MDF Producer Outlook for 2020 and Beyond

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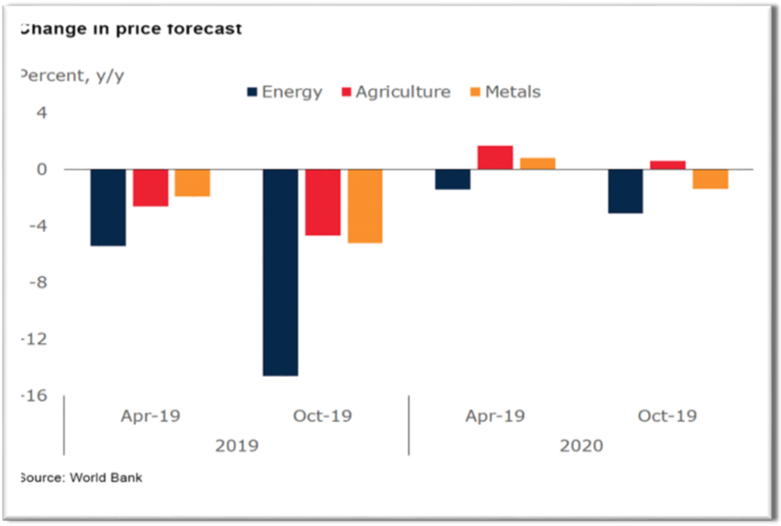
We continue to have conflicting economic issues that have placed our industry and many others in a constant state of flux for at least the past 5 years. During this time, we have had to adapt to the rapid rise of China, protectionism in India, environmental exuberance in Europe, geopolitical upheavals in the Middle East and the rewriting of the Global Trade Rules as dictated by the United States.

Under 'normal' economic conditions, commodity prices are generally 10% to 20% higher than the cost of marginal production. Long-term producers usually need a 20% margin to continue Capex expenditure and to maintain productivity. If we look at the overall commodity price index from 1970 to 2009, the index annualised at +12% and in comparison, the S&P 500 index annualised at +6.7%, significantly below the commodity index. After the financial crisis and the on-set of quantitative easing (QE) from the years 2010 to 2018, we find that this situation has completely changed. The annualised gain in the S&P 500 has reached +11.7%, whilst the annualised commodity index has been consistently negative at -7.7%. When you average out the 21 major commodities, they are cheaper than they have ever been relative to their marginal costs. For example, Oil is trading -5% below its worldwide marginal costs; wheat and cotton almost -30% below marginal costs.

Technological advances, improved production efficiencies and better logistics all contribute to a general trend of ensuring commodity prices remain competitive. In the short-term, commodity prices can fall below marginal production costs. Falls below marginal production costs are generally associated with supply and demand imbalances. The big difference here is that we are entering our 10th year where most commodity prices remain below marginal production costs.

If you refer to the below prediction made by the World Bank in November 2019 (Graph 1), we will see a reversal of fortunes for global commodities. In 2020, although Energy commodities remain negative (though at a very much lower rate), both Agriculture and Metals commodities turn slightly positive.



Graph 1

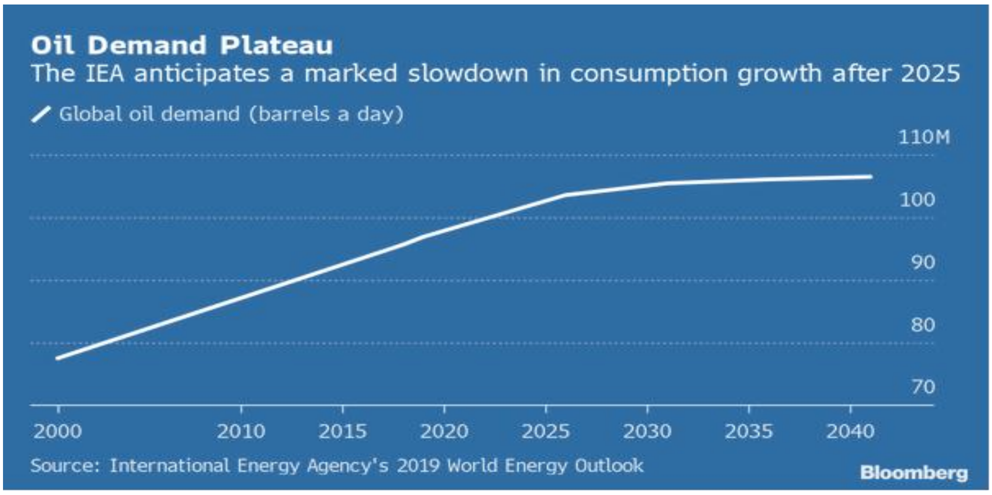
If we break this down into what is important for the cost structure of MDF, my predictions are as follows;

- ***Timber***

  This falls under 'Agriculture' and I do expect that timber prices will increase across the main Southeast Asian Rubberwood MDF producers. The main reasons for the increase will be related to increased latex prices, thus there will be a reduction in the replanting and the harvesting of Rubberwood. Additionally, with the lower overall planted acreage and the increase in the demand for Rubberwood, these shortages will result in price increases.

  For other timber species, the increase in labour costs and the higher costs of environmental certification will all lead to a more positive pricing.

- ***Resin (Glue)***
  Here we have two major components, Methanol and Urea. Both are ultimately derived from Oil. Methanol is much more directly related to oil prices and Urea only slightly less so as it is also a very important component for the production of agricultural fertilisers. According to the World Bank, Energy prices will remain low. Personally, I believe this assumes that tensions in the Middle East remain contained and that US Shale Oil production takes the edge off any potential supply shortages. I think that both assumptions will be incorrect. Furthermore, in another International Energy Agency (IEA) report, it is expected that global demand for oil will continue to significantly increase through to 2025 (Graph 2) despite all the efforts in moving to renewables. This in itself will contribute to higher oil prices.



Graph 2

- ***Energy (Electricity)***
  The World Bank forecast shows that Energy commodities will remain in negative territory. I think this is mainly due to the improved distribution of natural gas. Oil derivatives form part of our raw material (resin) and for the reasons mentioned above, I don't think oil prices will remain so low! Neither will electricity prices! In Malaysia, we are already experiencing a series of electricity price increases and the removal of special tariffs for large consumers. This is all part of the environmentalist drive to move away from high energy consumption and CO_2 production.

- ***Labour***
  In my limited management experience, I have never seen labour costs declining! Adding to this are new laws enforcing 'minimum wage' structures for all workers. This in itself is not a bad thing but the challenge is always how to increase productivity to counter such additional costs.

- ***Depreciation (Finance Costs)***
  This will be the 'million dollars' question? Will interest rates remain at historical lows or will financial market normalise? My hope is that they will normalise but my fear is that this policy of QE and low interest rates could continue with the sole purpose of satisfying political interests. This will prolong the pain in terms of suppressing commodity prices and prolonging deflation.

In conclusion, I predict that there will eventually be a reversal of fortunes in the prices of commodities in relation to their marginal costs. The speed at which this will happen will primarily depend on the geopolitical stability of the oil supply and on interest rates, especially in the U.S. When commodity prices normalise to cover marginal costs, it will occur quickly and will be initially bad news for the MDF panel manufacturers. Costs will increase far faster than the pace of MDF price increases. This will ultimately lead to some factory closures and maybe even some bankruptcies of producer companies. In the end though, the market will rebalance and those that survive the turmoil will once again be producing healthy margins and acceptable profits.