

Presentation to: Paper Industry Management Association

2006 PIMA Conference State of the Industry

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Outline

- ◆ Economy – Strong Growth Moderating Due to Higher Rates
- ◆ Key Themes
 - Commodity Prices
 - China is Driving Higher (and Lower) Prices
 - Timber – Change in Ownership Continues
 - U.S. and Global Supply/Demand is Favorable
 - Financial Returns – Better, but Further Improvement Needed
- ◆ Summary

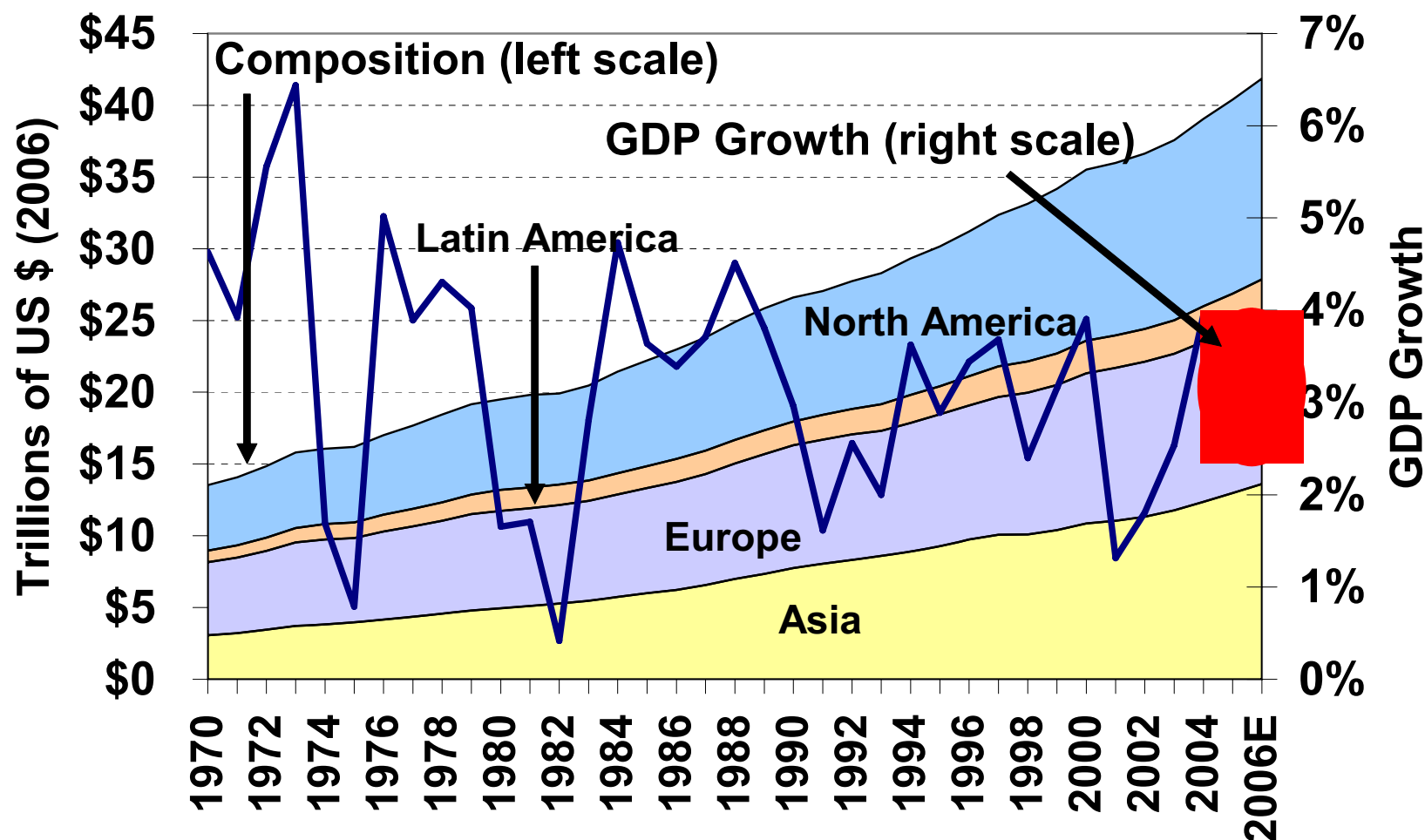
Economy

- ◆ Global economic growth is strong, but moderating.
- ◆ Interest rates are low, but rising.
- ◆ Interest sensitive sectors like housing are feeling the pinch.
- ◆ Twin deficits (budget/trade) may keep pressure on rates.
- ◆ The dollar continues to slide.

Economy

Global economic growth is strong but moderating...

Composition of Global GDP and GDP Growth



Source: DRI/McGraw Hill, International Monetary Fund, Lehman Brothers Estimates

Economy

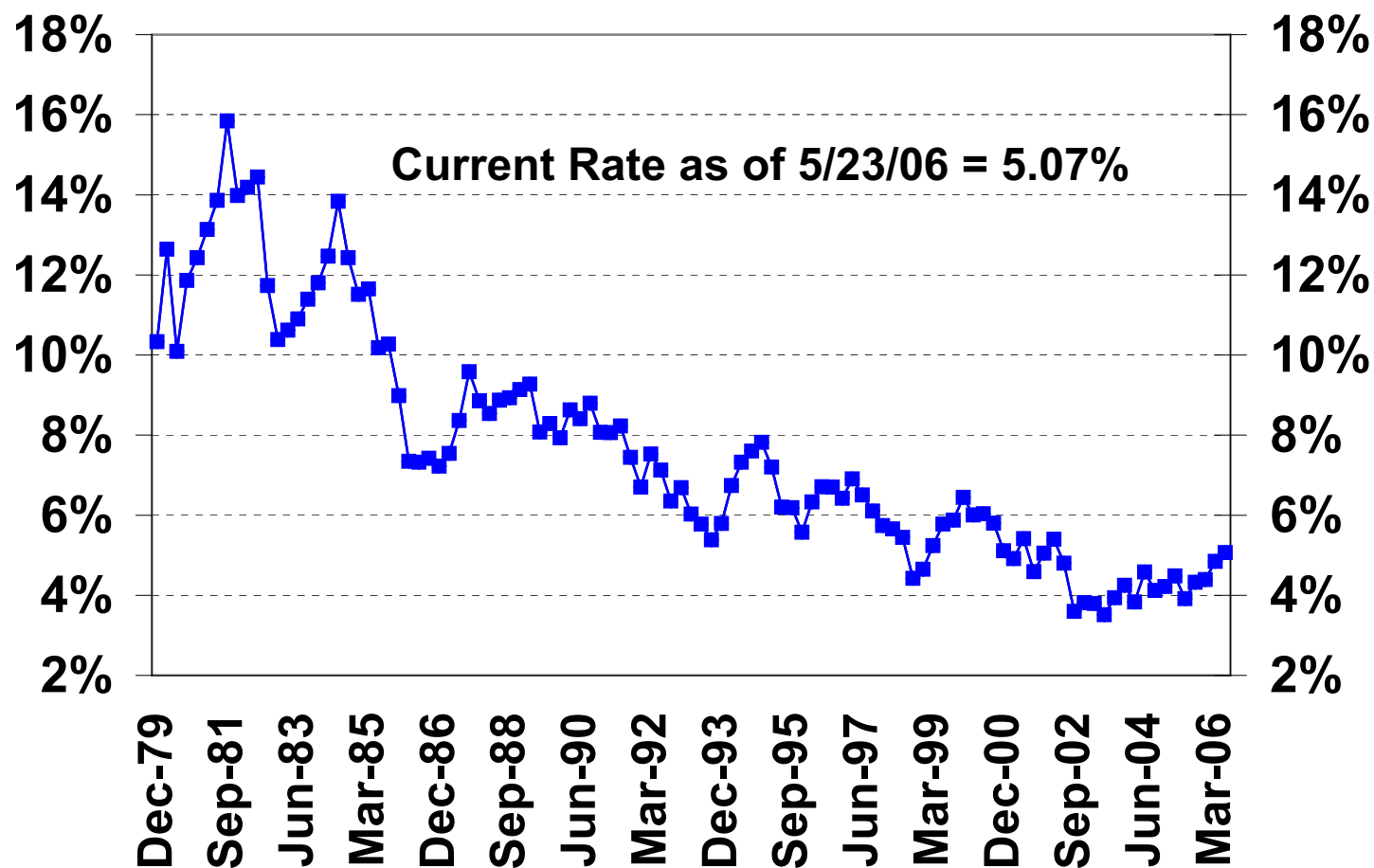
- ◆ Between 1968 and 2003 there was negative GDP somewhere in the world every year (looking at largest 47 economies of the world).
- ◆ For 2004, 2005, and 2006E, we've enjoyed synchronized growth with all of the 47 largest economies showing positive growth.

Sources: International Monetary Fund, McGraw Hill/DRI.

Economy

Economic growth has been supported by low interest rates...

10-Year Treasury Yield

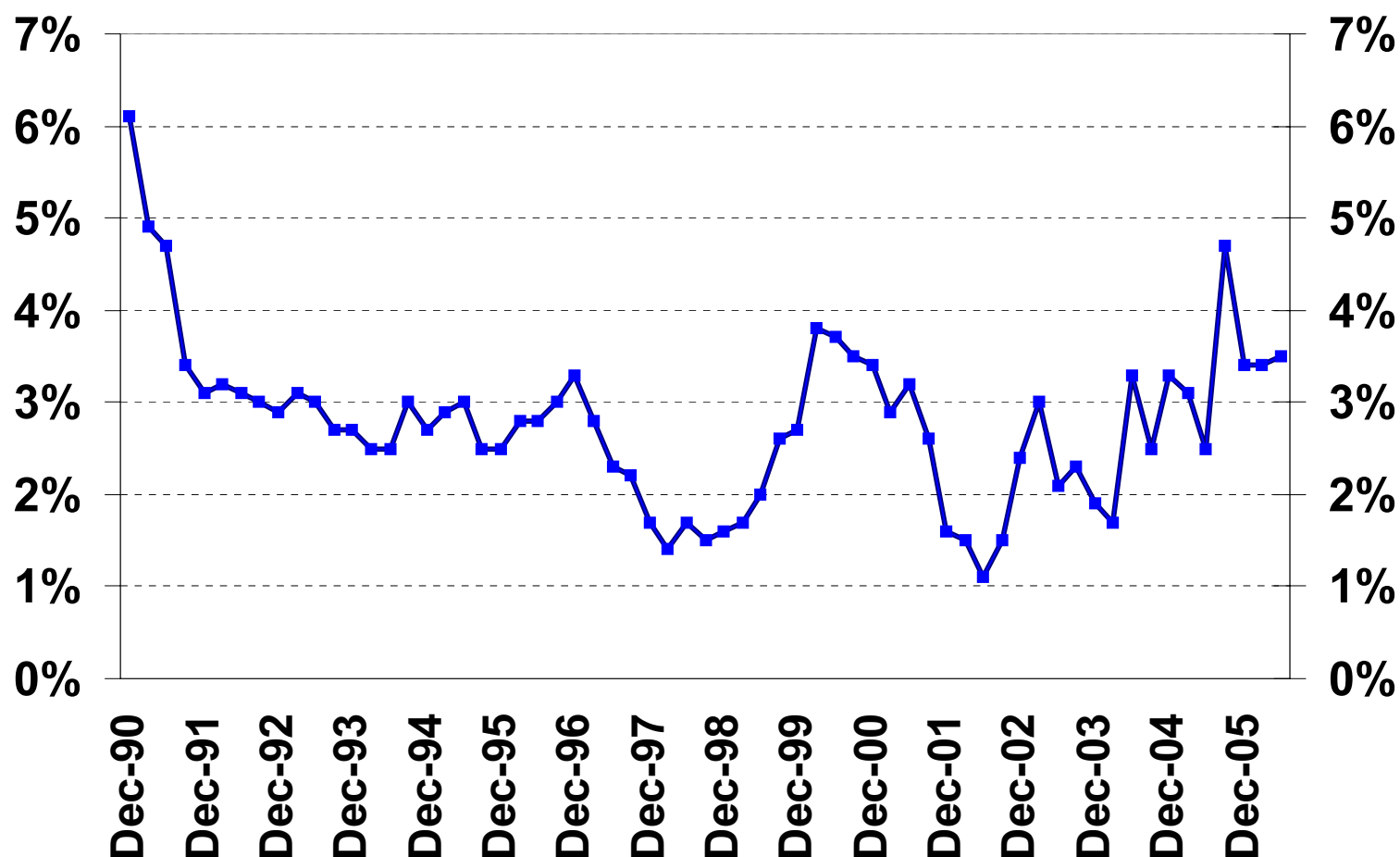


Source: Bloomberg

Economy

But the Fed is worried about signs of inflation...

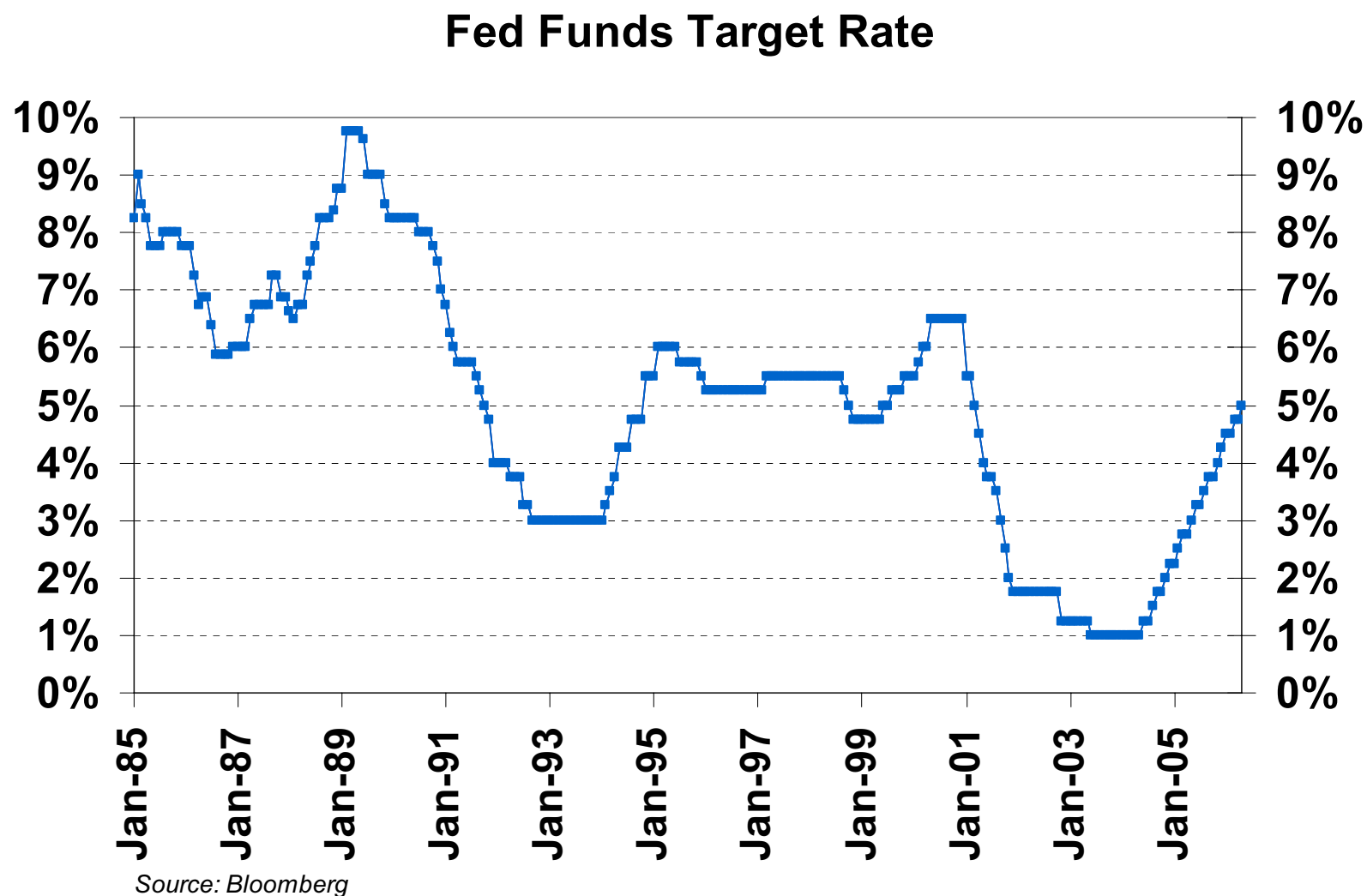
Consumer Price Index (including food and energy)



Source: Bloomberg

Economy

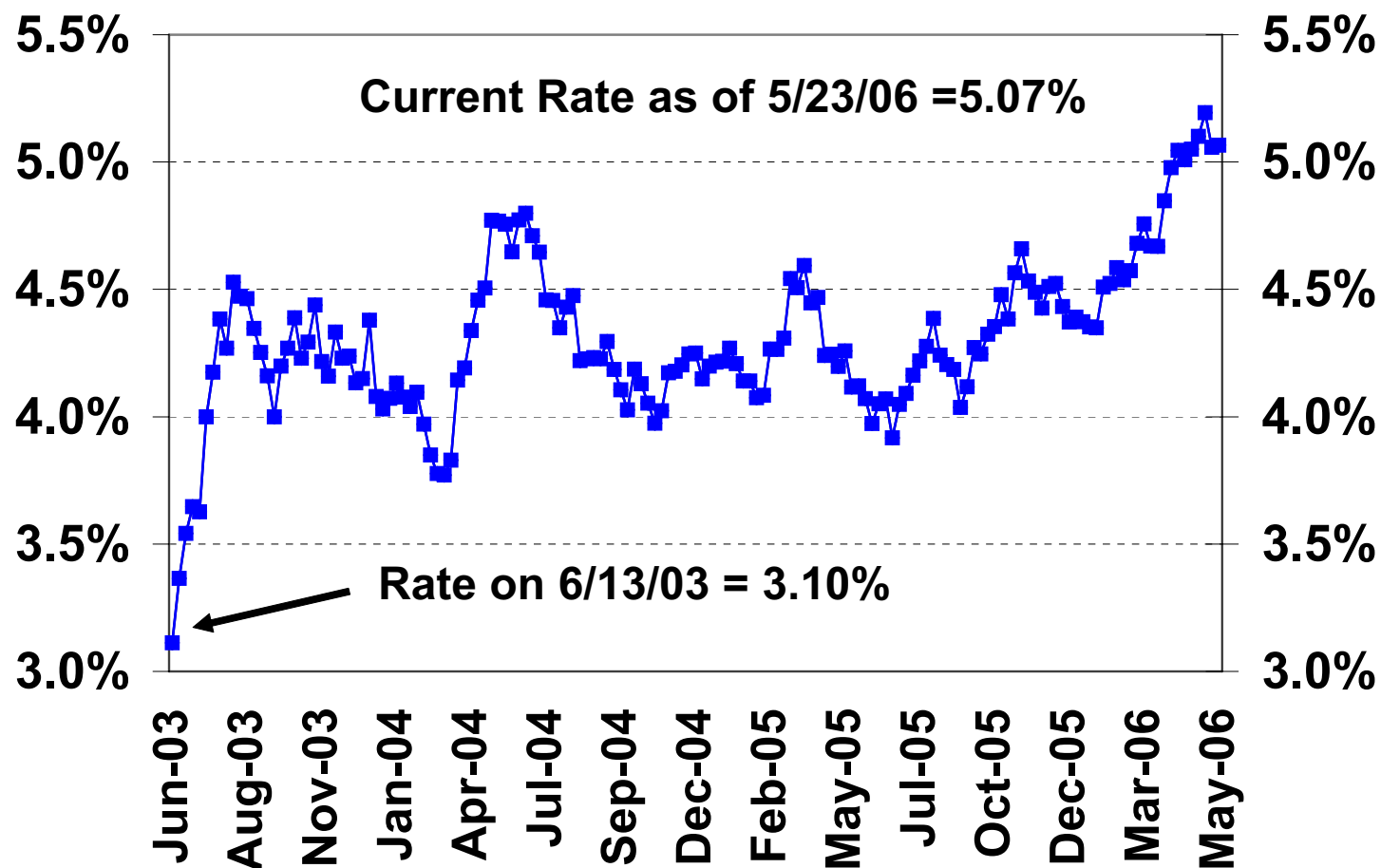
So the Fed continues to raise short-term rates...



Economy

And 10-Year Treasury Yields are finally rising...

10-Year Treasury Yield

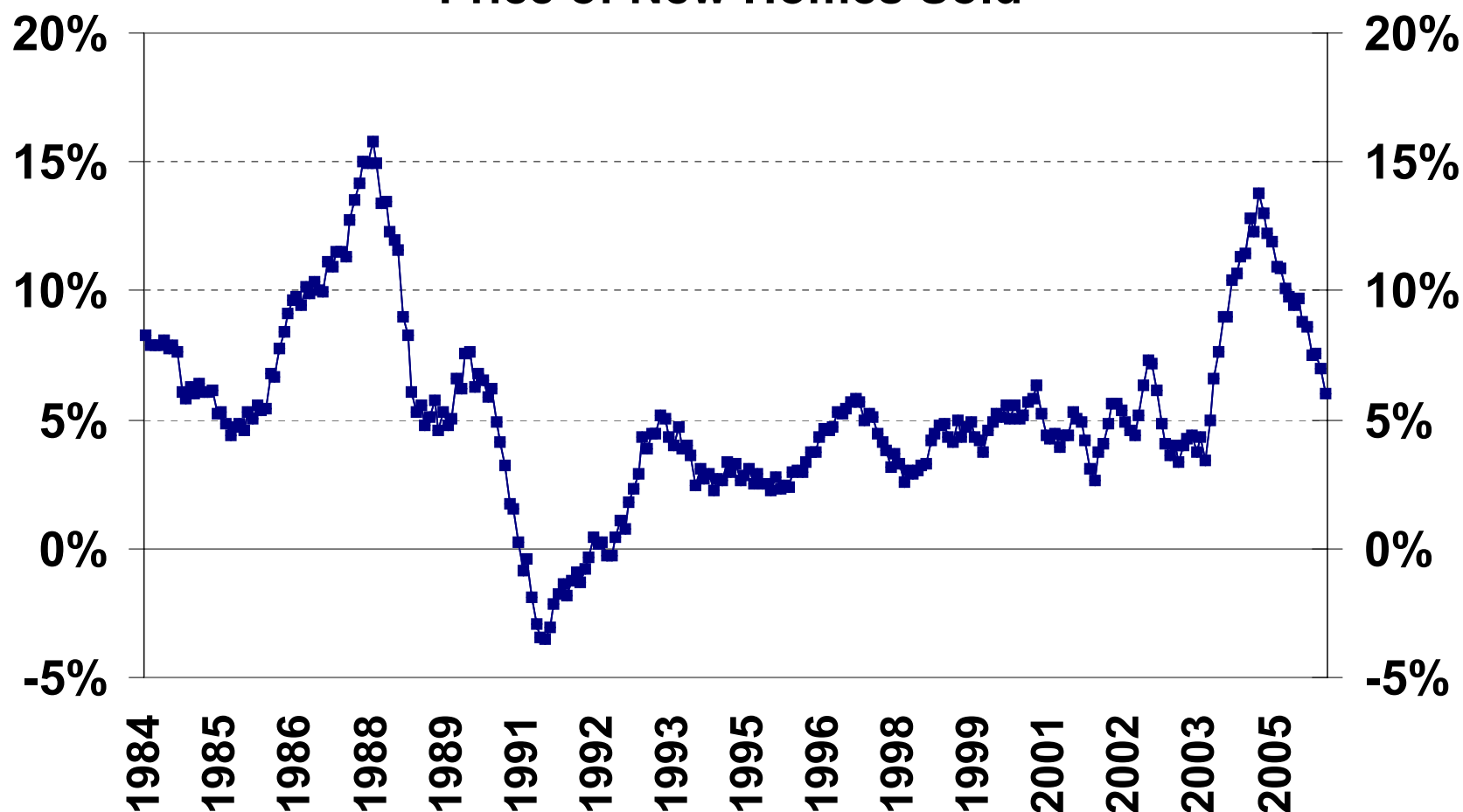


Source: Bloomberg

Economy

Home prices are responding to higher interest rates. A soft landing would help avoid a consumer-led recession.

**YOY % Change in Average 12-month Median
Price of New Homes Sold**

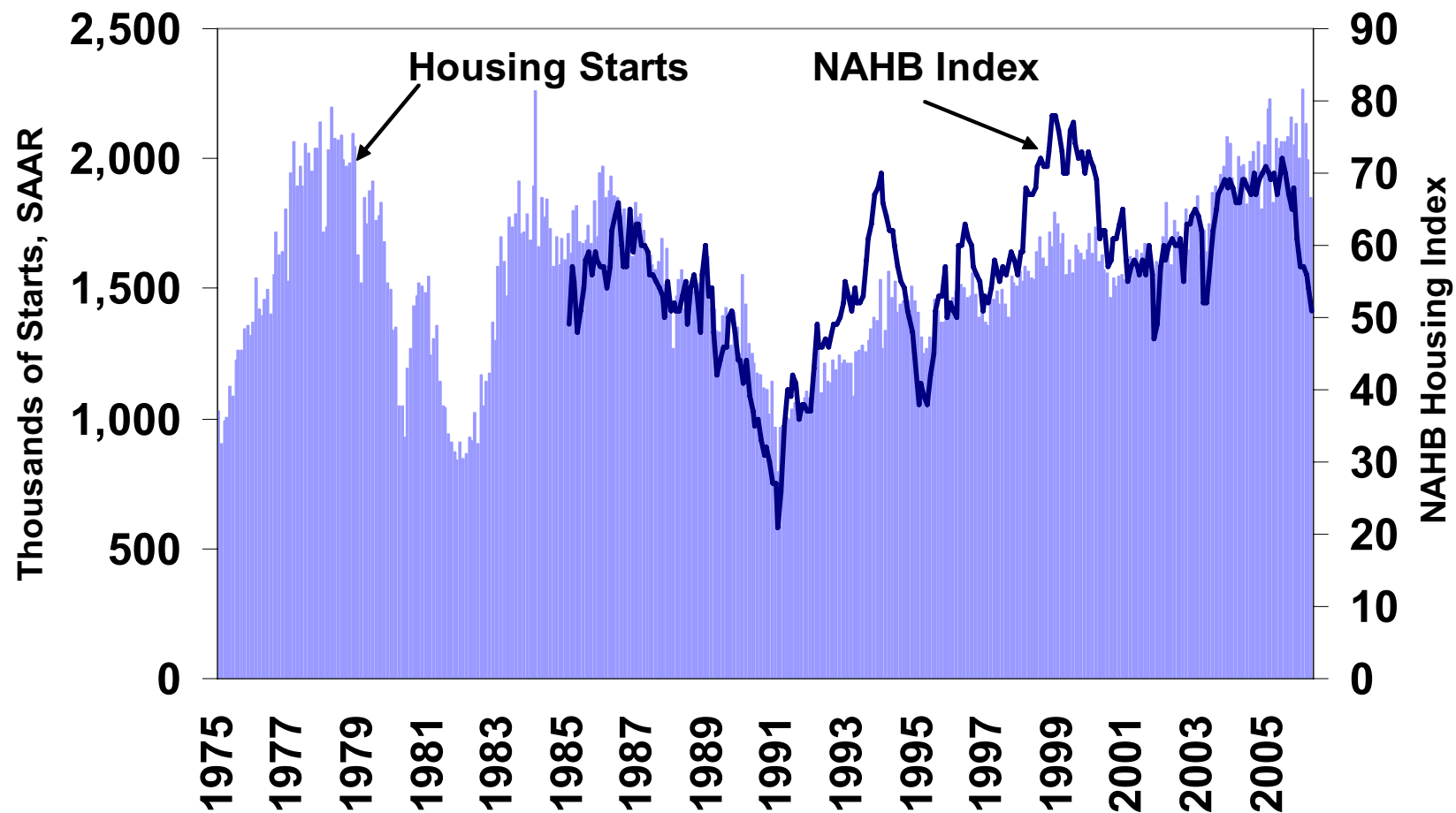


Source: U.S. Census Bureau.

Economy

But housing starts are beginning to correct...

NAHB Index vs. U.S. Housing Starts

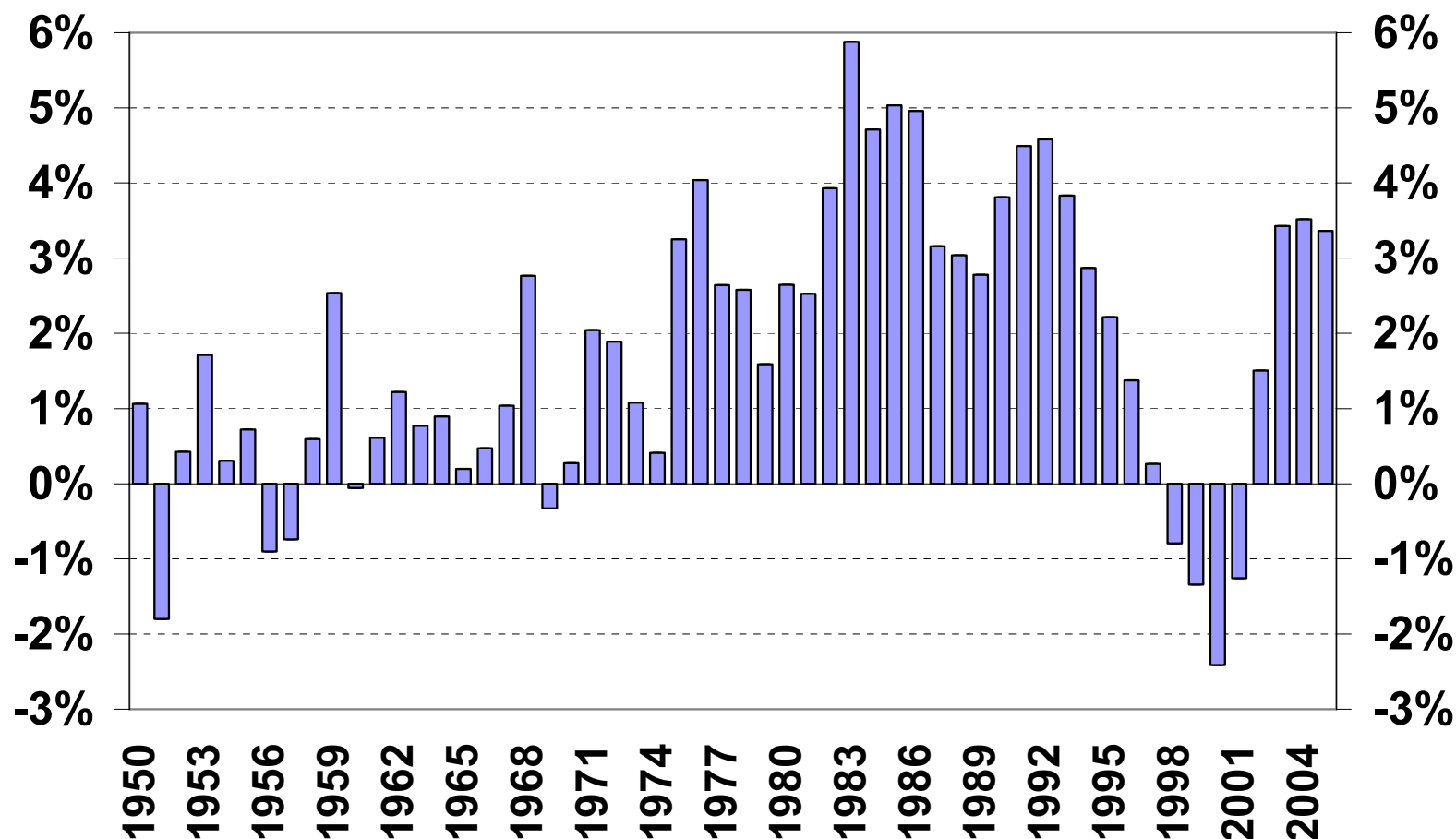


Source: U.S. Census Bureau; National Association of Home Builders

Economy

Unfortunately, the “Twin deficits” (budget and trade) could further pressure interest rates upward...

US Budget Deficit as % of GDP

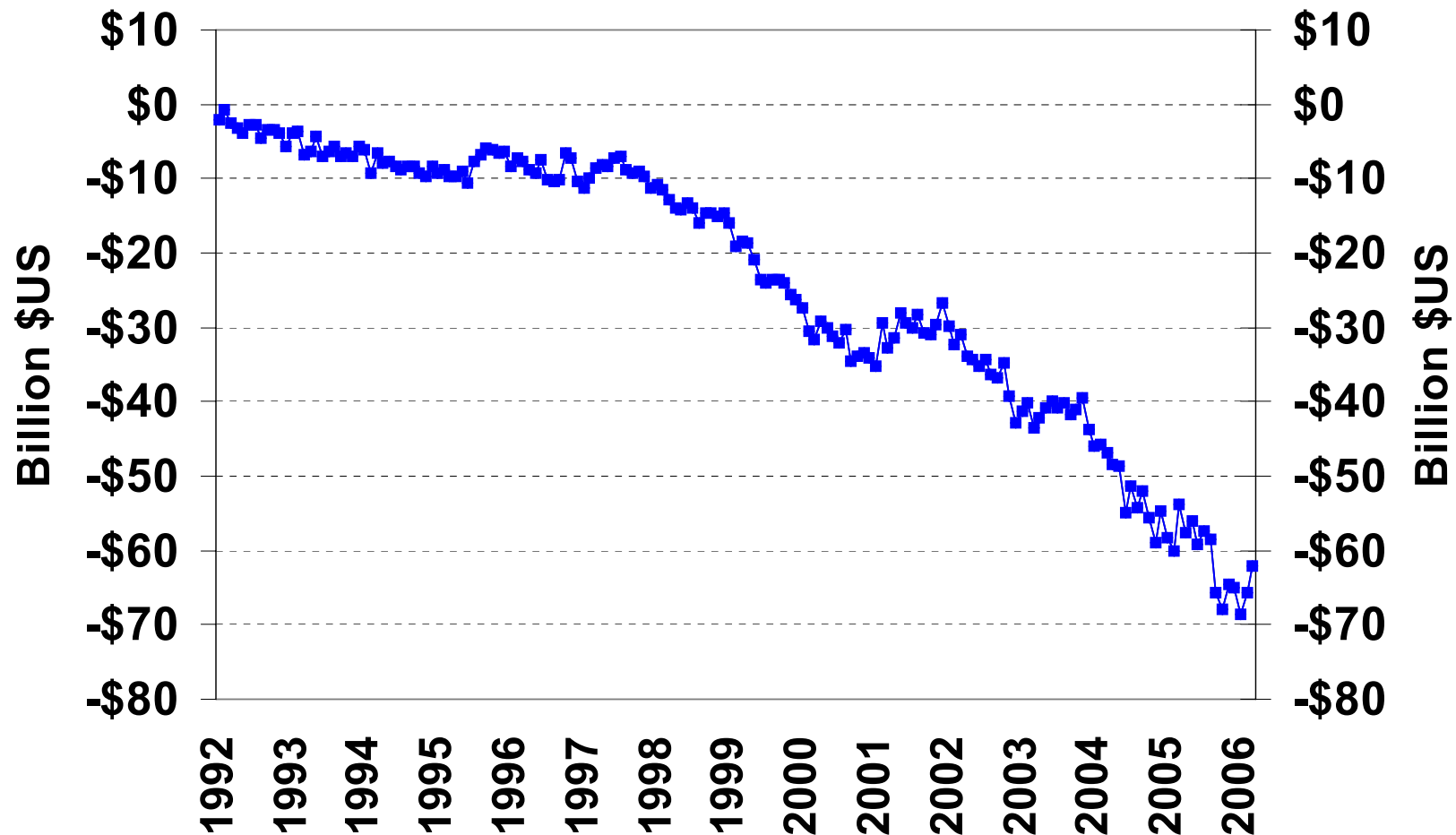


Source: Lehman Brothers and Bloomberg

Economy

With the U.S. trade deficit near a record \$65 BB per month, the U.S. is borrowing more than \$2 BB every day.

US Trade Deficit (Monthly)

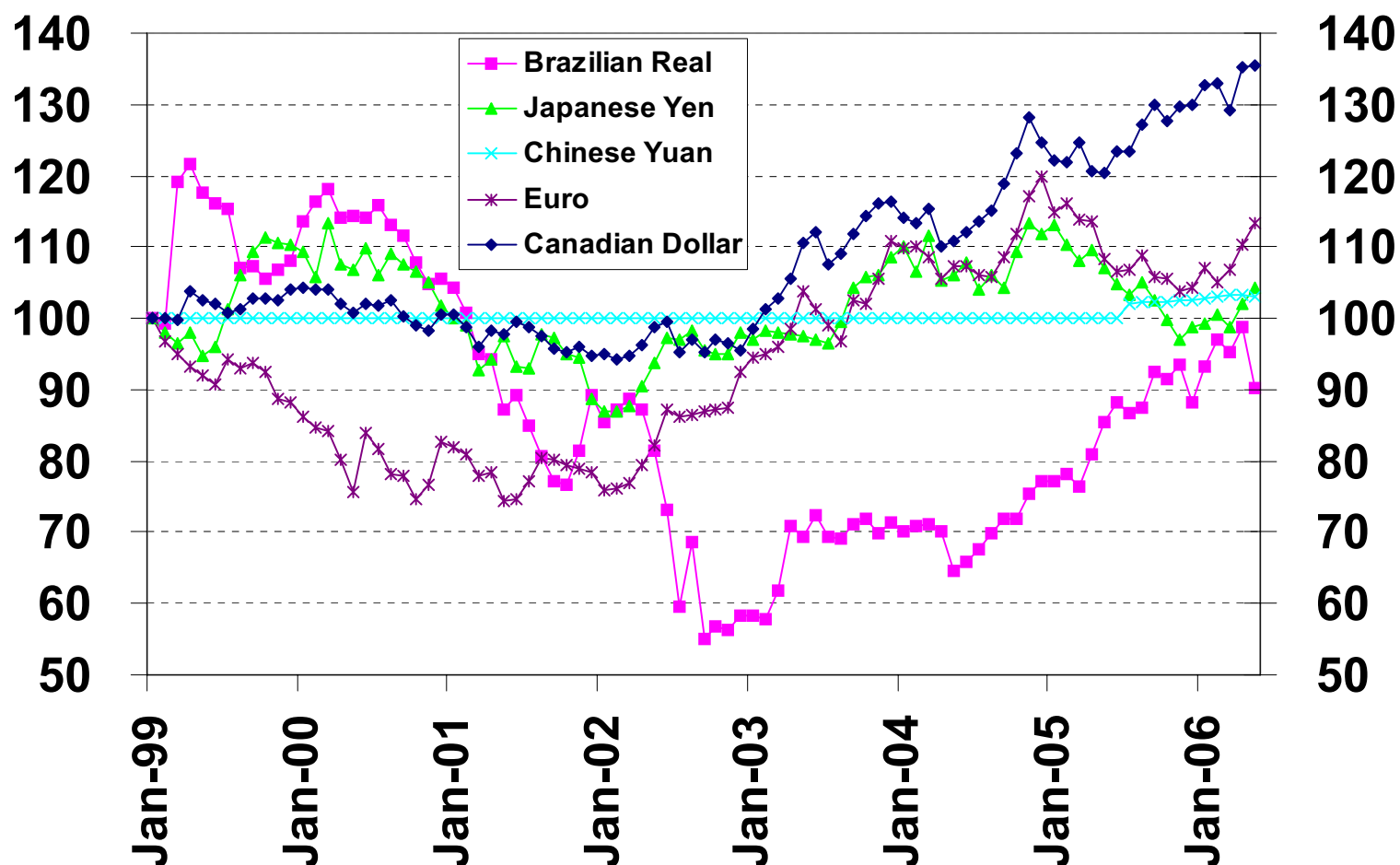


Source: Bureau of Economic Analysis, Lehman Brothers and Bloomberg

Economy

Among other factors, twin deficits are contributing to a weak \$...

Exchange Rate Movements USD/Currency



Source: Bloomberg

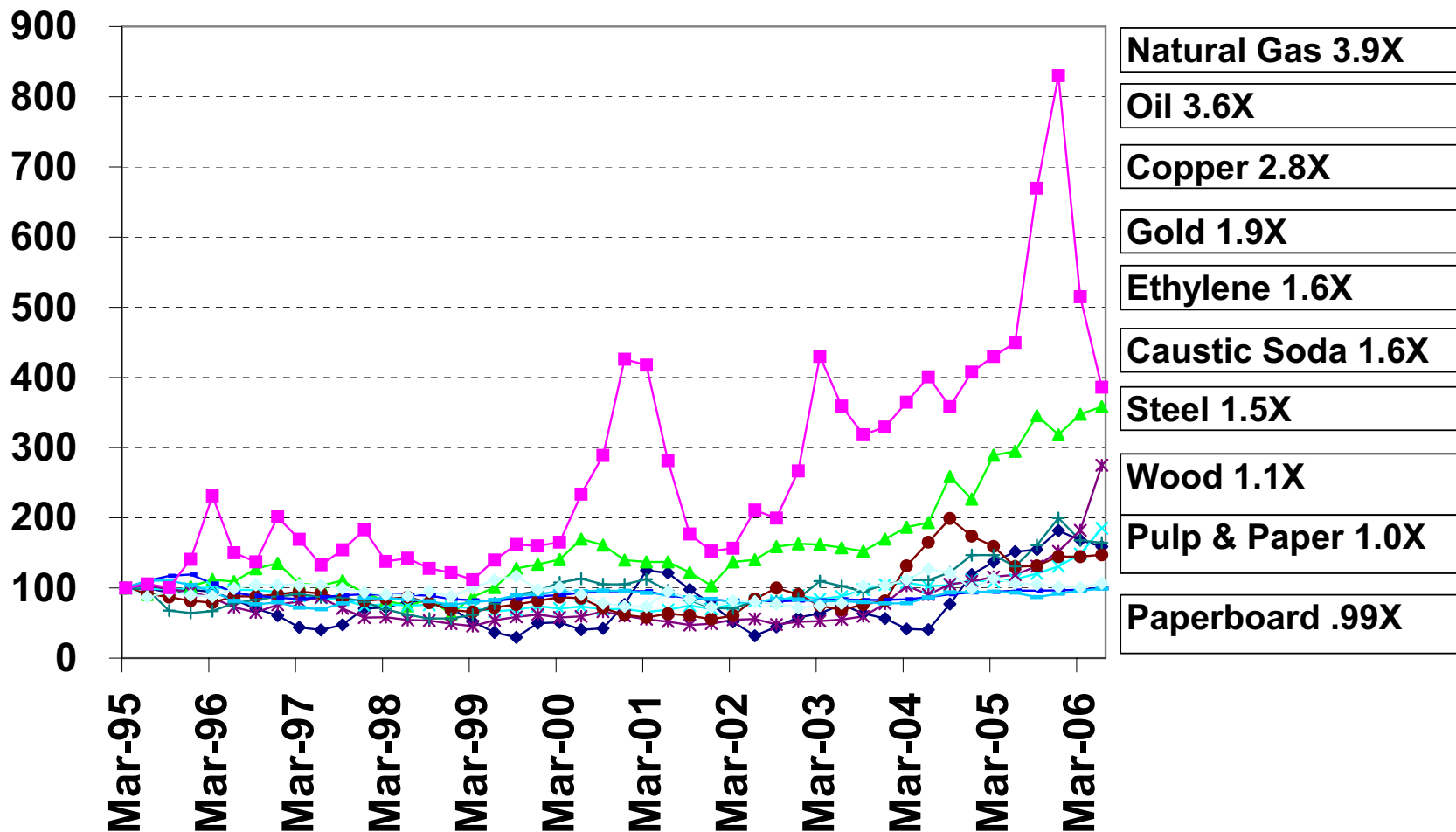
Commodity Prices

- ◆ **Commodity prices continue to pressure input costs.**
 - Oil prices are up 7X from the lows.
 - Natural gas prices are up 4X from the lows.
 - Caustic soda prices are up 4X from the lows.
 - Transportation (freight) cost index up 2X since 2001.
 - Fiber – we expect fiber costs to rise further.

Commodity Prices

Over the past decade paper/forest product prices have lagged...

Indexed Commodity Prices



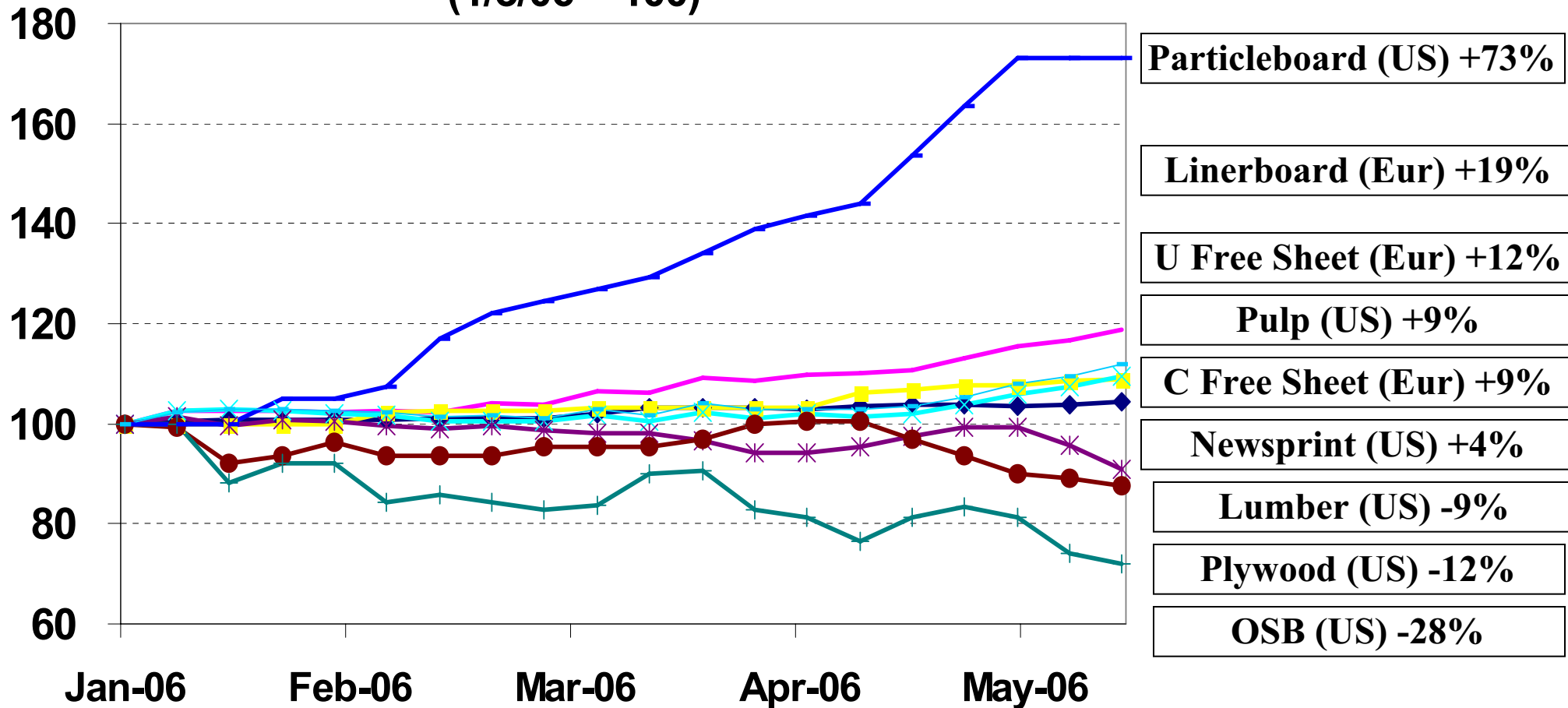
Source: Bloomberg, Industry Sources, Lehman Brothers

Commodity Prices

Year to date, paper prices are rising as most wood prices fall...

Weekly Commodity Price Index in US Dollars

(1/3/06 = 100)

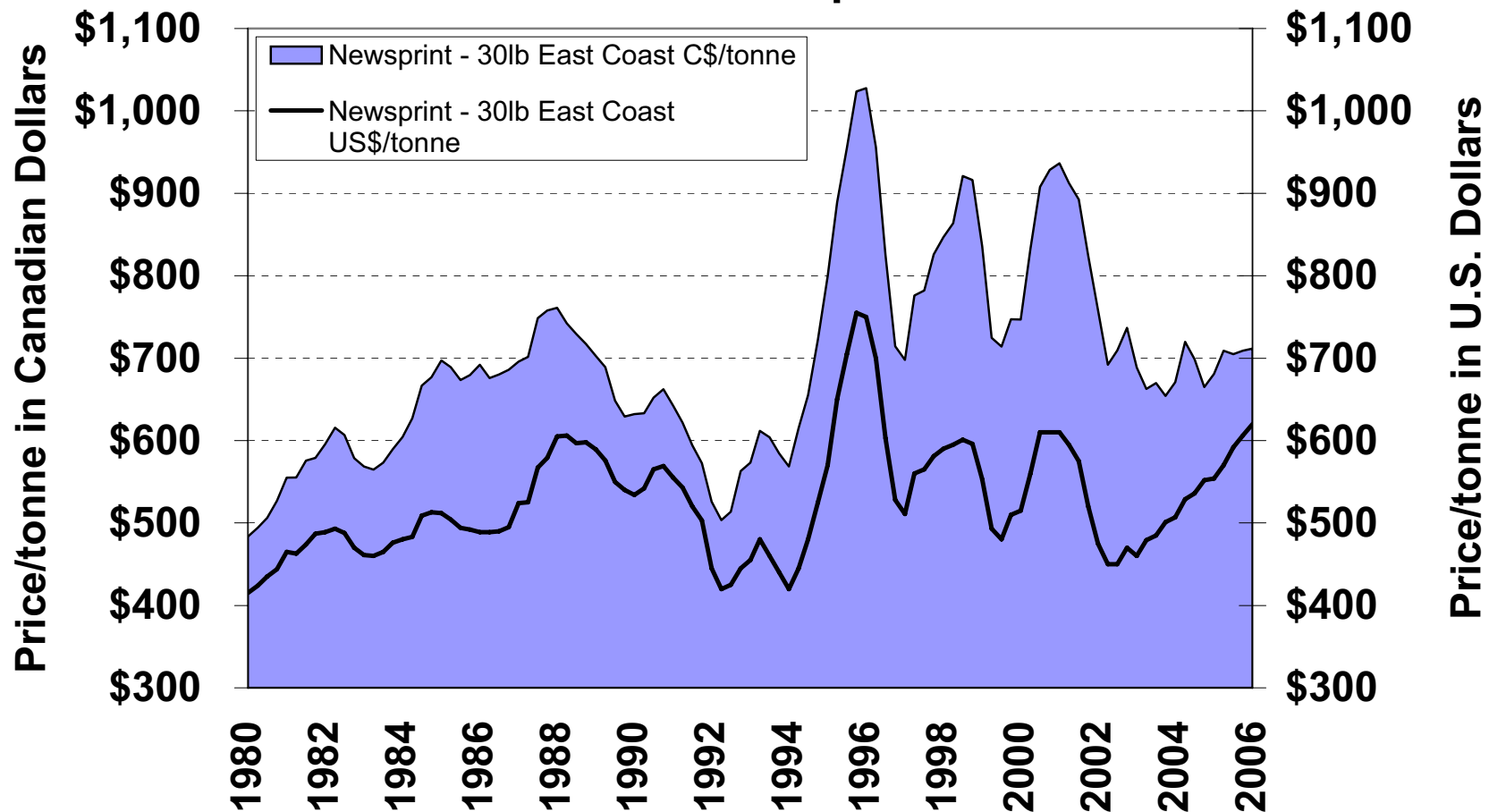


Sources: FOEX and Random Lengths

Commodity Prices

Newsprint prices higher in US \$ but flat in C\$ terms...

**Newsprint Prices - 30lb East Coast Delivery Quarterly,
In U.S.\$ and Canadian\$ per metric tonne**

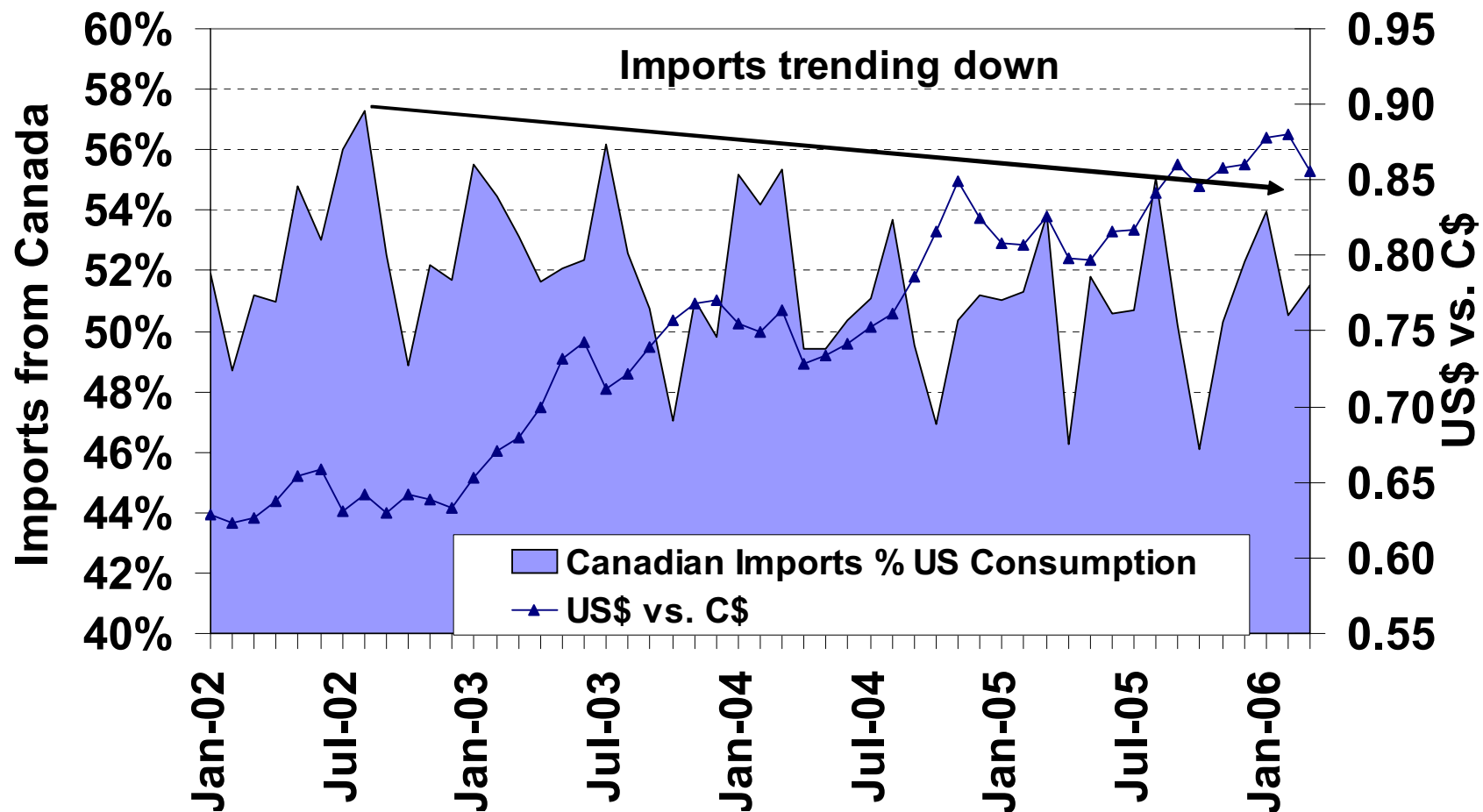


Source: Pulp & Paper Week; Bloomberg; Lehman Brothers.

Commodity Prices

Strong C\$ is reducing newsprint imports from Canada...

Newsprint - Canadian Imports as % of US Consumption & US/Canadian\$ Exchange Rate

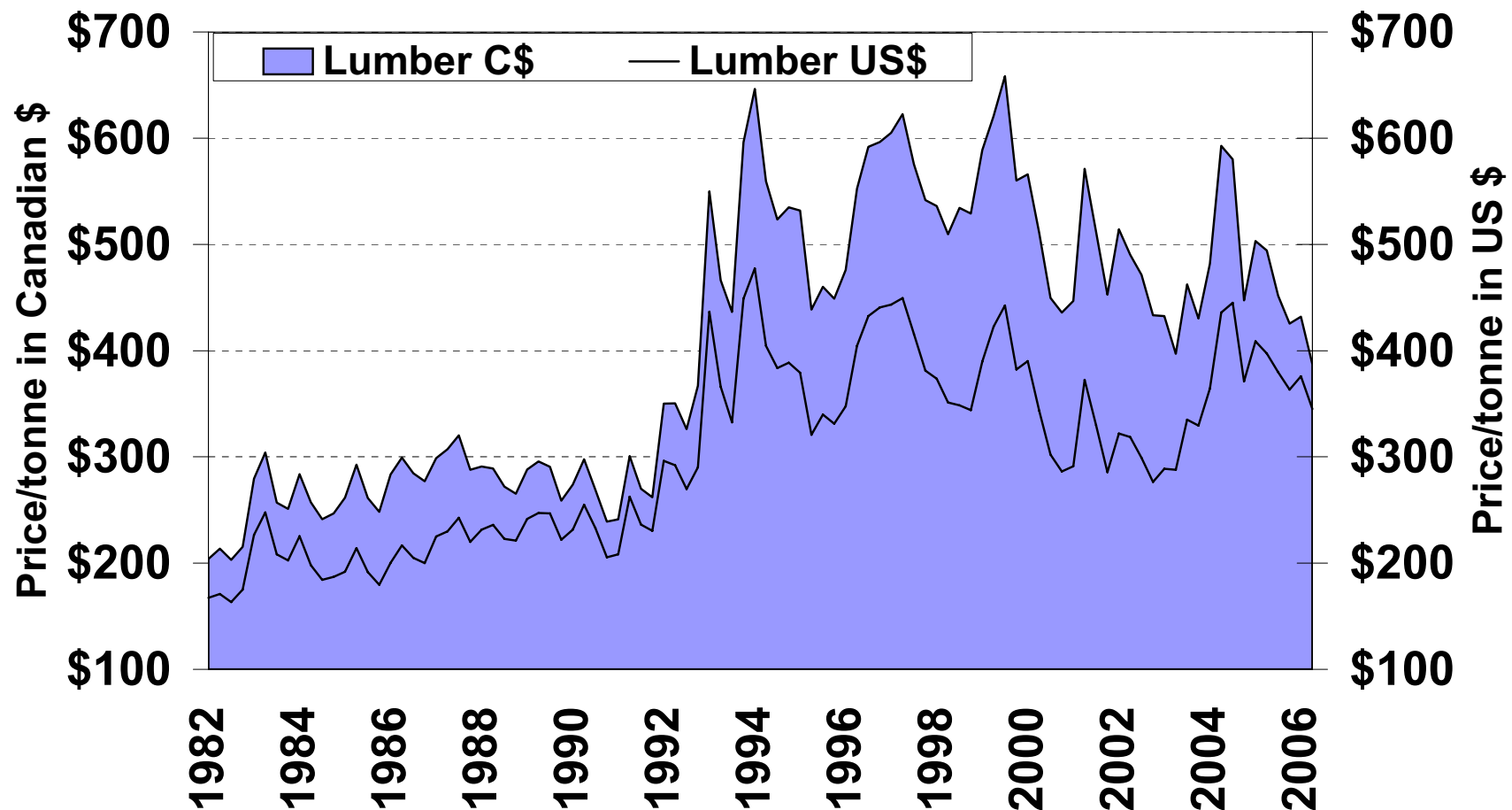


Source: Pulp & Paper Products Council and Bloomberg.

Commodity Prices

Lumber prices above trough in US \$, but at 14-year lows in C \$...

Lumber Prices, Quarterly
In U.S.\$ and Canadian\$ per thousand board feet

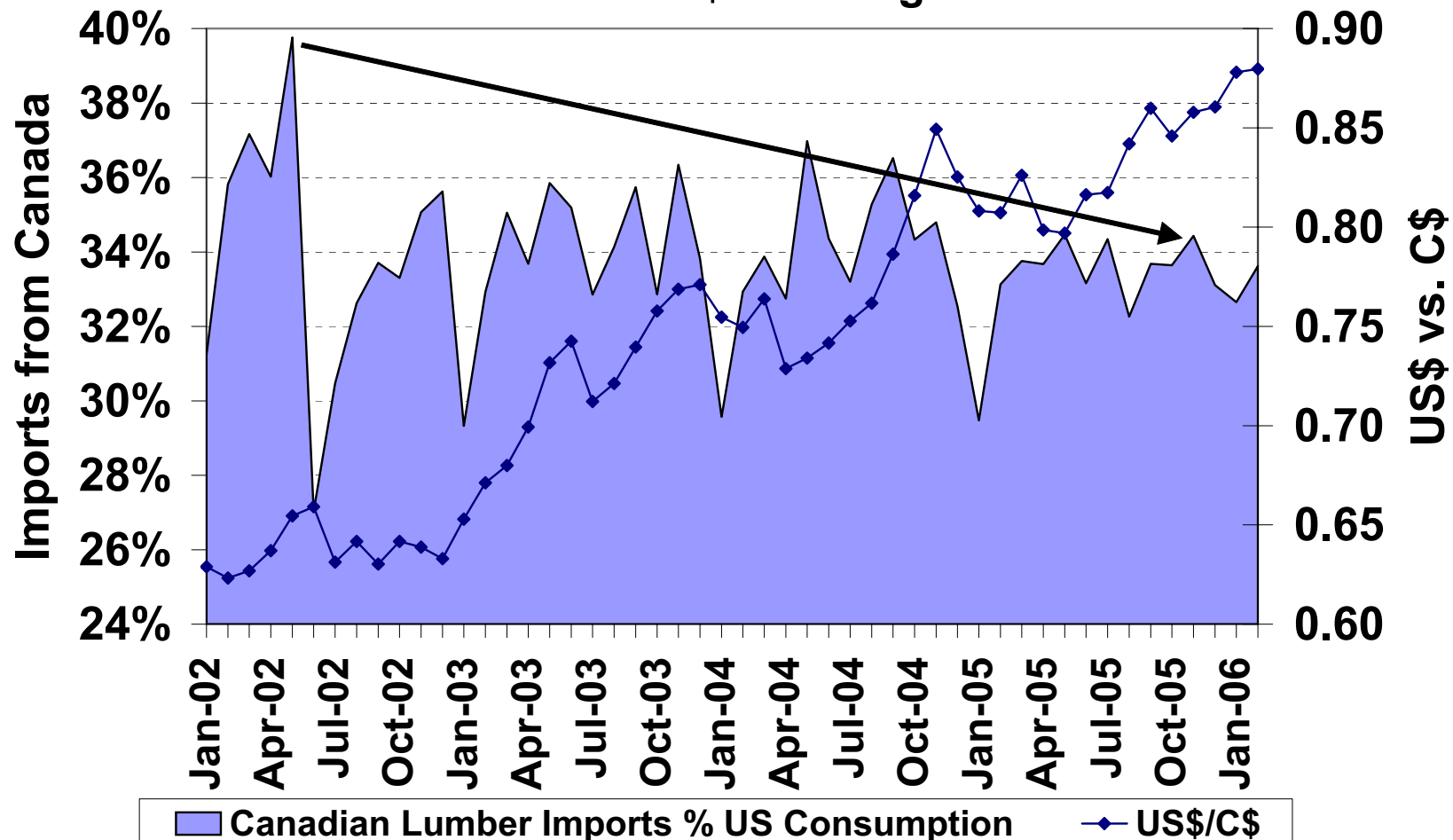


Source: Random Lengths

Commodity Prices

Strong C\$ is reducing lumber imports from Canada...

Lumber - Canadian Imports as % of US Consumption &
US/Canadian\$ Exchange Rate

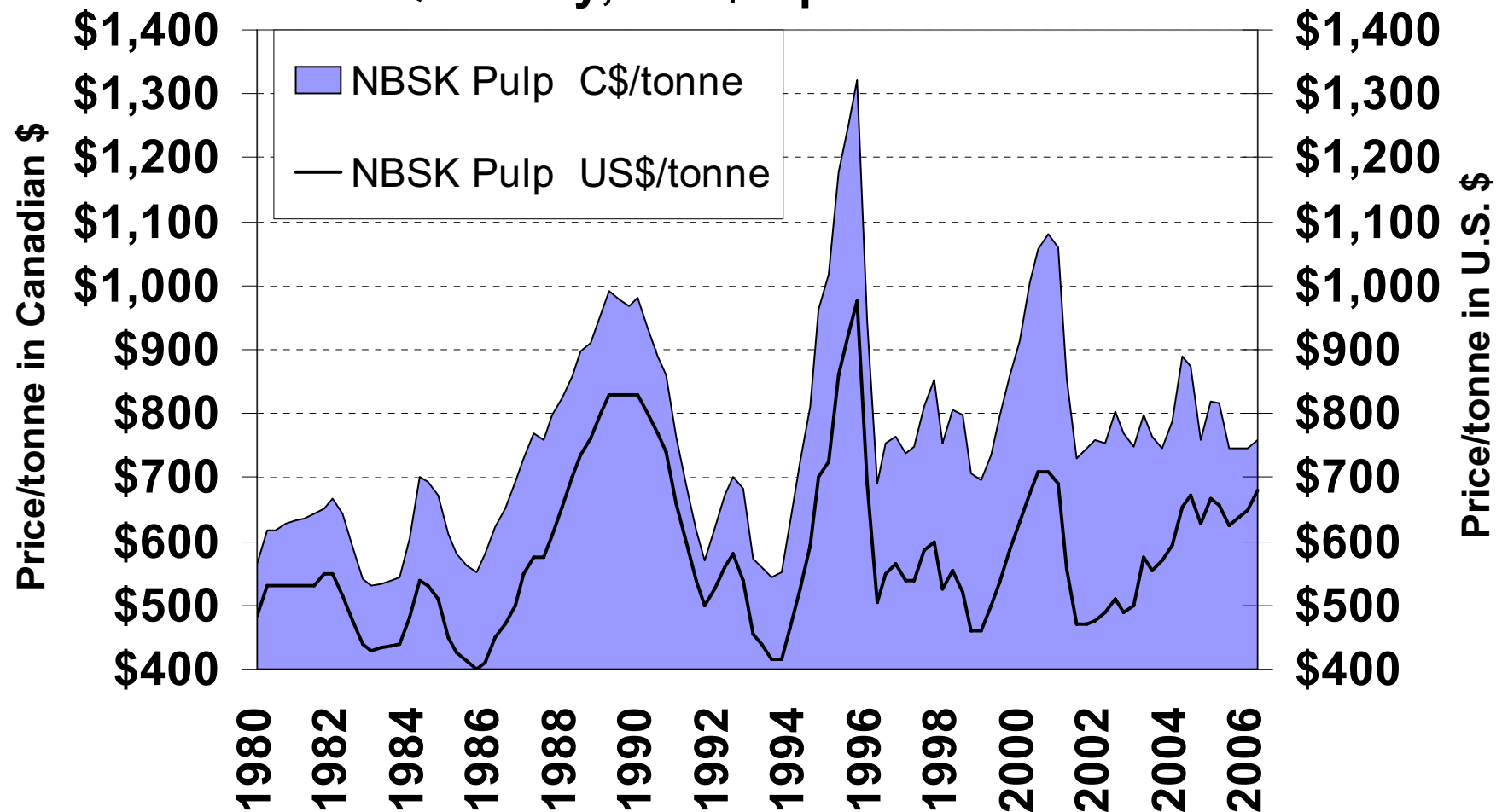


Source: Western Wood Products Association and Lehman Brothers estimates.

Commodity Prices

Pulp prices higher in US \$ but flat in Canadian \$...

Northern Bleached Softwood Pulp Prices
Quarterly, In C\$'s per metric ton



Source: Lehman Brothers Estimates

China

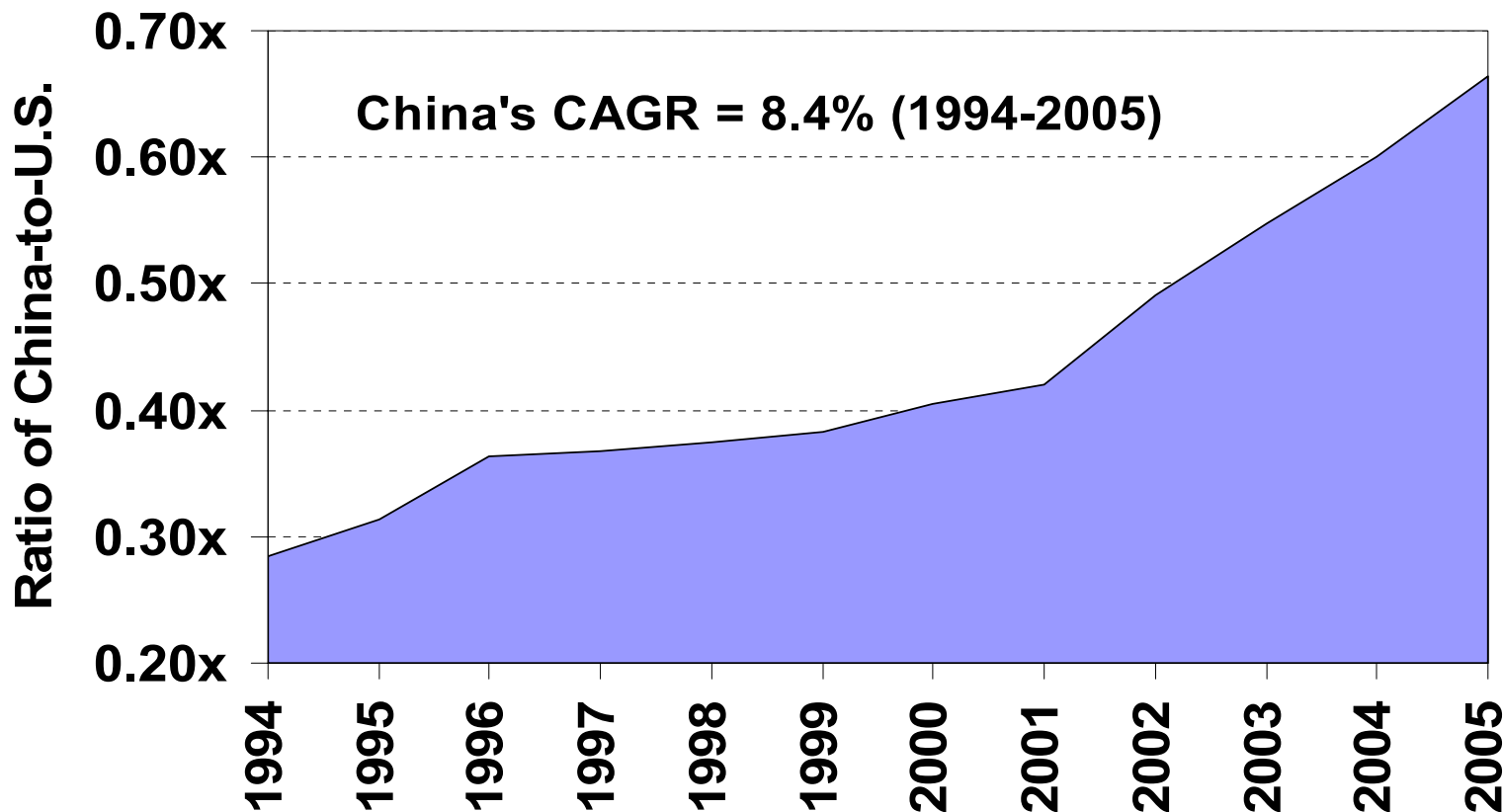
Top Reasons to Watch China Closely

1. World's largest consumer of steel by a 3-1 factor.
2. Second largest consumer of paper and paperboard in the world (for now) behind the US.
3. Large labor cost advantage (per capita income is 1/40th US).
4. Lower energy costs, coal vs. natural gas.
5. Willingness to tolerate lower returns.
6. Ambitious plans for capacity growth.

China

In just a decade, China's consumption of paper & board has increased from less than 1/3 the size of the U.S. market to 2/3.

Ratio of Chinese Consumption of Paper & Paperboard to U.S. Consumption

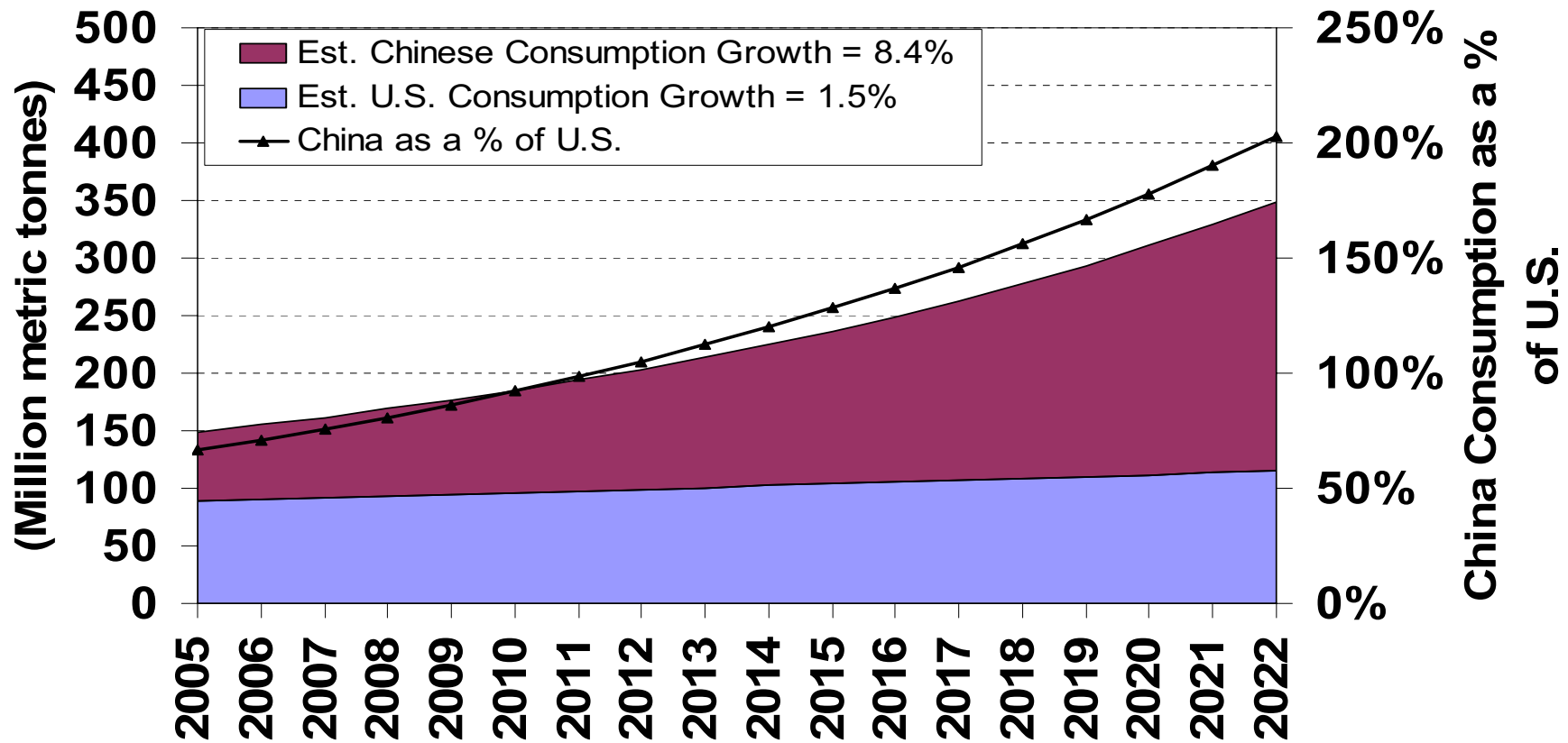


Source: Lehman Brothers Estimates, AF&PA, China Paper Association

China

As China industrializes, China's paper industry could match the U.S. by 2011 and become double the size by 2022.

Est. Consumption Growth of Paper & Paperboard of U.S. & China 2005 - 2022

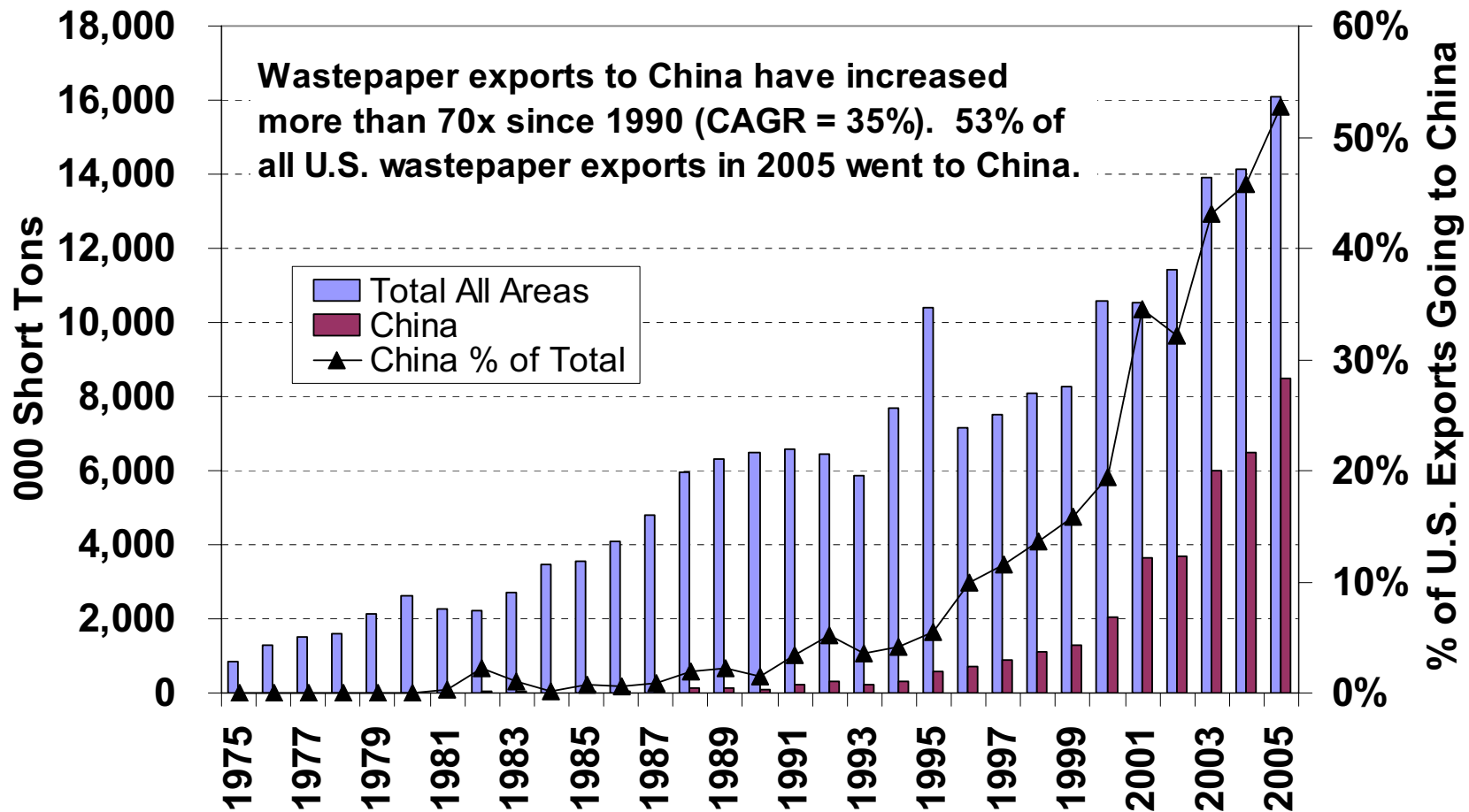


Source: Lehman Brothers Estimates, China Paper Association

China

With 53% of U.S. wastepaper exports now going to China...

U.S. Wastepaper Exports to China

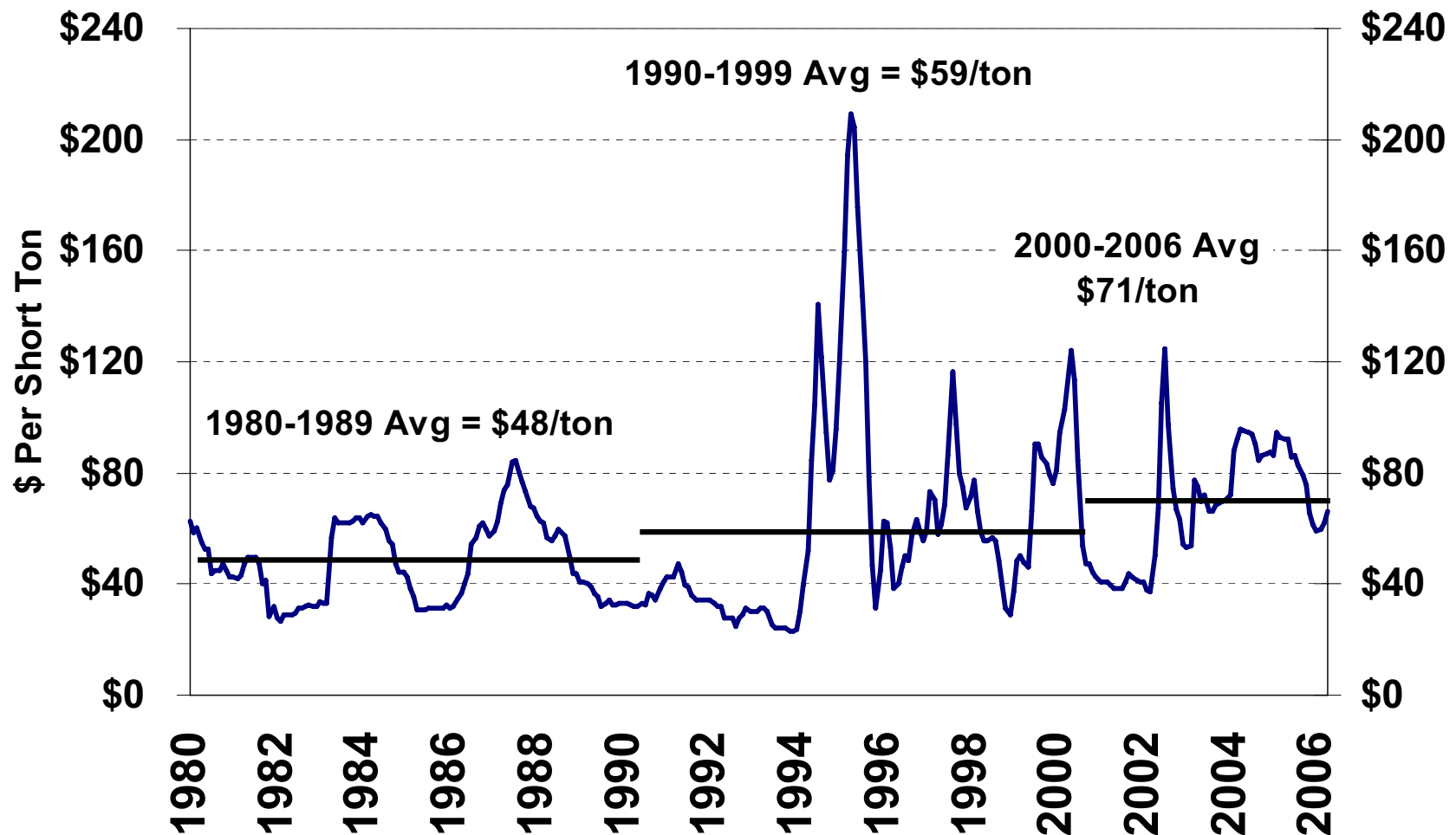


Source: Lehman Brothers, American Forest & Paper Association, RISI

China

We continue to believe in an eventual “boom” in fiber costs...

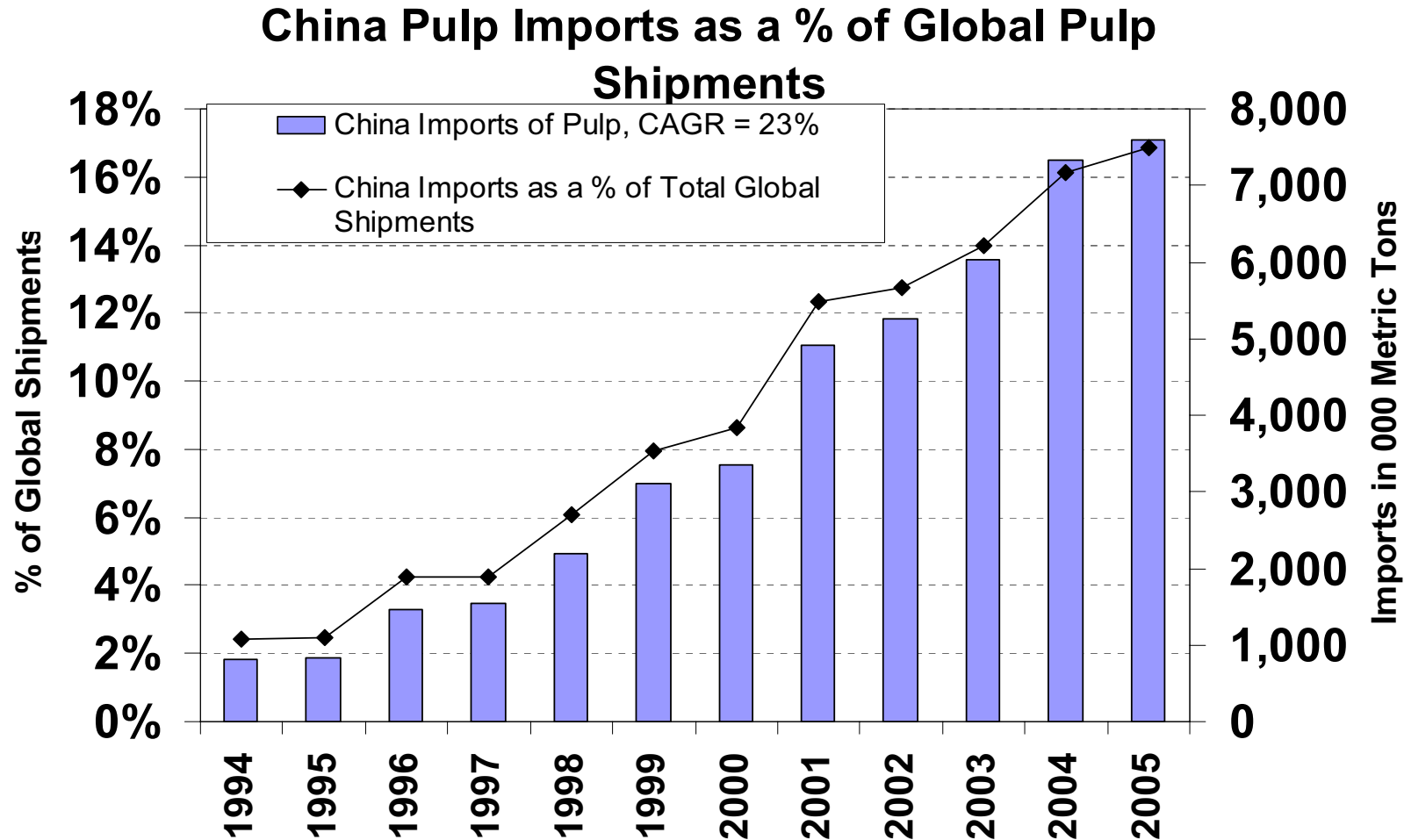
Old Corrugated Container #11 Costs



Source: Pulp & Paper Week

China

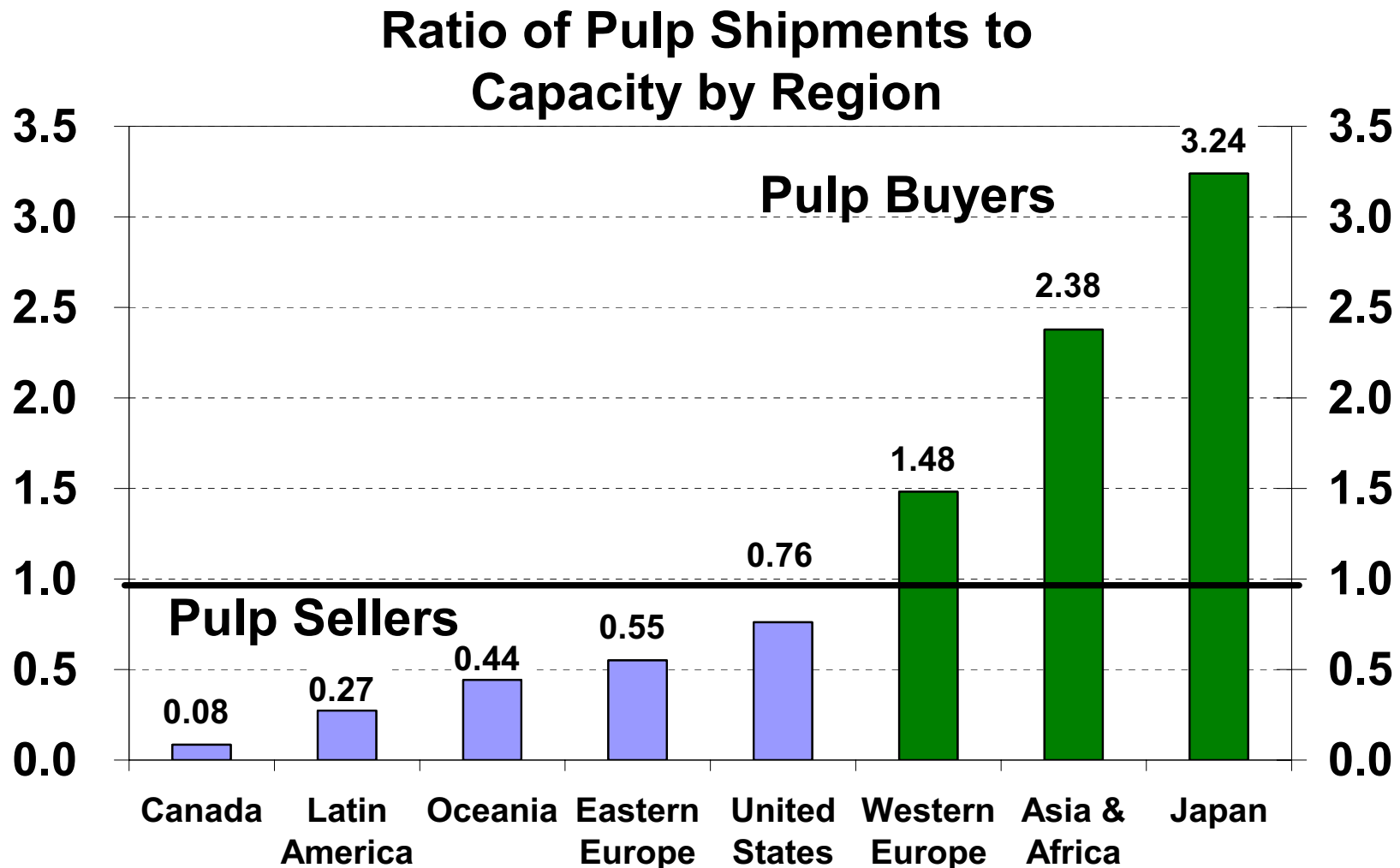
China's demand for pulp is also booming, supported by growth in paper supply and an upgrade to higher-quality pulps.



Source: Lehman Brothers, Pulp & Paper International, PPI Asia News.

China

Ratio of Pulp Shipments to Capacity by Region



Source: Lehman Brothers and Pulp & Paper Products Council

Timber

Timber transactions vary by region.

State/Region	Total Acres (000's)	Price/Acre
Pacific NW (West of Cascades)	2486	\$2,151
Washington (coast)	1004	\$2,011
Oregon (coast)	653	\$2,659
California (coast)	830	\$1,919
Pacific NW (East of Cascades)	3503	\$760
Washington (inland)	903	\$845
Oregon (inland)	1794	\$646
California (inland)	134	\$1,555
Idaho	627	\$780
Montana	43	\$906
Nevada	2	\$1,520
Central	1308	\$450
Wisconsin	815	\$448
Michigan	184	\$424

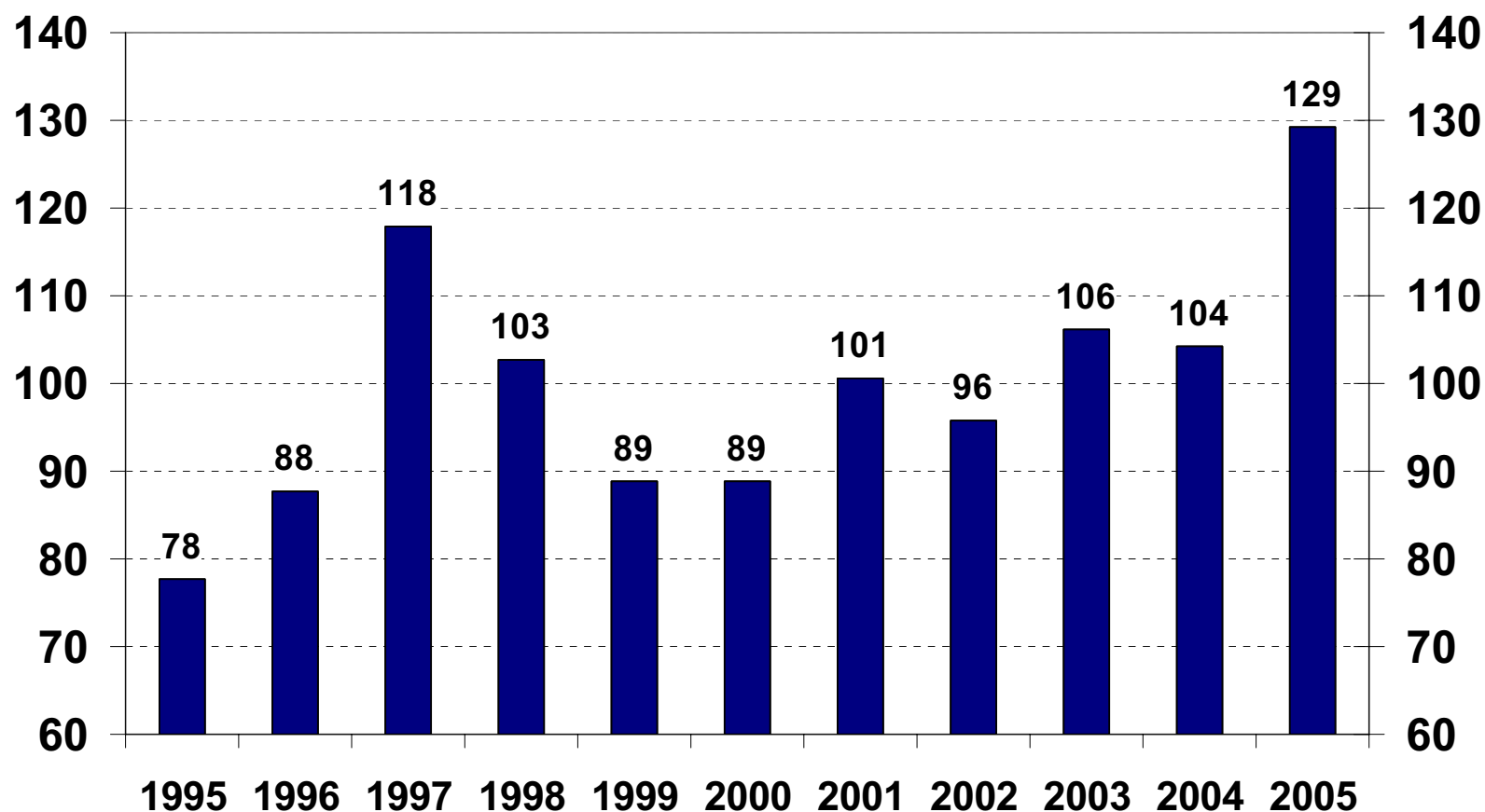
State/Region	Total Acres (000's)	Price/Acre
South	9435	\$876
Oklahoma	260	\$635
Texas	1085	\$667
Arkansas	517	\$940
Louisiana	1797	\$952
Mississippi	968	\$768
Alabama	1774	\$799
Georgia	915	\$932
Virginia	212	\$1,100
North Carolina	172	\$841
South Carolina	685	\$1,116
Florida	724	\$1,229
Tennessee	325	\$420
Northeast	7617	\$271
Maine	5900	\$227
New Hampshire	738	\$225
Vermont	112	\$218
New York	484	\$582
West Virginia	357	\$541
Maryland	25	\$1,500
Total U.S.	24,350	\$777

Source: Lehman Brothers and Industry Sources

Timber

Tax and capital structure arbitrage is allowing private buyers to pay up for timberlands...

Indexed Avg. Price of U.S. Timberland Transactions



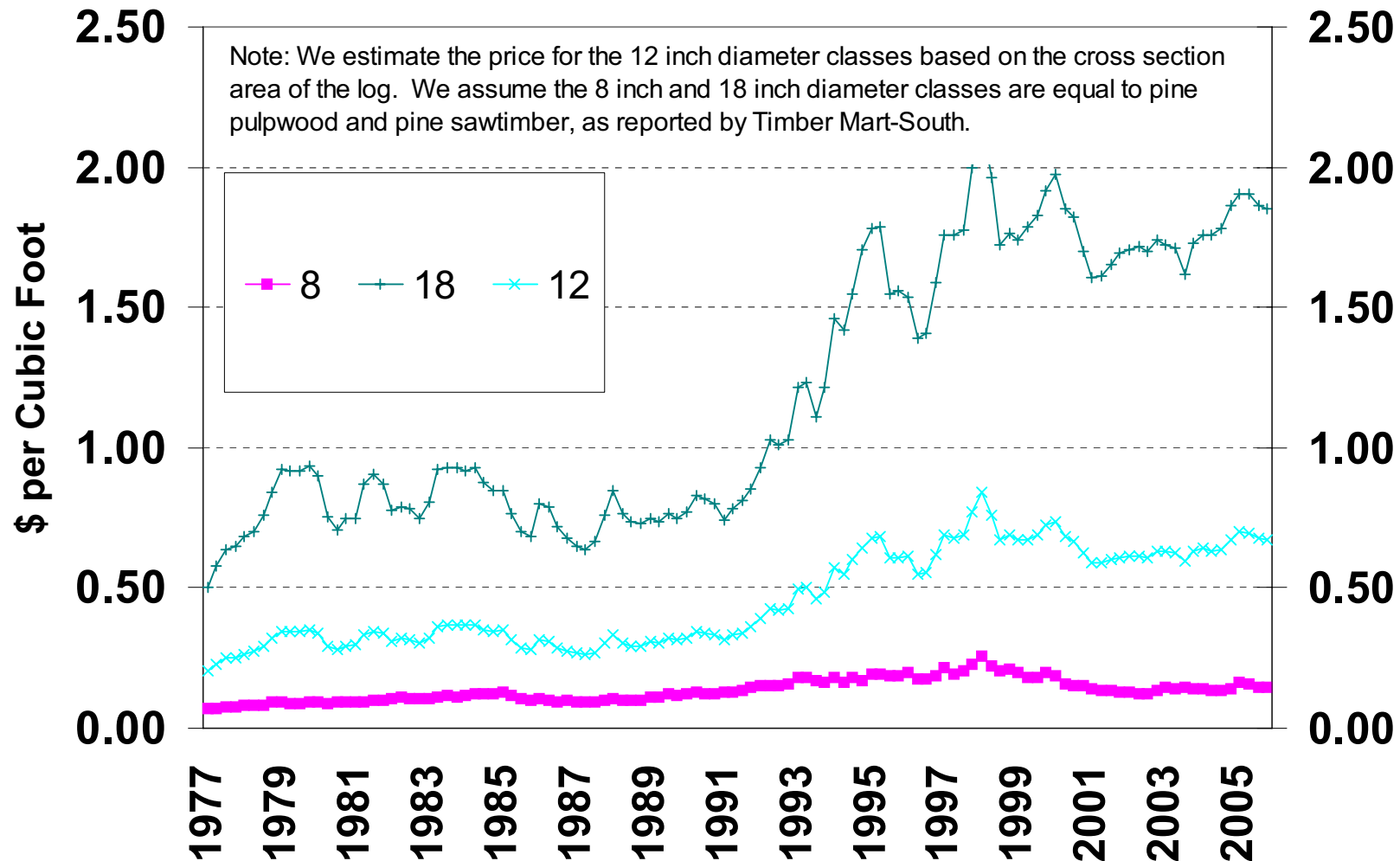
Source: Company reports, industry sources and Lehman Brothers.

Note: Trailing 10-year average timberland value = 100.

Timber

Prices vary greatly depending on the diameter of the log....

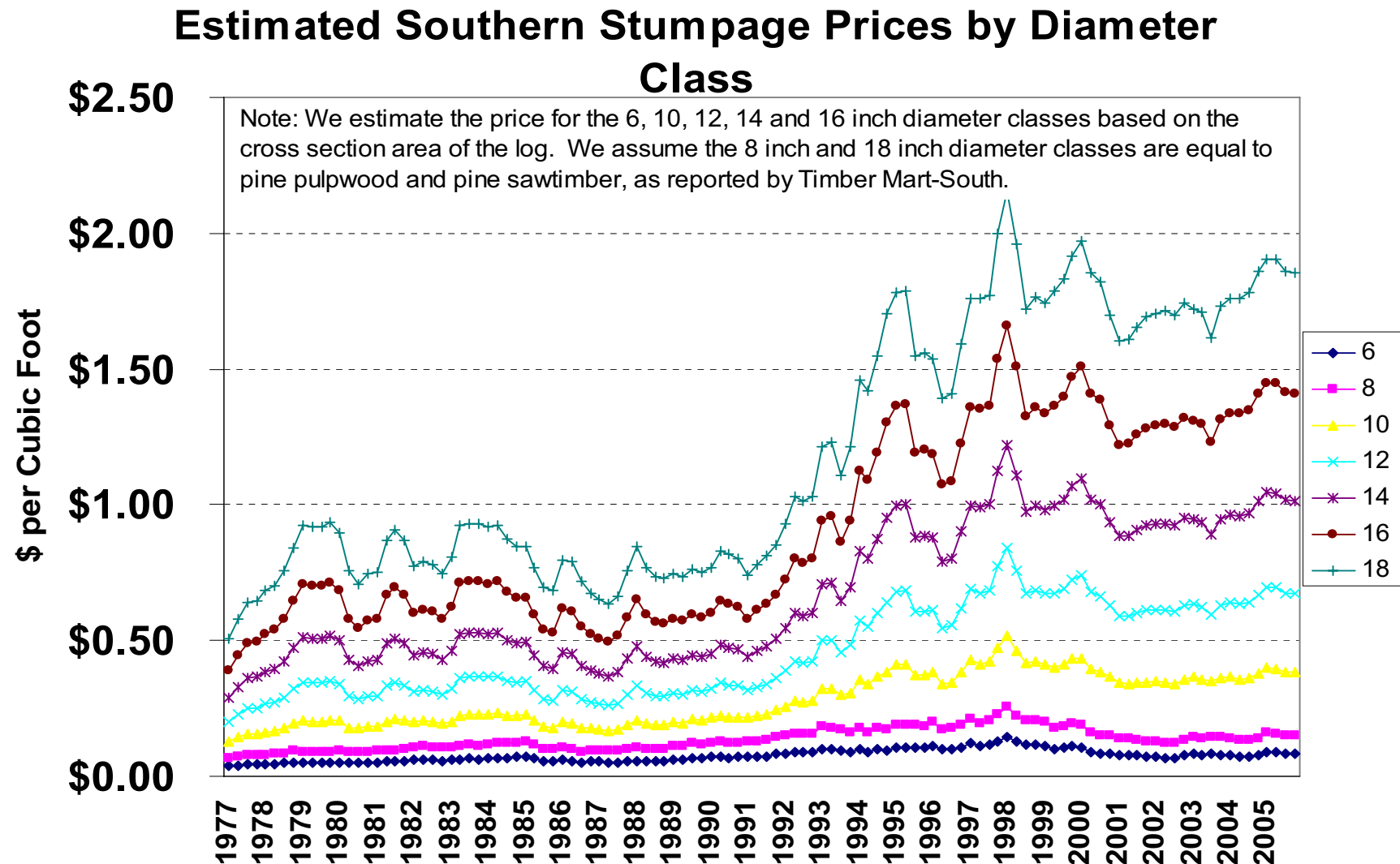
Southern Stumpage Prices by Diameter Class



Source: Timber Mart South

Timber

Estimated prices of 7 diameter classes...

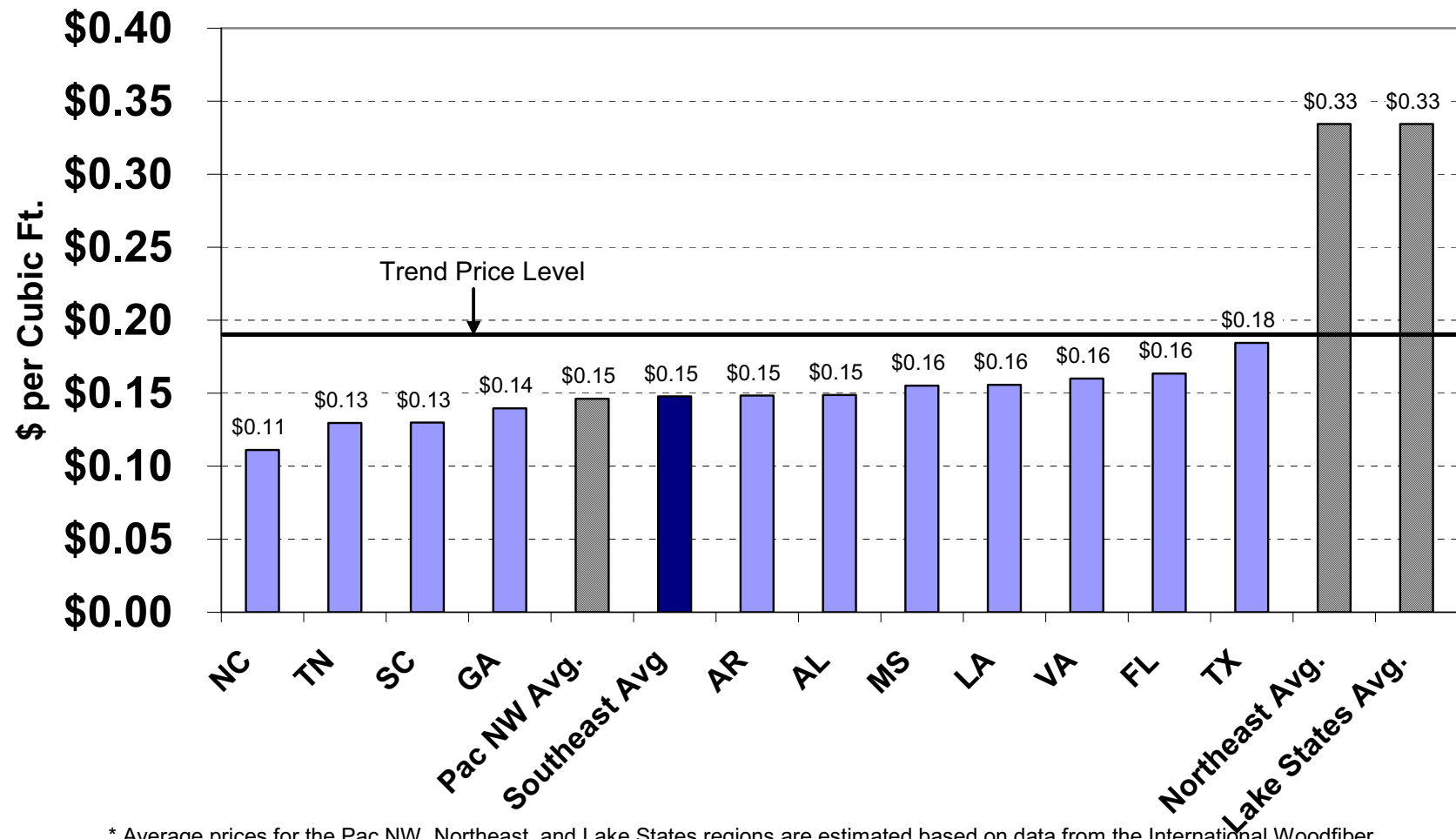


Source: Timber Mart South

Timber

Pulpwood prices are below trend level in the U.S. South...

Softwood Pulpwood Stumpage Prices

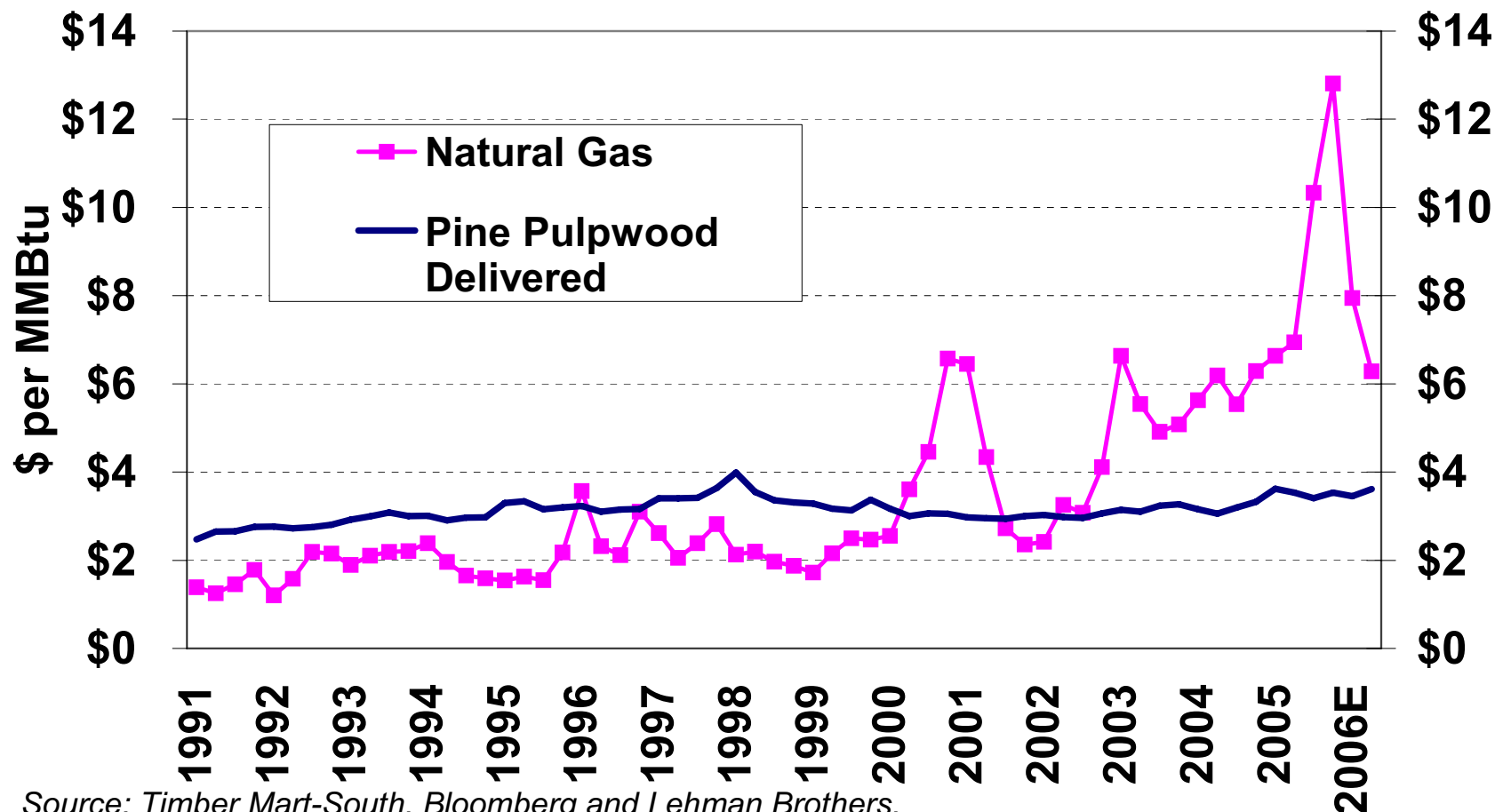


* Average prices for the Pac NW, Northeast, and Lake States regions are estimated based on data from the International Woodfiber Report. Data for the Southeast region and states are from Timber Mart-South.

Timber

At \$19/cord, pulpwood is priced to yield energy at an estimated cost of less than \$4 per MMBtu...

Pulpwood and Natural Gas Cost Comparison



Source: Timber Mart-South, Bloomberg and Lehman Brothers.

Note: We assume a 75% wood-burning efficiency ratio and 8,500 Btu's per air-dried lb. of pulpwood.

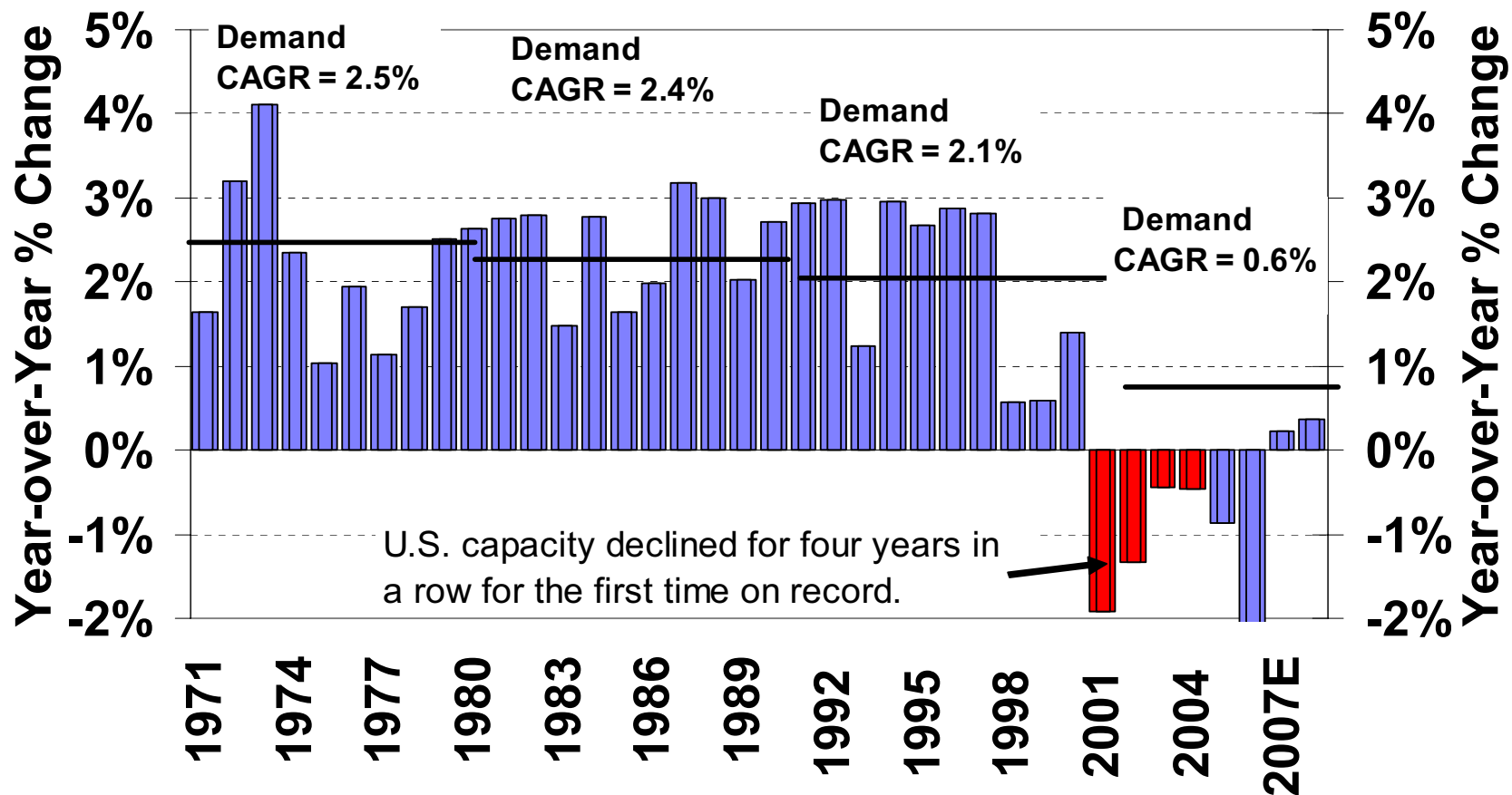
Supply/Demand

- ◆ U.S. demand growth is slowing, but supply is contracting much faster.
- ◆ Global trend demand growth also exceeds supply growth.
- ◆ U.S. trade flows are improving as exports rise and imports decline.

Supply/Demand

U.S. capacity growth remains the slowest in decades, but demand is also noticeably lower...

Yr/Yr Capacity Change, Total U.S. Paper & Paperboard

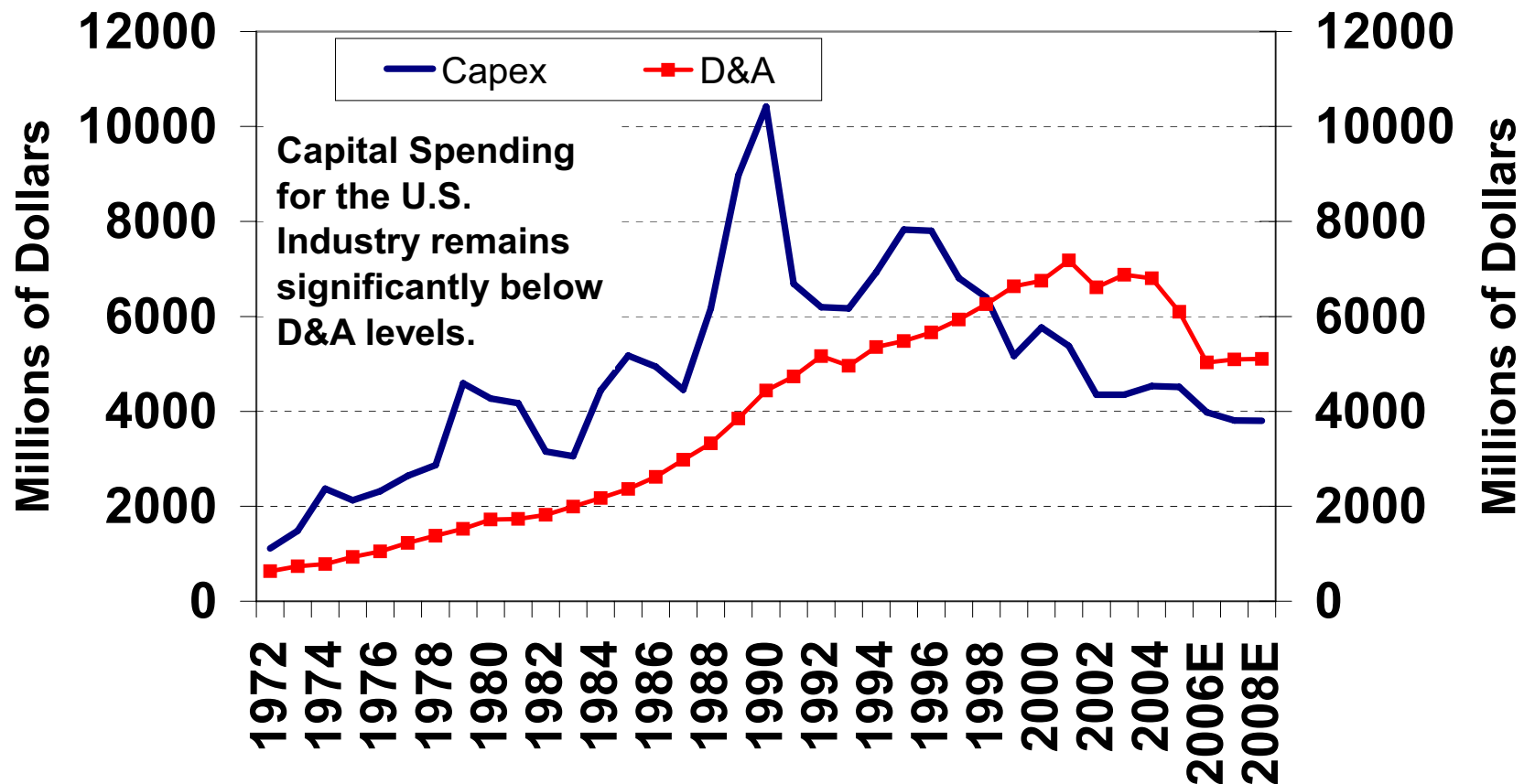


Source: AF&PA and Lehman Brothers estimates

Supply/Demand

Supply discipline and capital spending discipline both started for the first time in 1998...

Capital Expenditures vs. Depreciation - Lehman Brothers Index

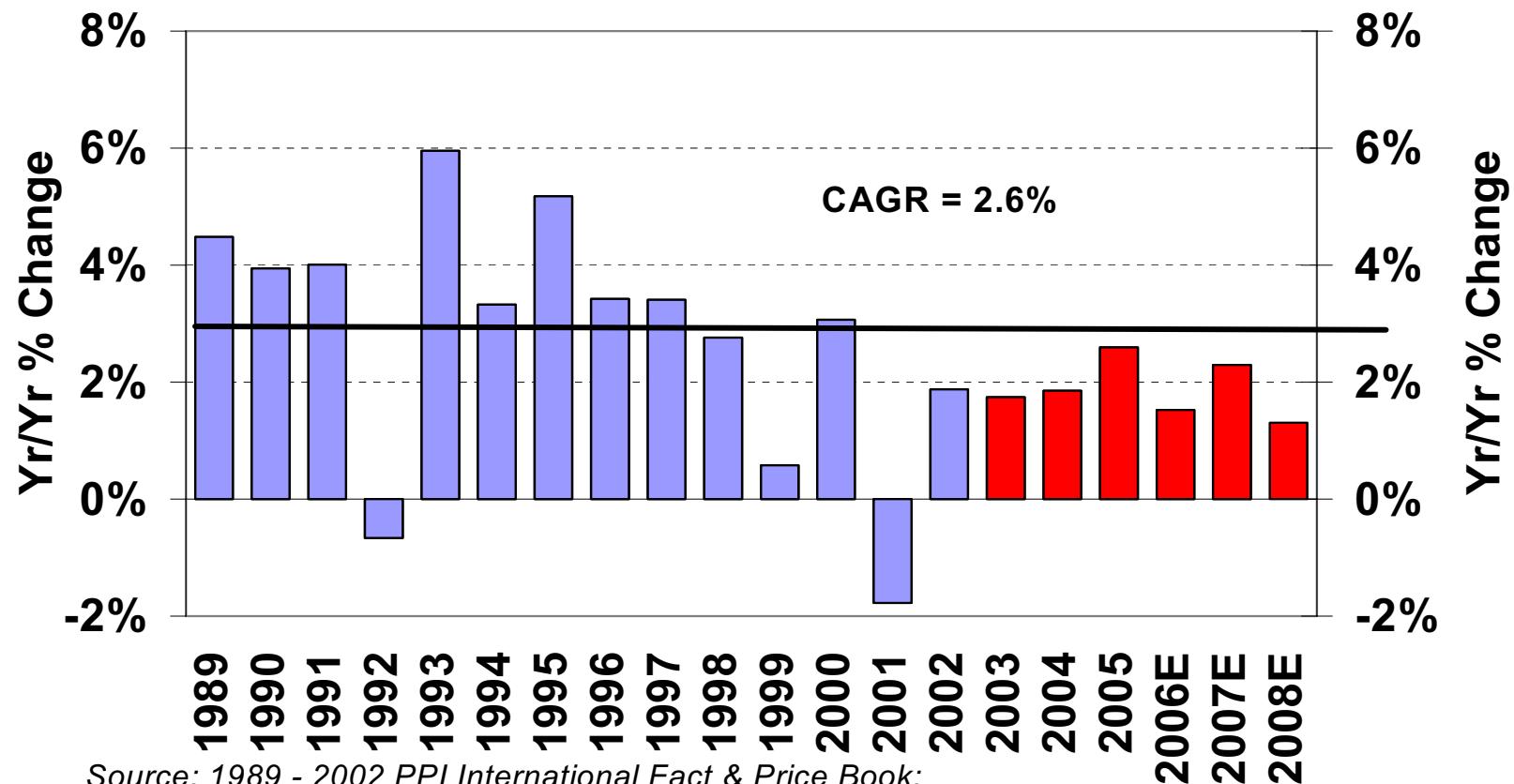


Source: Lehman Brothers and company reports. Lehman Brothers estimates for 2006-2008.

Supply/Demand

We believe global demand growth exceeds global supply growth by a healthy margin.

Year-over-Year Capacity Growth, Global Paper & Paperboard

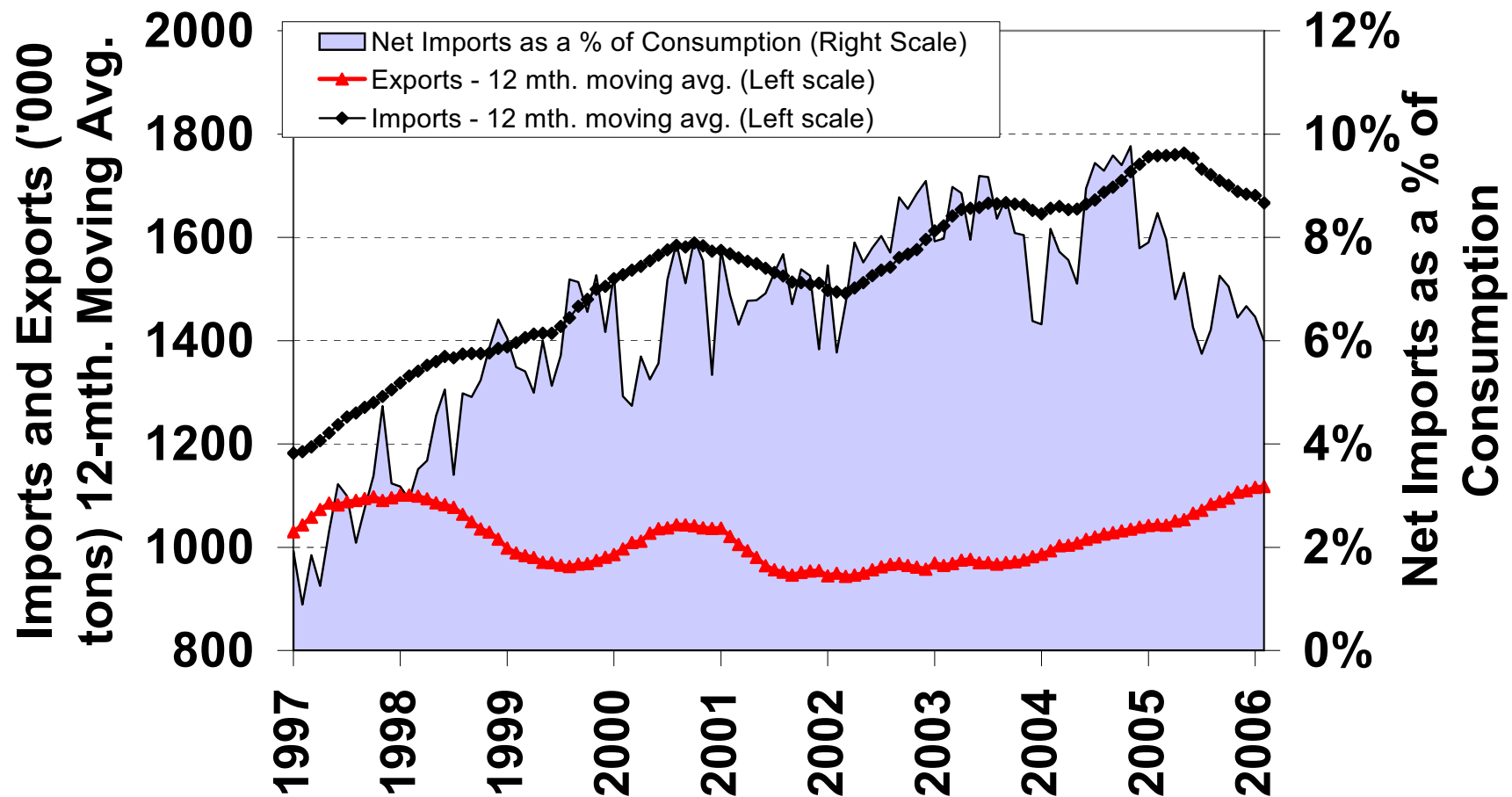


Source: 1989 - 2002 PPI International Fact & Price Book;
2003 - 2007 Lehman Brothers estimates.

Supply/Demand

U.S. imports are beginning to decline as exports rise, leading to a 350 basis point improvement in trade flows vs. consumption.

U.S. Total Paper and Paperboard - Import and Export Trends

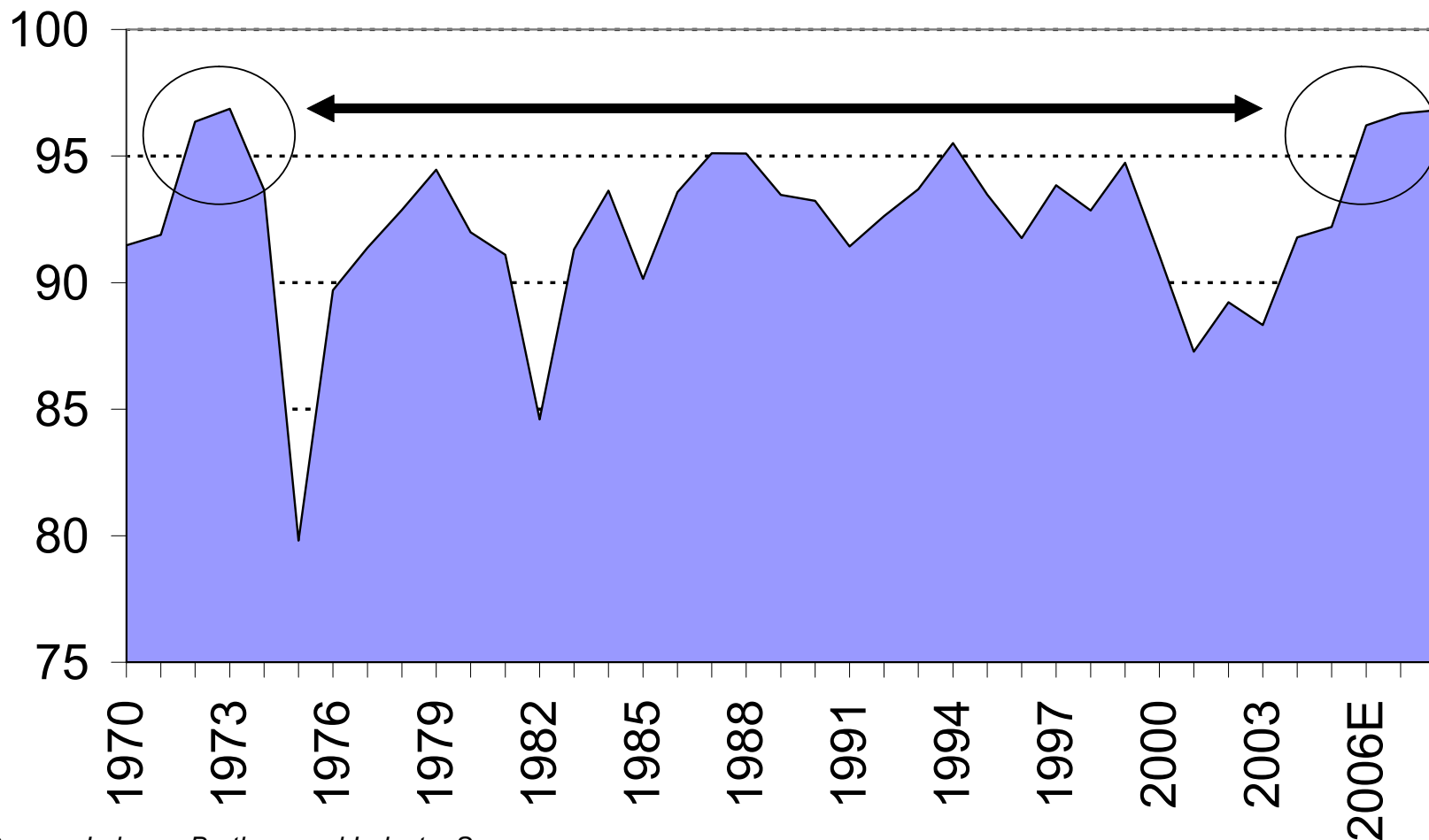


Source: Lehman Brothers and Industry Sources

Supply/Demand

During 2006, we estimate operating rates will rise to levels not seen since 1972-1973...

US Paper and Paperboard Operating Rates



— Source: Lehman Brothers and Industry Sources —

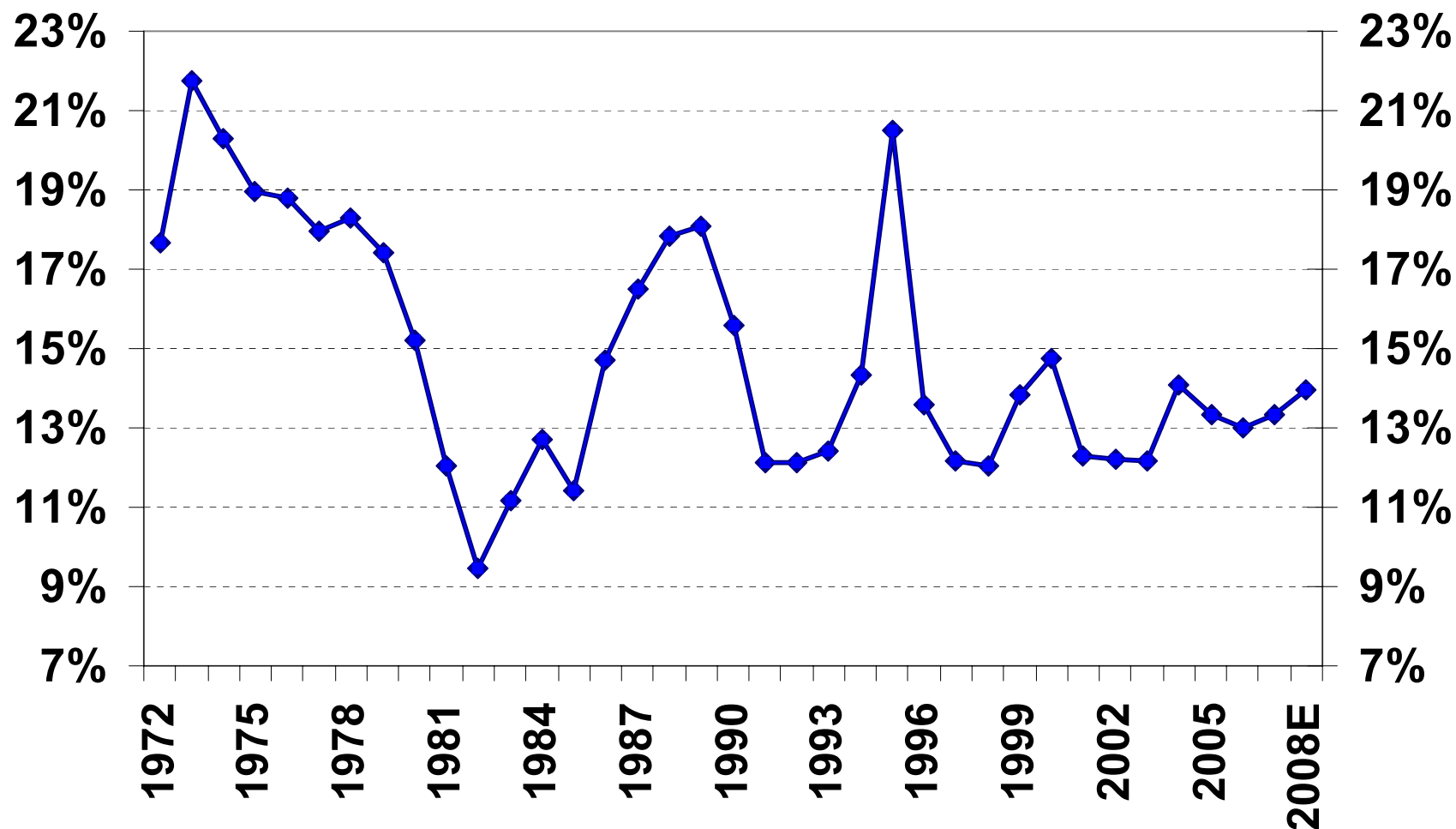
Financial Returns

- ◆ Ebitda margins for the industry are near the bottom quartile.
- ◆ But unlevered cash flow yields are near a 25 year high.
- ◆ While the industry's WACC is near a 25 year low.
- ◆ Yet returns still fall short of cost of capital.
- ◆ Including current cash flow and current unit growth, the industry is earning cost of capital for the first time in at least 25 years.
- ◆ Cost of equity vs. after-tax cost of debt is at an all-time high.
- ◆ Which is attracting significant interest from private equity investors.
- ◆ Capital discipline, free cash flow and operating rates are improving.

Financial Returns

EBITDA margins are near the bottom quartile of their historic range.

EBITDA Margins

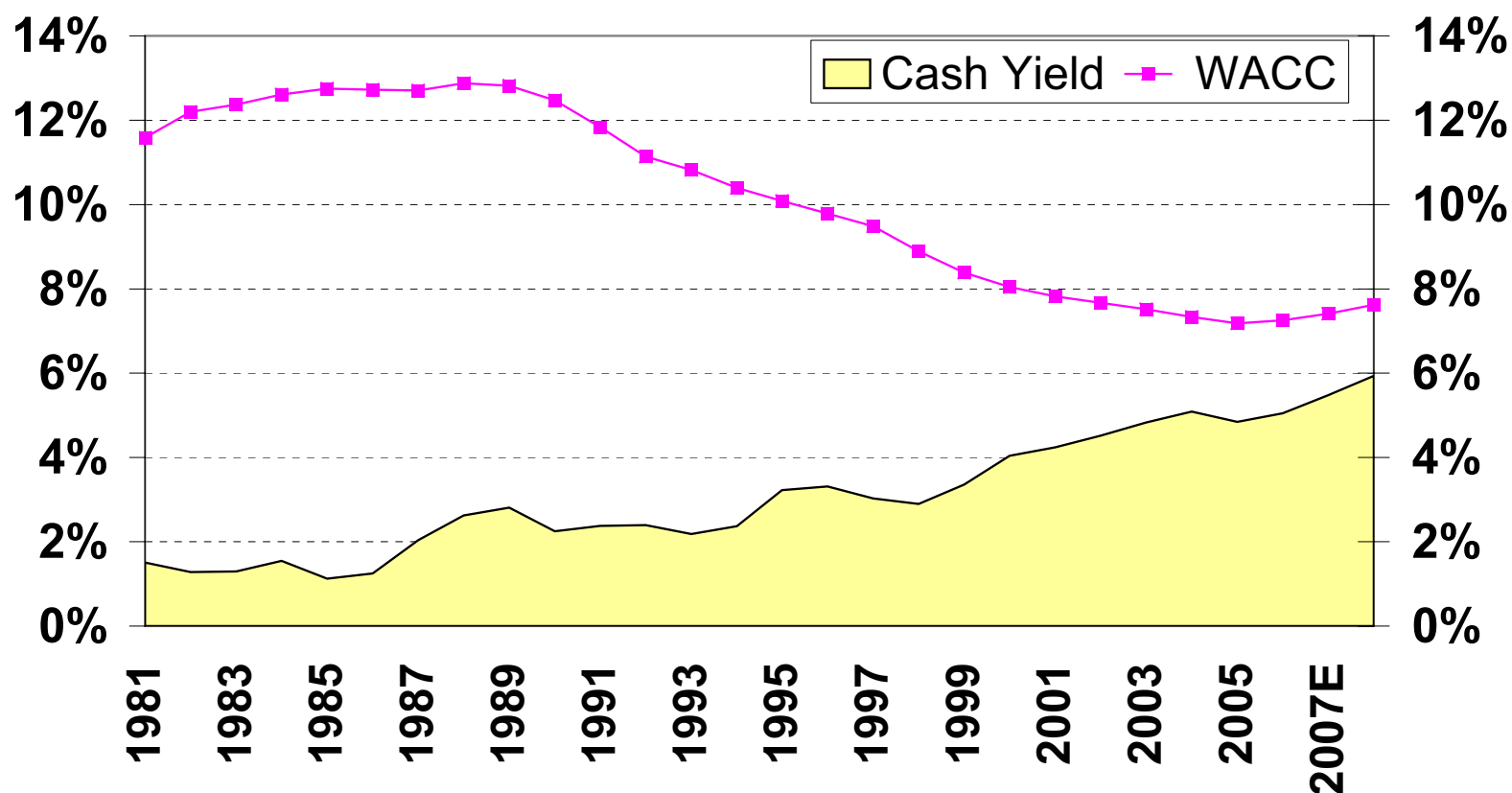


Source: Lehman Brothers

Financial Returns

10-year rolling unlevered free cash flow yields are near a 25-year high while WACC is near a 25-year low.

**Lehman Paper & Forest Index:
10-Yr Unlevered Free Cash Yield on Adjusted Enterprise
Value (with Actual Capex) vs 10-Yr WACC**

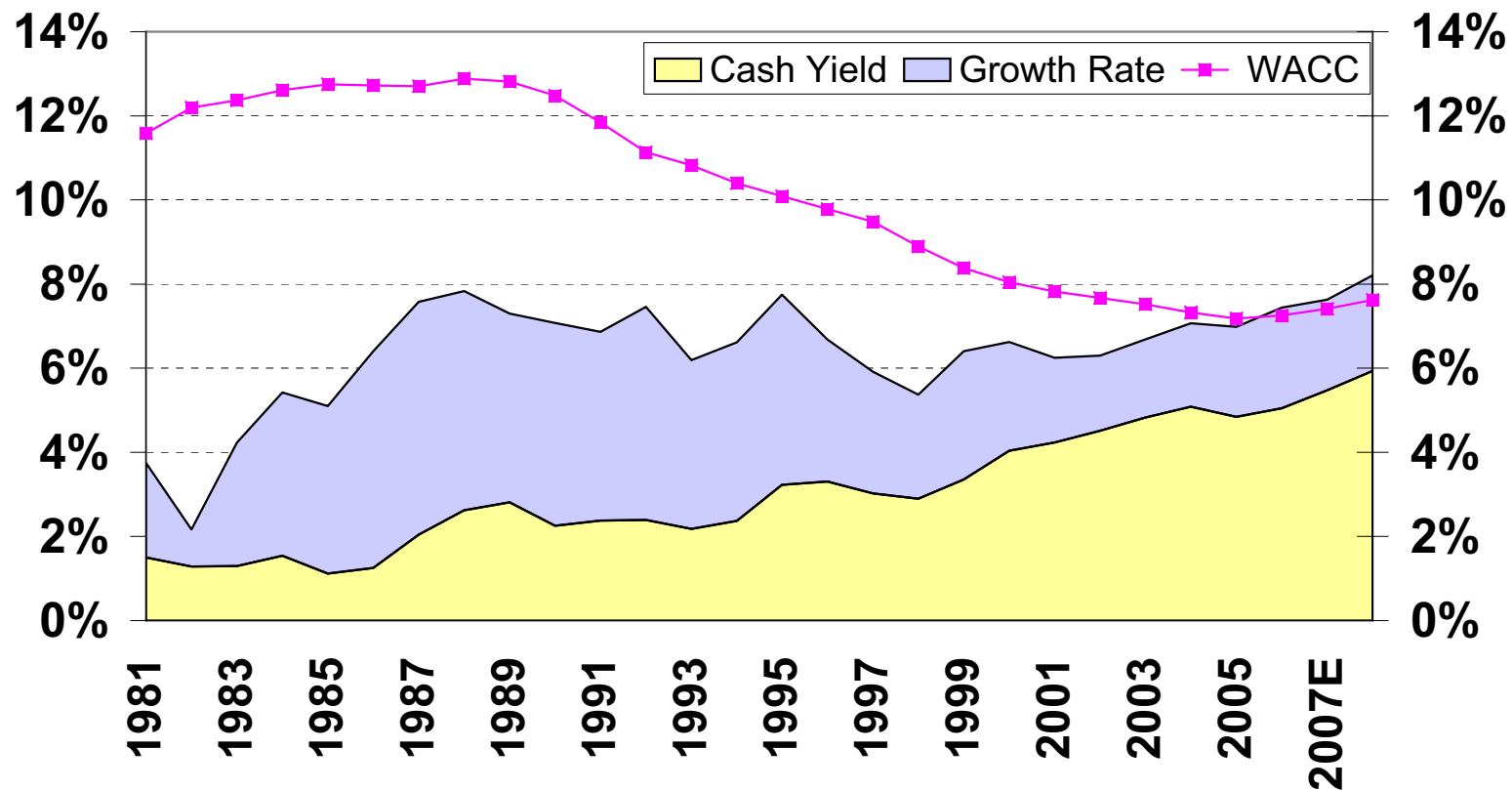


Source: Company reports and Lehman Brothers Estimates.

Financial Returns

Including 10-year unlevered free cash flow yield AND organic growth rates we estimate the industry can sustainably earn cost of capital for the first time in 25 years.

Lehman Paper & Forest Index:
10-Yr Unlevered Free Cash Yield on Adjusted Enterprise Value (with Actual Capex) & Growth vs 10-Yr WACC

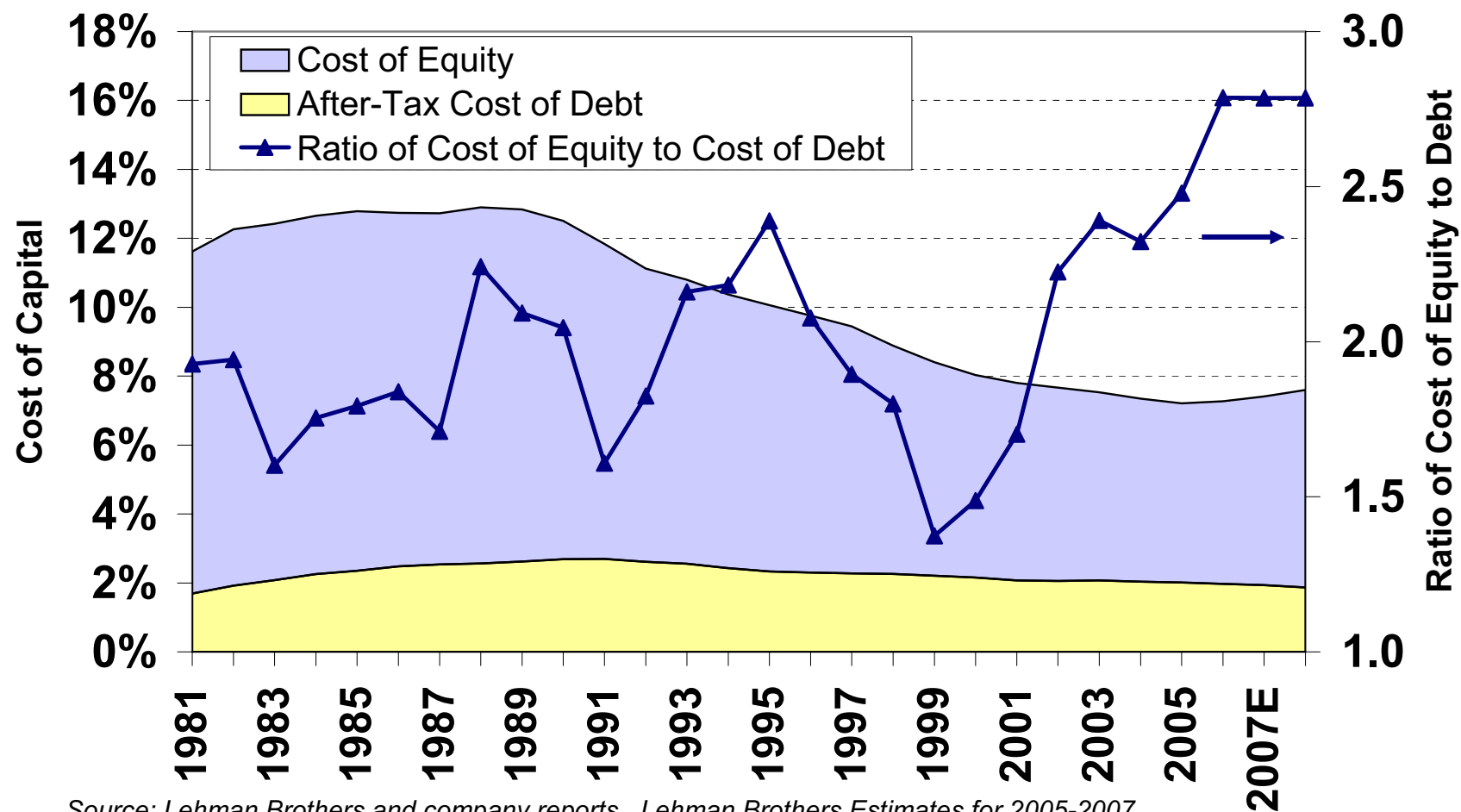


Source: Company Reports and Lehman Brothers estimates.

Financial Returns

Cost of equity is historically expensive relative to debt...

Lehman Paper and Forest Index: Blended 10-YR Weighted Avg Cost of Capital



Source: Lehman Brothers and company reports. Lehman Brothers Estimates for 2005-2007.

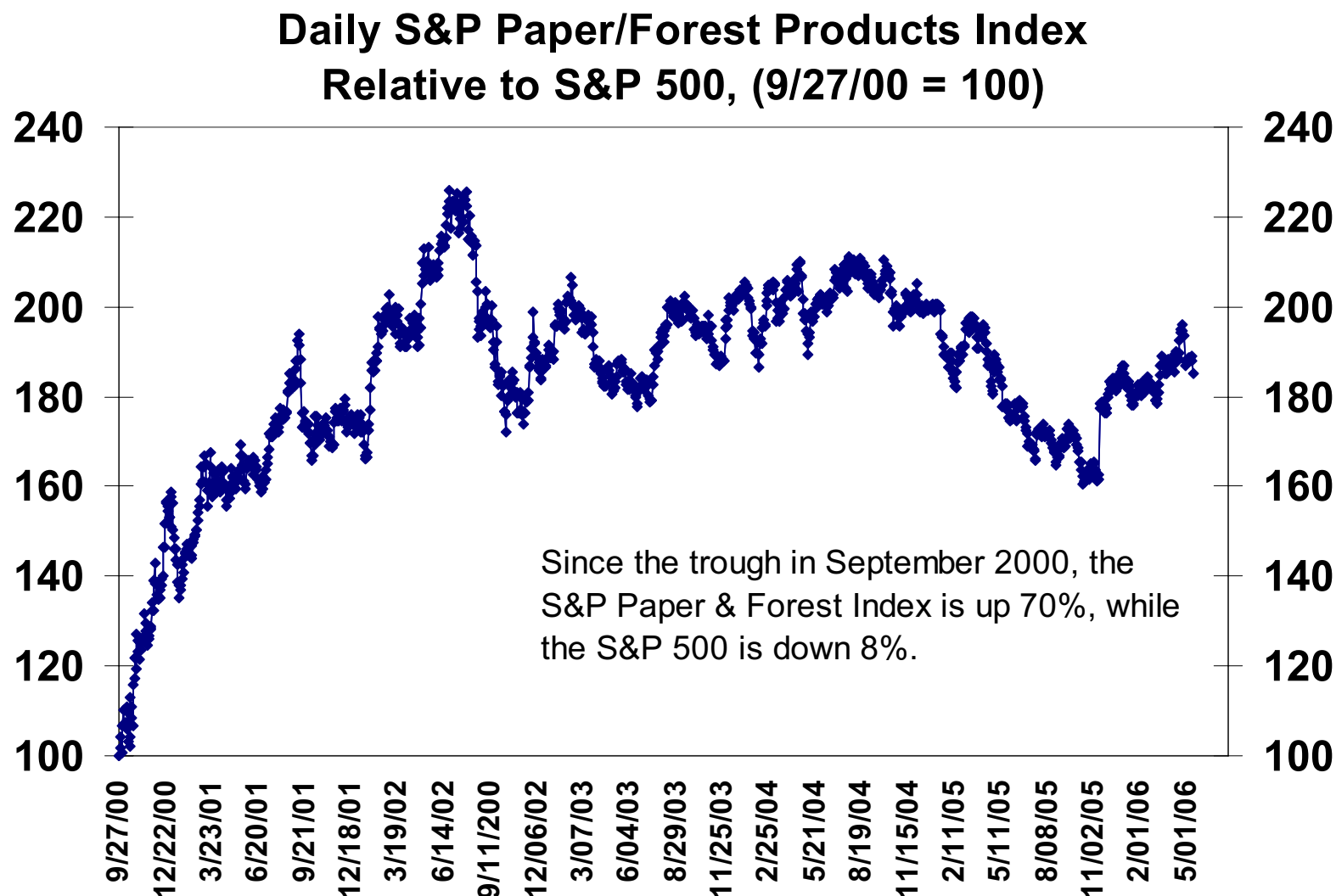
Financial Returns

Interest from private equity investors is up sharply...

- ◆ Texas Pacific Group is acquiring Smurfit-Stone Container's consumer packaging business for \$1 billion. *Lehman Brothers is acting as financial advisor to Texas Pacific Group on the acquisition of Smurfit-Stone's consumer packaging segment.*
- ◆ Private investors are acquiring over 5 million acres of timberland from International Paper for \$6 billion.
- ◆ Koch Industries spent \$21 BB to acquire Georgia-Pacific.
- ◆ Madison Dearborn Partners acquired Boise Cascade.
- ◆ Cerberus Capital acquired GP's building products distribution business and MeadWestvaco's coated paper business.
- ◆ Kohlberg & Co. acquired IP's specialty papers business.

Financial Returns

Relative Performance of Paper & Forest Products Index



Source: Lehman Brothers and FactSet.

Summary

ECONOMY:

- ◆ Solid growth, but interest rates are a concern.
- ◆ Interest rate sensitive areas like housing feeling the pinch.
- ◆ Twin deficits may keep pressure on the dollar

COMMODITY PRICES :

- ◆ Exchange rates often impact trade flows and commodity prices.
- ◆ Chronically high input costs likely to continue, especially in upstream commodities that China lacks.
- ◆ Most wood prices are down YTD, while paper prices are up.

Summary

CHINA:

- ◆ Driving upstream commodities up (pulp, wastepaper, timber), while driving labor-intensive downstream products down (finished consumer goods).
- ◆ Chinese paper industry could match size of U.S. industry by 2011 and grow to 2X our size by 2022.

TIMBER:

- ◆ Ownership structure is changing.
- ◆ Tax and capital structure arbitrage allows private buyers to pay more for timberlands.
- ◆ Timber prices are trending higher.

Summary

Supply/Demand:

- ◆ U.S. demand growth is slowing, but supply is contracting faster.
- ◆ Global trend demand growth also exceeds supply growth.
- ◆ U.S. trade flows are improving.

Financial Returns:

- ◆ Returns are still low, but getting better.
- ◆ Cost of equity is historically high vs. cost of debt.
- ◆ Private equity investors are active in the industry.

Important Disclosures

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In addition to the stock rating, we provide sector views which rate the outlook for the sector coverage universe as 1-Positive, 2-Neutral or 3-Negative (see definitions below). A rating system using terms such as buy, hold and sell is not the equivalent of our rating system. Investors should carefully read the entire research report including the definitions of all ratings and not infer its contents from ratings alone.

Stock Rating

1-Overweight - The stock is expected to outperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

2-Equal weight - The stock is expected to perform in line with the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

3-Underweight - The stock is expected to underperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

RS-Rating Suspended - The rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Lehman Brothers is acting in an advisory capacity on a merger or strategic transaction involving the company.

Important Disclosures

Sector View

- 1-Positive - sector coverage universe fundamentals are improving.
- 2-Neutral - sector coverage universe fundamentals are steady, neither improving nor deteriorating.
- 3-Negative - sector coverage universe fundamentals are deteriorating.

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