

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

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Latest Comments

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*Don Roberts,
Paper & Forest Products*

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Paper & Forest Products

Roundtable Forum

Many of the key commodities in this sector, such as newsprint and uncoated free sheet, are in secular decline in North America. The long-term downward pressure in demand is now being reinforced with a cyclical contraction caused by the economic slowdown. If there isn't a turnaround in demand numbers, there will probably be another round of capacity reductions. The bottom line is that there will be capacity closures in both paper and solid wood segments of the industry going forward. If there is good news coming out of this space it is that some larger companies have been getting more aggressive in pushing through price increases. The average return on capital in the global forest products industry has averaged between 3% and 5% in Canada and the US and it is clear that companies have to change the nature of the game. The industry has the chance to redefine itself over the next few years, particularly if there is a high energy price scenario that is partly driven by carbon pricing. There are opportunities to be found in bio-energy and bio-chemicals, and strategic alliances are being formed across sectors that reflect these fundamental shifts. Companies whose businesses are based on fossil fuels are reaching out to those that control the renewable resources like wood. By opening up a new field, it could well be the catalyst for changing the nature of the game for the forest products industry over time.

On the solid wood side, it will need a comeback in the housing market and the selling off of unsold new homes inventory. Investors should be in these stocks before the new housing start numbers start to rise, because the stocks will have already run by then. Our experts both like timber as an asset class. In terms of valuations, it is difficult to see prices going a lot higher. People are locking in yields that are around 5%, so you have to have a long-term horizon to want to bid up timber prices far north of where they are now.

On the lumber side, there could be a potential replay of the steel cycle. Our analysts expect further capacity closures, with the inability to bring the capacity back at a later date due to fundamental fiber shortages in key regions of North America. When the housing market does come back, there could be significantly higher lumber prices. This is one of the areas where investors should look to build a position over time.

Our panel: [Steven Chercover](#) of D.A. Davidson; [Don Roberts](#) of CIBC World Markets Inc.

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Paper & Forest Products



STEVE CHERCOVER joined D.A. Davidson & Co. in February 2000 as a Senior Research Analyst covering the paper and forest products sector. A native of Canada, he covered the sector for TD Newcrest in Toronto prior to joining D.A. Davidson. His knowledge of the Canadian industry and current location in Portland, Oregon, give him a unique perspective of the evolving North American forest products industry. In the past several years, he has enjoyed several accolades, including a number two ranking in The Wall Street Journal's 2004 "Best on the Street" analyst survey, and the number one ranking for earnings estimate accuracy, according to Starmine and Forbes magazine. He has also been named to the All-American Research Team in Institutional Investor magazine's ranking of regional and boutique brokerages for the past three years. He holds a BA in Economics from the University of Western Ontario, an MBA from the University of Toronto and the Chartered Financial Analyst designation.



DON ROBERTS is a Managing Director with CIBC World Markets Inc. He leads CIBC's Paper and Forest Products Research Team, and is also responsible for the bio-fuels sector. His primary responsibility is to lead a team of analysts in advising financial institutions (e.g., pension/mutual funds) on their investments in the global paper and forest products industry. He is consistently ranked by institutional investor surveys as one of the top equity research analysts covering the forest products industry. He specializes in international commodity markets and has collaborated with a number of international forestry organizations to gain a global perspective on the paper and forest products sector. He has over 30 years of experience related to various aspects of the forest products sector. Prior to joining the investment business, he was Chief Economist with the Canadian Forest Service. In addition to his work with CIBC World Markets Inc., he is also an Adjunct Professor in the Department of Forest Resource Management at the University of British Columbia (Vancouver); Guest Scholar at

IIASA — the International Institute for Applied Systems Analysis (Austria); on the Board of Executives of the Sloan Center for Paper Business and Industry Studies at the Georgia Institute of Technology (Atlanta, Georgia); and he serves in an advisory capacity for a range of government, industry and NGO groups. He has a Bachelor's degree in Agricultural Economics from the University of British Columbia, a Master's degree in Forestry Economics from the University of California at Berkeley, and both an MBA and doctoral studies in International Finance and Economics from the University of Chicago.

TWST: Don, in general how were results in the first quarter for the paper and forest products industry relative to what you thought that they were going to be?

Mr. Roberts: They came in a little weaker than we were expecting. There is some noise in them. I think we have to abstract a little from the short-term noise and see where we are in the cycle. That is probably where we should be focusing.

TWST: What has caused the shortfall that you have seen?

Mr. Roberts: It's input costs. That's one of the key things. We saw it clearly in the **International Paper** (IP) results, with higher costs of energy, chemicals, distribution and fiber. It is interesting to note that when we look at the output prices, they are clearly hovering near a cyclical peak. However, profit margins are well below those achieved at previous peaks. One of the reasons is exactly what I have mentioned — it is because we have this cost-push pressure on product prices.

Chercover: The companies try to manage what is within their own control, which is their cost structure. They are certainly price-takers when it comes to energy, chemicals and whatnot. All they can do is try to optimize their own mill.

TWST: Steve, what is your take on what you have seen so far for the first quarter?

Mr. Chercover: I would have to agree with Don. I have kind of labeled these input pressures the four horsemen: fiber, energy, chemicals and transportation. They accelerated throughout the first quarter and they are going to continue to be a headwind going forward. So not only was the first quarter perhaps a bit lighter than expected, but also the outlook is not particularly robust.

TWST: Following along on that, Steve, what are the companies saying at this point in terms of what the future looks like?

Mr. Chercover: There is really no change. The companies try to manage what is within their own control, which is their cost structure. They are certainly price-takers when it comes to energy, chemicals and whatnot. All they can do is try to optimize their own mill. The other factor is just the economy in general. We have seen some falloff in demand for all the commodities. It was dramatic in March. The uncoated free sheet, which is manufactured by **Domtar** (UFS) and **IP**, also fell off more than anticipated. Maybe the slowdown in the economy is starting to reverberate.

Mr. Roberts: Just to reinforce what has been said here, some of these key commodities on the paper side, such as newsprint and uncoated free sheet, are really in a secular decline, at least in

North America. Globally, demand may be rising by about 1% for these specific commodities, but it's on a secular decline in North America. The long-term downward pressure in demand is now being reinforced with this cyclical contraction. If we don't start seeing some turnaround in those demand numbers, we are going to have to see yet another round of capacity reductions. Then the interesting question becomes: Who is going to do it?

A lot of these stocks may look relatively cheap if you look at price to tangible book ratios, but if we fast-forward 12 or 24 months into the future, a key question is what the tangible book will be at that time. This is certainly even a bigger question for the solid wood companies like **Louisiana-Pacific** (LPX) and **Norbord** (NBD). Many investors are reluctant to step in and catch a falling knife, given the cash losses that are being incurred. The bottom line is that we think more capacity closures are in the offing for many companies in both paper and solid wood segments of the industry. **IP** may be one of the exceptions.

1-Year Daily Chart of International Paper



Chart provided by www.BigCharts.com

TWST: Steve, are we going to see another round of consolidation and shrinkage here?

Mr. Chercover: The industry is getting fairly consolidated along specific product lines. I don't think that **AbitibiBowater** (ABH), for instance, can do much more in terms of consolidation. You are seeing this with containerboard when **IP** completes the **Weyerhaeuser** (WY) transaction — another industry that is well

consolidated. On free sheet, you almost have a duopoly between **Domtar** and **International Paper**. There might be some smaller deals on the margins, but what I think Don is correctly alluding to is that if demand continues to shrink, then these companies will have to continue to look at their own asset base and say, “Okay, what’s next? We have to manage supply to demand.”

Mr. Roberts: If there is good news out there (and maybe it has been late in coming), it is that some of the big players in the paper industry have been getting more aggressive in pushing through price increases than I had anticipated. Maybe it’s because I had low expectations, but I think they have actually done a reasonable job.

We have already been seeing price increases driven by rising costs, but the cost pressure is unlikely to be over. Going forward, I expect we will be seeing further structural changes on the cost side. That is something that we haven’t talked as much about in North America, but you certainly are witnessing it in Europe. That is: what if we start to do things like pricing in carbon? I don’t mean that people should get excited in this sector about carbon offsets in the context of the timberland guys. I am talking more about the negative impact on costs (in addition to the stimulative

to position yourself. These changes include things like the explosion in Asia’s wood deficit; the convergence of the markets for food, fuel and fiber; the pricing of carbon (with all ramifications for input and output markets and transportation patterns).

It also includes the emergence of the Russian forest sector. Russia has been a sleeping giant. In the short term, they are probably going to pull back out of the market as they implement their dramatic export tax on logs. However, the government has publicly stated that it is targeting to have over \$50 billion invested in the sector between now and 2020. Now, a lot of that will have to go to infrastructure and a lot of central governments put out targets that are never met. However, they have a guy in the driver’s seat in Moscow who is relatively serious. We may not agree with how he’s doing things, but bear in mind that at the end of the day Russia has more standing timber than Canada and Brazil combined. Despite that tremendous resource, Russia ran a trade deficit in paper and forest products last year. I don’t think that that is going to last.

So we are in the midst of some big-picture changes. When you throw them all together, you have to ask, “So what?” Well, that is really the fun thing to ask right now from an analytical point of view and not get distracted with the quarterly numbers.

Roberts: We are seeing some very fundamental changes out there. You have to sit back and ask how you want to position yourself. These changes include things like the explosion in Asia’s wood deficit; the convergence of the markets for food, fuel and fiber; the pricing of carbon (with all ramifications for input and output markets and transportation patterns). It also includes the emergence of the Russian forest sector.

impact on new products). For example, what are the implications for energy and distribution costs if carbon were priced at \$50 per ton? What would it do to our financial forecasts for companies in this industry?

Again, this is why it’s important to not become fixated on the short-term numbers in this sector. The quarterly numbers contain too much noise. Right now we should be focusing on the big-picture fundamental changes that are occurring in this industry. In our view, the changes in markets and forest policies that are occurring at the global level are the biggest we have seen since the end of the Colonial era.

TWST: That is a big, bold statement.

Mr. Roberts: It really is. We are seeing some very fundamental changes out there. You have to sit back and ask how you want

TWST: Steve, do you see the same big-picture changes taking place?

Mr. Chercover: Yes, absolutely. Don prefaced his comments with a “What if?” And I’ll say, “what if oil hits \$200 a barrel as some of the pundits are saying?” Clearly, for an industry that is extremely energy intensive, that would be very, very negative. What could exacerbate it is not corn for fuel, but rather wood for biomass. We are already seeing some competition from biomass, in wood pellets, and that could grow if cellulosic ethanol becomes a reality in the next few years, and there are some trial facilities that are getting ready to ramp up. That could be a real challenge for this industry. What I think is important is trying to find an opportunity instead of a challenge. I don’t know exactly what a cellulosic ethanol still looks like but I bet you that it looks a lot like a pulp mill. I would hope that

some of the forward thinkers in the paper industry try to determine how they can participate or benefit from this trend, as opposed to why this is the final nail in the coffin.

Mr. Roberts: Steve is just bang on here. If you look over the last eight years, the average return on capital in the global forest products industry has been unacceptably low. It has averaged about 3% in Canada, 5% in the US and 7.5 % in Latin America. The best in the world happens to be India with roughly 10%, and this is despite that country having some of the highest energy and wood prices in the world.

Given that the cost of capital is hovering around 10% in many of these countries, you have to sit back and say, "It's not good enough to even be the best of the bad bunch." You have to change the nature of the game. The good news is that we are seeing some of these fundamental shifts, which may well do that. The industry has the opportunity to redefine itself over time, especially if we move into a high energy price scenario that is partly driven by carbon pricing. You are already seeing the emergence of a bio-energy industry. But that's not the endgame. The endgame is looking at

fuels, are reaching out to those that control the renewable resources like wood. I think behind the scenes people are starting to think about this more, although it may not have fully penetrated the consciousness of the folks occupying the corner offices.

At the end of the day, we have some of the best minds in science working in the field of renewable energy. There is a huge array of technologies out there. I am not smart enough to know which one of those is going to be the winner. There will likely be several. For example, the guy or gal who develops that special enzyme that breaks down wood far faster than the rest is going to make a heck of a lot of money. Having said that, once you see a technology adopted, most of the production companies will be in a straight commodity business. In our view, the real rent is going to be reflected into high feedstock prices, and these in turn will be capitalized into the value of the underlying land. It is the timberland owner who will likely benefit the most from these changes. Food products like corn are going to price themselves out of the energy market, and the preference will be for lower cost feedstocks like biomass.

Roberts: What we are starting to see now are strategic alliances that are being formed across sectors. One of the more obvious ones is the one between Weyerhaeuser and Chevron, In a number of cases we are seeing oil and gas or chemical companies trying to match up with feedstock companies, whether that is Weyerhaeuser, Stora Enso, or UPM-Kymmene. These companies, whose businesses are based on fossil fuels, are reaching out to those that control the renewable resources like wood.

things like bio-chemicals as well. I think that these are interesting opportunities. We are not there yet in a commercial sense, but we have to see the direction in which we are going and how fast we are going to get there.

TWST: Don, does the industry have the management that has that type of thought process? Historically, this has not been a very aggressive industry.

Mr. Roberts: What we are starting to see now are strategic alliances that are being formed across sectors. One of the more obvious ones that we have heard at least talked about is the one between **Weyerhaeuser** and **Chevron** (CVX), but that is just one example. In a number of cases we are seeing oil and gas or chemical companies trying to match up with feedstock companies, whether that is **Weyerhaeuser**, **Stora Enso** (SEOAY), or **UPM-Kymmene** (UPMKY). These companies, whose businesses are based on fossil

1-Year Daily Chart of Weyerhaeuser



Chart provided by www.BigCharts.com

TWST: If they haven't already.

Mr. Roberts: Absolutely. Aside from the ethical issues in the food versus fuel debate, it's just economics that will make commodities like corn ethanol less interesting. When we look at wood fiber, we think both sides of the market will be affected; it will change the nature of the game in the forest products industry. The shock on the wood side isn't just on the demand side where we are going to use wood fiber to produce products like cellulosic ethanol, acetic acid or xylitol. The shock is also coming on the supply side. I was just over in Vietnam last year. I went through a three-year-old eucalyptus plantation, but the owners were in the process of tearing

TWST: As we go through this metamorphosis, Steve, what should investors be doing? Can they invest in the space or are they really just forced to sit on the sidelines and see how all of this unfolds?

Mr. Chercover: I think that if you sit on the sidelines, it might be too late. Don alluded to where the economic rents really were, and that's in the timberlands. There are ways to play the timber assets, both in Canada and in the US. Within Canada, you even have a company that is primarily exposed to China, **Sino-Forest (TRE:TSX)**. There are timber REITs and investment trusts that can give you exposure to timber as an asset class.

Roberts: We are seeing a structural change in wood prices. The long-term trend has been downward. Right now, I believe that we are at an inflection point where we are going to see a reversal in this trend. While there will always be cyclical variation, I would argue that wood and forest product prices are going to be on an upward trend over the next 10-15 years. Wood fiber prices already are pretty high in places like Canada.

it down to put in palm oil. What's the message here? While the Southern Hemisphere continues to have an absolute advantage over the Northern Hemisphere in growing wood fiber, its comparative advantage may well be in other products, not in trees. Over time, we may be seeing the comparative advantage in forest products start to shift back to the Northern Hemisphere.

TWST: Steve, does the industry have the right management? You were the one that raised the issue that they have to be forward thinking. Are the people there?

Mr. Chercover: I think you are already seeing a changing of the guard within some of the companies that I cover. By and large, I don't think that the folks who are at the top of these companies today will necessarily be the guys who lead them through the next generation of this business, but I think that the writing is still on the wall. They know that they have to change, and if they don't do it, then someone will do it for them. The market will take care of that.

Even within the last 10 years, I think we have seen some folks in our industry who have grasped the magnitude of the changes ahead of them. Guys who literally had pulp running through their veins came to the conclusion at the end of their careers that the business that made them wealthy was not a business that had a great long-term future and they have tried to adjust already.

1-Year Daily Chart of Sino-Forest



Chart provided by www.BigCharts.com

When you start to look for companies to invest in, I would say that the criteria have to be a good balance sheet, strong free cash flows going forward, the vision to change, and where they tend to have their assets. As Don said, having assets in Brazil gives you a head start if you want to play in almost any of these games because we don't necessarily know what the perfect feedstock is but we know what the superior growing environment is. If you can grow a tree in Brazil in seven years versus 70 years up in Canada, then that's a problem for Canada as well as Russia. Even though Russia can mow

down one generation of forest, the second generation will take a good while to grow back.

Mr. Roberts: We have some neat changes going on. When we look at the Brazilian situation, if you own your land down there you are doing great. However, if we look at the market price of hardwood pulpwood right now, it is actually higher in Brazil than in either the US South or Eastern Canada.

TWST: Why is that?

Mr. Roberts: One reason is that that exchange rate can come around and bite you no matter where you are. We have seen a large appreciation in the Brazilian real. However, even in the domestic currency, we have seen meaningful increases in the price of fiber in Brazil and in Chile for that matter, because we have been putting in processing plants faster than we can get in the plantations. There are also increasing demands for the land from alternative uses. So prices are moving up and the market clears like it always does. What we are seeing is that increased value of the timber and alternative products is being capitalized once again into the value of the land, so your cost of new entry into these areas is pretty darn high in a lot of cases. Our sense is that a lot of the capital that has already been raised to go into global timberland investments is being reflected in the value of land pretty quickly. We have to scout out more and more exotic locations, whether it's Mozambique, Laos or wherever, and some of these places have not only political risks, but also a number of operating challenges.

There are shifts occurring behind the scenes. The thesis that we have is that, yes, wood prices are going to go up. We strongly believe that. We are also taking the view that food and energy prices are going to go up even more, so that in fact we will see people in a lot of the southern areas not want to go into wood, and that will shift the advantage perhaps over time back up into the North. If the North is not really making money now and the stocks are down, that is when and where you should start doing your analysis.

TWST: But given those returns that you cited earlier, Don, what is going to change that equation?

Mr. Roberts: One of the things that we are seeing is a structural change in wood prices. The long-term trend has been downward. Right now, I believe that we are at an inflection point where we are going to see a reversal in this trend. While there will always be cyclical variation, I would argue that wood and forest product prices are going to be on an upward trend over the next 10-15 years. Wood fiber prices already are pretty high in places like Canada.

So the good news for some of these stocks is that the bad news is already reflected in them. The perfect storm that hit a lot of the Canadian forest product companies has legs. It's now hitting Europe, and I would argue that it is increasingly going to hit South America. Near the start of this interview I mentioned that pulp, paper and packaging prices are near a peak. However, due to the cost-push effect on prices, I think that they are going to stay pretty

high. If these commodity prices start to fall, you are going to see capacity fall off pretty quickly, especially in those countries with strong currencies.

Don't get me wrong, I'm not saying people should currently be overweight the global forest products industry. In fact, our call right now is to underweight the sector. I am a little reluctant to wade into the pulp and paper stocks because when you are at a peak, often you can only go down.

Generally speaking, I am more positive on the solid wood segment of the industry over the longer term. At present, the prices of products like lumber and OSB are unsustainably low because of the US housing market. Furthermore, they will likely stay pretty bad right through the end of 2009. My own sense is that I will really like some of the solid wood stocks in about six to 12 months time, but I think that it is a little early to move in.

Steve had mentioned one particular company, **Sino-Forest**, which is traded in Toronto but is essentially a Chinese timber play. That's one of the ones that I like the best because you are in a situation where you are at the epicenter of the global shock on fiber. If wood is scarce anywhere, it's in China. So if you have timber in the ground in China and there are further good prospects for growth, that's a pretty interesting story.

TWST: Steve, what is your take on the pricing environment?

Mr. Chercover: When you take a quick cursory glance at any pricing chart, you will see prices at 10-12 year highs for commodities, whether it is NBSK (which is pulp), containerboard or any of the printing and writing grade. A lot of that comes down to what has happened to the US dollar. These commodities are denominated in dollars, so from a US perspective they seem high. In Canada and Europe, the prices really haven't changed all that much.

I would agree that there is very little room for the downside. Even though we look like we are at the peak, and normally there is nowhere to go but down, I don't think that there is too far to fall either. That is because I think that these facilities that aren't making money, where the party's on and no one's having fun, are going to have to look at different alternatives including shutting if pricing gets worse.

I also think that it is possible that maybe we are in the last spasm of huge capacity expansion. Most of it is happening in China right now. If the Brazilians, for instance, which tend to be the source of new fiber for all these Chinese mills, decide that they are better off allocating their land to the production of soybeans, sugarcane for bioethanol, pork or beef, then we might not be seeing vast new plantations for the next round of pulp mills. Maybe I am almost hopeful that we are not going to see a lot of capacity and then the world is going to have to determine how much paper it really needs and maybe the facilities that are on the ground now can price their product to satisfy the demand. However, it's not going to be a growth environment going forward.

Mr. Roberts: Steve's comments are really well founded when you start looking at the foreign producers right now. Currency has made all the difference. The Canadians and the Europeans do not have high prices when they are expressed in the local currency. I think that the US South is really one of the most exciting places to be globally over the next five to 10 years. It has a big wood basket. You get the benefits of the currency. And you have a transparent and relatively predictable operating environment. You can't say that about Siberia.

Among the US-based companies, I think **IP** will benefit from its significant exposure to the southern US. **IP** also has the benefit of having a foot on the ground in both Brazil and Russia. Management has finally been putting the "international" in **International Paper**.

TWST: So the complexion of this industry is changing dramatically?

Mr. Roberts: Yes, and given where it was, boy, isn't that a good thing?

TWST: Steve, as these changes take place, do the companies have the balance sheets to accomplish what they need to do?

Mr. Chercover: It depends on the company. **Weyerhaeuser**, which is really exiting the paper business altogether, has a tremendous balance sheet. **International Paper** is a little bit in the penalty

tions in a given asset base. That's the challenge for the investor. You want capacity down at the industry level; you just don't want to own the company that's taking it.

Mr. Chercover: That's the problem for some of these big consolidators. For years and years, they have been doing the heavy lifting and kind of playing the role of statesmen, doing what was right for the industry. But sometimes what's right for the industry means that you are paying the whole price. Looking back five years ago, you would speak to people who were bullish on a given company and say, "Just wait until they get volume times price. Their earnings power is enormous." And you would have to try to cool them down for a while and say, "Remember, if they try to ratchet up the volume, they will never get the price." So it is hard to say what the theoretical EBITDA or earnings potential of these companies is because if you look at their potential tonnage or their maximum capacity, they are never going to run it. If anything, they are going to keep on culling capacity.

TWST: So it is a bit of a shrinking game?

Mr. Chercover: Going back to business school theory, we are definitely in the cash cow phase of this business.

TWST: Don, do you see the same thing?

Mr. Roberts: On the paper side, I tend to think so. On the solid wood side, I think that is less so. I tend to look back and say,

Chercover: Smurfit-Stone is the biggest in containerboard in North American for another couple of months, but they don't have the balance sheet to do much consolidation on their own. They need other people. AbitibiBowater is in the same situation. The balance sheet there is very precarious. It really depends on the company.

box right now, but had a great balance sheet. This **Weyerhaeuser** acquisition, which is pending, is putting them in a fairly levered position all over again. The people who are upset with them for doing this deal are saying, "You essentially swapped trees for manufacturing, and I am not sure I like that trade." Longer term, I think that they are well positioned with good assets and a truly international company.

But there are other companies that need other people to do the heavy lifting for them frankly. **Smurfit-Stone** (SSCC) is the biggest in containerboard in North American for another couple of months, but they don't have the balance sheet to do much consolidation on their own. They need other people. **AbitibiBowater** is in the same situation. The balance sheet there is very precarious. It really depends on the company.

Mr. Roberts: I don't think that much further restructuring will come through M&A activity, but rather through capacity reduc-

1-Year Daily Chart of Smurfit-Stone



Chart provided by www.BigCharts.com

“What do the fundamentals look like right now for the US housing market three years out, five years out, seven years?” They don’t look bad. What we have is one heck of a case of indigestion with the unsold inventory of homes. No question that it is going to be bad through the end of 2009. However, I think that with lumber, we could see a potential replay of the steel cycle. We expect further capacity closures, with the inability to bring the capacity back at a later date due to fundamental fiber shortages in key regions of North America. When the housing market does eventually come back, I think that could be an interesting scenario with significantly higher lumber prices. That is one of the areas in which investors should be looking to build a position over time. The problem is that you don’t have too many pure plays there.

TWST: And it really is longer term.

Mr. Roberts: Well, what’s long term? Assume the recovery in housing is two years from now, and that stock prices reflect the environment prevailing 12 months in the future. This suggests that in about a year’s time from now, I want to have my position. Perfect timing is very difficult to get. We focus on the fundamentals. Do I like the product? Do I like the management team? Not all are created equal. Do I like the balance sheet? Well, the good news is that a number of the solid wood companies actually have good balance sheets. Now, their balance sheets may be bleeding due to the current cash losses, but management can control this to some extent through closures. My sense is that we are right on the cusp of another whole series of closures in the solid wood industry, whether it be OSB or lumber, and that’s good.

Mr. Chercover: It’s too bad you got Don and me for this panel because we are kind of singing from the same songbook.

TWST: That’s not all bad, so long as it is the right songbook.

Mr. Chercover: Maybe it’s more fun though to have diametrically opposed views, but I agree with Don. Longer term, I like exposure to wood products more than paper by and large for a couple of reasons. First of all, in the US, demographics suggest that we probably need more like 1.8 million housing starts annually to satisfy demand. For the past two to three years now, we have been running almost half of that. Long term, we do need wood products. At the end of the day, the facilities aren’t particularly capital intensive, certainly not compared to a paper mill.

While the demand is down, it is not like they are facing some kind of substitution from the Internet; there is no such thing as a virtual house. With global warming, igloos aren’t that viable either, so we are going to need a lot more homes. Other opportunities (and LP is pursuing this) are that to the extent that companies want to tout their green credentials, building homes the way that we do in North America out of lumber and structural panels is a lot more renewable (and tends to fare better in earthquakes too) than building them out of cinderblocks and concrete and rebar, as they do in South America, which requires mining and smelting and doesn’t grow back. I think

that our industry has a lot of potential long term on the solid wood side. It is as ugly as it has ever been right now, but it is not going to stay that way.

TWST: Steve, as you talk to the companies, are they seeing any signs of change yet?

Mr. Chercover: It has been 18 months already since people said we’d see the turn. They said they thought we would see the turn in the summer of 2007. Then it was going to be sometime in 2008. It’s kind of once bitten, twice shy. No one is willing to stick their neck out and say that they can see a turn now. I think that one of the things that we need fundamentally for housing to get back beyond just chewing through these inventories is for the psychology to change.

Right now, home prices are declining in the United States, and so buyers are staging what I call a buyer’s strike. They are sitting on their wallets and saying, “Why buy today what I can buy cheaper a month from now?” Mortgage markets are going to normalize. Credit will become available to homebuyers, which it really is not right now. And people are going to do the math and the cost of home ownership will at some stage trump renting, and people will step back into the market cautiously. *The Wall Street Journal* and *The Globe and Mail* will start to write about it and things will start to recover. People have to stop looking at their homes as part of their stock portfolio and expecting 20% returns, and just say, “I’ve got to live somewhere and if it appreciates by 4% or 5% a year, I am pretty happy with that.”

1-Year Daily Chart of Louisiana-Pacific



Chart provided by www.BigCharts.com

TWST: That is a change in thought process that may take a while.

Mr. Chercover: First of all, we write about recessions more often than they actually happen. Negative press can certainly sow the seeds of fear into the average person’s mind and negative press kind of becomes a self-fulfilling prophecy at some stage. Hopefully, in the next year or so, the positive press on the benefits of home ownership and some early signs of recovery will get people to put their toes back in the water.

Mr. Roberts: Just to reinforce Steve's point there, if you go through the entrails of the data, is there any positive news related to the housing market? In fact, there is. If you look at the absolute volume of unsold new single-family homes, it is on a steep downward path. It is down roughly 20% from its peak in July 2006. In spite of that, the months-of-supply of unsold new homes has stayed very high due to falling sales volumes. But the decline in sales volumes has masked the very real progress that is being made in reducing the absolute level of excess inventories. That is a hard number that you can point to.

TWST: Don, if we look back a year or two, there was a lot of interest in this space as asset rich companies. Is that still around or has that faded with the credit crunch?

Mr. Roberts: First of all, there is currently not as much money floating around as there used to be. The second is that there are not a lot of asset rich companies left; most have already been restructured, with the exception of **Weyerhaeuser**. **Weyerhaeuser** is still trying to pursue the TREE Act legislation in Congress and hoping that will come through. I think that the general M&A and the breakup stories have generally run their course. To the extent that we see deals out there done, it is going to be more asset sales as opposed to company sales.

TWST: Steve, do you see anything from this asset rich environment or is that pretty much behind us?

Mr. Chercover: I would have to pretty much agree with Don. I think that there is the potential for some smaller deals, but not the blockbusters that you have seen over the last few years. As I said a few minutes ago, most of these subsectors, or at least commodity groups, are getting consolidated to the point where you have to jump through some regulatory hurdles to get additional deals done. Sometimes, in my view, those hurdles are too high or they cause you to do some things that you might not want to do.

For instance, I believe that the Department of Justice was really unfair to **AbitibiBowater** when they made them sell Snowflake in an environment where they couldn't conduct competitive auctions. In my view, no one has a monopoly in the Southwest US. It was one of the only facilities, but it was a good one. I think that it was completely unfair to make them sell it. So I think that people will be reluctant to go and do deals where they are going to have to divest assets according to what some functionary in Washington or Ottawa says.

TWST: Steve, are there any regulatory issues that these companies are facing over the next couple of years that are of concern?

Mr. Chercover: There are the ongoing environmental challenges. From the public's perspective, we are glad that the industry has cleaned up its act and it has done wonders in a generation, but I think that the environmental ones are probably the biggest regulatory issues that the companies face right now. Going forward, their challenge is more in terms of whether they can justify their existence given the cost of fiber, fuel and everything else.

TWST: Don, is there anything that you see on the horizon that is worrisome?

Mr. Roberts: I think the carbon card is going to get played in North America within the next two years. We have already seen legislation go through the Senate in the form of the Lieberman-Warner bill. While this specific bill is unlikely to be passed, it demonstrates that a bipartisan agreement can be reached that provides the architecture for a cap-and-trade system. All three presidential candidates are also supporting some form of cap-and-trade system for carbon. I think that it is going to happen, and we have to figure out all the implications for investors in this space. Net net, we think the forest products industry is going to be a meaningful winner. By opening up the fields of bioenergy and biochemicals, it could well be the catalyst for changing "the nature of the game" for the forest products industry over time.

However, there is also some short-term downside. One of the things a price carbon will trigger is some interesting changes in different fossil fuel prices. Clearly, given coal has roughly double the carbon content of natural gas and 40% more than oil, you are going to see the big power guys move over to natural gas. Well, as soon as I see that, I see big increases coming in natural gas. And as soon as I see that, then I ask, "Okay, who is using it now? And who is vulnerable?" Already, for our clients we have identified two companies that are vulnerable: **AbitibiBowater** and **IP**. Relative to their comps, these two companies have a greater EPS sensitivity to changes in natural gas prices. That is one way in which you can think this through — identify the source of the shock and then trace through the logic.

1-Year Daily Chart of AbitibiBowater



Chart provided by www.BigCharts.com

Both Steven and I like the timber story. Having said that, I think that you will have some people get onto a bandwagon and say, "Given that growing trees sequesters carbon from the atmosphere, carbon is going to have a value, and therefore these timberlands are worth a lot more." You should maybe take a Valium before going down that road. I say that simply because when we actually implement carbon trading systems that incorporate carbon offsets, they reflect an

important concept called additivity. What this means is that it doesn't matter what you have done in the past; it's the incremental impact on carbon sequestration that counts. So, yes, **Weyerhaeuser** is growing a lot of trees and they sequester a lot of carbon, but they are not going to get credit for that; it's what you do in addition that matters. The bottom line is that we think the "carbon shock" is the next big issue on the horizon for this industry, and it has a wide range of implications.

TWST: Steve, as you talk with investors, what is the interest level, if any, that you are finding in the space?

Mr. Chercover: The stocks are pretty beaten up, and unfortunately I prefer to speak to investors who like to make money by buying stocks that go up. It's hard to really pound the table on some of these and say that they are going to go up any time soon. The other cadre of investors, who like to short stocks, are kind of starting to cover too. So things are kind of quiet right now. I think that a lot of these stocks are pretty beaten up, so we have to wait and see whether they can pull their operations out of a tailspin and make themselves work. We are almost in a bit of a no man's land.

and negative correlation to most stocks that make it attractive. But the bottom line is that there is a lot of money chasing not a lot of good at this stage, so they probably have some downside protection.

TWST: Don, are you finding any interest in the space at this juncture?

Mr. Roberts: There is some. By its very nature, this is a sector that tends to attract value investors. The problem is that a lot of the value investors got in at higher levels, and so they have tended to double-up as the share prices have fallen further. As a result, you no longer have this deep reservoir of new value guys to come in. Having said that, the calls that I am getting are more on the solid wood side generally. We have a franchise where we take very much a global perspective. So the guys are saying, "Well, tell me about these Chinese timber plays. What's going on there?" There are people doing their homework and there is interest. The phone isn't ringing off the hook, but there are incoming calls. Our reply back to them is that they may be a little early in terms of loading up on some of these names. The difficulty is that some of the best values are small caps, so you can't be too cute in your timing.

Roberts: I like Sino-Forest. It's essentially a China timber play. It's really a theme story in many respects — it's the fact that its operations are at the epicenter of this timber shortage. We think that real timber prices are at an inflection point where they are going to start going up again for 10-15 years. Sino-Forest has already experienced good growth. We see good growth prospects going forward.

In terms of valuations on assets like timberlands, Don's right. There has been a real Klondike mentality for the last few years and it is hard to see prices going a lot higher. People are locking in yields that appear to be 4%-5%, so you have to have a really long time horizon to want to bid up timber prices far north of where they are. The reason they have gone up so much in the last 10 years is because they weren't properly valued 10 years ago when people were saying, "I will do a discounted cash flow on the value of these trees, but I am not going to pay anything for any embedded auction for real estate (which has been a big, big driver) and maybe subsurface materials — aggregate, oil and gas." I think that pretty much has been priced into the asset class now. So, again, things are looking fairly priced and I am not sure if there is a big trade one way or the other.

One of the reasons that I still like timber in general is the finite nature of it. There are some attributes in terms of inflation hedge

TWST: So if you want to play, it is time to do your homework now?

Mr. Roberts: Absolutely. I would be doing my numbers now, very much so.

TWST: Is there anything on the horizon that is going to get these names moving?

Mr. Roberts: Clearly on the solid wood side, it's the housing numbers. Here is the chain of events that I expect to see. First of all, you had to see (which we have already seen) the absolute decrease in unsold inventories. Then you have to see the prices of housing drop, probably another 15%-20%. You have to get the affordability of houses in line. Then that will cause the home price to median income ratio to get back into line where it should be, so housing is more affordable. Once housing is affordable again for a broad audience, you are going to see the months-of-unsold-inventory drop. That has to happen before you see the new homes being built. I think

you want to be in these stocks before the new housing start numbers start to rise, because the stocks will have already run by then. Right now, I'm focusing a lot on home prices to see how they are falling. I need that to occur first.

Mr. Chercover: I also would say that housing is going to be important. While I also think that the best opportunities are in names like **Louisiana-Pacific** long term, ironically, when housing demand picks up and lumber production increases, the paper guys are going to benefit too because right now they haven't been able to get

interest ratio isn't bad. They can handle it. I also like, as I said before, the international exposure to the growth over time in Russia and Brazil.

LP is one company which must take steps to manage its cash losses. However, we like the long-term story and give the stock a Sector Outperform recommendation (in an Underperform Sector). Management has the ability to reduce the losses by shuttering more of its higher cost mills, and I think they are going to do more of that, which is good news.

Roberts: There is a smaller cap in Canada called International Forest Products. Interfor has a great balance sheet — 16% net debt to total capital. It is trading below 65% price to tangible book. When this recovery comes, this is a pure play and it will move well.

wood chips at almost any price. That will be one secondary benefit to the paper guys — to see housing pick back up.

TWST: Don, where are you pointing investors? Are there any names that you like at this point?

Mr. Roberts: I like **Sino-Forest**. It's essentially a China timber play. It's really a theme story in many respects — it's the fact that its operations are at the epicenter of this timber shortage. We think that real timber prices are at an inflection point where they are going to start going up again for 10-15 years. **Sino-Forest** has already experienced good growth. We see good growth prospects going forward. In addition, the company has a decent balance sheet. So I like **Sino-Forest**.

There is a smaller cap in Canada called **International Forest Products** (IFP:a:TSX). It's a lumber company. **Interfor** has a great balance sheet — 16% net debt to total capital. It is trading below 65% price to tangible book. When this recovery comes, this is a pure play and it will move well.

In the States, I find both **LP** and **IP** are interesting. **IP** because I think that the US South is a good place to be long term and they have an exposure there. Their product mix? Do I like uncoated free sheet? Well, not particularly. It's akin to newsprint once-removed. But **IP** does have the low-cost uncoated free sheet franchise. So while we expect further capacity closures in the industry, it is unlikely that it will be **IP**'s mills going down. I expect it will be other producers of UFS paper that have to participate in the next round of capacity closures. I recognize that **IP**'s balance sheet is getting a little more stretched due to the financing of its latest acquisition, and I am not delighted with that. On the other hand, while its net debt to capital ratio isn't great, its EBITDA to

1-Year Daily Chart of International Forest Products



Chart provided by www.BigCharts.com

I am not as positive on **Weyerhaeuser** right here. I think that it is probably valued where it should be. Is there real value in the timberland? Yes, though I am skeptical that there is a high probability it is an "event play" — that it is going to be broken up.

TWST: Steve, who do you like, if anybody, at this juncture?

Mr. Chercover: I will finally get a chance to disagree a bit with Don, but I too like **Louisiana-Pacific**. I like the assets that they have on the ground. Not that you would want to build a brand new **Louisiana-Pacific**, but you couldn't build it for \$25 or \$30 a share, so at \$12 I think it looks interesting. They do have the balance sheet to stick around. The dissipation of cash is troubling, but they have actually been building some new capacity, both to satisfy the next cycle in North America and also exposure in South America, where

I alluded to the benefits of the way that we build homes and an increasingly affluent middle class down there.

With respect to **Weyerhaeuser**, we both like timber as an asset class. I do think that **Weyerhaeuser** will see the conversion through. I think that the genie is out of the bottle and they have to do something or someone on the Street will force their hand. They have some shareholders who have been writing letters, but they haven't been that vocal as of late. It takes a long time to get these things done, but they are literally the last of the Mohicans here. The TREE Act, in my view, is not going to be enough for **Weyerhaeuser**. They are still going to have to change their structure. A change in the tax code is kind of a transitory thing that can be taken away, but the corporate structure is probably more permanent, although in

TWST: Steve, are there any names in your space that worry you, that are falling behind or not taking the right steps to survive here?

Mr. Chercover: Probably when both Don and I leave, we will finish off our models and notes on **AbitibiBowater**. I am still concerned there. Bad things happen to good people, and these aren't bad people but their industry is the poster child for a grade that is in secular decline. Newsprint declined by 15% in March and it had five Sundays. I think that the declines that you have seen in readership and circulation over the last 10 years might only be accelerating for a company that has a very highly levered balance sheet and survived a near-death experience on April Fool's Day, trying to refinance just a small portion of their debt. I am nervous there.

Roberts: *A name out there I am concerned about is Canfor Corporation, one of the largest lumber producers in North America. We liked lumber longer term, but we have to be careful when picking individual companies. Canfor is one of the companies that we expect will be forced to make significant capacity closures in the future. I still see about a 20% downside on that stock.*

Canada I suppose you have seen the income trusts suffer a blow as the government tried to stem that.

The other way to look at **Weyerhaeuser** beyond just the timber asset class is that if you are a deep value guy, you can say, "Well, I am getting exposure to both building materials and homebuilders here as well." So if I am a contrarian or deep value investor, I am getting exposure to both of those asset classes plus the second biggest and very well managed timber business. But if you look at precedent transactions, such as **Rayonier** (RYN), Longview Fibre (which is now private), and **Potlatch** (PCH), the conversion from a C-Corp to a REIT has been a very shareholder-friendly experience.

TWST: Are we going to see more of that then?

Mr. Chercover: No, I don't think so, because I think that **Weyerhaeuser** is the last one to play. **MeadWestvaco** (MWV) has a small, small timberland presence going forward. They are not in a position to convert to a REIT. They wouldn't pass the asset test. That is why at the end of the day, I think that **Weyerhaeuser** has been selling off divisions like white paper to **Domtar** and recently containerboard to **IP**. That is in part because as a portfolio asset, they weren't earning their cost of capital. The subtext is also probably to ultimately have the right ratio of timberlands to manufacturing to convert to a REIT.

1-Year Daily Chart of Canfor



Chart provided by www.BigCharts.com

TWST: Don, are there any names that worry you a lot?

Mr. Roberts: This is disconcerting when there is consensus like this. **Abitibi** is a concern. They are not out of the woods.

Another name out there I am concerned about is **Canfor Corporation** (CFP:TSX), one of the largest lumber producers in North America. We said that we liked lumber longer term, but we also said that we have to be careful when picking individual companies. **Canfor** is one of the companies that we expect will be forced

to make significant capacity closures in the future. I still see about a 20% downside on that stock.

TWST: Steve, is there anything else that we should touch on?

Mr. Chercover: This has been a really interesting dialogue and it was fun to do it with Don. I find it fascinating how the discussion of the paper and forest products industry focused at least half of our time on energy and the potential for our guys to take a problem and turn it into a solution. When you have lemons, find a way to make lemonade. I think that it is interesting how the conversation morphed in that direction. I believe that that is something that investors should focus on and be cognizant of those that can benefit from this trend.

Mr. Roberts: My sense is that we may have a selection bias with just Steve and myself. I am not at all convinced that this is the overall consensus among analysts (which may be a good thing from our point of view). It would have been interesting to see a different group of analysts. You are seeing two guys who are not in New York, and maybe that is one difference as well.

TWST: Thank you.

Note: Opinions and recommendations are as of 5/13/08.

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