

Equity Research Report

April 13, 2004

Short Sell: Bowater Inc.

Short Sell	Bowater Inc.
Symbol	BOW
Recent Price	\$43.20
Price Targets	\$39, \$36, \$32, \$26

Summary

Bowater, Inc. is one of the leading suppliers of newsprint paper, coated papers, and related products. But a host of fundamental factors -- from a poor operating environment to deteriorating margins to huge liquidity problems -- indicate that the company's share price is ripe for a fall. The company's...

- Industry is fraught with poor pricing power and a sluggish demand environment.
- Long-term 6.4% sales geometric growth rate lags peer group's 8.9% average.
- Operating margin is deteriorating quickly and hit an abysmal *negative* 8.3% in 2003.
- Gross margin is just 6.9%, about half the size of peer group's 13.5%.
- Lost \$142 million in 2002 and \$205 million in 2003. Those losses are likely to rise to \$406 million in 2004 or a mind-boggling \$7.39 per share.
- Has just 3 cents in cash on hand for every dollar it owes in current liabilities, which is worse than peer's by a factor of 10.
- Generated less than 1 cent in operating cash flow for every dollar in sales in 2003.
- 2003 EBIT was *negative* \$225 million but had \$175 million in interest expenses, thus making the company essentially insolvent.
- Has a deteriorating technical price pattern and growing downside momentum.

Given these factors, the shares have massive downward pressure. Initial downside technical price targets are at \$39, and then step down to \$36 and \$32. Adding more price pull is a \$26 composite fundamental valuation. Here are the details why Bowater is an excellent short candidate...

Stock Data
Recent Price \$43.20
Exchange NYSE
52 Week Range \$36.30 to \$48.00
Market Cap \$2,470 Mil
Shares Outstanding 55 Mil
20D Avg Vol 682 Mil
Dividend Yield 1.85%
Beta .90
Fundamental Snapshot
Industry Paper & Related Prod.
Fiscal Yr Ends December
Latest Qtr Data December
Latest Qtr Sales \$736 million
Latest Qtr Profit -\$51 million
Latest Qtr Cash \$19 million
EPS Current -\$4.40
IBES EPS Estimate -\$0.94
P/E Current Neg
IBES P/E Estimate Neg

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What is Bowater?

Bowater is the largest maker of newsprint in the US, producing about 2.7 million metric tons annually in North America. The company is responsible for 18% and 7% of the North American and worldwide newsprint capacity respectively, making it a major player in the space. Newsprint is the dominant revenue stream, accounting for 45% of 2003 sales. The company also makes coated and specialty papers (27%), market pulp (18%), and lumber and wood products (10%). Bowater operates 13 sawmills, 12 pulp and paper mills, and 2 conversion facilities for groundwood base sheet. The company operations are supported by 1.4 million acres of owned and leased timberlands in the US and Canada and 32 million acres of timber cutting rights in Canada.

Industry overview

The cyclical nature of the paper products makes the industry's fortunes tied to the health of the US and global economies. As a result, the group has taken its fair share of licks over the past few years. To make matters worse, the industry has few proprietary methods or products so, like any commodity producer, competition is brutal and good times rise and fall with price and demand. As the economic recovery – around the globe and in the US – continues to make traction, the group should see improvement.

That said, paper makers' overall price improvement remains horribly depressed. Average prices for newsprint, for example, was \$650 per ton in 1998, a far cry from the current market's \$530. To make matters worse, pricing flexibility seems to be out the window. A \$50 per metric ton increase in domestic newsprint prices, for example, was met with a lukewarm reception in February. And the groups' ability to fully realize that increase is now in serious jeopardy.

But that's hardly a surprise. Newspaper advertising lineage was up a miniscule .7% in 2003 over 2002. Without a growing demand environment from the newsprint user side, successful supplier price increases are slim to none. And that means that only those competitors with strong balance sheets and efficient capital structures will be able to weather the storm until demand improves.

And don't forget: Alongside stiff competition and a tight pricing environment, the group is also tormented by a myriad of environmental liabilities, currency fluctuations, and the growing intrusion of electronic data transmission.

Peer Group

The peer group uses metrics from the top players in the paper products space, including International Paper, Georgia Pacific, Boise Cascade, MeadWestvaco, and Temple Inland.

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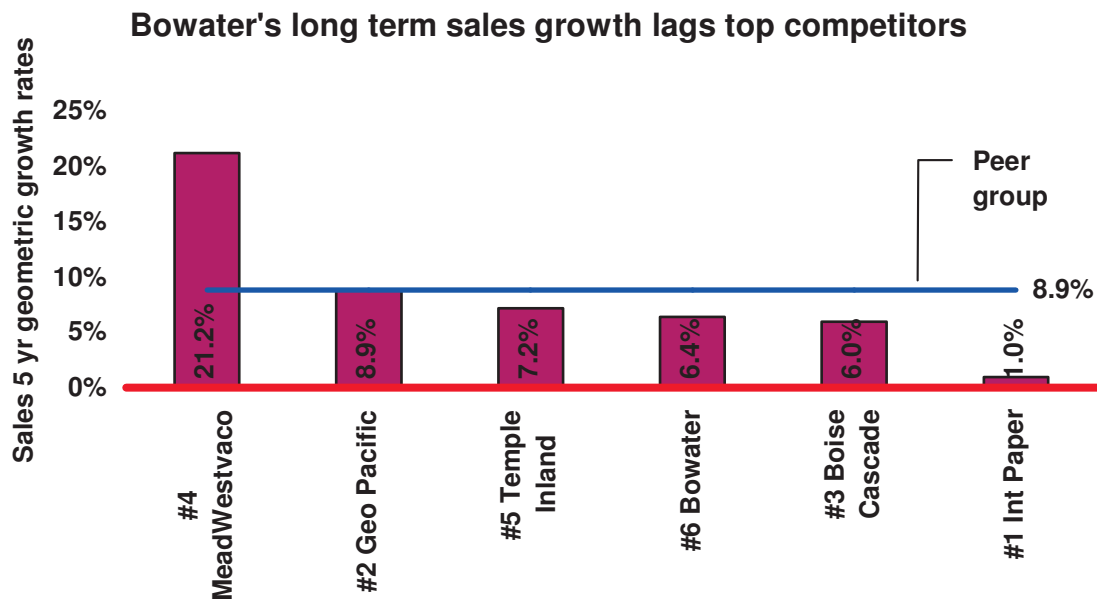
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Sales growth rates lag competitors

Bowater may be one of the bigger players in the newsprint business, but bigger is not necessarily better. In fact, a tour around the company's operations proves this company is in sorry shape.

Let's start with sales. Bowater sales were \$2.7 billion during 2003, up 5.4% over 2002. And at first glance, that sounds ok. But dig deeper and you find the company, long-term, is lagging top competitors. Take a look...



As you can clearly see from this graph, Bowater's long-term sales growth -- which is a 5 year compounded rate -- lags its competitors. In fact, the company's 6.4% rate means it falls in the bottom half of the peer group and below the group's 8.9% average.

Bowater's outlook may get even worse. That's because the company's largest revenue stream -- newsprint paper sales -- commands very little pricing power: Bowater's 2003 newsprint prices, for example, were just \$481 per metric ton, 15% less than where they were in 2001. And the company's second largest revenue source, coated and specialty papers, saw its prices drop to \$569 per short ton in 2003 from \$685 per short ton in 2001. Now factor in a sluggish newspaper advertising demand environment, and the message is clear: Hard times may be a way of life for Bowater's sales going forward.

Bowater's operating margins are abysmal

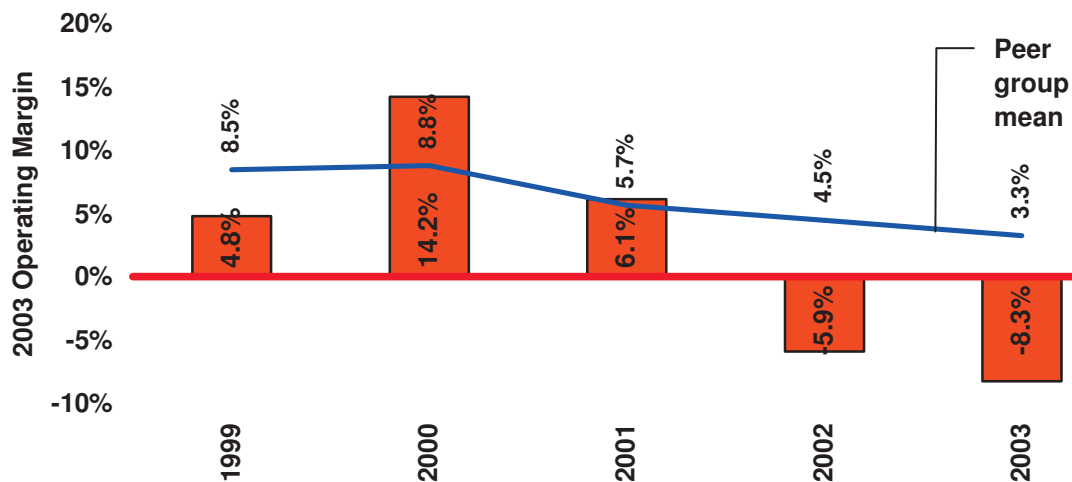
Bowater's long-term sales growth can't keep up with competitors -- a red flag. But drill down to the company's operating margins and the red flag becomes a whole lot worse...

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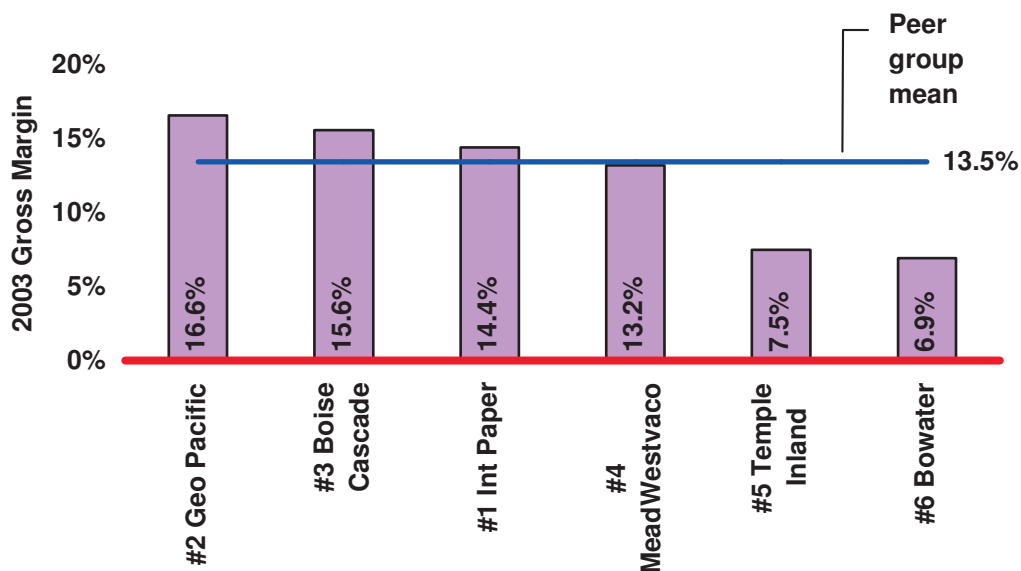
Bowater's operating margin is in lousy shape



As you can see, Bowater's core operating trend is in lousy shape. After a recent peak at 14.2% in 2000, the company's operating margin has deteriorated quickly, sliding from 6.1% in 2001 to -5.9% in 2002 to abysmal -8.3% in 2003. In the meantime, the company's peer group average has fared much better.

The main culprits? The inability of the company to control expenses in both major operating components. Cost of goods sold, for example, grew to 93% of sales in 2003 from 91% in 1999. Gross margin, therefore, was a miniscule 7% in 2003 and captured the bottom slot among peers...

Bowater's cost containment is poor



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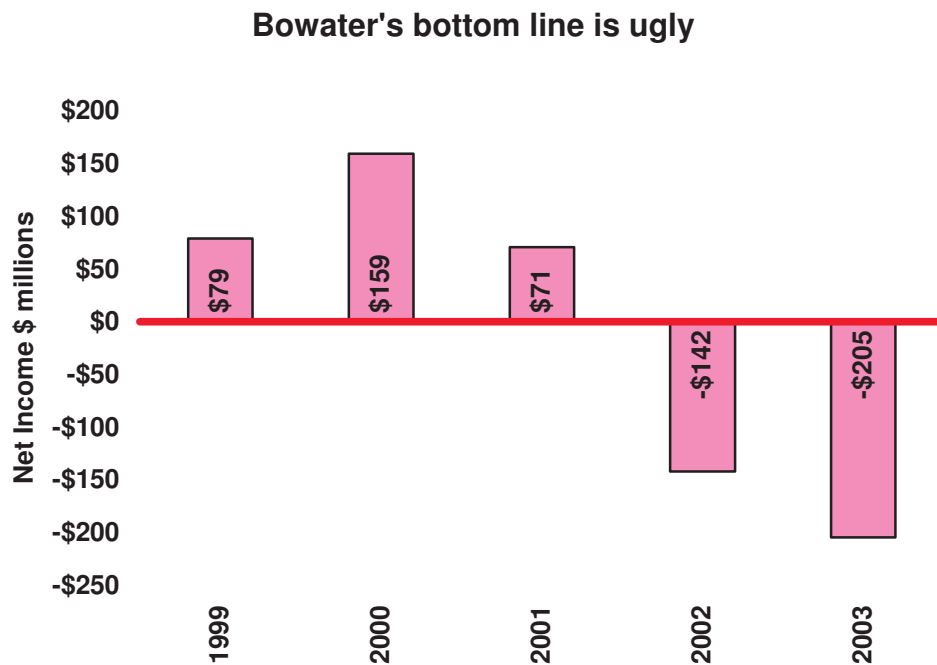
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As this chart shows, Bowater's gross margin lags top competitors by a long shot -- and is below the peer average by nearly a factor of two. To make matters even worse, the company's SG&A expenses skyrocketed to 15% of sales in 2003 from 4% in 1999. With terrible operating metrics like these, the company's current stock price has very little support.

Lack of profitability puts massive strain on the shares

A lagging sales picture and terrible operating margins hits Bowater's bottom line ... hard. Take a look.



The company lost \$205 million in 2003 and that's on top of the \$142 million lost in 2002. Since the company can't demonstrate an inability to control costs -- or handsomely drive the top line -- these losses are likely to continue unabated. Translation: More downward pressure on the shares.

Liquidity ratios show a strained Bowater

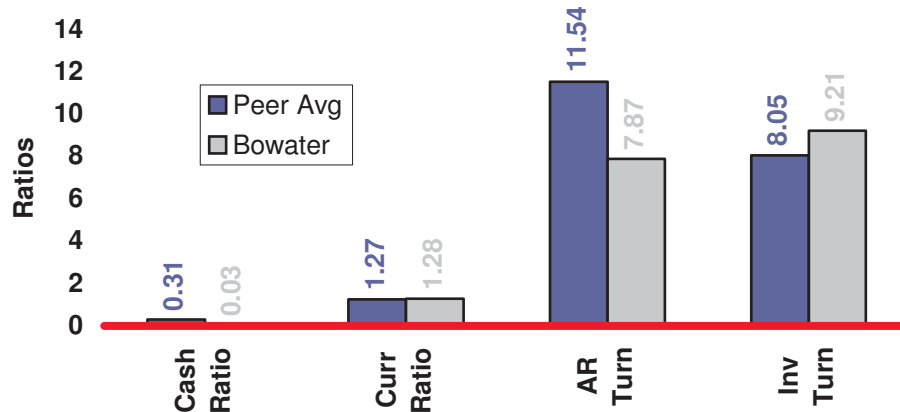
Not only are Bowater's activity metrics in trouble, the company is also under tremendous liquidity pressure. In fact, the major activity and liquidity ratios are far worse than peers...

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Bowater's liquidity and activity ratios show strain

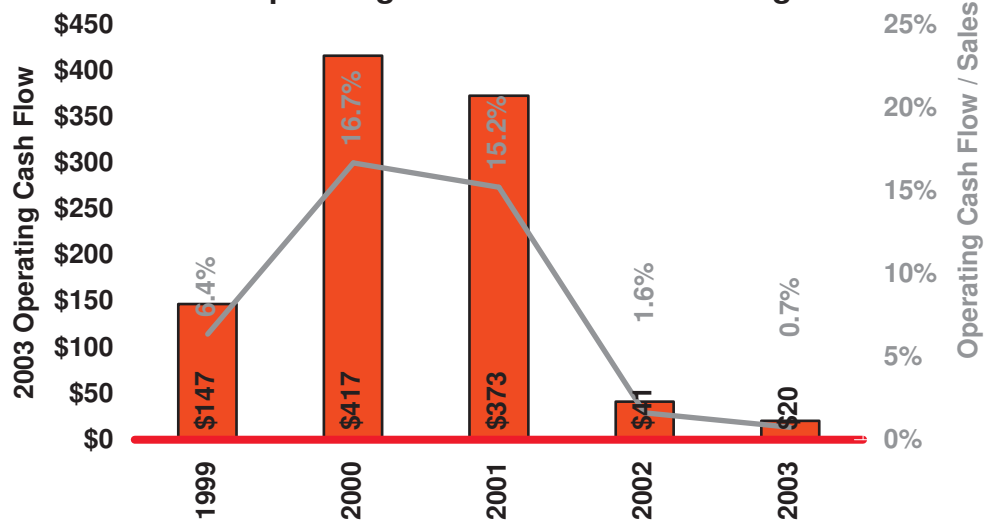


The company has just 3 cents in cash on hand for every dollar it owes in current liabilities. That's worse than the peer average *by a factor of ten*. The company's current ratio improves to the peer average, but that's mitigated by Bowater's slow accounts receivable turnover ratio. Inventory turnover remains in line, but hardly makes up for the company's working liquidity problems.

Bowater's liquidity problems are wide and deep

Bowater's liquidity problems aren't limited to working capital risk. In fact, the company's cash flow production is deteriorating fast...

Bowater's operating cash flow is deteriorating fast



As you can see, the company's cash flow from operations -- which amounted to just \$20 million in 2003 -- is now a whopping 95% below its recent peak of \$417 million. And that's in spite of a rising sales environment. In fact, by the end of 2003, for every dollar in sales, the company was

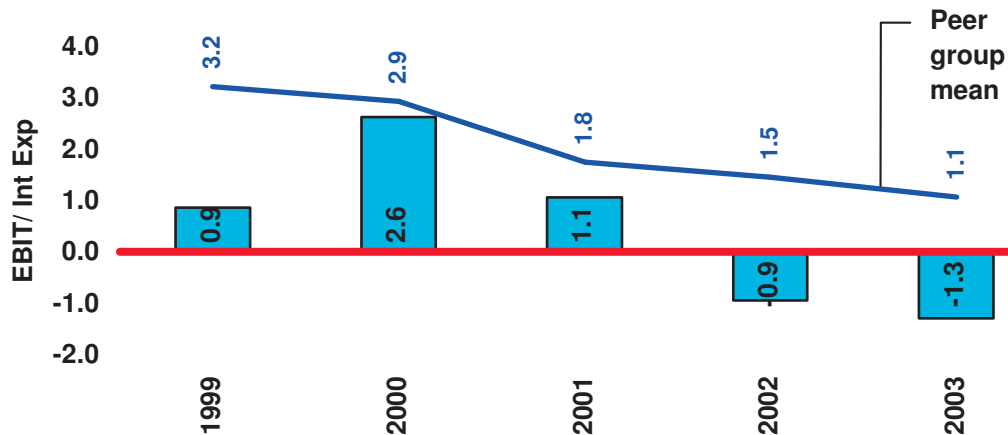
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generating *less than one cent in operating cash flow*. That's a huge decline from the 17 cents it was generating in 2000. But that's not all...

Bowater's solvency risk is sky high!

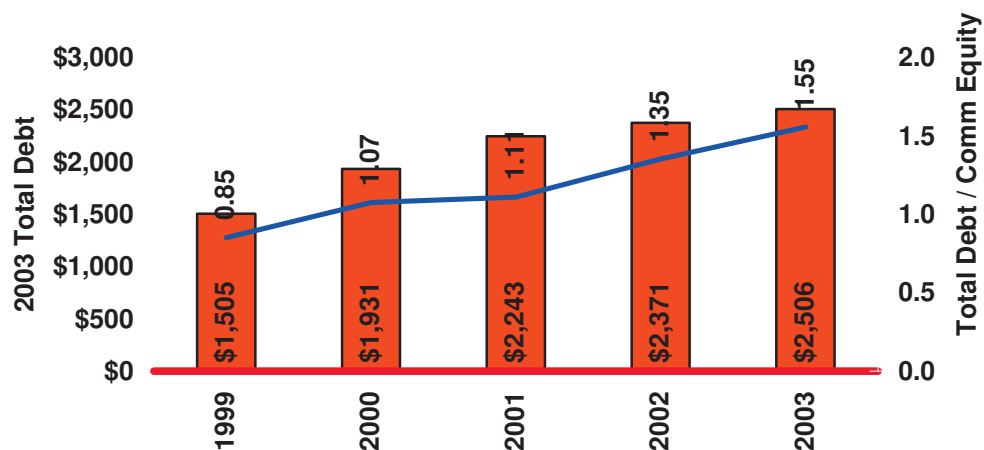


Adding even more strain on the shares is Bowater's fixed charge coverage, as this chart shows. Not only is the company coverage ability deteriorating, it trails competitors by a wide margin. And since the company's 2003 EBIT was *negative* \$225 million and its interest expense was \$175 million, the company is essentially insolvent. And that means big potential credit problems down the road.

Bowater keeps piling on the debt

Bowater's liquidity pressure is enormous, but it's really no surprise: The company is busy piling on debt, year after year after year...

Bowater debt is piling up fast



As of the end of 2003, Bowater had amassed \$2.5 billion in debt. In the meantime, the company's total shareholder equity has plummeted. That's pushed the company's total debt to

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common equity ratio to 1.55 in 2003. That's nearly double where it was in 1999 and shows the company's liquidity and risk profile is dismal indeed.

In fact the Bowater's debt picture is so ugly, the company has had to gain debt covenant concessions from its creditors. In February, for example, its net worth requirements *were reduced for its US and Canadian credit facilities*. That could mean its creditors are now stuck between a rock and a hard place. Plus, it greatly strains the company's ability to command favorable credit pricing and supply in the future.

Target Price: \$26.30

From deteriorating operations to declining margins to huge liquidity strains, the fundamental outlook for Bowater is grim. And that means the company's share price is in store for a big haircut...

	<u>P/E</u>	<u>P/Bk</u>	<u>P/Sales</u>	<u>P/CashFlow</u>
#1 Int Paper	52.51	2.46	0.80	11.06
#2 Geo Pacific	25.71	1.59	0.42	4.71
#3 Boise Cascade	126.40	1.43	0.26	6.73
#4 MeadWestvaco	NA	1.18	0.74	12.12
#5 Temple Inland	91.43	1.75	0.73	3.80
Peer Avg	74.01	1.68	0.59	7.68
Bowater	NA	1.52	0.90	120.20
Bowater Premium Over Peers	NA	-10.66%	34.44%	93.61%
Bowater Recent Price	\$43.20	\$43.20	\$43.20	\$43.20
Bowater Equilibrium Price	NA	\$47.80	\$28.32	\$2.76
Composite Price	\$26			

As this table shows, Bowater's share price trades at an 11% discount to peer's price-to-book ... a 34% premium to price-to-sales ... and a 94% premium to price-to-cash flow. With weight distribution even across the price metrics, Bowater's equilibrium composite target price is \$26.30.

Technically, the price targets tell the same story. Take a look...

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As you can tell from this graph, Bowater's share price is headed down. A move past initial support at \$42 should open the door for a test of October lows in the \$39 area, our first target area. The stock's momentum is now overbought and show add acceleration to the move down. After that success, we're looking for shares to move to \$36 and then \$32. Our fundamental composite target of \$26 adds strength to the downside projections.

Conclusion

Take a tour around Bowater's operations and you quickly discover that this newsprint maker's share price is under tremendous downside pressure. From lagging long-term sales growth to deteriorating operating margins to massive liquidity problems, this company's stock is in for a fall. Initial downside technical price targets are at \$39, and then step down to \$36 and \$32. Adding extra pull to the price is a \$26 composite fundamental valuation. Bottom line: Bowater is an excellent short candidate.

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BOWATER INCOME PROJECTIONS

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(in Millions except EPS)

	2004 (est)	2003	2002	2001	2000	1999
Sales	\$2,895	\$2,721	\$2,581	\$2,454	\$2,500	\$2,312
COGS	\$2,759	\$2,533	\$2,594	\$2,190	\$2,012	\$2,102
Gross Margin	\$136	\$188	-\$13	\$265	\$489	\$209
SG&A	\$572	\$413	\$140	\$115	\$133	\$99
Oper Inc	-\$435	-\$225	-\$153	\$150	\$356	\$111
Int Exp	\$196	\$175	\$163	\$141	\$135	\$127
Net Non-Oper Losses (G)	-\$144	-\$136	-\$59	-\$174	-\$22	-\$139
Inc Tax Exp (Cr)	-\$75	-\$70	-\$101	\$77	\$70	\$72
Inc (L) bef XtraOrd	-\$412	-\$211	-\$150	\$112	\$169	\$84
XtraOrd L (G) bef Tax	\$5	\$5	\$0	\$0	\$0	\$0
Minority Int (Cr)	-\$11	-\$10	-\$8	\$42	\$10	\$6
Net Income	-\$406	-\$205	-\$142	\$71	\$159	\$79
Shares Outstanding	55					
Est EPS	-\$7.39					