

MacMillan Bloedel Limited

Annual Report 1986

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Operating in a Global Marketplace

Corporate Profile:

MacMillan Bloedel is one of North America's largest forest products companies, with integrated operations in Canada and the United States as well as major investments in Canada, the United Kingdom and Continental Europe. The Company manages 1.5 million hectares of productive timberlands which supply most of its total fibre requirements. Of these timberlands, one million hectares are in British Columbia where the Company's head office is located and approximately 50 percent of its capital is invested. The products of MacMillan Bloedel and its affiliated companies are marketed throughout the world and include lumber, panelboards, kraft pulp, newsprint, groundwood printing papers, fine papers, containerboard and corrugated containers.

Front Cover:

The development of overseas markets for MacMillan Bloedel's growing number of value-added products has been a key element in the Company's resurgence (see *Operating in a Global Marketplace* page 7). Pictured here is Lynnterm in North Vancouver which is the major shipping terminal for MacMillan Bloedel's lumber specialties destined for Europe.



	1986	1985
Financial results (\$ millions)		
Sales	2,511.7	2,335.4
Operating earnings	222.5	108.9
Earnings before extraordinary item	133.3	42.9
Net earnings	178.3	42.9
Funds generated by operations	404.5	247.9
Return on common shareholders' equity (Note 1)	17.1%	2.4%
Per common share (\$ per common share)		
Net earnings after preferred dividends		
Before extraordinary item		
Basic	3.21	.54
Fully diluted	3.18	.54
After extraordinary item		
Basic	4.66	.54
Fully diluted	4.52	.54
Funds generated by operations	13.02	8.12
Cash dividends	.75	—
Stock dividends	—	.90
Book value (year-end)	28.93	24.58
Assets (\$ millions)		
Capital expenditures	100.0	96.6
Invested capital (year-end) (Note 2)	1,966.3	2,080.7
Additional information		
Debt to invested capital (year-end)	27.8%	41.5%
Common shareholders of record (year-end)	7,725	10,454
Common shares outstanding (year-end)	32,611,631	30,929,624
Number of employees (year-end)	15,102	15,139
Employee compensation (\$ millions)	605.5	636.7

Notes:

(1) "Return on common shareholders' equity" is defined as net earnings available to common shareholders as a percentage of average common shareholders' equity.

(2) "Invested capital" is defined as the sum of interest-bearing debt, deferred income taxes, deferred revenue and shareholders' equity.

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At MacMillan Bloedel, 1986 was another year of consolidation and guarded optimism. Consolidation, in that five years of effort to restore the Company to its position as a world-class competitor in the forest products industry began to pay off. Guarded optimism, in that a dramatic earnings recovery was tempered by difficult labour relations and the growing reality of protectionism in major markets.

During 1986, MacMillan Bloedel achieved operating earnings of \$222.5 million, the highest since 1979 and higher than was earned in the five years of 1981 to 1985 combined. Employees can justifiably be proud of this accomplishment. Earnings in the second half of the year were negatively impacted by an industry-wide strike which closed most of the Company's sawmills and curtailed pulp production. This reduced operating earnings by an estimated \$88 million. Earnings available to common shareholders totalled \$144.8 million and the return on common shareholders' equity was 17 percent. The capital markets recognized this earnings recovery with a 63 percent increase in MacMillan Bloedel's share price during the year.

The numbers tell only part of the story, however. The year 1986 provided hard evidence that MacMillan Bloedel is truly a customer-oriented, market-driven organization. Having stressed some years ago the importance of producing products that the customer wants, at a price and on terms that he finds acceptable, management defined ancillary objectives which would drive the Company toward that goal. One was to pay attention not just to volume of outturn but also to the quality of that outturn as defined by the customer. Another objective was to achieve production costs which would meet the customer's pricing requirements and the Company's financial return standards. Still another objective was to reduce debt service costs and get MacMillan Bloedel's financial house in order to a level that would be flexible in economic downturns without compromising long-term corporate plans.

Quality: What Customers Want

Quality product and quality service slogans have proliferated at MacMillan Bloedel over the past five years. Whether it is a manufacturing region's "Do It Right The First Time" or lumber marketing's "Wood is Good" theme, they stand for fundamental change in the way the Company does business.

The first step in this transition was to get closer to the customer, learn more about his product and service needs and fully understand his marketplace.

"The year 1986 provided hard evidence that MacMillan Bloedel is truly a customer-oriented, market-driven organization."

MacMillan Bloedel was the first and is still the only overseas forest products company to establish a lumber distribution company in Japan. Interaction with the customer that this direct selling has afforded has proved invaluable in developing the right products for that marketplace. The result has been greater customer satisfaction and significantly higher revenues to the Company.

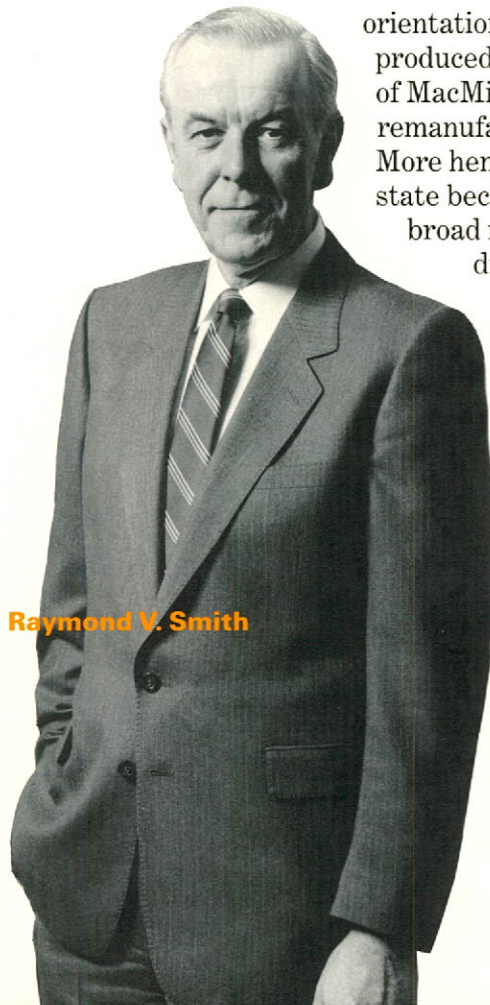
In the U.S. containerboard business, a new testing laboratory allows employees to work with customers to determine the packaging strength that most effectively safeguards the products they ship. Customer interaction in MacMillan Bloedel's pulp and paper business has long been a fact of life as sales and production personnel cooperate to meet ever-changing needs of the marketplace.

During the year MacMillan Bloedel employees proved willing to go the extra mile to service customers. In Canada, MacMillan Bloedel Building Materials was voted "The Best All-Round Supplier" by customers in a trade magazine poll. During the difficult strike period, employees throughout the organization worked hard to acquire substitute products and fibre to service customers and to keep Company mills running.

The result of this customer and product quality orientation has been a host of new value-added products not produced by the Company five years ago. Three quarters of MacMillan Bloedel's western red cedar is now remanufactured into over 100 different end-products. More hemlock is being upgraded to a semi-finished state because that is what customers want. An already

broad range of value-added printing papers has grown dramatically reflecting new printing technologies adopted by many customers. Additionally, in the western U.S. and Canadian markets the Company began marketing lightweight coated printing papers produced by its European affiliate, Koninklijke Nederlandse Papierfabrieken (KNP).

None of this implies an abandonment of traditional markets. On the contrary, efforts to upgrade the quality of "commodity products" will accelerate in coming years as newer technologies, some of which were developed by MacMillan Bloedel's Research Department, are incorporated into production processes. MacMillan Bloedel's construction-grade lumber has long earned a premium price because of the premium quality it represents.



Raymond V. Smith

Throughout the Company, employees are working together to ensure that a reputation for consistent quality, whether in primary production or value-added end-products will continue to differentiate MacMillan Bloedel products and service.

Cost Control: Key to Remaining Competitive

No amount of quality control alone can keep a customer if prices are out of line with those of competitors. Over the past five years, MacMillan Bloedel has addressed the problems of high logging costs and mill inefficiencies with technological improvement, mill closures where necessary and new or improved facilities within limited capital spending plans. Each of these has been well chronicled in previous reports. Striving for greater efficiencies is a continual process, however, and requires capital. In recent years, MacMillan Bloedel management made a commitment to strengthen the Company's balance sheet before proceeding with any major capital projects. However, detailed investigation and analysis of needs and opportunities continued during 1986 to develop a slate of high-return capital projects as financial circumstances permitted. Some of these are now underway.

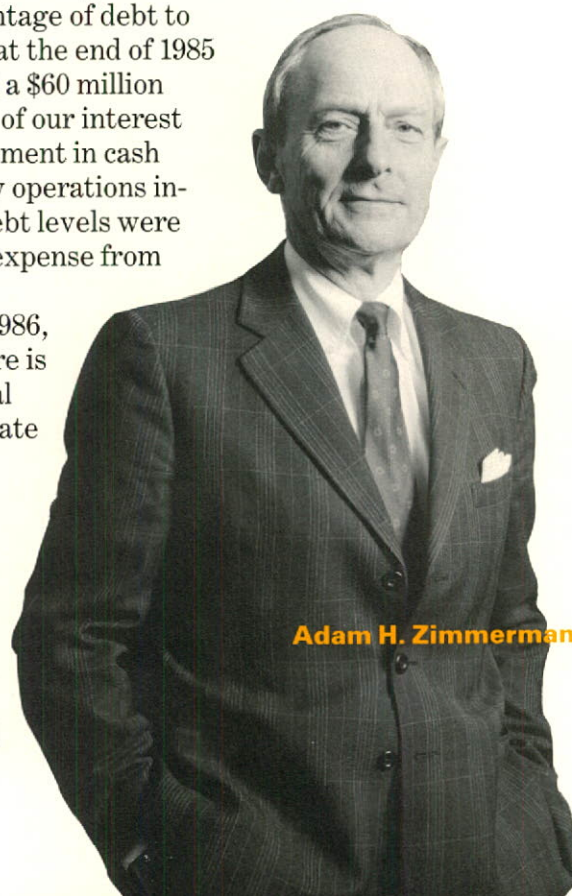
"Managed trade is really a euphemism for anti-trade and these agreements are virtually always designed to penalize the most efficient producers."

Putting Our Own House in Order

During the year there was a significant strengthening of MacMillan Bloedel's balance sheet. The percentage of debt to invested capital was reduced from 42 percent at the end of 1985 to 28 percent at the end of 1986. This reflected a \$60 million preferred share issue and the sale of a portion of our interest in KNP but, primarily, it reflected an improvement in cash flow. Compared with 1985, funds generated by operations increased 63 percent to \$404.5 million. Lower debt levels were largely responsible for a reduction of interest expense from \$92 million in 1985 to \$67 million in 1986.

Despite the positive achievements of 1986, reference to guarded optimism about the future is not frivolous. The year exposed some very real concerns about British Columbia's labour climate and the global free market system.

Following several weeks of industry-wide negotiations, the International Woodworkers of America (IWA), which represents most logging and sawmill workers in British Columbia, initiated strike action at the end of July. The dispute shut down the Company's coastal logging operations and two-thirds of its sawmill capacity. It also curtailed pulp and



Adam H. Zimmerman

paper production at the Company's Harmac and Alpulp mills. A key issue in the labour dispute was contracting out. The union wanted work currently performed in the bargaining unit guaranteed forever against loss to contractors even though most of those contractors are IWA-certified. From a management perspective, such a guarantee would have threatened the future viability of the industry by rendering it inflexible in adjusting to technological change and the forces of worldwide competition. The industry offer to guarantee that no full-time IWA Company employees would be put out of work through the use of contractors was not acceptable to the union membership. The strike continued until the first week of December. A two-year settlement came only after the parties agreed to request the appointment of a Commission of Inquiry to make non-binding recommendations on matters of contracting out, flexibility of shift scheduling and add-on compensation systems. The report of the Inquiry Commission is due March 1, 1988. Clearly, the contracting out, work practices and compensation issues remain unresolved and it will be a major industry challenge over the next year to find solutions which address employee concerns but which also preserve corporate flexibility and competitiveness.

The other major issue of 1986 was the threatened U.S. imposition of a countervailing duty on softwood lumber imports from Canada. In May, 1986 the Coalition for Fair Lumber Imports lodged a complaint with the U.S. Department of Commerce alleging that the Canadian forest products industry was subsidized through government grants and artificially low stumpage rates. Although the same case had been dismissed not quite four years earlier with no finding of a subsidy sufficient to attract a countervailing duty, the Canadian industry was once again called upon to defend itself. Although there had been no change to provincial stumpage policies in the interim, much had changed in the U.S. political environment between 1982 and 1986. A rising U.S. trade deficit had lent credence to lobbyists supporting protectionist measures and it appeared that emotion rather than facts would determine the outcome. MacMillan Bloedel's analysis indicated that the delivered cost of logs in comparable regions was similar, refuting the claims that any subsidy was received in the form of bargain stumpage. Nor did the performance of the Company's profitable sawmill in Pine Hill, Alabama reflect the "beleaguered" conditions being experienced by the U.S. lumber industry. In October, the International Trade Administration of the U.S. Department of Commerce ruled preliminarily that Canadian softwood lumber imports were subsidized to the extent of 15 percent. Concurrently, numerous

bills were being considered in the U.S. Congress that threatened even more draconian measures to constrain the quantity of Canadian lumber entering U.S. markets. To replace any U.S. countervailing duty, Canada and the U.S. subsequently entered into an agreement by which Canada would impose a 15 percent export tax on the primary mill value of softwood lumber destined for shipment to the U.S.

Alarming as the imposition of an export tax is, the protectionist sentiment which bred the allegation is even more disconcerting. The past year witnessed a number of counter-productive measures toward managed trade, not only in our own backyard, but worldwide. The problem with managed trade is that it is really a euphemism for anti-trade and these agreements are virtually always designed to penalize the most efficient producers. An escalation of this trend can only result in a serious threat to the well-being of our global marketplace on which all of the world's economies depend.

The answer to these and other trade irritants is to treat them as isolated, removable aberrations. Common sense dictates that the world must move further toward a freer — not a more restrictive — global economy. In the same way that our sawmill operators remove defects to maximize lumber quality, issues like these must be removed to maximize the quality of the global trading environment.

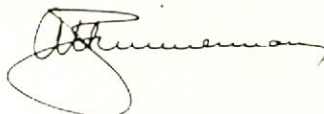
In saying, therefore, that 1986 was a year of consolidation it in no way implies that it was a year of complacency. As usual there is plenty on the horizon to demand an alert and sensitive response to change.

As we look to the future, the concept of guarded optimism must be again stressed. The world is too unpredictable a place with its volatile interest rates, currencies, economic growth and trade patterns to view the late 1980's with any degree of certainty. It can be said, however, that one constant at MacMillan Bloedel is concern for customers and for the global marketplace in which the Company earns its living.

During the year Mr. Frank J. de Wit, Mr. R. Tim Kenny, the Honourable Donald S. Macdonald and Dr. David W. Strangway joined MacMillan Bloedel's Board of Directors. Two of them replaced Dr. K. George Pederson and Mr. George M. Tidball whose wise counsel and participation during their periods of tenure were much appreciated.



R.V. Smith
President and Chief Executive Officer
February 6, 1987



A.H. Zimmerman
Chairman of the Board
Vancouver, Canada

Operating in a Global Marketplace



“The key to future prosperity lies in getting close to customers worldwide and supplying them with a wide range of value-added, cost-competitive products.”

The global participation of the Canadian forest products industry was brought into sharp focus in 1986. The industry was a prime beneficiary of the decline of the U.S. and Canadian dollars against other of the world's key currencies. The decline, initially orchestrated by the major industrial countries, restored the Canadian industry's traditional status as a major supplier of forest products to world markets. It also was largely responsible for the product price improvement that the industry enjoyed throughout the year. Pulp prices in major markets rose from just over US\$400 per tonne at the beginning of the year to approximately US\$520 by the end of December. Despite this increase, customers in western Europe and Japan experienced little cost impact in their currencies. MacMillan Bloedel's average net mill return for lumber in offshore markets rose approximately 25 percent, due to improved product mix and exchange gains. In addition, the relative decline of the U.S. dollar was a major cause of the rise in linerboard prices both in the U.S. and overseas, as greater volumes of U.S. export tonnage began again to move offshore. Newsprint was also a beneficiary of the lower dollar with world prices firming and less offshore tonnage entering the U.S. The list price was successfully raised from

US\$535 per tonne to US\$570 on October 1, 1986 in the U.S.

In early 1986, the Canadian dollar reached an historical low against the U.S., trading below 70 cents while inducing a three percentage point rise in the Canadian bank prime rate. This had the effect of increasing short-term costs of borrowing and increasing the value of U.S. dollar denominated accounts receivable.

U.S. Protectionist Sentiment

Meanwhile, however, south of the border, the large U.S. trade deficit was causing protectionist sentiment to become increasingly vocal. Demands for import restrictions were heard from lobby groups representing a wide range of industries most particularly softwood lumber, shingles and shakes.

In May, a stiff import duty was levied on western red cedar shingles and shakes and a petition was filed by the U.S. Coalition



The industry made news in 1986: a five-month strike, U.S. threats of countervailing duties, and profits their highest in years. All events brought to focus the realities of competing in an international marketplace.



for Fair Lumber Imports seeking a 27 percent duty on Canadian lumber. This marked the second time in four years that a U.S. lumber lobby had filed for countervail protection against Canadian softwood lumber imports. The 1982 initiative had ended seven months after it was filed with a finding by the U.S. Commerce department that no subsidy sufficient to attract a countervailing duty was conferred on the Canadian industry. Despite a united Canadian industry defence, the complainants succeeded in 1986 on the same facts, not because of the merits of their case but because of the political pressures they were able to exploit. In October the

International Trade Administration (ITA) of the U.S.

Department of Commerce ruled preliminarily that Canadian softwood lumber exports were subsidized to the extent of 15 percent of their value. On December 30, 1986 the ITA was to render its final decision regarding subsidy. Presumably to forestall the publication of any adverse decision, an eleventh hour agreement between the Canadian and U.S. governments established a 15 percent export tax to be imposed by our federal government on the primary mill value of virtually all softwood lumber destined for shipment to the U.S.

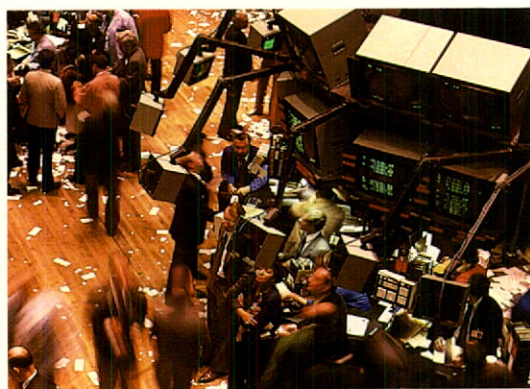
Labour Strife at Home

On a more regional note, the British Columbia industry was in the national press again in April when a contract settlement was reached with members of the Canadian Paperworkers' Union and the Pulp, Paper and Woodworkers of Canada two months before the former contract expired. This marked a milestone but the labour relations

harmony was short-lived, as it became clear that a routine contract settlement with the International Woodworkers of America, the major union representing the province's woodlands and sawmill workers, would be difficult. What was to follow was the longest and one of the most bitter labour disputes in the province's history. The strike, which began in late July and was not settled until early December 1986, received national attention and highlighted the dilemma faced by many of North America's traditional industries, that of cost-competitiveness versus job security. Although settlement was ultimately achieved, a decision on the issue of contracting out was deferred to an Inquiry Commission for study over the next year.

The Global Reality

All of these issues — currency fluctuations, interest rate policies, protectionism, flexible work practices, competition and global trading patterns — have a profound effect on the Canadian forest products industry. None of them is determined or even greatly influenced by decisions made by corporate management. That is the reality of the industry. The coastal industry of British Columbia was rooted in a global environment and, from its inception, MacMillan Bloedel has been an organization committed to



MB Newsprint: Lighter, Brighter, Stronger



Newspaper publishers are demanding more from their newsprint these days and the colourful national broadsheet

USA Today exemplifies this new standard. For its San Bernardino California printing facility (above), publisher Gannett relies on MacMillan Bloedel paper.

MB in Japan: Getting Closer to the Customer



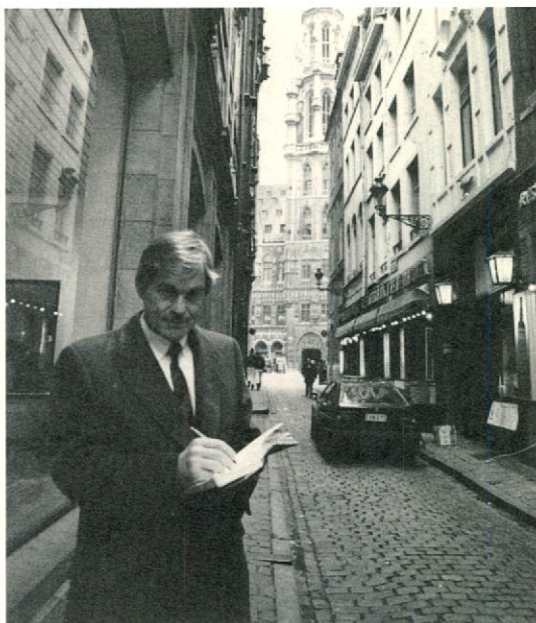
Two years ago MacMillan Bloedel established a distribution company in Japan to better service customers there who highly value the Company's old-growth clear lumber for a range of applications including window frames, shoji screens and traditional wood-frame housing systems.



world trade and minimal interference in the free market system. Product prices are determined in global rather than domestic markets and the Company does not participate in any one market in such a major way as to unilaterally determine pricing. Indeed the industry is a price taker, not a price maker. The increasingly competitive nature of world trade means that the key to future prosperity lies in getting close to customers worldwide and supplying them with a wide range of value-added and cost-competitive products.

MacMillan Bloedel has a long-established network of production facilities in North America and joint ventures, sales offices and agents worldwide. Whether it be a corrugated plant in Ayrshire, Scotland, a sales office in Sydney, Australia or a distribution centre in Tampa, U.S.A., the Company is represented and its own deep-sea shipping organization, Canadian Transport Company, provides the transportation link between the mills and many overseas customers.

MacMillan Bloedel pulp and newsprint is shipped worldwide. In its largest newsprint market of the western U.S., Powell River Alberni Sales Corporation serves customers from four offices along the U.S. Pacific coast. The Company's sales offices in Tokyo, Hong Kong, Kuala Lumpur and Sydney market pulp and newsprint into the high-growth Pacific Rim. The Canadian market is serviced from Vancouver, European customers from London and Brussels and United Kingdom customers from Twickenham, England. U.S. pulp customers buy from the Company's Stamford, Connecticut office. In addition, Export Sales Company Limited sells and distributes newsprint in Pacific Rim markets for MacMillan Bloedel and two other British Columbia companies.



Hans Vandeneijnde, manager of pulp sales for Western Europe, operates in one of the world's most competitive pulp markets. While MB's returns vary widely with global supply and currency fluctuations, its reputation as a reliable supplier of high-quality softwood pulp remains constant.

Wide Range of Printing Papers

A key goal at MacMillan Bloedel is to manufacture a wide range of groundwood printing papers in addition to standard grades. The Company is working hard to continually upgrade the quality of its newsprint and, as market expectations rise, it is able to match or excel the premium newsprints made in the world. Customers increasingly expect lighter and brighter newsprint papers with superior strength, opacity, smoothness and cleanliness as they respond to the needs of their respective marketplaces. Technological change in the printing and publishing businesses has brought forth a new era of offset, flexography and rotogravure printing processes which have in most cases replaced letterpress. Key newsprint products produced by MacMillan Bloedel and suited to these changing markets include the following:

Electratone is a high-finish grade used for rotogravure printing. This type of printing, in which ink is put in cells on an etched copper cylinder and transfer-

The Powell River mill enjoyed a banner year in safety, production, earnings and cash flow in 1986. Major capital programs are also in progress to ensure its continued leadership in product quality and cost-effectiveness.

red to the paper, requires a very smooth surface paper and our product meets this need. *Electratone* is commonly used for Sunday magazines, newspaper advertising inserts and flyers. *Electrabrite* is also used for newspaper inserts but is run on offset presses meeting the needs of customers using this offset lithography process. Computer print-out paper is included in this category. *Electraheat* is a high finish hi-brite paper used in either the heatset offset or rotogravure printing processes. Each of these products is produced on one of Powell River's numbers 6, 7 or 9 paper machines.

The Company's lightweight newsprints are printed on offset presses and are used, for example, in newspaper publications for which weight is an important factor, such as those distributed by mail. The Company also produces white, yellow and blue telephone directory and a super lightweight directory grade for use in advertising directories and information manuals. The Company's pulp and paper mill at Port Alberni, British Columbia has earned an international reputation for the quality of its lightweight and telephone directory papers.

In addition to cultivating the flexibility to produce a wide range of value-added newsprint products, the Company will also continue to enhance the quality and productivity of its

standard newsprint output. MacMillan Bloedel is proud to supply *USA Today*, owned by Gannett and known to have among the toughest quality requirements in the industry. Standard newsprint is the Company's largest single paper product and is produced on number 5 paper machine at Port Alberni and numbers 9, 10 and 11 at Powell River. Number 5 is currently undergoing a \$32 million modernization to install a twin-wire and a new wet end. This will further upgrade its paper quality and improve surface strength.

At the Powell River mill in 1986 a multi-year capital plan and programs to improve customer satisfaction and operating effectiveness reached new milestones. The mill posted a banner year in safety, production, earnings and cash flow. The start-up of the second stage of the chemi-thermomechanical pulp process (CTMP) has improved the quality and quantity of low-cost TMP pulp available for newsprint production. This process was developed and patented by the Company's Research Department. The completion and installation of the computerized Production Management System (PMS) during the year has given shipping crews an invaluable assist in their aim to exactly match the customer's order. Major efforts in long range planning and the quality management process in 1986 ensure that the Powell River mill, which celebrates 75 years of papermaking in 1987, will remain a leader in technology, newsprint quality and cost competitiveness.

The mill has also recently begun a \$70 million project to expand capacity for its groundwood printing papers.

The Company's bleached kraft softwood pulp is manufactured at Nanaimo Region's Harmac mill. In 1986 the mill successfully completed an \$8 million project to install state-of-the-art

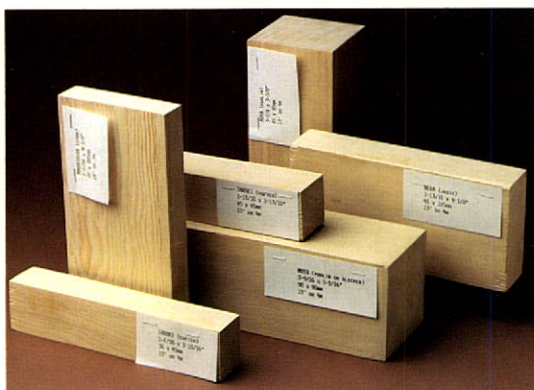


technology in the recausticizing plant. Benefits of this project include improved production quality and lower operating and maintenance costs. Enhancement of Harmac's position in the marketplace continues through achievement of higher standards of product quality and increased customer contact to identify specific requirements. Harmac continues to be the leader in production of cedar pulp, a specialized product.

MB Quality Worldwide

On the building materials side of the business an extensive marketing organization also exists to distribute the Company's products worldwide.

Within the last two years, MacMillan Bloedel has established a lumber distribution company in Japan to get closer to the customer and develop a better appreciation of the Japanese market. Japanese consumers are highly appreciative of the Company's clear lumber produced from its old-growth forest and by being able to more appropriately match production to their needs, the Company is substantially improving its returns. An example of the benefits of getting to know the customer is our hinoki program. This wood, the most prized in Japan but extremely scarce, is of the same genus as our coastal cypress or yellow cedar. MacMillan Bloedel has a significant amount of British Columbia's cypress resource so it makes sense to maximize the value of this production. By marketing it as an hinoki substitute and producing it to customer specifications it can sell for up to \$6,000 per thousand fbm. The Company is also marketing hemlock, Douglas fir, western red cedar and Sitka spruce in Japan for use in a multitude of products from Shoji screens to traditional wood-frame housing systems.



"Getting closer to the customer" means matching production to the particular needs of the market. For Japan, MB's Alberni Pacific Division manufactures an entire line of finished products designed specifically for the Japanese housing market.

The Company has building materials sales offices in Hong Kong, Australia and England which also market a full range of products and species subject to regional preferences. MacMillan Bloedel lumber is used in such diverse applications as paneling and siding in Australia, window frames in Germany, ladders and doors in England and pianos in Korea, to name only a few.

The producing mills for the Company's whitewood products include Alberni Pacific Division, Nanaimo Region's Chemainus Division, Harmac's numbers 3 and 4 woodrooms and Powell River Region's one sawmill. Alberni Pacific is producing an entire line of finished products directed primarily at the Japanese market. These include, for example, neda (joists), taruki (rafters), mabashira (studs) and moya (joist supports). Chemainus has expanded its customer base and is doing more custom packaging. Numbers 3 and 4 woodrooms continue to produce dimension lumber for the U.S. market and Powell River has worked closely with the Company's Custom Processing Division to provide value-added products to markets worldwide.

In the U.S. the Company operates 12 distribution centres and one district sales office under the MacMillan Bloedel Building Materials (MBBM) US

Competition and consumer demands are as challenging here at home as abroad. As a measure of MB's marketing skills and commitment to service, MBBM Canada's 22 distribution centres across the country were voted "Best All-Round Supplier".



name. The distribution centres are concentrated on the Atlantic coast but inland operations extend as far as Houston, Texas. In 1986, MBBM US celebrated twenty years of customer service.

In Canada, MacMillan Bloedel distributes its building materials products through 22 distribution centres located from Port Alberni, British Columbia to Dartmouth, Nova Scotia. The more than 300 people who make up MBBM Canada are committed to the efficient distribution of the Company's building materials and to providing the right combination of goods and services for the retail building supply and industrial markets they serve. For their efforts they were voted "The Best All-Round Supplier" in 1986 by their customers in a trade magazine poll. Head Office lumber marketing sells directly to some customers, coordinates distribution of the mills' production and carries out pricing, product planning and transportation functions.

Value-Added Lumber

The Company's lumber products are essentially divided into decorative and construction grades. Its range of decorative lumber products is concentrated in the western red cedar species. MacMillan Bloedel controls more than 10 percent of the world's resource of this species and over the last six years the range of value-added products has grown from less than 10 to over 100. MacMillan Bloedel produces approximately 40 sizes and grades of green and kiln-dried bevel sidings, close to 45 sizes and grades of green and dry channels and tongue and groove products, a number of which are used as wall panelling. The Company also produces selected cuttings and patio-grade for



decking and exposed beams.

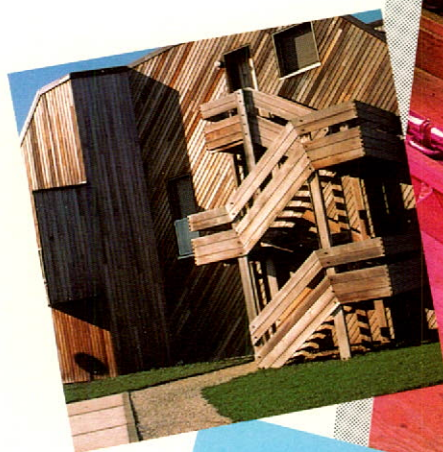
The cedar products are produced at Nanaimo Region's New Westminster and Canadian White Pine Divisions and at Alberni Region's Somass Division. Each of these mills has been upgrading the value of its outturn in the last few years with Canadian White Pine doing primary processing and the other two producing a full range of finished products. Most of the Company's western red cedar products are sold in North America but Europe and the Pacific Rim are growing markets overseas.

In the past three years, MacMillan Bloedel has introduced and made a major commitment to expanding the end-use of kiln-dried Pacific Coast Hemlock. To this end, MacMillan Bloedel's Custom Processing Division buys lumber from the Company's mills and further processes it to meet the specifications of customers worldwide. These products are primarily used in the production of wooden window frames in Europe and the U.S. as well as for other decorative purposes in the Japanese market.

The objective of the Custom Processing Division is to remanufacture the rough green lumber into value-added products suited to customer requirements. A combination of marketing strategy coupled with sawmill support has created a product line now in high

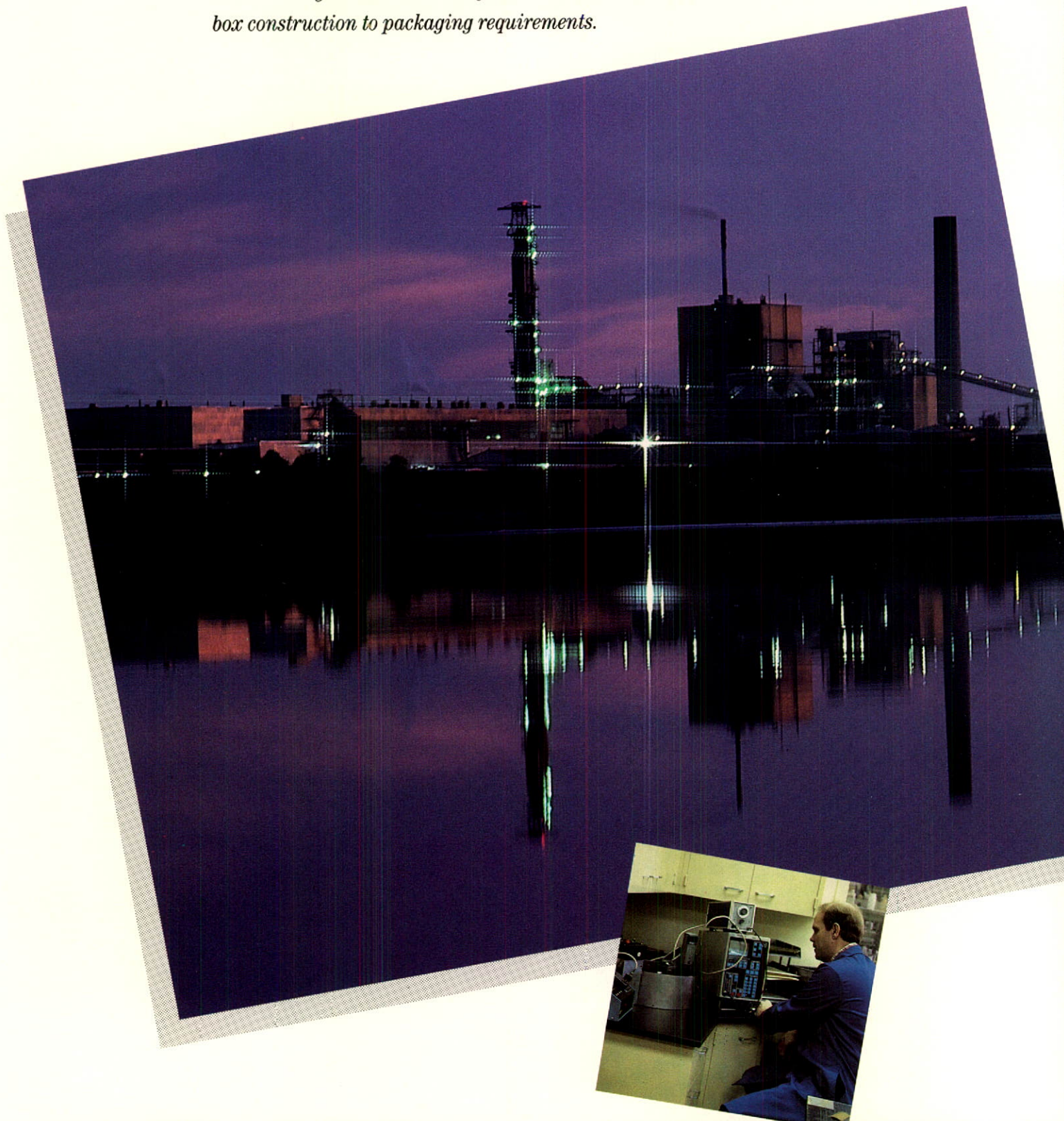
MB Cedar: Adding Value to a Vast Resource

MacMillan Bloedel controls over 10% of the world's western red cedar and supplies over 100 value-added products using this species. MB cedar products, like the kiln-dried bevel-edged siding shown here, have gained wide acceptance in North America, France, Germany, Australia and Japan.



MB Containers: Commitment to Quality

At Pine Hill, Alabama, quality of linerboard and medium production is ensured with the help of the testing laboratory shown here. The first to be accredited by the U.S. Bureau of Standards, the lab helps customers match box construction to packaging requirements.



demand throughout the world.

A wide range of panelboard products is produced at various mills across Western and Central Canada. Alberni Region's Alberni Plywood Division produces softwood plywood products and has recently introduced SYLVAFORM™, a Douglas fir overlaid concrete form plywood, for use in construction. This value-added product is treated to resist abrasion damage and prevent moisture penetration making it easier to use and ensuring customers a smoother concrete finish. FIRGROVE™ is another value-added plywood product which has a textured surface and is used for residential siding. The Company's specialty plywood plant at Nipigon, Ontario produces top quality hardwood plywood products. One of its specialty value-added products is the shafts for hockey sticks, made of up to 19 plies of high-grade birch veneer.

MacMillan Bloedel also manufactures a wide variety of CHAMPLAIN™ hardboard sidings at Sturgeon Falls and its ASPENITE™ product range has been widened and upgraded since the modernizations of the Hudson Bay, Saskatchewan and Thunder Bay, Ontario waferboard mills. These capital projects have allowed the production of the latest development in reconstituted panel products — oriented strand board. SUPERSTRAND™ is one of these new products used in roof and wall sheathing, and as subflooring. Panelboard products are marketed through MBBM sales offices and distribution centres across Canada.

Containerboard for U.S. Industry

MacMillan Bloedel markets a diverse range of corrugated containers from its eleven box plants in the U.S. and through joint ventures in Canada and the United Kingdom. The U.S. plants,



MacMillan Bloedel operates eleven box plants in the U.S. serving many of the leading consumer goods manufacturers with products ranging from bulk-bin industrial boxes to multi-coloured retail display packaging.

located between New York and Texas, produce and sell products ranging from bulk-bin industrial boxes to small, custom-designed display packaging. MacMillan Bloedel also has a large part of the U.S. lamp wrap market. Customers include Coca-Cola, Sylvania, General Electric, Philips, Lever Brothers, Zenith and General Motors.

The Company's mill at Sturgeon Falls, Ontario produces corrugating medium. Most of this is sold to MacMillan Bathurst Inc.

The U.S. corrugated container plants are supplied with linerboard and corrugating medium from the Company's facility at Pine Hill, Alabama. This mill produces a first-class medium and its linerboard machine is one of the industry's most efficient. Meeting customer needs begins with product quality and to ensure that it is consistently high the mill has established a testing laboratory that is the first to be accredited by the U.S. Bureau of Standards. This laboratory helps customers to evaluate box construction and match the most suitable product to their packaging needs. The laboratory also allows the mill to carry out quality-control testing. In conjunction with MacMillan Bloedel's Research Department, unique product tests such as those involving the photographing of medium flutes for analysis, have been carried out.

Quality of end-product begins with the quality of fibre. At Pine Hill, most of the fibre is from controlled lands where reforestation is a paramount concern. From the Robert E. Mitchell Nursery genetically superior seedlings, over 30 million a year, are planted.

The Pine Hill complex ensures product quality not only through operating a state-of-the-art mill but by having access to a consistently high-quality fibre. A significant portion of this fibre comes from controlled lands on which the Company carries out intensive reforestation. An integral part of this is the nursery and seed orchard which provides high-quality, genetically superior seedlings. The Robert E. Mitchell Tree Nursery began production in 1980 and has produced close to 200 million seedlings since that time. Its annual crop of over 30 million top quality seedlings is planted on lands in the Company's forest management regions and/or sold commercially.

In British Columbia, in which two-thirds of the Company's commercial hectares are located, MacMillan Bloedel operates the state-of-the-art A.P. MacBean Nursery and the Harmac Tree Improvement Centre.

These operations are a critical part of the Company's Designed Forest System — a program to assess and implement the optimum silvicultural treatments for the forest. The Designed Forest System is based on aggressive reforestation efforts on Company tenures which have been carried out on a planned basis since the Tree Farm Licences were awarded. Close to 170 million seedlings have been planted since 1938.

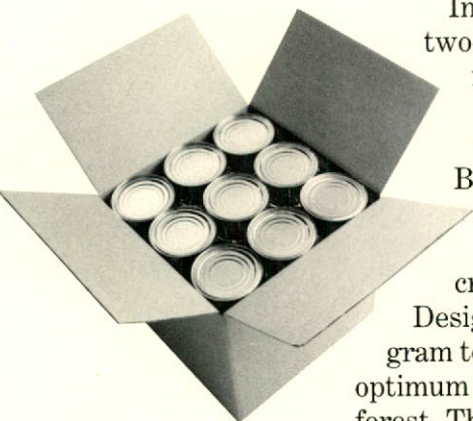
A common element throughout this worldwide organization is its employees. Although they are as diverse as the products and markets they represent, they share a common commitment to providing the best products and service at the best prices to customers around the world.

In a dynamic global marketplace it is the Company's employees who must



keep abreast of product markets, financial markets and technology so to maintain place against the competition.

In 1986 MacMillan Bloedel employees proved themselves equal to the challenges of the global industry today. They will no doubt meet the even more competitive conditions of tomorrow and make MacMillan Bloedel "the customer's first choice every time" •



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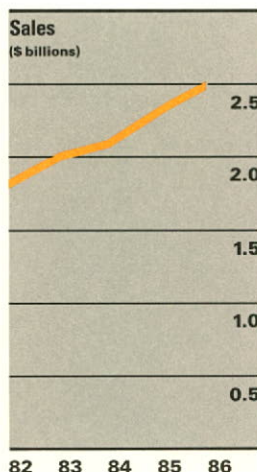
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Comparison 1986 and 1985 Earnings

In 1986 MacMillan Bloedel's sales totalled \$2,511.7 million, an increase of \$176.3 million over 1985. The following table provides an analysis of the change in key product sales from 1985 to 1986:



Product	Dollar Change in Sales 1985 to 1986	Change Attributed to: Shipment Volume	Price*
		(\$ millions)	
Lumber	\$ 58.4	\$ (18.6)	\$ 77.0
Pulp	40.3	1.9	38.4
Newsprint	37.0	33.4	3.6
Corrugated containers	15.8	26.7	(10.9)
Containerboard	10.4	(1.2)	11.6
	\$161.9	\$ 42.2	\$119.7
Other items	14.4		
Total	\$176.3		

*Including the effect of changing foreign currency exchange rates.

MacMillan Bloedel's operating earnings were \$222.5 million in 1986, representing a \$113.6 million increase from \$108.9 million in 1985. The strike by the International Woodworkers of America (IWA) in British Columbia reduced operating earnings by an estimated \$88.0 million in 1986. Despite the strike, the improvement in the contribution to earnings by the various product lines is very encouraging as explained in the commentary on the Company's three major industry segments which follows.

Throughout the strike the Powell River pulp and paper mill operated continuously, the Harmac pulp mill and woodrooms operated all lines except for the last month of the strike when some curtailment was necessary, and the Alberni pulp and paper mill ran two of its paper machines using purchased pulp and logs. With some exceptions, the Company maintained supply of product to its pulp and paper customers throughout the strike. The strike

stopped the supply of specialty and some construction grade lumber products to the Company's increasingly diversified group of customers. The Company made every effort to locate supply from alternative sources to minimize the detrimental effect on customer relationships.

As the strike progressed, the cost of purchased fibre rose with the strengthening demand for logs and pulp in British Columbia. The adverse effects of the strike will continue to be felt in the first quarter of 1987 as the finished goods inventories are rebuilt and the higher cost fibre is consumed.

The agreement with the IWA included the appointment of a Commission of Inquiry to study and issue non-binding recommendations dealing with the problems of contracting out, flexibility of shift scheduling and add-on compensation systems. It is expected that a long-term solution to these controversial issues will be developed and a cooperative relationship established to deal with changes arising out of advancing technology. There are many opportunities for significant productivity and value extraction gains which are still to be realized through a cooperative working arrangement and adoption of new technologies.

Lower debt levels and lower interest rates resulted in a reduction of interest expense of \$24.7 million in 1986 to \$67.3 million. The Canadian dollar was weaker relative to the U.S. dollar which increased the reported interest expense for the U.S. denominated debt.

The equity in earnings of partly-owned companies increased by \$2.4 million from \$24.1 million in 1985 to \$26.5 million in 1986. Although the Company reduced its interest in Koninklijke

Nederlandse Papierfabrieken N.V. (KNP) to 25 percent in the first quarter of the year, higher earnings resulting from relatively low raw material cost and higher sales volumes resulted in the increased equity earnings. Island Paper Mills Limited and MacMillan Smurfit SCA Limited also reported better operating results in 1986 than 1985. MacMillan Bathurst Inc.'s results were down from 1985.

The Company earned an extraordinary net profit of \$45.0 million on the sale of a portion of its interest in KNP in 1986. After deducting preferred share dividends of \$33.5 million, the net earnings attributable to common shareholders, before the extraordinary item, were \$99.8 million or \$3.21 per common share (\$3.18 per common share on a fully diluted basis). This compares to a net profit of \$42.9 million in 1985 which, after deducting preferred dividends of \$26.6 million, resulted in net earnings to common shareholders of \$16.3 million or \$.54 per common share.

Building Materials

MacMillan Bloedel's building materials segment reported a 1986 profit of \$83.3 million on sales of \$1,105.5 million compared to a 1985 profit of \$44.5 million on sales of \$1,032.7 million.

MacMillan Bloedel's log harvest in British Columbia totalled approximately 5.6 million cubic metres in 1986 compared to approximately 7.3 million cubic metres in 1985. In the summer of 1985, many of the Company's British Columbia logging operations were closed down due to the extreme forest fire threat. The IWA strike, which commenced in July, was the primary reason for the reduction in log production in 1986.

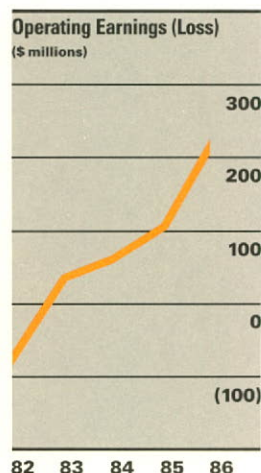
The British Columbia Govern-

ment log export policy, which changed effective March 31, 1986, combined with the curtailment of logging activity as a result of the IWA strike reduced export log sales revenue by \$9.1 million during the year.

In order to assure a continuing supply of raw materials for the future the Company maintains an active reforestation program. In 1986, 4.5 million seedlings were planted on 4,674 hectares compared to 6,400 hectares and 5.6 million seedlings in 1985. A new seedling cold storage facility was added in 1986 completing the state-of-the-art facility at the Company's A.P. MacBean nursery and Harmac Tree Improvement Centre near Nanaimo, British Columbia. It ensures that the Company produces the highest quality seedlings for its reforestation program. This program is supported by ongoing silvicultural research, land-use planning, fire prevention and control and development of forest management systems.

The strike at IWA-certified sawmills closed approximately two-thirds of the Company's coastal British Columbia lumber capacity. Housing starts in the U.S. for 1986 totalled 1.81 million compared to 1.73 million in 1985, 1.75 million in 1984, and 1.70 in 1983. Interest rates for mortgages dropped to new lows in 1986 compared with the past several years.

U.S. lumber consumption established a new record which preliminary computations show to be between 47 and 48 billion FBM, up from the previous record of 44.2 billion set in 1985. This compares to 43.5 billion in 1984, and 38.7 billion in 1983. U.S. sawmills responded to strike-induced reduction in supply by increasing operating rates by 10-20 percent in the last six months of the



Five year earnings data					
	1982	1983	1984	1985	1986
Sales (\$ millions)	1,843.1	2,044.1	2,127.6	2,335.4	2,511.7
Contributions to earnings (\$ millions)					
Building materials	(32.9)	42.9	26.1	44.5	83.3
Pulp and paper	(12.5)	22.5	33.9	70.7	141.9
Containerboard and packaging	(7.1)	(5.7)	28.0	8.1	19.7
Eliminations and unallocated items	(14.3)	(19.2)	(20.8)	(14.4)	(22.4)
Operating earnings (loss)	(66.8)	40.5	67.2	108.9	222.5
Other income	19.3	18.7	8.7	10.4	17.4
Interest expense	(78.3)	(80.8)	(88.9)	(92.0)	(67.3)
Severance and closure costs and other items	(65.7)	(6.6)	—	—	—
Earnings (loss) before income taxes	(191.5)	(28.2)	(13.0)	27.3	172.6
Income taxes	95.3	27.2	18.1	(8.5)	(65.5)
Equity earnings	2.3	2.3	14.4	24.1	26.5
Minority interests	.6	1.5	(.2)	—	(.3)
Earnings (loss) before extraordinary items	(93.3)	2.8	19.3	42.9	133.3
Extraordinary items	36.0	21.1	—	—	45.0
Net earnings (loss)	(57.3)	23.9	19.3	42.9	178.3
Less: Provision for preferred dividends	19.9	19.6	25.1	26.6	33.5
Net earnings (loss) for common shareholders	(77.2)	4.3	(5.8)	16.3	144.8
Per common share (\$ per common share)					
Operating earnings (loss)	(2.41)	1.40	2.24	3.57	7.16
Net earnings (loss):					
before extraordinary items					
basic	(4.08)	(.58)	(.19)	.54	3.21
fully diluted	(4.08)	(.58)	(.19)	.54	3.18
after extraordinary items					
basic	(2.79)	.14	(.19)	.54	4.66
fully diluted	(2.79)	.14	(.19)	.54	4.52
Cash dividends on common shares	.08	—	—	—	.75
Stock dividends	.72	1.87	2.06	.90	—

Note:

Foreign currency accounting changes have been applied prospectively commencing with 1984.

year. Prices were held above expected levels due to the effects of the strike and the threat of the countervailing duty.

Offshore lumber demand and prices were strong for upper grades with most of the price improvement due to strengthening of foreign currency. The offshore "merch" grade markets remained very competitive with price improvement limited to Japan.

The Company's sawmills operated at 72 percent of capacity producing 841 million board feet of lumber (MMFBM) in 1986, a 14 percent decrease over the 979 MMFBM produced in 1985 when the mills' operating rate was 85 percent. The decrease was strike-related.

In 1986 the plywood mills produced 243 million square feet of $\frac{3}{8}$ inch (MM sq. ft. $\frac{3}{8}$ ") plywood utilizing 75 percent of productive capacity. In 1985 production was 250 MM sq. ft. $\frac{3}{8}$ ". The Alberni plywood mill with an annual capacity of 175 MM sq. ft. $\frac{3}{8}$ " was closed by the strike in late July, 1986 and reopened after the settlement on December 10, 1986.

Waferboard production in 1986 was 333 MM sq. ft. $\frac{3}{8}$ " or 60 MM sq. ft. $\frac{3}{8}$ " over 1985. This increase was mainly due to the increase in capacity at the Thunder Bay, Ontario mill following its 1985 modernization. Prices remained strong through most of the year with net mill returns averaging 6 percent over 1985 levels as a result of a strong housing market in North America and the reduction in supply of British Columbia plywood due to the strike.

The major problems of labour disputes and the threat from external protectionism experienced this past year demonstrate that the Company cannot afford to take its achievements for

granted but must increase its effort to be an efficient producer and a strong competitor in the international marketplace.

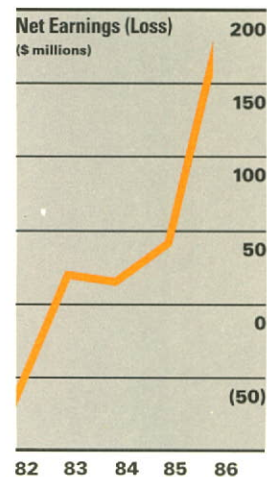
On December 30, 1986 the Canadian and U.S. governments agreed that Canada would impose a 15 percent export charge on lumber shipped to the U.S. In turn, the U.S. petitioners agreed to discontinue countervail proceedings against Canadian lumber producers. The degree to which this additional cost to Canadian producers will be passed on to U.S. consumers is unknown at this time. It is unlikely a definitive quantification of the economic impact can ever be made. However it is certain that for equivalent products a Canadian mill will receive 15 percent (of net mill value) less than a U.S. mill.

Pulp and Paper

The pulp and paper segment contributed a profit of \$141.9 million in 1986, compared to \$70.7 million in 1985. Sales for the segment increased to \$929.6 million from the \$848.2 million recorded in 1985.

The Company's newsprint and groundwood printing paper machines produced 876,000 tonnes in 1986 utilizing 92 percent of productive capacity compared to 850,000 tonnes and 88 percent in 1985. On the market pulp machines, production in 1986 was 408,000 tonnes or 86 percent of productive capacity compared to 422,000 tonnes and 91 percent in 1985. Both pulp and newsprint were affected by the interruption of raw material supply due to the IWA strike.

Consumption of newsprint in the U.S. in 1986 increased by 3.1 percent, as compared to 1985 and remains at peak levels. Competition for standard newsprint sales in the western U.S., the Company's principal newsprint market, continues to be strong. However, a



Selected quarterly financial data

(\$ millions)	First Quarter	Second Quarter
<i>Sales</i>	411.9	534.2
<i>Costs and expenses</i>		
Operating expenses	379.2	451.3
Depreciation, depletion and amortization	20.9	27.3
Selling, general and administrative	35.7	35.5
	435.8	514.1
<i>Operating earnings (loss)</i>	(23.9)	20.1
Other income	3.2	4.3
Interest expense	(19.0)	(20.6)
<i>Earnings (loss) before income taxes</i>	(39.7)	3.8
Income tax	19.3	.1
<i>Earnings (loss) before undernoted items</i>	(20.4)	3.9
Equity in earnings of partly-owned companies	2.9	5.8
Minority interests in subsidiaries	—	(.3)
<i>Earnings (loss) before extraordinary item</i>	(17.5)	9.4
Extraordinary item	—	—
<i>Net earnings (loss)</i>	(17.5)	9.4
Provision for dividends on preferred shares	(6.0)	(6.1)
<i>Net earnings (loss) attributable to common shareholders</i>	(23.5)	3.3
<i>Net earnings (loss) per common share (dollars)</i>		
<i>before extraordinary item</i>		
basic	(.79)	.11
fully diluted	(.79)	.11
<i>after extraordinary item</i>		
basic	(.79)	.11
fully diluted	(.79)	.11
<i>Price range of common shares on</i>		
<i>Toronto Stock Exchange (dollars)</i>		
high	32.13	30.70
low	26.82	22.97
<i>Dividends per common share (dollars)</i>		
cash dividends	—	—
stock dividends	.55	.59

1984		1985				1986			
Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
603.0	578.5	538.6	598.0	597.1	601.7	613.2	698.7	657.6	542.2
491.4	486.0	452.9	504.3	502.5	494.4	490.1	535.5	544.6	451.1
28.7	27.4	27.8	29.1	27.7	30.1	30.8	32.7	25.0	16.9
39.3	37.7	39.8	38.5	39.0	40.4	38.2	40.1	40.6	43.6
559.4	551.1	520.5	571.9	569.2	564.9	559.1	608.3	610.2	511.6
43.6	27.4	18.1	26.1	27.9	36.8	54.1	90.4	47.4	30.6
2.5	(1.3)	2.1	2.1	1.9	4.3	4.1	2.5	2.7	8.1
(24.5)	(24.8)	(23.7)	(25.0)	(22.4)	(20.9)	(19.5)	(17.4)	(15.1)	(15.3)
21.6	1.3	(3.5)	3.2	7.4	20.2	38.7	75.5	35.0	23.4
(11.9)	10.6	1.8	(1.9)	(2.5)	(5.9)	(18.0)	(33.4)	(8.6)	(5.5)
9.7	11.9	(1.7)	1.3	4.9	14.3	20.7	42.1	26.4	17.9
3.8	1.9	4.3	6.4	7.3	6.1	8.5	7.1	5.4	5.5
.2	(.1)	—	.1	(.1)	—	—	(.1)	(.1)	(.1)
13.7	13.7	2.6	7.8	12.1	20.4	29.2	49.1	31.7	23.3
—	—	—	—	—	—	45.0	—	—	—
13.7	13.7	2.6	7.8	12.1	20.4	74.2	49.1	31.7	23.3
(6.4)	(6.6)	(6.3)	(6.2)	(6.9)	(7.2)	(8.0)	(8.6)	(8.5)	(8.4)
7.3	7.1	(3.7)	1.6	5.2	13.2	66.2	40.5	23.2	14.9
.24	.24	(.12)	.05	.17	.43	.68	1.31	.74	.48
.24	.24	(.12)	.05	.17	.43	.68	1.26	.74	.48
.24	.24	(.12)	.05	.17	.43	2.14	1.31	.74	.48
.24	.24	(.12)	.05	.17	.43	2.01	1.26	.74	.48
25.91	25.71	29.16	25.37	22.31	25.38	30.00	39.75	39.00	43.38
21.43	23.67	24.51	20.10	17.40	17.63	23.50	28.13	34.00	35.50
—	—	—	—	—	—	—	.25	.25	.25
.44	.48	.54	—	—	.36	—	—	—	—

1986 Sales by Product
(\$ millions)

Lumber 30.7%	770.3
Panelboards 9.0%	226.3
Newsprint and Groundwood Printing Papers 25.7%	645.5
Pulp 10.2%	257.5
Containerboard and Packaging Products 17.4%	436.4
Other 7.0%	175.7
Total	2,511.7

better supply-demand balance prevailed as offshore supply stabilized due to a weakening of currency exchange rates, and Eastern Canadian producers enjoyed better market conditions in traditional territories. MacMillan Bloedel continued to benefit from its dual strategies of controlling costs and increasing production of higher value-added groundwood printing papers. Five of the Company's eight paper machines can now run groundwood printing papers such as hi-brite grades, telephone directory papers, lightweight and coloured newsprint. There is a growing demand for these products and they attract price premiums in the marketplace.

Standard newsprint net mill returns were similar in 1986 to those achieved in 1985 and reflect favourable exchange rates. In the U.S. market the list price remained at US\$535/tonne since October 1984. The Company announced and successfully implemented a US\$35/tonne price increase effective October 1, 1986. This raised the standard news selling price to US\$570/tonne. The 5 percent rebate program introduced by the Company in 1983 for customers taking their contracted volumes, and the competitive allowance of a further 5 percent which became effective December 1, 1985, remained in effect throughout 1986. Groundwood printing paper prices averaged approximately US\$640/tonne in 1986, unchanged from the previous year.

Offshore newsprint markets remained extremely competitive in 1986. In Latin America, oversupply and lack of U.S. currency were key factors which showed little sign of improvement. Demand in the Orient returned to more traditional levels. The Company particu-

larly benefited from the appreciation of the Japanese Yen in 1986.

Prices for northern bleached kraft softwood pulp gradually increased throughout the year to US\$520 per tonne in the major markets after having reached a low of US\$370/390 in late 1985. Early in December 1986 the Company announced a price increase to US\$550 effective for the first quarter of 1987. The decline of the Canadian and U.S. dollars relative to most major world currencies, combined with significant cost reductions, have restored the Company to its competitive position of pre-1981.

Containerboard and Packaging

In 1986 the containerboard and packaging segment reported a contribution of \$19.7 million compared to \$8.1 million in 1985. Sales in 1986 amounted to \$436.6 million, up from \$408.0 million in 1985.

The Company's linerboard and corrugating medium machines at Pine Hill, Alabama operated at an average 102 percent of productive capacity in 1986, producing 584,000 tonnes of containerboard compared to 542,000 tonnes in 1985. The corrugating medium mill at Sturgeon Falls, Ontario produced 70,000 tonnes and ran at 98 percent capacity in 1986 compared to 67,000 tonnes and 94 percent in 1985.

The containerboard market firmed up throughout 1986 largely as a result of the decline in the U.S. dollar with the resulting boost to export tonnage. Linerboard prices increased in 1986 and reached a list price of US\$320 per ton in the third quarter. A US\$30 per ton increase for linerboard was announced in early 1987. Prices had dropped to approximately US\$270 per ton in mid-1985 reflecting high inventory

levels and weak export markets resulting from the high U.S. dollar.

The corrugated container business in the U.S. has had a difficult year. Continued resistance to the implementation of higher box prices affected results despite record sales volumes. The 11 U.S. corrugated container plants located in the Midwest, South and East are highly integrated with the Pine Hill containerboard operation. The increase in containerboard price due to improvement of overseas markets was not successfully passed on to the U.S. box market until the fourth quarter of the year resulting in an operating loss in 1986 compared to an operating profit in 1985.

Labour Relations

Negotiations with the International Woodworkers of America this year were difficult. Demands for improved pension benefits, protection against contracting out and flexibility of shift scheduling were the main issues.

The union began strike action on a rotating basis in late July and all operations certified by the IWA were down by mid-August.

After several unsuccessful attempts at resolution using third party intermediaries, an agreement with the IWA leadership was reached on December 5, 1986. The membership voted in favour of the two-year contract which included a 40 cent per hour wage increase in the second year and improved pension benefits. The issues of contracting out and shift scheduling will go to a Commission of Inquiry which is to submit its non-binding recommendations by March 1, 1988.

Collective agreements with the Canadian Paperworkers' Union and the Pulp, Paper and Woodworkers of

Canada, which affect all three of the Company's pulp and paper mills in British Columbia, were concluded and ratified early in the year with no work stoppages. These contracts cover the two year period to mid-1988.

Comparison of 1985 and 1984 Earnings

MacMillan Bloedel's net earnings increased from \$19.3 million in 1984 to \$42.9 million in 1985.

The building materials business segment contributed to the improvement in 1985 with a profit of \$44.5 million compared to the 1984 profit of \$26.1 million. The main impetus behind this improvement was the significantly increased lumber shipments in 1985 in response to continuing strong North American demand.

The pulp and paper segment contribution was also up with a 1985 profit of \$70.7 million, compared to \$33.9 million in 1984. Higher shipment volumes in all of the Company's pulp and paper products accounted for this improvement.

Lower prices for containerboard in the U.S. which is the principal market for the Company's containerboard products, and weak export markets resulting from the high U.S. dollar, decreased the containerboard and packaging segment contribution from \$28.0 million in 1984 to \$8.1 million in 1985.

Equity in earnings of partly-owned companies increased by \$9.7 million to \$24.1 million in 1985 mainly from significantly higher earnings of Koninklijke Nederlandse Papierfabrieken N.V. (KNP).

Despite lower interest rates, higher average debt outstanding during 1985 caused the increase in interest expense of \$3.1 million to \$92.0 million.

1986 Sales by Market (\$ millions)		
Canada 18.6%		467.8
United States 56.0%		1,406.7
United Kingdom and Europe 10.6%		265.8
Japan and Orient 10.2%		255.9
Other 4.6%		115.5
Total		2,511.7

Inflows	
- Operating Earnings	222.5
- Depreciation, Depletion and Amortization	105.4
- Other Income	17.4
- Dividends from Partly-owned Companies	8.4
- Extraordinary Item	88.2
- Decrease in Operating Working Capital	50.8
- New Shares	66.3
- Disposals of Investments and Other Items	6.6
Total	565.6

Outflows	
- Reduction of Interest-bearing Debt	312.9
- Interest and Dividends	123.6
- Capital Expenditures and Investments	106.4
- Other (Increase in Net Cash Equivalents and Income Taxes Paid)	22.7
Total	565.6

MacMillan Bloedel raises funds in the world's major financial markets and, in order to obtain the most advantageous terms of credit, maintains a flexible financial structure. The Company has in excess of \$1.0 billion of credit lines with major commercial banks of which over \$600 million are long term contractual lines of credit and the balance represents short term lines of credit. The Company had reduced its available lines of credit in 1986, reflecting its reduction in interest-bearing debt from \$863.7 million to \$547.3 million. The unutilized bank lines of credit at the end of 1986 amounted to \$839.6 million of which \$448.0 million represented long term lines of credit and \$391.6 million short term lines of credit.

The significant improvements in 1986 noted above were achieved primarily by the generation of internal funds, the sale of approximately 40 percent of the Company's holding in Koninklijke Nederlandse Papierfabrieken N.V. (KNP) and the issue of additional shares.

Funds generated by operations in 1986 amounted to \$404.5 million with a net generation of funds of \$168.2 million after capital expenditures and investments of \$106.4 million and payment of dividends, interest and taxes of \$129.9 million.

In February of 1986 the Company reduced its holding in KNP from approximately 39 percent to approximately 25 percent through the sale of 1,350,000 KNP shares out of its total holding. The sale realized \$88.2 million and resulted in a net gain of \$45.0 million.

In January of 1986 the Company issued 2,400,000 preference shares for a net consideration in cash of \$58.0 million. In addition, the Company issued 335,297 common shares for a net consideration of

\$6.3 million of which \$4.8 million were sold through the employee share purchase plan and \$1.5 million through the exercise of share options.

Capital expenditures in 1986 on property, plant and equipment amounted to \$100.0 million which related to ongoing environmental and safety items and the replacement of existing capacity and technological updating.

During the year the Company resumed payment of cash dividends on its common shares which amounted to \$.75 per share.

In December the Company issued a notice of redemption of the class B series 1 \$2.00 preferred shares of which 1,718,152 shares were converted to common shares during January 1987, leaving a balance of 17,650 shares.

The Company's long term financial objective is to reduce interest-bearing debt and term preferred shares to 35 percent of invested capital. (For a definition of invested capital see page 1) At the beginning of 1986 the ratio was 52.0 percent and by the end of the year, the ratio had declined to 38.7 percent. To reach this goal MacMillan Bloedel continues to look for new and better ways to increase its profitability not only through increased sales but by reducing costs of production, carrying inventory and debt-financing.

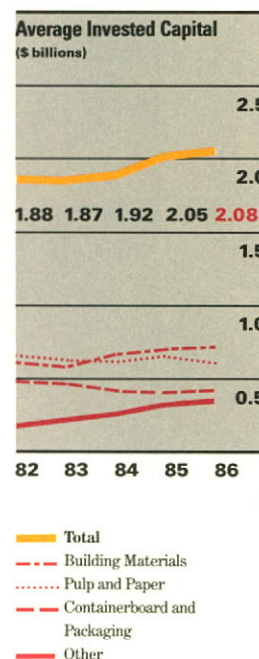
A significant portion of MacMillan Bloedel's sales is denominated in foreign currencies, principally U.S. dollars. Due to associated changing prices the precise effect of changing currency rates on Company results cannot be measured but a 1 cent change in the Canadian/U.S. exchange rate is expected to result in a change of about \$7.0 million in net cash received.

Five year financial data	1982	1983	1984	1985	1986
(\$ millions)					
Funds generated by operations	125.9	55.8	94.6	247.9	404.5
Depreciation, depletion and amortization	82.2	103.5	104.3	114.7	105.4
Capital expenditures	206.8	103.6	137.7	96.6	100.0
Interest paid	78.0	81.2	91.1	91.6	67.1
Preferred share dividends paid	19.3	19.9	24.4	26.5	33.2
Common share dividends paid	2.3	.3	.4	.2	23.3
Current assets	615.8	673.9	739.8	733.1	683.2
Current operating liabilities	236.4	250.6	241.5	239.5	229.6
Operating working capital	379.4	423.3	498.3	493.6	453.6
Property, plant and equipment	1,365.8	1,235.6	1,318.4	1,317.2	1,258.6
Investments and other assets	144.1	191.2	179.3	269.9	254.1
Net assets employed	1,889.3	1,850.1	1,996.0	2,080.7	1,966.3
Interest-bearing debt	865.5	775.6	917.3	863.7	547.3
Redeemable term preferred shares	135.3	136.4	211.4	218.3	214.6
Redeemable convertible preferred shares	95.9	95.9	95.9	95.9	50.1
Other redeemable preferred shares	—	—	—	50.0	110.0
Common equity	678.3	741.2	680.2	761.9	945.7
Deferred credits and minority interests	114.3	101.0	91.2	90.9	98.6
Total invested capital	1,889.3	1,850.1	1,996.0	2,080.7	1,966.3
Interest-bearing debt as a percentage of invested capital	45.8%	41.9%	46.0%	41.5%	27.8%
Interest-bearing debt and redeemable term preferred shares as a percentage of invested capital	53.0%	49.3%	56.5%	52.0%	38.7%

Notes:

(1) Foreign currency accounting changes have been applied prospectively commencing with 1984.

(2) The conversion of \$43.0 million of redeemable convertible preferred shares into common shares in January 1987 has been given effect as at December 31, 1986 in the above table.



Capital expenditures	1982	1983	1984	1985	1986	5 Year Total	% of Total
(\$ millions)							
Raw materials	14.7	20.3	46.9	24.1	40.4	146.4	22.7
Building materials	1.2	15.8	37.9	16.6	6.9	78.4	12.2
Pulp and paper	41.3	23.1	32.3	32.8	32.1	161.6	25.1
Containerboard and packaging	143.0	42.3	17.4	18.2	14.3	235.2	36.5
Other	6.6	2.1	3.2	4.9	6.3	23.1	3.5
Total	206.8	103.6	137.7	96.6	100.0	644.7	100.0

Consolidated Statements of Earnings



	Year ended December 31		
	1986	1985	1984
	(\$ millions)		
<i>Sales of products and services</i>	\$2,511.7	\$2,335.4	\$2,127.6
<i>Costs and expenses:</i>			
Materials, labour and other operating expenses	2,021.3	1,954.1	1,807.9
Depreciation, depletion and amortization	105.4	114.7	104.3
Selling, general and administrative	162.5	157.7	148.2
	2,289.2	2,226.5	2,060.4
<i>Operating earnings</i>	222.5	108.9	67.2
Other income	17.4	10.4	8.7
Interest expense	(67.3)	(92.0)	(88.9)
<i>Earnings (loss) before income taxes</i>	172.6	27.3	(13.0)
<i>Income tax recovery (expense):</i>			
Current	(31.5)	.2	(1.4)
Deferred	(34.0)	(8.7)	19.5
	(65.5)	(8.5)	18.1
<i>Earnings before undernoted items</i>	107.1	18.8	5.1
Equity in earnings of partly-owned companies	26.5	24.1	14.4
Minority interests in subsidiaries	(.3)	—	(.2)
<i>Earnings before extraordinary item</i>	133.3	42.9	19.3
Extraordinary item	45.0	—	—
<i>Net earnings</i>	178.3	42.9	19.3
Provision for dividends on preferred shares	33.5	26.6	25.1
<i>Net earnings (loss) attributable to common shareholders</i>	\$ 144.8	\$ 16.3	\$ (5.8)
<i>Net earnings (loss) per common share</i>			
Before extraordinary item			
Basic	\$ 3.21	\$.54	\$ (.19)
Fully diluted	\$ 3.18	\$.54	\$ (.19)
After extraordinary item			
Basic	\$ 4.66	\$.54	\$ (.19)
Fully diluted	\$ 4.52	\$.54	\$ (.19)

See Note 13 for earnings statement supplementary information.

Consolidated Statements of Changes in Financial Position



	Year ended December 31		
	1986	1985	1984
	(\$ millions)		
<i>Internal funds:</i>			
<i>Generated by operations:</i>			
Operating earnings	\$ 222.5	\$ 108.9	\$ 67.2
Depreciation, depletion and amortization	105.4	114.7	104.3
Other income	17.4	10.4	8.7
Dividends from partly-owned companies	8.4	7.2	3.7
Decrease (increase) in operating working capital			
Receivables	35.3	(9.7)	(29.2)
Inventories	22.1	26.2	(51.9)
Other	(6.6)	(9.8)	(8.2)
Generated by operations	404.5	247.9	94.6
<i>Required for:</i>			
Interest	67.1	91.6	91.1
Dividends	56.5	26.7	24.8
Income taxes currently paid	6.3	.2	1.9
	129.9	118.5	117.8
<i>Net internal funds</i>	274.6	129.4	(23.2)
<i>Funds invested long term:</i>			
Capital expenditures	100.0	96.6	137.7
Investments and other assets	6.4	24.7	7.6
	106.4	121.3	145.3
<i>Funds generated (required)</i>	\$ 168.2	\$ 8.1	\$ (168.5)
<i>Sources of financing:</i>			
Extraordinary item	\$ 88.2	\$ —	\$ —
Net interest-bearing debt incurred (repaid)	(312.9)	(83.6)	79.7
Issue of common shares	6.3	14.7	11.6
Issue of class B preferred shares	60.0	50.0	50.0
Disposal of investments and other items	6.6	12.8	10.9
Financing provided (repaid)	(151.8)	(6.1)	152.2
Decrease (increase) in funds*	(16.4)	(2.0)	16.3
<i>Funds supplied (repaid)</i>	\$ (168.2)	\$ (8.1)	\$ 168.5

*Funds are defined as cash less bank overdrafts and short term investments and deposits.

Consolidated Statements of Financial Position



	December 31	
Net Assets Employed	1986	1985
	(\$ millions)	
<i>Current assets:</i>		
Short term investments and deposits	\$ 25.0	\$ 17.7
Accounts receivable –		
Trade	240.2	276.2
Other	30.8	30.1
Inventories (Note 3)	383.0	405.1
Prepaid expenses	4.2	4.0
	<u>683.2</u>	<u>733.1</u>
<i>Deduct:</i>		
Current liabilities (excluding interest-bearing liabilities) –		
Bank overdrafts in excess of cash in banks	5.6	14.7
Trade accounts payable	101.3	103.0
Accrued payroll and related liabilities	75.4	75.2
Accrued interest on borrowed funds	15.1	14.9
Other accounts payable and accrued liabilities	23.2	28.1
Income taxes payable	7.3	1.7
Dividends payable	1.7	1.9
	<u>229.6</u>	<u>239.5</u>
Operating working capital	<u>453.6</u>	<u>493.6</u>
<i>Investments and other assets:</i> (Note 4)		
Investments accounted for by the equity method	186.3	200.8
Other investments and assets, at cost	57.6	55.6
Subsidiaries not consolidated	10.2	13.5
	<u>254.1</u>	<u>269.9</u>
<i>Property, plant and equipment:</i> (Note 5)		
Buildings and equipment	2,072.0	2,050.7
Less: Accumulated depreciation	<u>1,023.4</u>	<u>956.8</u>
	1,048.6	1,093.9
Timber and land less accumulated depletion	137.1	136.1
Logging roads	9.3	9.6
Foreign exchange translation adjustment (Note 11)	63.6	77.6
	<u>1,258.6</u>	<u>1,317.2</u>
	<u>\$1,966.3</u>	<u>\$2,080.7</u>

These consolidated financial statements have been approved by the Board of Directors:

R.V. Smith
Director

A.H. Zimmerman
Director

	December 31	
Invested Capital	1986	1985
	(\$ millions)	
<i>Interest-bearing indebtedness:</i>		
Current liabilities –		
Bank indebtedness (Note 6)	\$ 12.3	\$ 63.1
Notes payable	43.6	—
Current portion of long term debt (Note 7)	39.1	25.5
	95.0	88.6
Long term liabilities –		
Term bank loans (Note 8)	212.6	436.1
Bonds and debentures (Note 9)	174.0	232.8
Other secured liabilities	10.3	25.0
Foreign exchange translation adjustment (Note 11)	55.4	81.2
	452.3	775.1
Total interest-bearing indebtedness	547.3	863.7
<i>Deferred income taxes</i>	82.6	75.1
<i>Deferred revenue</i>	16.0	15.8
	645.9	954.6
 Shareholders' Equity		
<i>Share capital:</i> (Note 10)		
Preferred shares	374.7	364.2
Common shares	481.2	429.1
	855.9	793.3
<i>Contributed surplus</i> (Note 4)	15.9	18.2
<i>Retained earnings</i>	466.2	345.3
	1,338.0	1,156.8
<i>Foreign exchange translation adjustment</i> (Note 11)	(17.6)	(30.7)
	1,320.4	1,126.1
 Commitments (Notes 10 and 12)		
 Subsequent events (Notes 10 and 16)		
	\$1,966.3	\$2,080.7

Consolidated Statements of Retained Earnings



	Year ended December 31		
	1986	1985	1984
	(\$ millions)		
<i>Balance at beginning of year</i>	\$ 345.3	\$ 356.8	\$ 426.9
<i>Net earnings</i>	178.3	42.9	19.3
	523.6	399.7	446.2
<i>Deduct:</i>			
Cash dividends:			
Preferred shares	33.0	26.0	26.7
Common shares 1986 \$.75 per share (1985 and 1984 – \$ nil per share*)	23.3	.2	.4
	56.3	26.2	27.1
Stock dividends:			
Common shares 1986 \$ nil per share (1985 \$.90 and 1984 \$2.06 per share)	—	27.3	61.2
Costs of issue of class B preferred shares, less applicable income taxes of \$.9 million (1985 \$.7 million and 1984 \$.7 million)	1.1	.9	1.1
	57.4	54.4	89.4
<i>Balance at end of year</i>	\$ 466.2	\$ 345.3	\$ 356.8

*Cash dividends on common shares in 1985 and 1984 represent cash paid in lieu of issuing fractional common shares as stock dividends.

Consolidated Statements of Contributed Surplus



	Year ended December 31		
	1986	1985	1984
	(\$ millions)		
Balance at beginning of year	\$ 18.2	\$ —	\$ —
Class B preferred shares, series 9	—	18.2	—
Cash dividends	2.3	—	—
	\$ 15.9	\$ 18.2	\$ —

Auditors' Report

To the Shareholders of
MacMillan Bloedel Limited:

We have examined the consolidated statements of financial position of MacMillan Bloedel Limited as at December 31, 1986 and 1985 and the consolidated statements of earnings, retained earnings, contributed surplus and changes in financial position for each of the years ended December 31, 1986, 1985 and 1984. Our examinations were 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 1985 and the results of its operations and the changes in its financial position for the years ended December 31, 1986, 1985 and 1984 in accordance with generally accepted accounting principles which, except for the change in the method of accounting for investment tax credits adopted in 1985, as explained in Note 2 to the consolidated financial statements, have been consistently applied during the period.

Price Waterhouse
Chartered Accountants

Vancouver, British Columbia
February 6, 1987

December 31, 1986, 1985 and 1984



In these financial statements "MacMillan Bloedel" means MacMillan Bloedel Limited and its consolidated subsidiaries, and "Company" means MacMillan Bloedel Limited as a corporation.

1. Accounting policies:

MacMillan Bloedel follows accounting principles generally accepted in Canada. Information with respect to generally accepted accounting principles in the United States is provided in Note 17.

(a) Principles of consolidation –

The consolidated financial statements include all subsidiaries other than the subsidiaries located in Brazil. Significant restrictions on the repatriation of funds from Brazil make consolidation inappropriate.

(b) Foreign currency translations –

The assets and liabilities of self-sustaining foreign operations are translated at current rates of exchange while those of integrated foreign operations are translated at current rates for items measured at current prices, and at historical rates for items measured at past prices. Other assets and liabilities denominated in foreign currencies are translated at the year-end rate of exchange.

MacMillan Bloedel considers that its foreign currency denominated debt represents an effective hedge of its foreign currency investments in subsidiary and partly-owned companies. Accordingly, foreign currency translation adjustments relating to long-term debt are included with the foreign exchange translation adjustment relating to self-sustaining foreign operations as a separate component of shareholders' equity.

The foreign exchange translation adjustments which are separately identified in the consolidated financial statements represent the amounts required to adjust the Canadian dollar equivalents from those that are derived from using historical rates to those that are derived from using the above noted policy.

(c) Valuation of inventories –

Inventories of substantially all operating and maintenance supplies and raw materials are valued at the lower of average cost and replacement cost. Inventories of manufactured products are valued at the lower of average cost and net realizable value.

(d) Partly-owned companies –

Investments in partly-owned companies are accounted for by the equity method. Under this method, MacMillan Bloedel's share of the net earnings (losses) of the partly-owned companies is included in consolidated net earnings.

(e) Property, plant and equipment –

Property, plant and equipment are recorded at cost.

MacMillan Bloedel employs the units-of-production basis for depreciation of manufacturing assets. Non-manufacturing assets are depreciated on a straight-line basis.

The rates of depreciation being applied are intended to fully depreciate manufacturing assets (at normal production levels) and non-manufacturing assets over the following periods:

Buildings	20 and 40 years
Pulp and paper mill machinery and equipment	20 years
Logging machinery and equipment	5 to 7 years
Other manufacturing machinery and equipment	7 to 13 years
Tugs, barges and scows	10 to 13 years

Depletion of timber and amortization of main logging roads are determined on a basis related to log production.

(f) *Pension costs* –

Pension costs charged to earnings, including applicable amortization of pension plan experience gains and losses, are determined on the basis of annual reviews of MacMillan Bloedel's various pension plans and other retirement arrangements.

(g) *Capitalized interest* –

Interest is charged to major capital projects during the construction phase.

2. Accounting change:

Effective January 1, 1985 the Company adopted the deferral method of accounting for investment tax credits; the flow-through method was used in prior years. The effect of this change has been to decrease net earnings for 1986 by \$13.5 million (\$.43 per common share) (reduce net earnings for 1985 by \$5.6 million (\$.18 per common share)).

MacMillan Bloedel anticipates utilizing unused investment tax credits associated with expenditures made subsequent to 1980. Consequently investment tax credits of \$42.1 million have been credited to fixed assets and \$5.5 million credited against research costs in 1986.

3. Inventories:

	December 31	
	1986	1985
	(\$ millions)	
Operating and maintenance supplies	\$ 64.2	\$ 64.6
Logs, poles, pulp chips, pulpwood and cordwood	104.4	105.2
Lumber, plywood and other building materials	139.6	162.7
Pulp and paper products	41.8	40.4
Containerboard and packaging products	33.0	32.2
	\$383.0	\$405.1

4. Investments and other assets:

Investments accounted for by the equity method –

		December 31			
		1986		1985	
	% Owned	Cost	Undistributed earnings (losses) (\$ millions)	Total	Total
Koninklijke Nederlandse Papierfabrieken N.V. (KNP)	25.0	\$ 24.2	\$ 51.2	\$ 75.4	\$ 99.2
MacMillan Smurfit SCA Limited	50.0	28.2	(8.4)	19.8	23.9
Island Paper Mills Limited	50.0	32.2	(.5)	31.7	28.2
MacMillan Bathurst Inc.	50.0	24.6	6.3	30.9	29.6
Other		3.6	(4.6)	(1.0)	.1
		112.8	44.0	156.8	181.0
Foreign exchange translation adjustment		29.5	—	29.5	19.8
		\$142.3	\$ 44.0	\$186.3	\$200.8

4. Investments and other assets: (continued)

Summarized financial information relating to investments accounted for by the equity method is as follows:

	December 31			
	1986	1985		1984
	KNP	Other	Total	Total
	(\$ millions)			
Current assets	\$ 512.5	\$166.9	\$ 679.4	\$490.1
Non-current assets	545.2	178.1	723.3	433.8
Foreign exchange translation adjustment	124.1	(2.2)	121.9	33.1
	\$1,181.8	\$342.8	\$1,524.6	\$957.0
Current liabilities	\$ 253.1	\$102.8	\$ 355.9	\$261.2
Non-current liabilities	398.0	111.9	509.9	279.9
Foreign exchange translation adjustment	105.6	4.8	110.4	36.2
	756.7	219.5	976.2	577.3
Shareholders' equity	296.7	130.6	427.3	343.8
Foreign exchange translation adjustment	128.4	(7.3)	121.1	35.9
	\$1,181.8	\$342.8	\$1,524.6	\$957.0

	Year ended December 31				
	1986	1985		1984	
	KNP	Other	Total	Total	Total
	(\$ millions)				
Net sales	\$ 914.6	\$ 737.6	\$1,652.2	\$1,328.0	\$1,197.3
Gross profit	\$ 126.5	\$ 29.0	\$ 155.5	\$ 105.0	\$ 77.5
Net earnings	\$ 85.3	\$ 7.1	\$ 92.4	\$ 57.6	\$ 34.7

During 1986 MacMillan Bloedel sold a portion of its investment in KNP, reducing its interest to 25% (Note 13(c)).

During 1985 the convertible debentures of KNP were converted into common shares of that company resulting in a reduction of MacMillan Bloedel's interest from 40.7% to 38.9%. In 1983 conversions reduced MacMillan Bloedel's interest from 48% to 40.7%.

Subsidiaries not consolidated –

Losses of the Brazilian subsidiaries for the year ended December 31, 1986 aggregated \$3.4 million (1985 – \$1.9 million, 1984 – \$3.3 million), which amounts have been charged to earnings. The Company's share of the losses of the Brazilian subsidiaries since the original acquisition of shares aggregated \$21.8 million at December 31, 1986. The investment is carried in the Consolidated Statements of Financial Position at cost less provision for these losses.

Other investments –

During 1985 the Company acquired interests in oil and gas properties for \$23.2 million. As consideration for the acquisition, the Company issued 1,000 class B participating preferred shares series 9 with a flow through of investment tax credits of \$5.0 million to the vendor. One thousand dollars of the consideration has been allocated to share capital and \$18.2 million to contributed surplus.

5. Buildings and equipment:

	Cost*	Accumulated depreciation*	Net*
	(\$ millions)		
December 31, 1986			
Building materials	\$ 577.8	\$ 320.3	\$ 257.5
Pulp and paper	968.8	522.5	446.3
Containerboard and packaging	475.3	156.6	318.7
Corporate assets and other	50.1	24.0	26.1
	\$2,072.0	\$1,023.4	\$1,048.6

	Cost*	Accumulated depreciation*	Net*
		(\$ millions)	
December 31, 1985			
Building materials	\$ 562.0	\$ 309.4	\$ 252.6
Pulp and paper	958.9	487.7	471.2
Containerboard and packaging	485.1	136.4	348.7
Corporate assets and other	44.7	23.3	21.4
	\$2,050.7	\$ 956.8	\$1,093.9

*Before application of current exchange rates (Note 1).

Assets having an aggregate historical cost of \$172.9 million (1985 – \$186.8 million) (mainly the Alabama facilities) and the related depreciation and long term debt included in these financial statements are held under capital leases.

6. Short term bank indebtedness:

At December 31, 1986 MacMillan Bloedel had short term bank lines of credit aggregating \$403.9 million (1985 – \$472.2 million) of which \$12.3 million (1985 – \$63.1 million) had been drawn down.

7. Payments on long term debt and retractable preferred shares:

Required payments on long term debt, and payments which may be required in regard to retractable preferred shares at December 31, 1986 rates of exchange, for each of the five years after December 31, 1986 are as follows –

	Bonds and debentures	Term bank loans	Other liabilities	Subtotal	Retractable preferred shares	Total
				(\$ millions)		
1987	\$18.6	\$ 6.1	\$14.4	\$39.1	\$119.8	\$158.9
1988	19.8	6.5	1.6	27.9	54.0	81.9
1989	14.1	11.0	1.7	26.8	4.0	30.8
1990	16.4	17.9	1.5	35.8	4.0	39.8
1991	19.7	32.1	2.3	54.1	19.7	73.8

8. Term bank loans (unsecured):

	December 31	
	1986	1985
	(\$ millions)	
Advances under contractual term lines of credit	\$165.2	\$332.0
Loan of U.S. \$50.0 million maturing September 30, 1990 bearing interest at a floating rate not to be less than 9% nor greater than 12½%	—	58.8
Loan of Dutch Florins 74.8 million (1985 – U.S. \$31.8 million) maturing September 15, 1991 bearing interest at rates related to prime	37.9	39.3
Loan of U.S. \$5.5 million maturing March 31, 1989 bearing interest at a rate related to the London Interbank rate for U.S. dollar deposits	6.6	8.5
Loan maturing June 30, 1994 bearing interest at rates related to prime	8.1	—
	217.8	438.6
Less: Payments due within one year	5.2	2.5
	\$212.6	\$436.1

8. Term bank loans (unsecured): (continued)

At December 31, 1986 MacMillan Bloedel had contractual term bank lines of credit aggregating \$613.2 million (1985 – \$815.8 million) of which \$165.2 million (1985 – \$336.8 million) had been drawn down. These contractual term lines provide for loans on a revolving basis for three to eight years, followed by repayment periods of up to seven years.

9. Bonds and debentures:

	December 31	
	1986	1985
	(\$ millions)	
MacMillan Bloedel Limited –		
6.45% sinking fund debentures, series A, maturing October 1, 1990 (U.S. \$8.4 million)	\$ 9.0	\$ 11.3
6½% sinking fund debentures, series C, maturing July 15, 1992 (U.S. \$4.9 million)	5.2	9.5
8½% sinking fund debentures, series E, maturing May 15, 1991	5.1	12.0
8¾% sinking fund debentures, series F, maturing July 1, 1994 (U.S. \$34.5 million)	33.3	42.0
11¼% sinking fund debentures, series G, maturing January 15, 1995 (Note 16)	2.8	27.3
9% sinking fund debentures, series J, maturing February 1, 1992 (U.S. \$35.2 million)	35.9	37.3
9¼% sinking fund debentures, series K, maturing March 15, 1993 (U.S. \$35.0 million)	38.6	40.5
	129.9	179.9
MacMillan Bloedel Inc.* –		
4⅜% sinking fund industrial development revenue bonds, maturing June 1, 1988 (U.S. \$9.9 million)	10.7	15.4
4.90% - 5.50% general obligation industrial bonds, series 1977, maturing December 1, 1997 (U.S. \$6 million)	.7	.8
10¼% pollution control bonds, maturing November 1, 2000 (U.S. \$15.0 million)	18.0	18.0
10½% pollution control bonds, maturing November 1, 2015 (U.S. \$15.0 million)	18.0	18.0
9⅝% industrial development revenue bond	—	4.3
8½% to 10½% industrial development revenue bonds, maturing 1993 (U.S. \$6.0 million)	7.5	7.5
70% of prime industrial development revenue bonds maturing 1994 (U.S. \$2.9 million)	3.8	3.8
	58.7	67.8
	188.6	247.7
Less: Payments due within one year	14.6	14.9
	\$174.0	\$232.8

*These bonds are direct obligations of Industrial Development Boards and municipal authorities in Alabama, Arkansas, Mississippi and New Jersey.

Substantially all of MacMillan Bloedel's assets are pledged by fixed and floating charges as security for the outstanding bonds and debentures and other liabilities.

10. Share capital:

The Company's authorized capital consists of 50.0 million common shares, 3.4 million class A preferred shares and 20.0 million class B preferred shares issuable in series, all without par value.

	December 31	
	1986	1985
	(\$ millions)	
Outstanding shares without par value		
Preferred –		
3,400,000 class A	\$ 87.9	\$ 87.9
17,650 class B, series 1	.4	46.2
1,986,468 class B, series 2	49.7	49.7
227,250 class B, series 3	22.7	24.1
250,000 class B, series 4	22.3	22.3
2,000,000 class B, series 6	50.0	50.0
2,000,000 class B, series 8	50.0	50.0
1,000 class B, series 9	—	—
2,400,000 class B, series 10	60.0	—
	343.0	330.2
Foreign exchange translation adjustment	31.7	34.0
	374.7	364.2
Common –		
32,611,631 shares	481.2	429.1
	\$855.9	\$793.3

This note reflects the conversion of 1,718,152 class B, series 1 shares into 1,346,710 common shares during January 1987 (Note 16).

The Class A Preferred Shares –

The class A preferred shares are redeemable, at the option of the Company, at U.S.\$25.00 per share; the shares are retractable, at the option of the holder, on May 1, 1987 at U.S.\$25.00 per share (Note 16). The shares carry the right to cumulative preferential dividends at a rate of 1½% above ½ of the average U.S. prime rate.

The Class B Preferred Shares –

These shares rank on a parity with the class A preferred shares and prior to the common shares of the Company.

	Date	Price
Conversion features		
Series 1:		
Convertible into one common share on or before (called for redemption on January 19, 1987 – Note 16)	December 1, 1990	\$31.89
Series 2:		
Convertible into one common share on or before (Note 16)	March 1, 1991	\$38.60

10. Share capital: (continued)

Redemption features	Date	Price
Series 1: Company's redemption options – redeemable (called for redemption on January 19, 1987 – Note 16)	currently	\$26.00 (1)
Series 2: Company's redemption options – redeemable (Note 16)	currently	\$26.25 (1)
Company's redemption obligations – make all reasonable efforts during each calendar quarter commencing April 1, 1991 to purchase 1% of the shares outstanding on March 2, 1991		maximum \$25.00
Series 3: Company's redemption options – redeemable	currently	\$102.50 (2)
Company's redemption obligations – redeem 5% of original holdings annually on	July 1	\$100.00
Redeem remaining shares on	July 1, 1991	\$100.00
Series 4: Company's redemption options – redeemable before	September 1, 1992	U.S.\$100.00
Company's redemption obligations – redeem 4,687 shares each quarter	September 1, 1987 through June 1, 1992	U.S.\$100.00
Redeem remaining shares on	September 1, 1992	U.S.\$100.00
Series 6: Company's redemption options – redeemable after	March 1, 1988	\$25.00
Company's redemption obligations – make all reasonable efforts to purchase during each calendar quarter commencing April 1, 1988 1% of the shares outstanding on January 1, 1988		maximum \$25.00
Series 8: Company's redemption options – redeemable after	September 1, 1990	\$26.00 (3)
Company's redemption obligations – make all reasonable efforts to purchase, for \$25.00 or less per share, during each calendar quarter		
(i) commencing March 1, 1987 ½% of the shares outstanding on February 28, 1987 and		
(ii) commencing September 1, 1990 1% of the shares outstanding on August 31, 1990		
Series 10: Company's redemption options – redeemable on or after	March 1, 1991	\$25.50 (4)
Company's redemption obligations — make all reasonable efforts to purchase, for \$25.00 or less per share, during each calendar quarter commencing September 1, 1987 and ending on February 28, 1991, ½% of the shares outstanding on August 31, 1987		
Retractable features		
Series 6: Retractable at the option of the holder for redemption	March 1, 1988, 1989, 1990, 1991	\$25.00

(1) This price declines \$.25 annually to \$25.00.

(2) This price declines \$.50 annually to \$100.00.

(3) This price declines \$.50 annually to \$25.00.

(4) This price reduces to \$25.00 on or after March 1, 1993.

Dividends

- Series 1 \$2.00 per annum cumulative preferential, payable quarterly.
Series 2 \$2.08 per annum cumulative preferential, payable quarterly.
Series 3 Cumulative preferential equal to the sum of 1¼% and ½ of the defined average minimum lending rate per annum, payable quarterly.
Series 4 Cumulative preferential equal to the sum of 1½% and ½ of the defined average U.S. prime rate per annum, payable quarterly.
Series 6 Cumulative preferential of \$2.21 per annum, payable quarterly.
Series 8 Cumulative preferential of 9¼% to September 1, 1990 and 73% of the Canadian prime interest rate thereafter.
Series 9 Dividends are payable only to the extent of revenues received by the Company from oil and gas property interests (Note 4). The holder of the Series 9 preferred shares is also entitled to participate in dividends distributed to Common shareholders.
Series 10 Until March 1, 1991 dividends of \$2.175 per share (8.7%) per annum will be payable quarterly. Thereafter, dividends will be payable monthly. Commencing March 1, 1991, the dividend rate will be related to changes in prime and will also be adjusted for changes in the trading price. The initial annual floating dividend rate will be equal to 73% of prime.

Share purchase plans – Employee

The Company has reserved 2.5 million common shares for issuance pursuant to the employee share purchase plan of which 1,847,934 had been taken up as at December 31, 1986.

Senior management

At December 31, 1986 loans to employees under the senior management share purchase plan amounted to \$1.0 million. The loans are non-recourse, interest free, maturing June 25, 1991 and secured by a pledge of the common shares.

Options to purchase common shares –

Options for 1,160 shares were exercised and options for 5,640 shares were relinquished during 1984. Options for 4,874 shares were exercised during 1985 while certain options were extended to December 31, 1986. Options for 99,046 shares were exercised and options for 10,270 shares were relinquished during 1986. The outstanding options at December 31, 1986 were as follows –

Number of shares	Option price	Expiry date
1,274 shares	\$33.43	June 24, 1991
12,053 shares	14.98	July 27, 1987
4,618 shares	19.69	January 1, 1988

10. Share capital: (continued)

Changes in share capital –

The following is a summary of the changes in share capital since January 1, 1984 –

	Issued	
	Number of shares	(\$ millions)
Class A preferred shares		
Balance January 1, 1984 unchanged December 31, 1986	3,400,000	\$ 87.9
Class B preferred shares		
Series 1		
Balance January 1, 1984, unchanged December 31, 1984	1,848,270	\$ 46.2
Converted to 211 common shares during 1985	(273)	—
Balance December 31, 1985	1,847,997	46.2
Converted to 87,917 common shares during 1986	(112,195)	(2.8)
Balance December 31, 1986	1,735,802	43.4
Converted to 1,346,710 common shares during January 1987 (Note 16)	(1,718,152)	(43.0)
Pro-forma balance December 31, 1986	17,650	\$.4
Series 2		
Balance January 1, 1984 unchanged December 31, 1985	1,986,515	\$ 49.7
Converted to 30 common shares during 1986	(47)	—
Balance December 31, 1986	1,986,468	\$ 49.7
Series 3		
Balance January 1, 1984	262,500	\$ 26.2
Redeemed during 1984	(10,250)	(1.0)
Balance December 31, 1984	252,250	25.2
Redeemed during 1985	(11,000)	(1.1)
Balance December 31, 1985	241,250	24.1
Redeemed during 1986	(14,000)	(1.4)
Balance December 31, 1986	227,250	\$ 22.7
Series 4		
Balance January 1, 1984 unchanged December 31, 1986	250,000	\$ 22.3
Series 6		
Issued in 1984 unchanged December 31, 1986	2,000,000	\$ 50.0
Series 7		
Issued in 1984	200	\$ 10.5
Redeemed in 1984	(200)	(10.5)
Balance December 31, 1984, 1985 and 1986	—	\$ —
Series 8		
Issued in 1985 unchanged December 31, 1986	2,000,000	\$ 50.0
Series 9 (Note 4)		
Issued in 1985 unchanged December 31, 1986	1,000	\$ —
Series 10		
Issued in 1986 and outstanding at December 31, 1986	2,400,000	\$ 60.0

	Issued	
	Number of shares	(\$ millions)
Common shares		
Balance January 1, 1984	26,448,029	\$314.3
Stock dividends	2,181,207	61.2
Employee share purchase plan	433,010	11.5
Share options exercised	1,160	—
Balance December 31, 1984	29,063,406	387.0
Conversion of class B preferred shares	211	—
Stock dividends	1,176,576	27.3
Employee share purchase plan	684,557	14.7
Share options exercised	4,874	.1
Balance December 31, 1985	30,929,624	429.1
Conversion of class B preferred shares	87,947	2.8
Employee share purchase plan	148,304	4.8
Share options exercised	99,046	1.5
Balance December 31, 1986	31,264,921	438.2
Conversion of class B preferred shares during January 1987 (Note 16)	1,346,710	43.0
Pro-forma balance December 31, 1986	32,611,631	\$481.2

11. Foreign exchange translation adjustment:

	December 31, 1985	December 31, 1986	
	Balance	Year ended	Balance
		(\$ millions)	
Working capital	\$ 7.1	\$ 2.0	\$ 9.1
Long term investments	6.2	(3.4)	2.8
Fixed assets	77.6	(14.0)	63.6
Long term debt	(81.2)	25.8	(55.4)
Preferred shares	(34.0)	2.3	(31.7)
Deferred income taxes	(6.4)	.4	(6.0)
	\$ (30.7)	\$ 13.1	\$ (17.6)

This amount represents the unrealized foreign currency translation loss related to foreign operations of which the majority relates to operations in the United States and an investment in the Netherlands.

12. Commitments:

In addition to commitments for capital expenditures and the future supply of operating services and materials, MacMillan Bloedel is committed at December 31, 1986 in respect of the following –

(a) Ship charters and rentals under non-cancellable leases having an initial term of more than one year as follows –

	Ship charters	Leases	Total
		(\$ millions)	
1987	\$ 30.5	\$ 18.5	\$ 49.0
1988	26.6	16.1	42.7
1989	21.9	11.2	33.1
1990	22.4	7.1	29.5
1991	23.2	5.2	28.4
1992 - 1996	37.5	4.3	41.8
1997 - 2001	—	3.3	3.3
2002 - 2006	—	2.2	2.2
Subsequent to 2006	—	.5	.5
	\$162.1	\$ 68.4	\$230.5

12. Commitments: (continued)

(b) The acquisition of timber in Alabama under long term cutting contracts requiring minimum annual payments (extending in some cases to the year 2034); payment of approximately \$5.9 million is required in each of the next five years.

13. Earnings statements supplementary information:

(a) *Costs and expenses include the following –*

	Year ended December 31		
	1986	1985	1984
	(\$ millions)		
Interest expense –			
Long term debt interest	\$ 58.4	\$ 77.8	\$ 69.3
Other interest	9.0	14.3	20.8
	67.4	92.1	90.1
Less: Interest capitalized	.1	.1	1.2
	\$ 67.3	\$ 92.0	\$ 88.9
Effective average interest rate	9%	9%	10%
Other income –			
Income from investments	\$ 7.3	\$ 6.1	\$ 5.3
Other	10.1	4.3	3.4
	\$ 17.4	\$ 10.4	\$ 8.7
Depreciation	\$ 89.5	\$ 97.1	\$ 85.8
Depletion	11.9	11.8	12.5
Amortization	4.0	5.8	6.0
	\$105.4	\$114.7	\$104.3
Pension expense (Note 15)	\$ 20.2	\$ 19.0	\$ 18.8
Research and development expenses	\$ 17.8	\$ 14.7	\$ 10.6
Less: Government grants and investment tax credits	6.7	.6	.6
	\$ 11.1	\$ 14.1	\$ 10.0
Rental expense on leases of more than one month, and time charter hire	\$ 51.2	\$ 48.9	\$ 52.8

Selling, general and administrative expenses include direct remuneration of the directors and executive officers of the Company aggregating \$4.8 million (1985 – \$4.0 million; 1984 – \$3.5 million).

(b) *Income taxes –*

Consolidated income tax is composed of –

	Canadian federal	Canadian provincial	Foreign	Total
	(\$ millions)			
	(expense) recovery			
Year ended December 31, 1986				
Current	\$ (16.0)	\$ (12.9)	\$ (2.6)	\$ (31.5)
Deferred	(15.0)	(11.1)	(7.9)	(34.0)
	\$ (31.0)	\$ (24.0)	\$ (10.5)	\$ (65.5)
Year ended December 31, 1985				
Current	\$ 2.2	\$ (.5)	\$ (1.5)	\$.2
Deferred	(10.2)	(8.6)	10.1	(8.7)
	\$ (8.0)	\$ (9.1)	\$ 8.6	\$ (8.5)
Year ended December 31, 1984				
Current	\$.1	\$ (.5)	\$ (1.0)	\$ (1.4)
Deferred	6.2	6.2	7.1	19.5
	\$ 6.3	\$ 5.7	\$ 6.1	\$ 18.1

Deferred income taxes result from differences in the timing of the recognition of revenue and expense for taxation and financial statement purposes respectively. The sources of these differences and the tax effects of each were as follows:

	Year ended December 31		
	1986	1985	1984
	(\$ millions) (expense) recovery		
Deferred income tax related to –			
Depreciation, depletion and amortization	\$ 9.7	\$ (32.0)	\$ 28.1
Inventory valuation	5.8	(.9)	1.3
Differences in timing of income items	(.7)	(.7)	(.6)
Expense provisions	(2.6)	(5.5)	(2.3)
Losses for which tax recoveries are provided	(48.0)	34.2	(14.3)
Expenses renounced for income tax purposes	—	—	6.5
Other items	1.8	(3.8)	.8
	<u>\$ (34.0)</u>	<u>\$ (8.7)</u>	<u>\$ 19.5</u>

The components of MacMillan Bloedel's income tax for 1986, 1985 and 1984 as a percentage of earnings (loss) before income taxes are as follows:

	Year ended December 31		
	1986	1985	1984
	(expense) recovery		
Canadian federal income tax rate	(46.0%)	(46.0%)	46.0%
Canadian manufacturing and processing allowance	4.2	7.5	(8.5)
Provincial, state and withholding taxes	(4.6)	(10.2)	7.0
Losses for which tax recoveries were not recorded	.1	(7.1)	(2.6)
Deferred rate adjustments including investment tax credits	2.8	(4.5)	8.5
Inventory allowances	.3	11.2	21.2
Foreign exchange translation adjustments	—	—	11.3
Capital gains	2.3	19.7	—
Tax adjustments and assessments	2.1	(11.9)	3.8
Foreign tax rates different from Canadian rates	1.9	12.3	28.6
Items that are not deductible (taxable)	(.6)	(2.1)	16.0
Other items	(.5)	—	7.9
Effective income tax rate	<u>(38.0%)</u>	<u>(31.1%)</u>	<u>139.2%</u>

(c) *Extraordinary item –*

Profit on disposal of a portion of the investment in Koninklijke Nederlandse Papierfabrieken N.V., net of income taxes of \$nil.

(d) *Net earnings per common share –*

Basic net earnings per common share is computed by dividing the net earnings, after providing for dividends on the class A and class B preferred shares, by the weighted average number of shares outstanding during the year. The provision for dividends on the class A and class B preferred shares is made on a time elapsed basis rather than on a declared basis. Fully diluted earnings per common share assumes that all outstanding class B preferred shares series 1 and 2 and all share options were converted into common shares at the beginning of the year increasing the number of common shares outstanding and reducing the provision for preferred dividends.

14. Related party transactions:

MacMillan Bloedel sells products in the ordinary course of business and at fair market values to related parties and also purchases certain products for resale from related parties. These transactions include the sale of pulp to Koninklijke Nederlandse Papierfabrieken N.V., and Island Paper Mills Limited, the sale of containerboard to MacMillan Bathurst Inc. and MacMillan Smurfit SCA Limited and the purchase of lumber from Noranda Forest Sales Inc.

	Year ended December 31		
	1986	1985	1984
		(\$ millions)	
Sales to related parties	\$ 79.1	\$ 80.3	\$ 83.5
Purchases from related parties	\$ 35.5	\$ 32.5	\$ 40.1

	December 31	
	1986	1985
		(\$ millions)
Accounts receivable from related parties	\$ 12.5	\$ 12.5

15. Pension plans:

MacMillan Bloedel has a number of contributory and non-contributory pension plans, participation in which is available to substantially all employees after one or two years of continuous service. In addition, the Company has agreements with some of its officers and executives (including retirees) which call for payments to be made under certain conditions following retirement.

During 1986 MacMillan Bloedel adopted the 1983 group annuity mortality table for Canadian pension plans. The cost of this change in actuarial assumptions is estimated at \$15.0 million and is being amortized commencing in 1986.

As at December 31, 1986 the estimated excess of pension fund assets and provisions over the estimated obligations for pension benefits amounted to approximately \$9.0 million.

	December 31		
	1986	1985	1984
		(\$ millions)	
Pension fund assets at market value	\$376.3	\$353.9	\$311.3
Obligations for pension benefits under all plans and agreements	360.9	318.5	291.3
Excess of fund assets over obligations for benefits	15.4	35.4	20.0
Provisions	(6.4)	2.8	9.8
Excess over plan obligations	\$ 9.0	\$ 38.2	\$ 29.8

16. Subsequent events:

(a) On January 19, 1987 the Company redeemed all of the outstanding series G debentures for \$12,490,000. Redemption funds were deposited with the Trustee on December 17, 1986 and have been applied against the outstanding series G debentures in the consolidated statements of financial position.

(b) On December 17, 1986 the Company called the \$2.00 class B convertible preferred shares series 1 for redemption on January 19, 1987 at a price of \$26.27 per share. On January 19, 1987 virtually all of these shares were converted into common shares of the Company. These financial statements reflect the conversion of 1,718,152 class B series 1 shares into 1,346,710 common shares during January 1987.

(c) On December 23, 1986 the Company invited tender from the holders of class A preferred shares for the purchase by the Company of all the shares at a price of \$25.00 per share U.S. currency plus an amount equal to all accrued and unpaid dividends up to and including May 1, 1987.

On February 1, 1987 the Company had received for purchase and cancellation all class A preferred shares. These shares are to be purchased on May 1, 1987 at a price of U.S.\$25.00 per share plus an amount equal to all accrued and unpaid dividends up to and including May 1, 1987.

(d) On February 6, 1987 the Company announced that it will call its class B convertible preferred shares series 2 for redemption March 20, 1987 at a price of \$26.11 per share. The holders of the class B preferred shares series 2 have the option of converting preferred shares into common shares at \$38.60 per common share. It is expected that most class B series 2 preferred shareholders will convert their shares.

17. Information with respect to United States generally accepted accounting principles (U.S. GAAP):

There are no material differences in consolidated net earnings between U.S. GAAP and generally accepted accounting principles in Canada.

The balance sheet captions listed below are specifically required for the United States Securities and Exchange Commission (SEC):

	December 31	
	1986	1985
	(\$ millions)	
Total assets	\$2,211.5	\$2,329.7
Current assets	698.9	742.7
Current liabilities	329.9	327.4

The SEC requires that redeemable preferred shares not be shown as part of shareholders' equity. Accordingly, under U.S. GAAP shareholders' equity would be:

	December 31	
	1986	1985
	(\$ millions)	
Common shares	\$ 481.2	\$ 429.1
Contributed surplus	15.9	18.2
Retained earnings – U.S. GAAP	466.2	345.3
	963.3	792.6
Foreign exchange translation adjustment	(17.6)	(30.7)
	\$ 945.7	\$ 761.9

18. Segment information:

	Sales from Canada to	Sales to unaffiliated customers from	Contribu- tions to earnings (loss) (2)	Assets
	(\$ millions)			
Year ended December 31, 1986				
Canada	\$ 463.4	\$ 972.7	\$ 207.3	\$1,110.3
United States	787.5	1,369.5	42.3	680.5
Europe (primarily the United Kingdom)	207.7	78.8	2.0	21.8
Other	296.9	90.7	4.5	18.9
	1,755.5	2,511.7	256.1	1,831.5
Eliminations and adjustments:				
Inter-segment			(8.0)	(15.3)
General corporate			(8.2)	299.7
Foreign exchange translation adjustment				95.6
Interest expense			(67.3)	
Consolidated totals	\$1,755.5	\$2,511.7	\$ 172.6	\$2,211.5
Year ended December 31, 1985				
Canada	\$ 410.1	\$ 948.3	\$ 111.9	\$1,138.3
United States	815.1	1,292.1	18.1	734.2
Europe (primarily the United Kingdom)	193.7	93.5	1.5	30.6
Other	317.4	1.5	1.1	19.3
	1,736.3	2,335.4	132.6	1,922.4
Eliminations and adjustments:				
Inter-segment			(7.2)	(7.3)
General corporate			(6.1)	313.5
Foreign exchange translation adjustment				101.1
Interest expense			(92.0)	
Consolidated totals	\$1,736.3	\$2,335.4	\$ 27.3	\$2,329.7
Year ended December 31, 1984				
Canada	\$ 366.7	\$ 948.9	\$ 63.2	\$1,193.7
United States	601.9	1,097.7	26.7	724.6
Europe (primarily the United Kingdom)	202.0	78.9	.2	40.5
Other	349.4	2.1	.8	6.6
	1,520.0	2,127.6	90.9	1,965.4
Eliminations and adjustments:				
Inter-segment			(.5)	(.1)
General corporate			(14.5)	249.7
Foreign exchange translation adjustment				41.7
Interest expense			(88.9)	
Consolidated totals	\$1,520.0	\$2,127.6	\$ (13.0)	\$2,256.7

	Total revenue	Contributions to earnings (loss) (1)(2)	Depreciation, depletion and amortization	Capital expenditures	Assets
			(\$ millions)		
Year ended December 31, 1986					
Building materials	\$1,105.5	\$ 83.3	\$ 39.9	\$ 47.3	\$ 779.1
Pulp and paper	929.6	141.9	36.7	32.1	601.9
Containerboard and packaging	436.6	19.7	21.3	14.3	425.6
Other	40.0	3.2	.2	.2	9.6
Total operations	2,511.7	248.1	98.1	93.9	1,816.2
General corporate		(8.2)	1.3	6.1	299.7
Foreign exchange translation adjustment			6.0		95.6
Interest expense		(67.3)			
Consolidated totals	\$2,511.7	\$172.6	\$105.4	\$100.0	\$2,211.5
Year ended December 31, 1985					
Building materials	\$1,032.7	\$ 44.5	\$ 46.6	\$ 40.7	\$ 757.5
Pulp and paper	848.2	70.7	34.6	32.8	713.3
Containerboard and packaging	408.0	8.1	24.7	18.2	438.8
Other	46.5	2.1	.3	1.1	5.5
Total operations	2,335.4	125.4	106.2	92.8	1,915.1
General corporate		(6.1)	3.0	3.8	313.5
Foreign exchange translation adjustment			5.5		101.1
Interest expense		(92.0)			
Consolidated totals	\$2,335.4	\$ 27.3	\$114.7	\$ 96.6	\$2,329.7
Year ended December 31, 1984					
Building materials	\$ 964.9	\$ 26.1	\$ 45.8	\$ 84.8	\$ 777.3
Pulp and paper	713.8	33.9	28.4	32.3	723.4
Containerboard and packaging	403.0	28.0	23.2	17.4	459.1
Other	45.9	2.4	.4	.8	5.5
Total operations	2,127.6	90.4	97.8	135.3	1,965.3
General corporate		(14.5)	3.2	2.4	249.7
Foreign exchange translation adjustment			3.3		41.7
Interest expense		(88.9)			
Consolidated totals	\$2,127.6	\$ (13.0)	\$104.3	\$137.7	\$2,256.7

Notes:

(1) *Basis of segmentation*

MacMillan Bloedel carries on an integrated forest products business which involves extensive transfers of raw materials and products among operations. Segmenting an integrated forest products business into product and service categories involves allocating conversion and other costs and raw material costs. Raw material costs are allocated on a basis proportionate to the end product net revenue before deducting fibre cost. Other pricing policies and methods of allocating costs are possible but at this time the Company believes the above determined method to be most appropriate to its circumstances.

(2) *Contributions to earnings (loss)*

Contributions to earnings (loss) represent sales of products and services less cost of sales and services, selling expenses and allocated general and administrative expenses.

(3) *Sales of products and services*

Treated poles, pilings and export log sales are included in building material sales.

19. Subsidiary companies:

ACTIVE

Canada

Canadian Transport Company (International) Limited
Forest Industries Flying Tankers Limited
Kingcome Navigation Company Ltd.
MacMillan Bloedel Building Materials Limited
MacMillan Bloedel (Hudson Bay) Limited
MacMillan Bloedel (Pacific) Limited
MacMillan Bloedel (Thunder Bay) Limited
Vancouver Island Stevedoring Co. Ltd.
Vancouver Marine Engines Ltd.

United States

Canadian Transport (N.Y.) Inc.
Fibres International, Inc.
MacMillan Bloedel Financial Inc.
MacMillan Bloedel Inc.
MacMillan Bloedel (U.S.A.) Inc.
MacMillan Bloedel Particleboard Inc.
Powell River-Alberni Sales Corporation
Star Terminal Company, Incorporated

United Kingdom

MacMillan Bloedel Pulp and Paper Sales Limited
MBM Forest Products Limited

Other

Camarin Limited
Canadian Maas River Investment N.V.
Fortrans N.V.
MacMillan Bloedel (Asia) Limited
MacMillan Bloedel Building Materials K.K.
MacMillan Bloedel Europe B.V.
MacMillan Bloedel Finance Limited
MacMillan Bloedel FSC Ltd.
MacMillan Bloedel K.K.
MacMillan Bloedel (Limburg) N.V.
MacMillan Bloedel Pty. Limited
MacMillan Bloedel (South East Asia) Limited
MacMillan Bloedel (South East Asia) SDN.BHD.
MacMillan Bloedel (St. Maarten) N.V.

(1) Holding company for MacMillan Bloedel's subsidiaries located in Brazil which are not consolidated (Notes 1 and 4).

INACTIVE (including holding companies not carrying on active operations)

Canadian Transport Company Limited
Harmac Ltd.
MacMillan Bloedel Building Limited
MacMillan Bloedel Export Sales Ltd.
MacMillan Bloedel Packaging Limited
MacMillan Bloedel (Saskatchewan) Limited
MacMillan Bloedel Shipping Limited

MacMillan Bloedel Radio System, Inc.
MacMillan Bloedel Timberlands Inc.

Canadian Transport (Terminals) Limited
Hygrade Corrugated Cases Limited
MacMillan Bloedel Containers Holdings Limited
MacMillan Bloedel Holdings (U.K.) Limited
MacMillan Bloedel Panelboard Agencies Limited
MBM Terminals Limited

Canadian Transport Company Pty. Limited
MacMillan Bloedel (Brasil) Ltda.
MacMillan Bloedel European Holdings B.V.
Sociedade Civil de Investimentos Florestais Limitada (1)



Sales by segment	1982	1983	1984	1985	1986
(\$ millions)					
<i>Building Materials</i>					
Lumber	462.6	576.6	649.0	732.2	770.3
Plywood	83.6	108.3	97.0	96.7	119.0
Waferboard	24.1	40.8	42.9	51.2	67.3
Particleboard	10.4	10.7	10.6	10.7	9.0
Other	87.2	169.6	165.4	141.9	139.9
	667.9	906.0	964.9	1,032.7	1,105.5
<i>Pulp and paper</i>					
Newsprint	449.9	458.5	462.2	610.1	645.5
Market pulp	180.3	177.6	224.2	217.3	257.5
Fine papers*	38.3	4.3	0.5	0.8	1.1
Recycled fibre and other	14.5	20.6	26.9	20.0	25.5
	683.0	661.0	713.8	848.2	929.6
<i>Containerboard and packaging</i>					
Corrugated containers*	365.8	281.3	173.1	202.3	219.2
Containerboard	82.0	138.7	224.6	205.4	217.2
Other**	12.8	17.1	5.3	0.3	0.2
	460.6	437.1	403.0	408.0	436.6

*Includes sales from fine paper and corrugated container operations until they were transferred to joint ventures in 1983.

**Includes sales from the bag and specialty operation up to the time it was sold in 1984.

1986 Sales by market	Canada	United States	Japan and Orient	U.K. Europe and Other	Total
<i>Building Materials</i>					
Lumber (MMfbm)	310.0	1,010.2	123.0	129.3	1,572.5
Plywood (MMsq.ft.-3/8")	248.9	138.3	—	21.7	408.9
Waferboard (MMsq.ft.-3/8")	207.9	157.8	—	—	365.7
Particleboard (MMsq.ft.-3/4")	27.2	6.4	1.5	—	35.1
<i>Pulp and paper</i>					
Newsprint (k-tonnes)	101.2	607.8	87.0	88.2	884.2
Market pulp (k-tonnes)	13.1	51.3	106.1	264.7	435.2
Recycled products (k-tonnes)	14.1	134.0	—	—	148.1
<i>Containerboard and packaging</i>					
Linerboard (k-tonnes)	1.2	216.3	—	69.9	287.4
Corrugating medium (k-tonnes)	70.8	114.7	8.1	21.8	215.4
Corrugated containers (k-tonnes)	—	250.0	—	1.7	251.7

Production	1982	1983	1984	1985	1986
<i>Building Materials</i>					
Lumber (MMfbm)	635	822	845	979	841
Plywood (MMsq.ft.- $\frac{3}{8}$ ")	254	314	239	250	243
Waferboard (MMsq.ft.- $\frac{3}{8}$ ")	114	182	257	273	333
Particleboard (MMsq.ft.- $\frac{3}{4}$ ")	35	40	34	45	32
<i>Pulp and paper</i>					
Newsprint (k-tonnes)	702	788	718	850	876
Market pulp (k-tonnes)	326	369	358	422	408
<i>Containerboard and packaging</i>					
Linerboard (k-tonnes)	288	299	351	340	370
Corrugating medium (k-tonnes)	42	199	268	269	284
Corrugated containers (k-tonnes)*	386	322	194	219	252
Operating rates	1982	1983	1984	1985	1986
(percent)					
<i>Building Materials</i>					
Lumber	46	75	77	85	72
Plywood	55	79	81	82	75
Waferboard	41	65	78	78	92
Particleboard	65	74	63	84	58
<i>Pulp and paper</i>					
Newsprint	67	79	72	88	92
Market pulp	71	80	77	91	86
<i>Containerboard and packaging</i>					
Linerboard	76	74	87	91	100
Corrugating medium	58	76	103	99	105
Corrugated containers*	63	68	83	78	89

*Includes corrugated container plants in Canada and the United Kingdom until they were transferred to joint ventures in 1983.

Principal facilities

Building Materials	Division	Location	Aggregate effective annual capacities at year-end 1986	1986 Production
<i>Lumber and Lumber Specialties</i> (MMfbm)	Alberni Pacific	Port Alberni, British Columbia	238	118
	Somass	Port Alberni, British Columbia	175	76
	Harmac	Nanaimo, British Columbia		
	Woodroom #3		177	189
	Woodroom #4		149	146
	Chemainus	Chemainus, British Columbia	106	69
	Canadian White Pine	Vancouver, British Columbia	118	85
	New Westminster	New Westminster, British Columbia	78	49
	Powell River	Powell River, British Columbia	36	25
	Pine Hill	Pine Hill, Alabama	80	73
	Atlantic Forest Products	Edenton, North Carolina	15	11
			1,172	841
<i>Plywood</i> (MM sq.ft.- $\frac{3}{8}$ ")	Alberni Plywood	Port Alberni, British Columbia	175	97
	Pine Hill	Pine Hill, Alabama	133	122
	Nipigon	Nipigon, Ontario	26	24
			334	243
<i>Waferboard</i> (MM sq.ft.- $\frac{3}{8}$ ")	Hudson Bay	Hudson Bay, Saskatchewan	192	176
	Thunder Bay	Thunder Bay, Ontario	171	157
			363	333
<i>Particleboard</i> (MM sq.ft.- $\frac{3}{4}$ ")	Particleboard	Vancouver, British Columbia	54	32
<i>Hardboard</i> (MM sq.ft.)	Sturgeon Falls	Sturgeon Falls, Ontario	47	33
<i>Specialty Board</i> (MM sq.ft.)	Specialty Board	Vancouver, British Columbia	37	10
<i>Mouldings</i> (MM lineal ft.)	Kingtrim Operations	Toronto, Ontario	69	47
<i>Poles</i> (M pieces)	Wood Preserving	New Westminster, British Columbia	13	9
Pulp and Paper				
<i>Market Pulp</i> (k-tonnes)	Harmac	Nanaimo, British Columbia	360	322
	Alberni Pulp and Paper	Port Alberni, British Columbia	71	48
	Powell River	Powell River, British Columbia	50	38
			481	408
<i>Newsprint and Groundwood Printing Papers</i> (k-tonnes)	Alberni Pulp and Paper	Port Alberni, British Columbia	362	292
	Powell River	Powell River, British Columbia	590	584
			952	876
Containerboard				
<i>Linerboard</i> (k-tonnes)	Pine Hill	Pine Hill, Alabama	372	370
<i>Corrugating Medium</i> (k-tonnes)	Pine Hill	Pine Hill, Alabama	200	214
	Sturgeon Falls	Sturgeon Falls, Ontario	71	70
			643	654
<i>Corrugated Containers</i> (k-tonnes)	11 Locations	United States	284	252



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Treasurer, Noranda Inc.

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Partner, Davis & Company

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The Netherlands
Chairman of the Board of
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Koninklijke Nederlandse
Papierfabrieken, N.V.

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Caledon, Ontario
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Corporate Director

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Corporate Director

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Seattle, Washington
Vice-Chairman,
MacMillan Bloedel Limited

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Partner,
McCarthy & McCarthy

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West Vancouver,
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MacMillan Bloedel Limited

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Private Investor

Dr. D.W. Strangway 4,6
Vancouver, British Columbia
President,
University of British Columbia

A.H. Zimmerman 1,3,4
Toronto, Ontario
President and Chief
Operating Officer,
Noranda Inc.

Honorary Directors

The Honourable J.V. Clyne,
C.C., K.St.J.

J.E. Richardson

Committees of the Board

- 1 Executive Committee
- 2 Audit Committee
- 3 Compensation Committee
- 4 Nominating Committee
- 5 Pension Fund Investment
Advisory Committee
- 6 Donations Committee



- | | |
|---|---|
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Vice-President, Treasurer |
| A.H. Zimmerman
Chairman of the Board | J.C. Finkbeiner
Vice-President, Tax,
Properties and Risk
Management |
| C.C. Knudsen
Vice-Chairman of the Board | H.E. Fliessbach
Assistant Treasurer |
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Marketing Group |
| R.N. Wiewel
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Government Affairs |
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Lumber, Marketing Group |
| D.A. Dowsley
Vice-President,
Building Materials,
Nanaimo Region | V.R. Worthy
Vice-President, Panelboards,
Marketing Group |



Annual Meeting

The Company's Annual General Meeting of common shareholders will be held Thursday, March 26, 1987 at 10 a.m., in the Regency Ballroom, Hyatt Regency Hotel, 655 Burrard Street, Vancouver, British Columbia, Canada. Shareholders are invited to attend this meeting, participate in discussions about the Company and meet the directors and officers responsible for the operation of MacMillan Bloedel Limited.

Tax Provisions Relating to Dividends and Interest to Non-Resident Security Holders

Both stock and cash dividends paid to United States shareholders of the Company's shares are subject to a 15% Canadian non-resident withholding tax. Also, interest paid to United States holders of the Company's debt obligations is subject to 15% Canadian non-resident withholding tax, except for interest payable to exempt entities and to holders of debt issued by the Company after June 23, 1975 where the terms of the debt do not require repayment of more than 25% of the principal amount within five years from the date of issue.

Distribution of Common Shares and Registered Common Shareholders as at January 31, 1987

	Common Shares	Common Shareholders*
Canada	30,406,395	7,365
United States	2,214,379	679
Other	21,191	87
	<hr/> 32,641,965	<hr/> 8,131
Share warrants	184	
	<hr/> 32,642,149	

*Excludes approximately 10,000 beneficial shareholders, many of whom are employees of the Company.

Exchange Listings

Common Shares Listed: Toronto, Montreal, Vancouver.

Common Shares Quoted: NASDAQ.

Class B Preferred Share Listings: Toronto, Montreal, Vancouver.

Ticker Symbols: Canadian Stock Exchanges—MB; NASDAQ—MMBLF.

Transfer Agents and Registrars

Guaranty Trust Company of Canada

Vancouver, Calgary, Regina, Winnipeg, Toronto, Montreal

The Chase Manhattan Bank

New York

Form 10-K Available

The Company's Annual Report to the United States Securities and Exchange Commission (Form 10-K) is available on request. Please write to:

The Secretary

MacMillan Bloedel Limited

1075 West Georgia Street

Vancouver, B.C. V6E 3R9

Paper Stock:

The text stocks used in this report are both produced by MacMillan Bloedel fine paper affiliates. The front colour section was printed on 78M Barella Gloss, produced in the Netherlands by Koninklijke Nederlandse Papierfabrieken N.V. (KNP). The back section was printed on 60lb. Hi-Lite Offset, produced in New Westminster, British Columbia by Island Paper Mills Limited.

