Deutsche Bank

5 November 2008

Domtar

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

Domtar's 3Q in 100 words

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Reducing target from $6 to $4 and maintaining Hold

Reduction reflects DB's reduced '09 estimate as well as a higher market risk premium. While our $4 target offers substantial upside potential, we remain on sideline due to cyclical headwinds the company is facing. Our Hold rating is based on a balancing of modest valuation against cyclical challenges.

3Q was in line with FC, slightly ahead of DB

Pointing to $0.10 net of special items. DB @ $0.06, FC @ $0.10. Comps: 2Q08 = $0.06, 3Q07 = $0.09. At current C$ level of US$0.87, annualized EBITDA impact relative to LTM average of US$0.99 = +$116MM, net of hedging.

View?

Domtar doing impressive job of coping with challenges such as declining demand, rising input costs, and (until recently) a strengthening C$. Unfortunately, cyclical pressures are mounting: weak demand (exacerbated by a weak economy), capacity growth offshore, a stronger US$ (which makes the offshore capacity lower-cost), and falling market pulp prices (which gives non-integrated producers room to cut prices). A weaker C$ will only partially offset these issues.

Valuation/Risks

Our $4 price target is based on a DCF valuation. We use a 7.7% weighted average cost of capital, based on a 11.7% equity cost of capital and a 5.4% after-tax cost of debt. Our nominal growth rate of 1.0% reflects annual declines of about 1.5% when adjusted for inflation. Upside risks a potential recovery in the economy, an easing in some input costs, and a weakening of the C$ versus the US$. Downside risks include a weaker economy, falling pulp prices, and higher input costs.

Forecasts and ratios

Year End Dec 31	2007A	2008E	2009E
1Q EPS[1]	0.08	**0.05A**	–
2Q EPS	-0.01	**0.06A**	–
3Q EPS	0.09	**0.10A**	–
4Q EPS	0.06	**0.08**	–
FY EPS (USD)	0.22	**0.29**	0.15
OLD FY EPS (USD)	0.22	**0.23**	0.40
% Change	0.0%	**25.6%**	-63.4%
P/E (x)	40.5	**8.0**	16.1
Revenue (USDm)	5,947.0	**6,511.9**	5,876.5

Source: Deutsche Bank estimates, company data

[1] Includes the impact of FAS123R requiring the expensing of stock options.

Forecast change

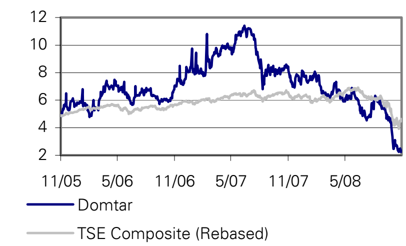
Hold

Price at 4 Nov 2008 (USD)	**2.36**
Price target	**4.00**
52-week range	**8.45 - 2.24**

Key changes

Price target	6.00 to 4.00 ↓	**-33.3%**
EPS (USD)	0.23 to 0.29 ↑	**25.6%**
Revenue (USDm)	6,708.6 to 6,511.9 ↓	**-2.9%**

Price/price relative

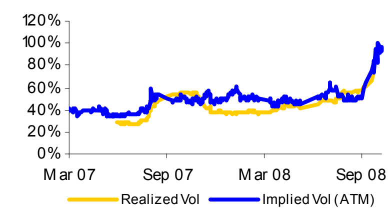


Performance (%)	1m	3m	12m
Absolute	*-38.5*	*-58.7*	*-72.3*
TSE Composite	*-6.4*	*-25.0*	*-29.6*

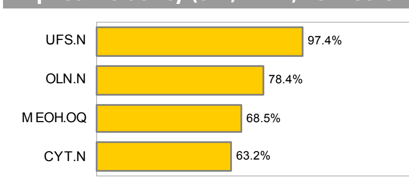
Stock & option liquidity data

Market Cap (USDm)	1,216.6
Shares outstanding (m)	515.5
Free float (%)	100
Volume (4 Nov 2008)	949,600
Option volume (und. shrs., 1M avg.)	5,287

Implied & Realized Volatility (3M)



Implied Volatility (3M, ATM) vs. Peers



*Weighted-avg. of index components
Data as of 22-Oct-08

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Domtar's 3Q in 100 words

Solid Q3 – nice performance. Reported GAAP EPS of $0.08, pointing to $0.10 net of special items. DB @ $0.06, FC @ 0.10. Comps: 2Q08 = $0.06, 3Q07 = $0.09. Gained $35MM q/q from prices & $10MM from lower energy & chemical usage. Hit by $24MM q/q in cost inflation & $16MM in lower volumes/mix. Costs up $400+MM on an annualized basis. At current C$ of US$0.87, annualized EBITDA impact versus LTM average of US$0.99 = +$116MM, net of hedging.

Paper: EBIT = $131MM (excl'g special items), 2Q08 = $106MM, 3Q07 = $143MM. Positives: prices up $40/ton q/q, lower energy usage, internal initiative benefits and FX. Neg. issues: lower paper ship's 12.5% y/y (vs industry avg. of 6% y/y) and high fiber & chemicals costs.

Merchants: Still Weak. EBIT = $1MM, 2Q08 = $2MM, 3Q07 = $6MM. YTD EBITDA of $8MM provides EBIDA margins of barely more than 1%. Higher paper deliveries +5.3% q/q & higher prices more than offset by higher paper costs & rise in allowance for doubtful accounts.

Wood: Weaker C$ beginning to help. EBIT = $(11MM), 2Q08 = $(12MM), 3Q07 = $(13MM). Decent performance, considering vol's -10% y/y & prices -14% y/y.

Others: (1) FCFE in 3Q = $82MM, despite $70MM of working capital build – very impressive for $1.3B mkt cap company. (2) Net debt/total cap = 39%. Total debt reduction target = $400-500MM. (3) Closing PM 1 at Dryden, ON (151K tpy capacity) due to weak demand. Closures since March 2007 = 700K tpy. (4) No major debt maturities until 2011. $750MM revolver remains untapped. (5) '08 Capex = $180MM. (6) Confident on revised synergy goal of $250MM by 12/31/08.

Takeaway? Solid Q3 w/ impressive free cash flow generation. Domtar doing an impressive job managing serious challenges: (1) declining demand, (2) rising inputs, (3) and (until recently) a strengthening C$. If Domtar can maintain anything near 3Q run-rate of FCF generation, the stock looks dramatically undervalued. Unfortunately, we don't think that it can. While a weaker C$ helps, we see serious headwinds: (1) weak demand, (2) capacity growth offshore, (3) a stronger US$, (4) and falling market pulp prices.

Estimates? DB boosting 4Q estimate from $0.06 to $0.08, based on strong 3Q run-rate. We expect 4Q to be modestly lower, due to seasonally & cyclically weaker volumes as well as lower pulp & wood prices. These negatives partially offset by a weaker C$. Cutting our '09 estimate from $0.40 to $0.15. We expecting price slippage & tighter margins, even w/ weaker C$ & moderating cost pressures.

Price target: We are trimming price target from $6 to $4. This reduction reflects our lower '09 estimate, as well as a higher market risk premium, based on extraordinary recent market volatility. We maintain our Hold rating. While our new $4 target provides substantial upside from current levels, we are not inclined to become constructive given the market volatility & cyclical headwinds.

Valuation

Our $4 price target is based on a DCF valuation. We use a 7.7% weighted average cost of capital, based on a 11.7% equity cost of capital and a 5.4% after-tax cost of debt. The equity cost of capital is based on assumptions of 4.0% risk-free rate, a 7% market-risk premium, and a 1.1 beta. While the market-risk premium is high relative to historical averages, we believe that it's appropriate given current market turmoil. We believe the business is in modest secular decline. Therefore, our nominal growth rate of 1.0% reflects annual declines of about 1.5% when adjusted for inflation.

Risks

Upside risks for Domtar include a potential recovery in the economy, an easing in some input costs, and a weakening of the C$ versus the US$, since a weaker CN$ will improve the competitive position of Domtar's Canadian operations. Other upside risks include better-than-expected volume and pricing. Besides the domestic and global macroeconomic risk, the greatest downside risk facing Domtar is potentially falling paper prices. Other key downside risks include exposure to various shifts in global exchange rates. While a strengthening in the US$ benefits Domtar's Canadian operations, it could negatively impact offshore trade flows, negatively affecting prices. It would also likely put pressure on global pulp prices, which in turn could put pressure on uncoated free sheet prices. Other downside risks include higher energy, fiber, and freight costs, which could cause unit costs to rise.

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist			
Company	**Ticker**	**Recent price***	**Disclosure**
Domtar	UFS.N	2.36 (USD) 4 Nov 08	2,6,14,17

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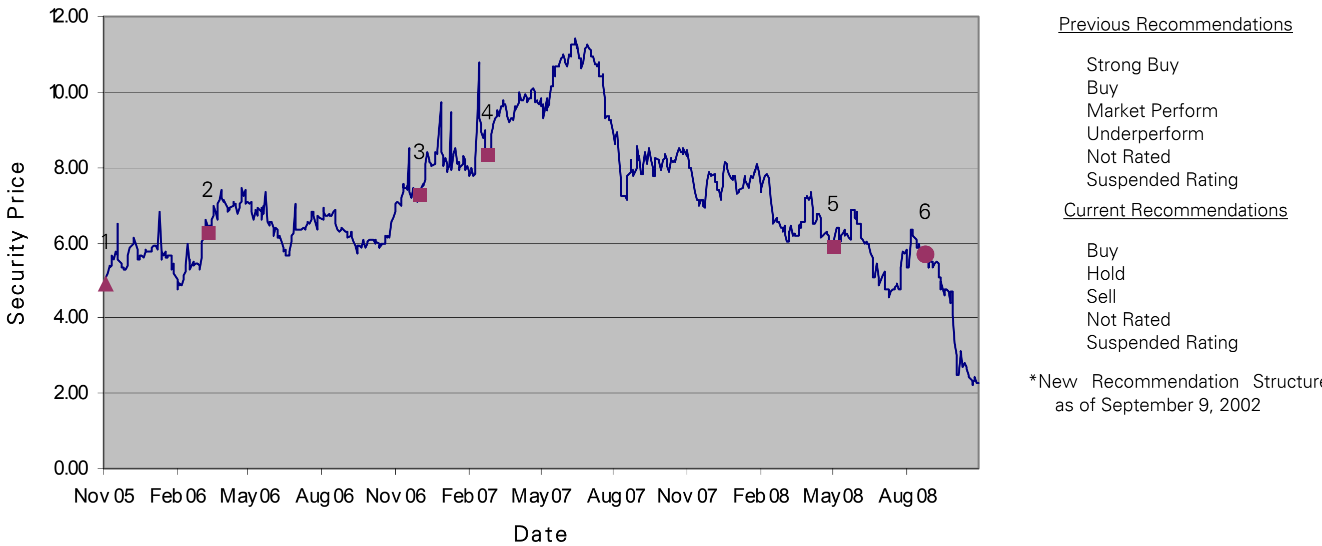
Historical recommendations and target price: Domtar (UFS.N)

(as of 11/4/2008)



1.	11/9/2005:	Upgrade to Buy, Target Price Change USD7.50	4.	2/28/2007:	Buy, Target Price Change USD14.00
2.	3/17/2006:	Buy, Target Price Change USD9.00	5.	5/6/2008:	Buy, Target Price Change USD10.00
3.	12/6/2006:	Buy, Target Price Change USD9.50	6.	8/29/2008:	Downgrade to Hold, Target Price Change USD6.00

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Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield) , we recommend that investors buy the stock.
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Notes:
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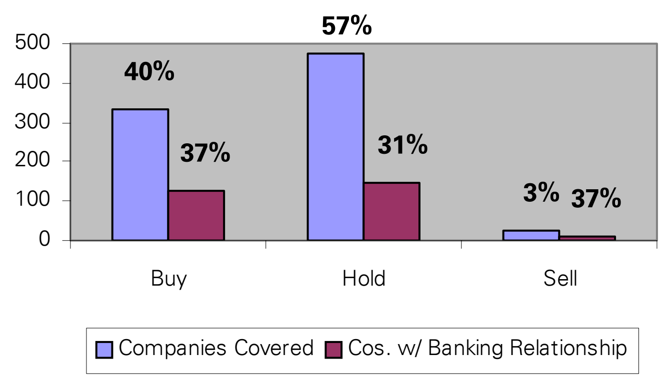

North American Universe

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