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Paper & Forest Products

Pulp Inventories Edge Higher But Producers Retain Pricing Power

Event

Jan-2010 World Pulp Stats revealed an uptick in softwood pulp inventory, however, the supply-demand balance continues to favour producers.

Action

To access cash flows associated with current strong pulp markets we recommend investors buy STRONG BUY rated Canfor Pulp (CFX.UN-TSX).

Analysis

Increased softwood pulp shipments to North America (+8%), W. Europe (+3%) and Latin America (+25%) offset a 13% decline in shipments to China. Softwood inventories saw a (seasonal) uptick in Jan-2010 as production outpaced shipments - pushing the shipment to capacity ratio to 86% from 90% last month. This resulted in inventories edging up from 23 days in Dec-09 to 25 days. With markets considered balanced at 30 days, we expect producers continue to enjoy pricing power. Heading into the spring maintenance season we expect inventories to moderate due to increased downtime.

After a successful Feb-2010 price hike, list U.S. NBSK prices are sitting at US\$880/mt. This week Canfor Pulp joined several other major producers in announcing a further US\$30/mt lift for Mar-2010. Speculation is that sustained incremental demand from China, which has typically stalled at previous cyclical peaks, could mean new highs in pulp prices this cycle. While our estimates assume NBSK prices pull back during 2H10 on capacity restarts, we acknowledge the strong current momentum and expect prices to move higher before giving up ground. A successful March increase would push list prices to US\$910/mt – making our US\$850/mt 2010 forecast appear conservative.

Canfor Pulp increased its monthly distribution to \$0.12 implying a 14% cash-on-cash yield. Given current pulp market strength we not only view this distribution level as sustainable for 2010 but see upside. The annualized \$1.44 in DC works out to a 66% payout ratio in our model. Consistent with past years, we expect a 90% payout ratio - implying a 20% yield on our \$2.17 per unit DC estimate. We expect upward 2010E earnings revisions as Street analysts price in current conditions.

Valuation

Our \$12.50 per unit Canfor Pulp target represents a 5.3x 2010E EV/EBITDA multiple. This compares to pulp SFK Pulp at 9.6x and Mercer at 9.0x.

SECTOR SUMMARY

COMPANY	CUR PRICE	RETURN	RATING	TARGET
Pulp & Paper				
Canfor Pulp Income Fund			STRONG BUY 1 =	
CFX.UN-TSX	C \$10.39	34%		\$12.50 =
Mercer International			MARKET PERFORM 3 =	
MERC-NASDAQ	US \$3.90	15%		\$4.50 =
SFK Pulp Fund			MARKET PERFORM 3 =	
SFK.UN-TSX	C \$1.44	-48%		\$0.75 =

KEY COMMODITY PRICING

	2008A	2009E	2010E
Pulp (US\$/mt)*	858	718	850
Pulp (US\$/mt)**	851	665	819

* NBSK del. U.S.

**NBSK del. Europe

Closing prices as of 23-Feb-10

All figures in C\$, unless otherwise noted.

Sources: Raymond James Ltd., ThomsonOne, CapIQ

Risks

Some of the specific risk factors that pertain to the projected 6 to 12 month stock price target for Canfor Pulp Fund (CFX) are as follows:

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.

Analyst Certification

The views expressed in this report (which include the actual rating assigned to the company as well as the analytical substance and tone of the report) accurately reflect the personal views of the analyst(s) covering the subject securities. No part of said person's compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this research report.

Stock Ratings

STRONG BUY 1: the stock is expected to appreciate and produce a total return of at least 15% and outperform the S&P/TSX Composite Index over the next six months. OUTPERFORM 2: the stock is expected to appreciate and outperform the S&P/TSX Composite Index over the next twelve months. MARKET PERFORM 3: the stock is expected to perform generally in line with the S&P/TSX Composite Index over the next twelve months and is potentially a source of funds for more highly rated securities. UNDERPERFORM 4: the stock is expected to underperform the S&P/TSX Composite Index or its sector over the next six to twelve months and should be sold.

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Risk Factors

Some of the general risk factors that pertain to the projected 6-12 month stock price targets included with our research are as follows: i) changes in industry fundamentals with respect to customer demand or product/service pricing could adversely impact expected revenues and earnings, ii) issues relating to major competitors, customers, suppliers and new product expectations could change investor attitudes toward the sector or this stock, iii) unforeseen developments with respect to the management, financial condition or accounting policies or practices could alter the prospective valuation, or iv) external factors that affect global and/or regional economies, interest rates, exchange rates or major segments of the economy could alter investor confidence and investment prospects.

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- 7 None of the above disclosures apply to this company.

COMPANY	SYMBOL	EXCHANGE	DISCLOSURES
Canfor Pulp Income Fund	CFX.UN	TSX	7
Mercer International Inc.	MERC, MRI.U	NASDAQ, TSX	1b, 1e, 3, 5 (Ken Shields)
SFK Pulp Fund	SFK.UN	TSX	7



