



6 August 2010

# Domtar

Reuters: **UFS.N** Bloomberg: **UFS CN** Exchange: **NYS** Ticker: **UFS**

## Strong 2Q for Domtar – Boost PT but maintain Hold

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2Q results were strong, and 3Q should be stronger, as higher paper prices flow through. Even allowing for a cyclical downturn in pulp, as well as a modest valuation multiple due to secular issues affecting paper, we think our previous target was overly pessimistic. We maintain our Hold rating based on fair valuation and a balancing of strong current conditions against long-term challenges.

**Strong 2Q results, boosted by low tax rate**

Pointing to \$2.67 in 2Q EPS net of special items. DBE was at \$1.80, Consensus at \$1.60. Comps: 1Q10 = \$1.59, 2Q09 = \$(0.76). Low tax rate helped. Take adjusted EBITDA of \$264MM. Deduct \$101MM in D&A and \$30MM in adjusted interest expense, and we get to \$133MM (\$3.06/share) in pre-tax income. Deduct a normalized 32% in taxes, and the number would look like \$2.08. The company's \$2.67 headline number appears to reflect a 13% tax rate.

**Near-term estimates go slightly higher**

3Q will benefit from lower maintenance and outage and higher paper prices, partially offset by weaker pulp results, higher SG&A, and no Wood Products. Our 3Q estimate goes up from \$2.70 to \$3.05. 4Q will likely be impacted by lower pulp prices, seasonal slowing, and seasonally higher costs, leading to our \$1.69 estimate for 4Q. We are making no change to our \$5.00 estimate for '11, as we anticipate a cyclical margin squeeze.

**Valuation/Risks**

Our \$60 price target is based on 4.5x our Normalized EBITDA estimate of \$745MM. This is a lower multiple of Normalized EBITDA than most of our companies, but we feel believe discount is warranted by the significant secular issues facing uncoated free sheet in North America. Downside risks include weak prices and volumes for paper and pulp, Domtar's primary commodities, and high costs for key inputs such as energy, fiber, chemicals, and freight. Upside risks include rising prices and volumes and falling input costs. (See page 4 for details.)

**Forecasts and ratios**

Year End Dec 31	2009A	2010E	2011E
1Q EPS <sup>1</sup>	-0.84	<b>1.59A</b>	-
2Q EPS	-0.76	<b>2.67A</b>	-
3Q EPS	1.32	<b>3.05</b>	-
4Q EPS	1.39	<b>1.69</b>	-
FY EPS (USD)	1.11	<b>9.00</b>	5.00
OLD FY EPS (USD)	1.11	<b>7.50</b>	5.00
% Change	0.0%	<b>20.1%</b>	-0.1%
P/E (x)	24.3	<b>7.0</b>	12.5
DPS (USD)	0.00	<b>0.50</b>	1.00
Dividend yield (%)	0.0	<b>0.8</b>	1.6
Revenue (USDm)	5,465.0	<b>5,818.2</b>	5,255.5

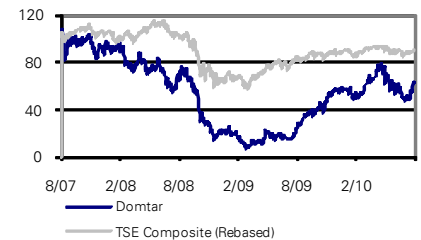
Source: Deutsche Bank estimates, company data

<sup>1</sup> Includes the impact of FAS123R requiring the expensing of stock options.**Forecast Change****Hold**

Price at 5 Aug 2010 (USD)	<b>62.57</b>
Price target	<b>60.00</b>
52-week range	<b>78.39 - 26.20</b>

**Key changes**

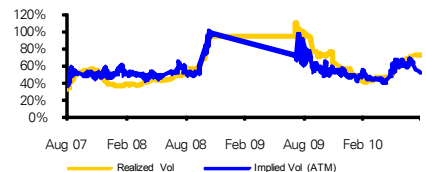
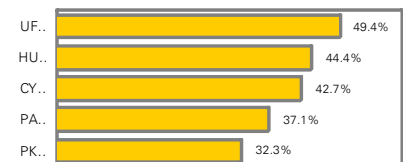
Price target	45.00 to 60.00	↑	<b>33.3%</b>
EPS (USD)	7.50 to 9.00	↑	<b>20.1%</b>
Revenue (USDm)	5,691.9 to 5,818.2	↑	<b>2.2%</b>

**Price/price relative**

Performance (%)	1m	3m	12m
Absolute	29.7	-9.6	154.9
TSE Composite	6.2	-0.8	6.6

**Stock & option liquidity data**

Market Cap (USDm)	2,690.5
Shares outstanding (m)	43.0
Free float (%)	100
Volume (5 Aug 2010)	175,400
Option volume (und. shrs., 1M avg.)	96,743

**Implied & Realized Volatility (3M)****Implied Volatility (3M, ATM) vs. Peers**\*Weighted-avg. of index components  
Data as of 18-Aug-09

Deutsche Bank Securities Inc.

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Model updated:06 August 2010

**Running the numbers****North America****Canada****Paper & Forest Products****Domtar**

Reuters: UFS.N

Bloomberg: UFS CN

**Hold**

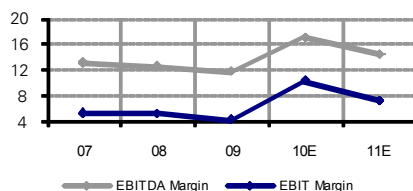
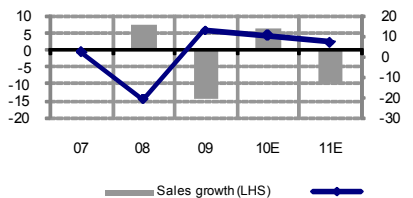
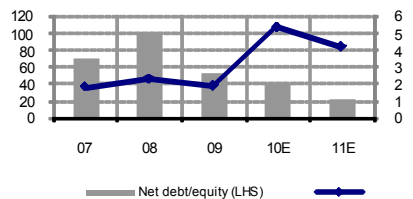
Price (5 Aug 10) USD 62.57

Target price USD 60.00

52-week Range USD 26.20 - 78.39

Market Cap (m) EURm 2,024  
USDm 2,691**Company Profile**

Domtar operates in three main business segments: (1) Papers (~81% of '08 revenues), (2) Paper Merchants (15%), and (3) Wood (~4%). With 4.1MM tons of capacity, Domtar is the largest integrated uncoated freesheet producer in North America. Domtar also has 238K tons of coated groundwood capacity. Approximately 83% of paper production capacity is domestic and the remaining 17% is located in Canada. In addition, Domtar is a net seller of market pulp (~1.6M mtons of capacity).

**Price Performance****Margin Trends****Growth & Profitability****Solvency****Mark Wilde**

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Fiscal year end 31-Dec

**Financial Summary**

	2007	2008	2009	2010E	2011E
DB EPS (USD)	2.64	2.04	1.11	9.00	5.00
Reported EPS (USD)	1.77	-13.34	7.18	6.77	5.00
DPS (USD)	0.00	0.00	0.00	0.50	1.00
BVPS (USD)	80.92	49.89	61.91	68.24	72.27

**Valuation Metrics**

Price/Sales (x)	0.7	0.4	0.2	0.5	0.5
P/E (DB) (x)	40.0	30.4	24.3	7.0	12.5
P/E (Reported) (x)	59.9	nm	3.8	9.2	12.5
P/BV (x)	1.1	0.4	0.9	0.9	0.9
FCF yield (%)	12.4	2.6	60.9	11.0	17.7
Dividend yield (%)	0.0	0.0	0.0	0.8	1.6
EV/Sales	1.1	0.8	0.5	0.7	0.6
EV/EBITDA	8.2	6.1	4.0	3.9	4.5
EV/EBIT	20.6	14.5	11.0	6.4	9.0

**Income Statement (USDm)**

Sales	5,947	6,394	5,465	5,818	5,256
EBITDA	782	795	641	994	759
EBIT	311	332	236	601	379
Pre-tax profit	99	-570	490	366	289
Net income	70	-573	310	294	217

**Cash Flow (USDm)**

Cash flow from operations	606	197	792	467	651
Net Capex	-87	-128	-85	-170	-175
Free cash flow	519	69	707	297	476
Equity raised/(bought back)	-1,431	0	0	0	0
Dividends paid	0	0	0	-22	-43
Net inc/(dec) in borrowings	518	-109	-400	-74	-119
Other investing/financing cash flows	492	-15	1	0	0
Net cash flow	98	-55	308	201	314
Change in working capital	5	-226	-147	-220	54

**Balance Sheet (USDm)**

Cash and cash equivalents	71	16	324	525	838
Property, plant & equipment	5,362	4,301	4,129	3,906	3,701
Goodwill	372	0	0	0	0
Other assets	1,943	1,787	2,066	2,224	2,112
Total assets	7,748	6,104	6,519	6,655	6,651
Debt	2,293	2,171	1,755	1,681	1,562
Other liabilities	2,258	1,790	2,102	2,040	1,981
Total liabilities	4,551	3,961	3,857	3,721	3,543
Total shareholders' equity	3,197	2,143	2,662	2,934	3,108
Net debt	2,222	2,155	1,431	1,156	724

**Key Company Metrics**

Sales growth (%)	nm	7.5	-14.5	6.5	-9.7
DB EPS growth (%)	na	-22.8	-45.6	711.0	-44.5
Payout ratio (%)	0.0	nm	0.0	7.3	19.8
EBITDA Margin (%)	13.1	12.4	11.7	17.1	14.4
EBIT Margin (%)	5.2	5.2	4.3	10.3	7.2
ROE (%)	2.2	-21.5	12.9	10.5	7.2
Net debt/equity (%)	69.5	100.6	53.8	39.4	23.3
Net interest cover (x)	1.8	2.3	1.9	5.4	4.2

**DuPont Analysis**

EBIT margin (%)	5.2	5.2	4.3	10.3	7.2
x Asset turnover (x)	0.8	0.9	0.9	0.9	0.8
x Financial cost ratio (x)	0.5	0.6	0.5	0.8	0.8
x Tax and other effects (x)	0.5	-3.1	2.8	0.6	0.7
= ROA (post tax) (%)	0.9	-8.3	4.9	4.5	3.3
x Financial leverage (x)	2.4	2.6	2.6	2.4	2.2
= ROE (%)	2.2	-21.5	12.9	10.5	7.2
annual growth (%)	na	na	na	-18.6	-31.7
x NTA/share (avg) (x)	80.6	62.2	55.6	64.5	69.6
= Reported EPS	1.77	-13.34	7.18	6.77	5.00
annual growth (%)	na	na	na	-5.6	-26.2

Source: Company data, Deutsche Bank estimates

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## Solid 2Q results

2Q was strong, although not quite as strong as headline EPS number suggests. Pointing to \$2.67 in 2Q EPS, net of special items. DB was at \$1.80, and Consensus at \$1.60. Comps: 1Q10 = \$1.59, 2Q09 = \$(0.76). They got there despite higher maintenance downtime impact.

On a normalized 32% tax rate, we think adjusted EPS number would be about \$2.08. Take adjusted EBITDA of \$264MM. Deduct \$101MM in D&A and \$30MM in adjusted interest expense, and we get to \$133MM (\$3.06/share) in pre-tax income. Deduct a normalized 32% in taxes, and the number would look like \$2.08. The company's \$2.67 headline number appears to reflect a 13% tax rate.

Segments:

### Paper:

EBITDA = \$260MM, 1Q10 = \$233MM, 2Q09 = \$121MM. Strong result considering \$40MM q/q increase in maintenance and outage costs at Kamloops, BC mill.

UFS: EBITDA: \$203MM (\$228/ton), +\$3MM q/q, +\$8MM y/y. Vol's (impacted by LWC mill closure): -7% q/q, -4% y/y. Prices: +\$35/ton q/q, +\$40/ton y/y.

Pulp: EBITDA: \$57MM (\$117/mton), +\$24MM q/q, +\$131MM y/y. Vol's +25% q/q, +24% y/y. Prices +\$106/mton q/q, +\$319/mton. Inventories -95K tons q/q.

### Merchants:

EBITDA = \$0MM, 1Q10 = \$2MM, 2Q09 = \$3MM. Margins shrank due to supplier price increases.

### Wood:

EBITDA = \$5MM, 1Q10 = \$(1MM), 2Q09 = \$(6MM). Nice spring price rally in last quarter with Domtar.

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## Other issues:

(1) Received \$368MM in black liquor credits in 2Q. (2) Net debt is now down to just \$700MM. (3) Instituted cash dividend of \$1/share/year. (4) Repurchased 340K shares in June. (5) Now expecting overall tax rate in '10 below 20%. (6) Capex in '10 = \$160-180MM.

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## Change in view?

Even with retreating pulp prices, 3Q is likely to represent a cyclical peak. Bigger question is trajectory of earnings beyond 3Q. While secular issues remain, stability of uncoated free sheet results in recent quarters has been impressive. For now, coming cyclical downturn in pulp appears to be a manageable issue. Global inventories have not ballooned. While prices remain under pressure, the downward trajectory does not appear as sharp as we had feared.

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## Estimates:

3Q will benefit from lower maintenance and outage costs (\$37MM) and higher paper prices (+\$25/ton q/q = \$23MM), as well as slightly lower D&A and interest expense (\$5MM each). Partial offsets will include lower pulp prices (-\$15MM), lower pulp volumes (-\$10MM), higher SG&A (-\$10MM) and no Wood Products (-\$5MM). This implies sequential improvement of \$20MM in adjusted EBITDA and \$30MM in pre-tax income. The EPS gain will be muted by a higher tax rate. We are assuming 20%, for 3Q EPS of \$3.05. 4Q will be impacted by lower

pulp prices, seasonal slowing, and seasonally higher costs, leading to our \$1.69 estimate for 4Q. We are making no change to our \$5.00 estimate for '11, as we anticipate cyclical margin compression.

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## Price target

Based on our more positive outlook, we are boosting our price target from \$45 to \$60. However, due to the rise in the stock, we are maintaining our Hold rating. As discussed below, our primary valuation method is a multiple analysis based on Normalized EBITDA. However, as a secondary method, we also run a DCF analysis. Our DCF analysis also shows a \$60 price target, based on the following assumptions. The WACC is 11.0%, based on a 12.5% cost of equity, 8.0% pre-tax cost of debt, and a 21% debt/capital ratio. The cost of equity is based on a 4.1% risk-free rate, a 6.0% market risk premium, and a 1.4 beta. The beta is high, but this is consistent with a volatile trading history and a high degree of operating leverage in the business. Beyond 2011, the long-term EBIT growth rate assumption is -10%. While this is a cautious view of future prospects, we think this is consistent with secular declines in uncoated free sheet volumes.

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## Valuation

With more than 5MM tons of annual net paper & pulp capacity and just 43MM shares outstanding, Domtar has a great deal of operating leverage. This makes Domtar a "higher risk" paper stock, with a great deal of potential volatility in both directions. Our \$60 price target is based on 4.5x our Normalized EBITDA estimate of \$745MM. This is a lower multiple of Normalized EBITDA than most of our companies, but we feel that the discount is warranted by the secular issues facing uncoated free sheet in North America. We also note that Domtar is very highly leveraged to global exchange rates. While some analysts focus on the C\$ with Domtar, we think the critical variable is the strength/weakness of the US\$ against a basket of pulp producer currencies. If the US\$ is weak, US\$-based pulp prices will tend to be higher and Domtar should do well. Higher pulp prices should also tend to yield higher US\$-based uncoated free sheet prices.

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## Risks

Downside risks include weak prices and volumes for paper and pulp, Domtar's primary commodities, and high costs for key inputs such as energy, fiber, chemicals, and freight. A weak economy and poor white-collar employment trends would tend to depress demand and pressure margins. Imports from overseas would tend to increase supply and also squeeze margins. Upside risks include rising prices and volumes and falling input costs. Factors promoting better margins would include a strong economy, high white-collar employment, and further industry capacity closures.

# Appendix 1

## Important Disclosures

Additional information available upon request

### Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Domtar	UFS.N	62.57 (USD) 5 Aug 10	1,2,8,14,17

\*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

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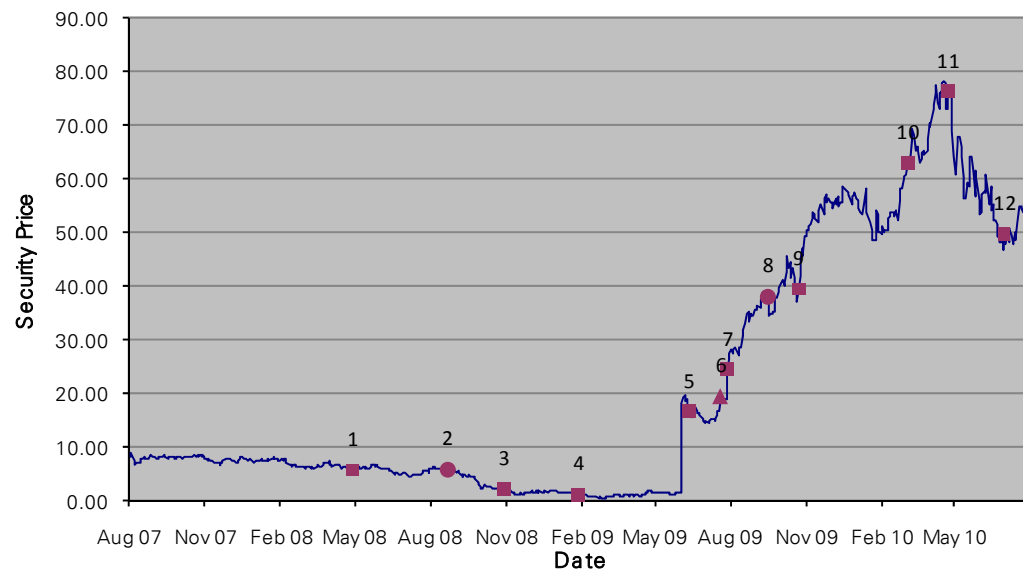
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**Historical recommendations and target price: Domtar (UFS.N)**

(as of 8/5/2010)



Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

\*New Recommendation Structure as of September 9, 2002

Date		Recommendation	Target Price Change
1.	5/6/2008:	Buy,	Target Price Change USD10.00
2.	8/29/2008:	Downgrade to Hold,	Target Price Change USD6.00
3.	11/6/2008:	Hold,	Target Price Change USD4.00
4.	2/5/2009:	Hold,	Target Price Change USD2.00
5.	6/19/2009:	Hold,	Target Price Change USD24.00
6.	7/28/2009:	Upgrade to Buy,	USD24.00
7.	8/5/2009:	Buy,	Target Price Change USD35.00
8.	9/23/2009:	Downgrade to Hold,	Target Price Change USD40.00
9.	10/30/2009:	Hold,	Target Price Change USD45.00
10.	3/12/2010:	Hold,	Target Price Change USD65.00
11.	4/30/2010:	Hold,	Target Price Change USD75.00
12.	7/8/2010:	Hold,	Target Price Change USD45.00

**Equity rating key** **Equity rating dispersion and banking relationships**

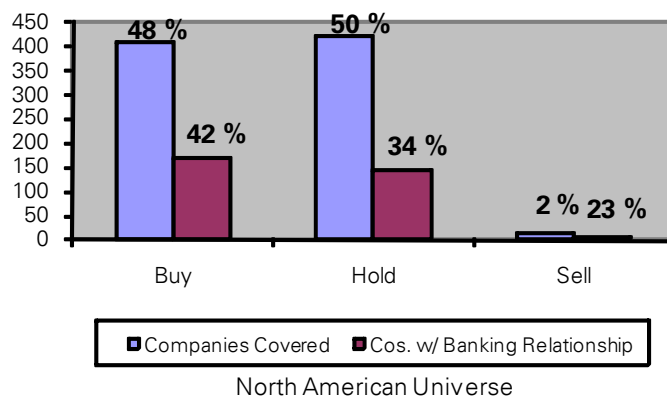
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