BRITISH
COLUMBIA

A Survey of Independent Forest Product Manufacturers: Key Success Factors

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Prepared for:

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Independent Lumber Remanufacturers Association:	Jim Fraser
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The "*Directory of Secondary Manufacturing of Wood Products in British Columbia*" (Working Paper 99.01) prepared by Bill Wilson and Valerie Sexton of the Canadian Forest Service, served as a valuable reference in targeting candidate firms for this study.

Executive Summary

This study was undertaken, under the direction of the Ministry of Forests, Forest Enterprises Branch in the interest of identifying those factors or variables key to the successful operation of an independent timber processing facility. This survey captures the responses of one-hundred eleven (111) producers who agreed to participate in this study. [1].

Two categories of respondents emerged over the course of the study, (i) those operators with no history of participation in the Small Business Forest Enterprise Program (71 respondents) and (ii) those operators with a history of participation in the SBFEP (40 respondents).

The findings of this study are as follows:

First Category of Respondents
- No History of Participation in the SBFEP

Heirarchy of Importance	***Success Factor***
First	**Product Positioning** - a product or product line which is clearly differentiated from competitors / substitutes in the market place.
Second	Knowledgeable, well – motivated marketing / **distribution channels**.
Third	Well-developed **market intelligence** system.
Fourth	Well capitalized **financial structure**.
Fifth	Reliable, responsive **network of components manufacturers and suppliers**.

- The first three success factors converge on common theme which a consensus of respondents in this category describe as "… *investing in developing a comprehensive knowledge of what customers value, and would value, so as to gain marketplace advantages over less knowledgeable competitors*".

[1] The majority participated on the condition of no corporate or personal attribution to their responses.

- Cash or working capital emerged as second in importance to establishing and defending a market presence.

- For the first category of respondents, secure access to raw material supply did not emerge as a "success factor". This group of respondents indicated that raw material inputs represented a comparatively modest component of the total finished product cost.

For those independent producers with no history of participation in the SBFEP, secure fibre supply was not identified to be a key success factor.

Second Category of Respondents
- Possessing a History of Participation in the SBFEP

Heirarchy of Importance	***Success Factor***
First	Rigorous product **quality control** standards throughout the production process**.**
Second	Well-capitalized **financial structure**.
Third	Market-based **raw material supply** agreement.
Fourth	**Market access** (U.S. Export Quota).
Fifth	**Periodic injections** of Crown (SBFEP) timber.

- Defending a market niche or market share in both specialty and commodity markets relies on consistent on-grade manufacturing. Recurring product turn-backs will ultimately collapse a market presence.

- The majority of respondents indicated that a persistently under-capitalized structure only exacerbates challenges related to developing markets, product quality and fibre supply. The [narrow] operating margins in secondary processing will not support inadequate or prohibitively costly financing over the long-term.

- Successful operators establish a supply arrangement that is market driven – that is the arrangement must be beneficial, over the long-term, to the supplier [major tenure holder or primary sawmill]. Such supply arrangements may be augmented by periodic injections of small business timber.

- Fibre supply relationships which are predicated on an uninterrupted supply of small business timber are risky and most often, short-lived.

- It is too risky to operate on a business strategy that is based on acquiring an uninterrupted supply of timber through the SBFEP. For any given economic timber sale, an operator is competing with as many as twenty (20) other firms.

- Lumber remanufacturers indicated that those producers with sufficient export quota, currently operate with protected market-share requiring little ongoing investment. Other respondents lacking sufficient export quota, indicated market development is "the whole game", particularly as it relates to non-U.S. markets or cultivating market outlets for products exempted from the Canada-U.S. Softwood Lumber Agreement.

- A representative of a major Canadian bank asserts that, for the small proportion of operators who possess primary breakdown capacity and operate on the basis of uninterrupted participation SBFEP timber, such a strategy is "*the kiss of death*". Such a strategy must be replaced by a long-term market-based supply arrangement with a primary producer.

Anecdotal Comments Related to the Administration of the SBFEP:

- Those independent operators surveyed with a history of direct participation in the SBFEP were unanimous in their view that the program, <u>Section 21 in particular, has been of enormous benefit to independent operators.</u>

In as much as Section 21 sales have contributed to the fibre needs of independent processors, the profits gained from these sales have been an effective source of supplemental capital available to investment in plant and operating assets.

- There is a generally held perception, on the part of operators with a history of participation in the SBFEP, that demand for small business volumes has declined for those operators unable to affix U.S. export quota to SBFEP timber.

- All respondents with a history of participation in the SBFEP applauded the new award criteria as a significant "*milestone"* in the evolution of the program.

"…*prior to the implementation of the 1996 guidelines for bid proposal sales, award decisions too frequently* ***…rewarded failure and punished success.*** *In certain regions of the province, past political interference has distorted the natural economic equilibrium and thwarted market-driven restructuring which removes uneconomic processing capacity."*

"To date, the new evaluation / award template has <u>considerably improved</u> the transparency of the Section 21 award process and reduced the ability of operators to apply political pressure in connection with competing for bid proposal sales".

- Several Coast & Interior Operators

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Purpose and Scope of Study

The purpose of this study is to identify those factors, separate and apart from Crown timber sold competitively through the Small Business Forest Enterprise Program (SBFEP), which determine business success, in economic terms, within the independent [1] processing sector.

This study was commissioned by the Ministry of Forests, Forest Enterprises Branch and is intended to contribute to the delivery of the SBFEP, in particular the bid proposal section of the program. The results of this study distinguish between two categories of independent solid wood secondary manufacturers:

First Category: Independent forest producers with no history of participation in the SBFEP.

Second Category: Independent manufacturers with a history of participation in the SBFEP.

Originally, the terms of reference for this study limited this survey to the first category of operators – independent producers with no history of participation in the Small Business Forest Enterprise Program. Over the course of this study, operators representing the second category of producers – independent producers with a history of participation in the SBFEP- vigorously advocated to be included in this study. This category of producers asserted that their exclusion, would diminish the significant contribution of the SBFEP and by extension, the importance of secure fibre supply, to encouraging investment, job creation, new product development, market development and expansion in the independent timber processing sector.

Moreover, the second category of operators considered this study an appropriate (and timely) opportunity to communicate concerns and suggestions regarding those policies guiding the delivery of the SBFEP. The Ministry of Forests, Forest Enterprises Branch, subsequently agreed to expand the terms of reference to include the second category of operators / respondents.

[1] Independents are described as those timber processors who do not hold a replaceable form of Crown forest tenure with an allowable annual cut greater than 10,000 cubic meters.

Those independent producers who participated in this study, either through an interview or the questionnaire survey, were represented through one of the five following classifications of secondary forest producers [2]:

- Remanufactured Products
- Millwork
- Furniture
- Cabinets
- Engineered Wood Products

The table below summarizes the distribution of responses by classification of operator, the two categories of respondents (with / without participation in the SBFEP), and the form of response. The majority of respondents agreed to participate in this study providing their responses remain confidential – any direct attribution may divulge sensitive corporate information.

Table 1 - Number and Form of Response by Category of Operator

Classification of Respondent	Respondents with NO History in the SBFEP	Respondents with a History of Participation in the SBFEP	Subtotal	Responded by way of personal or telephone interview	Responded by way of completed questionnaire	Subtotal
Remanufactured Products	14	38	**52**	41	11	**52**
Millwork	15	1	**16**	13	3	**16**
Furniture	20	0	**20**	18	2	**20**
Cabinets	15	0	**15**	12	3	**15**
Engineered Wood Products	7	1	**8**	6	2	**8**
Total:	**71**	**40**	**111**	**90**	**21**	**111**

This survey reflects the written or verbal responses of one hundred-eleven (111) operators. These responses are skewed as follows:

% respondents with no history in the SBFEP	**64%**
% responses by way of telephone or personal interview	**81%**

[2] These categories of secondary producers are five of seven identified by Forintek Canada Corp and Jim McWilliams in 1993.

PART I

SURVEY FINDINGS

I.a – Operators with No History of Participation in the SBFEP

The following table identifies the hierarchy of success factors described by operators with not history of participation in the Small Business Forest Enterprise Program. Seventy percent (70%) of the respondents in this category are either millwork, furniture or cabinet manufacturers. Only twenty percent (20%) of the respondents in this category produce forest products remanufactured from commodity grades of lumber or other primary product.

Table I.1 – Respondents with No History of Participation in the SBFEP

Hierarchy of Importance	Key Success Factors
First	**Product Positioning** - a product or product line which is clearly differentiated from competitors / substitutes in the market place.
Second	Knowledgeable, well – motivated marketing / **strong distribution channels**.
Third	Well-developed **market intelligence** system.
Fourth	Well capitalized **financial structure**.
Fifth	Reliable, responsive **network of components manufacturers and suppliers**.

First Three Success Factors: Market Orientation

The first three success factors converge on common theme which a consensus of respondents in this category describe as:

… investing in developing a comprehensive knowledge of what customers value, and would value, so as to gain marketplace advantages over less knowledgeable competitors.

These producers attach significant value to developing superior market knowledge and using that knowledge to skillfully position their products in relation to their competitors.

Customers, in the form of wholesalers and distributors of forest products, such as millwork, furniture stock and components (including RTA) and cabinetry, establish and maintain supplier relationships based on (i) consistent delivery of on-grade product (reliable product performance) at (ii) a competitive price (profitable trading margin).   Respondents asserted it is critical to adopt a market orientation which recognizes these two components of a buyer's purchase decision.

"Information on all important buying influences permeates every aspect of our business.   A company can be market oriented only if it completely understands its markets and the people who decide whether to buy its products".

" We use all kinds of customer data and bring that data into all functions – we do much more inter-functional (production & marketing) decision making than may of our competitors."

– Lower Mainland Cabinet Manufacturer.

For producers of building and home products (doors, windows, moulding, I-joists), wholesalers, retailers (such as Home Depot and Lowes), and other parts of the distribution channels have a profound impact on the choices customers make. So it is critically important to understand " the trade".

Fourth Success Factor: Well-Capitalized Operation

Securing adequate working capital and long term financing to support operating assets are fundamental requirements to a successful business outcome.

Cash or working capital emerged as second in importance to establishing and defending a market presence.   Ultimatley, an operation that cannot finance its short-term raw material purchases will have few long-term supply concerns.

Many of the respondents in this category indicated that growing companies too often become financially distressed by not controlling growth.   Growing companies, in their efforts to take advantage of market opportunities and gain market share, often cannot generate positive operating cash flows as they build receivables and inventories.   However, most respondents indicated they have little difficulty financing operating cash shortfalls as long as creditors and equity investors share the perception of their growth potential.

Most respondents acknowledged that in the early growth stages of their business they “broke every rule” governing conventional financing practices. As owners of private companies they have considerable financial freedom and the “old bromide” that you do not use short term debt (bank operating lines) to finance fixed assets is nonsense.

Respondents assert that in a growth spurt, they will get capital any way they can and use it any way they need to. Source and use decisions are based on bank restrictions and on their personal attitudes toward guaranteeing loans and drawing funds from the business – not on traditional financial wisdom. While using short-term debt to finance fixed assets can cause serious problems, in the absence of well-organized capital markets for independent operators, along with bankers’ resistance to making loans without personal guarantees, independent operators often have little choice.

Growth is determined in part by the owner’s willingness to leave earnings in the business and therefore accept greater personal financial risk. Several respondents indicated that the landscape of secondary producers is littered with successful businesses which collapsed prematurely owing to aggressive management drawings.

In the cyclical forest products industry, even mature operators may suffer operating cash flow difficulties. To avoid becoming financially endangered, respondents indicated they invest cash to build inventories well ahead of seasonal or anticipated peaks in their operating cycles.

This category of respondents observed that the more subtle reason to acquire a small business timber sale is that it may, depending on log markets, represent an off-balance sheet cash resource.

Fifth Success Factor: Developing Long-term Supplier Relationships

The fifth success factor identified by this category of respondents relates to cultivating strong supplier relationships.

Manufacturers of products such as furniture components, kitchen cabinetry, windows and doors and engineered wood products identified components sourcing to be a key strategic consideration. For products with a high degree of engineering or components, such as ready-to-install windows, components suppliers are integral to their business success, particularly when the decision is to out-source critical components rather than manufacture internally.

Several respondents indicated that secure, fluid relations with components suppliers can generate considerable financial returns where:

- The secondary manufacturer focuses on manufacturing only those components critical to product quality and that they have a distinct advantage in manufacturing;
- The outsource components are provided by suppliers with a distinct comparative advantage – greater scale or a lower cost structure; and
- Outsourcing may generate employee commitment to improving manufacturing performance (working with the highest quality components available throughout the manufacturing process).

For this first category of respondents, secure access to raw material supply did not emerge as a "success factor". This group of respondents indicated that raw material inputs represented a comparatively modest component of the total finished product cost. Inputs in the form specialty grades and species (such as hardwoods for furniture and cabinets) of boards or manufacturing blanks, particle board, medium-density fibre board, oriented strand board, laminated veneer lumber and sliced veneers) were comparatively accessible through local distributors such as Canwel, and Taiga Forest Products.

For those independent producers with no history of participation in the SBFEP, secure fibre supply was not identified to be a key success factor.

All respondents in this category expressed a reluctance to integrate backwards into their supplier's businesses (manufacture of lumber or other inputs) because of the potential to deflect management's attention away from the key business focus of meeting the needs of its end market customers.

"Only to the extent that the SBFEP once offered a form of arbitrage profit, were we interested in pursuing a small business timber sale…those profits are no longer evident".

- Lower Mainland Window & Door Manufacturer

I.b – Operators with a History of Participation in the SBFEP

The hierarchy of success factors identified by respondents with a history of participation in the SBFEP is presented in **Table I.2**

This section summarizes the responses of forty (40) operators with a direct history of direct participation in the Small Business Forest Enterprise Program, specifically the bid proposal section. Interspersed with these responses are the direct interview responses provided by two Canadian chartered banks; both banks possess an extensive history of financing independent forest product manufacturers.

Table I.2 – Respondents with a History of Participation in the SBFEP

Hierarchy of Importance	Key Success Factors
First	Rigorous product **quality control** standards throughout the production process**.**
Second	Well-capitalized **financial structure**.
Third	Market-based **raw material supply** agreement.
Fourth	**Market access** (U.S. Export Quota).
Fifth	**Periodic injections** of Crown (SBFEP) timber.

Context of Each Success Factor:

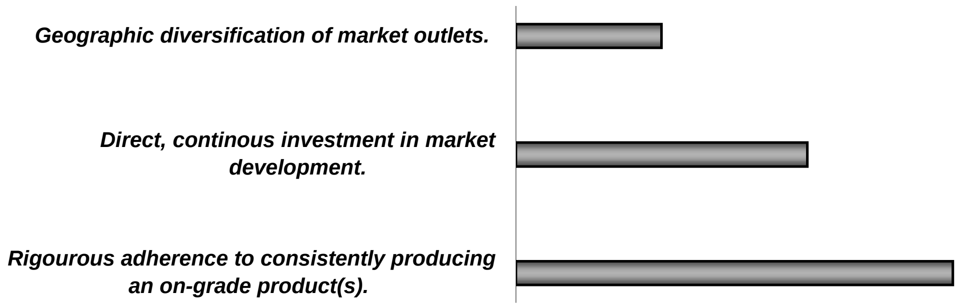
The sections to follow relate each of the five success factors identified in Table I.2 above to a wider set of variables that emerged out of personal interviews with respondents. Six broader themes arose out of the personal discussions and are presented below:

- Market Outlets
- Workforce
- Production
- Fibre Supply
- Financing
- Management

I.b.i - Market Outlets

The following graph relates the importance of manufacturing and marketing a product line which consistently achieves or exceeds customer requirements / specifications – each product shipment must be consistently on-grade.

Markets - Hierarchy of Importance of Factors



Supporting Rationale
Provided by Respondents:

- Defending a market niche or market share in a commodity market relies on consistent on-grade manufacturing.

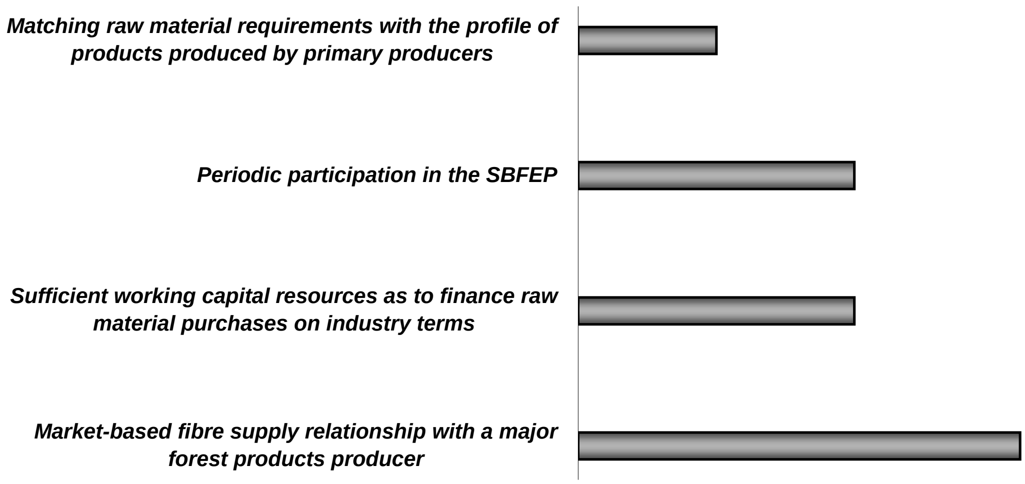
  Recurring product turn-backs will ultimately collapse a market presence. Continuous investment in the distribution network is critical to maintaining a market presence.

- The second ranked market related factor in the above graph identifies the requirement to constantly invest in market development. Lumber remanufacturers indicated that those producers with sufficient export quota currently operate with protected market-share requiring little ongoing investment. Other respondents lacking sufficient export quota indicated market development is "the whole game", particularly as it relates to non-U.S. markets or cultivating market outlets for products exempted from the Canada-U.S. Softwood Lumber Agreement.

- The third market related success factor reflects the operating risks associated with focussing on one geographic market (case in point, Japan). However, many respondents asserted that it is difficult for one manufacturing facility to be sufficiently flexible as to serve multiple markets.

I.b.ii - Fibre Supply

Fibre Supply - Hierarchy of Importance of Factors



Supporting Rationale:

- The majority of respondents asserted that the foundation to secure raw material supply is establishing a long-term (or renewable) supply arrangement with one or more major lumber producers. Periodic injections of SBFEP timber ranked equivalent in importance to having sufficient short-term financing available to purchase raw materials (working capital). This equivalent ranking suggests the underlying value of SBFEP timber is found in either the timber's use in development of a trading relationship with a major tenure holder [round log for square lumber] or that the profits from the sale are used to finance market-based purchases of suitable inputs.

- Successful operators recognize that it is critical to establish a supply arrangement that is market driven – the arrangement [3] must be profitable to the supplier [major tenure holder or primary sawmill].

- At present, U.S. export quota is an important component of any long-term supply arrangement – particularly if the arrangement requires the primary producer process SBFEP volumes.

- Small business sales have historically been an important tool in establishing and building supply relationships between independent producers and major operators. And while periodic injections of small business timber enhance these relationships, such supply agreements are only sustainable over the long term if they are market-based agreements. To be viable on a

[3] Such arrangements may also involve U.S. (softwood lumber) Export Quota.

long-term basis, the supply agreement cannot be predicated on uninterrupted participation in the SBFEP.

- The SBFEP is attributed with helping to diversifying the previously narrow product focus of primary solid wood producers - particularly in the north-central interior. Section 21 timber volumes have been a useful lever in helping to induce primary mills to produce a wider range of products that meet the needs of secondary wood manufacturers [lumber-for-logs supply arrangements].

The value of SBFEP timber in securing supply arrangements with primary mills is proportional to the incremental (timber) needs of the primary mill.

For the foreseeable future the limiting constraint or enabling factor in securing such agreements will be the ability to attach U.S. export quota to SBFEP volumes.

The majority (25) of responding lumber remanufacturers assert that, in the context of remanufacturing lumber, the overriding concern of management on the issue of fibre supply, should be to reduce all dependency on round logs to facilitate supply agreements. Moreover, the administration of the Bid Proposal Program should explicitly "reward" those operators who demonstrate a diminishing reliance on SBFEP timber [4].

"…[too many] remanufacturers focus too much time and effort on the fibre supply issue – often as much as fifty to sixty percent of management's efforts. With a long-term market based supply agreement in place with two major producers, our investment of management time on fibre supply is as little as ten percent. Such an arrangement has allowed our firm to focus on market development and constant refinements to our production process".

- An Interior Lumber Remanufacturer

[4] The ability of a producer to sustain operations on market purchases is currently considered as a tie-breaking factor – several operators recommended this requirement be injected into the formal points calculation.

Perspective of Lenders [5]
on Fibre Supply

- One bank official indicated that for the most part (90%) their independent sector clients were not critically dependent on SBEFP sales. The remaining 10% of the client base that exhibited a dependence were restricted to independent producers that process round logs or had supply arrangements with primary mills that consistently operate in a log supply deficit.

  The same bank representative is of the opinion that, for the small proportion of operators who possess primary breakdown capacity and operate on the basis of uninterrupted participation SBFEP timber, such a strategy is "*the kiss of death*". Such a strategy must be replaced by a long-term market-based supply arrangement with a primary producer.

  For the overwhelming majority of the bank's clients (90%) who operate without the need for round log inputs, a secure fibre supply position <u>is not a requirement imposed by the lender.</u> This financing risk is typically mitigated through an assessment of the management's ability to procure raw material on market terms. In short, on the issue of fibre supply, the lending decision focuses on management's ability to manage / negotiate supply arrangements throughout the business cycle.

- On a consistent basis, successful operators have pursued an operating strategy which effectively integrates their fibre (input) requirements with the average profile of products (dimension lumber) produced by major producers in their trading area.

- By comparison to fibre supply, a much greater financing risk emerges for lenders in connection with project management – new investment in expansion or new product lines / markets.

The SBFEP is not expected to generate the level of logging profits realized in the past. Within the bank, we expect to see the value of SBFEP sales decline over the foreseeable future and the frequency of (sale) take backs, for non-compliance, by the Ministry of Forests steadily increase.

Accordingly, little lending value will be attributed to SBFEP timber; the value of supply agreements with major licensees will increase.

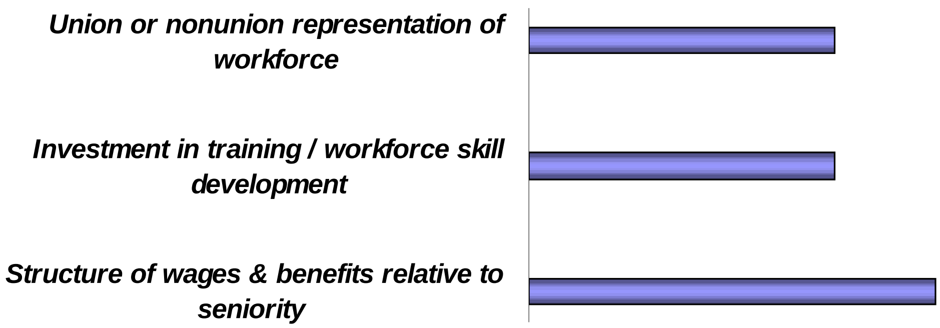
- ***A representative of a Canadian chartered bank.***

[5] Direct interviews with two Canadian chartered banks.

One bank official interviewed considered government policies which foster expanded long term relationships between independents and major producers, through initiatives such as the Wood Fibre Transfer Program and Fibre Facilitators, beneficial to the independent sector.

I.b.iii - Workforce

Workforce - Hierarchy of Importance of Factors



Supporting Rationale:

- Nearly two-thirds of those respondents interviewed in this category indicated the single greatest impediment to consistent improvements in labour relations and adapting the workplace to the changing business environment was the complex structure of institutions governing the workplace in British Columbia including:

  - BC Federation of Labour
  - Workers Compensation Board
  - Labour Relations Board
  - I.W.A. – Canada

- Several independent operators converged on the following view:

  - Organizing and managing production workers in a comparatively small (less than 100 production staff) workplace is more effectively accomplished where the definition of "us" is not defined by a union / nonunion boundary between management and salaried supervisory staff and hourly production workers.

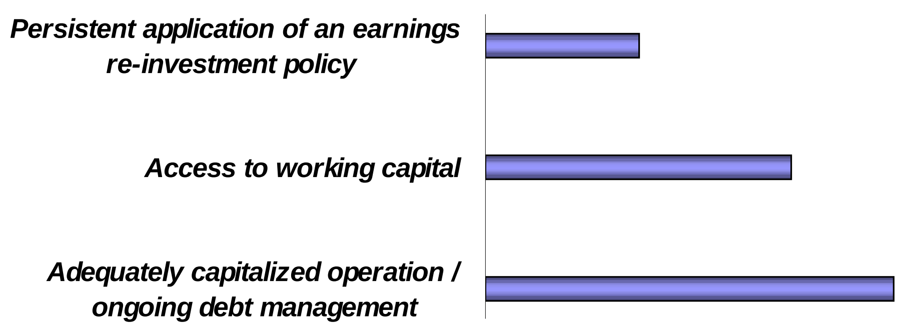
  - A plant which lacks a union / nonunion boundary is more conducive to creating a team environment between management and production workers which encourages productivity, innovation and a more inclusive identity of "us".

- However, the non-existence of a union / nonunion boundary does not eliminate conflict. Conversely as the tasks, roles and outcomes of work become more uncertain (not explicitly defined through a collective agreement covering the workplace) clashes of opinion and perspectives become more likely. Such conflicts are viewed as healthy and often productive – providing they are resolved.

- Respondents were divided on the wage impact of union certification – no consistent position emerged. Several remanufacturers indicated their cost structure would not allow them to absorb IWA rates for tasks related to grading and sorting (green-chain activities). Other respondents asserted the wage scale imposed by certification did not represent an economic hardship however the potential to reduced flexibility in the workplace was the more significant business risk.

I.b.iv - Financing

Financing - Hierarchy of Importance of Factors



Supporting Rationale:

- The majority of respondents indicated that a persistently under-capitalized structure only exacerbates challenges related to developing markets, product quality and fibre supply. The [narrow] operating margins in secondary processing will not support inadequate or prohibitively costly financing over the long-term.

- Respondents indicated "ruthless" attention to working capital is paramount – lumber remanufacturing in particular can consume considerable amounts of working capital. Two respondents held the view that many of their counterparts in the SBFEP under-estimate the amount of working capital associated with operating a SBFEP sale and the time lag associated with recovering working capital invested in timber sales.

Hierarchy of Financing Criteria
Identified by Lenders:

In the interviews conducted with two major Canadian banks, the importance of (secure) fibre supply emerged as secondary in importance to four (other) factors associated with financing independent producers:

i. A well-capitalized operation – assessed in terms of the proportions of debt and equity in the capital structure.

ii. A capable management team.

iii. A history of "reasonable or superior" operating performance, as reflected in financial statements.

iv. The quality of assets securing bank funds advances (program of continual reinvestment in operating assets).

In general, the borrowing relationship is not predicated on a secure source of fibre supply.

The character of the borrowing relationship is shaped by the company's year in and year out financial performance.

- **Representatives of two Canadian chartered banks.**

Similarly, several respondents converged on several similar factors considered critical to their ability to secure and regularly access financing through chartered banks:

- Performance as reflected in financial statements, typically provided in the course of lenders undertaking their annual review;

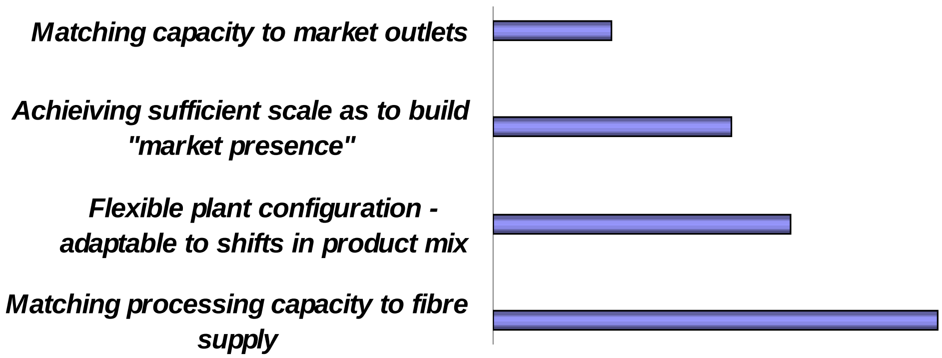
- Management – the level of confidence the company's lenders has in management's ability to respond to changes in their business environment or competitive forces;

- Maintaining the good value of the assets supporting the bank's advances through continuous reinvestment in operating assets and adoption of new technologies; and

- Compliance with "reasonable" lending covenants (ratio tests and restrictions on further borrowing, management drawings).

I.b.v - Production

Production - Hierarchy of Importance of Factors



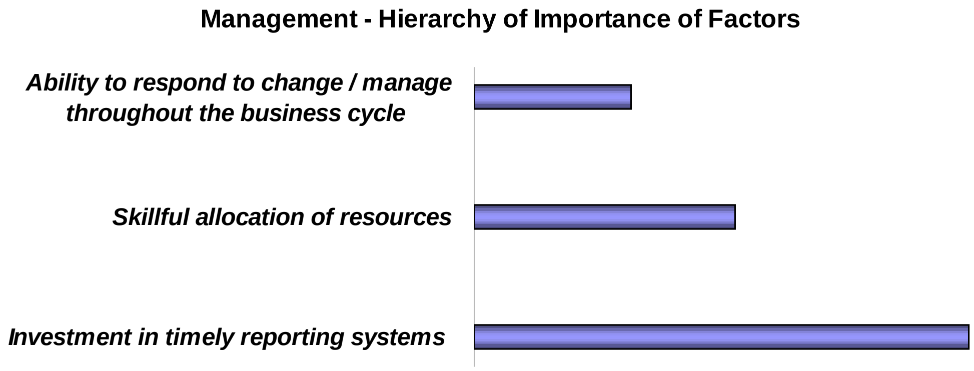
Supporting Rationale:

- Similar to the primary sector, the independent sector is undergoing a period of restructuring and rationalization of processing capacity.

- U.S. export quota considerations has driven much of the structural adjustment over the short term. Determining an appropriate scale of production balances (i) market outlook (ii) established supply relationships, (iii) market access (export quota) and (iv) periodic participation in the SBFEP.

- Several respondents indicated that the relative proportions of capital and labour employed in their facilities severely prejudices their ability to participate in the SBFEP. Large scale, efficient lumber remanufacturers, employing comparatively greater amounts of capital than labour, compete poorly within the SBFEP on measures of employment intensity.

I.b.vi - Management



Supporting Rationale:

- Several respondents indicated that no other single investment has enabled better decision-making than the adoption of sophisticated management reporting systems.

  Such reporting systems facilitate timely decision making on the basis of changes in prices, throughput levels, unit costs and operating margins - essential for any operator competing in markets where [market] information is widely held.

- One respondent asserted that management's philosophy must be to devote energy and resources to those parameters of the business which it can control, "…*business cannot wait for government to fix things"*.

- It is too risky to operate on a business strategy dependent on acquiring timber, on an uninterrupted basis, through the SBFEP. For any given economic timber sale, an operator is competing with as many as twenty (20) other firms.

- Past management ideology, particularly in the Interior, treated labour as the highest cost component and fibre inputs as a relatively cheaper input to production. Therefore, operating decisions emphasized labour efficiencies at the expense of "wasting" wood.

  More recently, the relationship between fibre and labour costs has reversed. Delivered wood costs are now the largest component of manufacturing costs and labour is comparatively cheaper. Not all operators have adjusted to this shift by ensuring more efficient processing (including trading) of small business timber.

Perspective of Lenders on Management:

- The single common management characteristic between successful clients is a <u>very</u> focussed operating strategy. These operators, cultivate and restrict their activities to specific niches and a narrow product line.

  Cedar remanufacturers operating on the Coast are a good example of a subset of operators which individually pursue <u>focused operating strategies</u>. While independents on the Coast do not have access to the volumes of timber generally available to Interior operators, Coast producers typically operate with higher value grades of timber and their end products generate higher margins on a unit ($/Mfbm) basis.

  Interior producers work with generally lower value timber and must work with customers very closely to ensure consistent delivery of on-grade products over the comparatively greater timber volumes they manufacture and market.

PART II

Enhanced Delivery of Section 21 Sales

Throughout the interviews conducted over the course of this study, both categories of respondents, particularly those with a history of direct participation in the SBFEP, were keen to offer their insights into past pitfalls of the SBFEP and how the economic potential of bid proposal sales may be fully realized on a consistent basis. This section summarizes the verbal and written comments offered by various interviewees.

II.a Overall Impact of the SBFEP Program

Those independent operators surveyed with a history of direct participation in the SBFEP were unanimous in their view that the program, Section 21 in particular, has been of enormous benefit to independent operators.

The program has served as a valuable financing vehicle for secondary manufacturers – particularly through the period 1987 to approximately 1994. Lacking access to equity markets, independent operators have relied on private investment, retained earnings and bank debt to capitalize their operations. These relatively costly or restrictive sources of financing have been supplemented by logging profits generated through acquiring and harvesting small business sales.

In as much as Section 21 sales have contributed to the fibre needs of independent processors, profits from harvesting of the sales have generated funds available for investment in plant and operating assets.

Over the period 1987 to 1996, Section 21 Sales represented an "economic boom" to the independent sector – these sales generated a much-needed source of capital to finance investment in the sector.

- several Coast manufacturers

Since the implementation of the Canada-U.S. Softwood Lumber Agreement in 1996 the market value of small business timber has diminished. There is a generally held perception, on the part of operators with a history of participation in the SBFEP, that demand for small business volumes has declined for those operators unable to affix U.S. export quota to SBFEP timber.

U.S. export quota has taken on a commodity value and as a form of new "currency" has reduced the value of Small Business timber, in its ability to facilitate access to a secure fibre supply.

II.b Implementation of Evaluation Template in 1996

All respondents with a history of participation in the SBFEP applauded the new award criteria as a significant "*milestone"* in the evolution of the program.

The previous policy emphasized the production of higher value products (emphasis on the absolute value-added) which encouraged independents to migrate into both higher value inputs and outputs. Conversely, the new policy encourages producers to exploit a larger portion of the "wood pile" concentrated lower grades of logs and lumber.

Two general observations emerged in connection with how the provincial template should be administered into the future:

i. The template should increasingly reward "innovative" new capital investment designed to:

   - create new product lines;
   - expand into new markets; and
   - develop new jobs.

   Innovative investment should also be distinguished from capital investment related to maintaining the status quo configuration of operations.

ii. The template should reward those operators who demonstrate a more modest or diminishing dependency on SBFEP timber, thereby allowing a greater diversity of operators to participate in the bid proposal program.

   Several respondents expressed their concerns that a few large-scale independents have achieved a near monopoly on the bid proposal program by virtue of their dependency on the program and that this has the potential to seriously undermine the competitive philosophy underlying the SBFEP.

II.c Political Interference

A significant number of respondents (23), with a history of participation in the SBFEP, identified a point in time when, to their perception, the administration of Section 21 sales or the bid proposal program dramatically shifted in philosophy.

These respondents hold the opinion that in its earlier, less structured format, the bid proposal program on a number of occasions experienced intervention designed to achieve "*political bail-outs".* The summary comments below reflect a subtle, albeit not universal [6] shift in perception regarding the operation of the bid proposal program.

"…*prior to the implementation of the 1996 guidelines for bid proposal sales, award decisions too frequently* ***…rewarded failure and punished success.*** *In certain regions of the province, past political interference has distorted the natural economic equilibrium and thwarted market-driven restructuring which removes uneconomic processing capacity."*

"To date, the new evaluation / award template has considerably improved the transparency of the Section 21 award process and reduced the ability of operators to apply political pressure in connection with competing for bid proposal sales".

- Several Coast & Interior Operators

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[6] Several respondents hold the view that Bid Proposals are increasingly being tailored at time of advertisement to achieve outcomes less related to pure economic competition.