



30 October 2009

Domtar

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

Domtar's 3Q in 300 words; Boosting price target to \$45

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Although 3Q results were extremely impressive, we are not yet convinced that we need to make meaningful adjustments to our estimates of normalized earnings or cash flows. Our price target goes from \$40 to \$45, based on de-leveraging. Strong operating results, limited capex spending, and black liquor credits are allowing the company to reduce debt quickly, providing equity holders a greater share of enterprise value. Our Hold rating balances modest valuation against secular challenges.

3Q09 was much better than expected

Pointing to \$1.32 net of special items (mostly black liquor credits). DB was at \$0.10 and Consensus at \$0.29. The Papers segment fueled the big upside. Adjusted segment EBITDA rose \$112MM q/q, almost double the gain that we expected. Results in other segments were about as expected.

Is Domtar in a cyclical "sweet spot"?

While paper volumes remain weak, pulp volumes were robust, and margins in both paper and pulp improved dramatically. Input costs fell \$44MM q/q, while overall prices rose \$12MM q/q. While margins will remain strong in 4Q, we think it's unlikely that Domtar can maintain margins this high indefinitely. Our normalized estimates assume that margins contract modestly from 3Q levels.

Valuation & Risk:

Our \$45 price target equates to 5.2x 2010E EBITDA on an EV/EBITDA basis and 4.8x our estimate of "normalized" EBITDA of \$675MM. Both ratios are somewhat below historical trading patterns, but we feel that this is appropriate because of the secular decline in uncoated free sheet. Downside risks include weak white-collar employment and rising input costs. Upside risks include an improving economy, and potential cyclical recovery in volumes.

Forecasts and ratios

Year End Dec 31	2008A	2009E	2010E
1Q EPS ¹	0.60	-0.84A	-
2Q EPS	0.72	-0.76A	-
3Q EPS	1.20	1.32A	-
4Q EPS	-0.48	0.70	-
FY EPS (USD)	2.04	0.42	2.25
OLD FY EPS (USD)	2.04	-1.50	1.00
% Change	0.0%	-128.3%	126.1%
P/E (x)	30.4	98.7	18.6
DPS (USD)	0.00	0.00	0.00
Dividend yield (%)	0.0	0.0	0.0
Revenue (USDm)	6,394.0	5,456.5	5,712.5

Source: Deutsche Bank estimates, company data

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

Deutsche Bank Securities Inc.

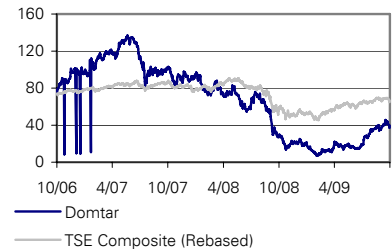
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Forecast Change**Hold**

Price at 30 Oct 2009 (USD)	41.89
Price target	45.00
52-week range	45.56 - 7.20

Key changes

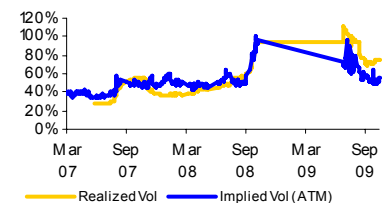
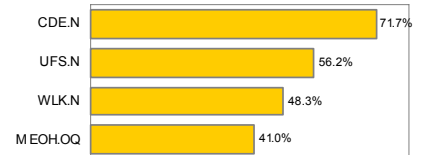
Price target	40.00 to 45.00	↑	12.5%
EPS (USD)	-1.50 to 0.42	↑	-128.3%
Revenue (USDm)	5,251.0 to 5,456.5	↑	3.9%

Price/price relative

Performance (%)	1m	3m	12m
Absolute	8.9	112.0	40.8
TSE Composite	-2.8	5.9	16.6

Stock & option liquidity data

Market Cap (USDm)	1,799.5
Shares outstanding (m)	43.0
Free float (%)	100
Volume (30 Oct 2009)	670,100
Option volume (und. shrs., 1M avg.)	12,154

Implied & Realized Volatility (3M)**Implied Volatility (3M, ATM) vs. Peers***Weighted-avg. of index components
Data as of 29-Oct-09

Model updated:30 October 2009

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

Reuters: UFS.N

Bloomberg: UFS CN

Hold

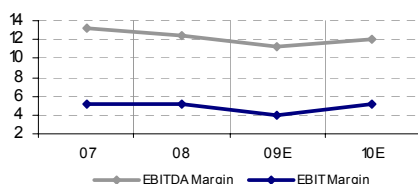
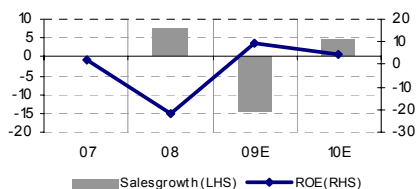
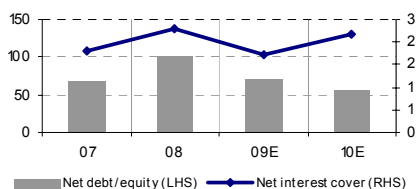
Price (30 Oct 09) USD 41.89

Target price USD 45.00

52-week Range USD 7.20 - 45.56

Market Cap (m) EURm 1,220
USDm 1,800**Company Profile**

With 2.3MM/mtons of uncoated free sheet capacity, Domtar is the third largest producer in North America. Domtar also produces coated free sheet and market pulp. Domtar is a 50% owner of Norampac a containerboard producer with 1.4MM tons of annual capacity. Finally, the company owns over 1.0MM acres of timberlands in the US & Canada and has lumber capacity of 1.2BBF.

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

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Fiscal year end 31-Dec

Financial Summary

	2007	2008	2009E	2010E
DB EPS (USD)	2.64	2.04	0.42	2.25
Reported EPS (USD)	1.77	-13.34	5.02	2.25
DPS (USD)	0.00	0.00	0.00	0.00
BVPS (USD)	80.92	49.89	54.92	57.18

Valuation Metrics

Price/Sales (x)	0.7	0.4	0.3	0.3
P/E (DB) (x)	40.0	30.4	98.7	18.6
P/E (Reported) (x)	59.9	nm	8.3	18.6
P/BV (x)	1.1	0.4	0.8	0.7
FCF yield (%)	12.4	2.6	26.3	16.7
Dividend yield (%)	0.0	0.0	0.0	0.0
EV/Sales	1.1	0.8	0.6	0.6
EV/EBITDA	8.2	6.1	5.7	4.7
EV/EBIT	20.6	14.5	16.3	10.8

Income Statement (USDm)

Sales	5,947	6,394	5,456	5,713
EBITDA	782	795	616	684
EBIT	311	332	214	294
Pre-tax profit	99	-570	369	159
Net income	70	-573	216	97

Cash Flow (USDm)

Cash flow from operations	606	197	618	475
Net Capex	-87	-128	-145	-175
Free cash flow	519	69	473	300
Equity raised/(bought back)	-1,431	0	0	0
Dividends paid	0	0	0	0
Net inc/(dec) in borrowings	518	-109	-237	-150
Other investing/financing cash flows	492	-15	0	0
Net cash flow	98	-55	237	150
Change in working capital	5	-226	0	-12

Balance Sheet (USDm)

Cash and cash equivalents	71	16	253	403
Property, plant & equipment	5,362	4,301	4,044	3,829
Goodwill	372	0	0	0
Other assets	1,943	1,787	1,787	1,827
Total assets	7,748	6,104	6,084	6,059
Debt	2,293	2,171	1,934	1,784
Other liabilities	2,258	1,790	1,790	1,819
Total liabilities	4,551	3,961	3,724	3,603
Total shareholders' equity	3,197	2,143	2,359	2,456
Net debt	2,222	2,155	1,682	1,381

Key Company Metrics

Sales growth (%)	nm	7.5	-14.7	4.7
DB EPS growth (%)	na	-22.8	-79.2	430.2
Payout ratio (%)	0.0	nm	0.0	0.0
EBITDA Margin (%)	13.1	12.4	11.3	12.0
EBIT Margin (%)	5.2	5.2	3.9	5.1
ROE (%)	2.2	-21.5	9.6	4.0
Net debt/equity (%)	69.5	100.6	71.3	56.2
Net interest cover (x)	1.8	2.3	1.7	2.2

DuPont Analysis

EBIT margin (%)	5.2	5.2	3.9	5.1
x Asset turnover (x)	0.8	0.9	0.9	0.9
x Financial cost ratio (x)	0.5	0.6	0.4	0.5
x Tax and other effects (x)	0.5	-3.1	2.4	0.6
= ROA (post tax) (%)	0.9	-8.3	3.6	1.6
x Financial leverage (x)	2.4	2.6	2.7	2.5
= ROE (%)	2.2	-21.5	9.6	4.0
annual growth (%)	na	na	na	-58.1
x NTA/share (avg) (x)	80.6	62.2	52.3	55.9
= Reported EPS	1.77	-13.34	5.02	2.25
annual growth (%)	na	na	na	-55.2

Source: Company data, Deutsche Bank estimates

3Q was much better than expected. Reporting GAAP EPS of \$4.24 and pointing to \$1.32 net of special items (mostly black liquor credits). DB was at \$0.10, FC at \$0.29. Comps: 2Q09 = \$(0.76), 3Q08 = \$1.20. After 1 for 12 reverse stock split earlier this year, EPS leverage is extremely high. Even so, we are very surprised by the magnitude of the upside.

Paper: EBITDA = \$233MM, 2Q09 = \$121MM, 3Q08 = \$242MM. Paper volumes -18% y/y, +2% q/q. EBITDA gain of \$112MM q/q was much greater than we expected. \$64MM came from pulp and \$48MM from paper. Pulp volumes +37% y/y, +13% q/q. Pulp realizations +\$59/mton q/q (-\$184/mton y/y). In UFS, offset rolls -\$12/ton q/q (-\$94/ton y/y), but copy +\$3/ton q/q (+\$15/ton y/y).

Merchants: EBITDA = \$3MM, 2Q09 = \$3MM, 3Q08 = \$2MM. Still sluggish, but steady.

Wood: EBITDA = \$(4MM), 1Q09 = \$(6MM), 3Q08 = \$(4MM). Modest seasonal improvement.

2Q to 3Q EBITDA bridge: Almost everything worked in Domtar's favor: (1) +\$53MM volume/mix (+\$25MM in paper on just 43K more tons and +\$20MM in pulp on 53K mtons), +\$44MM input costs, +\$12MM prices (+\$27MM in pulp and -\$15MM in paper).

4Q and beyond? Price will be a big q/q positive, with pulp prices up sharply again, and offset grades of paper also up q/q. However, volume/mix will be seasonally negative, and input costs are likely to be higher. We are looking for a substantial q/q decline, with EPS coming down from \$1.32 to \$0.70 q/q. However, even \$0.70 would be much higher than previous 4Q estimates (DB was at \$0.00 and Consensus at \$0.15). For 2010, our estimate goes up from \$1.00 to \$2.25 (Consensus was at \$0.76), as we think margins will contract somewhat from the 2H09 run-rate.

View? As impressive as 3Q results were, we are not yet convinced that we need to make meaningful adjustments to our estimates of normalized earnings or cash flows. Just 2 quarters ago, our \$675MM normalized EBITDA estimate looked unjustifiably aggressive to many observers, and now it probably looks too conservative. We would rather not make sharp revisions based on the results of the latest quarter. However, the sharp de-leveraging occurring at Domtar dictates that we boost our price target from \$40 to \$45. Strong operating results, limited capex spending, and black liquor credits are allowing the company to reduce debt quickly. Net debt was \$2.1B just 2 quarters ago. Now, on a pro forma basis (adjusted for black liquor credits to be received by mid-2010), net debt is just \$1.3B. Debt reduction is providing equity holders a greater share of the company's enterprise value.

Valuation

With about 5.5MM tons of annual pulp & paper capacity, current enterprise value of only \$3.2B (\$1.3B in adjusted net debt), and just 43MM shares outstanding, Domtar has a great deal of financial and operating leverage. This makes Domtar a "higher risk" paper stock, with a great deal of potential volatility in both directions. Our \$45 price target equates to 5.2x 2010E EBITDA on an EV/EBITDA basis and 4.8x our estimate of "normalized" EBITDA of \$675MM (on adjusted nebt of \$1.3B). Both ratios are somewhat below historical trading patterns, but we feel that this is appropriate because the secular decline of the uncoated free sheet market is becoming increasingly obvious.

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	39.54 (USD) 29 Oct 09	1,2,6,7,8,14

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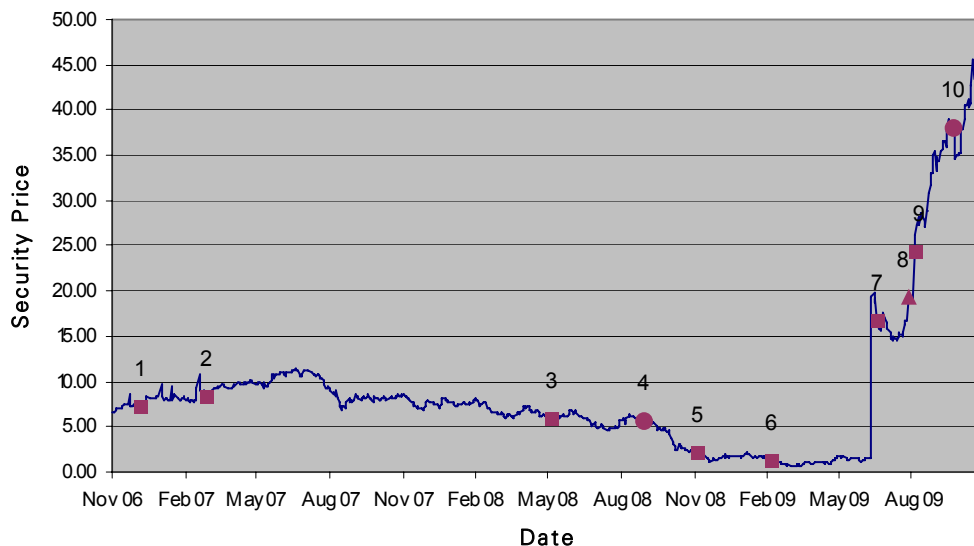
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Historical recommendations and target price: Domtar (UFS.N)

(as of 10/29/2009)



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
3.	5/6/2008:	Buy, Target Price Change USD10.00	8.	7/28/2009:	Upgrade to Buy, USD24.00
4.	8/29/2008:	Downgrade to Hold, Target Price Change USD6.00	9.	8/5/2009:	Buy, Target Price Change USD35.00
5.	11/6/2008:	Hold, Target Price Change USD4.00	10.	9/23/2009:	Downgrade to Hold, Target Price Change USD40.00

Equity rating key Equity rating dispersion and banking relationships

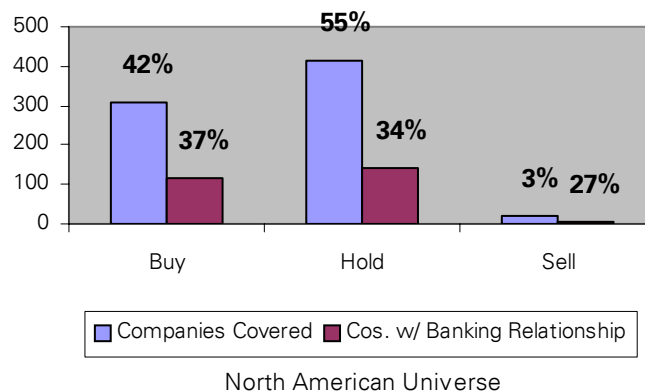
Buy: Based on a current 12- month view of total shareholder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield) , we recommend that investors buy the stock.

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

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