

TimberWest Forest Corp.
(TWF.UN : \$12.92)
Market Perform
Target Price: \$12.00

May 5, 2008

This is a case in which qualitative analysis is more critical than quantitative analysis. The quantitative analysis is straightforward: the company must generate \$84 million in cash each year to pay the \$1.08 distribution that has been unchanged for a decade. With the British Columbia forest industry in disarray, the cash will have to be generated by sale of Vancouver Island real estate. The land portfolio is big and attractive enough to sustain the distribution for many years.

However, there are qualitative issues that we believe will drive the stock down to produce a higher yield. Our target price is \$12.00, and the target yield is 9.0%. Our expected return is 1.2%, of which 8.3% from distribution yield and negative (7.1%) from price change. We rate TimberWest Market Perform.

There are three main qualitative issues. First, we believe the subordinate notes in the stapled units are equity, and we would disallow the interest charge as a deduction for tax. Second, the real estate portfolio originated more than a century ago in a railway land grant that we consider tainted. Third, it will be hard to obtain maximum land values through rezoning, because of local dissatisfaction with forestry policies and forest companies' conduct, the tainted railway land grant, and perhaps the sentiment that land sale proceeds should be made to support the railway's operations.

The Company

TimberWest came out of some significant 1997 restructurings in the British Columbia forest industry. Predecessor companies of TimberWest had been Fletcher Challenge Canada Limited (FCCL) and, before that, Crown Forest Industries. When FCCL decided to sell its operations, those in the BC interior were purchased by Slocan Forest Products, which assigned some of them in turn to Riverside Forest Products. TimberWest was created to hold the BC coastal and Vancouver Island properties.

In a further 1997 restructuring, TimberWest and Doman Industries took control of Pacific Forest Products – the former Canadian Pacific Forest Products Limited. The sawmills and public forest tenures were taken by Doman, while the private timberlands passed to TimberWest. Before being acquired, Pacific Forest Products had been the third-largest owner of private forest land in western Canada, after MacMillan Bloedel (later bought by Weyerhaeuser) and TimberWest. The acquisition of Pacific enabled TimberWest to become the largest owner of private forest land in the west. Its holdings, as those of Pacific had been, are largely on Vancouver Island – an island 50% larger than the US state of New Jersey. TimberWest's holdings are 796,000 acres, or 10.5% of Vancouver Island's area.

The Industry

At best, BC forests are in a sad plight. At worst, the plight may have been an intentional result of some corporations' behavior and some public policymakers' policies. The problems have been blamed on US protectionism as revealed in the softwood lumber dispute, but the dispute may have been only a rationalization for what happened after. It cannot be denied that a number of US demands – market-related stumpage, unrestricted log exports, dissociation of logging from milling – have been applauded by Canadian forest companies and embraced by many elected officials in Canada

The story is rich in paradoxes. Massive auctions of logging equipment are occurring on Vancouver Island, and buyers are coming – from abroad. The mountain pine beetle has devastated millions of acres of lodgepole pine in the BC interior, but there was little public discussion until the blight had almost reached the Alberta border. Replanting has been slow to get under way. The authorities have not decided what species are most appropriate for future forests affected by global warming, and the forest companies, invited to take the free timber, are not obliged to replant because they are deemed to be conducting a salvage, not a logging, operation.

Loggers and environmentalists are united as never before, firm in the belief that real estate developers are the common enemy. Tree huggers and tree fallers agree that downed trees will grow back, but not where condos and golf courses have been built. The Minister of Forests wants to give leeway to hard-pressed forest companies, but often these companies have been taken over, and the new owners are unabashed property developers. Refunds of duty paid during the softwood lumber dispute are going to those developers, not to the entities that paid them or to their employees. Sometimes the duty refunds are even being paid to US forest companies who operated on both sides of the border before and during the dispute, sold their Canadian affiliates after the dispute was settled, yet reserved the right to receive duty refunds.

Major Forest Industry Issues

Following is a summary of some major issues, and of how they relate to TimberWest:

Logging public lands. Between 85% and 90% of BC logging takes place on public land. Most is done by corporate licensees or their contractors. Three types of license predominate: forest licenses (FLs), which allow a specified volume of wood to be cut; timber licenses (TLs), which allow cutting in a particular area; and tree farm licenses (TFLs), whereby private and public lands in an area are harvested on an integrated basis with a view to sustained yield.

Up to 1995 forest companies paid relatively low royalty fees for the right to harvest timber on public lands. In 1995 royalties were replaced by stumpage fees paid per cubic meter of logs cut. For some companies, stumpage cost several times what they had paid before. Forest companies sued over the change. Because of TimberWest's relatively large operations on its own private land, to which stumpage does not apply, the effect of the change in its case was comparatively minor. Its logging rate has run at 3.3 million cubic meters annually, of which only about 20% comes from public lands. The company did sue nonetheless, claiming \$39 million in damages. In 2003 the provincial government passed legislation that denied compensation to tenure holders on this account, and so the point is now moot.

Market-based stumpage. Canadian forest companies were inclined to sue if the government charged too much, and members of the US softwood lumber industry filed trade complaints if they believed it charged too little. Really, no stumpage fee was high enough for the US industry: the Americans demanded an outright change to market-based stumpage, whereby all timber harvested from public lands would be sold at auction, and the cost of fiber determined accordingly.

The 20% takeback. In 2003 BC embarked on a Forest Revitalization Plan. A key feature of the plan was the province's takeback, termed "tenure reallocation," of 20% of each forest company's annual allowable cut (AAC). Initially, \$200 million was set aside to compensate licensees for loss of tenure. About half the takeback was to be awarded to First Nations or community logging companies. The other half was to be sold into the market, apparently to satisfy American demands that stumpage be market-based. That is, the results of timber sales auctions are used as a proxy for the value of Crown timber harvested under long-term tenures. Again, TimberWest was lightly affected relative to other license holders because its logging is done primarily on private lands. True, it was required to give back some 200,000 cubic meters of AAC, but practically all of this came out of TFL 46, a tenure which the company was then in process of selling. The sale was completed for \$17.9 million, and the company reported with satisfaction that the takeback had had no material effect on the transaction or the price realized.

12% parks. In the late 1990's the BC government announced its intention to set aside 12% of the province's land area for parks. Forest companies were to be compensated for consequent reductions in their AAC. Critics pointed out that: (a) companies had not been required to pay for AAC in the first place; (b) companies have rights to timber, not to land, and (c) the tradeoff of money or land for cutting rights was discretionary and thus arbitrary. TimberWest's own use of public land has been primarily in the form of tree farm licenses or TFLs, whereby, in return for the right to log the public land, a company could commit private land and the whole would be managed with a view to sustainable harvests. In return for 5,000 acres taken for parks, TimberWest received the right to withdraw 150,000 acres from TFLs and use them as it saw fit. Some critics opined that the tradeoff was much too generous to the company.

Appurtenancy. It was once a requirement in BC that logs cut from public land be processed or converted into lumber in BC. The processing could be done by someone other than the owner of the cutting rights, but if those rights were transferred to another party, the responsibility of supplying logs from the forest tenure went with them. The responsibility has tended to fade away, in part because of a case involving the TimberWest mill at Youbou on Lake Cowichan, in which the Minister (of an NDP government) allowed the transfer of cutting rights but seemingly forgot to append the requirement that the mill be supplied. The mill was closed in 2001. TimberWest has operated only one mill, Elk Falls, since then, and that mill will itself be shut down this month.

Log exports. It is now the rule in the province that logs harvested from public land may not be exported without first being offered for sale in BC. However, there has been no prohibition against closing mills in BC. As mills closed, logs could be exported, and there began a chicken-and-egg debate: had the mills closed because of a shortage of logs, or were logs being exported because there was a shortage of mills? Pulp mills closed as well, because they were dependent on sawmills for sawdust and chips.

The US softwood lumber dispute had a good deal to do with the quandary, because the US opposed the tying of timber harvesting to converting (milling) and the connection between milling and exporting. TimberWest was largely immune to this discussion because it logs largely on private land, free of export restraint, and will soon have no sawmills at all. However, Canada (not BC) has a regulation, Notice 102, that forbids the export of logs harvested on BC land, whether public or private, unless they have first been offered for sale in BC. TimberWest launched a lawsuit against the federal government, arguing that it was discriminatory to single out BC producers in this way, but the case has since been abandoned.

Contract logging. Typically, logging and log trucking in the province are carried on not by forest license holders but by contractors. The province drafted Bill 13, which argued for protecting contractors against the volatility of the forest products business. The sponsors noted that contractors must make considerable investments in equipment but have no control over the volume of business directed to them by licensees such as TimberWest. The observation was prophetic, but prophesy has not helped the contractors, whose bankruptcy rate has been disturbingly high. Questions not yet answered are whether contractors can make financial claims against the licensees that employed them, and whether licensees are liable for environmental damage (e.g., Robson Bight) committed by their contractors.

TimberWest has historically relied on contractors for about half its logging. In May 2004 it secured a labor agreement that allowed fully 100% of its logging to be carried out by unionized contractors on a competitive-bid basis. The company's report for 2004 announced with pride that TimberWest was "the first major forest company on the BC Coast to completely exit the operating side of the logging business." Upon exiting, the company paid \$21 million to purchase its leased equipment, then promptly resold it to its contractors for \$25 million. Ironically, in its 2007 annual report TimberWest lamented the fact that it had become overly dependent on contractors, two of whom, together producing almost 36% of the company's private land harvest, were in "financial difficulty." The report did not specifically link the contractors' problems to the fact that TimberWest, in view of housing market declines in the US and Japan, expects to harvest only 30% of its historic volumes in 2008.

Cut control. Historically, forest companies were fined for overcutting their AAC, while, if they undercut it, the unused allotment could be taken away. A feature of the Forest Revitalization Plan of 2003 was the abolition of cut controls. Forest companies were simply left on their own to observe the terms of their licenses.

Tenure transfers. Traditionally, forest tenures could not be transferred to another license holder or divided between license holders without the Minister's permission. If he gave his approval, transfer of a tenure entailed an automatic 5% reduction in the AAC. In 2004, with enactment of the Forest Revitalization Plan, penalties were put aside. Hence, TimberWest was able to sell TFL 46 without any 5% reduction, and the company was allowed to divide TFL 47 with its contractor.

Silviculture and other factors. TimberWest lost some forest-loving friends when it decided in 2007 to put its fleet of four Martin Mars water bombers, incorporated as Flying Tankers Inc., up for sale. The fleet was rescued by a private Port Alberni forestry company and immediately distinguished itself in service against California wildfires. TimberWest disposed of the planes to save money. However, forestry companies in BC do not seem to spend much money on land rehabilitation or purchasing and planting seedlings. From TimberWest's annual reports, we judge that spending on silviculture does not exceed \$1.5 million annually. The company expresses pride at having earned the ISO 14001 designation for regulatory compliance, and on having KPMG certify that its forest practices warrant the SFI (Sustainable Forestry Initiative) certificate. These are not costly procedures: TimberWest evidently pays less than \$200,000 for certification, less even than the \$300,000 it pays KPMG to audit its financial accounts.

In sum, the company does not log but contracts out its harvesting. It does not mill, having closed both its sawmills. It has annuitized its defined benefit pension plans, so it no longer must appropriate funding for pensions. It spends little on silviculture – less than 2% of what it distributes each year to unitholders. It has exited a long-term contract to supply more than 300,000 cubic meters of sawlogs annually to Western Forest Products: it would presumably prefer to export the logs or not cut at all, and Western, now under the control of the property company Brookfield, would perhaps just as soon not mill anyway. TimberWest has sold TFL 46 and transferred a part of TFL 47 in the Queen Charlottes to a logging contractor. It even disposed of its historic fleet of water-bombing airplanes. What it is doing is preparing to become a full-time real estate seller and developer. To its credit, it has deceived no one as to its intentions, but one wonders how long the Minister of Forests can accord the rights and privileges of a forest company to one that does so little forestry.

Stapled Units

A distinctive feature of TimberWest is its stapled units, described by the company as “a unique equity instrument.” There are currently 77.75 million units outstanding, each consisting of one common share, 100 preferred shares, and approximately \$8.98 face amount of Series A subordinate notes. The three components are “stapled” together: they trade as a single entity and cannot be transferred separately. All the income distributed to shareholders comes from the subordinate notes. The payments are tax-deductible to TimberWest but are taxed in the hands of unitholders.

Stapled units, like trust units, avoid tax at the business entity level. However, since there is no trust in the TimberWest organizational structure, there is no liability for the distribution tax that Minister Flaherty has imposed on trusts. Since the Minister said he was determined to crack down on tax avoidance by business entities, it would seem that TimberWest has dodged a bullet.

The CRA’s willingness to accept stapled subordinate note interest as tax deductible is difficult to fathom. The \$8.98 face amount of the notes is supposedly debt owed by unitholders to themselves. The value of the mythical debt was selected so that the coupon of 12% would produce the \$1.08 payout that has been distributed annually to unitholders for a decade. The only reason to believe this is debt interest is that TimberWest says it is. In our opinion, the debt is equity, and the distributions are dividends. The fact that the debt is stapled to the equity and cannot be traded apart from it marks it as equity.

In describing stapled units as “a unique equity instrument,” the company identifies the entire unit as equity. Moreover, when calculating its debt-to-equity ratio, the company does not class the subordinate notes with debt. There is another admission that the units are equity: if interest payments on the subordinate notes, or the amounts required to redeem them at their (extendible) maturity, cannot be paid in cash for whatever reason, the company may at its option make the payments in additional stapled units, the number of units to depend upon their market price at the time. The entitlement to repay debt with equity would seem to make it *de facto* equity.

The equity nature of the stapled units was clear from TimberWest’s inception. The entirety of the units was on the balance sheet as equity. The so-called interest charges on the subordinate debt were not on the income statement at all. Rather, they were charged directly to retained earnings, on an after-tax basis. This treatment made them “similar to dividends on common shares,” the company noted. That is exactly the point, except that dividends on common shares are not deductible for tax whereas TimberWest’s subordinate note payments, inexplicably, are deductible.

The presentation of stapled units in company reports changed on January 1, 2005. Since TimberWest can elect to make interest and redemption payments using a variable number of its own equity instruments, the CICA ruled that the subordinate notes should be carried as “other liabilities” on the balance sheet while the preferred and common equity elements of the stapled units remain in equity. On the income statement the payments on the subordinate notes now appear as interest charges. That treatment might seem to make their tax deductibility more credible, but we continue to believe that a serious error is being made by the CRA in allowing dividends to be recognized as interest expense, allowed for tax, and paid out of pretax profit.

Why do not all income trusts, besieged by Minister Flaherty, adopt the TimberWest approach of using stapled units? First, the debt owned by an operating company to a trust drops out on consolidation, whereas the stapled debt in TimberWest, mythical or not, stands out as “other liabilities” on the balance sheet. Second, trusts want to avoid having to make distributions that appear to be contractual rather than discretionary. Third, the operating cash flow out of which trusts pay distributions can often be highly variable. Increasingly TimberWest is funding its distributions with the proceeds of land sales, which, in the hot Vancouver Island real estate market, can supposedly be dialed up on demand.

We would bet there is a fourth set of reasons why trusts are not following TimberWest’s lead, and they are probably the most important of all. They may have been told they will not get the same entitlement to pay tax-allowed distributions, or they have not yet sought a favorable advance tax ruling, or they are simply not willing to take a chance. We believe that the tax treatment of the stapled unit, a treatment that is irregular and discriminatory, will find a way to be changed by the CRA or tested in the courts.

Operating Experience

Table 1 below summarizes the operating experience of TimberWest since 2001. At bottom, below the net earnings line, we have hypothesized that payments on the stapled Series A subordinate notes are disallowed for tax, as we believe they should be. Net earnings are increased by the hypothesis, even after providing for tax on the disallowed payout. However, distributions will then have to be funded by operating cash flow, which in our model is termed “Adjusted cash flow available for distribution.” In only two years (2004 and 2006) of the last seven would that sum have been sufficient to cover the annual distribution. Clearly, it will be necessary for the company to increase its rate of land sales.

Operating earnings have come mainly from log sales. As a major owner of private land, TimberWest has been an exponent of unrestricted log sales, especially to Asia. This policy has insulated it from the US softwood lumber dispute. It has, however, brought the company into conflict with Ottawa over Notice 102. By allowing private logs to be exported only after they have first been offered for sale in BC, Notice 102 has forced TimberWest to forego part of the normal premium that export markets enjoy over the provincial market.

On the other hand, that premium has been eroding in a big way. The falling Canadian \$-equivalent price of export logs is the main reason for the \$50 million drop in logging division operating earnings between 2002 and 2007. There is a moral here about living and dying by the sword. Because of the closing of sawmills in BC and Canadian official kowtowing to US trade protectionism in lumber, forestry companies turned to raw log export. The consequence was a surfeit of logs in Japan and other Asian markets and a consequent sharp fall in price realizations. The price change was magnified by the Loonie’s strength against the US dollar.

Since 2002, falling export log realizations have reduced operating cash flow by an average \$25 million a year. If the CRA should begin to see things our way with respect to the taxability of distributions, the change could require the company to pay cash taxes also around \$25 million a year. These two factors would use up more than half the \$84 million needed to distribute \$1.08 annually to 77.7 million shares. That is reason enough for TimberWest's having to step up land sales to generate cash. Land sales are not simply a strategic choice, but a necessary response to adversity and uncertainty.

Land Sales

TimberWest owns 796,000 acres of private forest land. The land constitutes roughly 10.5% of Vancouver Island and is said to include 75 kilometers of waterfront. The land is carried on the books at an average \$1,470 an acre, with the total carrying value of \$1,172 million making up more than 90% of TimberWest's total book assets. In recent years sales have been made at prices up to \$11,000 an acre, suggesting a large potential for cash generation and profit. At a hypothetical average realizable price of \$3,000 an acre, the company could cover its distribution for 30 years by selling land, without having to conduct any logging or milling operations. If payments on the stapled notes are disallowed for tax, and the distribution maintained anyway, it could still be supported for 20 years.

Of its total holdings, the company has singled out 134,000 acres of "higher use properties" suitable for rezoning and high-value development. Of these acres, 39,000 have been classified as "core," 41,000 as "adjacent to core," and the remaining 54,000 "to be sold as is."

TimberWest recently put 15,000 acres up for sale. We assume these are among the 54,000 acres to be sold "as is." The properties are located near the Vancouver Island communities of Parksville, Campbell River, Port Alberni, Duncan, Port Renfrew, Nanaimo, and Courtenay. The suggested reserve prices per acre range from \$4,000 to \$15,000. At the weighted average price of \$7,000, sale of the complete land package on offer could generate more than \$100 million in cash.

Although private land can be sold at will, the realization of top value on sales is subject to important constraints. Ownership can be challenged by First Nations claims; the use and value are limited by local zoning ordinances; and the authorities can levy higher taxes on more valuable uses.

The company may have made a mistake in currently offering such a large package, and one that touches such a wide range of Vancouver Island forestry communities. Most of them are smarting over mill shutdowns, logging cutbacks, and contractor bankruptcies. The company may be betting that adversity will make them friendlier to development. However, it could equally well make them obstinate – determined to oppose the rezoning that prospective buyers will seek.

In the future, TimberWest can elect to do three things with its property – develop the land itself; sell it slowly and dearly; or sell it quickly and cheaply. Probably we have named the three in shareholders' order of preference. Probably, too, the three options describe the company's respective intentions for "core," "adjacent to core," and "sale as is" properties. While gradual development is preferred, one must recognize that such a course takes time; that cash flows out during that time; and that prices and turnover in the short run can go down as well as up.

While 15,000 acres seems a sizeable package, and \$100 million a goodly sum, it does not do much more than provide for one year of distributions to shareholders. High-yield stocks and trusts have an insatiable appetite for cash to distribute. Under the circumstances, management might become restive and opt for more quick and cheap sales. The option would be a wasteful one – blowing the land portfolio cheaply is stealing from the future. Worst of all – the last few years of booming real estate prices have seen some distressing cases in which taxpayers’ and shareholders’ interests were betrayed by those charged with faithfully representing them. If land sales were to be made cheaply to unknown persons or numbered companies, TimberWest’s shareholders might fear that their company was being used as a conduit for transferring to others values that should belong to them.

The Dunsmuir Agreement

The lands being offered for sale by TimberWest were part of the Esquimalt & Nanaimo (E&N) Railway lands. They were awarded to Robert Dunsmuir in the 1880’s as an incentive to build what was supposed to be the western end of the Canadian trans-continental railway. In 1905 Robert’s son James Dunsmuir sold the railway and land to the Canadian Pacific Railway (CPR), which sold the land in turn to settlers and forestry companies.

In our opinion, the lands in question were improperly obtained in the first place. It is probably not feasible to contemplate returning them to public ownership. However, knowledge of the circumstances under which the lands were obtained is likely to make Vancouver Island communities stiff-necked about rezoning them for high-density development. Moreover, it is possible that the lands are encumbered by a financial obligation to guarantee the continued operation of the E&N.

Our argument has three parts, discussed in order below:

- British Columbia’s 1871 terms of union did not oblige Canada to provide land and funding for a railway on Vancouver Island.
- When land for the railway was nevertheless transferred in 1875 from BC to Canada and then in 1883 to the Dunsmuir Syndicate, Canada’s participation was not only unwarranted but probably unconstitutional.
- The Dunsmuir Syndicate accepted an obligation to operate the line “continuously,” and that obligation is carried over to the lands with which the Syndicate was incentivized.

The Terms of Union

British Columbia entered Confederation in 1871. Under Term 11 of the Terms of Union, Canada agreed to begin within two years the construction of a railway connecting the “seaboard of British Columbia with the railway system of Canada” and to “secure the completion” of that railway within ten years.

In 1873 a route was selected calling for the transcontinental railroad to cross the province from the Yellowhead Pass to Bute Inlet, traverse Seymour Narrows to Vancouver Island near Campbell River, then descend the eastern shore of the island to a terminus near Victoria at Esquimalt. In 1875 British Columbia transferred to Canada the requisite land, which included a wide 20 km swath on each side of the rail line.

In 1877, under BC Premier Elliot, all parties agreed that the Vancouver Island routing was technically and financially not feasible. An alternate route was selected through Kicking Horse Pass and down the Fraser Canyon to Burrard Inlet, the site of present-day Vancouver. Although Victoria was the province's population center at the time, it did not take much imagination to see that Burrard Inlet qualified as "seaboard" as much as Esquimalt did. The lands necessary for the new route were duly transferred to the CPR. At that point the Vancouver Island lands should have been returned to BC by Canada, but they were not.

The Dunsmuir Syndicate

Instead, in 1883 Canada transferred the Vancouver Island lands to the Dunsmuir Syndicate, which agreed to construct the Nanaimo-to-Esquimalt railway line and "continuously and in good faith operate the same." The arrangement was ratified in both federal and BC provincial legislation. Officially, the legislation was intended to mollify BC for the delay in commencing and completing construction of the rail link with Canada.

In our opinion, Canada should not have participated in the transfer to the Dunsmuirs. Once the Fraser Canyon route had been agreed, Canada's obligation was fulfilled. The E&N would not (and still does not) link with the rest of Canada. Its building was therefore strictly an intra-provincial affair, in which Canada should not have intervened.

There were two other irregularities in the matter. First, both the Vancouver Island and the Fraser Canyon land grants were of contiguous or unbroken plots of land. This was in contrast to CPR land grants elsewhere in Canada, where alternate sections were granted, to create a checkerboard pattern that would allow competitive access to the right of way. Critics of the arrangement believed that the lands given to the Dunsmuirs were contiguous so that they could enjoy complete ownership of the rich coal fields near Nanaimo.

Second, Dunsmuir's partners in the syndicate included at least three Californians – Messrs Crocker, Huntington, and Stanford – rumored to have manipulated the accounts of the Southern Pacific, the western end of the US transcontinental railway.

In 1905, James Dunsmuir sold the E&N Railway and lands to the CPR. Curiously, given that this was a private sale contract, Canada saw fit to pass an act, the 1905 Declaratory Act, declaiming that the railway had been a work for the general advantage of Canada. The fanfare was probably intended to affirm Canada's interest in a railway land grant that should not have involved the federal government, and to protect the CPR, which had received land and money for two routes in BC, against charges of double dipping.

Contingent Liability

The Dunsmuir Syndicate agreed to "construct, complete, equip, maintain and work continuously" the E&N line, and to "continuously and in good faith operate the same." There seems little doubt that the CPR assumed responsibility for operating the E&N in perpetuity, and that the lands purchased from Dunsmuir along with the railway bear a contingent responsibility for ensuring this result. It has often been observed that the generous land grants indemnified the railway owner against the potentially unprofitable operation of the line, and some authors are of the opinion that the E&N, receiving two million acres for just 77 miles of track, represented an acres-per-mile ratio unparalleled in the history of railroad land grants.

Conclusion

The trouble with Vancouver Island is that its mild climate and verdant landscapes make it as perfect for humans as it is for trees and wildlife. If the trees gradually disappear, the people will still come, and there will continue to be natural beauty, and jobs, and tax base, and votes, and money to be made.

These truths are self-evident, but the political system – by oversight or by design – has not been well-adapted to deal with them. For page after page the Forest Act of 1996 described the rigorous standards for administering private land within a tree farm license. It all came apart in section 39, which allowed private land simply to be withdrawn from the TFL with the consent of the Minister of Forests. Time and again the legislative intent of the Forest Act has been defeated, as companies have been allowed by the Minister of the day to withdraw land and put it up for development, without charges and without public notice or hearing.

The concept of municipalization has similarly failed to keep pace with modern realities. Municipalization of a formerly unincorporated area is meant to apply to rural communities that have attained a certain size and wish simply to govern themselves. In the modern context, however, it has been applied to communities like Colwood and Langford on the very edge of Victoria's urban conurbation. A coterie of mayors and councilors are given dominion over remarkably large and valuable tracts of formerly common land, which they can then rezone and subdivide at will. Trees are felled, parkland is converted to golf courses, and condo towers and big-box stores are erected that draw taxpaying residents and retail trade out of the downtown core. The electoral majority in that core, who will be called upon to fund most of the attendant costs for sewerage, water, power, and transportation, are denied representation.

Ironically, similar problems can arise if communities do not municipalize but choose to remain unincorporated. The Minister of Forests last year allowed the withdrawal of 64,000 acres of land from three Vancouver Island TFLs by Western Forest Products (now controlled by Brookfield), which promptly made a "conditional" sale of a choice portion to a developer. Many opinions have been expressed about the deal, mostly by persons who oppose commercialization of these forest lands. Nevertheless, because the area is rural and unincorporated, it will be up to a single unelected employee in the Ministry of Transportation to determine whether the lands can be immediately subdivided for development.

The Dunsmuir Agreement revolved around land and transportation. The lands TimberWest is selling, and the lands Western Forest wants to sell from Sooke to Jordan River, came out of the Dunsmuir Agreement. If Western Forest gets its rezoning, it will do so by the grace of the Ministry of Transportation – again, transportation rearing its head. If it be argued that part of TimberWest's land sales proceeds should be held in trust to guarantee operation of the E&N, Colwood and Langford's mayors will probably be pleased. They will need the E&N to haul commuters to and from Victoria. Without it their present frenetic pace of development cannot continue.

TimberWest is in the thick of these controversies. The forest industry is in turmoil, and TimberWest's reduced harvesting, export of raw logs, and closing of sawmills have been unpopular features. The lands the company wants to sell have a dubious past and probably should still belong rightfully to all the people of British Columbia. The company's stapled units rely on implausible tax accounting that we believe will have to change. We do not recommend that investors purchase the units. There must be less risky and less controversial ways to make money.

Table 1. TimberWest - Summary of Operations (\$ millions except as noted)

	2001	2002	2003	2004	2005	2006	2007
Log sales - thousand cubic meters	3,391	3,416	3,389	3,252	3,615	3,087	2,641
Revenue per cubic meter - \$							
Domestic	94	94	86	86	72	79	86
Export	145	135	124	136	113	119	102
Weighted average	112	111	100	104	91	98	93
Revenues	378.4	378.2	340.1	337.6	327.9	303.2	246.4
Direct operating costs		268.2	262.1	229.6	242.9	212.2	197.4
Operating earnings		110.0	78.0	108.0	85.0	91.0	49.0
Lumber sales - million foot board measure	130.2	115.3	133.3	171.7	166.9	184.6	125.3
Revenue per '000 foot board measure - \$	465	503	470	619	552	635	606
Revenues	60.5	58.0	62.6	106.2	92.2	117.3	76.0
Revenues including chip sales	68.5	65.6	71.2	118.7	103.2	130.2	88.4
Direct operating costs		67.9	77.4	121.8	115.7	130.9	88.5
Operating earnings (loss)		(2.3)	(6.2)	(3.1)	(12.5)	(0.7)	(0.1)
Real estate sales - acres			1,960	1,800	1,630	3,190	24,530
Revenue per acre - \$			4,400	5,800	8,900	11,200	2,700
Revenues	11.2	16.5	8.6	10.8	15.1	36.0	67.1
Direct operating costs		13.8	7.0	6.6	6.5	21.0	45.9
Operating earnings		2.7	1.6	4.2	8.6	15.0	21.2
Other revenues	3.8	4.6	8.6	9.9	12.0	8.7	7.1
Other operating expenses (income):							
Selling and administrative	15.0	14.0	13.5	14.5	14.2	14.1	17.0
Depreciation, depletion, amortization	13.4	11.5	9.8	10.1	8.8	8.2	7.8
Writedown of property and equipment							18.4
Countervailing and anti-dumping duty refund						(3.0)	
	28.4	25.5	23.3	24.6	23.0	19.3	43.2
Total revenues	461.9	464.9	428.5	477.0	458.2	478.1	409.0
Total operating costs and expenses		375.4	369.8	382.6	388.1	383.4	375.0
Total operating earnings		89.5	58.7	94.4	70.1	94.7	34.0
Financing costs:							
Series A subordinate notes (stapled)	69.9	81.8	82.1	82.5	83.3	83.6	83.7
Other, net	27.0	23.1	15.6	9.1	23.6	32.2	9.3
	96.9	104.9	97.7	91.6	106.9	115.8	93.0
Earnings (loss) before income taxes		(15.4)	(39.0)	2.8	(36.8)	(21.1)	(59.0)
Income tax (recovery)	(13.8)	0.4	0.9	(11.9)	(41.6)	(38.2)	(27.2)
Extraordinary item, expropriation settlement				9.0			
Net earnings (loss)	4.1	(15.8)	(39.9)	23.7	4.8	17.1	(31.8)
(do) if Series A note interest is disallowed for tax	50.2	38.2	14.3	78.2	59.8	72.3	23.4
Non-cash charges (credits)	0.4	11.4	9.1	(6.3)	(39.3)	(25.6)	(30.4)
Adjusted operating cash flow before WC change	50.6	49.6	23.4	71.9	20.5	46.7	(7.0)
Change in non-cash working capital (WC)	(13.8)	(3.8)	13.2	(10.0)	(7.1)	19.6	(8.0)
Adjusted operating cash flow	36.8	45.8	36.6	61.9	13.4	66.3	(15.0)
Gross proceeds from sale of property	12.4	17.5	11.4	33.3	42.8	33.0	71.9
Adjusted cash flow available for distribution	49.2	63.3	48.0	95.2	56.2	99.3	56.9
Compare: distributions @ \$1.08 per stapled unit	80.7	82.3	82.3	82.6	83.4	83.7	83.9
Average number of stapled units, millions	74.7	76.2	76.2	76.5	77.2	77.5	77.7

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