



Methodology

Rating the Forest Products Industry

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Insight beyond the rating.

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Note: DBRS provides third-party, independent evaluations in four major areas: the corporate sector, financial institutions, public finance and structured finance. The corporate sector consists of a wide variety of industries.



I. Overview

DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security, or an obligation. They are opinions based on forward-looking measurements that assess a company's ability and willingness to make timely payments on outstanding obligations (whether principal, interest or dividend) with respect to the terms of an obligation. Ratings are not buy, hold or sell recommendations and they do not address the market price of a security.

DBRS rating methodologies include consideration of general business and financial risk factors applicable to most industries in the corporate sector as well as industry specific issues and more subjective factors, nuances and intangible considerations. Our approach is not based solely on statistical analysis but includes a combination of both quantitative and qualitative considerations. The considerations outlined in DBRS methodologies are not intended to be exhaustive. In certain cases, a major strength can compensate for a weakness that would be more critical for a peer company. Conversely, there are cases where one weakness is so critical that it overrides the fact that the company may be strong in most other areas.

DBRS rating methodology is underpinned by a stable rating philosophy, which means that in order to minimize the rating changes due primarily to global economic changes, DBRS generally factors the impact of a cyclical economic environment into its rating. Consequently, DBRS takes a longer-term "through the cycle" view of a company and, as such, rating changes are not based solely on normal economic cycles. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future. An equally important aspect of DBRS analysis is its broad industry coverage, which it undertakes in order to understand the major differences and subtle nuances within a particular industry and to form an appropriate rating of a company relative to its competitors.

As a framework, DBRS rating methodologies consist of three components that together form the basis of the rating: an assessment of the company's general business risk profile based on cross-industry and macro business considerations; an assessment of the company's financial risk profile primarily based on quantitative ratio analysis; and consideration of industry-specific factors and measures particularly unique to the company. To some extent, the business risk and financial risk profiles are inter-related. The degree of financial risk considered acceptable for a company depends to a large measure on the business risks it faces.

Critical in the determination of a rating is the application of the analyst's experience and expertise in forming an initial rating opinion and recommendation for the rating committee and the role of the DBRS rating committee as the final decision maker. DBRS rating committees, which comprise experienced and knowledgeable DBRS personnel, strive to provide objective and independent rating decisions which are based upon all relevant information and factors, incorporate both global and local considerations, apply DBRS-approved methodologies and reflect the opinion of DBRS.

II. General Business Risk Profile

A fundamental component of DBRS analysis is the consideration of macro business factors that apply to most, if not all, industries within the corporate sector. The general business risk profile is largely a qualitative assessment of the environment a company is affected by and operates in. An assessment of the general business risk profile serves as a backdrop for the analysis of the company's financial risk profile as well as other qualitative and quantitative factors that are particularly unique to the company. Differing business risk profiles impact the assessment of a company's financial risk profile, and thus, it is important to understand the extraneous influences and business factors a company is or could be affected by despite its financial strength.

KEY CONSIDERATIONS IN EVALUATING A COMPANY'S BUSINESS RISK PROFILE

The following considerations, while not intended to be an exhaustive list, indicate the key areas DBRS considers in evaluating a company's business risk profile:

Economic Environment

The importance of the industry within the overall economy, in terms of either how it impacts or is impacted by the economy, shapes a company's viability. Also of importance is how the industry is influenced by current economic factors such as inflation or deflation, supply and demand, interest rates, currency swings and demographics.

Legislative and Regulatory Environment

Whether an industry is regulated or not is key, as the degree of regulation and legislative oversight can severely restrict or assist a company depending on its stage of growth, industry influence and regulatory relations. A regulated industry imposes a certain rigour and governance. It is also important to understand the frequency of change or stability in industry rules and whether regulations may require companies to make costly modifications to their infrastructure.

Competitive Environment

The nature of the market structure (e.g., monopoly versus oligopoly) determines the extent of competitiveness and the barriers to entry a company may face. Many industries are undergoing significant structural changes such as consolidation or deconsolidation, excess capacity, or competitive threats from new capacity in "low-cost" countries such as China, Brazil and Russia in both domestic and international markets. Even small changes in the competitive environment can have a profound impact on a company.

Country Risk

Governments often intervene in their economies and occasionally make substantial changes in policy regarding competition, ownership, wage and price controls, restrictions on foreign currency, capital and imports/exports, among other things. Such policy changes can significantly affect a company, and therefore, considerations include the company's main location or country of operation, the extent of government intervention and support, and the degree of economic and political stability. The assessment of country risk is not limited to direct government actions to interfere with the private sector, but also encompasses the full range of financial and economic events that can spill across a country, causing widespread defaults in otherwise healthy corporate credits. As such, country risk can have considerable implications for corporate ratings. A country ceiling is assigned to corporate foreign currency ratings based on the country's susceptibility to systemic shocks and the private sector's ability to maintain its foreign currency debt payments when shocks occur.



Industry Cyclicity

Cyclicity is influenced by factors such as levels of consumer spending, consumer confidence and the strength of the economy. The degree of cyclicity is influenced by the market segment in which a company specializes. Non-cyclical industries are better able to withstand dramatic economic changes, as are companies with more predictable cycles, than those with significant peaks and troughs. It is important to examine a company's strategies and performance over the longer term and understand them in cyclical highs and lows.

Management

The capability and strength of management is a pivotal factor in company success. An objective profile of management can be obtained by assessing the following: the appropriateness of core strategies; rigour of key policies, processes and practices; management's reaction to problem situations; its appetite for growth, either organically by adding new segments or through acquisition; its ability to smoothly integrate acquisitions without business disruption; and its track record in achieving financial results. Retention strategies and succession planning for senior roles are also critical considerations.

Corporate Governance

Effective corporate governance requires a healthy tension between management, the board of directors and the public. There is no one "right" approach for all companies. A good board can have a profound impact on growing companies, those in fragile financial states or those undergoing significant change. Beyond a review of management, assessment should focus on the appropriateness of board composition and structure (including the independence and expertise of the audit committee) to approve executive compensation and corporate strategy, and to oversee execution and opportunities for management self-interest. Other important areas include the extent of disclosure of financial and non-financial information (including aggressiveness of accounting practices and control weaknesses), share ownership (including director's) and shareholder rights.



III. General Financial Risk Profile

The financial risk profile is largely a quantitative assessment of the company's financial strength and an estimation of its future performance and financial profile. DBRS reviews three key areas: earnings, cash flow, and additional measures for balance sheet and financial flexibility. Within each area, DBRS focuses on key metrics and considerations which are assessed over time noting that the trend in the ratios is also important to the rating. However, ratios alone cannot be used as an absolute test of financial strength. With a focus on future expectations, the primary goal of financial risk assessment is to understand the inter-relationship between the numbers, interpret what they mean, and determine what they indicate about the company's ability to service and repay debt on a timely basis given the industry background.

KEY CONSIDERATIONS IN EVALUATING A COMPANY'S FINANCIAL RISK PROFILE

The following financial considerations and ratios tend to be analyzed for the majority of industries in the corporate sector. There may be additional quantitative factors and ratios that are considered on an industry-specific basis which are noted under Section IV – Industry-Specific Factors.

Also refer to the Corporate Sector – Glossary of Ratio Definitions.

A. Earnings

DBRS's earnings analysis focuses on core or normalized earnings and in doing so considers issues such as: the sources, mix and quality of revenue; the volatility or stability of revenue; the underlying cost base (e.g., company is a low-cost producer); optimal product pricing; and potential growth opportunities. Accordingly, earnings as presented in the financial statements are often adjusted for non-recurring items or items not considered part of ongoing operations. DBRS generally reviews company budgets and forecasts for future periods. Segmented breakdowns by division are also typically part of DBRS's analysis.

Typical earnings ratios include:

- Gross margin
- Return on common equity
- Return on capital
- EBIT margin and EBITDA margin

B. Cash Flow/Coverage

DBRS's cash flow analysis focuses on the core cash flow generating ability of the company to service current debt obligations and other cash requirements as well as the future direction of cash flow. From a credit analysis perspective, insufficient cash sources can create financial flexibility problems even though net income metrics may be favourable. DBRS evaluates the sustainability and quality of a company's core cash flow by focusing on cash flow from operations and free cash flow before and after working capital changes. Using core or normalized earnings as a base, DBRS adjusts cash flow from operations for as much non-recurring items as possible. In terms of outlook, DBRS focuses on the projected direction of free cash flow, the liquidity and coverage ratios, and the company's ability to internally versus externally fund debt reduction and future capital expenditure and dividend/stock repurchase programs, as applicable.

Typical cash flow ratios include:

- EBIT interest coverage and EBITDA interest coverage
- EBIT fixed charges coverage
- Cash flow/total debt and cash flow/adjusted total debt
- Cash flow/capital expenditures
- Capital expenditures/depreciation



- Debt/EBITDA
- Dividend payout ratio

C. Balance Sheet and Financial Flexibility Considerations

As part of determining the overall financial risk profile, DBRS evaluates various other factors to measure the strength and quality of the company's assets and its financial flexibility.

From a balance sheet perspective, DBRS focuses on the quality and composition of assets including goodwill and other intangibles, off-balance sheet risk, and capital strength including the quality of capital, appropriateness of leverage to asset quality and the ability to raise new capital. DBRS also reviews the company's strategies for growth including capital expenditures, plans for maintenance or expansion, and the expected source for funding these requirements. Where the numbers are considered significant and the adjustments would meaningfully impact the credit analysis, DBRS adjusts certain ratios for items such as operating leases, derivatives, securitizations, hybrid issues, off-balance sheet liabilities and various other accounting issues.

Typical balance sheet ratios include:

- Current ratio
- Turnover – Receivables and inventory
- Asset coverage (times)
- Per cent total debt to capital and per cent adjusted total debt to capital
- Per cent adjusted net debt to capital

The following factors focus on the company's liquidity:

- Maintaining sufficient bank-lines or cash balances
- Prudent use of cash balances for dividends or stock repurchases
- Terms and conditions of credit facilities including unique terms and/or financial covenants
- Debt management approach including dependence on short-term versus long-term debt, fixed versus variable rate debt, and debt maturity schedule
- Interest rate and/or foreign exchange exposure
- Relationship and strength or weakness of a parent holding company or associated companies, if applicable

IV. Industry-Specific Factors

Each industry within the corporate sector has unique features that cannot be broadly applied across all industries. For example, capital spending is a key area in the utilities industry, reserves are particular to the mining industry, adequate R&D is critical for the pharmaceutical industry and seasonality significantly impacts merchandisers. Against the backdrop of the general business and financial risk profiles, a company's unique strengths, weaknesses and industry-specific concerns need to be factored into the credit analysis to form an appropriate credit rating. These particular business and financial issues and measures also help to shape the company's status relative to its peers.

KEY CONSIDERATIONS IN EVALUATING A COMPANY WITHIN THE FOREST PRODUCTS INDUSTRY

Since demand and prices of forest products commodities are cyclical, the operating and financial performance of forest products companies can swing dramatically from peak to trough. As a result, DBRS rates each company through a cycle, and does not penalize a company at market troughs nor reward it at market peaks. The following considerations more specifically characterize the forest products industry, and supplement the macro business and financial considerations, respectively, in Sections II and III of DBRS methodology. All three sections, Section II, III and IV, should be considered together.

PRIMARY FACTORS

Fibre Supply and Costs

The type of fibre used in the manufacturing process and the degree of ownership can substantially change the cost structure of manufacturing operations within geographical and/or socioeconomic regions. Wood fibre and reclaimed fibre markets are highly competitive and price-sensitive and have historically exhibited price and demand cyclicity. A high dependency on open market fibre purchases leaves a company exposed to future supply shortages, significantly higher fibre costs, and increased operating costs that restrict profitability. During strong markets these increased costs can be passed on to customers but in weak market conditions companies must absorb the costs. Important elements in determining the current and future cost impacts are: (1) type of fibre supply – harvesting rights, private timberland ownership, or purchase contracts; (2) fibre mix – softwood versus hardwood, pulp logs versus saw logs, virgin fibre versus recycled fibre; (3) the relative location of the fibre basket to the mills and the associated impact on wood costs; and (4) the evolution of each company's fibre supply and the likelihood that future supply sources will be different than current sources.

Mill Integration and Efficiency

A company's cost competitiveness is directly linked to the age of manufacturing equipment and the energy self-sufficiency of manufacturing facilities. Each manufacturing location should be assessed in terms of: (1) capital expenditure requirements for general maintenance and compliance with environmental guidelines; (2) the degree of mill modernization and need for future upgrades, replacement or expansion projects; and (3) mill energy sources, including captive or long-term contracts with local area energy sources, as well as each mill's ability to convert to alternative energy sources.

Capital Intensity

Forest products companies have grown by means of acquisitions and greenfield expansions, both of which require large amounts of capital. Lesser amounts of capital are also required to upgrade and rationalize operations to improve quality and to lower unit operating costs. Low-cost facilities limit the impact of tough market conditions at cyclical troughs and increase earnings potential in strong markets.

An assessment of the company's ability to lower operating costs and build its business would include: (1) the company's capital expenditure history and its ability to maintain a conservative credit profile; (2) its historical track record of successfully integrating acquisitions and achieving stated goals of incremental earnings, cash flows and synergies; and (3) the corporate history of expansions in existing geographic areas and product lines, as well as in products and/or areas new to the company.

Saleable Assets

The only assets that are easily saleable in both expansionary and recessionary economic conditions are timberlands and hydro-electric power generation facilities. In addition to providing low-cost sources of fibre and electrical energy – competitive advantages in a high-cost environment – these assets can also be easily monetized, providing additional support to corporate debt. The market value of each company's saleable assets must be updated in a timely manner.

Product Diversity

Historically, building products markets have exhibited countercyclical trends through an economic cycle when compared to pulp, paper and packaging markets, a feature that moderates corporate earnings volatility during periods of rapid product price changes. Each company's segmented earnings and segmented production capacity must be analyzed to determine the degree of future earnings and cash flow volatility.

Product Development

Earnings from timberlands, power generating facilities, consumer products and high value-added products tend to experience less severe demand fluctuations and higher margins than commodity products. The conversion of commodity products to higher-margin specialty grades moderates the cyclical impact of commodity products on corporate earnings and improves corporate profit margins. Each company should be assessed in terms of (1) historical success in converting commodity products into higher value products; (2) the current percentage of commodity products and specialty products; and (3) plans to convert additional commodity products to specialty grades.

Currency Exchange Rates

Most large forest products companies have manufacturing operations in more than one country. As a result, rapid and substantial changes in a country's exchange rates can significantly change the international cost competitiveness of manufacturing facilities located in that region. In addition, many large forest products companies export a high percentage of their production. As a result, currency exchange rates between the country of manufacture and the country of sale can significantly change profit margins.

Distribution Channels

Extensive fine paper distribution networks increase the marketability of fine paper products. Strategically located distribution centres enable a company to guarantee efficient delivery, providing a competitive advantage.

Governmental Regulations

Governmental operating, environmental and trade regulations directly impact raw material supply, operating costs, and selling, general and administrative expenses. Of specific interest are regulations pertaining to stumpage fees, harvesting, environmental and labour practices. The political influence of conservationist groups can also have a major impact on harvesting costs. Political trade issues and the likelihood of future trade export or import constraints on raw materials and finished products are also important factors.



SECONDARY FACTORS

Fragmentation

The forest products industry is generally very fragmented, despite recent consolidation activities. The lack of dominant players leads to a lack of discipline among industry players regarding supply management, with detrimental effects on pricing.

Pricing Environment

Pulp, paper, packaging and building products are essentially commodities with prices fluctuating according to demand and supply. Since cyclicalness is inherent in most paper, packaging and building products, it is important to determine if each primary product cycle is evolving in a manner consistent with historical norms – if not, what are the characteristics of the new cycle structure and how will it affect future pricing trends?

Global Demand/Supply

The forest products industry operates in a global marketplace and major changes in regional supply and/or demand can have ramifications worldwide. It is important to monitor and assess global demand and supply trends and the associated impact on operating rates and product prices. In addition, new capacity, which is typically added in large chunks, also adds to the supply and demand imbalance.

Labour Relations

Frequent and prolonged labour disruptions can not only negatively impact cost structures but can also erode a company's image or perception as a reliable supplier. Important factors include: (1) historical relationship between company and employees; (2) degree of unionization; (3) major labour contract details, for example, expiry date of collective bargaining agreement, wage agreements, pension provisions; (4) company or industry negotiation process; and (5) strike history.

Economies of Scale

Large production capacities and market shares provide competitive marketing advantages and operating flexibility and efficiencies, factors that increase profit margins in strong markets. Conversely, companies with product lines that have low market shares are unable to influence market demand and supply relationships. In addition to being a price follower rather than a price leader in these smaller businesses, the business units also compete for capital and management time that may be more profitably deployed in other areas. Each company's market share by product line must be continuously monitored.

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