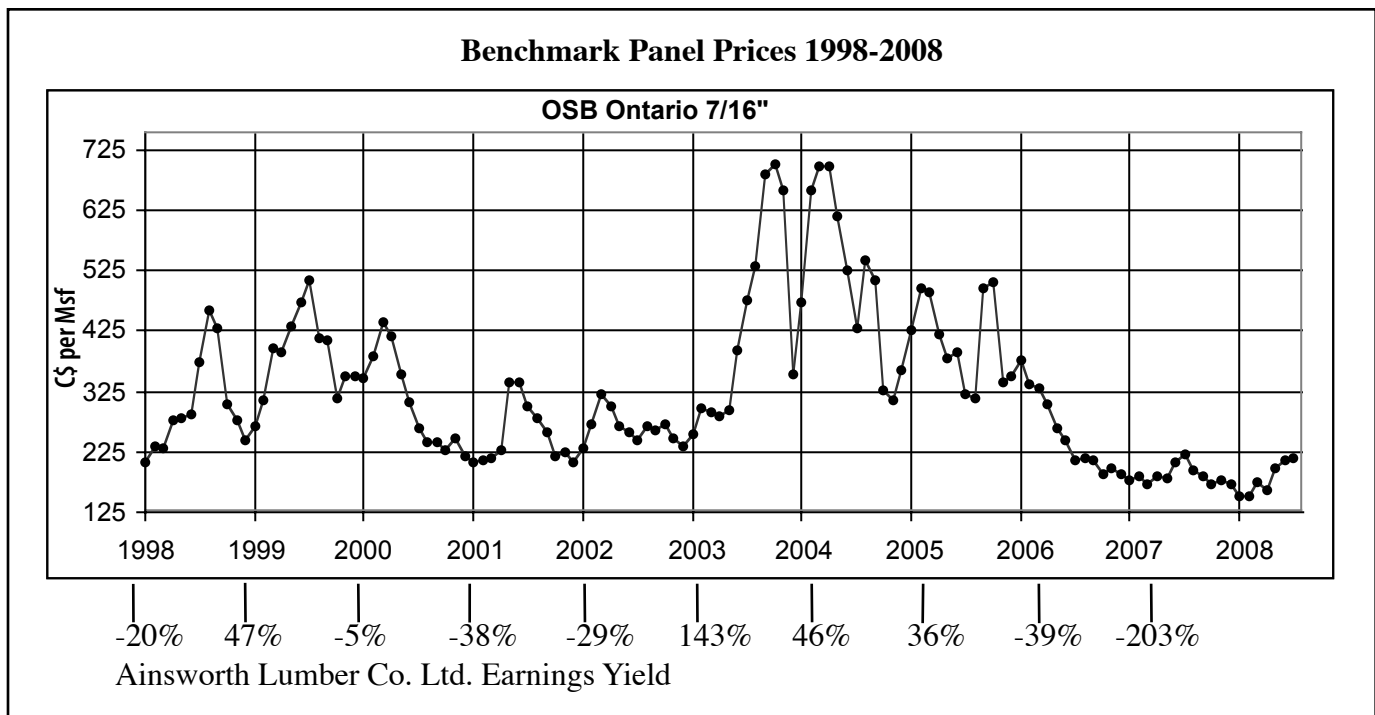




July 24, 2008

The saga of Canadian family owned wood products companies being taken over by bondholders started with a bang in June 2004. Doman Industries Ltd., now Western Forest Products, has been the single largest employer on Vancouver Island for decades. The restructuring has not seemed to help that company's bottom line however, with financial statements continuing to show very poor results.

The most recent bondholder takeover has been of Ainsworth Lumber Co. Ltd., a panel producer based in Vancouver. Like Doman, Ainsworth was started as a "mom & pop" operation with a portable mill in Alberta and, until recently, was held in majority by close family members. Veteran lumber industry professionals will remember the boom of 2003/04, which saw benchmark panel product OSB (oriented strand board) 7/16" (Toronto) rocket to C\$713 per Msf (from a 10 year average of about C\$350). During the three-year period from 2003-2005, Ainsworth enjoyed an average earnings yield on its shares of 76 per cent.



What happened to cause the company's earnings yield to drop to -203 per cent for year-end 2007? Too much expansion too quickly. In September 2004 the company acquired Potlatch Corp. (MI), owner of three panel mills for a total of US\$450 million (payable over eight years). In May of 2006 the curtailments started, by January of 2008 all three Minnesota plants had been at least temporarily shut down, affecting over 1,000 employees. Ainsworth also embarked on some ambitious mill building projects, announcing in June of 2005 a C\$200 million upgrade to the OSB plant in Grande Prairie (AB). Since then that mill has been curtailed numerous times.

Each time a line or plant was closed Ainsworth cited market conditions as the cause. It seems that, like many forest products BC companies across North America, Ainsworth directors anticipated that the panel market would remain red-hot. However panel production, particularly OSB, was already at record

highs. Only sustained home building activity in the United States could digest that product. Given the crash of the US home building market in the past two years, it turned out there were no customers to absorb the oversupply.

When the house building boom in the United States began to slow down, North American panel makers kept production levels high (just as dimension lumber producers were doing) in an effort to keep ahead of their competition. The practice became known as "the last man standing" approach, and served to quickly drive more than a few medium-sized producers out of business.

Another financial blow was dealt to Ainsworth in the form of a successful United States class action antitrust law suit of price fixing from 2001 to 2008. Nine panel producers were accused and have since been ordered to pay reparations; including Louisiana-Pacific Corporation, Georgia-Pacific Corporation, Weyerhaeuser Company, Potlatch Corporation, Ainsworth Lumber Co., Ltd., Norbord, Inc., and J.M. Huber Corporation. The US\$8.7 million Ainsworth settlement was reached in October of 2007; Norbord had to pay US\$32 million.

Three main lumber components go into building a wood-framed house: 2x4's, studs and panel. OSB is considered engineered wood, making panel a radically different product than regular dimension lumber, with the OSB market behaving differently. Part of the reason for the difference is that panel has other uses than strictly for home building, for example as window protection against hurricanes.

The panel market can become so volatile, with retailers selling out week's worth of product in mere days, that the price at the mill can fluctuate radically. For example, rising by C\$350 per Msf in the course of one month at year-end 2003. In fact the State of Florida had to pass an "anti-price gouging" law on panel products after Hurricane Andrew in 1992 due to retailers raising the price by \$100 per sheet overnight. Reconstruction after a hurricane also affects the panel market differently than dimension lumber, as it is often the roofs of homes that are damaged most.

Through 2007 Ainsworth, like Doman before it, was unable to renegotiate its debt-repayment. On February 15, 2008 Ainsworth was saddled with over US\$800 million in existing debt notes (due by 2014) and US\$596 million in new debt notes. With 2007 losses of C\$216 million, it was obvious the company would have trouble making payments.

The bondholders were swift to move in, taking over the board and leaving the Ainsworth family with a scant 6 per cent controlling interest. Only two original board members were kept on, as consultants, and only into the short term.

In the end it seems the big mistake was for Ainsworth to assume the panel market would remain in high gear. While capital investment is crucial, a more steady, long-term approach could be less harmful.

Next time . . . the West Coast wood products industry (Cedar and Douglas Fir).

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