



WHONNOCK
INDUSTRIES
LIMITED

1986
ANNUAL
REPORT



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MANAGEMENT
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honnock Industries Limited is a Canadian-owned forest products company with sawmills and logging operations on the Coast and in the Interior of British Columbia. Originally incorporated in 1963 to operate a lumber mill in Whonnock, B.C., the Company has expanded rapidly to become one of the larger sawmill operators and lumber exporters in British Columbia.

Whonnock Industries owns 28 logging operations cutting hemlock, balsam, cedar, fir, cypress and spruce. The Company has seven sawmills and one shake and shingle mill. The mills process a variety of species into a wide range of products, many of which are custom orders.



Through Whonnock's interest in Western Forest Products, the Company has access to one-third of W.F.P.'s extensive timber holdings in British Columbia and an interest in Western Pulp's two pulp mills.

Whonnock's decentralized operations focus responsibility at the ground level, encouraging the development of an entrepreneurial spirit. In the mills and in the woods, each team makes marketing and production decisions, and each is accountable for results. Whonnock Industries nurtures this system, recognizing that flexibility to the marketplace makes good business sense.

FINANCIAL SUMMARY

	12 months ended	Dec. 31, 1986	Dec. 31, 1985
Income Statement			
Sales		\$325,544,000	\$260,321,000
Operating Profit		27,055,000	3,131,000
Income Before Extraordinary Item		14,040,000	2,277,000
Income After Extraordinary Item		21,540,000	3,477,000
Net Income (Loss) After Dividends on Preferred Shares of Subsidiary		11,281,000	(6,860,000)
Net Income (Loss) Per Share		1.12	(.69)
Balance Sheet			
Working Capital	\$	43,358,000	\$ 27,186,000
Total Assets		228,503,000	216,914,000
Shareholders' Equity		49,699,000	30,986,000
Equity Per Common Share		4.18	3.10





*Clockwise from bottom:
John Southcott,
president;
Laurie Cocke,
controller;
Bob Fechtner,
general manager,
Forestry and Logging;
Gerry Friesen,
vice-president,
Finance;
Bob Sitter,
vice-president,
Manufacturing.*

REPORT FROM THE CHAIRMAN

1986 Results

The trend of improved profitability which began in 1985 improved even more in 1986. Operating income for the year increased ninefold, from \$3 million in 1985 to \$27 million in 1986, representing the best results since 1979.

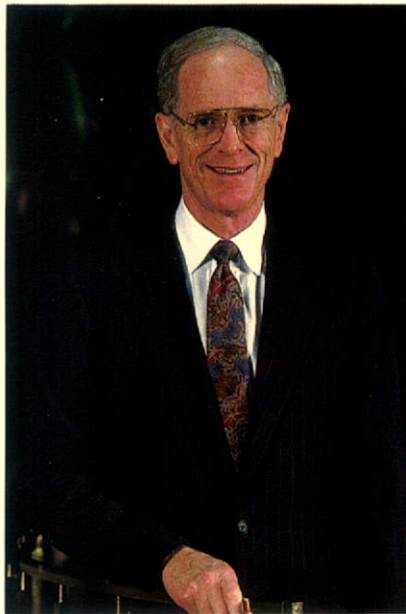
Perhaps even more important is the measure of cash flow generated from operations each year. In 1986 it quadrupled over 1985, from \$8 million to \$34 million, after paying the preferred share dividend. This \$34 million, or \$3.42 per common share, was the highest level of cash flow in the history of the Company.

The strengthening of the European and Japanese currencies that began in late 1985 continued throughout the year, enabling Whonnock to regain market share lost principally in 1984. The strengthening of these currencies and increased construction activity in overseas markets resulted in lumber prices improving significantly in the first quarter and again in the fourth quarter of the year. In North America, lumber prices rose sharply in early 1986 due to a continuing high level of housing starts.

As a result of improvements in all major market areas, lumber sales volumes increased by 17 percent while the Company's average selling price increased by 12 percent over the previous year.

Share Issues

In August 1986, the Company sold approximately \$8 million worth of convertible preferred shares to provide the Company's equity contribution to the project financing of a \$38 million new small-log sawmill. This addition to the Company is a very important step in both the modernization and the



realignment of the Company's manufacturing facilities to accommodate the small-log portion of the timber resource.

In February of 1987, the Company sold another \$17.5 million of Class A shares on a private placement basis. These proceeds will enable the Company to accelerate several other capital projects which have an extremely short payback period.

Changes in Directors

Long time Vice-President, Gus Kneteman, retired at the end of the year as an officer but will remain as a director of the Company, and Evans Lougheed retired as a director after sixteen years. We thank these men for their years of service and look forward to the continuing association with Mr. Kneteman at the board level.

Two new directors were appointed to the board in February 1987; Joseph Segal, President of Kingswood Capital Corporation, and George O'Leary,

Chairman of Scott Paper Limited, each of whom will bring years of senior management experience to our board.

Outlook

Strong overseas currencies continue to provide a buoyant overseas market, enabling the company to sell most of its overseas production for the first and second quarters. The Company has now begun to accept orders for shipment in the third quarter of 1987. Because of the Company's relatively low dependence on U.S. markets, the 15 percent export tax should not have a serious impact on earnings in 1987.

The outlook is particularly good for the higher grades of lumber, for larger dimensions, and for the scarcer species, all of which are prevalent within our timber supply.

The Company has carefully planned its sawmill changes to enable it to maintain high production levels during this time of strong markets.

We thank our customers and shareholders for their continued support, and we thank our employees for enabling us to continue with high production while at the same time developing our capital expenditure program. We look forward to 1987 with optimism.

A handwritten signature in cursive script that reads "W. L. Sauder". The signature is written in a dark ink on a light background.

William L. Sauder
Chairman and Chief Executive Officer

PERSPECTIVE

*Interview with
President John Southcott*

How was the year in general?

Southcott: It was a turnaround year. The strengthening of foreign currencies was the key that helped change the picture for us. It started in late 1985 and we got the full impact of it in 1986. We are back in the markets we were in before and we've substantially increased our sales to Japan.

At year-end, Whonnock had started construction of a new mill as part of a \$67-million, multi-year sawmill capital expenditure program. Where will this fit into the company structure?

Southcott: The new small-log facility will bring us in *balance* between our converting facilities and our log supply and will result in lower operating costs. In fact, we estimate the cost saving to the company will be around \$20 per thousand board feet across our total lumber production.

A big issue in 1986 was the Canada-U.S. lumber negotiations and the export tax.

Southcott: Our company is in a favourable position because we export a significantly higher percentage outside of the United States than most other companies. Only about 23 percent of total sales value of what we sell goes to the U.S. We can avoid the export tax on the balance.

Another plus is that two-thirds of our exports to the U.S. are cedar products. And cedar is more of a specialty product — the U.S. doesn't have much. So we have a better chance over good times and bad to be able to include most of that 15 percent in our pricing.

Some analysts are predicting the demise of the coastal industry. How would you respond to this?

Southcott: To paraphrase Mark Twain: "The report of our death is greatly exaggerated."

Why?

Southcott: The coastal industry still has the best log supply in the world in terms of size, quality, species and availability. With the realignment of world currencies, our markets have returned, and our high value products are now in strong demand around the world and will continue to be.

You sound pretty optimistic about the future then.

Southcott: Yes, I am. We have a good log supply. We will soon have a group of sawmills that will be efficient and matched to the log supply. Overseas markets and currencies are strong, setting the stage for a much improved coastal industry.



The company produces a wide range of products from small specialty products through to forty-foot timbers.



WHONNOCK INDUSTRIES LIMITED

NOTICE OF ANNUAL GENERAL MEETING APRIL 30, 1987

The Annual General Meeting of the shareholders of Whonnock Industries Limited will be held in the Arbutus Room, Four Seasons Hotel, 791 West Georgia Street, Vancouver, British Columbia on Thursday, April 30, 1987 at the hour of 10:00 o'clock in the forenoon for the purpose of:

- (1) Receiving the Financial Statements of Whonnock Industries Limited for the fiscal year ended December 31, 1986 and the Auditors' Report thereon and the Directors' Report;
- (2) Appointing Auditors of the Company for the ensuing year and authorizing the Directors to fix the remuneration to be paid to the Auditors;
- (3) Fixing the number and electing the Directors of the Company for the ensuing year;
- (4) Transacting any other business that may properly come before the meeting.

Accompanying this Notice are copies of:

- (1) The Report of Directors;
- (2) The Financial Statements for the fiscal year ended December 31, 1986;
- (3) The Information Circular; and
- (4) The Instrument of Proxy.

Shareholders who are unable or who are not expecting to be present at the meeting are urged to complete the enclosed instrument of proxy and return it to Montreal Trust Company, 510 Burrard Street, Vancouver, British Columbia, V6C 3B9, not later than 48 hours, excluding Saturdays and holidays, before the time for holding the Annual General Meeting.

Dated at Vancouver, British Columbia, this 30th day of March, 1987

HELMUTH KNETEMAN
Secretary



WHONNOCK INDUSTRIES LIMITED

INFORMATION CIRCULAR

FOR THE ANNUAL GENERAL MEETING OF SHAREHOLDERS
TO BE HELD ON APRIL 30, 1987

SOLICITATION OF PROXIES

This information Circular is furnished in connection with the solicitation of proxies BY THE MANAGEMENT OF WHONNOCK INDUSTRIES LIMITED (THE "COMPANY") for use at the Annual General Meeting of the shareholders of the Company to be held at the time and place and for the purposes set out in the accompanying Notice of Meeting. The cost of solicitation by management will be borne by the Company.

APPOINTMENT AND REVOCATION OF PROXIES

The persons designated as proxies in the enclosed instrument of proxy are Directors of the Company. A member desiring to appoint a person to attend and act for him and on his behalf at the meeting, other than the persons so designated, may do so in accordance with the instrument of proxy.

A member may revoke a proxy by an instrument in writing:

- (a) executed by the member or by his attorney authorized in writing or, where the member is a corporation, by a duly authorized officer, or attorney, of the corporation; and
- (b) delivered either to the registered office of the Company at any time up to and including the last business day preceding the day of the meeting at which the proxy is to be used, or to the chairman of the meeting on the day of the meeting;

or in any other manner provided by law.

EXERCISE OF DISCRETION BY PROXIES

The persons named in the enclosed instrument of proxy will vote the shares in respect of which they are appointed in the manner specified in the instrument of proxy. So far as is known no matters other than those stated in the attached notice of meeting will be presented at the meeting, but if any such matters should arise, the enclosed instrument of proxy confers a discretionary authority upon the persons named therein with respect to amendments or variations to matters identified in the notice of meeting, and with respect to other matters which may properly come before the meeting.

VOTING SHARES AND PRINCIPAL HOLDERS THEREOF

Members registered as holders of Class "A" Subordinate Voting ("Class "A" Shares") shares and members registered as holders of Class "B" Common ("Class "B" Shares") shares on the date on which the notice of the Annual General Meeting is mailed will be entitled to attend and vote at the meeting. At the meeting each person appointed under an instrument of proxy for use at the meeting will be entitled to vote the shares represented thereby if the instrument of proxy is properly completed and delivered to Montreal Trust Company, 510 Burrard Street, Vancouver, British Columbia, V6C 3B9, not later than 48 hours before the time of the meeting or any adjournment thereof.

The authorized capital of the Company consists of 106,700,000 shares without par value divided into 100,000,000 Class "A" Subordinate Voting shares, 1,700,000 Class "B" Common shares and 5,000,000 Preference shares. Each Class "A" share carries the right to one vote either on a show of hands or on a poll. Each Class "B" share carries the right to one vote on a show of hands and to ten votes on a poll. The Preference shares do not carry the right to vote except as provided for in Article 21.3(h) of the Articles of the Company.

As of the date of this Information Circular, there were 11,158,389 Class "A" shares, 1,325,703 Class "B" shares and 1,455,000 7% Cumulative Redeemable Convertible Preference shares outstanding. The holders of Class "A" shares have the exclusive right, voting separately and as a class, to elect one member to the Board of Directors of the Company. The holders of the Class "B" shares have the exclusive right, voting separately and as a class, to elect the remaining members to the Board of Directors, provided that if there are no holders of Class "B" shares, the holders of the Class "A" shares have the right to elect all members of the Board of Directors of the Company. Class "B" shares are exchangeable for Class "A" shares, share for share.

Mountclair Investment Corporation owns 2,859,410 Class "A" shares and 663,004 Class "B" shares representing 28.21% of the outstanding shares of the Company, and as of the date of this Information Circular, 38.87% of the voting rights attached to all the outstanding shares of the Company. All the issued shares of Mountclair Investment Corporation are owned by a holding company, the voting shares of which are held directly or indirectly by proposed nominee for Director, William L. Sauder.

Vanpac Company No. 9512 (nominee for The Toronto Dominion Bank) owns 2,620,519 Class "A" shares and 657,592 Class "B" shares representing 26.26% of the outstanding shares of the Company, and as of the date of this Information Circular, 37.66% of the voting rights attached to all the outstanding shares of the Company. Pursuant to an agreement made the 30th day of April, 1985, between Mountclair Investment Corporation, The Toronto-Dominion Bank, the Company and The Canada Trust Company, Mountclair Investment Corporation has the right to vote the shares owned by Vanpac Company No. 9512 so long as none of the events permitting the bank to vote the shares has occurred.

REMUNERATION OF MANAGEMENT AND OTHERS

The Company has six executive officers whose aggregate cash compensation during the year ended December 31, 1986 was \$939,633. Each director who is not an officer of the Company was paid a director's fee of \$6,000 per year. In addition, each director who is a member of the audit committee was paid a further fee of \$1,000 per year.

In lieu of pension benefits the Company has entered into consulting agreements with certain long-time vice-presidents which commence upon retirement. The maximum remuneration proposed under the agreements will be \$930,000 payable over a ten year period in each case, in equal monthly installments with a final balance at the end of the tenth year. During 1986, \$120,000 was accrued in the accounts in respect of these payments.

APPOINTMENT OF AUDITORS

The persons designated in the enclosed instrument of proxy intend to vote for the appointment of Thorne Ernst and Whinney, Chartered Accountants, Vancouver, British Columbia, as Auditors of the Company to hold office until the next Annual General Meeting of Shareholders and to authorize the Directors to fix the remuneration of the Auditors so appointed.

ELECTION OF DIRECTORS

The number of Directors now authorized according to Article 10.1 of the Articles of the Company is seven. The Directors recommend that the number of Directors be increased to ten by passing the following ordinary resolution: "Be it resolved that pursuant to Article 10.1, the number of Directors be fixed at ten."

The persons designated in the enclosed instrument of proxy intend to vote for the election of the nominees whose names are set forth below and who are the persons proposed by the management to be nominated for election as Directors. The management does not contemplate that any of the nominees will be unable to serve as a Director. Each Director elected will hold office until the next Annual General Meeting or any adjournment thereof, unless his office is earlier vacated in accordance with the Articles of the Company or the Company Act. All of the nominees are ordinarily resident in Canada except Robert A.C. McColl who is ordinarily resident in the United States of America. Information regarding the nominees is set out in the following table:

	Positions and Offices if any with The Company and Principal Occupation or Employment and Name and Principal Business of Company in which the Employment is carried on	Director Since	Number of shares beneficially owned	
			Class "A" Subordinate Voting Shares	Class "B" Common Shares
Nominee for Holders of Class "A" Subordinate Voting Shares Only				
Robert A.C. McColl (b)	Retired	Dec. 17, 1967	344	Nil
Nominees for Holders of Class "B" Common Shares Only				
H. Clark Bentall	Chairman of the Bentall Group		Nil	Nil
Herbert L. Henri	Vice-President of the Company	March 22, 1974	13,065	Nil
Helmuth Kneteman	Retired	January 4, 1966	37,504	Nil
John A. Milroy (b)	Business Consultant	March 23, 1978	2,666	Nil
George L. O'Leary	Chairman of Scott Paper Limited, Canada	February 2, 1987	Nil	Nil
E. Lawrence Sauder	Vice-President of Sauder Industries Limited (Manufacturing and Distribution Company)	April 18, 1984	Nil	Nil
William L. Sauder (a)(b)	Chairman of the Board of the Company, President of Sauder Industries Limited (Manufacturing and Distribution Company)	July 27, 1977	2,859,410	663,004
Joseph Segal	President of Kingswood Capital Corporation	February 2, 1987	2,000	Nil
John C. Southcott (a)	President of the Company, Executive Vice-President of Sauder Industries Limited (Manufacturing and Distribution Company)	March 21, 1980	1,854	Nil

(a) Member of the Executive Committee

(b) Member of the Audit Committee

NOTES:

1. The advance notice required to be published under Section 135 of the Company Act was published in The Vancouver Sun on February 28, 1987. Copies of the advance notice were sent to the Vancouver Stock Exchange and the Superintendent of Brokers.
2. The number of shares of the Company beneficially owned, directly or indirectly, by the nominees for Director is based on information provided by each nominee as of March 23, 1987.

DATED at Vancouver, British Columbia this 30th day of March, 1987.



HELMUTH KNETEMAN
Secretary

FORESTRY & LOGGING

*Interview with Bob Fechtner,
General Manager,
Forestry and Logging*

How did the division perform in 1986?

Fechtner: Every operation was profitable. Our people did an excellent job. Logging made \$8.5 million in 1986. We made this money by reducing costs, meeting our production target of 2.3 million cubic metres, and exporting a small percentage of our logs.

The logging division has recently become more market driven. What exactly does this mean?

Fechtner: For years, the forest industry has been driven by production and low cost. There were customers everywhere. Then the market began to shrink and customers began to get more particular. Now we find out what the customer wants and set about to provide it.



Helilogging eliminates extensive road building and reduces disturbance in environmentally sensitive areas.

For example, Scott Cove, one of our big cedar-producing camps, has started a "dedicated sort" for our Silvertree mill. This means sorting logs at the logging camp for that particular mill's requirements — or, sending the right tree to the right customer.

In another instance, we started a dedicated sort of hemlock logs that had been going to Japan, retailed them, and now our MacKenzie mill is cutting them for our Japanese customers. We are making a concerted effort to find out what we can do to take the basic resource, the tree, and fit it into the proper market niche.

Were log exports a big factor this year?

Fechtner: It was smaller than in 1985 because we sold more in the form of manufactured lumber. In 1986, we exported about 15 percent of our total production. In 1987, we're looking at about 12 percent. In the years after that, when our new sawmill is on-stream, there will be a much larger demand within our own company for these logs.

In 1985, there was a dramatic improvement in safety performance. Did 1986 see the trend continue?

Fechtner: The severity of accidents has lessened, but our safety record wasn't quite as good as in 1985 in terms of accident frequency. However, our accident severity rate was the second best of the eight major coastal forest companies.

In 1985 Whonnock managed to reduce logging costs by 5 percent per cubic metre. How did you fare in 1986?

Fechtner: By year-end, we reduced costs by another 3 percent, for a total of 8 percent over the last two years.



High productivity and a better accident severity record were highlights of 1986.



A majority of the company's logs harvested in the coastal region is from old growth timber stands from which premium grades of lumber can be produced.

Whonnock is partway through a major capital expenditure program which includes the upgrading of existing mills and construction of a new small-log mill.



What was the highlight of 1986 in your division?

Fechtner: We had high production, a good profit and excellent quality. Employee involvement is a factor in these highlights. First, we have emphasized safety, we are now working employee involvement into production, and our next focus will be on quality. It involves everybody and needs the commitment of everyone.

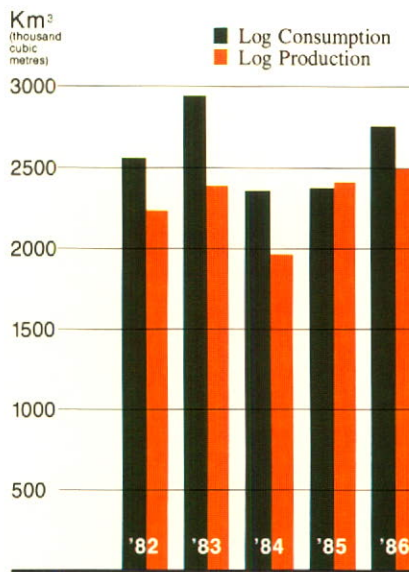
What is the status of Whonnock's timber base?

Fechtner: Probably the most important job I have in the long term is ensuring that we have a good timber supply. Of what avail are seven sawmills with no timber? We continuously update our 25-year timber supply plan.

What about silviculture programs?

Fechtner: At all our operations, we do a tremendous amount of brush control to get our newly planted trees

Log Production & Consumption



“free to grow.” We also planted more than 1.6 million trees this year, which continues to represent three trees planted for every two we log. We spent \$1.25 million on silviculture programs.

What are the plans for 1987?

Fechtner: We want to continue to lower our costs and raise the quality of our logs.

Our real effort is to somehow do better at involving our people in a participation type of environment. In fact, we cannot succeed without involving our people in this way.

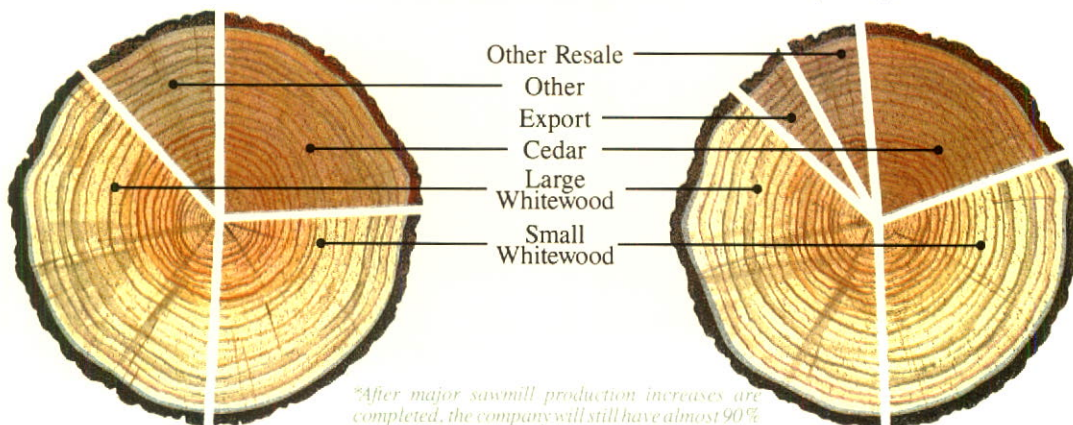
For these initiatives — safety, production, quality, cost — we recognize that we need to get the cooperation of everyone.

LOG SUPPLY*

Coastal Log & Mill Balance

LOG USE

(After Major Capital Expenditures)



*After major sawmill production increases are completed, the company will still have almost 90% of its log supply from company operations or under long-term contracts.

MARKETING/ MANUFACTURING

*Interview with Bob Sitter,
Vice-President, Manufacturing
and Herb Henri, Vice-President*

There is a perception in some quarters that Whonnock has tired old sawmills. How would you respond to this?

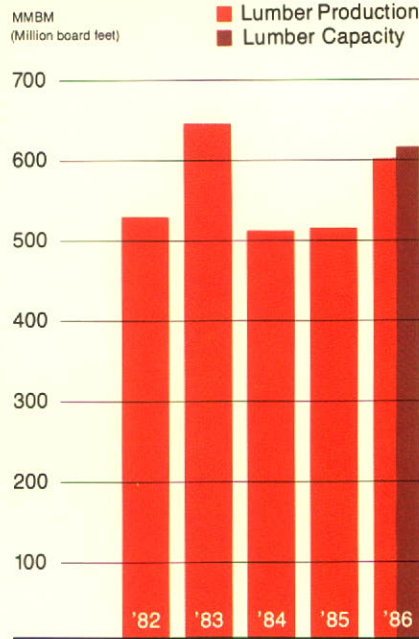
Sitter: That is history now! We are well along the path to rebuilding our manufacturing facilities to an efficient world-class level. We have always been proud of our high comparative productivity and only in the last few years did we start to slip because the recession meant money for capital improvements was tight. During that pause, we did a lot of planning and now we are catapulting ahead of our competitors.

For example, our oldest mill is being replaced by a very efficient small-log mill. This new mill, which will utilize European technology, will be one of the largest single line sawmills in the world, that is, its productivity will be tops.

What are the other elements of the capital expenditure program?

Sitter: We are partway through an \$8-9 million rebuilding program at Bay Forest Products which will completely change the nature of that mill. Its production will more than

Lumber Production and Capacity



triple. It will have the market flexibility to cut lumber for the U.S., Japanese and European markets ... we can aim it at any market we want.

In the case of McDonald Cedar, we have nearly completed the upgrading of the siding mill so that it will produce over 25 million board feet per year. Further, plans for upgrading the sawmill are all but complete. When these improvements are completed, our three cedar mills will continue to be very competitive.

All of our other mills are also getting attention in our capital expenditure program. As a result, this mix of new and upgraded mills will fit our total coastal log supply very well — we will have highly efficient mills able to recover full value from each log.

How did the mills perform in 1986?

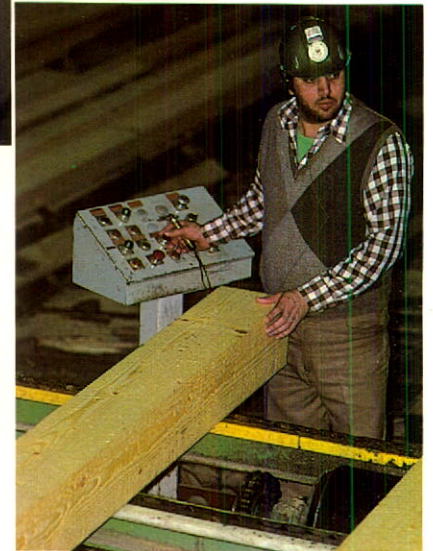
Sitter: All the mills were profitable, some more than others. Holding Lumber was the most profitable, with Silvertree just behind it. The Whonnock Lumber mill did extremely well. A great deal of their profit came from cost reduction. All

Seaboard is one of the western world's largest offshore lumber exporters. Whonnock is both the largest shareholder and the largest shipper.



Whonnock's long-term timber supply consists of a species mix of 58% hemlock-balsam, 21% western red cedar, 10% Douglas fir, 9% spruce and 2% cypress.

Whonnock has made some impressive productivity gains in recent years, and that is a credit to its people.



of our people really produced this year. I am proud of the quality and commitment of our people at all levels — from managers to lumber graders and forklift operators.

The Interior mill has performed well for the company over the years. How was 1986?

Henri: It was a good profit year, due to the effects of modernizing over the last five years. We increased production to 148 million board feet, up 3 percent from 1985, and 70 percent from five years ago.

Whonnock as a whole has made some impressive productivity gains in recent years.

Sitter: Yes, a lot of this improvement is a result of people and not capital improvements. We have worked on our employee involvement initiative with the emphasis on safety and on production.

Gradually, we are changing traditional management styles that are deeply embedded in our industry. We are heading down a path that I believe will enrich both our shareholders and our employees.

What about lumber prices and markets in 1986?

Sitter: They were up. Total lumber sales were substantially up, to \$235 million, compared to \$177 million in 1985.

The Japan market has been a pleasant surprise. This market had 1.3 million housing starts while forecasting only 1.1 million. The company's China business was down because of their lack of foreign exchange. Algeria was also a disappointment in 1986, but looks much better for 1987. In their places came Japan, Australia, Europe and the U.S.

We are working more closely with Seaboard* to coordinate our plans and production with their marketing efforts on our behalf. We are doing more travelling, so we are more in touch with our customers in the field.

What do you see for 1987?

Sitter: We are going to continue to emphasize the concept of "best fit" —

matching our trees to our customers' requirements.

We are a timber company with 3.4 million cubic metres per year available to us and we've got about 20 major customer types. Our mission is to be simultaneously commodity and specialty suppliers of lumber.

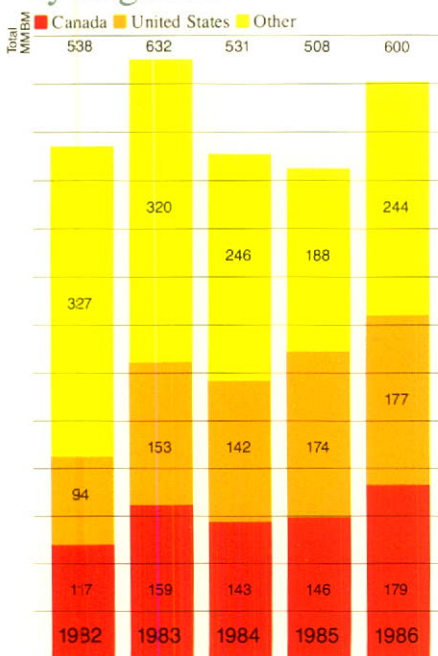
Furthermore, we supply our customers with domestic and export logs, siding, panelling, poles, pulp chips, hog fuel, and so on.

We must think of ourselves as a forest products company with a large and high quality timber resource, and with this resource, we have many opportunities to supply customers all over the world.

This means constantly innovating and exploring new market niches that suit the "best fit" concept.

(*Seaboard Lumber Sales and Seaboard Shipping Company. Whonnock is a major shareholder.)

Sales Volume by Segment



FISCAL COMMENTARY

*Interview with Gerry Friesen,
Vice-President, Finance*

What were the 1986 results for the company?

Friesen: As you can see in the graph, the improvement trend that began in mid-1984 strengthened in 1986. In fact, the fourth quarter of the year had the best quarterly operating results since 1979. We attribute much of this improvement to the increasing strength of the overseas economies and stronger currencies.

How did net profits compare with recent years?

Friesen: Net profits after tax and financing costs were also much higher in 1986. Before the benefit of any extraordinary items, the fourth quarter showed the best results since 1980.

Whonnock raised money to enable it to embark on a major capital expenditure program. How did that go?

Friesen: Our first share offering in August was a little disappointing, but we did raise \$7.5 million which was considered good for market conditions at the time. We also arranged project financing from the B.C. Development Corporation and the Bank of Montreal to enable us to get started on our capital expenditure



In 1986, helilogging accounted for approximately 9% of the harvest from Whonnock's coastal operations.

program. Then in early 1987 we arranged another share issue, this time for over \$17 million, which will allow us to accelerate that program. **One of Whonnock's major four-year objectives is to reduce the debt load.**

Friesen: That's true — and here we are increasing it.

So the objective wasn't to reduce the debt load year by year?

Friesen: We are increasing our debt temporarily on specific things that will give us a good payback. We are being very careful.

All these expenditures are cost reduction expenditures. In other words, we don't need new markets to make these investments pay for themselves. We'll be going to existing markets, but more efficiently.

What were the extraordinary items in 1986?

Friesen: Actually there was just one item, and it related to deferred income taxes. In 1982, for example, we recorded large pretax losses. We could not show the entire future tax savings resulting from these losses because we could not be sure that they would all be utilized before expiring.

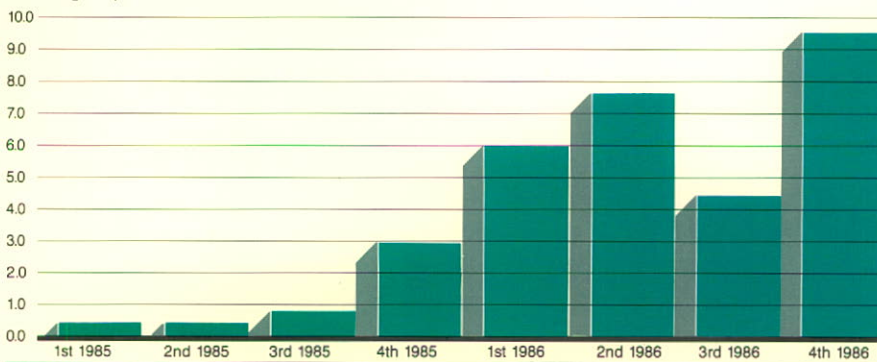
In the first three quarters of 1986, we used up those losses by reducing our income tax provision but accounting convention requires that we show this benefit as an extraordinary item.

What do you see for Whonnock in 1987?

Friesen: 1987 will be a year of major rebuilding and transition. The small-log sawmill will be completed and our converting facilities will be in better balance with our log supply. It should be a year of strong overseas markets, which after all is our company's greatest strength.

Results Before Taxes and Financing Costs (\$ millions)

Last eight quarters



CONSOLIDATED BALANCE SHEET

*Whonnock
Industries
Limited*

As at December 31, 1986

Assets	1986	1985
(Thousands of dollars)		
Current Assets		
Trade and other accounts receivable	\$ 22,694	\$ 21,648
Inventories (note 2)	51,077	44,213
Prepaid expenses	1,374	661
	75,145	66,522
Investments and Other Assets		
Investments and advances	12,997	7,159
Investment in Western Forest Products Limited (note 3)	55,541	56,360
	68,538	63,519
Fixed Assets		
Property, plant and equipment, at cost (note 4)	97,505	90,824
Less accumulated depreciation	51,754	46,528
	45,751	44,296
Timber, at cost less accumulated depletion	11,081	11,236
Logging roads, at cost less accumulated amortization	14,226	14,585
	71,058	70,117
Deferred Charges		
Deferred financing fee, net of accumulated amortization	1,012	1,156
Deferred income taxes (note 5)	12,750	15,600
	13,762	16,756
	\$228,503	\$216,914

Approved by the Board:



Director



Director

Liabilities	1986	1985
Current Liabilities		
Bank indebtedness (note 6)	\$ 8,797	\$ 16,887
Accounts payable and accrued liabilities	22,703	20,787
Principal due within one year on long-term debt (note 6)	287	1,662
	31,787	39,336
Long-Term Debt (note 6)	1,017	592

Shareholders' Equity

Redeemable Preferred Shares of Subsidiary Company (note 7)	146,000	146,000
Capital Stock (note 8)		
Issued and fully paid		
Class A subordinate voting shares	28,924	26,212
Class B common shares	5,044	5,164
7% convertible preference shares	8,003	—
	41,971	31,376
Retained Earnings (deficit)	7,728	(390)
	49,699	30,986
	\$228,503	\$216,914

Commitments and contingent liabilities (note 9)
Subsequent event (note 15)

Auditors' Report

To the Shareholders of Whonnock Industries Limited

We have examined the consolidated balance sheet of Whonnock Industries Limited as at December 31, 1986 and the consolidated statements of income, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Company as at December 31, 1986 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Vancouver, Canada
February 16, 1987

Thorne Ernst & Whinney
Chartered Accountants

CONSOLIDATED STATEMENT OF INCOME

*Whonnock
Industries
Limited*

Year Ended December 31, 1986

(Thousands of dollars)	1986	1985
Sales	\$325,544	\$260,321
Costs and expenses		
Production	265,469	230,890
Selling and administration	13,145	10,246
Depreciation	6,682	6,248
Depletion and amortization	13,193	9,806
	298,489	257,190
Operating income	27,055	3,131
Interest on long-term debt	103	373
Other interest expense	1,073	312
Other income	161	1,031
Income before the following	26,040	3,477
Income taxes (note 5)		
Current	1,300	—
Deferred	10,700	1,200
	12,000	1,200
Income before extraordinary item and dividends on preferred shares of subsidiary company	14,040	2,277
Extraordinary item		
Income tax reduction on application of prior years' losses (note 5)	7,500	1,200
Income before dividends on preferred shares of subsidiary company	21,540	3,477
Dividends on preferred shares of subsidiary company	10,259	10,337
Net Income (Loss)	\$ 11,281	\$ (6,860)
Net Income (Loss) Per Share (note 10)	\$ 1.12	\$ (.69)

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

Year Ended December 31, 1986

(Thousands of dollars)	1986	1985
Retained Earnings (Deficit) at Beginning of Year	\$ (390)	\$ 6,470
Net income (loss)	11,281	(6,860)
	10,891	(390)
Less		
Share issue expenses, net of deferred income taxes of \$350	414	—
Cash dividends on 7% convertible preference shares	121	—
Stock dividends		
Class A subordinate voting shares	2,417	—
Class B common shares	211	—
	3,163	—
Retained Earnings (Deficit) at End of Year	\$ 7,728	\$ (390)

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

*Whonnock
Industries
Limited*

Year Ended December 31, 1986

(Thousands of dollars)	1986	1985
Cash Provided by (used for):		
Operations		
Income before extraordinary item	\$14,040	\$ 2,277
Less dividends on preferred shares of subsidiary company (note 7)	10,259	10,337
	3,781	(8,060)
Items not affecting cash		
Depreciation, depletion and amortization	19,875	16,054
Deferred income taxes	10,700	1,200
Equity in earnings of investee companies	20	(189)
Other	(181)	(828)
	34,195	8,177
Cash generated from (used in) operating working capital		
Trade and other accounts receivable	(1,046)	(5,048)
Inventories	(6,864)	(10,421)
Prepaid expenses	(713)	808
Accounts payable and accrued liabilities	1,916	3,912
	27,488	(2,572)
Financing Activities		
Issue of		
Common shares	—	19,000
Preferred shares of subsidiary company	—	146,000
7% convertible preference shares, net of issue expenses	7,238	—
Reduction in long-term debt	(950)	(160,750)
Cash dividend on 7% convertible preference shares	(121)	—
Other	(36)	—
	6,131	4,250
Investment Activities		
Additions to property, plant and equipment	(8,700)	(7,818)
Disposal of property, plant and equipment	412	1,414
Logging roads	(11,383)	(8,874)
Timber	—	(23)
Investments and other assets	(5,858)	364
	(25,529)	(14,937)
Increase (Decrease) in Bank Indebtedness	(8,090)	13,259
Bank indebtedness at beginning of year	16,887	3,628
Bank Indebtedness at End of Year	\$ 8,797	\$ 16,887

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Year Ended December 31, 1986

1. Significant Accounting Policies

- (a) Principles of consolidation
These financial statements include the accounts of the wholly-owned subsidiaries, Holding Lumber Company Limited, Wide Angle Forest Products Inc. and 286101 British Columbia Ltd., the Company formed to issue the redeemable preferred shares.
- (b) Inventories
Inventories have been valued at the lower of cost and net realizable value.
- (c) Investment in Western Forest Products Limited
The investment in Western Forest Products Limited (WFP) has been accounted for on the cost basis since January 31, 1982.
- (d) Depreciation, amortization and depletion
Depreciation of plant and equipment is provided on a straight-line basis during periods of production at rates (ranging from 5% to 20%) based on the estimated useful lives of the fixed assets. Depletion and road amortization are computed on the basis of timber cut. Amortization of the deferred financing fee is provided over the original term of the related bank credit facility.
- (e) Statement of changes in financial position
The previous year's data in the statement of changes in financial position has been reclassified to conform with the change from the working capital to the cash basis of presentation.

2. Inventories

(Thousands of dollars)	1986	1985
Logs	\$36,420	\$31,869
Lumber	13,786	11,979
Other	871	365
	\$51,077	\$44,213

3. Investment in Western Forest Products Limited

The Company holds a 19.4% voting interest in WFP. Condensed consolidated financial information for WFP at its October 31, 1986 year end was as follows:

BALANCE SHEET AS AT OCTOBER 31, 1986

(Thousands of dollars)	1986	1985
ASSETS		
Working Capital	\$ 22,067	\$ 18,284
Investment in Western Pulp Limited Partnership	191,199	188,696
Investment in Oil and Gas	35,352	—
Fixed Assets	216,033	223,376
Other Assets, net	55,160	55,240
	\$519,811	\$485,596
LIABILITIES AND SHAREHOLDERS' EQUITY		
Long-Term Debt	\$226,273	\$195,000
Preferred Shares	141,094	142,472
Common Shares	282,614	280,000
Deficit	(130,170)	(131,876)
	\$519,811	\$485,596

In the year ended October 31, 1986, WFP reported a net income (loss) of \$1,766,000 (1985 - \$(5,855,000)) on sales of \$121,011,000 (1985 - \$130,929,000).

The Western Pulp Limited Partnership was formed in 1983 to acquire and operate two pulp mills formerly owned by WFP and the partnership raised \$110,000,000 in new equity to rebuild and improve the two mills. WFP has the option to convert its investment into a 60.1% interest in the limited partnership.

Whonnock has not guaranteed any bank loans or other liabilities of WFP. Management has carefully considered the underlying values of the timber and other assets of WFP and its future prospects, and has concluded at this time that any current decline in value does not represent a permanent impairment in the value of this investment.

4. Property Plant and Equipment

(Thousands of dollars)	1986		1985	
	Cost	Accumulated Depreciation	Net	Net
Land	\$10,336	\$ —	\$10,336	\$10,339
Buildings	18,437	9,176	9,261	10,745
Machinery and equipment	56,543	34,532	22,011	19,112
Automotive equipment	5,968	4,751	1,217	1,274
Other	6,221	3,295	2,926	2,826
	\$97,505	\$51,754	\$45,751	\$44,296

5. Income Taxes

The Company has reflected as an asset the tax benefit related to accounting losses of \$26,800,000. Total losses available to reduce future years' taxable income are as follows:

Losses tax-effected in the accounts	\$26,800,000
Amount by which book values exceed tax values	13,700,000
Losses available to reduce future years' taxable income	\$40,500,000

During the year, the Company utilized the balance of tax losses of \$15,950,000 that were not previously tax-effected resulting in an extraordinary gain of \$7,500,000.

The Company has not recorded the benefit of investment tax credits totalling \$790,000 which are available for periods of one to seven years.

The Company's effective income tax rate is determined as follows:

	1986	1985
Basic federal and provincial tax rate	52.5%	52.0%
Manufacturing and processing allowance	(5.0)	(5.0)
	47.5%	47.0%

The Company's income taxes are determined as follows:

(Thousands of dollars)	1986	1985
Income before income taxes, extraordinary item and dividends on preferred shares of subsidiary company	\$26,040	\$3,477
Inventory allowance	(200)	(1,014)
Other	(580)	82
Accounting income	\$25,260	\$2,545
Income taxes at 47.5%	\$12,000	\$1,200

6. Bank Indebtedness and Long-Term Debt

(Thousands of dollars)	1986	1985
Obligations under capital lease and purchase agreements	\$1,304	\$ 754
Bank term loan - Royal Bank of Canada due 1986	—	1,500
	1,304	2,254
Less principal included in current liabilities	287	1,662
	\$1,017	\$ 592

Principal amounts due on long-term debt within the next five years are as follows:

1987	\$287,000
1988	219,000
1989	233,000
1990	248,000
1991	228,000

The Company has available an operating line of credit totalling \$39,000,000 subject to certain working capital requirements.

Bank indebtedness and term bank loans are secured by accounts receivable, inventories, the shares in WFP and a debenture providing a first floating charge on the assets of the Company (see note 7).

7. Redeemable Preferred Shares of Subsidiary Company

A wholly-owned subsidiary company, which was created in 1985 solely to meet legal requirements for the issuance of the preferred shares, issued \$146,000,000 in cumulative, redeemable, retractable non-voting first preferred shares with a dividend rate of one-half of bank prime plus 1-3/4%. These preferred shares are redeemable as follows:

- The subsidiary is required to redeem the shares at par in accordance with an excess cash flow formula, set out in agreements between the Company, the subsidiary and the bank.
- The shares will, in any event, be redeemed in full at par, not later than December 31, 1989.

A term standby credit facility in the amount of \$146,000,000 has been arranged to fund the redemption of the preferred shares.

The redeemable preferred shares of the subsidiary are subject to an agreement wherein, upon the occurrence of certain events of default, the bank may at its option require the Company to purchase these shares at par on 30 days notice. This agreement is secured as set out in the existing loan agreement between the bank and the Company (note 6). Events of default include among others:

- a default which continues for a period of thirty days in the payment of any principal or interest outstanding in respect of the credit facility;
- a default which continues for a period of thirty days in the payment of

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Year Ended December 31, 1986

- dividends on the preferred shares; and
(c) exceeding Whonnock's operating line of credit for a period of sixty days.

8. Capital Stock

Authorized capital consists of:

- 100,000,000 class A subordinate voting shares without par value
- 1,700,000 class B common shares without par value
- 5,000,000 preference shares without par value
- 1,455,000 7% cumulative, redeemable, convertible preference shares without par value, series 1

Share transactions during the year were as follows:

	Number			Total	Amount
	Class A	Class B	7% Convertible Preference		
Balance at beginning of year	8,231,365	1,357,103	—	9,588,468	\$31,376,000
Issued for cash	—	—	1,455,000	1,455,000	8,002,500
Share conversion	31,400	(31,400)	—	—	—
Stock dividends	398,806	—	—	398,806	2,592,000
Balance at end of year	8,661,571	1,325,703	1,455,000	11,442,274	\$41,970,500

During the year, the authorized number of class A subordinate voting shares was increased from 15,400,000 to 100,000,000 and class B common shares was reduced from 4,600,000 shares to 1,700,000 shares. In addition, a new class of shares, the 7% cumulative, redeemable, convertible preference shares without par value, series 1, were created ("7% convertible preference shares"). 1,455,000 7% convertible preference shares were authorized and issued.

The holders of the 7% convertible preference shares are entitled to fixed cumulative dividends of \$0.385 per annum per share. Each 7% convertible preference share is convertible at the option of the holder at any time prior to July 31, 1993 into one class A subordinate voting share at a conversion price of \$5.50 per share, subject to adjustment in certain events.

The 7% convertible preference shares are redeemable at the option of the Company after July 31, 1989 at either \$5.75 or \$5.50 per share depending on the circumstances and the timing of the redemption.

Each 7% convertible preference share was issued with one-half class A share warrant. Each whole class A warrant will entitle the holder to purchase one class A share at \$5.50 per share on or before December 31, 1987. 727,500 warrants are outstanding at December 31, 1986.

The first 13-1/3¢ per share per annum of dividends to common shareholders declared are paid on the class A shares. Any additional dividends shall be declared in equal amounts on the class A and B shares.

The class B shares (carrying ten votes per share) are exchangeable into class A shares (carrying one vote per share) at any time at the option of the holder or, under certain conditions which will result in the automatic conversion of the class B shares into class A shares, on the basis of one class A share for one class B share. Class A shares are reserved for possible future issuance as follows:

- (a) 1,325,703 class A shares are reserved for the conversion of class B shares;
- (b) 2,080,379 class A shares are reserved for possible issuance to holders of Western Pulp Limited Partnership units at a price of \$17.63 per share in exchange for their partnership units;
- (c) 1,455,000 class A shares are reserved for the conversion of the 7% convertible preference shares; and
- (d) 727,500 class A shares are reserved for the exercise of the warrants.

9. Commitments and Contingent Liabilities

- (a) The Company is obligated under various operating leases requiring minimum annual rental payments in each of the next five years as follows:

1987	\$4,461,000
1988	3,673,000
1989	3,231,000
1990	2,882,000
1991	2,423,000
- (b) Under the terms of the 1983 refinancing agreement entered into by Whonnock and WFP, Whonnock will be required, commencing in 1987, to acquire \$10,000,000 of the voting preferred shares at an annual rate equal to the lesser of \$2,500,000 or 20% of Whonnock's net income for the previous year, after excluding non cash extraordinary items.
- (c) Whonnock, as a partner in the Bay Lumber Partnership, is contingently liable for all debts of the partnership which includes a mortgage in the amount of \$4,000,000 as at December 31, 1986. Whonnock is obligated to advance funds

to repay the mortgage at \$1,000,000 per year. Whonnock may also be required after 1986 to contribute to the partnership an amount sufficient to reduce the partnership interest of the other partner to a nominal amount.

- (d) Under the terms of the Western Pulp Limited Partnership agreement, Whonnock, Doman Industries Limited, B.C. Forest Products Limited and WFP have agreed, if required, to make revolving loans to the partnership to a maximum of \$25,000,000 to cover cash deficiencies that may occur before July 1, 1990. Whonnock's share of the contingent liability is limited to a maximum of \$5,000,000 to June 30, 1988, \$3,000,000 thereafter to June 30, 1989 and \$2,000,000 thereafter to June 30, 1990. Whonnock has arranged a line of credit with its bank to borrow any funds that might be required to meet any cash deficiencies of the partnership. At December 31, 1986, Whonnock had advanced \$1,400,000 to the Western Pulp Limited Partnership under the terms of this agreement.
- (e) During the year, the Company commenced construction of a new sawmill, to be completed by October 1987, at an estimated cost of \$38 million of which \$5.8 million had been spent or advanced by December 31, 1986. The sawmill is being financed from the proceeds of the preference share issue and term loans of five and seven years.

10. Income (Loss) Per Share

The basic income (loss) per share is calculated using the weighted average number of shares outstanding during the respective fiscal years after giving retroactive effect to stock dividends. The income (loss) per share before extraordinary item was \$37 (1985 - \$(.81)).

The possible conversion of the 7% convertible preference shares and the Western Pulp Limited Partnership units and the exercise of the warrants does not have a material dilutive effect on the earnings per share.

11. Pension Plans

The Company contributes to several retirement plans for its employees on a current service basis. These plans are fully funded and there is no unfunded past service liability.

12. Related Party Transactions

Lumber sales to a significant shareholder in the regular course of business amounted to \$3,521,000 (1985 - \$2,069,000). The Company has paid \$7,039,000 (1985 - \$5,707,000) for custom cutting services which includes all operating costs provided by the Bay Lumber Partnership, owned by the Company and a significant shareholder. These transactions were conducted on a normal commercial basis, including terms and prices.

13. Other Information

Remuneration of directors and senior officers of the Company amounted to \$965,133 (1985 - \$1,013,052).

14. Segmented Information

The Company operates exclusively in the forest products industry and all of its operations are based in Canada.

The Company sells to foreign markets, principally through a Canadian sales agency, Seaboard Lumber Sales Company Limited. Sales by major markets are as follows:

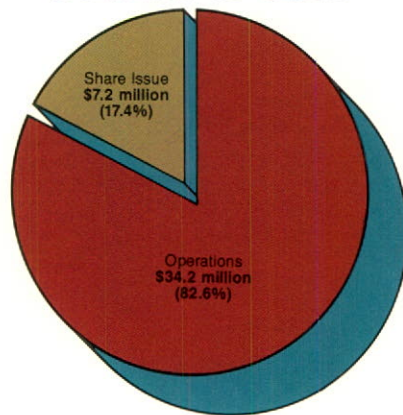
(Thousands of dollars)	1986			1985	
	Lumber and Shakes	Chips and Other By-products	Logs	Total	Total
Canada	\$ 55,391	\$14,199	\$32,157	\$101,747	\$ 82,128
United States	82,929	3,929	—	86,858	77,160
Other export	104,675	—	32,264	136,939	101,033
	\$242,995	\$18,128	\$64,421	\$325,544	\$260,321

15. Subsequent Event

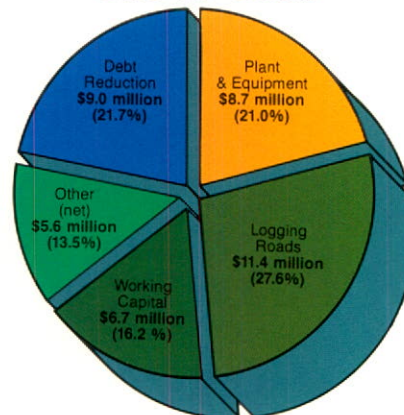
The Company has accepted an offer from DSI Investments Limited and Dominion Securities Inc. for the purchase of 2,496,818 class A subordinate voting shares at an aggregate consideration of \$17,477,726. The offer is subject to receipt of regulatory approvals.

1986 CASH FLOW

Sources of Cash



Use of Cash



FIVE YEAR REVIEW

	1986	1985	1984	1983	1982
Production Statistics					
Lumber (million FBM)	600	510	508	641	529
Logs (thousand cubic metres)	2,484	2,381	1,949	2,365	2,200
Employee Statistics					
Wages, salaries (\$000)	66,400	59,171	57,106	65,503	58,929
Number of employees	1,990	2,009	2,089	2,081	1,895
Financial Statistics					
Sales (\$000)	325,544	260,321	239,929	269,612	224,324
Stumpage (\$000)	12,011	9,984	8,612	9,320	8,212
Income taxes (recovery) (\$000)	4,500	—	(6,100)	(2,600)	(11,148)
Net income (loss) (\$000)	11,281	(6,860)	(19,774)	4,746	(21,189)
Earnings (loss) per share*	\$ 1.12	\$.69	\$(2.79)	.67	\$(3.15)
Total assets (\$000)	228,503	216,914	202,353	218,948	210,626
Ratio and Investment Information					
Current ratio	2.3:1	1.7:1	2.3:1	1.5:1	1.4:1
Equity per common share* \$	4.18	3.10	2.66	5.45	4.59
Share price range — high \$	8.50	5.88	10.75	12.00	9.00
— low \$	4.60	3.10	3.00	6.38	2.20
Re-Investment					
Working capital generated from (applied to) operations (\$000)	34,195	8,177	(11,995)	11,932	(14,182)
Plant, equipment and roads (\$000)	20,083	16,692	9,901	11,240	11,348
Working capital retained (provided from other sources)	14,112	(8,515)	(21,896)	692	(25,530)

*Stock dividends applied retroactively

Head Office**Registered Office**

P.O. Box 49114, Bentall Centre
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(604) 681-3221

Management

W.L. Sauder
Chairman and Chief Executive Officer
J.C. Southcott
President and Chief Operating Officer
H.L. Henri
Vice-President
R.M. Sitter
Vice-President, Manufacturing
R.W. Fechtner
General Manager, Forestry and Logging
G.J. Friesen
Vice-President, Finance
L.D. Cocke
Controller

Directors

H.L. Henri, Chase, B.C.
H. Kneteman, Vancouver, B.C.
R.A.C. McColl, Tucson, Arizona
J.A. Milroy, Vancouver, B.C.
G.L. O'Leary, West Vancouver, B.C.
E.L. Sauder, Vancouver, B.C.
W.L. Sauder, Vancouver, B.C.
J. Segal, Vancouver, B.C.
J.C. Southcott, Vancouver, B.C.

Auditors

Thorne Ernst & Whinney,
Vancouver, B.C.

Transfer Agent

Montreal Trust Company,
Vancouver, B.C. and Toronto, Ont.

Forestry and Logging Group

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Sawmill Operations

BAY FOREST PRODUCTS 465-9933

Box 577
10985 South Bohson Road
Pitt Meadows, B.C. V0M 1T0

McDONALD CEDAR PRODUCTS 888-1616

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MacKENZIE MILLS 580-1494

11732 - 130th Street
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PACIFIC PINE 525-9411

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New Westminster, B.C. V3M 5H6

SILVERTREE 327-9242

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WHONNOCK LUMBER 462-7111

P.O. Box 10
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Whonnock, B.C. V0M 1S0

WHONNOCK SHAKE & SHINGLE 462-7111

P.O. Box 10
25910 Lougheed Hwy.
Whonnock, B.C. V0M 1S0

HOLDING LUMBER 679-3234

COMPANY LIMITED

R.R. 2
Chase, B.C. V0E 1N0

PACIFIC DIVISION

(under construction)

Logging Locations

Adams Lake	Menzies
Bear Lake	Moh Creek
Chamiss	Narrows Inlet
Cleagh Creek	Porcher
Drury Inlet	Port Neville
Goat Lake	Scott Cove
Hecate	Squamish
Helilog Eclipse	Stave Lake
Hope (4)	Taleomey
Homathko	Whonnock
Kingcome Inlet	
Kumealon	
Kwatna	
Lizzie Creek	
Malcolm Island	

