

April 27, 2009**Three Forest Companies****PRT Forest Regeneration Income
Fund (PRT.UN: \$1.18)****Change from Outperform to Not
Rated****Western Forest Products Inc. (WEF:
\$0.17)****Change from Outperform to Not
Rated****TimberWest Forest Corp. (TWF.UN:
\$3.46)****Change from Market Perform to Not
Rated****Summary and Conclusion**

These three equities sell at exceptionally low ratios of price to book value: 23%, 33%, and 61% for Western, PRT, and TimberWest, respectively. Their operating experience and outlook deserve higher ratings: despite the well-publicized woes of the forest industry, these companies have managed to hold their cash flows remarkably stable, with little net new borrowing and only modest asset sales. What has depressed prices so severely, if not the operating outlook, is investors' concern that the eventual recovery of market values will not accrue to them. To assess that concern, one must answer questions in four problem areas: definition of corporate control; privileges accorded to major shareholders; rules governing rights offerings and going-private transactions; and responsibilities of elected officials. We have suspended our ratings on all three equities until these questions have been addressed. Only then can investors buy these deeply undervalued equities confidently and in the expectation of capital gain.

Net Asset Values

From Table 2 it is clear that all three equities are selling at extremely low – even ridiculously low – percentages of their net asset values. The price-to-book ratio is 33% for PRT, 61% for TimberWest, and 23% for Western Forest Products. If one wished to gild the lily, one might point out that PRT reduced its book equity by heavy writedowns in 2008, or that a third of Western’s cumulative net loss was due to a non-recurring factor, namely, strike action by most of its unionized employees in the 2007 second half.

It is not just net asset values we are talking about but net tangible asset values. Only two things could justify such low price-to-tangible-book ratios: either the operating outlook is so poor that continuing erosion in asset values must be expected; or else investors have reason to fear that the ultimate recovery of price-to-tangible-book ratios will not benefit them.

We discuss these two matters in order below.

Operations in 2008 and 2009

Many companies are suffering losses in these days. Often operating losses are supplemented by asset writedowns that magnify the overall loss and establish tax losses that will insure a long tax holiday when the good times roll again. In the meantime, the immensity of the overall loss may be used to justify actions that would normally cause outrage: disinvestment, work force layoffs, and the elimination of dividends.

We are expected to feel sorry for businesses that are “bleeding red ink.” The bleeding that matters is not accounting losses but cash drain. In Table 1 we have combined the 2008 income statement with the 2008 cash flow statement to see whether our three companies that are “bleeding red ink” are truly experiencing cash drain. Since we aim to use last year’s statements for a preliminary idea of what the current year may look like, we have eliminated certain one-off non-cash special items that cannot possibly recur. For example, we have not shown PRT’s writeoff of goodwill and intangible assets, or TimberWest’s restructuring of subordinate debt that produced a large reported accounting profit in last year’s final quarter.

All three companies recorded pre-tax losses in 2008. The losses were certainly large – they exceeded \$80 million for Western and \$100 million for TimberWest. Yet PRT and Western experienced only insignificant cash drains, while TimberWest showed a large cash buildup. How did they all manage to do so well?

TimberWest, which actually increased its cash position by \$30 million, took a seemingly unhealthy route: it simply increased its net borrowed position by drawing on its revolving credit line. The circumstances that forced it to borrow were not of the forest industry’s making. Indeed, TimberWest has closed its sawmills, reduced employment to fewer than ninety persons, and moved toward being a land management and real estate company. Even those designations are open to question, as the company managed to sell only \$10 million of real estate last year while paying out \$81 million to its unitholders.

However, 2009 will almost certainly be a much better year. Regular payments to unitholders - \$81 million last year – have been cut by 83% and will be completely foregone this year. Debt has been restructured in a move that will raise interest charges slightly from \$10 million to perhaps \$13 million but will lengthen maturities and cause the lion's share of debt to convert to equity in a few years time. Even if real estate sales remain meager, TimberWest is set to sail through 2009 with only minor operating and pre-tax losses and little change in cash. Given the degree of restructuring accomplished at year-end, TimberWest's borrowing that boosted cash holdings by \$30 million in 2008 does not look so improvident after all.

Western Forest Products experienced an insignificant net cash outflow last year. Like TimberWest it made net borrowings, but these were a comparatively minor \$15 million. Three factors were responsible for shrinking more than \$80 million in net operating losses to a negligible cash drain:

First, close to half the operating losses were non-cash charges, mainly depreciation of plant and equipment;

Second, the company booked more than \$20 million of "other income," primarily compensation from the BC provincial government for such things as takeback of timber licences and reductions in the annual allowable cut. Much of the compensation was for events that had predated the acquisition of Doman Industries;

Third, the "Investing" portion of the cash flow statement reversed from outflow to inflow, as Western raised \$40 million by sale of the former New Westminster sawmill.

More so than TimberWest, Western remains an operating forest company. Still, the word "operating" must be qualified. Since logging and haulage have been contracted out, Western has somewhat the character of a forest tenure holding company: it could suspend operations entirely and save itself \$80 million of operating losses, about half of which would be cash-retentive. The company's \$150 million asset sales program continues in effect, to be actuated, the company says, whenever the market is willing to pay prices that management considers adequate. Western is by no means bleeding cash; it is rich in assets held for sale; and it has hundreds of millions of dollars of tax loss carryforwards that would be a juicy plum for an acquirer.

PRT was at near-breakeven last year at both the operating profit and the net profit level. Surprisingly for such a small company, it achieved operating cash flow of almost \$8 million – enough to keep cash balances practically stable despite investing \$1 million, reducing the operating credit line by \$3.3 million, and paying distributions until deciding to suspend them at year-end.

PRT can only grow and sell forest seedlings if timber companies cut and the government makes them replant. The seedling business is dependent on timber and lumber companies like Western and TimberWest, and since it cannot control or sometimes even anticipate their actions, PRT must be run conservatively.

Still, we think PRT's decision to eliminate – not simply reduce – distributions for 2009 was more extreme than it needed to be. The company regularly calculates "cash available for distribution," which is that part of operating cash flow available for distribution after discretionary debt repayment and certain reserves. The lower the ratios of distributable cash and distributions to operating cash flow, the more cautiously PRT must be judging its ability to pay distributions. Over the five years 2003 to 2007 "cash available for distribution" averaged 89% of operating cash flow; last year the ratio was a mere 47%. Over the five years distributions averaged 95% of operating cash flow; last year they averaged only 37%. Plainly the rules have changed, and unitholders – the company's nominal owners – have borne the brunt of the change. They have lost 70% of the value of their units over five years, their distributions were allotted an abnormally small share of operating cash flow last year, and they face 2009 with the expectation of no income at all.

Management says it needs to conserve cash in the face of a likely 20% drop in seedling orders. That is all well and good, but just how should the burden be distributed? Surely there is borrowing power: PRT's long-term-debt-to-capital ratio last December 31 was only 14%, and it would have been below 10% had goodwill and intangible assets not been completely written off in the course of 2008. It will be a shame if paying down debt is always preferred over paying distributions, or if banks that have themselves enjoyed bailout money respond by tightening the loan covenants of their borrowers.

Investors' Questions

There are four questions that must trouble investors and explain their reticence to purchase these three equities:

1. What constitutes control of one corporation by another?
2. In what measure does a major shareholder – unfriendly, friendly, or white knight – become a privileged person?
3. Are our laws governing rights offerings and going-private transactions (GPTs) sufficiently strong and unambiguous?
4. Do our governments do what we want them to do and elected them to do?

Corporate Control

Western's dominant owner is Brookfield Asset Management, an Ontario enterprise whose main business is urban property development and ownership. If Brookfield should be shown to control Western, the BC Forest Minister could invoke the "change of control" clause and cancel Western's forest tenures. Western, while denying that any such change in control has occurred, has itself revoked contracts with its independent loggers and truckers if it has evidence that they are negotiating to sell the contracts. A case in point is Koprino Logging of Port Hardy, BC.

Brookfield contends that it does not exercise control over Western because its affiliate Tricap owns only 49% of Western's voting common stock. However, four of Western's eight directors are Brookfield or Tricap directors or officers, and that is already a 50% ratio. Of the remaining four, one has overseen the BC business interests of a Brookfield director, and another served recently on a Tricap fund advisory board. A third was for some years a deputy minister in the BC government. His directorship might challenge the government's responsibility for oversight. With the best will in the world, they might be reluctant to cancel a company's forest tenures when one of their colleagues sits on the board.

The issue here is not just whether one entity controls another. It is the Forest Minister's power to make that judgment on his own and decide, again on his own, whether forest licences should be revoked. By leaving it to him to make the control decision and act upon it or not, the BC statute seems flabby.

Privileged Persons

All three companies have dominant ownership elements whose aims are not necessarily aligned with those of the public at large.

Western Forest Products. The dominant owners are Brookfield and its affiliate Tricap. There is a question whether Harbinger Holdings and affiliates, which have been identified with Brookfield since the restructuring of Doman Industries in 2004, should be classed with Brookfield or with the independent minority.

PRT. The company has adopted a shareholder rights plan that limits ownership to 20% of the total in the absence of a takeover bid for all outstanding units. However, most unitholders would not want to be taken out at the present unit price level. Moreover, an existing holder that we believe holds more than 20% has been grandfathered in that position and exempted from having to make a bid for the whole. Although we accept that the plan was adopted in good faith, it seems that it will serve to protect the grandfathered large holder from competition more than it will protect unitholders generally. Protection against competition tends to hold down the unit price, contrary to the wishes of independent unitholders.

TimberWest. In December the company announced a rights offering whereby it would sell \$50 million of new 9% convertible debentures to existing unitholders. Concurrently it agreed to sell to the Investment Management Corporation of British Columbia (bcIMC) \$100 million of the same debentures in a private placement. That corporation manages around \$75 billion, three-quarters of which is represented by public sector pension funds. It was part of the provincial government until being made an independently managed corporation in 1999.

Other investors in TimberWest stapled units did not take kindly to the bcIMC purchase of convertibles, nor should they have. On a fully converted basis, the private placement represents an equity interest of about 24% in TimberWest. Since that is a large enough share to block a takeover attempt, it removes the stapled units from play and constitutes a depressant on their price.

One wonders whether bclMC will use its prestige and the public capital it manages to develop the forest lands along the E&N or to preserve them from development. Either path seems fraught with political peril. It seems doubtful that the financial upside is worth the peril. Not only does bclMC's very presence remove the chance for a quick payback – a third-party takeover bid – but the ire of local communities whose forest industries have been decimated will more likely retard than quicken the pace of development.

The ambiguity of bclMC's role may have been heightened by its selection of David Emerson as a TimberWest director. Mr. Emerson's political party affiliation is itself ambiguous. Therefore, if the Minister of Forests should consider whether to cancel TimberWest's forest tenures – on the grounds that it is moving toward being a dedicated land management or real estate company – one cannot know if he will regard Mr. Emerson as a confederate or an object of spite. Local communities will not be happy that Mr. Emerson signed the 2006 Softwood Lumber Agreement on behalf of the Federal Conservatives. That document, which obliges the Canadian industry to continue paying a 15% export tax merely because the market price for lumber remains below an arbitrary benchmark, is a millstone around the Canadian neck.

Rights Offerings and Going-Private Transactions (GPTs)

In 2004, Brookfield became the dominant shareowner of Western upon the restructuring of Doman Industries. Since then, Western has twice resorted to rights offerings, which give existing shareholders the right to buy new shares at a specified price. Brookfield says the rights allow shareholders to maintain their proportionate interest in the company and are intended purely to raise capital. Its critics say the rights have had the effect of driving down the share price, making a possible going-private transaction (GPT) that much more affordable. Before last December's rights offering, shares were trading around \$0.50, or at 31% of the then net asset value of \$1.60 a share. The offering price was \$0.19, or just 24% of the new asset value of \$0.81 diluted by the large increase in shares outstanding. The offering price was set an almost-unprecedented 40% below the average price recorded during a model 10-day period in December when only \$25,000 of stock changed hands. Harbinger Holdings and affiliates have revealed in National Instrument 62-103 filings that they sold shares both around and since that time.

Rights offerings are governed by National Instrument 45-101. The regulation largely prohibits pricing above the recent market price and above "fair value." It seems to offer no protection against the risk that dominant owners might underprice shares preparatory to launching a lowball bid for the minority.

The rules governing the buyout of minority interests by a dominant owner seem to have become murky. Up to 1994 a majority shareholder had to gain 90% acceptance of his bid to buy out the minority before he could compulsorily acquire the remaining shares on the same terms. Some enterprises – TimberWest among them – have retained this rule in their by-laws. Others have seized on more flexible interpretations introduced since 1995. Last month Brookfield agreed to acquire MediSolution Ltd by way of a GPT. The agreement provides for approval by a bare majority of minority shareholders and is evidently expected to be completed in May. If Brookfield should decide to pursue a GPT with respect to Western, an important question would be whether Harbinger's interest is to be classed with Brookfield's or with that of the independent minority.

Government and the Will of the People

Governments are sworn to uphold the law. However, they are also given discretion to change the law if they see fit and if they have the seats to do so. If the government of the day chooses not to uphold the law but to change it, is it thwarting or fulfilling the will of the people?

There is no reason why the issue of corporate control cannot be clarified by government. The same goes for the regulations governing rights offerings or going-private transactions. If governments do nothing, or if they wait for these issues to be clarified in the courts, they are failing shareholders and unitholders and doing the markets a disservice.

One issue – that of privileged shareholders – reflects negatively on government policies. Two of the three equities discussed here – PRT and TimberWest – are income trusts. For reasons he did not explain, Finance Minister Flaherty decided that the new tax he introduced on income trusts should be applied only to publicly-traded trusts, not those that are privately owned. By making trust income more valuable to private equity than to public unitholders, he implicitly encouraged the takeover of trusts by private interests. Once those interests had acquired meaningful positions, they requested and got board representation, blurring the distinction between outsiders and insiders. It is no indictment of them to say that public unitholders may distrust their influence on matters like the deferral of distributions or of asset sales.

The question of the proper role of government could extend well beyond our three-equity scenario. Whatever the level of Canadian stumpage fees, the US industry and authorities will not cease to cry “subsidy” unless the forests of Canada become privately owned. In Canada, both the federal Conservative party and the provincial Liberal party seem intent on privatization in principle and on the creation of more PPPs – public-private partnerships. They are in an awkward position: they will want to affirm their privatization agendas, but they must repel any charge that those agendas made them soft bargainers with US softwood lumber negotiators. Carbon cap-and-trade will also touch the nerve of forest privatization. From what we have seen so far, cap-and-trade proponents will try their hardest to deny government agencies any financial benefit from replanting Crown lands themselves.

Conclusion

As shown in Table 2, these three equities are selling for a mere one-quarter to three-fifths of their net asset value. In Table 1, we have tried to demonstrate that they have not been nearly so savaged as one might think by the downturn in the economy and the forests. They are cheap, and they are weathering the storm, so of course they are deeply undervalued.

Whether they should be bought or not is another matter. The owners of equity in these companies are part of the select but sorry group of folks – the others being the forest communities and the contract loggers – who truly have been savaged by the downturn. PRT’s unit price, now \$1.18, was \$3.95 a year ago. TimberWest’s price, now \$3.46, was \$12.99 a year ago. Western’s share price, now \$0.17, was \$1.15. It is not enough to say that these prices are down because global equity prices are down. Our political leaders and their agencies have failed to give clarity to concepts like corporate control, independent directors, rules for going-private transactions, pricing of rights offerings. These equities have plummeted because our own market mechanisms have deserted us – not just because global market mechanisms have failed.

The questions that need clarifying are largely governance issues. These are outside the usual framework of investment analysis, and we do not know what answers will be forthcoming, or when. Although we remain convinced of the deep undervaluation of these equities, we cannot recommend that they be purchased at this time. We are classifying all three as Not Rated.

Table 1. Three Forest Companies, in million dollars

2008 Operations and Cash Flow (excluding one-time noncash charges and credits)			
	PRT	TimberWest	Western Forest
Sales	38.8	163.7	814.8
Operating costs incl depreciation	(38.4)	(178.6)	(890.9)
Restructuring costs			(6.3)
Operating profit (loss)	0.4	(14.9)	(82.4)
Interest expense:			
Series A interest		(80.8)	
Long term debt		(7.6)	
Short term debt		(2.6)	
Net interest expense	(0.8)	(91.0)	(19.7)
Net other income (expense)	(0.6)	(0.5)	21.9
(Loss) before tax	(1.0)	(106.4)	(80.2)
Income (tax) recovery	1.2	6.1	(0.2)
Net earnings (loss)	0.2	(100.3)	(80.4)
Adjust noncash (credits) charges:			
Depreciation, amortization	5.0	4.8	33.7
(Gain) on sale of property		(5.5)	(16.3)
Future income tax (recovery)	(1.2)	(6.1)	
Other items	0.7	(1.0)	(4.2)
Cash flow from operations	4.7	(108.1)	(67.2)
Change noncash working capital	3.0	13.7	14.0
Operating cash flow after WC change	7.7	(94.4)	(53.2)
Add (deduct) cash flow from:			
(Investing) or disinvesting	(1.0)	9.4	41.4
Financing or (repayment)	(7.1)	108.7	14.7
Discontinued operations		5.9	(4.3)
Increase (decrease) in cash	(0.4)	29.6	(1.4)
PRT - excluding 4.1 long-lived asset impairment and 19.2 goodwill impairment charges			
TimberWest - excluding 461.6 gain from writedown of series A subordinate notes and related 114.5 future income tax expense			

Table 2. Three Forest Companies, in million dollars

Balance Sheet	PRT	TimberWest	Western Forest
	31-Dec-08	31-Dec-08 adj	31-Dec-08 adj
Current assets	13.8	71.1	286.1
Property, plant, and equipment	35.6	1,222.0	429.8
Other assets	0.9	7.1	10.1
Total assets	50.3	1,300.2	726.0
Operating credit line	6.1		58.9
Accounts payable	4.1	23.9	72.7
Current portion, long-term debt		31.3	53.5
Other current liabilities	0.4	1.5	6.4
Total current liabilities	10.6	56.7	191.5
Revolving credit		116.8	
Long-term debt	5.5	57.7	74.1
Deferred revenue, other liabilities			107.5
9% cv debs due 2014		150.0	
Future income taxes	0.3	234.9	
Unitholders' Series A sub notes		240.4	
Total liabilities	16.4	856.5	373.1
Equity:			
Capital contributions	90.2	192.9	602.4
Cumulative net earnings (loss)	15.8	250.8	(249.5)
Cumulative (distributions)	(72.1)		
Total equity	33.9	443.7	352.9
Total liabilities and equity	50.3	1,300.2	726.0
Shares / units outstanding, million	9.6	77.765*	467.6**
Equity per share / unit (Book value) \$	3.53	5.71	0.75
		4.92 FC	
Compare: current share or unit price \$	1.18	3.46	0.17
Price-to-book ratio %	33.4	60.6	22.5

* 120.62 fully converted (FC); ** of which 339.0 non-voting

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