



# MADISON'S TIMBER PREVIEW

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September 25, 2009

For a perfect example of current investor confusion in the North American forest products industry, one need look no further than Domtar Corp. This week Mark Wilde of Deutsche Bank released a report that Domtar shares have risen quickly of late and are now "fairly valued". The noted analyst downgraded his rating from Buy to Hold, going on to explain that he raised his long-term estimate of Domtar share prices from \$35 to \$40, the level at which Domtar shares are currently selling. The day Wilde's report was released, the volume of Domtar shares traded was 1,092,400, above its average daily volume of 794,609 shares.

Promptly following Wilde's assessment, another analyst released a report expressing the exact opposite opinion. Chip Brian, of SmarTrend, maintained that "Domtar is currently above its 50-day moving average of \$27.98 and above its 200-day moving average of \$19.07. SmarTrend is bullish on shares of Domtar and our subscribers received an Uptrend alert on July 28, 2009 at \$18.75, which has returned 102.7 per cent to date."

Also this week, Motley Fool Stock Advisor released a note stating that Domtar, among a few other Canadian companies, is "selling for less than its tangible book value." Motley Fool found that Domtar's 'Price to Tangible Book Value Ratio' is only \$0.74, while its 'Price to Normalized Earnings Ratio' is \$12.80. "Domtar is trading below what it might fetch in a liquidation sale. Yet it has posted positive normalized earnings over the past 12 months, which indicates that it may not be quite as dead as the market thinks it is."

Who can the average market-watcher believe? (For historical information on Domtar Corp, refer to your November 28, 2008 issue of *Madison's Timber Preview*.)

The day before Wilde's report came out, Domtar announced that it was divesting \$150-million worth of its assets, including its forest products business, in order to focus on its core business and reduce debt. "It has become clear that Domtar's biggest money maker is what the industry calls uncoated freesheet paper, the type that's widely used in photo copiers and personal computer printers," said CEO and president John Williams Wednesday, at the company's investor day in Montreal.

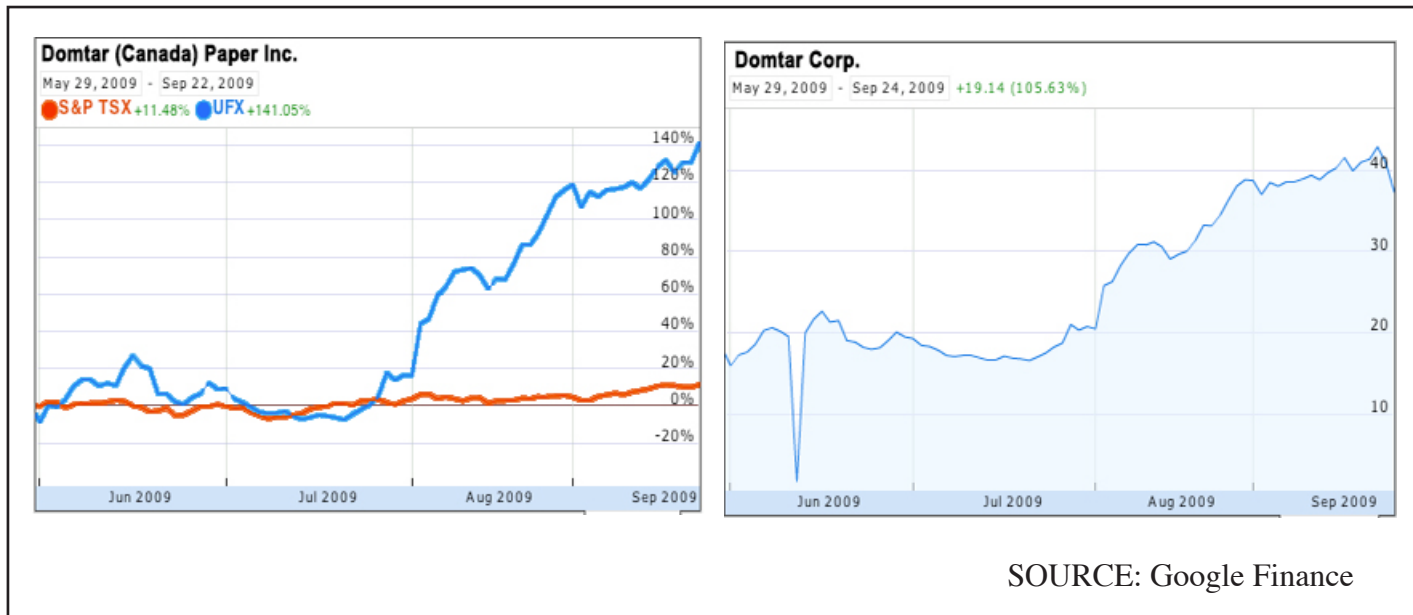
With a 32 per cent share in the North American market for uncoated freesheet, Domtar is well ahead of former market leader International Paper, which has dropped to 26 per cent market share.

Having manufactured its first Forest Stewardship Council certified ton of paper in 2002, Domtar announced the sale of its one-millionth ton of FSC certified paper on September 23.

On August 4, 2009 Domtar announced 2Q 2009 results with a profit of \$48 million, a major improvement when compared to a loss of \$45 million in 1Q 2009. Sales for 2Q 2009 amounted to \$1.3 billion. The improvement was mostly attributable to an increase of \$85 million in US Highway Act (otherwise known as Black Liquor) tax credits, and a \$35 million charge in the first quarter of 2009 attributable to the write-down of property, plant and equipment. Probably the most tangible improvement, however, was an increase in pulp shipments of 25 per cent volume when compared to 1Q 2009. (For more information on Domtar's 1Q results, refer to your May 08, 2009 issue of *Madison's Timber Preview*.)

Domtar's 2Q 2009 report stated in its Executive Summary, "We are prudently optimistic about an economic recovery with market conditions in our paper business beginning to stabilize. While demand is still weak overall, we expect paper volumes to stay flat to positive by year-end. The pulp business continues to rebound with demand expected to remain strong and pulp prices improving."

Several factors are responsible for remarkably stable uncoated freesheet prices. Market pulp is a more cyclical business than uncoated free sheet, but even pulp is enjoying a cyclical rebound. Uncoated freesheet prices have “de-coupled” from market pulp prices, falling only about \$100/ton from peak to trough compared with about \$300/ton for market pulp. Capacity closures have kept the market in reasonable balance; since 2008 about 1.3MM annual tons of uncoated freesheet has been taken out of the supply chain. The industry is substantially consolidated, with the top five producers having 80 per cent market share today, compared with 59 per cent ten years ago. And finally, even during this sharp downturn, Paper EBITDA has been relatively stable, falling from a high to \$215MM in 2Q 08 to a low of \$163MM in 4Q 08, before rebounding to \$195MM in 2Q 09.



SOURCE: Google Finance

As if foreshadowing this week's announcement of a focus on paper production, June 1, 2009 the company announced a reverse stock split at a 1-for-12 ratio of its outstanding common stock. At the same time, the company's indirect subsidiary, Domtar Paper Inc, authorized an equivalent reverse split of its outstanding exchangeable shares. On June 11 the 12:1 reverse stock split was completed, and Domtar's share prices recovered \$3.10, to \$22.66 the following week. Since then Domtar's shares have risen \$20.18, to \$42.84, a development that unquestionably contributed to the downgrading by Wilde.

Indirect subsidiary Domtar Paper, which is focussed solely on manufacturing uncoated freesheet paper, is benefitting greatly from the exchangeable share split. Domtar Papers' shares have risen \$24.90, to \$41.22 since the stock split was announced and currently show no signs of slowing their rise. This improvement, however, is a far cry from the company high of \$144.12 on June 15, 2007. Put another way, Domtar Papers' shares are up 43 per cent as of this week from the first week of January 2009, and up 78 per cent from this year's low of \$9.12 on March 6.

Buy or Hold? Either way the shrewd investor is going to want to have some Domtar shares in their portfolio.

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