

Corporates  
North America  
Special Report

# Paper and Forest Products: Stress Testing

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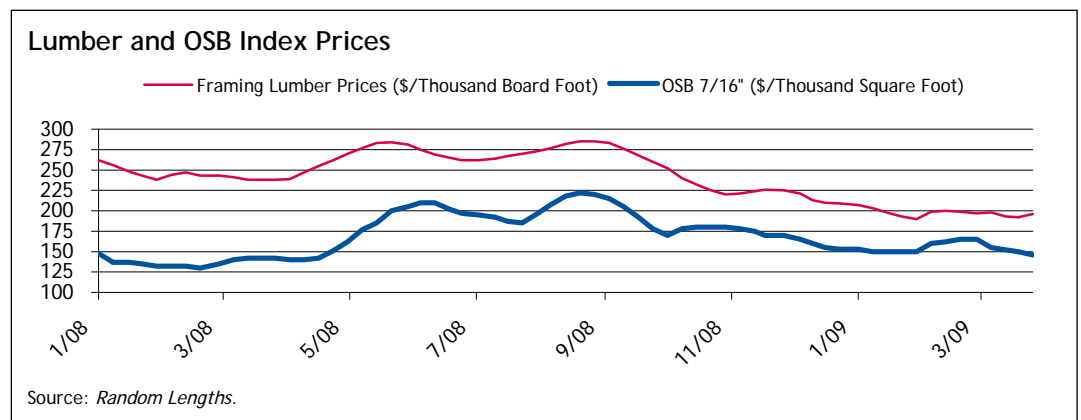
- *Liquidity Focus: Paper and Forest Products, Nov. 21, 2008*

## Woeful Quarters

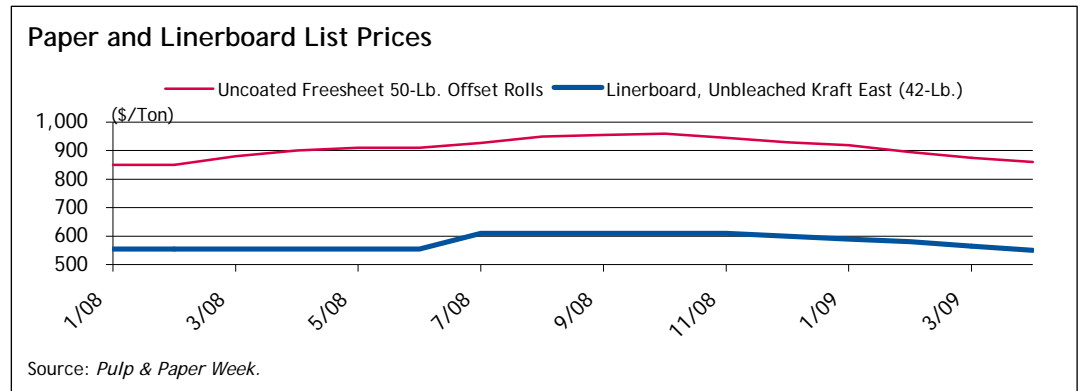
Having endured a punishing fourth quarter — and for most, an even a worse first quarter — few companies are hiding any doubts about a difficult 2009. All facets of business coming out of the nation's forests are suffering and without any conclusive signs of a turnaround.

## Recent Statistics

- North American oriented strand board (OSB) production dropped 40.8% this past first quarter compared to a year ago, in tandem with a 49% drop in U.S. housing starts. Plywood production is off 22.3%.
- In the first two months of the year, softwood lumber production in the U.S. (45% of which finds its way into new home construction) plunged 30.1% from a year ago, following a 17% decline for all of 2008.



- U.S. paper production in the first quarter declined 17.9% from 2008 with mills operating at an average 79% of capacity. Uncoated freesheet (UFS) production for the quarter was down 16.6%. Coated paper production sunk 32.1%, while uncoated mechanical paper was off 28.6%.
- U.S. corrugated shipments were 11.5% behind the first quarter of 2008. Linerboard production was down 19.6% with mills operating at 77.7% of capacity, versus 96.4% a year ago.



### Seeds of Optimism

Although the volumes of wood and paper sold are down substantially from a year ago, falling precipitously in the past six months, prices have held amazingly well. The conclusion is that the sheer amount of idled time at sawmills and paper machines is taking enough supply out of the system (market downtime) to complement the real-time fall in demand.

A plus for the industry (the paper and container side of the business) has been declining input costs (deflation) for logs turned into lumber, wood chips turned into pulp, fuel for transport, recycled fiber and chemicals used in both processing and finishing. This has helped soften, but not compensated for, the increase in unabsorbed burden from taking market downtime. Energy (natural gas, oil and coal) and recycled fiber have led costs downward but are now leveling off or increasing. Chemicals and virgin fiber have been lagging but are still falling, and we expect that, in combination, input costs will still retreat somewhat before stabilizing. The question is how likely and how quickly this deflationary windfall will work back into lower prices for paper and containers.

There has also been a slight uptrend in the month-to-month shipments of UFS and corrugated containers, albeit this increase may be seasonal rather than a recovery.

### Stress Testing

The first quarter is a poor benchmark to use to gauge a year. The third quarter is the “make or break” quarter for the coated paper producers, with orders beginning to flow in May. The third and fourth quarters are the best periods for corrugated manufacturers, and the late first through early fourth quarters the best periods for uncoated papers. Typically lumber and panel producers do their best in the second and third quarters, sometimes also the fourth quarter depending on weather. Backing into paper production, the summer is a slow period for pulp producers.

Volume declines on the order of 20% to 40% in the past six months extend well beyond seasonality, however, and beg the question of a seasonal uptick in the flow of business (either orders and/or price); their extension is likely a reasonable guide for the “worst possible to come.” Functionally, in our tests we have prolonged the stress of the last six months to extrapolate the full year, using first-quarter cost structures and actual or anticipated market downtimes. Trends in paper and container prices apparent in the fourth and first quarters were also sparingly extended.

Not all the stresses applied are uniform across all companies. The stresses reflect company-specific market downtimes, prices, cost structures and announced savings

programs from restructurings, capital expenditure curtailments and dividend cuts. Future biofuel cash credits from the government have not been included as stress relievers.

### **Liquidity Revisited**

Last November we identified three companies that appeared to have potential liquidity problems: AbitibiBowater Inc. (ABY) and subsidiaries, Smurfit-Stone Container Corporation (SSCC) and Louisiana-Pacific Corporation (LPX). SSCC was the first to file for bankruptcy on Jan. 26; ABY filed on April 16 in the U.S. and on April 17 in Canada. LPX completed a series of secured refinancings in the second week of March to replenish cash.

### **To Watch**

LPX remains on our list to watch. The company's cash burn last year totaled negative \$112 million (before debt repayment and excluding an acquisition, proceeds from the sale of a note and changes in investments). The first quarter's cash flow from operations was a positive \$2.3 million, but included \$39.8 million from working capital which cannot be repeated indefinitely. Revolver availability was \$38 million at the end of the first quarter.

To our list of companies to watch, we add Verso Paper Corp. (VRS). First-quarter results are not indicative for the year, but free cash flow in the first quarter was negative \$99 million, which included \$30 million in biofuel cash from the government. Revolver availability at the close of the first quarter was \$61 million.

NewPage Corporation (NWP) is also added to the list. With a business model very similar to VRS', NWP's free cash flow of negative \$85 million in the first quarter included working capital builds for the upcoming busy season (also similar to VRS), but shipments were down 40% year-over-year, and we question the strength of pricing. Revolver availability at the end of the first quarter was \$247 million.

Potlatch Corporation (PCH) could also have cash flow difficulties this year, but the company has the discretion to sell land (maybe at lower prices) or trim its dividend.

### **Covenants**

Companies that may have to revisit covenant structures include the following.

Domtar Corporation (Domtar) — Domtar's debt/EBITDA covenant may need some relaxation if UFS shipments do not improve and if prices weaken.

Graphic Packaging Holding Company (GPK) — A stepdown in permitted debt/EBITDA next October could be problematic if volumes do not pick up or if paperboard prices falter.

Weyerhaeuser Co. (WY) — WY will be using a substantial amount of cash this year to finance tough business conditions. The company has the equity markets open to it and could also sell timberlands, but in the absence of these options, WY may need to seek relief in its minimum net worth covenant.

### **Biofuel Manna**

Paper producers are earning a lot of money by mixing diesel with waste black liquor flowing from the pulping process and burning the resulting mixture in recovery boilers. The government is paying \$0.50/gallon of black liquor for saving fossil fuel consumption through the end of 2009. International Paper Co. (IP) is in the forefront of paper producers booking \$522 million in profits in the first quarter, having collected \$145 million. VRS booked \$105 million in the first quarter and collected \$30 million. Domtar booked \$46 million and received it all in the second quarter, while

MeadWestvaco Corporation's (MWV) second quarter will reflect at least \$77 million, and Temple-Inland, Inc., (TIN) will get \$16 million from first-quarter operations. WY and GPK are awaiting registration from the Internal Revenue Service. WY blended 77 million gallons through May 2 (approximately \$38 million). GPK burns about 800,000 gallons of black liquor per day.

None of the above sums can be annualized. They do not necessarily represent a full quarter's operations, and the year's benefit depends on market-related downtimes at mills, which companies are loath to predict in these uncertain times. What is certain is that the credits could not come at a better time.

### Company Particulars

#### Canfor Corporation

The average price for spruce-pine-fir (SPF) in Canadian dollars dropped CAD44/thousand board feet (mbft) in the fourth quarter and another CAD37/mbft in the first quarter of 2009. Southern yellow pine (SYP) increased CAD12/mbft in the fourth quarter but fell CAD20/mbft in the first quarter. With no substantive change in conversion/milling costs, Canfor Corporation's (CAN) EBITDA plunged CAD40.6 million in the fourth quarter and CAD16.1 million again in the first quarter. CAN exited the first quarter operating its sawmills at 60% of capacity and having indefinitely idled all of its plywood/OSB operations, save for the Peace Valley OSB joint venture with LPX.

Pulp prices (northern bleached softwood kraft) fell \$93/tonne in the fourth quarter and \$114/tonne in the first quarter. Profitable operations in the third quarter turned into a small loss in the fourth quarter and a CAD17 million loss in the first quarter, which benefited from lower freight and fiber costs.

CAN wrote-down its assets by CAD100 million in the fourth quarter (CAD77 million linked to the idled Tackama plywood and PolarBoard OSB plants), which had no impact on cash flow. In sequential quarters funds from operations (before working capital) sunk CAD50 million in the fourth quarter and another CAD84 million in the first quarter. This caused CAN to borrow CAD13.6 million and use CAD179 million of balance sheet cash to fund capital expenditures and repay \$77 million of private placements in March. CAN also sold its shuttered New Westminster, B.C., operation for CAD46 million in the first quarter and collected CAD20 million in insurance proceeds for the fire at its North Central Plywoods mill in the fourth quarter.

Should conditions continue as they are, CAN could burn through another CAD250 million or so by year-end after reduced capital expenditures and the remaining insurance claims from the North Central Plywoods fire. CAN repaid its \$60.0 million 5.66% private placement due April 1, its last installment of long-term debt due this year. Maturities are light in 2010 and 2011.

CAN had available unreserved bank operating lines totaling CAD413 million at the end of the first quarter which mature in June 2011. CAN had also arranged for \$60.4 million in non-recourse finance collateralized by its impaired asset-backed commercial paper (CP) investments. Canfor Pulp Limited Partnership, 52% owned and consolidated, had CAD32.7 million in available and unreserved bank operating lines which mature next November. Consolidated cash totaled CAD155 million at last quarter-end. CAN does not disclose nor report financial tests in its non-public debt.

#### Domtar Corporation

Paper shipments by North America's largest producer of uncoated freesheet (UFS) plunged 14.7% in the fourth quarter and 7.3% in the following first quarter of 2009.

Domtar took 197,000 tons of production downtime to balance to demand in the fourth quarter, followed by 185,000 tons in the first quarter. Prices held firm in the fourth quarter, which kept the revenue line's attrition to 9.0%, but fell \$33/ton for printer offset rolls and \$91/ton for softwood kraft pulp in the first quarter, which accelerated the decline in the revenue line to 10.8%. After adding back closure costs, asset impairment charges and goodwill write-offs from the Dryden, Lebel-sur-Quevillon and Columbus pulp and paper mills, EBITDA dropped 45% running from the third to fourth quarters in the Papers segment while paper distribution and sawmill operations cancelled each other. First-quarter results, which included a pickup of \$19 million from cost deflation (freight, energy and fiber) and was additive to \$16 million of cost deflation in the fourth quarter, caused the Papers segment's EBITDA to retreat another 26%. There was no change in the profitability of paper distribution while the losses from sawmill operations increased \$7 million on lower prices and shipments.

The fall in business cascaded into a negative \$160 million fourth-quarter swing in funds from operations before differences in pension contributions and working capital, and did not move much from there in the first quarter (before biofuel credits). Domtar wound up borrowing a net \$105 million in the combined quarters to fund capital expenditures, pension contributions and a \$60 million build in working capital.

The first calendar quarter is always a weak fiscal quarter for papermakers, but were this past quarter prophetic, Domtar would likely be cash breakeven for the year without any relief from biofuel credits. Capital budgets are being managed to less than 50% of depreciation, and Domtar has eyes on selling some of the 900,000 acres of forestland that it owns, plus non-core hydroelectric assets, to garner \$150 million over the next 12 months.

Domtar also has good liquidity. Its \$750 million senior secured revolver matures in March 2012, and only \$193 million was borrowed and/or used to issue letters of credit at last quarter-end. Financial tests to watch include a 2.5 to 1.0 EBITDA/cash interest coverage ratio and a maximum debt/EBITDA leverage ratio of 4.5 times (x). Some temporary covenant relief may be necessary in the EBITDA portion of these ratios if pulp and paper shipments continue the patterns set in this past first quarter and absent any asset sales. Domtar also has a U.S. and Canadian dollar accounts receivable securitization program (\$150 million) maturing in 2011. This program is generally wholly used, and only \$55 million was available at quarter-end.

### Graphic Packaging Holding Company

Since GPK's merger with Altiivity Packaging, LLC, (March 2008) and through the end of last year, \$119 million of the \$1.17 billion of debt inherited in the merger was repaid. A little over \$70 million was repaid in the fourth quarter despite a 14.5% decline in coated recycled boxboard (CRB) shipments (open market sales) and an 18.7% decline in multiwall bag shipments. Realized prices increased \$55/ton in the fourth quarter in paperboard packaging and \$20/ton in multiwall bags. GPK took 43 days of market-related downtime across its CRB mill system in the fourth quarter and closed the No. 2 paper machine at its West Monroe, La., facility. Cost inflation abated by \$18 million in the fourth quarter, mostly energy, but was offset by \$15 million–\$17 million of unabsorbed burden from the mills' downtime and higher cost inventory depletion. The net effect of the tempered fourth quarter was a \$27 million sequential decline in operating profits (excluding asset write-offs). Cash flow from operations was boosted by a working capital runoff (permanent inventory reduction in CRB), which financed the debt reduction in the final quarter of the year.

Volumes also declined running from the fourth to first quarter, down 3.6% for container shipments (mostly open medium sales) and 10.4% for multiwall bags. GPK's price

realizations for paperboard packaging rose \$40/ton sequentially (same as IP) and were stable for bags. Costs declined moving from quarter to quarter, basically attributable to merger synergies and cost reduction programs, with cost deflation getting hung up in inventories to be sold in the second quarter. Operating segment margins (excluding corporate expenses) improved an absolute 4.3% on a 2.7% sales decline. Cash flow from operations retreated from the fourth quarter on a seasonal working capital build for beverage carton sales, and GPK financed the build with \$44 million in additional borrowings.

GPK should get some benefit from a decline in raw material costs in the second quarter (virgin and recycled fiber, chemicals and transportation), which could make any significant inroads in prices difficult. This places the onus for earnings improvement on added cost reduction and process improvement, and maintaining negligible market downtime. If GPK can hold prices, volumes and costs at the first quarter's run rate, the company has a fair chance of meeting its debt reduction goal of \$170 million for the year on reduced capital expenditures of \$150 million. A \$60/ton fall in average paperboard realizations for the balance of the year would approximate cash breakeven.

GPK has the finance necessary to get by. Its \$400 million secured revolver expires in May 2013 with \$177 million available at the close of the last quarter. Significant financial covenants include a maximum secured leverage ratio (secured debt to EBITDA plus projected cost savings limited to the lesser of \$100 million and 10% of EBITDA). A step-down in the maximum permitted ratio, from 5.00x to 4.75x, goes into effect next October, which could be tight if volumes do not recover or if prices weaken. At quarter-end the ratio was 3.98x with EBITDA headroom of \$68 million. GPK also had \$180 million in cash available.

#### International Paper Co.

Certain of IP's businesses went into a tailspin in the fourth quarter, whereas other operations were only modestly affected. North American UFS earnings fell \$58 million (volumes down 15%, prices almost flat); U.S. market pulp earnings fell \$30 million (volumes down 10%, prices down 10.5%); and Brazilian pulp and paper earnings fell \$14 million (higher costs and currency deflation). North American containerboard volumes fell 24% and corrugated packaging volumes declined 17%, but the average prices for both rose sequentially and tempered the earnings' attrition to negative \$10 million. The net move in earnings from continuing operations (including corporate expenses but excluding one-time items) was negative \$106 million or 26% of the third quarter's earnings. The swing in fourth-quarter earnings was mimicked by a negative \$233 million swing in cash flow from operations, but IP remained free cash flow positive in the quarter and added \$370 million to cash.

The first quarter of this year yielded a further negative \$47 million move in earnings (excluding biofuel credits) or down 16%. North American UFS rebounded \$11 million (volumes down 7%, prices flat, lower input costs); U.S. market pulp earnings also improved \$11 million (volumes down 21%, prices down 7%, lower input costs); and Brazilian pulp and paper earnings fell \$24 million (due to higher maintenance costs and lower export prices). North American containerboard volumes fell another 23%, and packaging volumes declined 5%; the average prices for containerboard fell 6% sequentially, but rose 1% for corrugated, and cost deflation added \$81 million to gain back \$43 million on the fourth quarter. In the first quarter, cash flow from operations would have declined another \$64 million except for \$145 million in biofuel tax credits received. IP was again free cash flow positive and in the combined two quarters cumulatively repaid a little over \$600 million in debt.

Due to lax demand, during the fourth quarter IP took market downtime of 130,000 tons in UFS, 120,000 tons in pulp and 700,000 tons in containerboard. This grew to 152,000 tons of UFS, 48,000 tons of pulp, 729,000 tons of containerboard and 127,000 tons of coated paperboard in the first quarter. IP ran its UFS, containerboard and coated paperboard mills at 80%, 75% and 75% of capacity, respectively.

Were production and prices to settle at these levels for the balance of 2009 (but penalizing corrugated prices by \$50/ton), the containerboard capacity purchased from WY in 2008 would almost nullify the loss in revenues from UFS, pulp and bleached board. The mix of business, however, combined with our deflation estimates in feedstock costs, would reduce EBITDA by a projected \$400 million and cash flow from operations by \$700 million, the difference being taxes and interest on the debt financing the acquisition of WY's containerboard assets. In the plus column for 2009 are projected savings on IP's reduced capital expenditures (\$400 million), savings on the dividend (\$290 million) and the sale of 114,000 acres of forestland (\$220 million but yet to close), which should leave IP cash flow positive almost mirroring 2008. IP has a remaining \$50 million of debt maturing this year; before biofuel credits, the company should still be able to repay a net \$400 million in debt for all of 2009 without touching the \$955 million in cash on its balance sheet at the end of the first quarter.

At the end of March, IP had an unused \$1.5 billion revolver maturing in March 2011 and a \$1.0 billion receivables securitization facility maturing in January 2010. Financial covenants include a minimum net worth of \$9 billion and a total debt to capital ratio that is less than 60%. At last quarter-end the company's minimum net worth (as defined in the covenants) was \$11.4 billion, and the debt to capital ratio was 50.3%. IP priced a \$1.0 billion 10-year issue in May at a 9.75% yield to maturity (659 basis points over Treasury notes); proceeds are being used to extend the company's debt maturity profile.

### Louisiana-Pacific Corporation

LPX (No. 1 in OSB) found new money in this past first quarter but found it to be expensive. First, the company bought the right to grant exclusive liens on its personal and real property from its 8.875% notes due in August 2010 for \$5 per \$1,000 bond. Then, LPX issued \$375 million of eight-year senior secured notes at a coupon of 13% with a discount of 25%. The notes are secured by substantially all real property plus a second lien on the company's personal property, and are packaged as units accompanied by warrants for stock (one for one warrant cover). The warrants are good for 49.0559 LPX common shares at an exercise price of \$1.39, a 10.3% premium to the company's closing price on March 3. The warrant life coincides with the life of the senior secured notes, and disregarding an allocated value for the warrants, the yield to maturity on the secured notes is 19.24%.

Coincident with the closing of the secured notes, LPX signed on for a \$100 million asset-backed revolver maturing in September 2012. The revolver is secured by substantially all of the company's personal property plus shares in LPX's foreign subsidiaries. Advances are tied to a borrowing base of eligible receivables and inventory while pricing is tied to unused availability with a minimum spread of 3.50% over Libor. Borrowings are limited by a 1.1 to 1.0 fixed-charge coverage ratio for so long as the smaller of the borrowing base or \$100 million supports less than \$50 million in unused availability.

LPX also bought back \$126.6 million of the 8.875% notes; a proviso in the revolver is that its maturity advances to February 2010 if cash or borrowings have not been reserved for that series' repayment.

In the end, LPX raised approximately a net \$138 million in cash, and cash plus short-term investments at the end of March totaled close to \$288 million. The company's funds from

operations before working capital and taxes did improve from negative \$35.8 million in the fourth quarter to negative \$15.4 million in this past first quarter, reflecting a 16% decline in the costs for resins and wax and a 26% decline in OSB volumes. Last year's OSB plant closures (Chambord, Que.; Clarke County, Ala.; and Athens, Ga.) and "right sizing" are expected to save \$65 million–\$75 million, while a lower capital expenditure budget is expected to save another \$12 million or so. Added cash interest from the new notes less those retired will cost \$37.5 million annually. The sum of these parts is an estimated cash burn of \$160 million after required debt payments should business conditions not improve, and LPX's credit availability at the end of March was limited to about \$40 million by the revolver's fixed-charge coverage ratio.

### MeadWestvaco Corporation

Coated natural kraft (CNK) and bleached board shipments are typically weaker moving from the third through the fourth quarters of the year, and MWV's decline in shipments (down 20% for CNK and down 18% for bleached board) was not atypical of 2007. First-quarter CNK shipments of 240,000 tons and bleached board shipments of 320,000 tons, however, were off 12% and 18%, respectively, from the prior year, highlighting the weak economy's toll on packaging. First-quarter earnings in Packaging Resources (MWV's most challenged business) have fallen \$51 million over the past six months (80%). Operating earnings in MWV's Consumer and Office Products business tumbled \$43 million, and although the first quarter of the year is typically the weakest for school supplies and office products, the comparative second half of 2008 was also 38% behind 2007.

Pricing in MWV's product grades has held up well by comparison to paper and corrugated packaging. This may not be the case moving through 2009, especially with early signs of cost deflation in raw materials. Volumes are likely to show more weakness before pricing. Absent any divergent movement in price/cost margins, a fall in shipments on the order of that seen in the first quarter, plus a repeat of last year's school supplies and office products business, could affect cash flow from operations by negative \$160 million. Some make-whole may come from cost reductions begun this year. The incremental savings is supposed to tally almost \$65 million (net of cash restructuring costs) and will come from a 10% reduction in MWV's global workforce and the closure or restructuring of 12 to 14 manufacturing facilities (including announced closures in Enfield, Conn.; Washington Court House, Ohio; Louisa, Va.; Wilmington, N.C.; and Caguas, Puerto Rico).

If need be, MWV has plenty of liquidity to tap. In addition to \$519 million in cash on the balance sheet at the close of the first quarter, the company had access to a \$750 million unsecured revolver maturing in December 2010 and a one-year \$200 million revolver secured by certain trade receivables which will not be renewed at its expiry this May. Both facilities were undrawn at the end of March. The pertinent financial test is a debt (including non-recourse debt) to total capital (including deferred taxes) limitation of 55%.

### NewPage Corporation

The end of the catalog season and the tailspin in advertising in fourth-quarter 2008 stripped 13% from this No. 1 coated paper producer's revenue line. Prices for coated papers fell a modest 1%, volumes of coated and supercalendered papers fell 12%, and market-related downtime at NWP's mills increased to 60,000 tons, which cost \$22 million, from 13,000 tons in the third quarter. Volumes were worse in the first quarter of 2009, off another 24%, and prices were down another 2% with market-related downtime of 149,000 tons, which cost \$41 million. EBITDA fell sequentially from

\$120 million in the fourth quarter to \$26 million in the first quarter. The sunny side is cost deflation, which added \$23 million in the fourth quarter and \$51 million in this past first quarter (chemicals accounting for \$25 million and fiber accounting for \$16 million).

Stripping out working capital changes, NWP made \$62 million in cash flow in the fourth quarter and \$26 million in cash flow in the first quarter, all financing an \$84 million build in inventories in anticipation of the third-quarter catalog season and a new supply agreement with Unisource Corp. valued at 100,000 tons annually.

NWP announced that it will be taking 150,000 tons of market downtime in the second quarter in 2009 to balance production with demand, and list prices have retreated slightly in April. Were NWP forced to extend its mill downtime history through the end of this year, volumes would decline 22% from last year's tonnage; and if average prices slip another \$25/ton, cash flow from operations could sink into negative territory, on the order of negative \$120 million, using the first quarter's cost structure. NWP also projects capital expenditures of \$75 million for year, cut back from \$165 million in 2008, which would bring total downside cash flow in 2009 based on known parts to negative \$200 million, excluding biofuel tax credits.

NWP ended the first quarter with \$247 million available under its \$500 million secured revolver. Availability is determined by a borrowing base: a) 85% of receivables plus b) the lesser of 75% of inventory at cost and 85% of the net orderly liquidation value of inventory minus c) reserves. The revolver matures on the earlier of December 2012 and 181 days prior to the scheduled maturity of NWP's term loan, and is secured by the borrowing base plus bank accounts. NWP's \$1.5 billion term loan matures on the earlier of December 2014 and 181 days prior to the maturity of its senior secured notes, and is secured by real property and other assets and a second lien on the revolver's security. The term loan is entitled to 50% of excess annual cash flow (EBITDA plus working capital changes less term loan repayments, capital expenditures, cash interest and cash taxes).

NWP's 10% senior secured notes (\$806 million) and the Libor plus 6.25% floating-rate senior secured notes (\$225 million) are due May 2012 and are collateralized by a second pledge on the term loan collateral (excluding the revolver's security). The 12% senior subordinated notes (\$200 million) are due May 2013.

Near-term scheduled debt payments are term loan amortizations only, \$16 million per year. Covenants to watch in the term loan include a maximum leverage ratio of 5.75x, stepping down to 5.0x on Dec. 31, 2009, and a minimum fixed-charge coverage ratio of 1.1x. At the end of the first quarter, these ratios were 5.63x and 1.26x, respectively.

#### **Plum Creek Timber Company, Inc.**

Plum Creek Timber Company, Inc., (PCL) deferred harvests across the board in the fourth quarter (both sawlogs and pulpwood) as the demand for lumber and pulp waned with housing starts and paper shipments. In the Southern wood basket, harvests dropped 21% sequentially; in the Northern regions the curtailment was a smaller 5.3%. The deferrals grew in the first quarter with the Southern harvest down 12% sequentially and with the Northern harvest almost 23% lower. Prices for Southern sawlogs and Northern and Southern pulpwood have been fairly stable, but Northern sawlogs have retrenched \$17/ton in the past six months, and PCL is expecting price declines for all saw timber and pulpwood in the second quarter. Harvest operating income was off 46% over the past six months while the first quarter was down 57% year-over-year. PCL's downstream manufacturing losses have swollen fivefold to -\$22 million on lower volumes and prices for lumber, plywood, medium-density fiberboard and asset impairments. Timberland sales, notably 112,000 acres in Montana sold to The Nature Conservancy and The Trust for Public Land, buttressed operating earnings by

\$162 million in this past first quarter. Absent this sale cash flow from operations would not have been sufficient to cover the \$69 million in dividends paid to shareholders or the \$87 million used to repurchase common stock.

PCL is projecting a 2009 harvest of between 15 million–16.5 million tons, a deferment of 3 million–4.5 million tons from 2008's harvest levels. Assuming no material declines in timber prices, cash harvest income could be \$40 million or more lower than last year; if there is no relief in manufacturing, last year's operating losses could increase by almost \$40 million. Phase II of the Montana forestland sale that closed in the first quarter underwrote a little more than 50% of PCL's real estate earnings guidance for 2009 (about \$300 million). In combination, funds from operations (before working capital) but with a lower interest expense could decline \$30 million, and PCL would likely not earn the cash to pay its projected dividends for the year after capital expenditure guidance (\$60 million–\$65 million) and maturing debt (\$158 million), some of which was paid in the first quarter.

Nonetheless PCL's liquidity is strong. It exited the first quarter with \$355 million in cash and \$525 million available under its revolver, which matures in June 2011. Key financial covenants include a 2.75 to 1.00 EBITDA (including the basis of land sold) to interest coverage ratio for each fiscal quarter, and a maximum funded debt to total capital ratio of 65%.

#### Potlatch Corporation

Harvest revenues tumbled sequentially in the fourth quarter and into this past first quarter, largely in PCH's Northern land base (Idaho) and largely due to lower sawlog harvests and prices. As a consequence, operating earnings from log harvests fell 48% in the fourth quarter and another 32% in the first quarter. PCH's manufacturing operations lost a little more than \$11 million in each quarter. PCH bolstered its cash flow in the first quarter with the sale of 24,800 acres in Southwest Arkansas for \$43 million, which allowed funds from operations to cover capital expenditures plus the \$20 million paid to shareholders quarterly.

In the fourth quarter, PCH spun off its weaker pulp and paper business, Clearwater Paper Corporation (Clearwater), and refinanced its unsecured maturing \$250 million revolver with a secured \$250 million revolver maturing in December 2013. Clearwater retained a \$100 million obligation to PCH for the latter's 9.125% credit-sensitive debentures maturing in December 2009. Until those debentures are repaid, the availability of PCH's new credit facility is limited to \$150 million. At the close of the first quarter PCH had \$45.3 million available, plus \$6.8 million in cash and short-term investments. The new credit facility is secured by a pledge of the capital stock of PCH's subsidiaries plus a portion of the company's timberlands in Idaho. This collateral also secures \$22.5 million of PCH's debentures maturing in 2015 and \$48.8 million in medium-term notes, the last piece coming due in 2022. The company must maintain a 2.25x collateral coverage of these debts (2.95x at the end of the first quarter), as well as an EBITDA interest coverage ratio of 2.50x (5.83x at the end of the first quarter), and a maximum funded debt to capitalization ratio of 60% (54.5% at the end of the first quarter).

PCH will be under some stress in the quarters to come. With flagging log prices and weak demand, the company will curtail 500,000 tons of harvest this year. It may have to sell some non-core lands at less than desired prices to support its current dividend distribution. Even with a drastically lower capital expenditure budget, a \$30 million cash shortfall is not improbable and may not be judicious if Clearwater cannot repay its \$100 million due bill and restore PCH's revolver availability. Fortunately, apart from the credit-sensitive debentures, near-term debt maturities are practically nil.

### Temple-Inland Inc.

By comparison TIN was an exception to circumstance in the fourth quarter, which carried through into 2009. In the fourth quarter containerboard outshined a more dismal Building Products segment, and operating income rose 160% to \$42 million. Box shipments were nearly flat with the third quarter (which only included the Premier Boxboard Limited acquisition from July 25); mill downtime was 130,000 tons. Prices were 2.4% higher sequentially while all-in costs were flat. The income from Building Products declined \$8 million sequentially with lumber prices and volumes continuing to fall, and the net effect on cash flow from operations was an increase of \$15 million, which all went to finance capital expenditures and dividends.

First-quarter 2009 box shipments fell 4.8% from the fourth quarter while net realizations improved 1.3% and costs fell 4.2% to yield a record quarter for corrugated earnings. Total mill downtime dropped to 60,000 tons. Operating income in Building Products improved \$12 million on a small seasonal pickup in gypsum and lumber volumes at lower prices but at substantially lower costs, and cash flow from operations grew another \$19 million.

On the horizon, lower containerboard prices of \$50/ton could sap \$140 million in cash flow from operations, assuming no additional offsets from lower feedstock costs and no increase in market-related mill downtime. We assume TIN will at least be able to hold lumber and gypsum to near breakeven, and the 2009 capital budget is \$44 million less than that spent in 2008. The sum of these variables would still leave TIN free cash flow positive by \$100 million or so after current dividend payments. The company has \$65 million in debt maturing this year, including \$14 million of 6.75% notes paid in early March. The company also has ample borrowing capacity, \$685 million at the end of the first quarter of 2009, which includes a \$750 million revolver maturing in July 2011. TIN is also party to a \$250 million accounts receivable securitization facility expiring in 2010, which is generally wholly used. Covenants to monitor include a 70% debt/total capital limitation and a 3.0x minimum interest cover (best four out of five trailing quarters EBITDA/interest). TIN is well within these guidelines (57.5% debt/total capital and a 5.2x interest cover at the end of the first quarter).

### Verso Paper Corp.

VRS is heavily wedded to advertising and print media (it is North America's second-largest coated groundwood and coated freesheet producer), and the decline in advertising has been leading the recession. Coated paper volumes sold declined 22.3% in moving from the third to the fourth quarter at the end of the catalog season, and 20.5% again in moving from the fourth to first quarters. While prices and costs were stable in the fourth quarter, prices gave up \$38/ton in the first quarter, costing \$17 million, but VRS earned back \$10 million on cost deflation (latex and starch down 5%, fiber down 9%, and distribution down 15%). VRS swung from \$47.3 million in operating earnings before restructuring charges to losses of \$3.4 million in the fourth quarter and \$31.5 million in the first quarter. Adjusted EBITDA margins fell from 17% to 9% in the fourth quarter, and funds from operations (before working capital swings) fell to negative \$18.2 million from \$31.1 million. Adjusted EBITDA margins fell again in the first quarter to 3.5% and funds from operations to negative \$24.1 million (after backing out alternative fuel mixture tax credits). VRS took 74,000 tons of market-related downtime at its mills in the fourth quarter, versus 87,000 tons for all of 2008 and 140,000 tons of downtime in the first quarter. The unabsorbed burden from the first quarter's downtime was \$31.3 million. VRS has suspended dividends and 401(k) contributions, and is working through selling, general and administrative reductions and incentive compensation and salary freezes to save \$65 million.

Prices are still under pressure even with the record amount of mill downtime being taken in the industry, and VRS expects to increase its market downtime above 140,000 tons in the second quarter. On the positive side of the ledger are continued signs of cost deflation for latex, caustic soda, fiber, fuel oil and transportation. Assuming slightly weaker prices and a 40% loss in volume for the balance of the year (similar to the first quarter in year-over-year comparisons), VRS could be \$40 million or so free cash flow negative after intended capital expenses and without additional biofuel tax credits. This estimate is tentative and assumes the upcoming catalog season will be as bad as the market is today.

VRS has a \$200 million revolver, secured by substantially all tangible and intangible assets, maturing in August 2012. At the close of this past quarter \$61 million was available, and the company reported compliance with all covenants; VRS also had \$17 million in cash. The incurrence of additional debt is restricted; net first lien secured debt is not permitted to exceed 3.25x adjusted EBITDA (1.4x at the end of March).

#### West Fraser Timber Co.

West Fraser Timber Co.'s (WFT) EBITDA was nominally positive in the fourth quarter as well as for the year, but descended into the red, negative CAD18 million, in the first quarter of 2009. *Random Lengths'* Framing Lumber Composite Price lost \$50/mbft in the fourth quarter and another \$27/mbft in the first quarter. WFT reigned in lumber production, 10.9% in the fourth quarter and another 11.6% in the first quarter, and is now operating at about 70% of capacity in Canada and 60% of capacity in the United States. The quarterly operating profit in lumber has declined CAD79.1 million in the past six months and would have been more if not for the depreciation of the Canadian dollar. Softwood kraft pulp prices lost \$95/tonne in the fourth quarter and another \$112/tonne in the first quarter, which was largely responsible for a negative CAD26.8 million swing in pulp and paper operating profits over the past six months.

Cash flow from operations was slightly negative in the fourth quarter and negative CAD16.3 million in the first quarter. WFT has borrowed CAD33 million over the past six months to balance cash demands, but has still kept its CAD6.0 million quarterly dividend. There has been a slight lift in lumber prices recently, but this is likely due more to production curtailments rather than construction activity, and there is no sign of a meaningful turnaround in the lumber business or WFT's operating cash flow, which amounts to negative CAD65 million if the first quarter is annualized.

Capital expenditures are projected to cost CAD47 million in 2009, similar to 2008. WFT has a 4.94% CAD150 million bond coming due this October and a CAD100 million term note coming due the following March. WFT will likely have to tap its CAD600 million unsecured revolver to help make these payments or find alternate finance. The CAD600 million revolver matures in March 2012; about CAD516 million was available at the end of the first quarter. The revolver requires WFT to maintain a consolidated debt to total capitalization ratio equal to or less than 50%, and a 2.0 to 1.0 EBITDA interest coverage ratio if the capitalization ratio is greater than 37.5%. At the end of the first quarter the capitalization ratio was 25.8%.

#### Weyerhaeuser Co.

After eliminating tax payments made as a result of the sale of its containerboard business, the cash flow drain from WY's operations grew \$123 million in the fourth quarter. Forest-related activity (the Timberlands segment) and pulp were the only enterprises that made any cash (and also in the first quarter of 2009), but all of WY's businesses contributed to the cash shortfall, which totaled some \$200 million in the fourth quarter. This figure doubled in the first quarter to negative \$436 million; most of

the increase was related to working capital (restructure payments, tax refunds due and another \$85 million loaned to WY's pension fund).

Some of WY's negative cash is seasonal, but most of it is tied to declining conditions in the company's business model. Lumber, OSB, plywood and structured wood products have fared the worst as lumber and panel shipments fell 15% and 11%, respectively, in the fourth quarter and 12% and 36% again in this past first quarter, all in tandem with prices. The business was about \$136 million EBITDA negative in the fourth quarter and \$94 million EBITDA negative in the first quarter with mills running at 58% of capacity. Real estate (homebuilding) closings in the combined fourth and first quarters are down 43% year-over-year, and operating margins fell, affecting EBITDA by negative \$12 million in the fourth quarter (excluding land basis) and negative \$26 million in the first quarter. Timberland harvests were down 13% from the third to fourth quarters and down 21% from the fourth to first quarters, with operating earnings falling \$67 million cumulatively in the past six months. Average pulp realizations have declined \$130/tonne in the past six months, and operating earnings have fallen \$31 million cumulatively.

It is difficult to see much relief in the rest of 2009. WY is being challenged to adjust its sawmill and panel operations to get them to cash breakeven, and has taken some draconian cash conservation measures: cutting capital expenditures by about \$225 million, lowering headcount by 1,500; freezing executive and salaried pay; suspending 401(k) contributions; and slicing the dividend by 58%. Yet even with these actions, it is still possible that WY could burn through \$1.0 billion (before required debt payments) of the \$2.4 billion in cash that it started with at the top of the year.

Debt maturities for the remainder of 2009 amount to \$400 million but are negligible in 2010 and 2011. Of available credit facilities, WY has a \$1.2 billion revolver maturing in March 2010 and a \$1.0 billion revolver maturing in December 2011. Both are unsecured and are available to Weyerhaeuser Real Estate Company (WRECO) for \$400 million apiece. Financial tests within these agreements restrict WY's funded indebtedness to 65% of total capital after deducting WY's investment in WRECO. WY must also keep a minimum shareholders' interest of \$3.75 billion after deducting the investment in WRECO. WRECO must keep its shareholders' equity plus subordinated debt above \$100 million and cannot permit its senior debt to be greater than 80% of its total capital. At the end of the first quarter WY reported headroom equity of \$1.0 billion for WRECO and \$340 million for WY. WY's funded indebtedness was 57.7% of total capital; WRECO's debt to total capital was 49.3%.

**Liquidity Profiles — Paper and Forest Products (I)**

(\$ Mil.)

Ticker	Period Ending	Qtrly. Free Cash Flow <sup>a</sup>	Cash and Investments	Revolver			Other Revolvers			Securitization Facilities		Total Liquidity
				Amount	Available	Expiry	Amount	Available	Expiry	Amount	Available	
CAN <sup>b</sup>	March 2009	(149)	155	431	413	June 2011	75	33	Nov. 2009	—	—	601
UFS	March 2009	33	145	750	557	March 2012	—	—	—	150	55	757
GPK	March 2009	(34)	181	400	178	May 2013	18	10	NA	—	—	369
IP	March 2009	558	955	1,500	1,500	March 2011	—	—	—	1,000	871	3,326
LPX	March 2009	(2)	288	100	38	Sept. 2012	—	—	—	—	—	326
MWV	March 2009	7	519	750	750	Dec. 2010	—	—	—	—	—	1,269
NWP	March 2009	(85)	2	500	247	Dec. 2012	—	—	—	—	—	249
PCL	March 2009	198	355	750	525	June 2011	—	—	—	—	—	880
PCH	March 2009	19	7	100	45	Dec. 2013	—	—	—	—	—	52
TIN	March 2009	51	24	750	600	July 2011	85	85	2009 and 2010	250	—	709
VRS	March 2009	(99)	17	200	61	Aug. 2012	—	—	—	—	—	78
WFT <sup>b</sup>	March 2009	(29)	22	600	516	March 2012	5	5	NA	—	—	543
WY	March 2009	(560)	1,745	1,200	1,200	March 2010	1,000	1,000	Dec. 2011	—	—	3,945

<sup>a</sup>Cash flow from operations for the quarter minus capital expenditures minus dividends. <sup>b</sup>Canadian dollars. <sup>c</sup>Includes \$783 million note owed to Southern Diversified Timber, LLC. Debt/EBITDA calculation offsets this note with PCL's retained preferred interest in the joint venture of \$705 million.

Source: Fitch calculations and company reports.

**Liquidity Profiles — Paper and Forest Products (II)**

(\$ Mil.)

Ticker	Short-Term Debt	Long-Term Debt				Debt/LTM EBITDA
		2009	2010	2011	Remainder	
CAN <sup>b</sup>	18	74	40	101	302	9.1
UFS	52	13	8	548	1,644	3.5
GPK	8	11	22	447	2,739	7.6
IP	586	50	680	550	9,629	3.3
LPX	2	11	194	7	411	(4.7)
MWV	11	85	16	15	2,268	3.0
NWP	—	16	16	16	2,931	8.5
PCL	—	58	56	627	1,316	3.9 <sup>c</sup>
PCH	—	100	11	5	301	4.1
TIN	—	19	1	2	1,121	3.0
VRS	—	3	3	3	1,339	8.3
WFT <sup>b</sup>	—	150	100	0	431	4.8
WY	1	406	43	30	5,536	(122.8)

<sup>a</sup>Cash flow from operations for the quarter minus capital expenditures minus dividends. <sup>b</sup>Canadian dollars. <sup>c</sup>Includes \$783 million note owed to Southern Diversified Timber, LLC. Debt/EBITDA calculation offsets this note with PCL's retained preferred interest in the joint venture of \$705 million.

Source: Fitch calculations and company reports.

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