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Paper & Forest Products

3Q09 - Momentum in P&P; Value in Building Materials

We are publishing our expectations for the 3Q09 reporting season commencing later this week. While higher building materials and pulp prices were partially offset by FX, we expect generally better sequential results.

Pulp & Paper - Based on consensus estimates, we expect Domtar, Canfor Pulp Fund and Fortress Paper to report better-than-expected results and expect the stocks to respond positively. We acknowledge that the demand outlook remains weak in the case of Domtar's core product (uncoated freesheet) and potentially transient in the case of NBSK pulp, however, we are encouraged by inventory management in both grades. Reflecting our outlook we are increasing Domtar's target to \$45 per share (from \$24) – representing a 6.9x 2010E EV/EBITDA multiple near the high end of its historic range. We are reiterating our OUTPERFORM rating on Canfor Pulp and increasing our target to \$7 per share (from \$3.50) reflecting a 4.4x mid-cycle EV/EBITDA multiple. With better visibility on project financing and fibre supply we are reinstating targets on Mercer International and SFK Pulp at \$3.25 (5.1x mid-cycle EV/EBITDA) and \$0.65 (3.9x mid-cycle EBITDA) per share respectively. We note that OUTPERFORM rated Fortress Paper has minimal operating earnings exposure to the bilateral exchange rate. Reflecting a high FX sensitivity and continuing difficult groundwood paper fundamentals we are downgrading Catalyst Paper to UNDERPERFORM from MARKET PERFORM.

Building Materials - We also forecast building materials stocks beating consensus estimates, however, based on lower spot commodity prices and the high C\$ we expect cautious producer commentary to temper near term enthusiasm for the equities. Despite the high probability for negative EBITDA generation over the next two quarters, we remain positive on the longer term outlook. Specifically, we expect modestly improving demand coupled with a depleted supply chain to lift lumber prices during the spring 2010 building season. We regard the resulting cash flow positive inflection point as a positive catalyst leading to lumber equity valuations rising from trough, to the mid-cycle levels our 6 to 12 months targets are based on. We encourage value investors to “buy the dips” as trough valuations represent an asymmetric payoff, in our view. We regard Interfor as having the best upside with the lowest exposure to the rising C\$, Canfor offering the best trading liquidity and West Fraser the lowest absolute risk.

SECTOR SUMMARY

COMPANY			RATING
TICKER	CUR PRICE	RETURN	TARGET
Building Materials			
Canfor Corp.			OUTPERFORM 2 =
CFP-TSX	C \$6.44	16%	\$7.50 =
Interfor			OUTPERFORM 2 =
IFP-TSX	C \$2.99	51%	\$4.50 =
Norbord			MARKET PERFORM 3 =
NBD-TSX	C \$1.53	14%	\$1.75 =
West Fraser			OUTPERFORM 2 =
WFT-TSX	C \$27.80	26%	\$35.00 =
TimberWest			MARKET PERFORM 3 =
TWF.UN-TSX	C \$3.66	9%	\$4.00 =
Pulp & Paper			
Canfor Pulp Income Fund			OUTPERFORM 2 =
CFX.UN-TSX	C \$5.70	25%	\$7.00 ↑
Catalyst Paper			UNDERPERFORM 4 ↓
CTL-TSX	C \$0.31	-35%	\$0.20 =
Domtar			MARKET PERFORM 3 =
UFS-NYSE	US \$41.73	8%	\$45.00 ↑
Fortress Paper			OUTPERFORM 2 =
FTP-TSX	C \$8.11	23%	\$10.00 =
Mercer International			MARKET PERFORM 3 =
MERC-NASD	US \$3.02	8%	\$3.25 ↑
SFK Pulp Fund			UNDERPERFORM 4 =
SFK.UN-TSX	C \$0.98	-34%	\$0.65 ↑

Closing prices as of 20-Oct-09

All figures in C\$, unless otherwise noted.

Sources: Raymond James Ltd., ThomsonOne, CapIQ

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Exhibit 1: Changes to Estimates (EPS) and Targets

Company		Recent Price	2009E				2009E Yr	2010E Yr	Rating	6-12 Mth Target	Rationale
			Q1	Q2	Q3	Q4					
Building Materials											
Canfor	Revised	\$6.44	\$ (0.55)	\$ (0.12)	\$ (0.22)	\$ (0.33)	\$ (1.21)	\$ (0.73)	2	\$7.50	OUTPERFORM 2
CFP-T	Previous		\$ (0.55)	\$ (0.12)	\$ (0.22)	\$ (0.31)	\$ (1.20)	\$ (0.54)	2	\$7.50	
Interfor	Revised	\$2.99	\$ (0.28)	\$ (0.32)	\$ (0.20)	\$ (0.30)	\$ (1.10)	\$ (0.59)	2	\$4.50	OUTPERFORM 2
IFP.A-T	Previous		\$ (0.28)	\$ (0.32)	\$ (0.20)	\$ (0.30)	\$ (1.10)	\$ (0.55)	2	\$4.50	
Norbord (US\$)	Revised	C\$1.53	\$ (0.07)	\$ (0.04)	\$ (0.01)	\$ (0.03)	\$ (0.15)	\$ (0.03)	3	C\$1.75	MARKET PERFORM 3
NBD-T	Previous		\$ (0.07)	\$ (0.04)	\$ (0.01)	\$ (0.03)	\$ (0.15)	\$ (0.03)	3	C\$1.75	
West Fraser	Revised	\$27.80	\$ (1.26)	\$ (1.39)	\$ (1.01)	\$ (1.43)	\$ (5.08)	\$ (1.86)	2	\$35.00	OUTPERFORM 2
WFT-T	Previous		\$ (1.26)	\$ (1.39)	\$ (0.73)	\$ (1.37)	\$ (4.75)	\$ (1.85)	2	\$35.00	
TimberWest*	Revised	\$3.66	\$ (0.08)	\$ (0.07)	\$ (0.01)	\$ (0.04)	\$ (0.21)	\$ 0.06	3	\$4.00	MARKET PERFORM 3
TWF.UN-T	Previous		\$ (0.08)	\$ (0.07)	\$ (0.04)	\$ (0.04)	\$ (0.22)	\$ 0.06	3	\$4.00	
Pulp & Paper											
Canfor Pulp Fund	Revised	\$5.70	\$ (0.06)	\$ 0.02	\$ 0.24	\$ 0.25	\$ 0.44	\$ 0.81	2	\$7.00 ↑	OUTPERFORM 2
CFX.UN-T	Previous		\$ (0.06)	\$ 0.02	\$ 0.12	\$ 0.09	\$ 0.17	n.m.	2	\$3.50	
Catalyst Paper	Revised	\$0.31	\$ 0.03	\$ (0.06)	\$ (0.09)	\$ (0.10)	\$ (0.22)	\$ (0.20)	3	\$0.20	UNDERPERFORM 4 ↓
CTL-T	Previous		\$ 0.03	\$ (0.06)	\$ (0.05)	\$ (0.06)	\$ (0.14)	n.m.	3	\$0.20	
Domtar (US\$)	Revised	\$41.73	\$ (0.90)	\$ (0.76)	\$ 0.44	\$ 0.44	\$ (0.79)	\$ (0.12)	3	\$45.00 ↑	MARKET PERFORM 3
UFS-N	Previous		\$ (0.90)	\$ (0.76)	\$ (0.02)	\$ (0.13)	\$ (1.81)	n.m.	3	\$24.00	
Fortress Paper	Revised	\$8.11	\$ 0.28	\$ 0.24	\$ 0.29	\$ 0.24	\$ 1.05	\$ 1.29	2	\$10.00	OUTPERFORM 2
FTP-T	Previous		\$ 0.28	\$ 0.24	\$ 0.29	\$ 0.26	\$ 1.07	n.m.	2	\$10.00	
Mercer (US\$)	Revised	\$3.02	(€ 0.75)	(€ 0.32)	(€ 0.17)	€ 0.10	(€ 1.14)	(€ 1.22)	3	\$3.25 ↑	MARKET PERFORM 3
MERC-Q	Previous		(€ 0.75)	(€ 0.32)	(€ 0.20)	(€ 0.16)	(€ 1.43)	n.m.	3	UR	
SFK Pulp Fund	Revised	\$0.98	\$ (0.07)	\$ (0.26)	\$ (0.05)	\$ (0.00)	\$ (0.38)	\$ (0.04)	4	\$0.65 ↑	UNDERPERFORM 4
SFK.UN-T	Previous		\$ (0.07)	\$ (0.26)	\$ (0.22)	\$ (0.21)	\$ (0.76)	n.m.	4	UR	

Source: Raymond James Ltd

Exhibit 2: 3Q09 RJ vs. Consensus Estimates

Company	Symbol	Recent Price	3Q09E			First Call		Prior Quarter	Prior Year
			Revised	Previous	Change	Consensus	Difference	2Q09	3Q08
Building Materials									
Canfor	CFP-T	\$6.44	\$ (0.22)	\$ (0.22)	\$0.00	(\$0.26)	\$0.04	(\$0.12)	(\$0.07)
Interfor	IFP.A-T	\$2.99	\$ (0.20)	\$ (0.20)	\$0.00	(\$0.21)	\$0.02	(\$0.32)	(\$0.13)
Norbord	NBD-T	\$1.53	\$ (0.01)	\$ (0.01)	(\$0.00)	(\$0.02)	\$0.01	(\$0.04)	(\$0.04)
West Fraser Timber	WFT-T	\$27.80	\$ (1.01)	\$ (0.73)	(\$0.28)	(\$1.10)	\$0.09	(\$1.39)	\$0.14
TimberWest ¹	TWF.UN-T	\$3.66	\$ (0.01)	\$ (0.04)	\$0.03	(\$0.05)	\$0.04	(\$0.07)	(\$0.04)
Pulp & Paper									
Canfor Pulp ¹	CFX.UN-T	\$5.70	\$ 0.24	\$ 0.12	\$0.12	\$0.16	\$0.08	\$0.02	\$0.53
Catalyst Paper	CTL-T	\$0.31	\$ (0.09)	\$ (0.05)	(\$0.04)	(\$0.08)	(\$0.01)	(\$0.06)	\$0.02
Domtar	UFS-N	\$41.73	\$ 0.44	\$ (0.02)	\$0.46	\$0.26	\$0.18	(\$0.76)	\$0.10
Fortress Paper	FTP-T	\$8.11	\$ 0.29	\$ 0.29	\$0.00	\$0.27	\$0.02	\$0.24	\$0.22
Mercer	MERC-Q	\$3.02	(€ 0.17)	(€ 0.20)	€ 0.03	(\$0.24)	n.m.	(€ 0.32)	€ 0.00
SFK ¹	SFK.UN-T	\$0.98	\$ (0.05)	\$ (0.22)	\$0.17	(\$0.06)	\$0.00	(\$0.26)	\$0.08

¹ Distributable cash per unit.

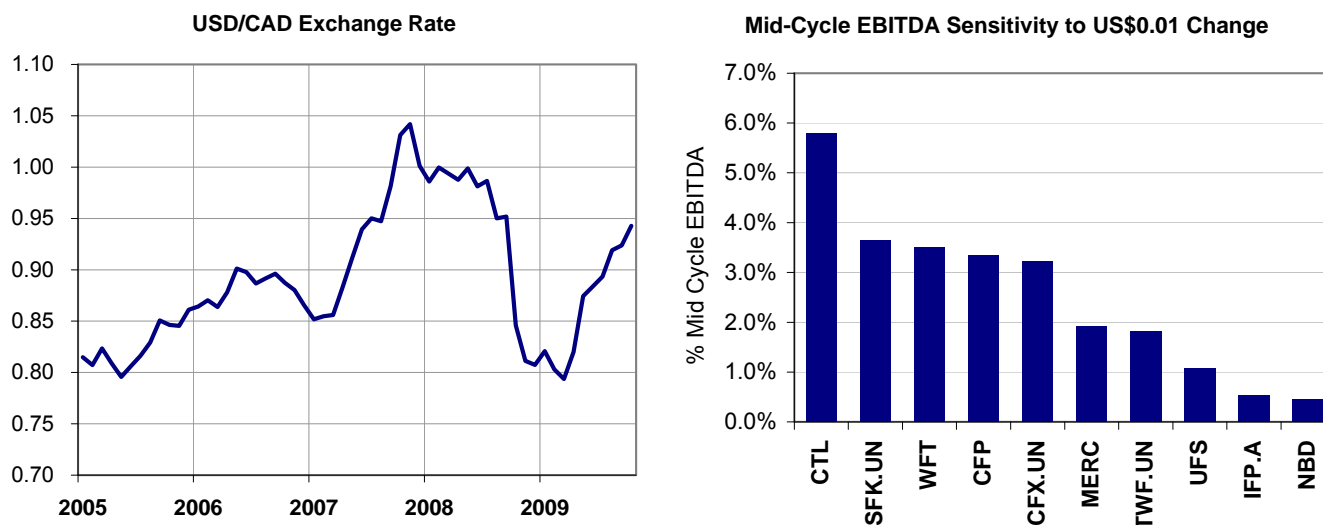
Source: Company Reports, FirstCall, Raymond James Ltd.

Forest Products Commodities Outlook**Currency**

The C\$ continued the trend of appreciation seen in 2Q09, increasing 6% during 3Q09 to settle at an average rate of US\$0.91 for the quarter with the current spot rate at US\$0.95. The Bank of Canada has repeatedly warned of the negative impacts a high loonie has on the export dependant Canadian economy – including the forest sector.

Exhibit 3 details the recent change in the bilateral FX rate along with individual company sensitivity to a US\$0.01 change. We highlight that these are first order impacts. History has shown that over time, commodity prices with a significant Canadian share of production (e.g., NBSK pulp and lumber) tend to move to offset at least a portion of the negative impact as higher cost Canadian capacity curtails. Consistent with Raymond James Ltd.'s FX marked to market policy we assume a \$0.91 US\$/C\$ and \$1.43 US\$/€.

Exhibit 3: Bilateral Exchange Rate and EBITDA Sensitivity



Source: Pacific Exchange Rate Service, Company Reports, Raymond James Ltd.

Building Materials

Benchmark WSPF 2x4 lumber prices averaged US\$192/mfbm for 3Q09, registering a 10% qtr/qtr increase, and a 24% increase from 1Q09 lows. Unfortunately, unfavourable currency moves offset more than half the gain for Canadian producers. Although prices have risen for the past two quarters, we note that WSPF prices are still down 26% year over year (reflecting excessive operating rates given the beleaguered state of the U.S. home construction industry). Current spot lumber prices, at US\$195/mfbm, have moved higher than the 3Q09 average; and are in line with our 2009 forecast of US\$190/mfbm.

Reflecting relatively higher downtime rates, NC 7/16" OSB prices were up 22% to US\$179/msf; more than double lumber's performance (despite similar demand drivers). However, OSB prices have now dropped from average 3Q09 levels to a current spot price of US\$156/msf, below our 2009 forecast average of US\$161/msf.

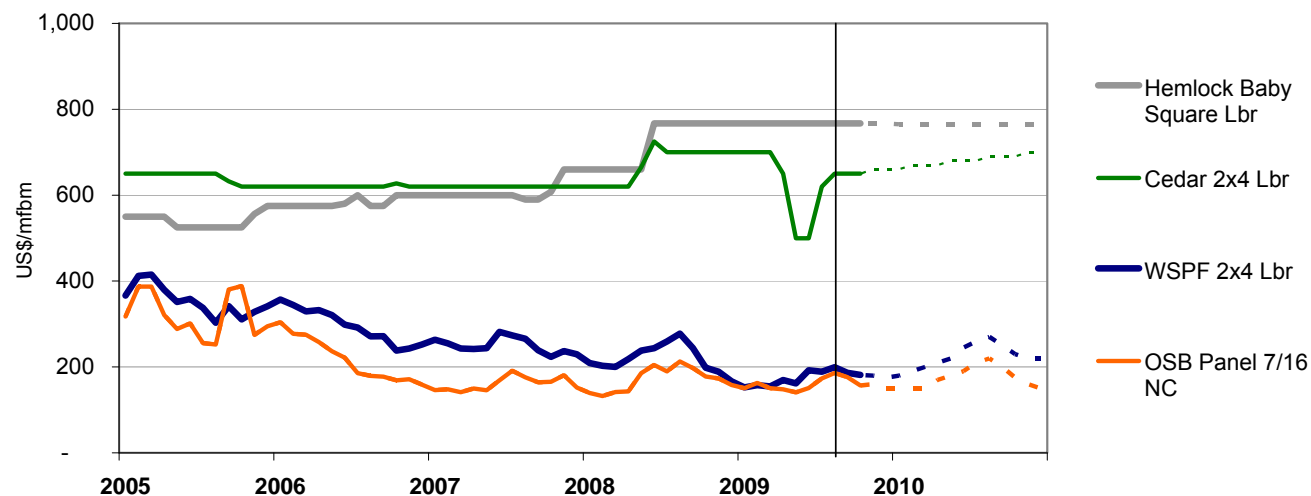
The U.S. housing market remains the key demand driver and the most uncertain input for the building materials outlook. Total U.S. housing starts stabilized at just under the 600,000 (SAAR) level over the summer. This was higher than the sub 500,000 rate experienced during the spring but more than 30% off last summer's 800,000-900,000 start level. Using consensus macro

estimates our 8 factor regression model forecasts U.S. total housing starts averaging 530,000 in 2009, 650,000 in 2010 and breaking the 1.0 mln level in 4Q11. See our INsight published September 22, 2009 for details.

Assumptions on Foreclosures and Inventory levels remain key to the outlook. While mortgage delinquencies are running at record rates, translations into foreclosures have not kept pace. U.S. home foreclosures dropped 4% from August to September marking the second straight month over month decrease; however, they are still 29% higher than September 2008 and September was still the third highest foreclosure filing month since these statistics started being measured in 2005. It remains to be seen if the U.S. Government's housing rescue efforts will have a significant impact on foreclosure filings, especially in the face of mounting defaults due to high and rising unemployment (9.5% for September). We assume a peak in late 2010. With improved affordability and sales volumes we also expect total housing inventory has already peaked for this cycle.

We apply a simple regression model to equate total U.S. housing starts to North American lumber demand. Our housing start forecast translates into North American lumber demand increasing from 45 bfbm in 2009 to 52 bfbm in 2011 – approx. 40% below peak levels in 2005/06. We peg North American lumber capacity at 69 to 71 bfbm for the forecast period – roughly 15-20% lower than prior peak capacity reflecting permanent and indefinitely idled mills. Together these assumptions result in a North American lumber operating rate increasing from 66% in 2009 to 73% in 2011.

Unlike 2009, we expect a more pronounced seasonal run-up in pricing next year due to a reduced supply response reflecting: 1) a distribution chain berift of inventory and, 2) reduced financial capacity to run unprofitable operations. Based on this, forecast operating rates and our US\$0.91 FX rate assumption we are calling for benchmark average WSPF 2x4 lumber prices of US\$190/mfbm in 2009 and US\$225 in 2010.

Exhibit 4: Building Materials Commodity Prices

Source: Randon Lengths, Madison's, Raymond James Ltd.

Pulp & Paper

NBSK del. U.S. list prices increased 14% qtr/qtr to US\$733/mt for 3Q09 and are up by nearly US\$100/mt from lows of US\$635/mt in April and May. Similar to lumber however, unfavourable currency moves offset nearly half of the increase for Canadian producers.

World pulp deliveries increased 13.1% year over year for the month of August to 3.568 mln mt on the back of strong demand from China where shipments increased to 833,000 mt, up 28% from July and 131% from August 2008. In fact, worldwide deliveries to core pulp consuming regions were actually down from a year ago with deliveries to North America off 1.5% and Europe deliveries down 7.7% year over year.

Asian demand coupled with production curtailments have combined to result in very low inventory levels. This is illustrated by total overall inventory days having dropped to 27 in August from 28 in July and 41 in August 2008. By grade, softwood inventory was at 23 days and hardwood was at 30 days. The shipment to capacity ratio was a robust 93% for August, unchanged from the previous month.

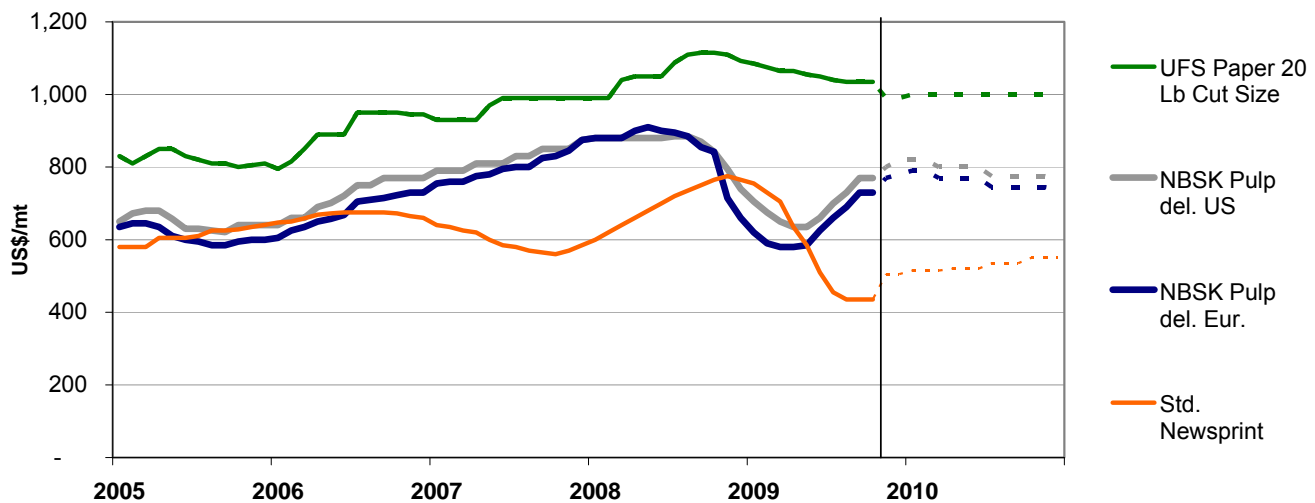
The combined effects of strengthening currencies in pulp producing nations (such as Canada and Brazil) and tight worldwide supply have resulted in another round of price increases for October. Industry sources indicate that

these increases will be in the range of US\$30-50/mt in North America, Western Europe and Asia and pulp producers including SFK Pulp, Canfor Pulp, Domtar, Mercer International, and West Fraser Timber have all indicated their plans to increase prices for October deliveries.

In accordance with the above commentary, our 2009 forecasts have been increased to US\$715/mt for NBSK del. U.S. (from US\$685/mt) and US\$665/mt for NBSK del. Europe (from US\$630/mt). We expect NBSK del U.S. to average US\$790/mt in 2010.

Pulp & Paper week's reported uncoated freesheet paper prices showed a 3% erosion qtr/qtr falling by US\$23/st to US\$822/st. Meanwhile the PPPC indicates that the freesheet operating rate was 92% for August 2009, unchanged year over year, but up from 86% in July. With industry sources expecting advertising revenues to end the year down 14% and white-collar unemployment levels showing the potential for further downside, we do not anticipate any near-term turnaround in freesheet demand. With major players focusing on price retention through supply management, we expect supply rationalization efforts to continue through the downturn. We have increased our 2009 and 2010 forecast prices for offset rolls to US\$860/st (from US\$840/st).

Exhibit 5: Pulp & Paper Commodity Prices



Source: Pulp & Paper Week, Raymond James Ltd.

Exhibit 6: RJ Commodity Price Forecast Summary

Commodity Product	Units	Current	3Q09	2009E		% Chg	2010E Forecast
				Forecast	Previous		
<u>LUMBER</u>							
WESTERN SPF 2x4	US\$/mfbm	195	192	190	190	0%	225
BABY SQUARES - 3 9/16"	US\$/mfbm	767	767	767	745	3%	765
<u>PANEL</u>							
OSB - 7/16" NC	US\$/msf	156	179	161	155	4%	175
PLYWOOD - CSP 3/8" del. Van	C\$/msf	298	331	295	265	11%	285
<u>PULP/NEWSPRINT</u>							
NBSK del. U.S. NE	US\$/mt	789	733	715	685	4%	785
NBSK del. N. Europe	US\$/mt	747	693	665	630	6%	760
Eucalyptus Pulp	US\$/mt	700	617	610	590	3%	655
Newsprint U.S. East	US\$/mt	435	442	560	575	-3%	530
<u>PAPER / PACKAGING</u>							
UFS - 50 lb offset roll	US\$/st	820	822	860	840	2%	860
UFS - 20lb cut size	US\$/st	1,035	1,037	1,040	975	7%	1,000
CGW - #5, 40lb roll	US\$/st	770	777	820	850	-4%	785
SCA - 35lb	US\$/st	785	787	830	830	0%	775
LINERBOARD 42lb del. West	US\$/st	580	590	600	560	7%	590
<u>EXCHANGE RATES</u>							
US\$/C\$		0.96	0.91	0.91	0.91	0%	0.91
US\$/€		1.49	1.43	1.43	1.35	6%	1.43

Sources: Random Lengths, Madison's, Pulp & Paper Week, FOEX, Bloomberg, Raymond James Ltd.

Exhibit 7: RJ Paper and Forest Products Coverage Universe Earnings Calendar

	Symbol	3Q09 Earnings Release	Timing	Conference Call	Details
Thursday, October 22, 2009					
Interfor	IFP.A-T	✓	After Mkt		
TimberWest	TWF.UN-T	✓	After Mkt		
Friday, October 23, 2009					
Interfor	IFP.A-T			✓	11am EST, 1-866-323-8540
TimberWest	TWF.UN-T			✓	12pm EST, 1-800-918-9476
Canfor Pulp	CFX.UN-T	✓	After Mkt		
Monday, October 26, 2009					
Canfor Pulp	CFX.UN-T			✓	11am EST, 1-800-952-4972
Wednesday, October 28, 2009					
Mercer	MERC-Q	✓	After Mkt		
Thursday, October 29, 2009					
Canfor	CFP-T	✓	After Mkt		
Mercer	MERC-Q			✓	10am EST, Number TBD
Friday, October 30, 2009					
Canfor	CFP-T			✓	12pm EST, 1-866-223-7781
Norbord	NBD-T	✓	Before Mkt	✓	11am EST, 1-866-322-2356
SFK Pulp	SFK.UN-T	✓	After Mkt		
Domtar (tentative)	UFS-N	✓	Before Mkt	✓	TBA
Monday, November 2, 2009					
West Fraser	WFT-T	✓	After Mkt		
SFK Pulp	SFK.UN-T			✓	TBA
Tuesday, November 3, 2009					
West Fraser	WFT-T			✓	11:30am EST, 1-800-355-4959
Catalyst Paper	CTL-T	✓	During Mkt		
Wednesday, November 4, 2009					
Catalyst Paper	CTL-T			✓	11am EST, 1-800-594-3790
Monday, November 9, 2009					
Fortress Paper (Tentative)	FTP-T	✓	After Mkt		
Tuesday, November 10, 2009					
Fortress Paper (Tentative)	FTP-T			✓	1pm EST (Tentative)

Source: Company news releases

Estimated earnings release and conference call times/details are subject to change.

Risks

Some of the specific risk factors that pertain to the projected 6 to 12 month stock price target for our universe are as follows:

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, an appreciation of the Canadian 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, and v) Forest product markets are global in nature, trade issues affecting market access could impact earnings.

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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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