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Whonnock Industries Limited

Annual Report 1985

Whonnock Industries Limited

Whonnock 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 24 logging operations cutting hemlock, balsam, cedar, 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 partnership, recognizing that flexibility to the marketplace makes good business sense.

Financial Summary

12 Months Ended	December 31, 1985	December 31, 1984
Income Statement		
Sales	$260,321,000	$239,929,000
Operating margin (Loss) before interest	3,131,000	(6,740,000)
Income (Loss) before dividends on preferred shares	3,477,000	(19,774,000)
Loss for the year	6,860,000	19,774,000
Loss per share	.72	2.91

	December 31, 1985	December 31, 1984
Balance Sheet		
Working Capital	$ 27,186,000	$ 29,704,000
Total Assets	216,914,000	202,353,000
Total Common Shareholders' Equity	30,986,000	18,846,000
Equity per Common share	3.23	2.77

Report from the Chairman

If we were to characterize the year 1985, we would say it was a start in the right direction.

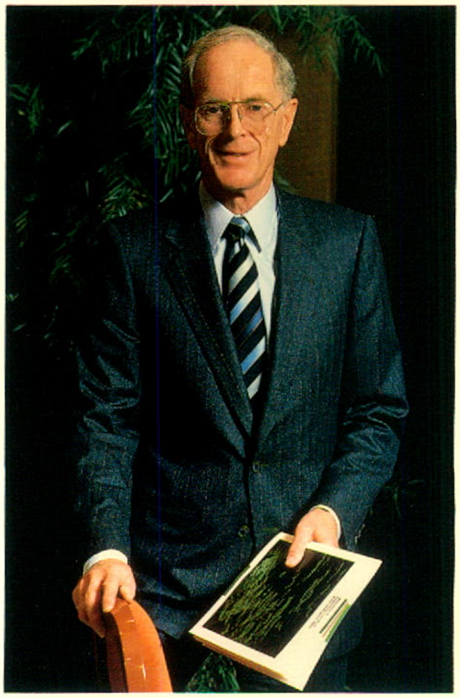
The Company returned to profitability in the fourth quarter after eight successive quarters of losses.

Although the total annual results did not yet show a profit, it was gratifying to see a year-over-year improvement of almost $13 million. During the year we concluded refinancing arrangements with the Toronto Dominion Bank which represented their confidence in our Company and our industry. But the year was not satisfying nor will any year be, until we are able, once again, to provide an adequate return to our shareholders.

The potential to move toward continued profitability over the next several years is becoming more and more promising as negative factors begin to disappear. With the strengthening of overseas currencies to the levels of the late 1970s, our lumber has gradually become more affordable to these customers. As a result, world demand for our products is increasing.

As profitability improves and greater cash flows are generated, an obvious priority will be to reduce bank debt and redeem preferred shares.

An equally important priority, which is being approached cautiously, will be to effect efficiency improvements in the manufacturing side of our coastal operations. In particular, we are developing plans to add a small log facility that will efficiently cut our small logs. Such an addition would provide a much improved balance to our converting facilities for both our timber resource on one hand and our customers' requirements on the other. Improvements of this nature, on a smaller scale, have already resulted in substantially reduced costs and log consumption in our Interior operations.



A third priority will be to develop products and markets that more fully reflect the specialty potential of our timber resource for higher grades, large dimensions and variety of species.

We appreciate the support of our customers, employees and suppliers and look forward to 1986 with optimism for a more satisfying year.

W. L. Sauder

William L. Sauder
Chairman and Chief Executive Officer

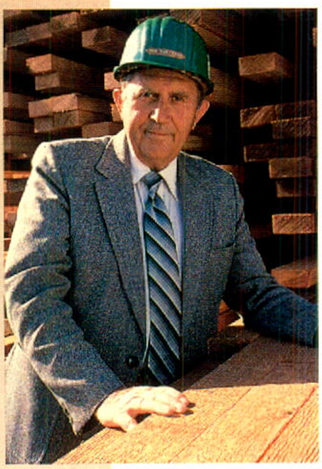
Perspective

An interview with President John Southcott and Vice-President Gus Kneteman.

Where do you see Whonnock in relation to the rest of the industry?

Southcott: There are really two separate industries, the Interior and the Coast. I'd say we're in an excellent situation with our Interior operation. Our species mix is better than average because we have a lot of Douglas fir and cedar as well as typical spruce, pine, white fir. Our mill has been updated over the years, so we're in good shape there. We're not the lowest-cost producer, but our built-in flexibility of raw material and manufacturing facilities makes us more profitable than most.

On the Coast, the whole industry has had a very difficult time with high log costs and high conversion costs compared to other regions. Whonnock's log supply is probably one of the best on the Coast. Our logging costs are relatively low, but our mills are not as low cost as we'd like to see them.



President John Southcott (left); Vice-President Gus Kneteman (right).

Where do you want Whonnock to be in five years?

Southcott: We are actively pursuing a four-year strategic plan that has a number of objectives: to improve our lumber recovery, to reduce manufacturing costs, to fully utilize the small log portion of our lumber supply and to reduce our debt load. If we do the first three, it will help us meet the fourth objective.

We've got three "stakeholder" groups in Whonnock: our bank, our employees and our shareholders. If our strategic plan is successful, we'll be paying back our loan to the bank, we'll be able to offer our employees job security and our shareholders will see a return on their investment.

None of this is going to happen overnight. But we are going to have the best facilities around. Some of the new technology will give us the ability to recover far more out of a log than any mill in North America and to produce merchantable grade lumber for any market in the world. We are going to take a quantum leap forward in the lumber manufacturing side of our business.

To put this in perspective, what changes in the industry have you seen over the years?

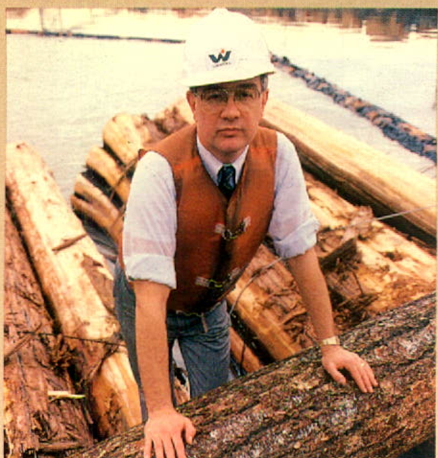
Kneteman: I've seen sawmill and logging employees go from transient "camp inspectors" to highly trained professionals. Logging technology has gone from hand falling when I started more than thirty years ago to powerful, lightweight saws and grapple yarders.

In the mills, we are cutting faster, more accurately and with fewer people. At one time, lumber went out in random lengths, unpackaged. Nowadays, we deal with 80-120 different sizes, lengths and grades *every day*.

The industry has changed a lot and Whonnock is going to contribute to the evolution in the next few years.

Forestry & Logging

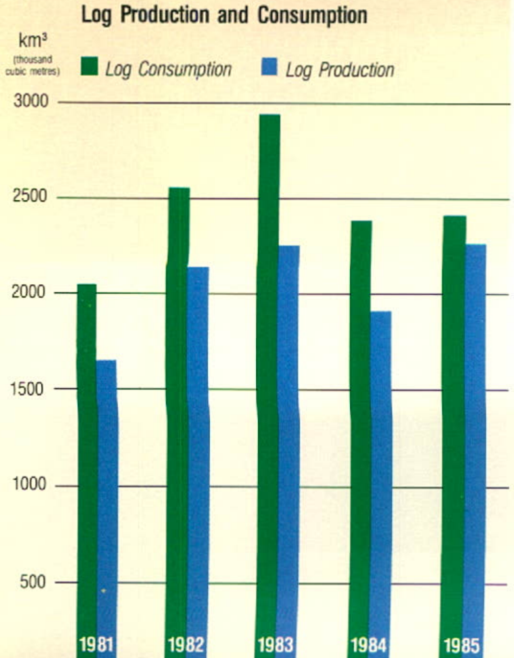
An interview with Vice-President Bob Sitter.



Vice-President Bob Sitter.

Logging costs were reduced by $2 per cubic metre.

Log Production and Consumption



What was 1985 like for your group generally?

Sitter: It was a good year for us in logging. We did well in production, cost reduction, profits, marketing, employee involvement and safety improvement. And this was in spite of adverse weather conditions and unfavourable markets early in the year.

First of all, we had a late snow. It was very poor for logging because of the snow at high elevations. We logged for about two months and then we ran head on into the worst fire season in many years. We lost a great amount of production time in the middle of summer.

After Labour Day, we set nearly all-time records in production until we had an early snow and a cold snap in November which shut everything down or made it difficult to operate.

The gratifying part of it was that we did really well in the short time we had to produce. We got close to 90% of our original target.

So productivity was high. What about costs?

Sitter: A major objective during the year was to continue to reduce logging costs. All year we were on a cost reduction program.

What are some examples?

Sitter: We worked on every angle. We made shift changes so that our grapple yarders now run seven days a week, and up to 10 hours a day, daylight permitting. Because we are getting more hours on our grapple yarders, fixed costs are reduced as a result.

Then there is the massive ''nuts and bolts'' area of savings, such as reducing cookhouse costs and so on. It's just a product of the hard times.

What was the end result of all this?

Sitter: Overall, we reduced our logging costs by over $2 per cubic metre. In 1986, we're aiming at another $2 in our company-operated logging camps.

How did the fire season affect your division? Were any areas burned?

Sitter: We had two bad fires where we lost or damaged 40,000 cubic metres of felled and bucked timber and a similar amount of standing timber. This will have no effect on our future log supply.

Were there any new activities that proved noteworthy?

Sitter: The big breakthrough was the sheer profitability of the Forestry and Logging group this year. We're moving in the direction of matching the trees in the forest to the end product market. The log export program was a really important element in that.

Isn't log exporting a big issue in terms of jobs?

Sitter: Yes it is a big issue. It creates lots of jobs — logging and milling jobs.

Many logging operations ran because of the percentage of log exports. In some cases, the percentage was 15% or less. But because of that small percentage, the camp was able to run and break even. Otherwise, the camp would have been shut down. So you're immediately creating jobs for loggers.

But if 15% of the logs were exported, what about the other 85%?

Sitter: They went to domestic mills: pulp mills, plywood plants, sawmills, everything.

Here is a dramatic example of this. Cedar logs are in short supply right now, for various reasons. Very few cedar sawlogs were exported in the past year and almost none in the last six months. And yet all those logging camps that are running because of log exports are producing cedar — anywhere from 5-25% cedar in all those camps. We think the log export business has kept our company and many others running.

1985 saw a dramatic downward trend in accident frequency and severity.

What would the scenario have been without log exports?

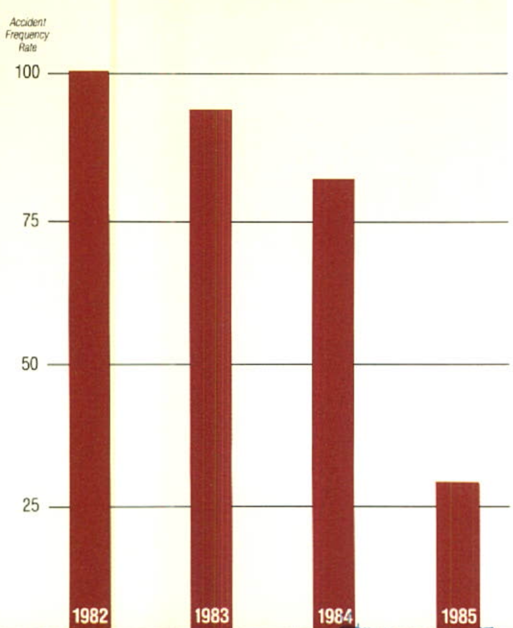
Sitter: We would have had at least twelve operations shut down in 1985 had it not been for log exports. So we generated logs all year for our mills as well as for the log export business.

On the coast, there are six species and between seven and ten log sorts for each species, so log grading, such as on this dry land sort at Hope, is important.

Where did your log exports go?

Sitter: Japan, China, Korea, in that order. We sent about 375,000 cubic metres of logs to Asia.

Forestry and Logging/IWA Safety Performance



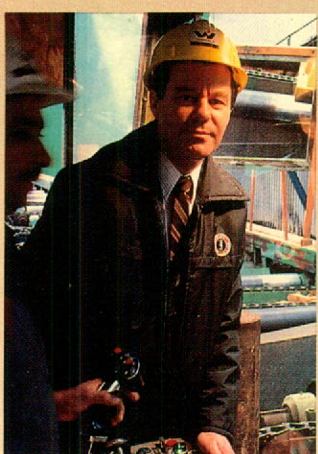
What future trends do you see?

Sitter: The conventional way of looking at a forest products company on this coast has been, and still is in many companies, to say, "we are seven mills with a log supply and a market." This thinking makes logging and the basic resource just a supply function and marketing just another adjunct of production.

Instead, we are looking at it this way: we have annually 3.4 million cubic metres of logs for our mills and for log sales. This is very different thinking. We try to use the market system to allocate logs most efficiently to our mills while maintaining a 10-15% log export level. It leads to looking hard at the *real* opportunities for the company.

Marketing/ Manufacturing

An interview with Vice-Presidents Ron Neil and Herb Henri.



Vice-Presidents Ron Neil (left); and Herb Henri.

What was 1985 like for your group generally?

Neil: 1985 was a holding year for the mills, in the sense that our sawmills on the Coast basically broke even. No one has been able to make any significant money in hemlock since about 1981 because world prices have been too low. Cedar prices, on the other hand, were reasonable.

We had some successes in 1985 if we look at it mill by mill. In 1984, we made a decision to put Silvertree entirely on western red cedar and develop a concerted marketing effort. Since the spring of 1985, the mill has run continuously on two shifts. The company's annual cedar production has gone from one mill — McDonald — and 50 million board feet, to two mills and in excess of 120 million board feet.

How did Whonnock's other mills do?

Neil: In early 1985, the export market was still very poor. We made a decision to swing MacKenzie Mills more into the Japanese market. That program has continued very successfully; our Japanese customers are very pleased with the product.

Pacific Pine tried to cut as much fir as possible, but it was difficult this year to find good quality in the Vancouver log market.

McDonald Cedar carried on its normal program of upgrading cedar into bevel siding, panelling, etc. It ran at 90-95% of normal capacity.

Whonnock Lumber's small log mill operated at capacity, but the large log mill operated only one shift (50% of capacity) because of poor export markets. It is back on two shifts now.

We purchased Bay Lumber in 1984 with the intention of making certain modifications. Until they are made, the mill will operate below capacity, cutting primarily for the Japanese market and cutting only when we have suitable logs and suitable lumber orders to make a profit.

It's a good achievement when you can run part-time and make money. However, from our employees' point of view, if you run only 35-40% of the time, they don't view you as being a very dependable employer.

Whonnock Shake and Shingle had a reasonably successful year despite the cyclical markets.

How did you hold the line on costs?

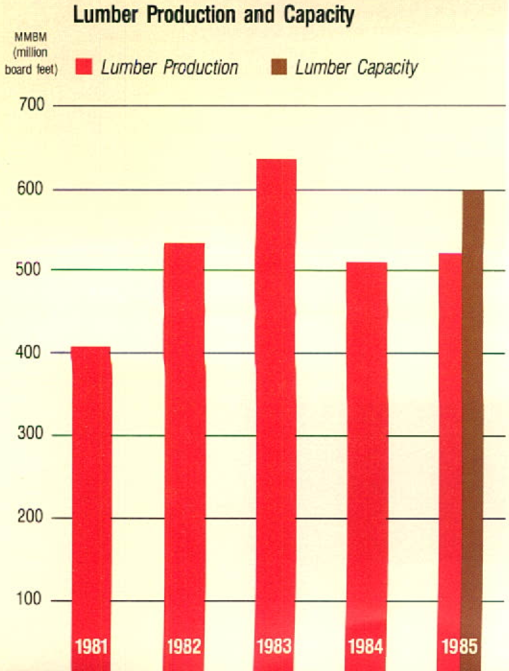
Neil: We have made crew reductions, combined or eliminated jobs and everyone has become more productive.

Unions and all employees have to be given credit for understanding the industry's problem. It is a matter of survival.

Did you have to consider closing any mills?

Neil: Our objective was to survive and hang in there with all our mills until the currency and the market changed. We did meet that objective. There were some people who felt we should have closed two or three mills. Rather than close them and reopen them when the markets improved, our approach was to keep each mill running and keep them in the marketplace. In 1986, we'll reap the benefits of this. As the markets picked up in late '85, we had a good order file in front of us.

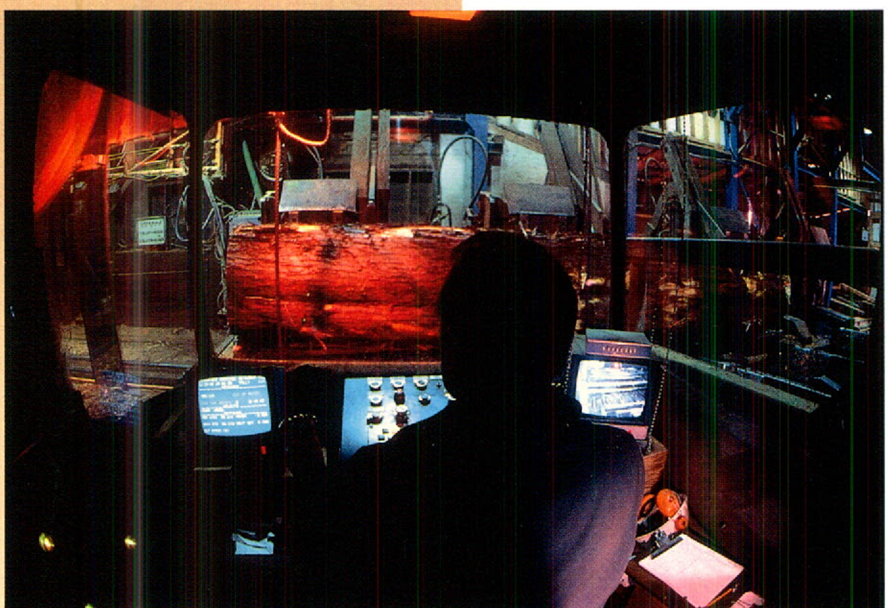
Lumber Production and Capacity



Had we closed those mills, we might not have had a balanced order file. It's very awkward to start up a mill in a difficult market. You can never get the right mix of orders.

Which markets were important in 1985?

Neil: We participated in a large way in the China market in 1985, although the prices were not what they should have been. We increased our volume to the Japanese market; we re-entered the European markets when the currency changed. We did not repeat any business in Africa; we're hoping to return to that market in 1986.



Whonnock's people have earned the Company its reputation for quality products.

How did the strong North American currencies affect the mills?

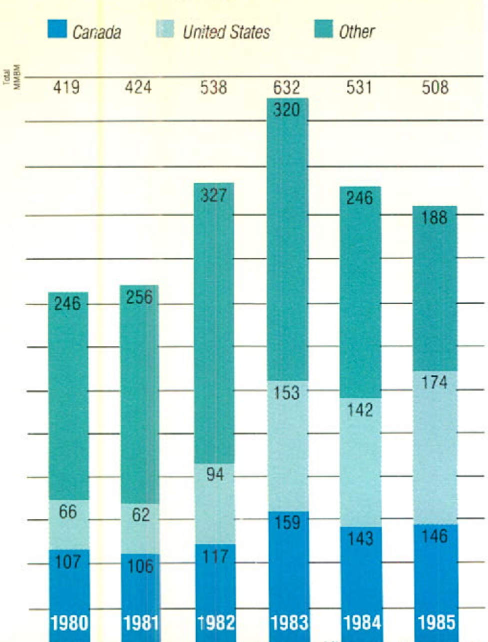
Neil: The first half of '85, we took business that barely contributed to our fixed costs in many of our sawmills, especially in the hemlock mills. But as the second half of the year rolled around, about August, you could see the picture changing. By October we started to receive inquiries from our traditional markets, such as the United Kingdom and Continental Europe, that we were able to quote on. And it was all helped because of the weakening dollar. As we left the end of the year, we had significantly larger order files at better prices than we have seen for several years.

Houses like this in Japan are made from Whonnock lumber products.

How did Holding Lumber manage to increase its profits during a recession in the lumber business?

Henri: The money we spent previously to modernize that mill definitely paid off, because the mill is able to produce efficiently, with a high recovery. Production increased from about 80 million board feet in 1982 to 144 million in 1985. Yield (lumber recovery) increased 11% for the same period.

Sales Volume by Segment



What about manufacturing costs?

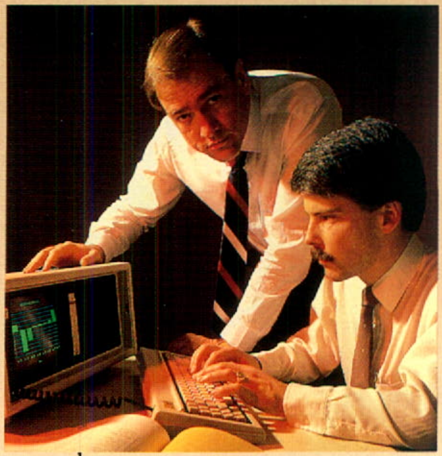
Henri: Manufacturing costs per thousand board feet went down by 13%. Logging costs have stayed virtually the same over the past three or four years. Of course, profits improved each year. For example, 1985 profits were more than double 1984.

How much will markets affect you in 1986?

Henri: We feel the North American market will remain firm. U.S. housing starts are expected to improve slightly over 1985, probably to 1.7-1.8 million for the year. This is all we need. With our efficient plant and a strong sales program, we'll have another good year.

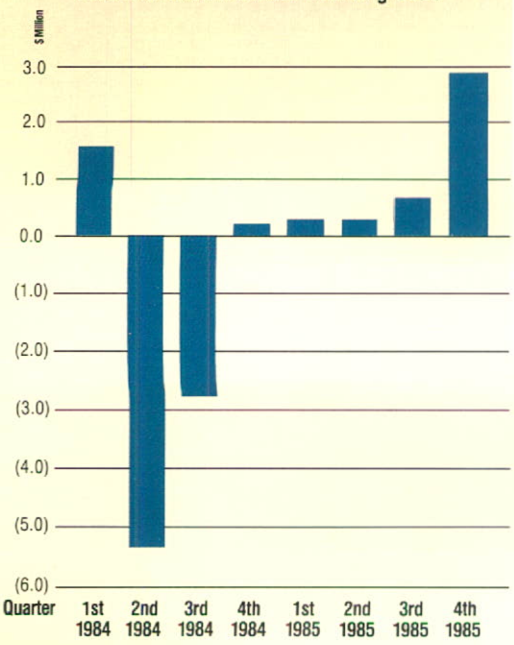
Fiscal Commentary

An interview with Vice-President Gerry Friesen.



Vice-President Gerry Friesen, left, attributes the better year to improved operating plans, cost reductions and productivity improvements.

Results Before Taxes and Financing Costs



What was 1985 like for the company?

Friesen: The good part is it was better than 1984. It was steadier, more controlled, partly because of the economic environment and partly because of our operating plans. We're also more selective; we look for the best orders, the best mill to cut it in and we don't try to keep all operations running for the sake of keeping running.

In a bad economic environment, there are two ways of improving your lot. One way is to really accelerate the production and produce more at a lower cost. The other is to operate at a lower level and choose your best opportunities. The former method worked extremely well in the Interior. The latter worked best on the Coast.

On the Coast the name of the game is selling price. To get the selling price, you've got to add some value to the product or cut as much high grade as you can. You can frequently do a better job by going slower. Often, our higher-cost mills make the most money.

What was the highlight of 1985?

Friesen: The bright spot in 1985 was log exports. We entered the log export market as a matter of survival, but soon found it was good for both logging and sawmilling, provided it's done in moderation.

Were there any other bright spots?

Friesen: Another plus for 1985 was our refinancing with the Toronto Dominion Bank. It saved a lot of cash, $6-7 million for the year, in addition to providing larger lines of credit.

We have about $25 million in unused lines of credit. It's worked out well. We're operating within a comfort level now. We can plan better knowing we have the working capital to do what we want to do.

How did all this impact on operating results?

Friesen: Each quarter we update a graph of our operating results measured before income taxes and financing costs. As you can see, there have been six successive quarters of improvement. The improvement was greatest in the last quarter of 1984 as we overcame the market collapse of mid-1984 and in the last quarter of 1985 as market conditions began to improve because of stronger overseas currencies.

What do you see for 1986?

Friesen: I see improved overseas markets and stable North American markets.

In 1986, we'll have wage negotiations. We'll probably see a greater degree of cooperation and interest in getting a settlement. If there are labour disruptions, there will be no winners.

Whonnock Industries Limited
(a British Columbia corporation)

Consolidated Balance Sheet

Year Ended December 31, 1985

Assets

(Thousands of dollars)	1985	1984
Current Assets		
Trade and other accounts receivable	**$ 21,648**	$ 16,600
Inventories (note 2)	**44,213**	33,792
Prepaid expenses	**661**	1,469
	66,522	51,861
Investments and Other Assets		
Investments and advances	**7,159**	7,327
Investment in Western Forest Products Limited (note 3)	**56,360**	57,380
	63,519	64,707
Fixed Assets		
Property, plant and equipment, at cost (note 4)	**90,824**	85,944
Less accumulated depreciation	**46,528**	43,205
	44,296	42,739
Timber, at cost less accumulated depletion	**11,236**	11,958
Logging roads, at cost less accumulated amortization	**14,585**	14,188
	70,117	68,885
Deferred Charges		
Deferred financing fee, net of accumulated amortization	**1,156**	1,300
Deferred income taxes (note 5)	**15,600**	15,600
	16,756	16,900
	$216,914	$202,353

Approved by the Board

Director

Director

Liabilities

	1985	1984 Pro forma (notes 7 and 8)	1984
Current Liabilities			
Bank indebtedness (note 6)	**$ 16,887**	$ (2,272)	$ 3,628
Accounts payable and accrued liabilities	**20,787**	16,875	16,875
Principal due within one year on long-term debt (note 6)	**1,662**	1,654	1,654
	39,336	16,257	22,157
Long-term Debt (note 6)	**592**	2,250	161,350

Shareholders' Equity

	1985	1984 Pro forma (notes 7 and 8)	1984
Redeemable Preferred Shares of Subsidiary Company (note 7)	**146,000**	146,000	—
Capital Stock (note 8)			
Issued and fully paid			
8,231,365 class A subordinate voting shares	**26,212**	26,212	11,906
1,357,103 class B common shares	**5,164**	5,164	470
9,588,468	**31,376**	31,376	12,376
Retained Earnings (deficit)	**(390)**	6,470	6,470
	30,986	37,846	18,846
	$216,914	$202,353	$202,353

Commitments and contingent liabilities (note 9)

Auditors' Report

To the Shareholders of
Whonnock Industries Limited

We have examined the consolidated balance sheet of Whonnock Industries Limited as at December 31, 1985 and the consolidated statements of income, retained earnings (deficit) 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, 1985 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 24, 1986

Thorne Riddell
Chartered Accountants

Whonnock Industries Limited
(a British Columbia corporation)

Consolidated Statement of Income

Year Ended December 31, 1985

(Thousands of dollars)	1985	1984
Sales	**$260,321**	$239,929
Costs and expenses		
Production	**230,890**	222,331
Selling and administration	**10,246**	10,052
Depreciation	**6,248**	6,863
Depletion and amortization	**9,806**	7,423
Interest on long-term debt	**373**	15,405
Other interest	**312**	4,216
	257,875	266,290
Operating income (loss)	**2,446**	(26,361)
Other income	**1,031**	487
Income (loss) before income taxes, extraordinary item and dividends on preferred shares	**3,477**	(25,874)
Deferred income taxes (reduction) (note 5)	**1,200**	(6,100)
Income (loss) before extraordinary item and dividends on preferred shares	**2,277**	(19,774)
Extraordinary item		
Income tax reduction on application of prior year's losses	**1,200**	—
Income (loss) before dividends on preferred shares	**3,477**	(19,774)
Dividends on preferred shares	**10,337**	—
Loss Applicable to Common Shares	**$ 6,860**	$ 19,774
Loss per Share (note 10)	**$0.72**	$2.91

Consolidated Statement of Retained Earnings (Deficit)

Year Ended December 31, 1985

(Thousands of dollars)	1985	1984
Retained Earnings at Beginning of Year	**$ 6,470**	$ 27,216
Loss applicable to common shares	**(6,860)**	(19,774)
	(390)	7,442
Less stock dividends		
Class A subordinate voting shares	—	952
Class B common shares	—	20
	—	972
Retained Earnings (Deficit) at End of Year	**$ (390)**	**$ 6,470**

Whonnock Industries Limited
(a British Columbia corporation)

Consolidated Statement of Changes in Financial Position

Year Ended December 31, 1985

(Thousands of dollars)	1985	1984
Working Capital Derived From		
Operations		
Loss applicable to common shares	**$ (6,860)**	$ (19,774)
Items not involving working capital	**15,037**	7,779
Cash flow (loss) from operations	**8,177**	(11,995)
Disposal of property, plant and equipment	**1,414**	820
Increase in long-term debt	**—**	32,098
Issue of shares		
Common	**19,000**	—
Preferred shares of subsidiary company	**146,000**	—
Less repayment of term bank loan	**(159,100)**	—
	15,491	20,923
Working Capital Applied to		
Property, plant and equipment	**7,818**	4,045
Logging roads	**8,874**	5,856
Timber	**23**	2,190
Investments and other assets	**(364)**	3,526
Current portion of long-term debt	**1,658**	1,605
	18,009	17,222
Increase (Decrease) in Working Capital	**(2,518)**	3,701
Working Capital at Beginning of Year	**29,704**	26,003
Working Capital at End of Year	**$ 27,186**	$ 29,704

Whonnock Industries Limited
(a British Columbia corporation)

Notes to Consolidated Financial Statements

Year Ended December 31, 1985

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.

Deferred interest included in the investment is being amortized at $1,020,000 per year commencing November 1, 1981.

(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.

2. *Inventories*

(Thousands of dollars)	1985	1984
Logs	$31,869	$23,416
Lumber	11,979	9,770
Other	365	606
	$44,213	$33,792

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, 1985 year end was as follows:

Balance Sheet as at October 31, 1985

Assets

(Thousands of dollars)	1985	1984
Working Capital	$ 18,284	$ 24,938
Investment in Western Pulp Limited Partnership	188,696	181,216
Fixed Assets	223,376	232,274
Other Assets, net	55,240	53,023
	$485,596	$491,451

Liabilities and Shareholders' Equity

Long-Term Debt	$195,000	$195,000
Preferred Shares	142,472	142,472
Common Shares	280,000	280,000
Deficit	(131,876)	(126,021)
	$485,596	$491,451

In the year ended October 31, 1985, WFP incurred a loss of $5,855,000 (1984 - $10,323,000; 1983 - $40,939,000) on sales of $130,929,000 (1984 - $148,754,000; 1983 - $227,801,000).

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)	1985			1984
	Cost	Accumulated depreciation	Net	Net
Land	$10,339	—	$10,339	$10,339
Buildings	17,815	$ 7,070	10,745	9,646
Machinery and equipment	51,357	32,245	19,112	18,700
Automotive equipment	5,475	4,201	1,274	1,302
Other	5,838	3,012	2,826	2,752
	$90,824	$46,528	$44,296	$42,739

5. Income Taxes

The company reflects as an asset only the future tax benefit related to recording depreciation, amortization and depletion in excess of the amount claimed for tax purposes. The company also has losses of $15,950,000 which have not been tax benefited and are available to reduce future years' income taxes. In addition, the company has not recorded the benefit of investment tax credits totalling $1,025,000 which are available for periods of one to five years.

The company has losses totalling $66,800,000 which are available to reduce future years' taxable income.

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

	1985	1984
Basic federal and provincial tax rate	52.0%	52.0%
Manufacturing and processing allowance	(5.0)	(5.0)
	47.0%	47.0%

The company's deferred income taxes are determined as follows:

(Thousands of dollars)	1985	1984
Income (loss) before income taxes, extraordinary item and dividends on preferred shares	$3,477	$(25,874)
Inventory allowance	(1,014)	(1,700)
Portion of loss not tax-effected	—	14,400
Other	82	174
Accounting income (loss)	$2,545	$(13,000)
Deferred income taxes at 47%	$1,200	$ (6,100)

6. Bank Indebtedness and Long-Term Debt

(Thousands of dollars)	1985	1984 Pro forma (note 7)	1984
Bank term loan — Royal Bank of Canada due 1986	$1,500	$3,000	$ 3,000
Obligations under capital lease and purchase agreements	754	904	904
	2,254	3,904	3,904
Less principal included in current liabilities	1,662	1,654	1,654
	592	2,250	2,250
Bank term loan, Toronto Dominion Bank, converted to equity (note 7)	—	—	159,100
	$ 592	$2,250	$161,350

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

1986	$1,662,000
1987	170,000
1988	155,000
1989	105,000
1990	105,000

The company has available an operating line of credit totalling $35,000,000 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 (see note 8).

7. Redeemable Preferred Shares Of Subsidiary Company

During the year, a wholly-owned subsidiary company created 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 1¾%. These preferred shares are redeemable as follows:

(i) 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.

(ii) 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 (see note 6). Events of default include among others:

(a) 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;

(b) A default which continues for a period of thirty days in the payment of 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:

15,400,000 class A subordinate voting shares without par value
4,600,000 class B common shares without par value
5,000,000 preference shares without par value

Share transactions during the year were as follows:

	Number			
	Class A	Class B	Total	Amount
Balance at beginning of year	6,131,357	668,111	6,799,468	$12,376,000
Issued for cash	2,100,008	688,992	2,789,000	19,000,000
Balance at end of year	8,231,365	1,357,103	9,588,468	$31,376,000

During the year, the company and its banker completed a recapitalization arrangement with effect from December 31, 1984. Under terms of the agreement, 2,100,008 and 688,992 class A and B common shares, respectively were issued for $19,000,000 with the proceeds used to reduce the term bank loan as of December 31, 1984. In addition, a wholly-owned subsidiary company issued $146,000,000 in preferred shares (see note 7). $140,100,000 of the proceeds were used to retire the balance of the term bank loan outstanding at December 31, 1984 and the balance of $5,900,000 was used to provide additional working capital.

The first 13⅓¢ per share per annum of any dividends 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, 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) 1,357,103 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.

9. Commitments and Contingent Liabilities

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

1986	$3,925,000
1987	3,227,000
1988	2,947,000
1989	2,457,000
1990	2,371,000

(ii) 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.

(iii) 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 $5,000,000 as at December 31, 1985. Whonnock is obligated to advance funds to repay the mortgage at $1,000,000 per year commencing in 1986. 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.

(iv) 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 $50,000,000 to cover cash deficiencies that may occur before July 1, 1990. Whonnock's share of the contingent liability is limited to a maximum of $10,000,000 to September 30, 1986 reducing to $5,000,000 thereafter 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.

10. Loss Per Share

The 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 loss per share before extraordinary item was $0.84 (1984 - $2.91). No fully diluted loss per share has been calculated arising from the possible conversion of Western Pulp Limited Partnership units because of the anti-dilutive effect of the loss applicable to common shares.

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 $2,069,000 (1984 - $1,889,000). The company has paid $5,707,000 (1984 - $4,752,000) for custom cutting services which includes all operating costs provided by the Bay Lumber Partnership, owned equally 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 $1,013,052 (1984 - $988,341).

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)	1985				1984
	Lumber and shakes	Chips and other by-products	Logs	Total	Total
Canada	$ 41,920	$ 11,732	$ 28,476	$ 82,128	$ 74,217
United States	72,566	4,594	—	77,160	65,026
Other export	71,436	—	29,597	101,033	100,686
	$185,922	$ 16,326	$ 58,073	$260,321	$239,929

Five Year Review

		1985	1984	1983	1982	1981
Production Statistics						
Lumber (million FBM)		**510**	508	641	529	415
Logs (thousand cubic metres)		**2,253**	1,820	2,250	2,130	1,725
Employee Statistics						
Wages, salaries.	($000)	**59,171**	57,106	65,503	58,929	42,829
Number of employees		**2,047**	2,089	2,081	1,895	1,835
Financial Statistics						
Sales	($000)	**260,321**	239,929	269,612	224,324	174,692
Stumpage	($000)	**9,984**	8,612	9,320	8,212	9,270
Income taxes (recovery)	($000)	**—**	(6,100)	(2,600)	(11,148)	(8,130)
Net income (loss)	($000)	**(6,860)**	(19,774)	4,746	(21,189)	(9,408)
Earnings (loss) per share*	$	**(.72)**	(2.91)	.70	(3.28)	(1.46)
Total assets	($000)	**216,914**	202,353	218,948	210,626	217,683
Ratio and Investment Information						
Current ratio		**1.7:1**	2.3:1	1.5:1	1.4:1	1.4:1
Equity per common share*	$	**3.23**	2.77	5.68	4.78	7.84
Share price range - high	$	**5.88**	10.75	12.00	9.00	16.75
- low	$	**3.10**	3.00	6.38	2.20	5.75
Re-Investment						
Working capital generated from (applied to) operations	($000)	**8,177**	(11,995)	11,932	(14,182)	(862)
Plant, equipment and roads	($000)	**16,692**	9,901	11,240	12,344	32,543
Working capital retained (provided from other sources)		**(8,515)**	(21,896)	692	(26,526)	(33,405)

*Stock dividends applied retroactively.

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J.C. Southcott
President and Chief Operating Officer

H.L. Henri
Vice-President

H. Kneteman
Vice-President and Secretary

R.M. Sitter
Vice-President, Forestry and Logging

R.W. Neil
Vice-President, Manufacturing

G.J. Friesen
Vice-President, Finance

Directors
H.L. Henri, Chase, B.C.
H. Kneteman, Vancouver, B.C.
T.E. Lougheed, Penticton, B.C.
R.A.C. McColl, Portland, Oregon
J.A. Milroy, Vancouver, B.C.
E.L. Sauder, Vancouver, B.C.
W.L. Sauder, Vancouver, B.C.
J.C. Southcott, Vancouver, B.C.

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HOLDING LUMBER COMPANY LIMITED 679-3234
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Chase, B.C. V0E 1N0

Logging Locations
Adams Lake
Bear Lake
Bute
Chamiss
Cleagh Creek
Drury Inlet
Grilse Creek
Hecate
Helilog Eclipse
Hope (3)
Kingcome Inlet
Kumealon
Kwatna
Malcolm Island
Moh Creek
Narrows Inlet
Pemberton
Porcher
Port Neville
Scott Cove
Taleomey
Whonnock

LITHO'D IN CANADA