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Annual Report **1986**



DOMAN INDUSTRIES LIMITED

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Contents

- 2** Corporate Profile
 - 3** Financial Highlights
 - 5** President's Report
to the Shareholders
 - 8** Reference Map
 - 9** Graphs
 - 11** Sawmills
 - 15** Lumber Marketing
 - 19** Truck Transport
 - 21** Silviculture and Forest Tenures
 - 23** Logging and Log Supply
 - 25** Progress
 - 27** Financial Reports
-

Corporate Profile

Doman Industries Limited

Incorporated under the Laws of British Columbia

Board of Directors

H. S. Doman, President and Chairman of the Board
Doman Industries Limited, Duncan, B.C.

J. Brouwer, Chairman, Brouwer Claims Canada
& Co. Ltd., Vancouver, B.C.

J. C. Davie, D.S.C., C.D., Barrister and Solicitor
Duncan, B.C.

J. R. Abercrombie, C.A., Vice-President
Doman Industries Limited, Duncan, B.C.

J. R. Frumento, Vice-President
Doman Industries Limited, Duncan, B.C.

Officers

H. S. Doman, President

J. R. Abercrombie, Treasurer, Vice-President
Finance and Administration

J. R. Frumento, Vice-President
Timber and Manufacturing

B. R. McCutcheon, Secretary

D. R. Williams, Q.C., Assistant Secretary

Head Office

435 Trunk Road
Duncan, B.C.
Canada V9L 2P9
Telephone (604) 748-3711

Transfer Agent and Registrar for Common Shares and Class B Non-Voting Shares

The Royal Trust Company, Vancouver, B.C. and
Toronto, Ontario

Stock Exchanges

Class A Common Shares—Toronto and Vancouver

Class B Non-Voting Shares, Series 2—Toronto
and Vancouver

Transfer Agent and Registrar for 10 ¼% Series A Debentures

The Canada Trust Company, Montreal, Toronto,
Winnipeg, Calgary and Vancouver

Bankers

The Royal Bank of Canada

Solicitors

Williams, Davie & Company
Duncan, B.C.

Auditors

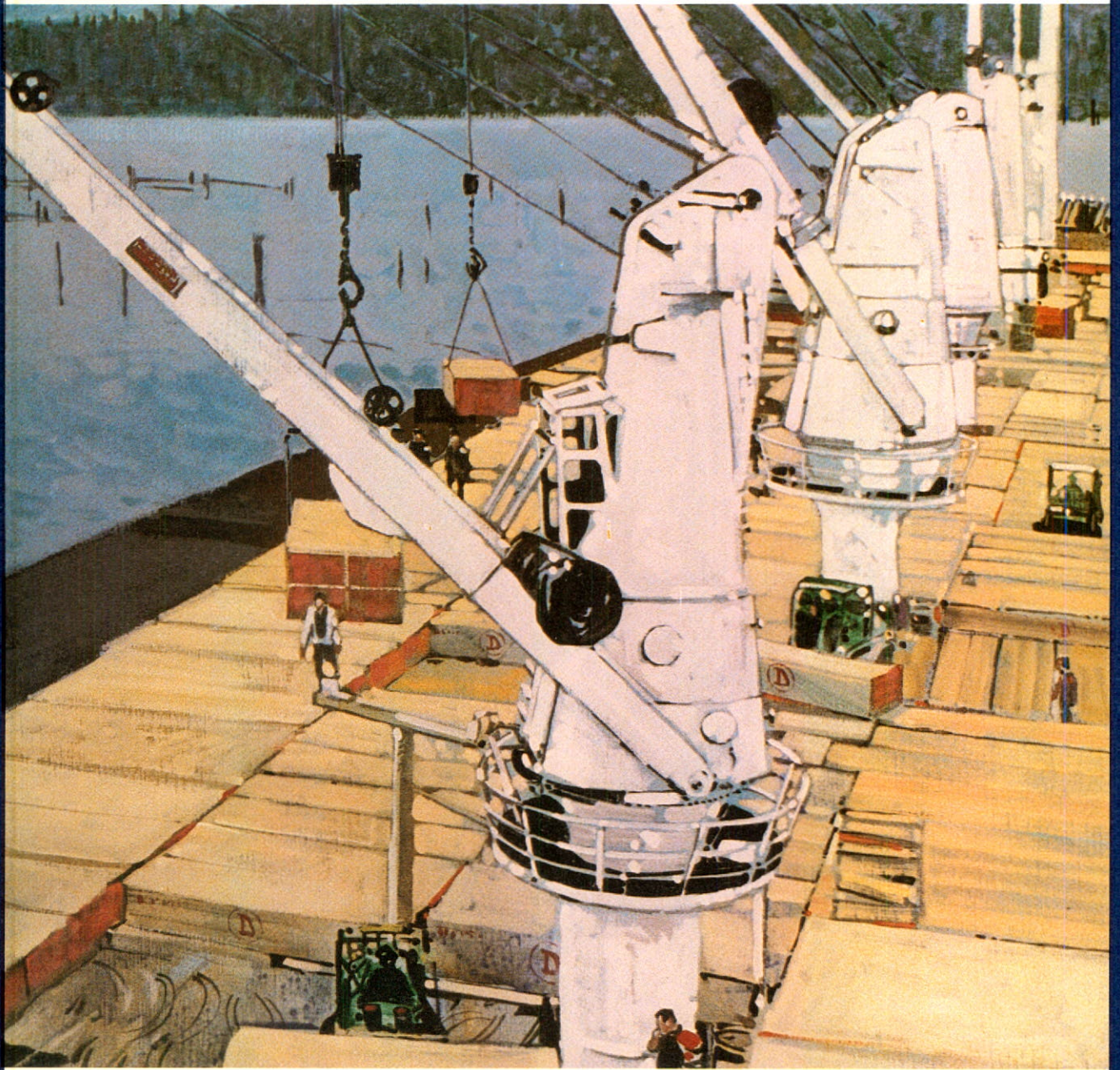
Deloitte Haskins & Sells, Vancouver, B.C.

Annual Meeting

The Annual General Meeting of the shareholders of
the Company will be held in Vancouver, B.C., at the Pan
Pacific Hotel on Thursday, April 30, 1987 at 10:00 a.m.

Financial Highlights

For the year ended December 31,	1986	1985	Increase
		(000's except where noted)	
Sales	\$271,103	\$205,943	\$65,160
Earnings before interest expense	41,652	20,468	21,184
Net earnings	22,473	5,134	17,339
Provision for Preferred Share dividends	3,342	2,920	422
Earnings available for Common and Non-Voting Shares	19,131	2,214	16,917
Per share, in dollars	1.19	.14	
Dividends on Common and Non-Voting Shares			
Per share, in dollars			
- cash	.06	—	
- stock, 2%	—	.04	
Cash from operations	36,517	8,707	27,810
Per share, in dollars	2.26	.56	
As at December 31,	1986	1985	Increase (Decrease)
		(000's)	
Total assets	\$186,877	\$197,010	\$(10,133)
Working capital	41,125	20,261	20,864
Long-term debt	91,154	91,626	(472)
Shareholders' equity and Preferred Shares of subsidiary	79,499	59,891	19,608



President's Report to the Shareholders



I am pleased to report to you on the 1986 operating results and on the outlook for 1987.

OPERATING RESULTS

In 1986 we achieved new records for sales, lumber production, log production, net earnings and cash from operations. The financial results for 1986 with 1985 in brackets were: Sales \$271 million (\$206 million), operating earnings before interest expense \$41.7 million (\$20.5 million), net earnings \$22.5 million (\$5.1 million) and cash from operations \$36.5 million (\$8.7 million). Lumber production for 1986 was 527 million board feet and log production was 625,000 cubic metres. After spending \$9 million on additions to property, plant and equipment we were also able to reduce current floating rate bank debt by \$22.4 million and to reduce long-term debt by \$358,000. At December 31, 1986 the Company's working capital was \$41.1 million, more than double the working capital of \$20.3 million at December 31, 1985. I am very pleased with these 1986 achievements.

When we were preparing our prospectus in February 1987, which I will refer to later in this report, I was asked to describe what Doman Industries Limited is all about. First and foremost, Domans directly employs 760 hardworking, highly motivated people who have been given the right equipment to do the job. This top-notch group of people do their jobs well. On behalf of myself and the Board of Directors I want to express our sincere appreciation to the people at Domans, some of whom, but unfortunately not all, have their photographs in this Annual Report.

Doman's business is market driven in the style of a trading company. The core of the business is five modern sawmills on British Columbia's west coast. Doman's plants have the capacity to produce an aggregate of 673 million board feet of lumber annually. Logging operations and a public trucking business complete the circle to support Doman's in-house lumber marketing organization which sells on a global basis. The Company produces, buys and sells both lumber and logs. It remanufactures lumber to attain added values. It also produces pulp chips and other sawmill by-products for delivery to British Columbia pulp mills including the Western Pulp Limited Partnership mill at Squamish. Doman's consolidated sales revenue has grown from \$131 million in 1982 to \$271 million in 1986, an average annual compounded growth rate of 20%.

COMPETITIVE POSITION

Domans is in a strong competitive position in world lumber markets. Its sawmills are well located to attract labour and raw material and have easy access to most major markets. The Company concentrates on both the trading and the production aspects of the business in order to react quickly to the changing demands of each lumber market. The lumber business is cyclical, with wide fluctuations in supply and demand within each cycle. Business volume and profit levels are influenced by economic conditions in the North American lumber market and in offshore lumber markets. Currency fluctuations play a major role. Currently, North American lumber producers are enjoying a significant currency advantage in offshore markets. Doman's competition includes lumber producers in British Columbia, the United States, Eastern Canada, the U.S.S.R. and Europe. The competitive position of Canadian lumber mills in relation to those in other countries is influenced by the availability and quality of raw material, the value of the Canadian dollar, and the Canadian experience in relation to others in respect to inflation, energy costs, plant efficiencies, labour costs and productivity. In general, the competitive

position of Canadian lumber producers is good. In turn, Domans is in a very strong competitive position in relation to other Canadian lumber producers.

RECENT DEVELOPMENTS IN THE INDUSTRY

On December 30, 1986 the Canadian and American governments entered into a lumber export agreement whereby the threatened 15% United States countervailing duty on Canadian softwood lumber imports into the United States was cancelled. This rescinded the October 16, 1986 preliminary ruling by the United States Department of Commerce and the effect was that no U.S. duty was paid in 1986. Commencing in 1987 the Canadian government will impose a 15% export charge on Canadian lumber exported to the United States. This export charge may be reduced if stumpage fees on timber from Crown lands is increased by the provinces. Domans currently sells approximately 61% of its lumber by value to United States customers, and will mitigate the Canadian government export charge by a number of steps including selling more lumber in other markets which we are particularly well positioned to do, by passing on the charges to customers in the United States to the extent possible, and by further increasing productivity at our sawmills.

HUMAN RESOURCES

At Domans we believe in and actively encourage communication both within and between departments and divisions. This dialogue is vital to the planning process and to the success of daily operations. The number of people directly employed by Domans has ranged between 750 and 760 in the past two years as compared to a 10-year high of 865 in 1981 and a low of 700 in 1984.

1986 was a contract bargaining year for the British Columbia forest industry with major contracts up for renewal on June 15, 1986. A new two-year agreement expiring June 15, 1988 was agreed with the International Woodworkers of America ("IWA") on December 5, 1986. The IWA represents most of the sawmill workers and loggers on the coast of British Columbia. During the negotiations much of the British Columbia forest industry was on strike. Doman's operations continued to work except that 10 production days were lost due to illegal picketing by non-Doman employees during these 1986 forest industry labour negotiations. In the period from 1980 to 1985 the Company experienced minimal work stoppages of less than 1 day per annum.

CLASS A COMMON AND CLASS B NON-VOTING SHARES

I have previously reported to you on the comprehensive "Coat-Tail" rights which attach to our Class B Non-Voting shares. For the benefit of new shareholders I would like to point out that our Class B Non-Voting shares rank equally with the Class A Common shares both as to dividends and return of capital. While in most circumstances the Class B shares do not vote, a "Coat-Tail" right is attached to the Class B shares to protect the Class B shareholders in the event of a takeover.

The contingent option which the Royal Bank of Canada held to acquire Class A Common shares is no longer in effect.

WESTERN PULP LIMITED PARTNERSHIP EXCHANGE PRIVILEGE

The exchange privilege for the Western Pulp Limited Partnership Units begins on April 1, 1987. Details are set out under note 7(c) to the Consolidated Financial Statements in this report. For purposes of the exchange privilege, the unit exchange value for the

twelve-month period beginning on April 1, 1987 is \$507.16, and if all of the unit holders were to exercise their option to exchange during this twelve-month period the Company would issue 2,479,449 Class B Non-Voting shares, series 2 at a pre-determined exchange price of \$7.50 per share.

1987 CLASS A CONVERTIBLE PREFERRED SHARE ISSUE

On February 20, 1987 the Company accepted the offer of Gordon Capital Corporation, Dominion Securities Inc. and Pemberton Houston Willoughby Bell Gouinlock Inc., to purchase from Doman Industries Limited, on a "bought deal" basis, \$25,000,000 of 7% convertible Class A preferred shares, series 2 of Doman Industries Limited, convertible into Class B Non-Voting shares of the Company. Doman Industries Limited has filed a preliminary prospectus with the securities authorities across Canada in order to qualify the shares for sale to the public. The estimated net proceeds of this issue are equivalent to 26% of Doman's long-term debt at December 31, 1986.

DIVIDENDS

In 1986 the Company met all outstanding cumulative preferred share dividend obligations which dated back to 1984. A 6 cent cash dividend was also paid on December 23, 1986 on Doman's Class A Common and Class B Non-Voting shares. On January 1, 1987 the regular semi-annual dividends were paid on the Company's preferred shares.

ELIGIBILITY FOR INVESTMENT

The Company understands that its Class A Common and Class B Non-Voting shares are currently, and the Class A Convertible Preferred Shares, Series 2 to be issued in 1987 under the proposed offer will be, eligible investments for financial institutions regulated under the Canadian and British Insurance Companies Act and certain other Federal and Provincial statutes in Canada.

OUTLOOK

The outlook for Doman Industries Limited is distinctly positive. We have a strong balance sheet, inventories are well balanced, and in 1986 there was no growth in accounts receivable even though 1986 sales increased 32% over 1985. Substantial debt reductions were made in 1986. The 1987 convertible preferred share issue will further strengthen the Company's financial position in 1987.

We expect world lumber markets will be strong in 1987. There is a ready supply of mortgage money at favourable interest rates to support the North American demand for housing. In offshore markets Canadian lumber producers have a currency advantage and there is a steady demand for our lumber. Pulp markets are also strong which improves our sales returns for pulp chips as these are indexed to pulp price levels.

Earnings and cash from operations will again be good in 1987.

Respectfully submitted,



Duncan, B.C.
March 1987

H. S. Doman
President and Chairman of the Board

Reference Map



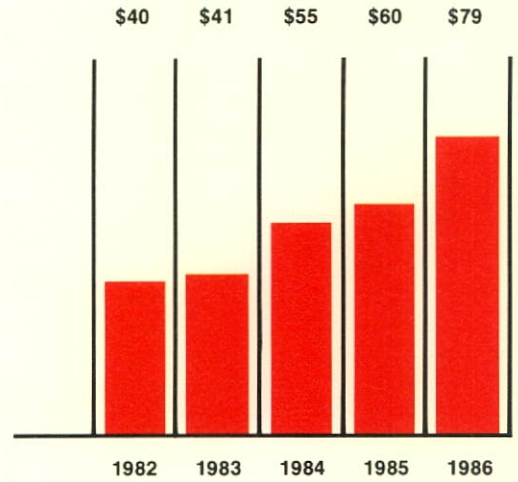
Annual Sales

MILLIONS OF DOLLARS



Shareholders' Equity and Preferred Shares of Subsidiary Company

MILLIONS OF DOLLARS

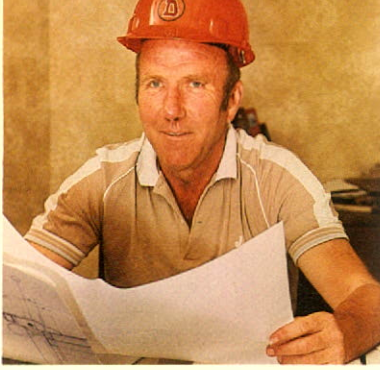


Lumber Production

MILLIONS OF BOARD FEET







Sawmills



Doman's modern high productivity sawmills have a combined lumber production capacity of 673 million board feet annually. Each plant has a separate planer mill which handles the sawmill's total production. At Doman's sawmills in Nanaimo and Chemainus there are secondary manufacturing facilities to process higher value lumber beyond the primary manufacturing stage.

In 1986 these five plants produced 527 million board feet of lumber operating at approximately 78% of capacity, up from 476 million board feet of lumber produced in 1985.

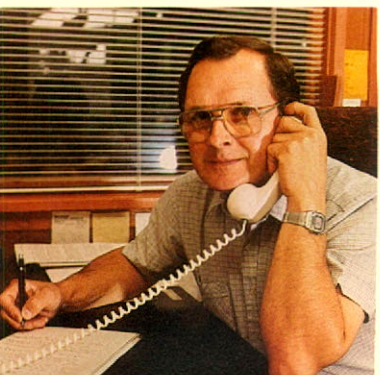
Lumber Production for the Year Ended December 31,

Sawmill	1986	1985	1984	1983	1982
	(millions of board feet)				
Nanaimo	141	141	114	115	106
Cowichan Bay	120	100	106	131	91
Ladysmith	134	111	113	100	96
New Westminster	90	84	76	32	31
Chemainus	42	40	21	19	11
	<u>527</u>	<u>476</u>	<u>430</u>	<u>397</u>	<u>335</u>



Doman's four sawmills on Vancouver Island are located at Nanaimo, Ladysmith, Chemainus and Cowichan Bay. Doman's fifth sawmill is at New Westminster, B.C. The mills are close to deep-sea docks and rail lines for export lumber shipments, and are close to the pulp mills which buy our pulp chips and other sawmill by-products. As each sawmill is designed to handle a specific type of log, logs are sorted to specification before being sent to the mills. Sawmill production, productivity and lumber recovery are all significantly enhanced by the delivery, on a consistent basis, of the appropriate logs to each mill.

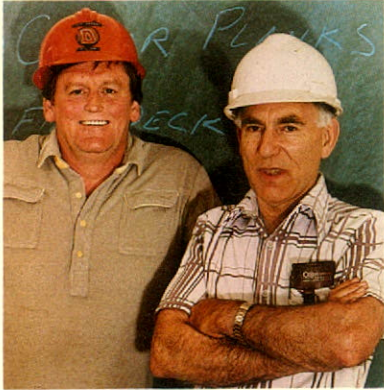
Our largest volume sawmill is located at Nanaimo. This plant cuts large diameter logs, and an attached remanufacturing plant processes selected lumber to attain a value added product. There are barge loading facilities at this Nanaimo site to handle waterborne shipments of sawmill by-products, which include pulp chips, sawdust and hog fuel, from our Vancouver Island sawmills.







Sawmills



The sawmill at Cowichan Bay processes small to medium sized logs and at the Ladysmith sawmill small logs are milled. In 1986, barge load-out facilities were added at the Ladysmith site to handle waterborne shipments of sawmill by-products. The plants at Cowichan Bay and at Ladysmith process large numbers of logs and consistently maintain a high lineal flow rate.

The sawmill located at Chemainus is our only mill which is not located on a navigable body of water. Its log supply comes from approximately 125 small wood lot operators who deliver logs to the mill yard by truck. A lumber remanufacturing plant at Chemainus permits lumber to be upgraded without interfering with the sawmill's rate of production. The Chemainus sawmill cuts medium to large diameter logs, and the New Westminster sawmill cuts small to medium diameter logs. The New Westminster site is well located for rail shipments and has barge load-out facilities for lumber and for sawmill by-products.



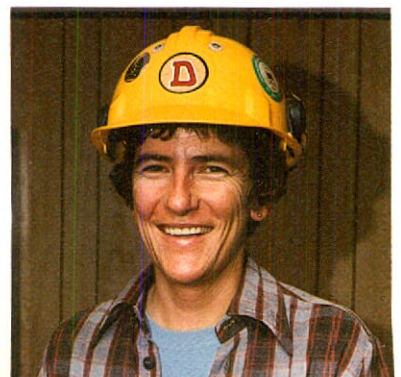
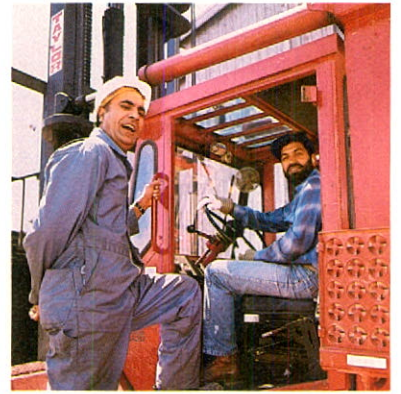
Transportation costs for lumber are minimized due to the proximity of our plants to deep-water loading facilities. Distances by road from the plants to deep-water docks are: Nanaimo and Cowichan Bay—1 mile; Ladysmith and Chemainus—12 miles. The New Westminster plant is 20 miles by barge to deep-water docks.

Chips and other sawmill by-products are moved either by barge from Doman's loading facilities at Nanaimo, Ladysmith and New Westminster, or by truck transport from the sawmills directly to pulp mills at Nanaimo and Crofton on Vancouver Island.



Sawmills

The sawmills are all modern plants. The Nanaimo plant came into production in 1980, the Cowichan Bay plant in 1975 and the Chemainus plant in 1973. The Ladysmith plant, which was built in 1966, has been modernized through regular annual capital expenditures. The New Westminster plant, leased by Doman in 1981, was modernized in 1983. Our policy is to maintain and upgrade all mills on a continuing basis. During the five-year period 1982 through 1986, approximately \$12,714,000 was spent on capital improvements and modernization of existing plant and equipment. Due to the quality of our plants, as well as that of Doman's employees, we achieve productivity levels which we believe are far better than the average for lumber plants in British Columbia. The average productivity for Doman's plants was 496 board feet of lumber ("FBM") per man hour in 1986, 379 FBM per man hour in 1985 and 391 FBM per man hour in 1984. Published figures for the British Columbia industry show 316.8 FBM of lumber per man hour as the industry average in 1984.





Lumber Marketing



The market for lumber is highly sensitive to price, quality, on-time delivery and continuity of supply. Doman's expertise in adapting to the requirements of the marketplace has been responsible for an average compounded annual growth rate in lumber sales of 31% over the last four years.

	<u>1986</u>	<u>1985</u>	<u>1984</u>	<u>1983</u>	<u>1982</u>
			(000's)		
Lumber sales	<u>\$204,995</u>	<u>\$150,250</u>	<u>\$124,186</u>	<u>\$114,583</u>	<u>\$ 69,583</u>



Lumber sales are handled by our sales groups in Duncan and Vancouver. Sales to Canadian customers are delivered by the Company's trucking fleet or by rail. Most Doman lumber shipments originate from deep-sea docks at Nanaimo and Cowichan Bay on Vancouver Island and in the case of Canadian sales, may originate from our sawmills or from the Company's wholesale assembly yards on Vancouver Island and the B.C. Mainland. Deliveries to offshore points and to the U.S. east coast are by deep-sea vessel while California deliveries are made by barge.



On October 16, 1986, in response to a petition submitted by the Coalition for Fair Lumber Imports, the United States Department of Commerce, in a preliminary ruling, imposed a temporary 15% countervailing duty on substantially all Canadian softwood lumber imports into the United States. On December 30, 1986 the Canadian and American governments entered into a Lumber Export Agreement whereby the Canadian government agreed to impose an export charge on Canadian softwood lumber exported to the United States equal to 15% of the value of such products and the United States agreed that the October 16, 1986 preliminary ruling would be of no force and effect and agreed to release any bonds posted or refund any amounts collected pursuant to the preliminary ruling for the period ended December 30, 1986. Simultaneously, the Coalition for Fair Lumber Imports withdrew its petition for a permanent countervailing duty on Canadian softwood lumber exported to the United States.



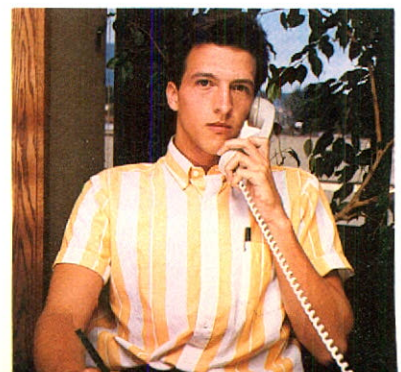
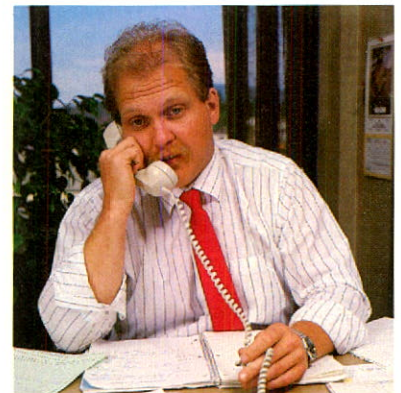
The Lumber Export Agreement provides that the 15% Canadian export charge may be reduced to the extent that applicable provincial stumpage fees and other charges on the harvesting of softwood timber from Crown lands are increased. The extent to which any increase in such provincial fees and

Lumber Marketing

charges will result in a decrease to the import charge is subject to further consultation and agreement between the government of Canada and the United States. The Company currently sells approximately 61% of its lumber by value to United States customers, and in 1987 will work to limit the effect of the export charge by selling more of its lumber in markets other than the United States, by passing on the charge to customers in the United States to the extent possible and by further increasing productivity at its sawmills.

Lumber markets were stronger in 1986 than in 1985 due to falling interest rates, a good supply of money for house mortgages in North America and, in offshore markets, a realignment of currencies against North American currencies which increased the purchasing power of Europeans and Japanese in North America. North American lumber markets were directly affected by the British Columbia Coast lumber strike in 1986 and by the uncertainty which surrounded the U.S. lumber market in the last quarter of 1986 until the threat of a U.S. tariff on Canadian lumber was lifted on December 30, 1986.

The outlook for 1987 lumber markets is good. There is a good supply of mortgage money at affordable rates to support North American lumber demand. In offshore markets we have a currency advantage which translates into increased purchasing power for our offshore customers. This is particularly important because these offshore customers are the principal buyers of high quality lumber. Approximately 30% of the lumber produced at the Company's Nanaimo sawmill is high quality lumber made up of clear lumber and shop or factory grades. A sales return of 3 to 4 times that realized on the sale of dimension lumber is enjoyed on this high quality lumber.









Truck Transport



The truck transport division of Doman's conducts a public freight business mainly in British Columbia. Operations extend into Alberta and into the eleven most westerly U.S. states. Through inter-line facilities with other carriers our truck transport can reach into every state in the United States. The division owns 60 tractors and 150 trailers. In addition to Company equipment a large number of driver-owners work for the Company on a contract basis. The entire fleet operates out of dispatch and repair facilities at Richmond on the British Columbia mainland and at Duncan on Vancouver Island. Extensive use is made of computer assisted job quotation, trip routing and equipment allocation programs.

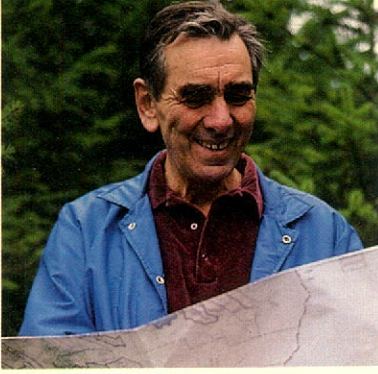


Domans successfully competes with major trucking companies by staying in the trailer load lot business, rather than participating in the labour intensive LTL or less than trailer load lot business. The Company has moved steadily to acquire a fleet of double trailers with vastly increased pay loads over those handled by conventional trailers. There has been significant growth in the use of contractors in order to keep our truck transport rates competitive.

The truck transport business is extremely competitive. Doman's employees have met the challenge, co-operating with the Company in introducing new techniques and equipment. The truck transport division of Domans is meeting the challenge of the competition through co-operation at every level both to control costs and to provide service to customers. Its business as a licensed public carrier in British Columbia, Alberta and the eleven western U.S. states complements the business of trucking lumber and sawmill by-products from Doman's five sawmills. The ability to control our own truck transport is a contributing factor to the success of the Company.







Silviculture and Forest Tenures



Doman's have met all Provincial Forest Service tree planting and restocking requirements. Tree planting usually occurs one to three years after logging, and replanted areas generally contain merchantable timber approximately 60 years after replanting.



The Province of British Columbia owns approximately 95% of all timber lands in British Columbia and regulates forestry operations on these lands under the Forest Act. The act empowers the Ministry of Forests and Lands to grant timber tenures including Forest Licences and Tree Farm Licences. A Forest Licence grants the right to cut a specific volume of timber on public lands in a managed forest area called a Timber Supply Area. A Forest Licence has a term of 15 years and is renewable every five years for a further 15-year term subject to satisfactory performance by the licensee as determined by the Ministry of Forests and Lands. A Tree Farm Licence is granted to a licensee who undertakes to manage an area of timber land to yield an annual harvest on a sustained basis sufficient to support the manufacturing facilities of the licensee. A Tree Farm Licence is for a term of 25 years and is renewable every ten years for a further 25-year term subject to satisfactory performance. Under Tree Farm Licences and Forest Licences an allowable annual cut ("AAC") is determined by the Ministry of Forests and Lands. The cut in any one year may vary up to 50% above or below the AAC, as long as the average annual cut over a five-year period is within 10% of the specified AAC for that period.



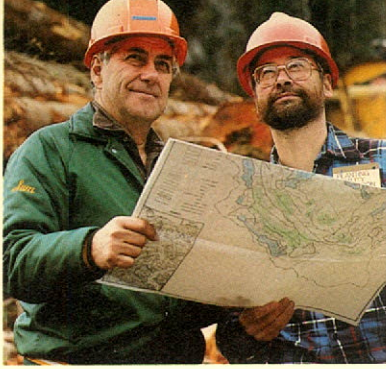
Doman's logging operations are based on three Forest Licences on the coast of British Columbia with an aggregate AAC of approximately 600,000 cubic metres and current 15 Year tenures expiring in 1997. In addition, Doman receives approximately 700,000 cubic metres of logs annually under a long-term contract with Western Forest Products Limited, ("WFP"). The WFP logging operations are based on three Tree Farm Licences with an AAC of approximately 2,500,000 cubic metres, consisting largely of high grade hemlock. WFP also has an allowable annual cut of approximately 100,000 cubic metres from other tenures and from 16,000 hectares of WFP owned timberlands. These licences contain approximately 45 years' supply, at current rates of use, of old growth timber.

The photographs on this page depict part of Doman's silviculture program, from the planning stage through planting and restocking of logged-over lands, to the strong healthy second growth stands on Doman's Forest Licence areas.





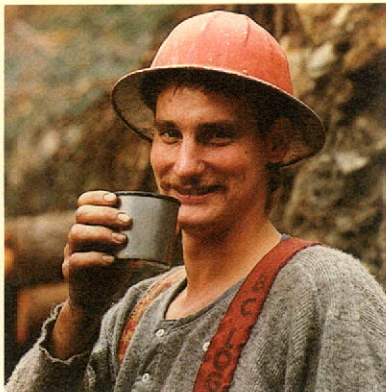
Robert Genn



Logging and Log Supply



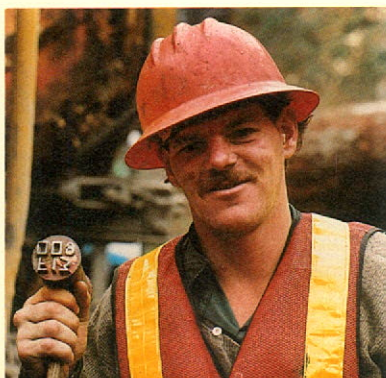
Doman's logging operations are on the coast of British Columbia at Jervis Inlet, Nootka Island, Rivers Inlet and Kimsquit River. A fifth logging operation is being developed at the Wash Wash, see map on page 8. Logging is based on government timber allocated to the Company under Forest Licences. These licences provide an allowable annual cut based on the principle of a sustained yield for the logging operations within each Timber Supply Area. Authority to cut is given by the Ministry of Forests and Lands which issues the necessary cutting permits. Logs are transported to the mills from the northern areas by self dumping log barges. In the more protected southern waters logs are moved to the mills in bundle booms and flat rafts.

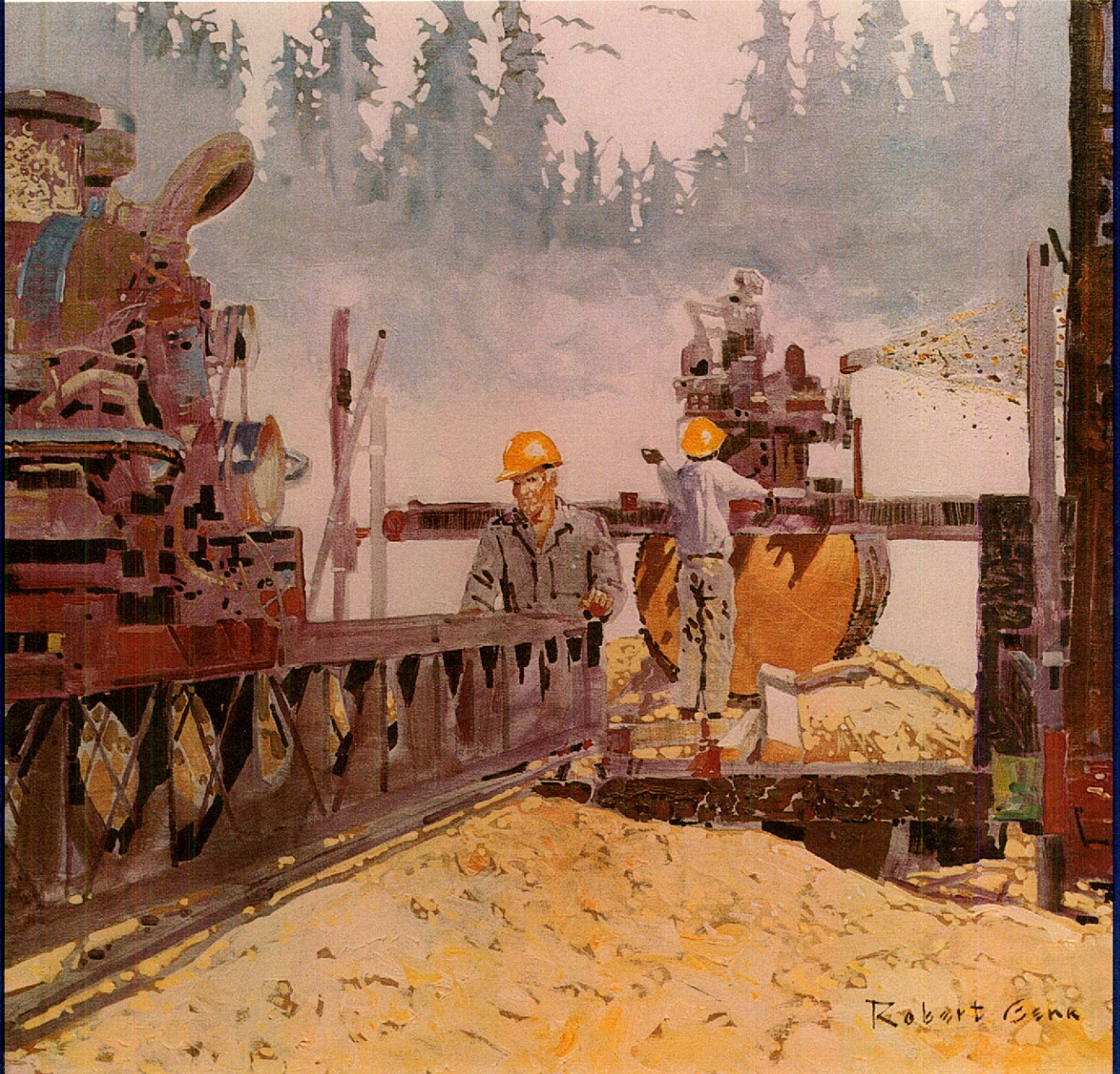


The Company holds three Forest Licences. The timber covered by these Forest Licences contains a high percentage of "old growth" stands. Old growth timber is located in areas which have never been commercially harvested and is often referred to as virgin growth. It is particularly valuable because it can produce a large percentage of lumber which is clear of knots. This clear lumber commands high selling prices and is sought after for high quality panelling, door and window frames. Lumber produced from virgin growth from British Columbia's west coast is recognized internationally for its good quality.



Through Company logging based on the Forest Licences we are able to supply logs to the Doman sawmills at or below the prevailing market prices for comparable logs. The balance of the timber required by Domans is obtained by our log trading department from a number of sources including logs acquired under long-term supply contracts and purchases from approximately 95 suppliers on the British Columbia coast and from approximately 125 suppliers on Vancouver Island. Doman's log trading activities have enabled the Company to limit its investment in logging relative to the size of its production facilities. Log trading activities have also provided us with the flexibility to react quickly to adjust lumber production to meet the demands of the lumber market at any given time. In 1986 Doman's log requirements for its sawmills was approximately 2,200,000 cubic metres; Doman's logging operations provided approximately 625,000 cubic metres, long-term log supply contracts provided approximately 900,000 cubic metres and log trading activities provided the balance of Doman's log supply requirements.

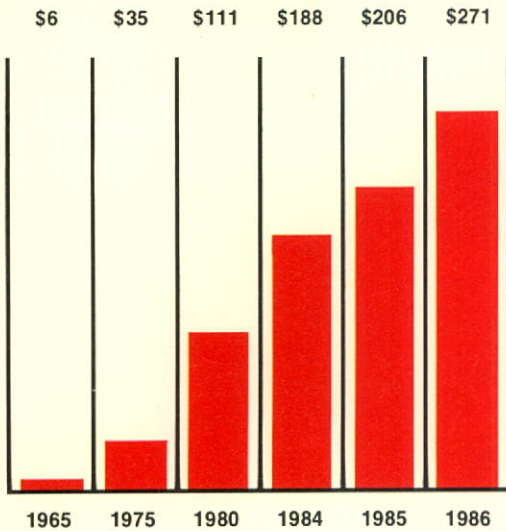




Robert Gena

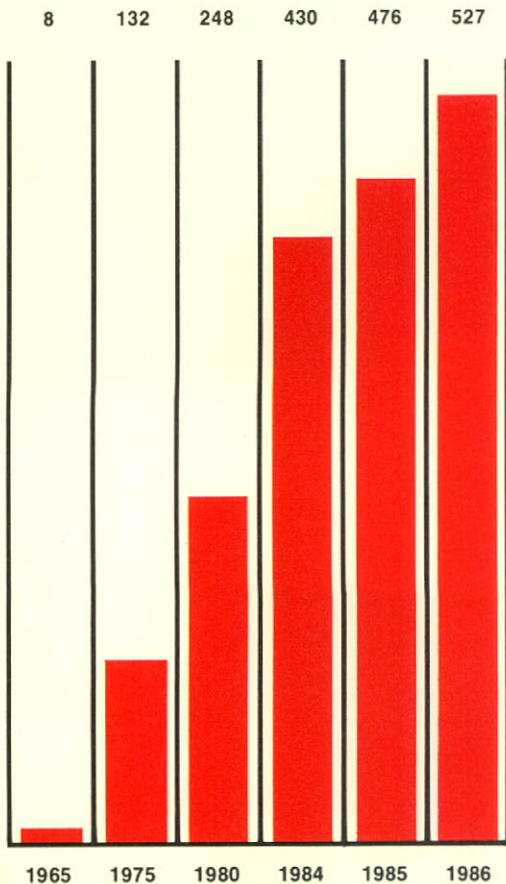
Sales

MILLIONS OF DOLLARS



Lumber Production

MILLIONS OF BOARD FEET



Progress

Domans commenced operating in 1955 as a trucking business in British Columbia.

1965

Doman Industries Limited became a Public Company in 1965 at which time its business included four building supply yards, the trucking business and two very small sawmill operations.

1975

Lumber manufacturing had become the growth area based on four sawmills. Logging which started in 1969 was expanding.

1980

Four operating sawmills with the fifth plant coming into production in December 1980; four logging shows; five building supply outlets, all in British Columbia and a truck transport fleet operating in British Columbia, Washington and Oregon. An interest in Western Forest Products Limited was acquired in late 1980.

1984

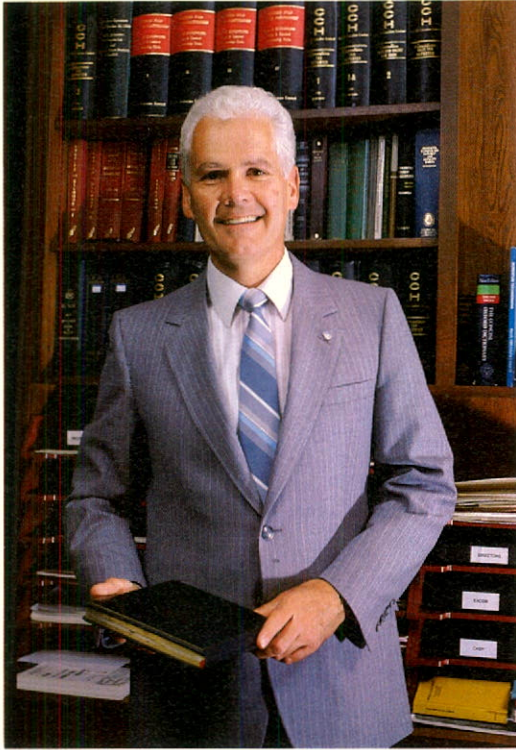
Five sawmills operated at 74% of their then 580 million board feet aggregate annual lumber production capacity. This level of lumber production was assisted by the Company's logging, truck transport, and lumber marketing divisions. The building supply yards were replaced in 1984 by lumber wholesale operations and the truck transport division now operated in B.C., Alberta and the eleven western U.S. states.

1985

In 1985 there was a \$17.7 million year over year improvement in net earnings and a \$15.2 million year over year improvement in cash from operations. Highly mechanized sawmills staffed by well trained people allowed the Company to increase lumber production and to take advantage of improved lumber prices. The sawmills operated at 82% of their then 580 million board feet capacity, again supported by the other divisions of the Company.

1986

1986 net earnings were \$22.5 million with 1986 cash from operations of \$36.5 million. Lumber production was 527 million board feet and by year end lumber production capacity had increased to an aggregate of 673 million board feet annually for Doman's five modern sawmills.



FINANCIAL REPORTS

Consolidated Financial Statements

Earnings and Deficit

For the years ended December 31,	1986	1985
		(000's)
Sales of products, merchandise and services	\$ 271,103	\$ 205,943
Costs and expenses		
Cost of goods sold	212,940	172,521
Selling and administration	8,272	7,099
Depreciation	4,265	4,098
Depletion of timber and amortization of roads	3,974	1,757
	229,451	185,475
Operating earnings before interest expense	41,652	20,468
Interest expense (note 12(c))	15,524	16,696
Operating earnings	26,128	3,772
Equity in operating earnings of joint venture companies	167	368
Earnings before income taxes and extraordinary items	26,295	4,140
Income taxes (recovery) (note 8)		
Current	8,169	3,472
Deferred	4,116	(1,664)
	12,285	1,808
Earnings before extraordinary items	14,010	2,332
Extraordinary items (note 9)	8,463	2,802
Net Earnings	\$ 22,473	\$ 5,134
		(Dollars)
Basic Earnings (Loss) Per Share (note 10)		
Earnings (loss) before extraordinary items		
• Before preferred dividends	\$.87	\$.15
• Provision for preferred dividends	(.21)	(.19)
• After provision for preferred dividends	.66	(.04)
Extraordinary items	.53	.18
Net earnings	\$ 1.19	\$.14
		(000's)
Deficit, Beginning of Year	\$ 13,722	\$ 18,246
Net earnings	22,473	5,134
Dividends (note 7(d))	8,751	13,112
	10,820	610
Deficit, End of Year	\$ 2,069	\$ 13,722

Changes in Financial Position

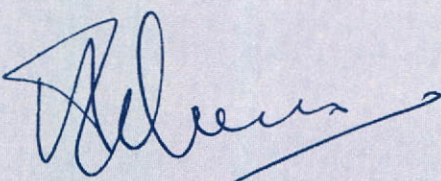
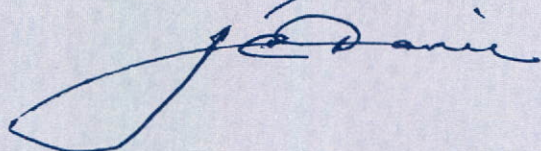
For the years ended December 31,	1986	1985
		(000's)
Operating Activities		
Net earnings	\$ 22,473	\$ 5,134
Add (deduct) items not involving cash:		
Depreciation and amortization of property, plant and equipment	8,239	5,855
Other amortization	1,431	1,431
Equity in operating earnings of joint venture companies	(167)	(368)
Deferred income taxes	4,116	(1,664)
Extraordinary items	(294)	670
Working capital provided by operations	35,798	11,058
Net decrease (increase) in non-cash operating items*	719	(2,351)
Funds provided by operating activities (\$2.26 per share in 1986 and \$.56 per share in 1985)	36,517	8,707
Financing Activities		
Proceeds from long-term debt	1,400	114
Reduction of long-term debt	(1,758)	(24)
Cash dividends on common and non-voting shares	(1,040)	—
Funds (used in) provided by financing activities	(1,398)	90
Investing Activities		
Additions to property, plant and equipment	(9,030)	(6,209)
Increase in investments	(2,763)	(1,033)
Disposals of property, plant and equipment	196	213
Funds (used in) investing activities	(11,597)	(7,029)
Decrease in Current Bank Indebtedness (Current Bank Indebtedness), Beginning of Year	23,522 (22,374)	1,768 (24,142)
Cash (Current Bank Indebtedness), End of Year	\$ 1,148	\$ (22,374)
Changes in Working Capital Items		
Net increase or decrease in current financing items (cash, current bank indebtedness, preferred share dividends payable and principal due within one year on long-term debt)	\$ 21,583	\$ 1,764
* Net increase (decrease) in non-cash operating items (accounts receivable, inventories, prepaid expenses and accounts payable and accrued liabilities)	(719)	2,351
Increase in Working Capital	20,864	4,115
Working Capital, Beginning of Year	20,261	16,146
Working Capital, End of Year	\$ 41,125	\$ 20,261

Consolidated Balance Sheet

Assets

As at December 31,	1986	1985
		(000's)
Current Assets		
Cash	\$ 1,148	\$ —
Accounts receivable	14,866	14,865
Inventories (note 2)	39,781	49,251
Prepaid expenses	1,554	1,638
	57,349	65,754
Investments (note 3)	62,807	60,603
Property, Plant and Equipment		
Land, buildings, machinery and equipment (note 4)	76,774	74,420
Less accumulated depreciation	30,671	27,125
	46,103	47,295
Timber holdings and logging roads, less accumulated depletion and amortization	11,877	10,090
	57,980	57,385
Deferred Income Taxes	6,170	10,286
Deferred Costs , less amortization	2,571	2,982
	\$ 186,877	\$ 197,010

On behalf of the Board:


 DIRECTOR

 DIRECTOR

Liabilities and Shareholders' Equity

As at December 31,	1986	1985
		(000's)
Current Liabilities		
Bank indebtedness (note 5)	\$ —	\$ 22,374
Accounts payable and accrued liabilities	14,261	23,095
Preferred share dividends payable	1,825	—
Principal due within one year on long-term debt	138	24
	16,224	45,493
Long-Term Debt (note 5)	91,154	91,626
Preferred Shares of Subsidiary Company (note 6)	18,000	18,000
Shareholders' Equity		
Share capital (note 7(a))	68,786	60,831
Deficit (note 6)	(2,069)	(13,722)
	66,717	47,109
Shares held by subsidiary company (note 6)	(5,218)	(5,218)
	61,499	41,891
	\$ 186,877	\$ 197,010

Auditors' Report

To the Shareholders of Doman Industries Limited:

We have examined the consolidated balance sheet of Doman Industries Limited as at December 31, 1986 and the consolidated statements of 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, 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 6, 1987, except as to
Notes 11(d) and 13 which
are as of February 20, 1987

Deloitte Haskins & Sells
Chartered Accountants

Notes to the Financial Statements

December 31, 1986

1. Significant Accounting Policies

(a) Basis of Consolidation

The consolidated financial statements include the accounts of Doman Industries Limited (the "Company") and all of its subsidiaries (individually and collectively referred to as "Doman").

(b) Inventories

Inventories are valued at the lower of cost and net realizable value.

(c) Investments

Investments in joint venture companies are accounted for using the equity method whereby Doman's share of their earnings and losses is included in earnings and its investments therein adjusted by a like amount. Dividends received are credited to the investment accounts.

The investment in Western Forest Products Limited ("WFP") and other investments are accounted for using the cost method whereby dividends are included in earnings when received. The investment in WFP includes capitalized interest on funds borrowed for the acquisition which is being amortized to earnings on a straight-line basis to 1989.

(d) Property, Plant and Equipment

Property, plant and equipment are stated at cost including interest capitalized during construction of major projects. Depreciation is charged to earnings on a straight-line basis for the period of operations at rates based on the estimated useful lives of between 5 to 10 years for automotive equipment, 10 to 15 years for other equipment and 20 to 25 years for buildings. Costs of timber holdings and logging roads are charged to earnings on the basis of timber removed.

(e) Deferred Costs

Deferred costs, consisting principally of a financing fee related to a debt restructuring, are being amortized to earnings on a straight-line basis to 1994.

(f) Income Taxes

Doman uses the tax allocation method of accounting for income taxes whereby differences between the provision for income taxes on earnings for accounting purposes and the income taxes currently payable are shown as deferred income taxes.

2. Inventories

	1986	1985
		(000's)
Logs	\$ 21,912	\$ 21,348
Lumber	13,419	25,524
Supplies and other	4,450	2,379
	\$ 39,781	\$ 49,251

3. Investments

	1986	1985
		(000's)
Western Forest Products Limited	\$ 55,983	\$ 56,536
Joint venture companies	3,882	1,809
Western Pulp Limited Partnership (note 11(b))	1,400	—
Other investments	1,542	2,258
	\$ 62,807	\$ 60,603

The investment in WFP, representing a 19½% voting interest, is carried at cost less equity in losses to January 31, 1982, at which time Doman ceased to have significant influence over the affairs of WFP. Financial information of WFP as at October 31, 1986 is set out below.

	1986	1985
		(000's)
Condensed Balance Sheet October 31,		
Assets		
Current assets	\$ 28,787	\$ 34,434
Investment in Western Pulp Limited Partnership	191,199	188,696
Investment in oil and gas properties	35,352	—
Property, plant and equipment	216,033	223,376
Other assets	57,986	57,303
	\$ 529,357	\$ 503,809
Liabilities		
Current liabilities	\$ 6,720	\$ 16,150
Bank term loan	195,000	195,000
Bank oil and gas loan	31,273	—
Other liabilities	4,867	2,063
	237,860	213,213
Shareholders' Equity	291,497	290,596
	\$ 529,357	\$ 503,809

For the year ended October 31, 1986, WFP had earnings of \$1,766,000 (losses of \$5,855,000 in 1985 and \$10,323,000 in 1984) on sales of \$121,011,000 (1985 - \$130,929,000; 1984 - \$148,754,000).

In 1983, the Western Pulp Limited Partnership (the "Partnership") issued units to the public for aggregate net proceeds of approximately \$100,600,000 which, together with a bank term loan of \$150,000,000, were used to modernize two pulp mills acquired by the Partnership from WFP. WFP's investment in the Partnership consists principally of amounts owing by the Partnership for the purchase of the two pulp mills. WFP has an option to convert its investment into a 60.1% interest in the Partnership.

Doman has not guaranteed any bank loans or other indebtedness of WFP. Management of the Company has carefully considered the underlying values of WFP's assets, principally its timber rights and the investment in the Partnership, as well as the outlook for WFP's future operations, and is of the opinion that there has been no permanent decline in the value of Doman's investment in WFP.

Notes continued

4. Land, Buildings, Machinery and Equipment

	1986	1985
		(000's)
Land	\$ 3,413	\$ 3,429
Buildings	16,785	17,102
Machinery and equipment	56,576	53,889
	76,774	74,420
Less accumulated depreciation	30,671	27,125
	\$ 46,103	\$ 47,295

5. Long-term Debt

	1986	1985
		(000's)
Sinking Fund Debentures, Series A 10¼% maturing in 1997, retractable at the option of the holder in 1987	\$ 16,407	\$ 16,928
Bank term loan maturing in 1989	10,823	12,000
Bank term loan maturing in 1990 (note 11(b))	1,400	—
Bank capital loan maturing in 1994	42,000	42,000
Bank capital loan maturing in 1995	20,000	20,000
Other	662	722
	91,292	91,650
Principal amount included in current liabilities	138	24
	\$ 91,154	\$ 91,626

The Sinking Fund Debentures, Series A (the "Debentures") are secured by fixed and floating charges on certain assets of Doman. The trust agreement relating to the Debentures requires the Company to establish sinking funds to retire, in each of the years 1988 to 1996, 5% of the principal balance of the Debentures outstanding on December 15, 1987.

The \$42,000,000 bank capital loan bears interest at 12.1%. All other bank capital and term loans bear interest at the Royal Bank prime rate plus 1%. At Doman's option, the rate for the \$10,823,000 term loan and the \$20,000,000 capital loan may be fixed for varying periods at rates based on the bank's U.S. base rate, London Interbank offered rates or Bankers' Acceptances.

The bank loans, including the current bank indebtedness, are secured by the shares of WFP owned by Doman, an assignment of accounts receivable, inventories and the advances to the Partnership, and, subject to the prior charges of the Debentures, fixed and floating charges on the assets of Doman.

5. Long-term Debt (cont'd)

Long-term debt maturing in the next five years, including estimated sinking fund payments, is as follows:

	(000's)
1987	\$ 138
1988	1,370
1989	21,129
1990	10,846
1991	10,846

6. Preferred Shares of Subsidiary Company

The preferred shares of a subsidiary company were issued to The Royal Bank of Canada pursuant to a debt restructuring. No dividends are payable on these preferred shares, which are redeemable by the subsidiary company not later than December 31, 1987 at the issue price of \$1,000 per share plus a premium (the "Redemption Amount"). The premium increases at a rate of 14¼% per annum, and is payable either in cash or by the assignment of shares of the Company owned by the subsidiary company, to a maximum of 1,528,000 Class B non-voting shares, series 2 and 1,188,444 Class C non-voting shares, reduced proportionately by any cash payments. By agreement, the number of shares to be assigned in payment of the redemption premium is limited to the Royal Bank acquiring, on a fully diluted basis, not more than 25% of either of the Class A common shares or the Class B non-voting shares of the Company then outstanding after the assignment. The preferred shares are also retractable in certain circumstances at the option of the holder at the Redemption Amount, which at December 31, 1986 was \$1,320.63 per share.

The subsidiary company's obligations to redeem these preferred shares and to pay the premium thereon are supported by a debenture securing a \$42,000,000 bank capital loan and by a pledge of its investments in 1,528,000 Class B non-voting shares, series 2 and 1,188,444 Class C non-voting shares of the Company.

The payment of the premium at December 31, 1987 in cash or by the assignment of the shares discussed above, will depend on a number of factors, including the financial requirements of Doman at that time, and the amount of after-tax proceeds that could be realized on a sale or partial sale of those shares. However, should the premium be paid entirely by the assignment of the shares, the effect on total shareholders' equity would be limited to the amount of income taxes, if any, payable or recoverable by the subsidiary company as a result of the assignment.

Notes continued

7. Share Capital

(a) Authorized and Issued Share Capital

Authorized shares (without par value)		1986	1985
		(000's)	
5,000,000	Class A preferred		
100,000	Class B preferred		
25,000,000	Class A common		
60,000,000	Class B non-voting		
4,000,000	Class C non-voting		
Issued shares			
40,000	Class A preferred, series 1	\$ 40,000	\$ 40,000
8,616	Class B preferred	8,616	8,616
		48,616	48,616
6,713,555	Class A common	1,115	1,118
—	Class B non-voting, series 1	—	3,703
10,620,279	Class B non-voting, series 2	13,837	2,176
* 1,582,328	Class B non-voting, series 2	2,782	2,782
* 1,188,444	Class C non-voting	2,436	2,436
		20,170	12,215
		\$ 68,786	\$ 60,831

* Held by a subsidiary company (note 6)

During the year, 1,767,721 Class B non-voting shares, series 2 were issued pursuant to a stock dividend of \$7,955,000 on the outstanding Class A preferred shares. In addition, 1,516,366 Class B non-voting shares, series 2 were issued during the year on conversion of 20,008 Class A common shares and 1,496,358 Class B non-voting shares, series 1.

(b) Rights of Classes of Issued Shares

The Class A preferred shares, series 1 have a cumulative annual dividend rate of one-half of the Royal Bank prime rate plus 2%, to a maximum of 10%, payable semi-annually, with no compounding where dividends are not declared and paid. These shares are retractable at any time at the option of the holder at the issue price of \$1,000 per share plus any accrued and unpaid dividends (the "Redemption Price") payable six months after notice by the holder and are redeemable by the Company not later than December 15, 1987 at the Redemption Price.

The Class B preferred shares have a cumulative annual dividend rate of 10% which commenced on July 1, 1986, payable semi-annually, with no compounding where dividends are not declared and paid. These shares are redeemable by the Company at any time at the issue price of \$1,000 per share plus any accrued and unpaid dividends.

The Class B non-voting shares and the Class C non-voting shares have the same rights as the Class A common shares except as to voting and conversion rights. The Class A common shares are convertible at the option of the holder into Class B non-

7. Share Capital (cont'd)

voting shares, series 2, and the Class C non-voting shares are convertible at the option of the holder into Class A common shares, on a share-for-share basis. The Class B non-voting shares, series 2 are not convertible into any other class of shares. However, in the case of an offer to purchase made to the holders of all or substantially all (as defined) of the outstanding Class A common shares, each Class B non-voting share, series 2 shall, in certain circumstances both for purposes of the offer and thereafter if taken up under the offer, be deemed to be a Class A common share.

(c) Commitments to Issue Shares

The Company has reserved an adequate number of authorized and unissued shares to satisfy the conversion rights attached to each class of shares as outlined in (b) above and to satisfy the following commitments:

- (i) The Company has granted options to certain officers to purchase a total of 40,000 Class A common shares and 40,000 Class B non-voting shares, series 2 at \$3.88 per share. These options expire in 1990.
- (ii) The Company may be required to issue up to a maximum of 4,888,889 Class B non-voting shares, series 2 in connection with an exchange privilege with respect to the outstanding units of the Partnership which were sold to the public (note 3). However, if all of the holders of the units exercise their exchange privilege during the twelve months ending March 31, 1988, the Company would be required to issue an aggregate of 2,479,449 Class B non-voting shares, series 2 rather than the maximum of 4,888,889 shares.

(d) Dividends

Dividends on the various classes of shares were as follows:

	1986	1985
		(000's)
Class A preferred shares	\$ 9,346	\$ —
Class B preferred shares	434	—
Common and non-voting shares	1,040	610
	\$ 10,820	\$ 610

Notes continued

8. Income Taxes

	1986	1985
		(000's)
Income taxes on earnings before income taxes and extraordinary items based on combined basic Federal and Provincial income tax rates of 52%	\$ 13,673	\$ 2,153
Increase (decrease) resulting from:		
Manufacturing and processing profits deduction	(1,631)	(235)
Inventory allowance	(112)	(600)
Non-taxable incomes, including equity in operating earnings of joint venture companies	(193)	(338)
Accounting losses for which potential future tax benefits have not been recognized	—	442
Other items, including non-deductible items	548	386
Provision for income taxes	\$ 12,285	\$ 1,808

9. Extraordinary Items

	1986	1985
		(000's)
Income tax reductions on utilization of loss carry-forwards (including \$294,000 with respect to earnings of joint venture companies in 1986 and net of \$670,000 of investment credits written off in 1985)	\$ 8,463	\$ 2,802

10. Earnings and Cash Flow Per Share

The basic earnings and the cash flow per share have been calculated using the weighted average aggregate number of common and non-voting shares outstanding during each year (excluding those held by the subsidiary company) after giving retroactive effect to stock dividends on the common and non-voting shares. In computing the basic earnings per share, the earnings before extraordinary items have been adjusted for the dividend obligations with respect to the outstanding preferred shares.

The fully diluted earnings per share for 1986 have been calculated using the weighted average aggregate number of common and non-voting shares which would have been outstanding assuming that additional shares had been issued as at the beginning of the year pursuant to the redemption provisions attached to the preferred shares of the subsidiary company outlined in note 6 and to the outstanding commitments to issue shares outlined in note 7(c). For purposes of this calculation, the earnings before extraordinary items have been reduced by a net amount of \$253,000 for

10. Earnings and Cash Flow Per Share (cont'd)

an imputed after-tax share of the loss of the Partnership and an imputed after-tax return on additional funds assumed to have been received on exercise of options to certain officers. Since the Partnership was, until June 30, 1986, in a period of modernization, the imputed after-tax share of the loss of the Partnership was based on its loss for the six months ended December 31, 1986. The fully diluted earnings per share for 1986 was as follows:

Earnings before extraordinary items	\$.52
Extraordinary items	.42
<hr/>	
Net earnings	\$.94

11. Commitments

(a) Doman is required to purchase up to 9,589,000 of a class of voting preferred shares of WFP for their paid-up amount of \$1.00 per share plus any accrued and unpaid dividends (\$0.18 per share at December 31, 1986), and at the annual rate of the lesser of \$2,500,000 and 20% of Doman's net earnings (exclusive of non-cash extraordinary income) for the preceding year. This will result in the Doman's voting interest in WFP increasing to 22.6%.

(b) Doman has established a line of credit with its bank to make revolving loans to the Partnership to cover any cash deficiencies that may occur before July 1, 1990, to a maximum of \$5,000,000 in the period to June 30, 1988, \$3,000,000 thereafter to June 30, 1989 and \$2,000,000 thereafter to June 30, 1990. At December 31, 1986 Doman had advanced \$1,400,000 to the Partnership through a draw-down of this line of credit.

(c) Doman is obligated under an operating lease of a sawmill to annual payments of approximately \$835,000 to 2008.

(d) In connection with two of its forest licences, the Company is obligated to build and operate a wood residue processing facility at a cost currently estimated to be \$20,000,000. It is not possible for the Company to meet this obligation by the due date of December 31, 1987, in which case the Ministry of Forests and Lands of British Columbia (the "Ministry") may, at its option, terminate the forest licences. However, the Ministry has advised the Company that an extension beyond December 31, 1987 may be considered, once the Ministry has reviewed details of the Company's progress in advancing the project in 1987.

Notes continued

12. Other Information

(a) Related Party Transactions

- (i) Sales to a joint venture company during the year were \$68,020,000 (1985 - \$55,031,000) and interest paid or payable amounted to \$1,758,000 (1985 - \$1,601,000).
- (ii) In order to maintain production at one of Doman's sawmills, Doman purchased logs during the year and a parcel of timbered lands during 1985 from companies controlled by a principal shareholder of the Company and his associate, at a cost of \$1,529,000 and \$800,000, respectively. These transactions were conducted using normal commercial terms and prices.

(b) Segmented Information

- (i) Industry segments
Doman conducts essentially all of its business activities in the forest industry.
- (ii) Export sales
Doman's export sales, based on the known origin of the customer, were \$146,677,000 (1985 - \$111,267,000), including \$124,638,000 (1985 - \$95,715,000) to the United States.

(c) Interest Expense

Interest on current debt amounted to \$3,691,000 (1985 - \$4,134,000) and on long-term debt amounted to \$11,833,000 (1985 - \$12,562,000).

(d) Subsidiary Companies (all wholly-owned)

Doman Forest Products Limited
Doman's Transport Limited
Doman-Marpole Transport Limited
Doman Enterprises Limited
Doman's Freightways Limited
Doman Investments Limited

(e) Comparative Figures

Certain of the comparative figures have been reclassified to conform with the current year's presentation.

13. Subsequent Event

On February 20, 1987, the Company agreed to issue and sell to Gordon Capital Corporation, Dominion Securities Inc. and Pemberton Houston Willoughby Bell Gouinlock Inc. 1,000,000 7% Class A cumulative redeemable convertible preferred shares, series 2 for \$25.00 per share. Each share will be convertible at the option of the holder at any time up to May 31, 1994 into approximately 3,2051 Class B non-voting shares, series 2, subject to adjustment in certain circumstances. The Company has reserved 3,205,128 Class B non-voting shares, series 2 for this purpose. The net proceeds of the issue to the Company will be approximately \$23,688,000.



Logging
Sawmills
Lumber Remanufacturing
Lumber Marketing
Truck Transport

