MADISON'S TIMBER PREVIEW

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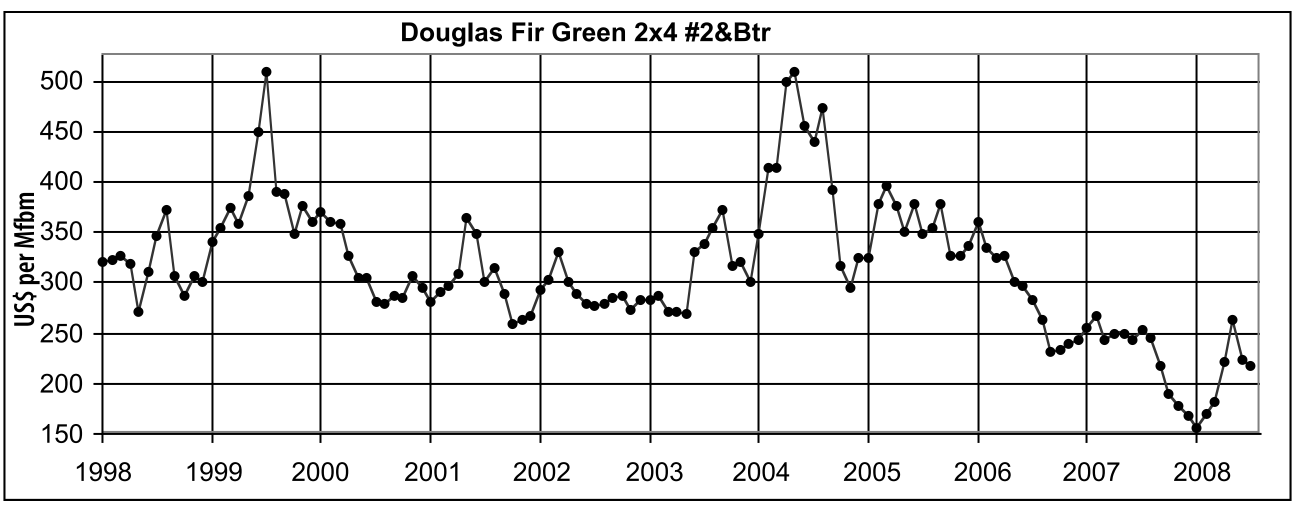
The coastal North American forest industry (including Vancouver Island) is distinct in almost every respect from the rest of the mainland. With different tree species (Douglas Fir, Cedar and Hemlock as opposed to Spruce, Pine and Fir) and a markedly different landscape from the interior, coastal logging and sawmilling presents its own unique challenges.

Cedar forest operations are mixed-species logging, taken along with Hemlock and often Douglas Fir. If the Cedar market is doing well but prices for the other two species are low, a logging contractor's revenue drops. Similarly at the mill level, a yard might be stacked with recently logged Douglas Fir for a few months until that market turns around. In the past two decades major industry changes, market factors and economic issues have reduced the number of Cedar producers to very few.

In addition to the changing face of the wood products industry in general and the fact that coastal species and commodities are specialty items, the terrain on the coast presents its own set of challenges. Historically, like logging practices on the mainland, Cedar and Douglas Fir were felled by chainsaw. That has not changed. The west coast being contoured by steep hillsides, even cliffs, there is no possibility of bringing in a fellerbuncher and grappleskidder to harvest the fibre en masse. In fact most of the accessible coastal forest has already been logged, leaving modern companies to often use expensive techniques like helicopter logging.

Starting with Macmillan Bloedel (incorporated in 1919 and sold to Weyerhaeuser in 1999) through to Doman Industries (founded in 1953 and restructured into Western Forest Products in 2002), forestry has dominated the economies of both Vancouver Island and the northwest coast of North America. Currently the major players are Western Forest Products (WFP) and TimberWest (TW). Financials for WFP are only available from 2004 onward so TW will be the subject of my analysis.

Benchmark Green Douglas Fir Prices 1998-2008



4.5% | 7% | 13.2% | 10.8% | -0.2% | -0.4% | -0.2% | 0.1% | 1.5% | -2.5%

TimberWest Forest Products Earnings Yield

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A small company, with year-end 2007 sales of C$409 million (compared to Canfor's C$3,276 million), TW is however the single largest private land owner in Western Canada. The benchmark coastal lumber commodity is Douglas Fir (green) 2x4 #2&Btr. Generally speaking Douglas Fir is not kiln dried (KD) because it air dries quickly with almost no warping or bending. The item is shipped to the east coast of the US, as some builders greatly prefer Douglas Fir to Western Spruce. When the green Douglas Fir 2x4 price exceeds WSPF by a large margin, producers will take the time to kiln dry, thus selling for a greater profit margin.

Another significant feature that sets coastal forestry apart from the mainland is the lack of mill and equipment upgrades. Back in the mid-1980's the phrase "the coast is toast" was bandied about regularly. Japan was dropping out as a major consumer, interior companies were buying each other out and merging, while the coast stayed with the same products and the same business model. The situation is now dire in the extreme with outmoded mills and severely outdated equipment, but the companies have no capital with which to invest.

TW's 11 per cent earnings yield in 2001 was due mainly to exporting of raw logs. While nice for a short-term boost to the bottom line, exporting raw logs is potentially risky as a long term practice because the fibre runs out too quickly, local communities are dissatisfied at the loss of skilled jobs, and - while production costs are lower - the rate of return when compared to milled lumber commodities is not as good. In the short term however, for example if lumber prices are temporarily depressed, shipping raw logs can turn profits. To quote TW's 2003 year end annual report, "Some 80 per cent of TimberWest's operating revenues are log sales and, relative to 2002, the average external log sales realization declined 10 per cent in the year, resulting in a C$38 million decline in revenues related to log sales."

In 2005 TW completed its transformation to a contractor model for logging operations, thereby reducing its staff costs significantly. Several other one-time costs affected the company's bottom line. In 2006 a rise in log costs brought success to the company strategy of raw log exports. However poor weather on Vancouver Island that winter caused a reduction in harvesting volumes. In addition, a five year plan to embark on the real estate sale of timberlands was being enacted.

As with all other lumber producers in North America, 2007 was a very challenging year for TW. The sale of 20,000 hectares (almost 50,000 acres) for $64 million to a conservation society kept the annual results from being even poorer.

Having announced itself as a prospective player in the west coast real estate market early on, clearly outlining the size, scope and location of the proposed real estate lands, and entering into lengthy discussions with local communities, TW avoided any backlash or public protest over its real estate activities.

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