



20 October 2009

Domtar

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

Domtar Converting Paper Mill to Fluff Pulp

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Domtar's recently-announced plan to shutter a 200K/tpy uncoated free sheet machine at Plymouth, NC and convert the entire mill to fluff pulp looks like a reasonable, rational strategic decision. It shrinks Domtar's UFS capacity by roughly 4.5%, taking out one of the firm's smallest commodity paper mills. The commitment to shrinking capacity is essential in uncoated free sheet, where the mkt is in secular decline and Domtar is the clear mkt leader. We maintain our Hold rating and \$40 price target based on valuation.

Domtar will invest \$73.5MM to expand the mill's current production from 153K/mtons of fluff pulp to 444K/mtons of fluff pulp.

Growing amounts of fluff is used in tissue & absorbent products and has tended to be relatively more stable from both a price & demand standpoint. Fluff also commands a modest price premium (\$30-50mton) to standard southern softwood pulp. The mill, located in the tidewater region, is well-situated with ample supplies of low-cost southern loblolly pine. Loblolly is the preferred species of pine for producing fluff pulp. Despite raising gross mill tonnage by 20%, the reconfiguration will trim staffing from 530 to 360 employees. We estimate those reductions will reduce the mill's labor costs by \$12-15MM – roughly \$30-40/ton. We expect that a significant portion of the incremental fluff output could find its way to Asia. Domtar recently opened a Hong Kong sales office and has reportedly been selling paper grade pulp from its restarted Woodland, ME mill to China.

Other issues?

Domtar is not alone in targeting the fluff pulp market for expansion. Privately-held Parsons & Whittemore has recently announced plans to swing a portion of the capacity at its 500K/mt Alabama River mill to fluff. When coupled with Domtar's conversion, it raises the spectre of excess capacity. Looking a bit further down the road, the conversion should make Plymouth a more valuable asset for Domtar, but could also be a more interesting asset for other fluff pulp producers. Rather than shuttering another white paper mill (and incurring related closure & remediation costs), today's plan could create some real value & incremental options.

Valuation/Risks

Our \$40 price target equates to 6.0x 2010E EBITDA on an EV/EBITDA basis and 5.2x our estimate of "normalized" EBITDA of \$675MM (on current Net Debt of \$1.8B). Both ratios are consistent with historical trading patterns. 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.

Forecasts and ratios

Year End Dec 31	2008A	2009E	2010E
FY EPS (USD)	2.04	-1.50	1.00
P/E (x)	30.4	-	44.7

Source: Deutsche Bank estimates, company data

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

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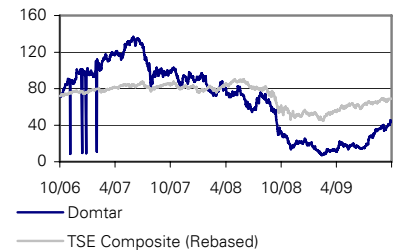
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Company Update

Hold

Price at 19 Oct 2009 (USD)	44.46
Price target	40.00
52-week range	45.56 - 7.20

Price/price relative

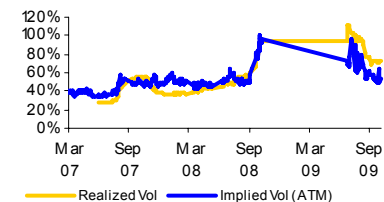


Performance (%)	1m	3m	12m
Absolute	16.0	193.3	38.2
TSE Composite	0.8	11.3	20.7

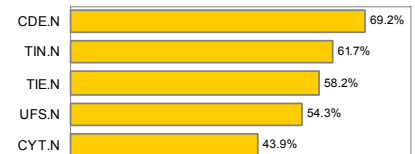
Stock & option liquidity data

Market Cap (USDm)	1,909.9
Shares outstanding (m)	43.0
Free float (%)	100
Volume (19 Oct 2009)	271,500
Option volume (und. shrs., 1M avg.)	12,813

Implied & Realized Volatility (3M)



Implied Volatility (3M, ATM) vs. Peers



*Weighted-avg. of index components
 Data as of 19-Oct-09

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Domtar	UFS.N	44.46 (USD) 19 Oct 09	1,2,6,7,8,14,17

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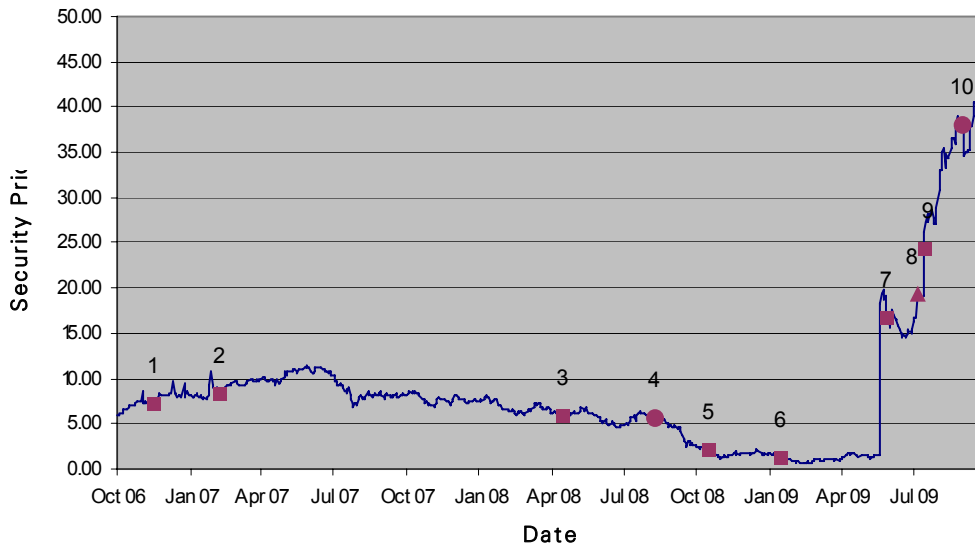
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Historical recommendations and target price: Domtar (UFS.N)

(as of 10/19/2009)



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

1.	12/6/2006:	Buy, Target Price Change USD9.50	6.	2/5/2009:	Hold, Target Price Change USD2.00
2.	2/28/2007:	Buy, Target Price Change USD14.00	7.	6/19/2009:	Hold, Target Price Change USD24.00
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4.	8/29/2008:	Downgrade to Hold, Target Price Change USD6.00	9.	8/5/2009:	Buy, Target Price Change USD35.00
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Equity rating key Equity rating dispersion and banking relationships

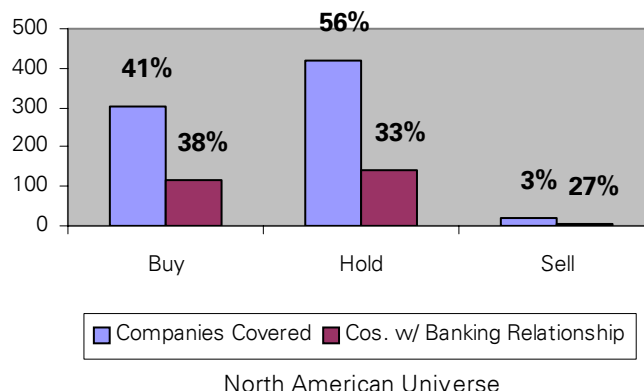
Buy: Based on a current 12- month view of total shareholder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield) , we recommend that investors buy the stock.

Sell: Based on a current 12-month view of total shareholder return, we recommend that investors sell the stock

Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

Notes:

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