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Industry Brief

Forest Products

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Pulp & Paper

Pulp & Paper: Oct-11 Pulp Stats Weak; Reiterating Cautious Outlook

Oct-11 pulp stats weak but backward looking and likely already reflected in pricing – The Pulp and Paper Products Council (“PPPC”) released pulp stats for Oct-11 this morning revealing a 76% NBSK pulp operating rate, drastically lower than Sept-11’s 99% as monthly softwood pulp shipments to key markets such as North American and Western Europe posted y/y declines of 9.3% and 14.8% respectively. YTD, NA shipments are down 5.9% to 3,703K mt vs. 2010 while W. Europe shipments are down 7.3% to 5,970K mt. Chinese shipments, the primary source of growth in pulp demand globally, also fell by 9.4% vs. Oct-11 reversing a trend of big y/y monthly gains, however, YTD shipments of 4,143K mt are still up a healthy 48.2%. While these pulp stats are weak by most measures, we believe they are already reflected in current pricing given the US\$50/mt fall during Oct-11 and Nov-11. We note, relative to this Spring, when operating rates were in the in mid-90’s and prices were en route to all-time highs of US\$1,040/mt (reached in Jun-11) global softwood pulp shipments are down ~13%, or ~240K mt on a monthly basis. Since this time, shipments to Europe are relatively flat, meaning the bulk of decline relates to reduced shipments to NA and China. Therefore, in order to return to balanced global pulp markets, we estimate an improvement in monthly shipments of between 150K-200K mt is necessary, which would equate to a ~25% increase in shipments to China (to just above the YTD average) and a ~9% improvement in North America from Oct-11’s depressed levels – something we believe will be achievable as we move into the spring.

Inventories rise, now materially above balanced levels – Oct-11 softwood pulp inventories rose to 35 days (seasonally adjusted), from 32 in Sept-11 and 26 in Oct-10. These inventory levels are now materially above balanced levels of 30 days. We believe, once demand returns to normalized levels it will take 2-3 months to absorb the excess supply on the market. As of Nov-11 NA NBSK pricing is down 11.5% from Jun-11 highs to US\$920/mt (our 2012 forecast is US\$915/mt) while China pricing is down 25% to US\$700/mt over the same period. We are yet to hear of any pricing announcements for Dec-11.

Attractive valuations offset by near-term pricing pressure – With market pulp producer equities down an average of 30% since late Aug-11, valuations in the sector are now approaching cyclical lows by our estimates with Canfor Pulp, Mercer International and Fibrek now trading at 2012E EV/EBITDA multiples of 3.1x, 3.8x, and 3.4x respectively. However, although we now see downside in the equities as limited we also do not expect significant capital appreciation in the face of commodity price headwinds.

Company	Ticker Primary	Ticker Secondary	Current Price	Rating
Pulp & Paper				
Canfor Pulp Products Inc.	CFX-TSX		C\$10.89	Market Perform 3
Domtar	UFS-NYSE	UFS-TSX	US\$74.74	Strong Buy 1
Fibrek Inc.	FBK-TSX		C\$0.72	Market Perform 3
Fortress Paper	FTP-TSX		C\$31.95	Outperform 2
Mercer International Inc.	MERC-NASDAQ	MRI.U-TSX	US\$5.85	Market Perform 3

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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)	73%	58%	41%	51%	14%	26%
Market Perform (Hold)	26%	36%	53%	25%	5%	3%
Underperform (Sell)	1%	6%	6%	33%	6%	0%

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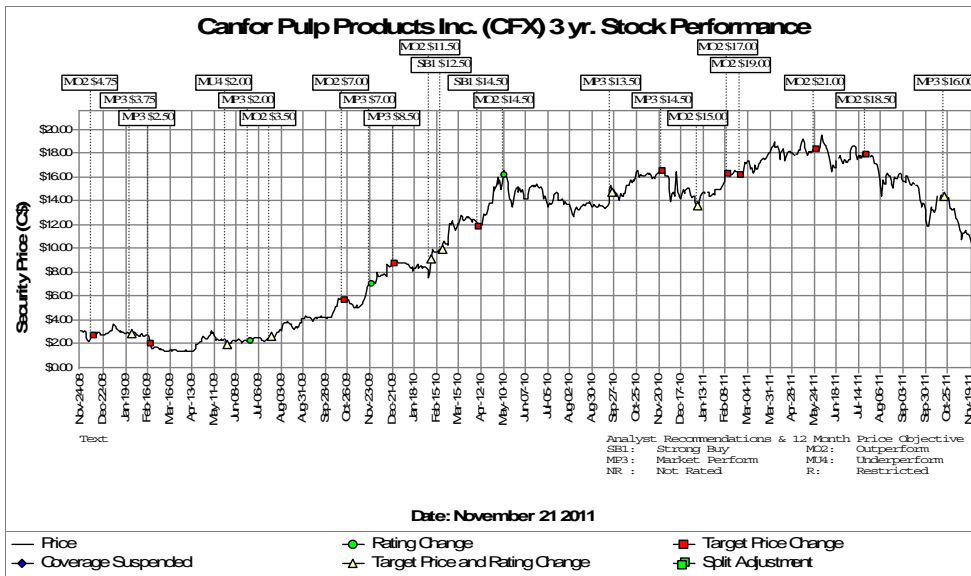
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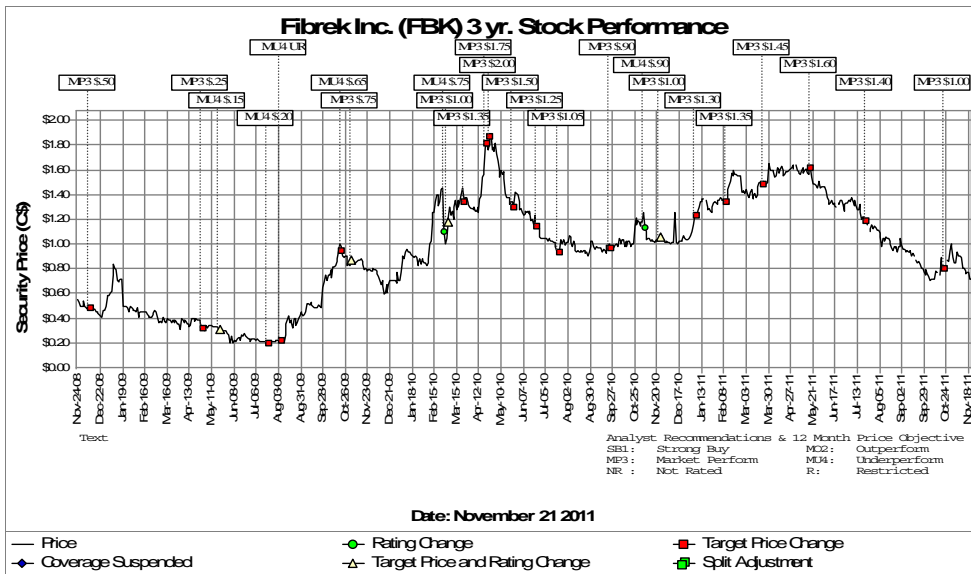
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Target Prices: The information below indicates target price and rating changes for the subject companies included in this research.



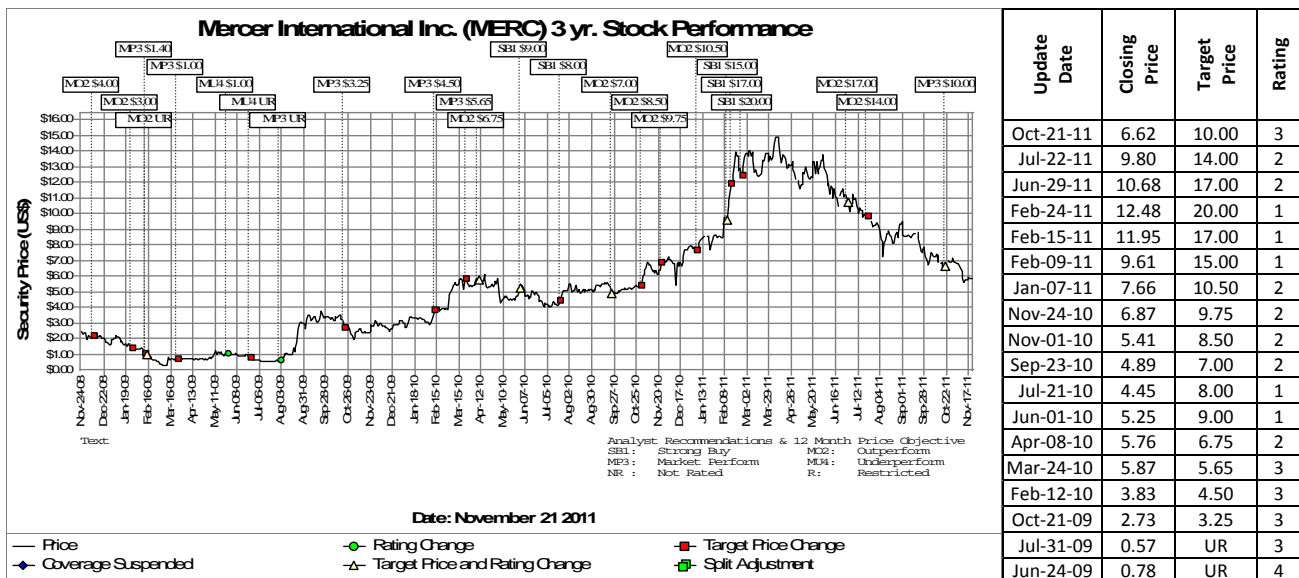
Update Date	Closing Price	Target Price	Rating
Oct-21-11	14.35	16.00	3
Jul-22-11	17.97	18.50	2
May-24-11	18.38	21.00	2
Feb-24-11	16.17	19.00	2
Feb-09-11	16.35	17.00	2
Jan-07-11	13.61	15.00	2
Nov-24-10	16.54	14.50	3
Sep-23-10	14.68	13.50	3
May-11-10	16.20	14.50	2
Apr-08-10	11.90	14.50	1
Feb-22-10	9.90	12.50	1
Feb-08-10	9.10	11.50	2
Dec-23-09	8.81	8.50	3
Nov-24-09	7.10	7.00	3
Oct-21-09	5.69	7.00	2
Jul-21-09	2.66	3.50	2
Jun-24-09	2.26	2.00	3
May-27-09	1.90	2.00	4

Valuation Methodology: Our valuation methodology for Canfor Pulp includes a comparison of EV/EBITDA multiple relative to appropriate industry competitors.



Update Date	Closing Price	Target Price	Rating
Oct-21-11	0.80	1.00	3
Jul-22-11	1.19	1.40	3
May-19-11	1.62	1.60	3
Mar-25-11	1.48	1.45	3
Feb-09-11	1.34	1.35	3
Jan-07-11	1.23	1.30	3
Nov-24-10	1.06	1.00	3
Nov-05-10	1.13	0.90	4
Sep-23-10	0.97	0.90	3
Jul-21-10	0.94	1.05	3
Jun-23-10	1.14	1.25	3
May-25-10	1.30	1.50	3
Apr-26-10	1.87	2.00	3
Apr-21-10	1.82	1.75	3
Mar-24-10	1.34	1.35	3
Mar-03-10	1.18	1.00	3
Feb-26-10	1.10	0.75	4
Nov-03-09	0.87	0.75	3

Valuation Methodology: Our valuation methodology for Fibrex includes a comparison of EV/EBITDA multiple relative to appropriate industry competitors.



Valuation Methodology: Our valuation methodology for Mercer International includes a comparison of EV/EBITDA multiple relative to appropriate industry competitors.

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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 - 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.

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