices are starting to bite.

"In response to higher construction costs, some homebuilders are delaying housing starts as they wait for prices to fall back," Sam Hall, assistant property economist at Capital Economics, said in a note.

As well, the U.S. Department of Commerce last week released a preliminary ruling that proposed doubling tariff rates on Canadian softwood shipments, to an average of 18.32 per cent, potentially driving construction costs even higher.

The temptation to take some money off the table, then, is hard to resist, especially if you've been fortunate enough to see your holdings triple in price over the past year (as Canfor's share price has done).

But there is a case for riding out the current bout of turbulence or even buying into it: Far from being priced to perfection, forestry stocks are reflecting far lower lumber prices by the end of the year. In other words, lumber mania isn't priced in.

According to Raymond James analyst Daryl Swetlishoff, stocks are discounting the benchmark price of two-by-four lumber falling to just US$500 per thousand board feet (abbreviated as mfbm). That's less than a third of the recent record-high price of $1,640 mfbm.

Most observers don't expect the current price of lumber to hold, given that it has soared 355 per cent over the past year. But the discounted price may be far too low, based on tight supply and strong demand – which is where the buying opportunity kicks in.

John Duncanson, timber analyst at Corton Capital's Global Timber Fund, expects the price will average US$1,100 mfbm in 2021, with a new "floor" price of $1,000, or double the discounted price.

He believes that new mill construction is not enough to meet demand, while the sector struggles with a shortage of skilled labour.

"You can't turn on capacity that fast," Mr. Duncanson said in an interview. "There are a couple of greenfield mills that will be starting up next year, but it's a drop in the bucket."

The bet that lumber demand will hold up is also compelling.

Although U.S. housing starts faltered in April, demand for new homes remains strong amid low inventory. As a result, Mr. Hall expects that developers will have to start building more homes again even if lumber prices remain elevated.

As well, observers expect that the prospect of rising U.S. tariffs on Canadian softwood doesn't pose a serious threat to stock prices.

For one thing, they won't begin for another six months at the earliest. For another, the higher tariffs are being proposed at a time when housing affordability has become an important political issue, putting home-buyer pressure on the White House to resolve the dispute.

"Extending an olive branch to Canada in the form of relaxed lumber trade sanctions could represent an easy political win for the Biden administration," Mr. Swetlishoff said in a note.

In the meantime, investors who stick with forestry stocks can look forward to dazzling second-quarter cash flow generation, given the current record-high lumber prices and order backlogs. This cash flow could fund additional share buybacks and special dividends.

Interfor is paying a special dividend of $2 a share at the end of June, which implies an annualized yield of 6.3 per cent based on Thursday's closing share price. Other companies could follow suit.

“What’s West Fraser going to do with all of its cash?” Mr. Duncanson said. “Wait for the special dividends. They’re going to be massive.”

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