Forest Products

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Industry Comment

Daryl Swetlishoff CFA | 604.659.8246 | daryl.swetlishoff@raymondjames.ca
David Quezada CFA (Associate) | 604.659.8257 | david.quezada@raymondjames.ca

Pulp & Paper

Pulp & Paper: Pulp Stats Reveal Higher Inventories & Lower Operating Rates; Firming Expected in Fall

Jul-2011 pulp stats confirm seasonal softening – The Pulp and Paper Products Council released pulp industry statistics for the month of Jul-11 yesterday confirming the general softening in fundamentals with higher inventories, lower operating rates, and reduced shipments to the key North American and Western European markets. With shipments to North America of 347K mt down 6.7% y/y and 6.5% YTD and shipments to Western Europe of 524K mt down 14% y/y and 5.5% YTD operating rates fell for northern and southern softwood pulp grades in Jul-11, with NBSK (the key grade for Canadian producers) dropping significantly to 84% from 91% in Jun-11 and 93% in Jul-10. As a result of these weaker shipments, global softwood inventories rose to 32 days from 28, coming above what is generally considered balanced inventory levels at ~30 days. Chinese softwood pulp shipments, while 48.5% higher y/y and 56.5% higher YTD, were down 4% for Jul-11 at 378K mt from 393K mt in Jun-11.

Fall outlook positive on downtime, improving Chinese demand – While soft, we regard these backward looking stats as neutral given the announced US$50/mt July and August NBSK pulp price declines. We highlight, however, that current list pricing at US$990/mt remains high relative to historic levels. Looking forward we expect significant maintenance downtime during the fall (exacerbated by capital plans associated with the Canadian governments Green Transformation Program), a recovery in Chinese demand, and improving demand in North America and Western Europe will serve to tighten markets. What's more, the declining value of the C$, now at US$1.01 from US$1.06 a month ago, is a material positive for pulp sector earning, representing an offset to declining NBSK prices.

Seasonal softening already reflected in equities; Mercer and Canfor Pulp top picks – With share prices for market pulp producers Canfor Pulp, Mercer International, and Fibrek, down 15%, 24%, and 27% respectively from early July highs (versus the TSX down 8%), we regard the seasonal downturn in pulp markets as fully reflected in equity prices. Looking ahead, we highlight Canfor Pulp for yield (currently at 10% and safe for at least the remainder of 2011, in our view) and Mercer for capital appreciation as our top picks amongst market pulp producers in our universe, while noting we believe Strong Buy rated Domtar, Outperform rated West Fraser and Outperform rated Canfor Corp also stand to benefit from a firming in pulp markets. We also highlight Strong Buy rated Fortress Paper as having the greatest total return to target among our pulp and paper coverage list. We expect Fortress Paper to appreciate with upwardly trending dissolving pulp prices - currently at US$1,530/mt from recent lows of US$1,480/mt. Lastly, we note that the Thurso dissolving pulp mill is scheduled to commence shipments in early 4Q11.

Company	Ticker Primary	Ticker Secondary	Current Price	Target Price (6-12 months)	Dividend Yield	Total Return To Target	Rating
Pulp & Paper							
Canfor Pulp Products Inc.	CFX-TSX		C$15.97	C$18.50	10%	26%	Outperform 2
Domtar	UFS-NYSE	UFS.T-TSX	US$72.59	US$125.00	2%	73%	Strong Buy 1
Fibrek Inc.	FBK-TSX		C$0.98	C$1.40		43%	Market Perform 3
Fortress Paper	FTP-TSX		C$24.30	C$50.00		106%	Strong Buy 1
Mercer International Inc.	MERC-NASDAQ	MRI.U-TSX	US$8.60	US$14.00		63%	Outperform 2

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Company Citations

Company Name	Ticker	Exchange	Currency	Closing Price	RJ Rating	RJ Entity
Canfor Corp.	CFP	TSX	C$	9.19	2	RJ LTD.
West Fraser Timber	WFT	TSX	C$	38.09	2	RJ LTD.

Notes: Prices are as of the most recent close on the indicated exchange and may not be in US$. See Disclosure section for rating definitions. Stocks that do not trade on a U.S. national exchange may not be approved for sale in all U.S. states. NC=not covered.

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High Risk (HR) Companies with less predictable earnings (or losses), rapidly changing market dynamics, financial and competitive issues, higher price volatility (beta), and risk of principal.

Venture Risk (VR) Companies with a short or unprofitable operating history, limited or less predictable revenues, very high risk associated with success, and a substantial risk of principal.

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	Coverage Universe Rating Distribution			Investment Banking Distribution		
	RJL	**RJA**	**RJ LatAm**	**RJL**	**RJA**	**RJ LatAm**
Strong Buy and Outperform (Buy)	76%	57%	37%	58%	15%	25%
Market Perform (Hold)	23%	38%	53%	39%	4%	0%
Underperform (Sell)	2%	5%	9%	0%	2%	0%

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Risks - Canfor Corp.

Forest product prices are cyclical, worse than expected economic conditions could reduce our price forecasts. ii) As sales are typically denominated in U.S. dollars, a depreciation of the U.S. dollar could negatively affect earnings. iii) Canfor operates on Crown land. Government policy changes could negatively affect operating margins. v) Forest product markets are global in nature issues affecting transportation or market access could impact earnings. vi) Extreme weather conditions or fires could impact harvesting plans and hence earnings.

Risks - Canfor Pulp Products Inc.

i) Slower than expected economic growth could reduce our commodity price forecasts. ii) A strengthening of the Canadian dollar could negatively affect earnings. Downward pressure could be placed on pulp price forecasts if the Euro depreciates relative to the US$. iii) CFX has a fibre agreement with Canfor Corporation, a shortage of fibre supply or higher chip prices could negatively affect earnings. iv) A rise in interest rates would place downward pressure on CFX's high-yielding units.

Risks - Fibrek Inc.

i) Slower than expected economic growth could reduce our commodity price forecasts. ii) A strengthening of the Canadian dollar could negatively affect earnings. Downward pressure could be placed on pulp price forecasts if the euro depreciates relative to the US$. iii) A shortage of fibre supply or higher chip prices could negatively affect earnings. iv) A rise in interest rates would place downward pressure on Fibrek's units. v) Fibrek earnings could be negatively affected by unexpected curtailments.

Risks - Fortress Paper

i) cost overruns, delays and implementation issues relating to Fortress' capital expansion program, ii) pulp, cotton, energy, chemicals, synthetic fibre and other input cost inflation, iii) their ability to secure initial contracts for new products as customers are cautious on being "first adopters", iv) increasing usage of debit, credit and electronic point of sale transactions as substitutes for physical cash usage, v) the risk of new entrants in the non-woven wallpaper or dissolving pulp markets and possible erosion of Fortress' market share, vi) potential negative impact of EUR/C$ and CHF/C$ fluctuations given Fortress' exposure to both operational and translational foreign exchange risk, vii) dependence on a few key, large customer contracts , viii) the ever-evolving highly technical and innovative nature of products within the security industry - potential loss of market share and key contracts if Fortress cannot keep abreast of the competition. ix) Slower than expected economic growth could reduce our commodity price forecasts. x) A strengthening of the Canadian dollar could negatively affect earnings. Downward pressure could be placed on dissolving pulp price forecasts if the CAD depreciates relative to the US$.

Risks - Mercer International

i) Forest product commodities are cyclical, slower than expected economic growth could reduce our commodity price forecasts. ii) As pulp prices are denominated in U.S. dollars, an appreciation of the Euro (and to a certain extent, the Canadian dollar) could negatively affect earnings. iii) A reduction in the availability or an increase in price of raw materials (e.g., related to market conditions or weather) could negatively affect operating margins iv) Forest product markets are global in nature, trade issues affecting market access could impact earnings. v) Successful appeals from competitors regarding government grants could delay and/or reduce the amount of grants Mercer is entitled to.

Risks - Domtar

i) Forest product commodities are cyclical, slower than expected economic growth could reduce our price forecasts. ii) As sales are denominated in U.S. dollars, a depreciation of the U.S. dollar could negatively affect earnings. iii) An increase in energy prices could negatively impact earnings iv) A reduction in the availability or an increase in price of raw materials could negatively affect operating margins v) Forest product markets are global in nature, trade issues affecting market access could impact earnings.

Risks - West Fraser Timber

Forest product prices are cyclical, worse than expected economic conditions could reduce our price forecasts. ii) As sales are typically denominated in U.S. dollars, a depreciation of the U.S. dollar could negatively affect earnings. iii) West Fraser operates on Crown land. Government policy changes could negatively affect operating margins. v) Forest product markets are global in nature issues affecting transportation or market access could impact earnings. vi) Extreme weather conditions or fires could impact harvesting plans and hence earnings.

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