



CIBC
World Markets

Sector: Paper & Forest
Products

Sector Weighting: Under
Weight

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Global Trends in The Forest Products Sector:

China's Boom
Vancouver, B.C.
January 18, 2006

See "Price Target Calculation" and "Key Risks to Price Target" sections at the end of this report, or at the end of each section thereof, where applicable.

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Outline

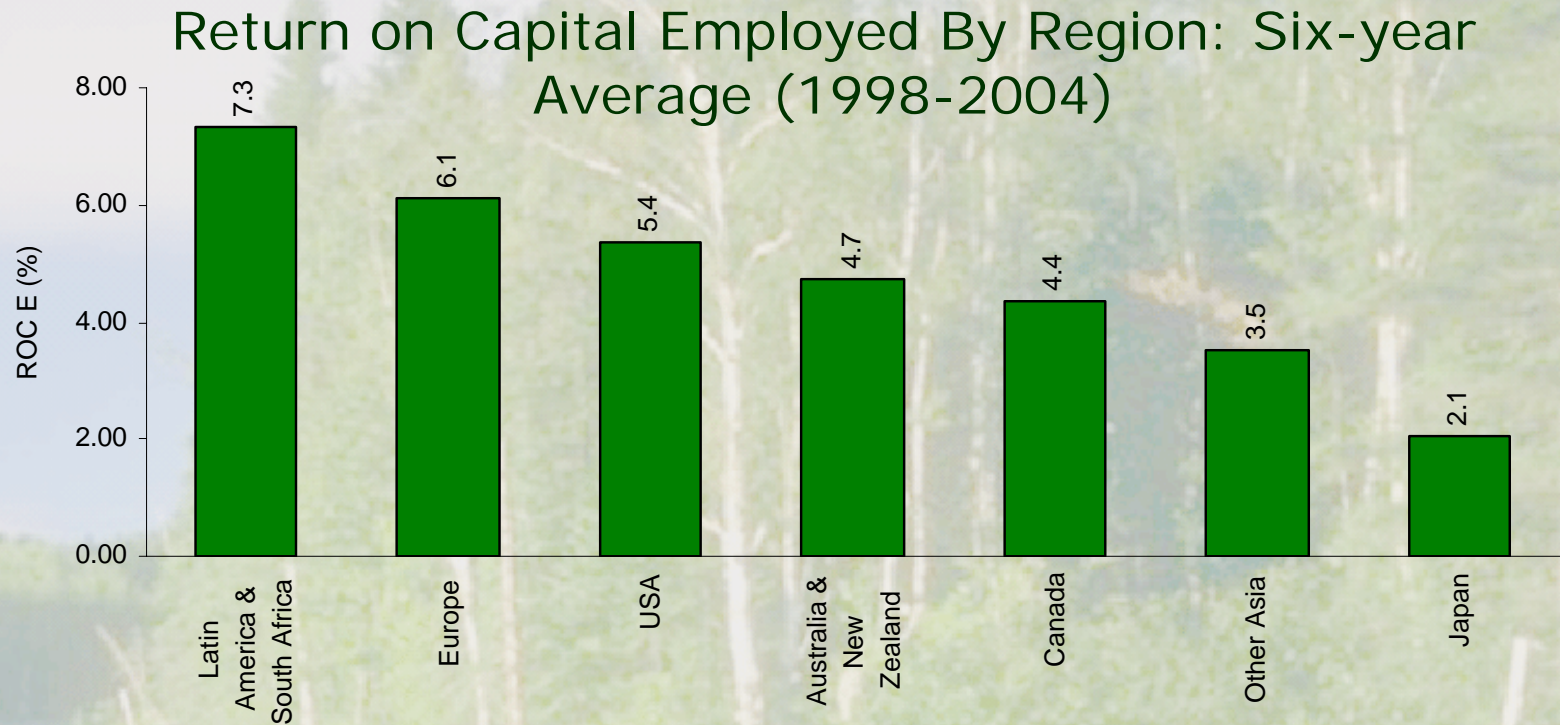
Financial Performance

Changes in the Global Environment:

1. Consolidation
2. Wood Supply
3. Energy
4. Exchange Rates
5. Paper Demand
6. China

Points to Ponder

Financial Performance



Source: PricewaterhouseCoopers, CIBC World Markets.

- The cost of capital is roughly 10%-13%, but even the most profitable region has only generated an average ROCE of 7%, with the very best companies at 12%-15%.
- The average ROCE in North America is in the 4%-6% range. The markets are saying "take capital out of the forest products industry" – we must compete against other industries.
- Problem? Few barriers to entry, but significant barriers to exit.

3

Is this inevitable due to private use of a public resource?

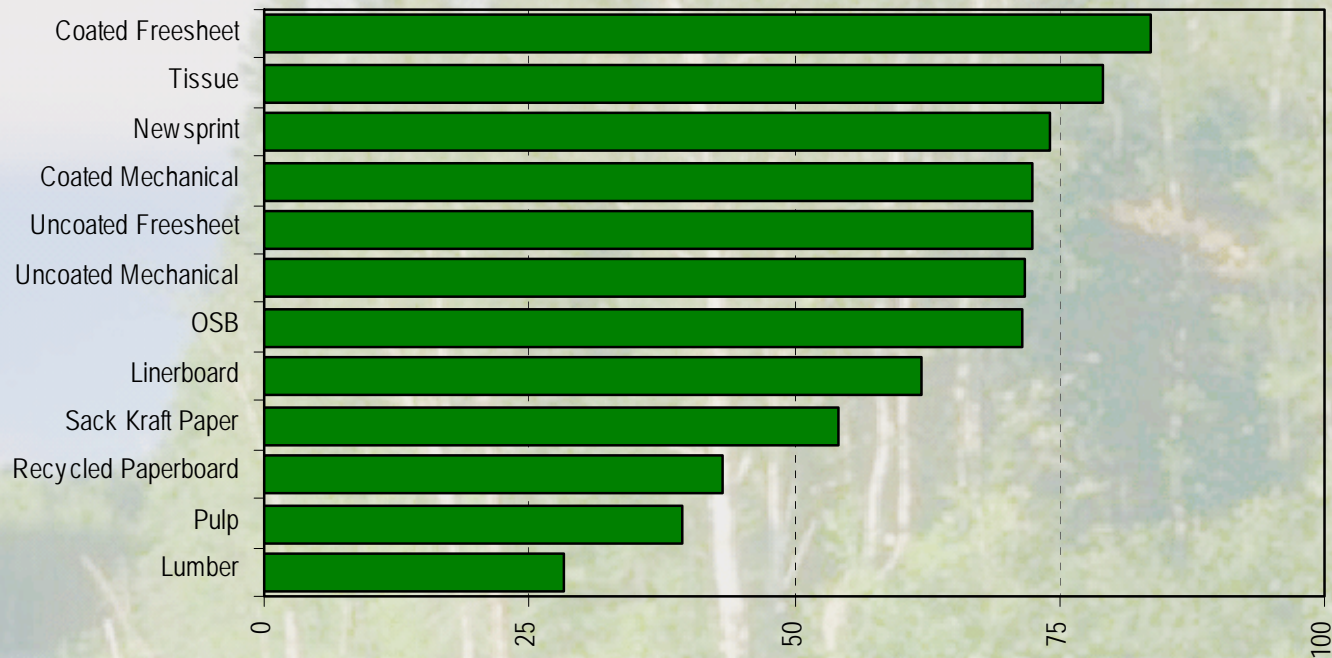
Changes In The Environment

We focus on 6 changes in the global environment:

1. Increasing industry consolidation.
2. Increasing global wood supply.
3. Decreasing supply of low-cost energy.
4. Depreciation of the US\$.
5. Decreasing “paper intensity”
6. Emergence of China – customer or competitor?

1 Industry Consolidation

Market Share Of Top Five Producers In North America - 2004



Source: Paperloop, Pulp & Paper Factbook, CIBC World Markets.

- **After significant consolidation, the top five producers of most products now account for 70% or more of North American capacity.**
- **Lumber and pulp clearly stand out as the two least concentrated – just below 30% and 40%, respectively.**

1 Industry Consolidation

U.S.

International Paper

~~Georgia-Pacific~~

Weyerhaeuser

~~Union Camp~~

~~Fort James~~

Westvaco

~~Mead~~

~~Blandin~~

Bowater

~~Boise Cascade~~

~~Consolidated Papers~~

Smurfit Stone

~~Stone Container~~

Temple-Inland

~~Champion~~

Willamette

~~Gaylord~~

Canada

Abitibi

~~Donohue~~

~~St. Laurent~~

~~Alliance~~

Tembec

~~MacMillan Bloedel~~

~~Avonor~~

Domtar

~~Pacifica Paper~~

Norske Skog Canada

Canfor

~~Slocan~~

West Fraser

~~Weldwood~~

Tolko

~~Riverside~~

Europe, Africa and Asia

Amcor

April

APP

~~AssiDomain~~

~~Fletcher Paper~~

Nippon Paper

~~AWA~~

~~ENGE~~

~~Haindl~~

Mitsubishi Paper

Norske Skog

~~Carter Holt Harvey~~

Jefferson Smurfit Group

Oji Paper

~~Enso~~

~~Soporcel~~

Portucel

Stora

SCA

Burgo

Sappi

UPM

~~Kymmene~~

D.S. Smith

M-Real

Major changes since 1990, and the list is not complete

1 Industry Consolidation

Economics (not egos) is driving consolidation:

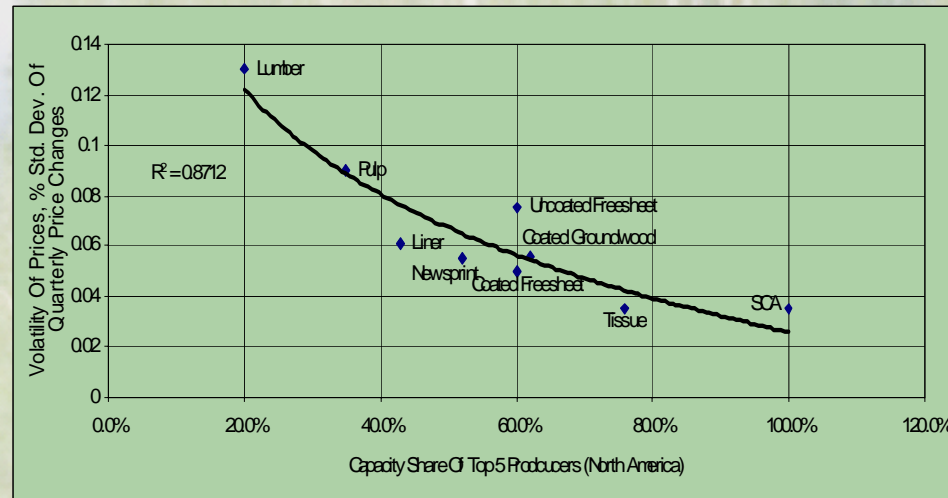
- Lowers operating costs – synergies, best practices over larger asset base (roughly 9% savings in target's CGS).
- Capital avoidance – cheaper to buy than build.
- Lower cost of both debt and equity capital.
- Economies of scale in R&D and marketing, and potential counterweight to large customers.
- Facilitates rationalization – easier to remove redundant assets in an industry with excess capacity.
- May result in greater stability in commodity prices.

.....but there can also be

- Diseconomies of scale – “X inefficiency.”

1 Industry Consolidation

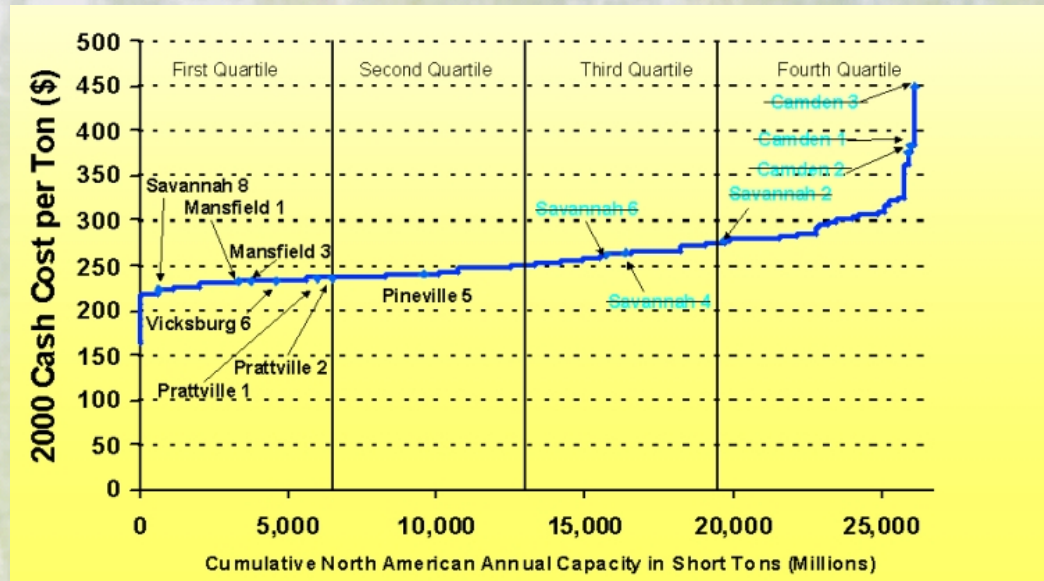
Industry Concentration In North America Versus Commodity Price Volatility, By Product



Source: Paperloop, CIBC World Markets.

- The data suggest greater consolidation may result in greater price stability.
- Higher average prices are unlikely due to “flatter cost curves,” productivity improvements, substitution between grades and regions, lack of barriers to entry.

1 Industry Consolidation



Linerboard Case Study

Source: International Paper, CIBC World Markets.

- IP bought Federal, Union Camp & Champion – closed roughly 1 million tons of high-cost linerboard. Added at least 700,000 tpy at low end of the curve through machine specialization & leveraging best practices.
- Weyerhaeuser bought MB and Willamette – closed roughly 750,000 million tons. This was completely offset by increases in productivity – dramatic increase in creep.
- Large M&A deals have resulted in a flattening of the industry curves.
 - Lower prices at both the peak and trough of the cycle?
 - Exchange rates playing a bigger role in determining relative costs across countries.

Mill Closures

Canadian Pulp & Paper Mill/Machine Closures: 2003 - 2005

| Mill | Province | Product | Capacity | Job Loss | Status | Province Total Job Loss |
|--|---------------|------------------|----------|----------|------------|----------------------------|
| Domtar, New Westminster | BC | Coated Paper | 45,000 | 80 | Permanent | |
| NorskeCanada, Port Alberni | BC | Newsprint | 140,000 | 200 | Indefinite | |
| Western Forest Products | BC | Kraft Pulp | 275,000 | 323 | Permanent | |
| Port Alice Specialty Cellulose, Port Alice | BC | Specialty Pulp | 160,000 | 350 | Indefinite | 953 |
| Weyerhaeuser, Prince Albert | Saskatchewan | Kraft Pulp | 130,000 | | | |
| Weyerhaeuser, Prince Albert | Saskatchewan | UFS | 280,000 | 690 | Permanent | 690 |
| Fraser Papers, Edmunston | New Brunswick | Boxboard | 55,000 | 75E | Permanent | |
| Smurfit-Stone, Bathurst | New Brunswick | Containerboard | 220,000 | 270 | Permanent | |
| St Anne Nackawic, Nackawic | New Brunswick | Kraft Pulp | 260,000 | 400 | Indefinite | |
| UPM-Kymmene, Miramichi | New Brunswick | Kraft Pulp | 240,000 | 400 | Permanent | 1,145 |
| Abitibi-Consolidated, Grand Falls | Newfoundland | Newsprint | 65,000 | 75 | Permanent | |
| Abitibi-Consolidated, Stephenville | Newfoundland | Newsprint | 195,000 | 300 | Permanent | 375 |
| Interlake Paper, St. Catherines | Ontario | Tissue | 10,000 | 48 | | |
| Tembec, Kapuskasing | Ontario | Newsprint | 75,000 | 65 | Indefinite | |
| Weyerhaeuser, Dryden | Ontario | Fine Paper | 155,000 | 80 | Permanent | |
| Bowater, Thunder Bay | Ontario | Newsprint | 140,000 | 100 | Indefinite | |
| Smurfit-Stone, Thunder Bay | Ontario | Containerboard | 140,000 | 100 | Permanent | |
| Weyerhaeuser, Sturgeon Falls | Ontario | Containerboard | 95,000 | 125 | Permanent | |
| Norampac, Red Rock | Ontario | Containerboard | 135,000 | 135 | Permanent | |
| Neenah Paper, Terrace Bay | Ontario | Kraft Pulp | 125,000 | 140 | Permanent | |
| Norampac, Red Rock | Ontario | Kraft Linerboard | 150,000 | 150 | Permanent | |
| Domtar, Ottawa | Ontario | Fine Paper | 60,000 | 185 | Permanent | |
| Abitibi-Consolidated, Kenora | Ontario | Newsprint | 90,000 | | Permanent | |
| Abitibi-Consolidated, Kenora | Ontario | Newsprint | 150,000 | 250 | Permanent | |
| Cascades, Thunder Bay | Ontario | Fine Paper | 175,000 | 525 | Permanent | |
| Domtar, Cornwall | Ontario | Fine Paper | 240,000 | | | |
| Domtar, Cornwall | Ontario | Kraft Pulp | 140,000 | 910 | Permanent | 2,813 |
| Mohawk Pulp, St. Antonin | Quebec | Ground Pulp | 15,000 | 60 | Permanent | |
| Bowater, Donnacona | Quebec | Specialties | 105,000 | 75 | Permanent | |
| Cascades, Cap de la Madeleine | Quebec | De-inked Pulp | 125,000 | 75 | Permanent | |
| Cascades, St. Jerome | Quebec | Fine Paper | 7,000 | 100 | Permanent | |
| Spexel, Beauharnois | Quebec | Specialties | 16,000 | 120 | Permanent | |
| Tembec, St Raymond | Quebec | Specialties | 70,000 | 165 | Permanent | |
| Smurfit-Stone Container, New Richmond | Quebec | Containerboard | 210,000 | 295 | Permanent | |
| Domtar, Quevillon | Quebec | Kraft Pulp | 300,000 | 425 | Indefinite | |
| Abitibi-Consolidated, Port Alfred | Quebec | Newsprint | 400,000 | 650 | Permanent | 1,965 |

Source: Canadian Paper Analyst, CIBC World Markets.

- Since 2003, over 7,000 jobs have been lost across Canada due to the closure of pulp/paper mills – over 75% of the losses were in Eastern Canada
- The losses have been almost equal in Ontario, Quebec and the Maritimes.

2 Wood Fibre

Average Delivered Softwood Pulp-fibre Prices For Q3/05 (US\$/ODMT)



Source: Wood Resources International.

- **Canada is at both ends of the curve when it comes to fiber costs for the pulp & paper producers – highest in Eastern Canada, and lowest in Western Canada**
- **Delivered wood costs are especially high in Ontario and Quebec, and it's not due to stumpage**
 - **Harvest costs roughly 50% higher in Ontario/Quebec than in B.C. Interior.**
 - **Hauling & road costs in Ontario are roughly 45% higher than in Quebec, 80% higher than in B.C. Interior, and 120% higher than in the Prairies.**

2 Wood Fibre

- Mountain Pine Beetle will have a long-term effect on BC fibre supply
 - 2004: 280 million m³ of timber attacked
 - 2009 projection: >600 million m³ of timber attacked – over 3 times Canada's total annual harvest
 - AACs being increased to salvage attacked timber – some areas by up to 30%
 - Favourable impact in the short-term
 - B.C. chip prices will likely fall another US\$10/ODMT
 - AACs expected to later fall to below pre-MPB levels
 - Looming closures of both sawmills and pulp mills – if you can't make money now, what will happen then?

2 Wood Fibre

Quebec is reducing its softwood harvest by 5 million m³ (20%)

Impact?

- Lumber:
 - maximum decrease of 1 BBF,
 - 0.8 BBF decrease more likely (13 sawmills)
- Chips:
 - max decrease of 1.0 million ODMT,
 - Gov't asserts full physical shortage can be mitigated, but at what cost?
 - 700,000 ODMT decrease more likely

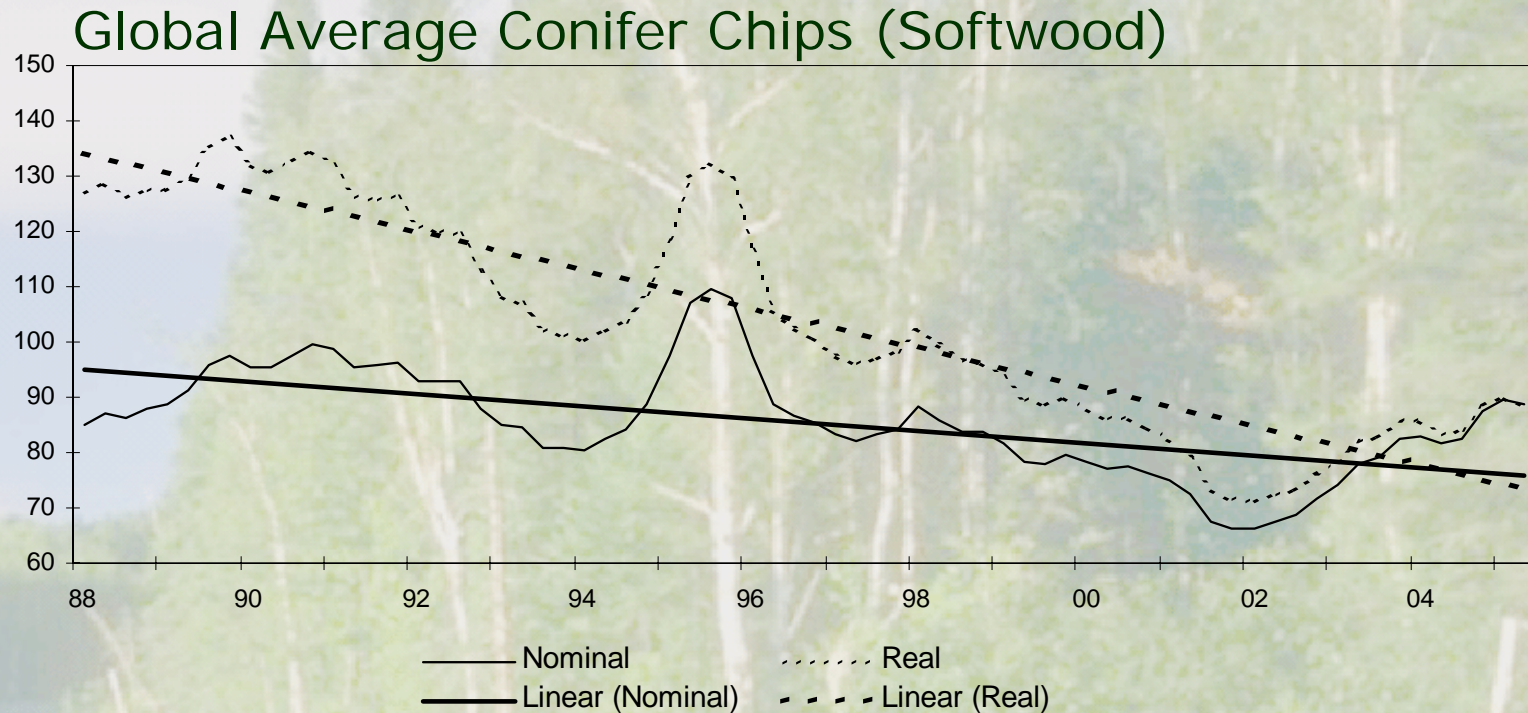
2 Wood Fibre

- Given 1 million ODMT softwood chip shortfall
 - 15% reduction in the Quebec softwood chip supply
 - 7% reduction for Eastern Canada.
- Chip prices expected to rise even further next year
 - +US\$15/ODMT to US\$160/ODMT?
- Even higher fiber costs add one more “nail in the coffin” – especially in Ontario (since it’s a regional chip market).

2 Wood Fibre

- 15 mills identified as “high risk” in Eastern Canada
 - 7 of these produce 1.6 million tonnes of newsprint/uncoated groundwood
 - Consume roughly 5 million ODMT of chips
- If closures occur, chip prices will fall and the survivors will be more competitive. Chips back to US\$100/ODMT – a 35% decline?
- Now is the time to start scouting for opportunities.

2 Wood Fiber

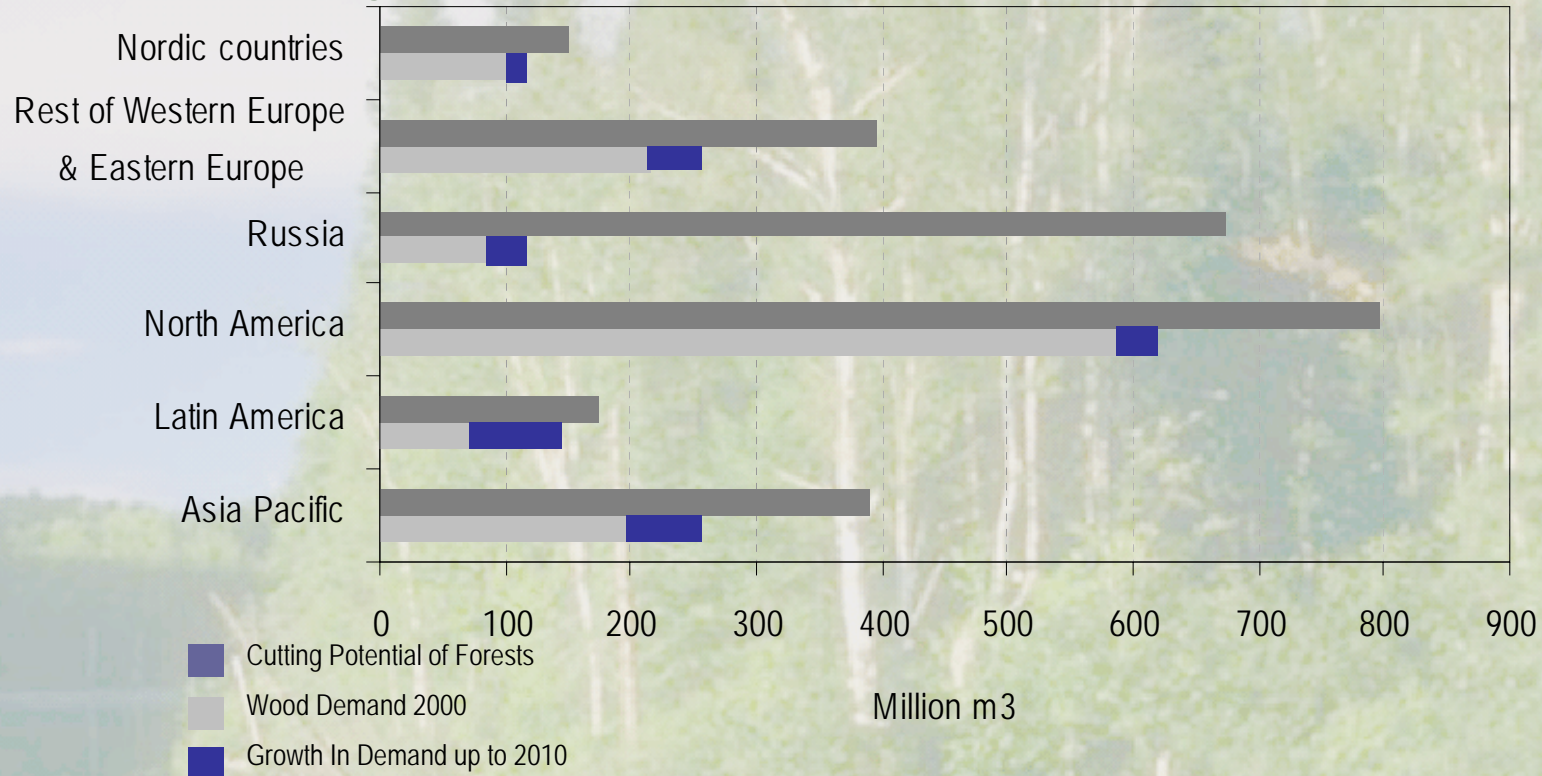


Source: Wood Resources, CIBC World Markets.

- **Real wood prices are on a secular decline. This suggests that virgin wood fiber has become less economically scarce over time.**
- **Will the downward trend continue?**

2 Wood Fiber

Regional Growth In Fibre Vs. Annual Demand



Note: Tropical Natural Forest excluded.
Source: Jaakko Poyry Consulting.

• **Russia is likely the biggest “wild card” wrt wood supply (but is 30-50% of the harvest is illegal?)**

- **China and Eastern Canada are short of wood, but every other major region is growing more than it is using – wood prices are expected to continue to decline.**

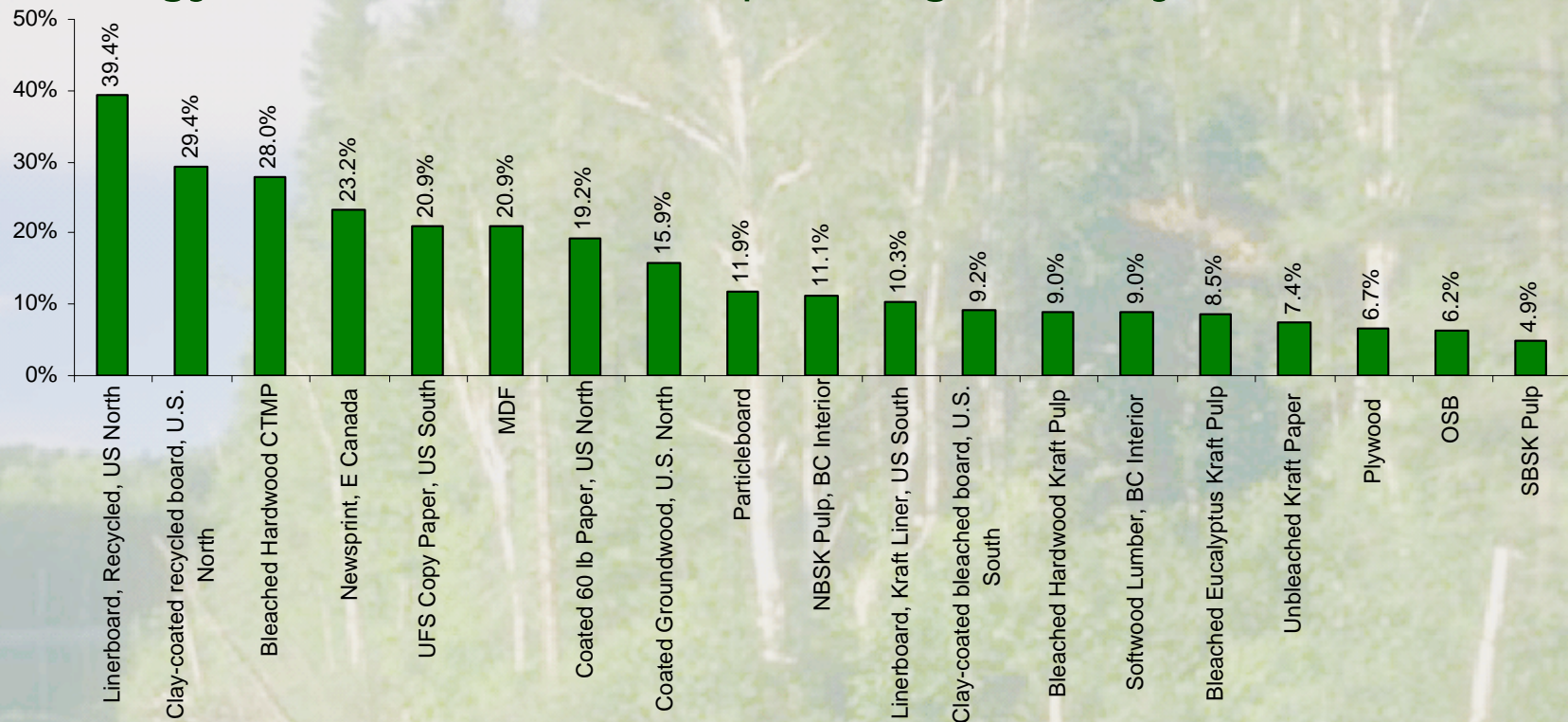
2 Wood Fibre

- **Implications of declining prices for wood fibre:**

- Due to the competitive nature of markets, the costs and prices of forest products will tend to continue to decline.
- Stumpage price earned by governments on their sale of public timber will be reduced over time.
- The value of timberland will tend to decline – time to sell?
- More difficult for industrial forest producers to compete with alternative uses (e.g., recreation/wild life in Canada; soya bean and cattle production in Brazil).

3 Energy

Energy As % Of Mill Gate Operating Cost, By Product (2004)

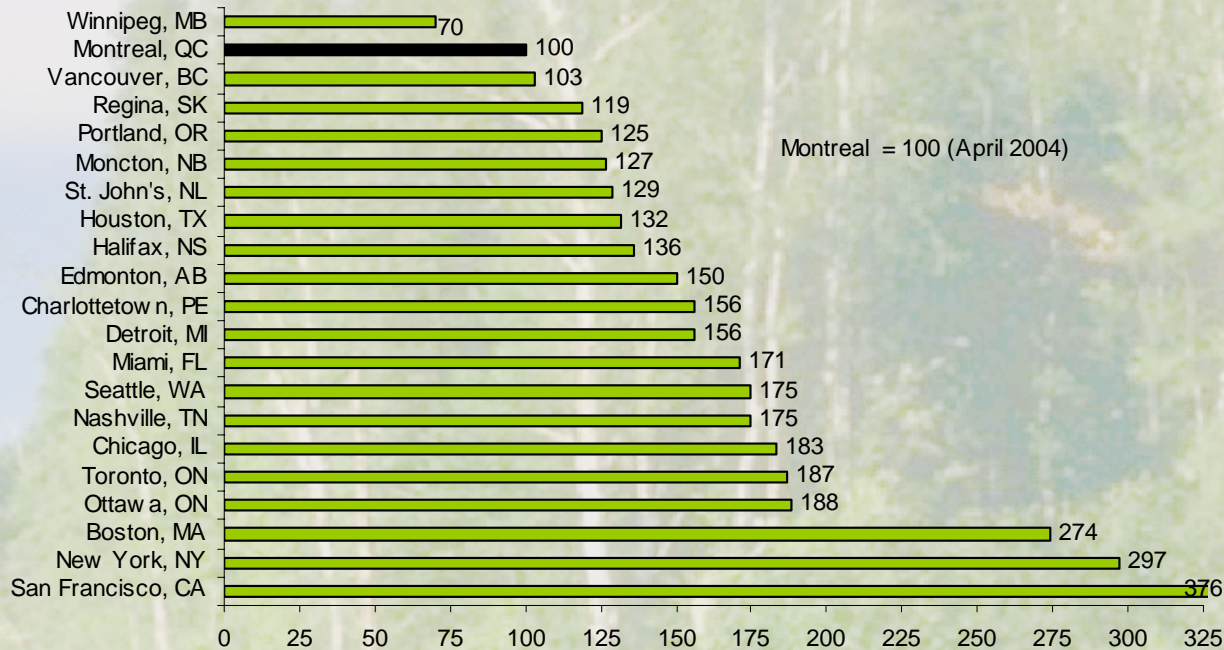


Source: RISI, CIBC World Markets.

- We expect a secular increase in real energy prices.
- Paperboard mills (especially recycled-based) are most exposed to energy.
- Solidwood producers among the least exposed to higher energy prices.
- Most kraft pulp mills can technically be net suppliers of energy.

3 Energy

Comparative Index Of Electricity Prices For Large Power Customers



Source: Hydro Quebec, CIBC World Markets.

- **With the exception of Ontario, electricity prices in Canada are still relatively low.**
- **Inexpensive electricity is especially beneficial for newsprint/groundwood paper & CTMP.**
- **A \$10/MW-hr rise in electricity prices increases costs in the typical mill by: \$25/tonne for CTMP pulp, \$20/tonne for newsprint, \$3/tonne for NBSK pulp and \$2/Mbf for lumber.**

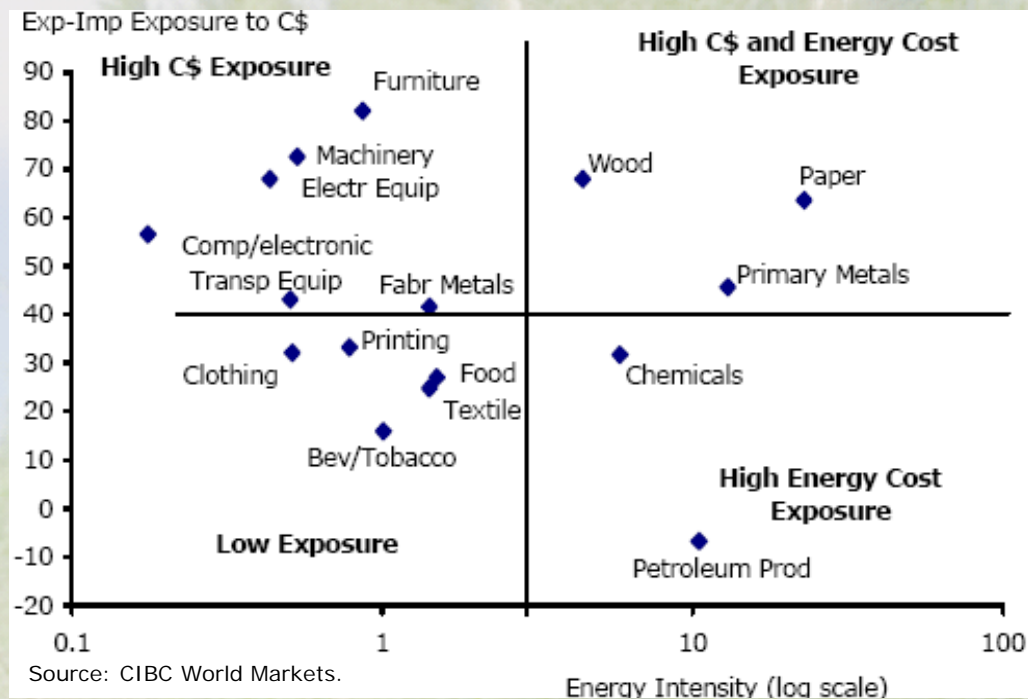
4. Exchange Rates

Expect:

- A secular depreciation of the US\$ due to the twin budget and trade deficits
- A a secular appreciation in the yuan and rouble.

4 Exchange Rates

Sectoral Exposure to C\$ and Energy Costs



- **US\$ has fallen because of concerns over U.S. trade and budget deficits.**
- **Now the C\$ is acting like a “Petro-currency”higher energy prices lead to stronger currency, which leads to less competitive manufacturing.**
- **Within Canada, the Paper and Forest Products industry is arguably the most vulnerable to the “Dutch Disease.”**

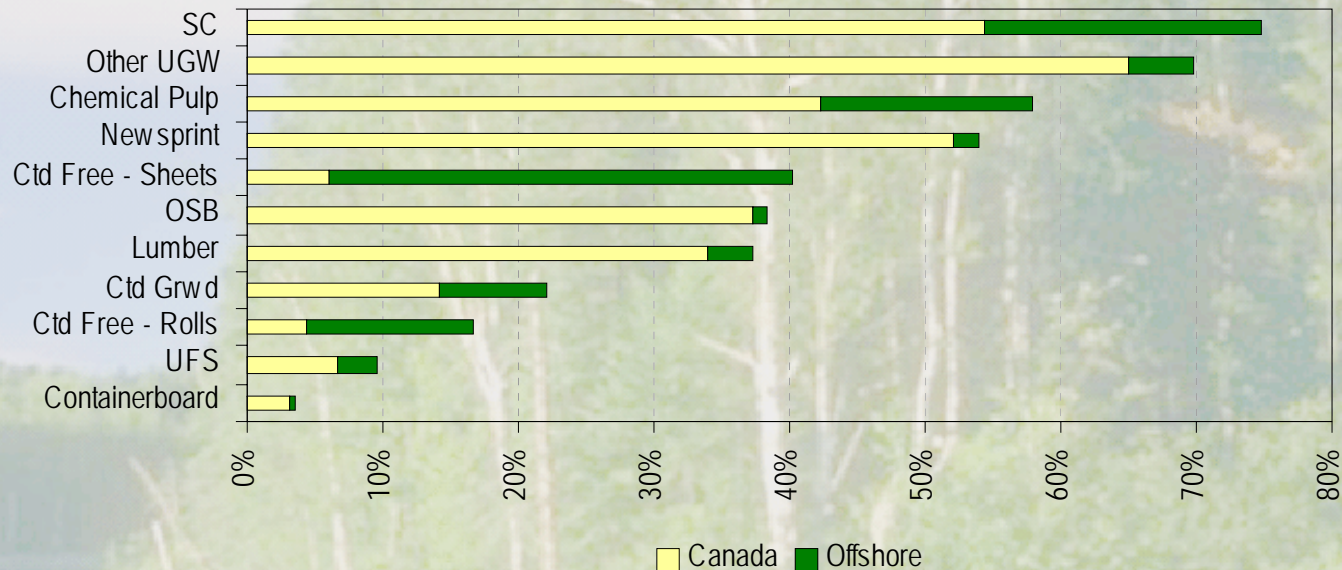
4 Exchange Rates

A stronger C\$ has multiple impacts on the industry:

- Increases the relative cost of producing in Canada –
 - Since Jan. 2001, the US\$ cost up roughly 30% due to the stronger C\$
- Given most products are sold in US\$, it reduces the C\$ revenue: e.g., since Jan. 2001
 - Newsprint prices up 3% in US\$, but down roughly 20% in C\$
- Makes it relatively cheaper for Canadian firms to buy assets in the U.S. (and an incentive for U.S. firms to sell their assets in Canada).

4 Exchange Rates

Share Of U.S. Paper & Forest Products Demand Supplied By Imports



Source: CIBC World Markets.

- **Products for which imports from Canada satisfy more than 1/3 U.S. demand are uncoated groundwood papers, pulp, newsprint, OSB, and lumber – these prices experience the greatest “cost-push” effect on US\$ prices as the US\$/C\$ rises.**
- **Expect little positive feedback on the prices of UFS and containerboard as the C\$ strengthens.**

Impact of US\$/C\$ on the Cost Curve

Given the Canadian mills generally started near the top of the cost curves, the stronger C\$ causes the curves to steepen.

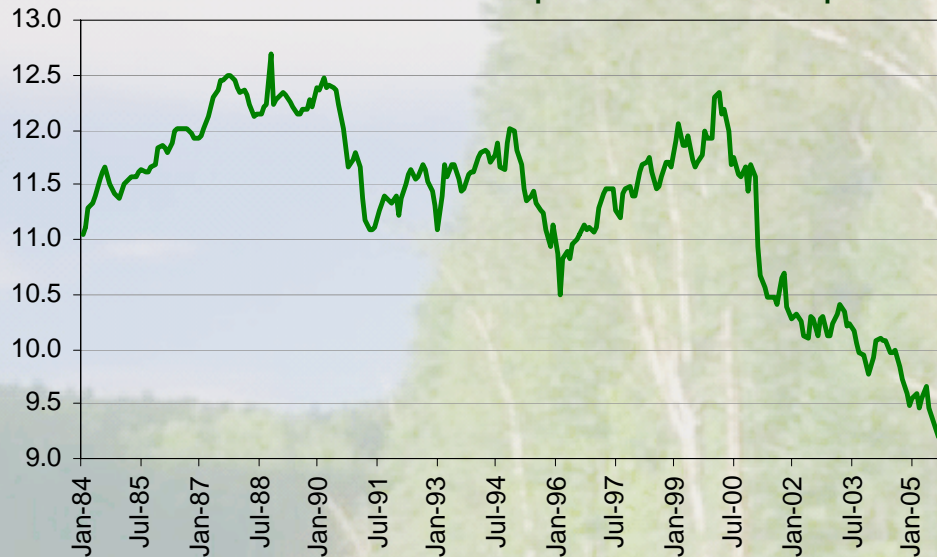
Fourth quartile cost/First quartile cost when C\$ moves from \$0.75 to \$0.95?

- Newsprint: 1.22 to 1.37
- Pulp: 1.51 to 1.60
- No big impact on other grades – Canada is too small

Marginal cost of the industry rises when the C\$ rises.....cost push on prices.

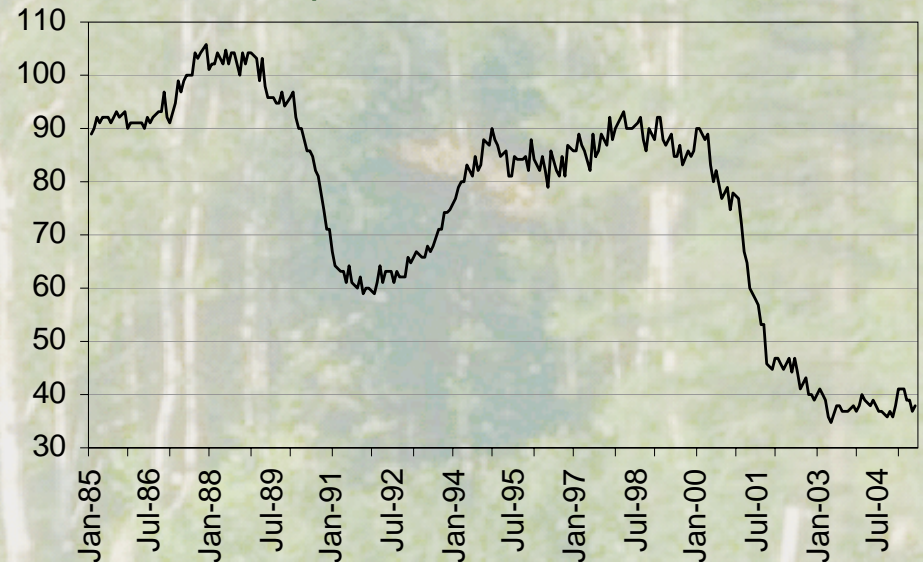
5 Paper

SAAR Total U.S. Newsprint Consumption



Source: PPPC

Help-Wanted Index

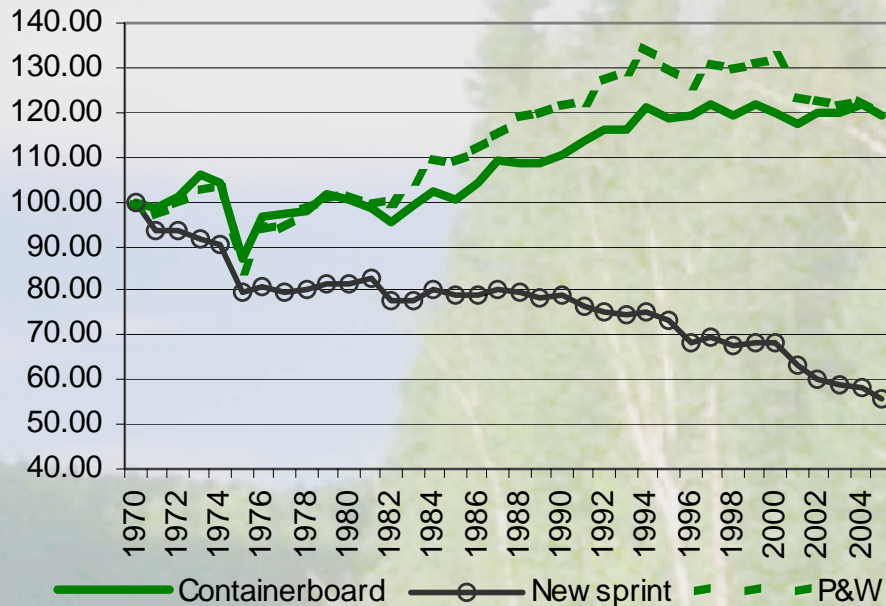


Source: The Conference Board

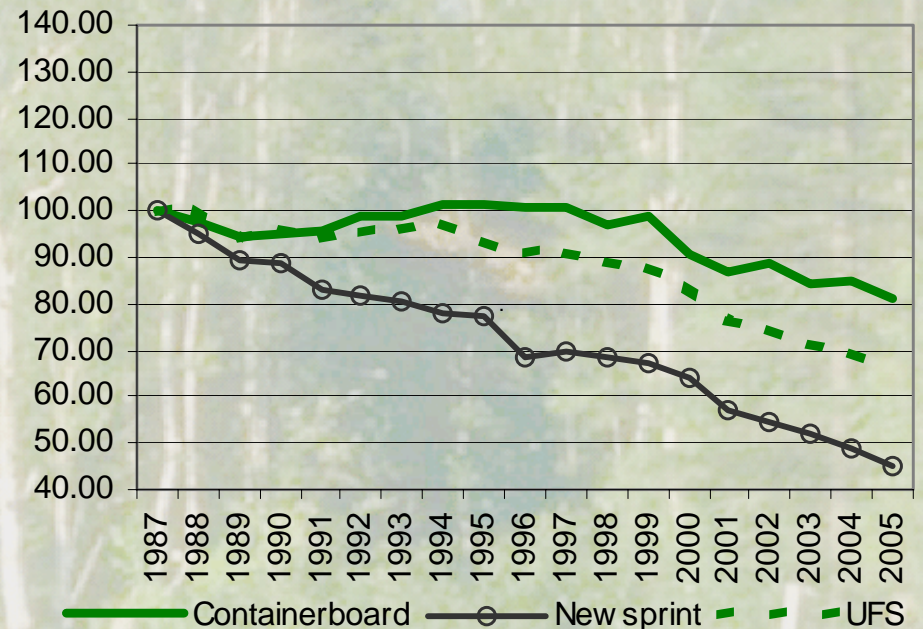
- The consumption of newsprint in North America is on a secular decline.
- In order to balance supply with the falling demand, the industry has already reduced N. Am. newsprint capacity by roughly 18% since 2000. Most of the decline has been in Ontario and Quebec.
- Will the other paper grades follow? – we think so.

5. Paper

Global Consumption Per Unit of Real GDP



N.American Consumption Per Unit of Real GDP



Source: RISI

Source: RISI

- The “intensity of consumption” has been declining for newsprint in both the N. American and global market.
- Same has occurred for UFS paper – the dominant grade of printing & writing paper – since the early 1990s.
- Containerboard is holding its own on the global level, but not totally immune in N. America.
- The paper industry’s problem is a basic supply/demand imbalance.

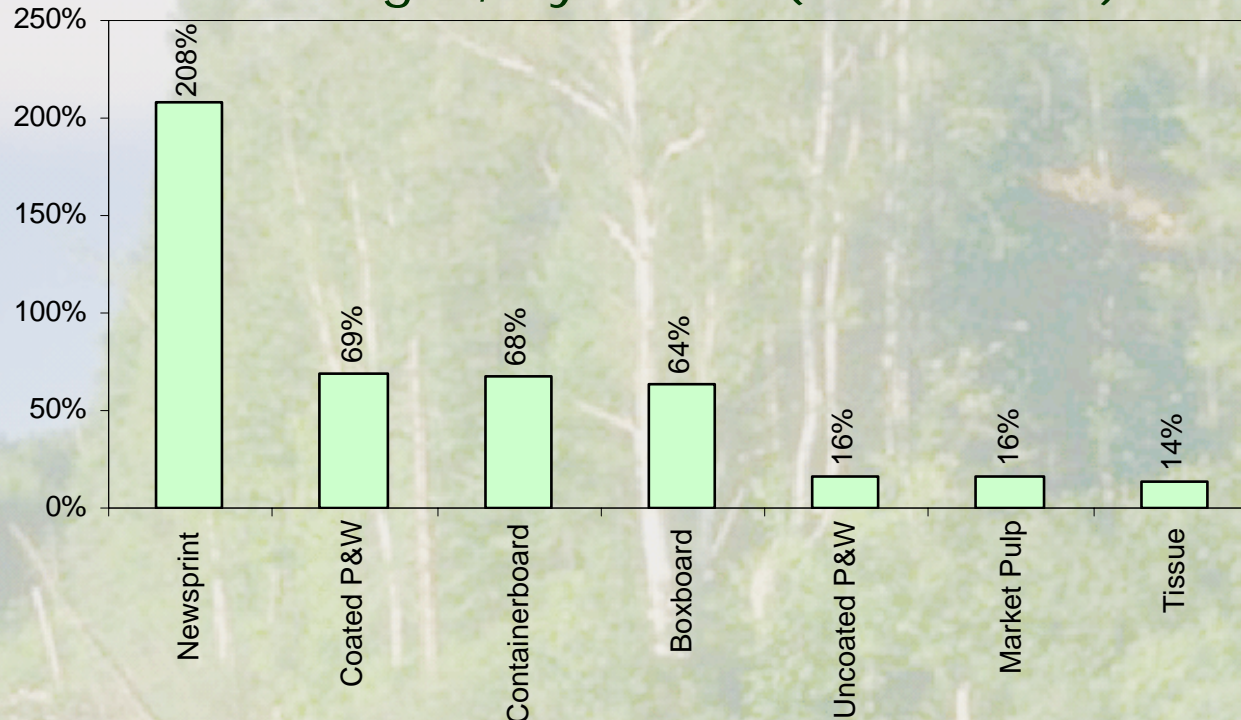
6 Emergence Of China

What distinguishes the Chinese paper & forest products sector?

- Large by international standards:
 - 2nd largest in global production and consumption.
 - Harvests 365 million m³/year – significantly higher than Canada (but industrial harvest only about 450 million m³/year).
 - Produces 43 million Tpy of paper & p.board - > 2x Canada.
- Short of wood fiber
 - Only 40% self-sufficient in industrial timber.
 - Big pulp producer, but 80+% from non-wood fiber (with pollution and water concerns).

5 Emergence Of China

Chinese As A % Of Global Confirmed Capacity Changes, By Grade (2004-2007)



Source: NLK, CIBC World Markets Corp.

- **Going forward, China will become even more dominant in driving changes in global capacity.**
- **Produced roughly 40 million Tpy of paper & paperboard in 2003 – target of 50 million Tpy-60 million Tpy by 2010 (i.e., 20%-50% increase).**

5 Emergence Of China

- Is China a customer or a competitor for Canada?
- It depends:
 - Market pulp – a customer
 - Paper – both a customer & competitor
 - Solidwood – both a customer & competitor
- ... We need to better understand the global market in general, and view China/India/Russia in an integrated fashion.

Points to Ponder

- Given a myriad of structural changes in the market, empirical analysis based on historical data is very difficult.
- The forest products industry is characterized by significant barriers to exit, but few barriers to entry.
- The scope for inter-grade, inter-product, and inter-regional substitution is significant.
- There is no global shortage of fiber, and a secular decline in fiber costs puts downward pressure on prices.
- Given the new environment, essentially every labor agreement in N. America must be reassessed – expect labor turmoil.

Points to Ponder

- The pulp & paper segment is very capital intensive, but the industry has been marginalized in the capital markets.
- There are economies of scale in the capital markets, and in R&D and market development.
- The industry must “redefine the game”.....Ultimately, the answer likely lies in new products and new markets.
- The current industry model is broken - even the “competitive regions” are not earning their cost of capital.

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Abitibi-Consolidated Inc. (2a, 2d, 2e, 2f, 2g, 6a) (A-TSX, C\$4.93, Sector Outperformer)

Bowater Inc. (2g, 9) (BOW-NYSE, US\$31.70, Sector Outperformer)

Canfor Corporation (CFP-TSX, C\$14.07, Sector Performer)

Cascades Inc. (2a, 2e, 2g, 7, C16) (CAS-TSX, C\$10.47, Sector Outperformer)

Catalyst Paper Corporation (2a, 2e) (CTL-TSX, C\$3.44, Sector Underperformer)

Domtar Inc. (2a, 2c, 2d, 2g, 7) (DTC-TSX, C\$6.85, Sector Outperformer)

Fraser Papers (2g) (FPS-TSX, C\$10.05, Restricted)

Georgia-Pacific Corp. (GP-NYSE, US\$47.98, Sector Underperformer)

International Forest Products Limited (2g, 12) (IFP.SV.A-TSX, C\$7.11, Sector Performer)

International Paper Co. (IP-NYSE, US\$34.25, Sector Performer)

Louisiana-Pacific Corp. (LPX-NYSE, US\$27.98, Sector Performer)

Norbord Inc (2g) (NBD-TSX, C\$12.23, Sector Underperformer)

Tembec Inc. (TBC-TSX, C\$1.17, Sector Underperformer)

West Fraser Timber Co. Ltd. (2g) (WFT-TSX, C\$40.64, Sector Outperformer)

Weyerhaeuser Co. (2a, 2e) (WY-NYSE, US\$68.49, Sector Underperformer)

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Ainsworth (ANS-TSX, C\$24.06, Not Rated)
Amcor (AMCR-NYSE, US\$22.63, Not Rated)
Asia Pacific Resources (APQ-TSX, C\$0.12, Not Rated)
Asia Pulp & Paper (APUUY-OTC, US\$0.05, Not Rated)
Boise Cascade Corporation (BCC-NYSE, US\$29.52, Not Rated)
David S. Smith Holdings (SMDS-L, p168.75, Not Rated)
M-Real (MRLAV-HE, €4.35, Not Rated)
MeadWestvaco Corp. (MWV-NYSE, US\$28.56, Not Rated)
Mitsubishi Paper (3864-F, €1.90, Not Rated)
Neenah Paper (NP-NYSE, US\$29.45, Not Rated)
Nippon Paper Group (3893-T, ¥428000.00, Not Rated)
Norske Skogindustrier ASA (NSG-OL, [NOK]99.00, Not Rated)
Oji Paper Co. Ltd (OJIPY-OTC, US\$54.14, Not Rated)
Portucel (PTI-LS, €1.84, Not Rated)
Sappi Ltd Adr (SPP-NYSE, US\$11.64, Not Rated)
Smurfit Stone Container Corp. (SSCC-NASDAQ, US\$13.76, Not Rated)
Stora Enso Oyj (SEO-NYSE, US\$13.42, Not Rated)
Svenska Cellulosa AB (SCABQ-L, p2067.00, Not Rated)
Temple Inland Inc. (TIN-NYSE, US\$45.85, Not Rated)
UPM-Kymmene Corp. (UPM-NYSE, US\$19.60, Not Rated)
Western Forest Products Inc. (WEF-TSX, C\$1.95, Not Rated)

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CIBC World Markets Price Chart

For price and performance information charts required under NYSE and NASD rules, please visit CIBC on the web at <http://www.cibcwm.com/research/sec2711> or write to CIBC World Markets Corp., 300 Madison Avenue, 7th Floor, New York, NY 10017-6204, Attn: Research Disclosure Chart Request.

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| Abbreviation | Rating | Description |
|----------------------------|-----------------------|--|
| Stock Ratings | | |
| SO | Sector Outperformer | Stock is expected to outperform the sector during the next 12-18 months. |
| SP | Sector Performer | Stock is expected to perform in line with the sector during the next 12-18 months. |
| SU | Sector Underperformer | Stock is expected to underperform the sector during the next 12-18 months. |
| NR | Not Rated | CIBC does not maintain an investment recommendation on the stock. |
| R | Restricted | CIBC World Markets is restricted*** from rating the stock. |
| Sector Weightings** | | |
| O | Overweight | Sector is expected to outperform the broader market averages. |
| M | Market Weight | Sector is expected to equal the performance of the broader market averages. |
| U | Underweight | Sector is expected to underperform the broader market averages. |
| NA | None | Sector rating is not applicable. |

**Broader market averages refer to the S&P 500 in the U.S. and the S&P/TSX Composite in Canada.

"Speculative" indicates that an investment in this security involves a high amount of risk due to volatility and/or liquidity issues.

***Restricted due to a potential conflict of interest.

"CC" indicates Commencement of Coverage. The analyst named started covering the security on the date specified.

Ratings Distribution

Ratings Distribution*: CIBC World Markets' Coverage Universe

| (as of 11 Jan 2006) | Count | Percent | Inv. Banking Relationships | Count | Percent |
|---------------------------------|-------|---------|---------------------------------|-------|---------|
| Sector Outperformer (Buy) | 295 | 36.0% | Sector Outperformer (Buy) | 164 | 55.6% |
| Sector Performer (Hold/Neutral) | 393 | 47.9% | Sector Performer (Hold/Neutral) | 192 | 48.9% |
| Sector Underperformer (Sell) | 106 | 12.9% | Sector Underperformer (Sell) | 49 | 46.2% |
| Restricted | 16 | 2.0% | Restricted | 14 | 87.5% |

Ratings Distribution: Paper & Forest Products Coverage Universe

| (as of 11 Jan 2006) | Count | Percent | Inv. Banking Relationships | Count | Percent |
|---------------------------------|-------|---------|---------------------------------|-------|---------|
| Sector Outperformer (Buy) | 5 | 33.3% | Sector Outperformer (Buy) | 5 | 100.0% |
| Sector Performer (Hold/Neutral) | 4 | 26.7% | Sector Performer (Hold/Neutral) | 1 | 25.0% |
| Sector Underperformer (Sell) | 5 | 33.3% | Sector Underperformer (Sell) | 3 | 60.0% |
| Restricted | 1 | 6.7% | Restricted | 1 | 100.0% |

Paper & Forest Products Sector includes the following tickers: A, BOW, CAS, CFP, CTL, DTC, FPS, GP, IFP.SV.A, IP, LPX, NBD, TBC, WFT, WY.

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