

嘉漢林業

Sino-Forest Corporation

1998 Annual Report



STRENGTH

OPPORTUNITY

GROWTH



Mission Statement

To position Sino-Forest Corporation (“Sino-Forest” or the “Company”) as a fully-integrated, leading company supplying the forest products industry throughout Asia.

Corporate Profile

In 1998, Sino-Forest celebrated its fifth anniversary as a public forest products company. Over the 1994-1998 period, the Company met or exceeded its financial performance targets for twenty consecutive quarters, achieving revenue and net income increases of over 350% and over 600%, respectively, as well as a more than 10-fold increase in wood chip production from 156,000 bone dry metric tonnes (“BDMT”) to 1,603,900 BDMT.

Sino-Forest is the only foreign-owned, integrated forest products company in the People's Republic of China (“PRC” or “China”). Through its first-in advantage in China, strong core tree plantation business, and steadily increasing timber asset base, Sino-Forest has captured a major share of the domestic wood chip and lumber and wood products markets and continues to grow profitably. In this major marketplace, the Company enjoys a leading reputation as a reliable supplier to both the pulp and wood product industries.

Sino-Forest continues to diversify its operations in China and expand its markets into other parts of Asia. In particular, lumber and wood products trading has proven to be an important opportunity for expanding the Company's revenue base and represents a significant ongoing business development opportunity.

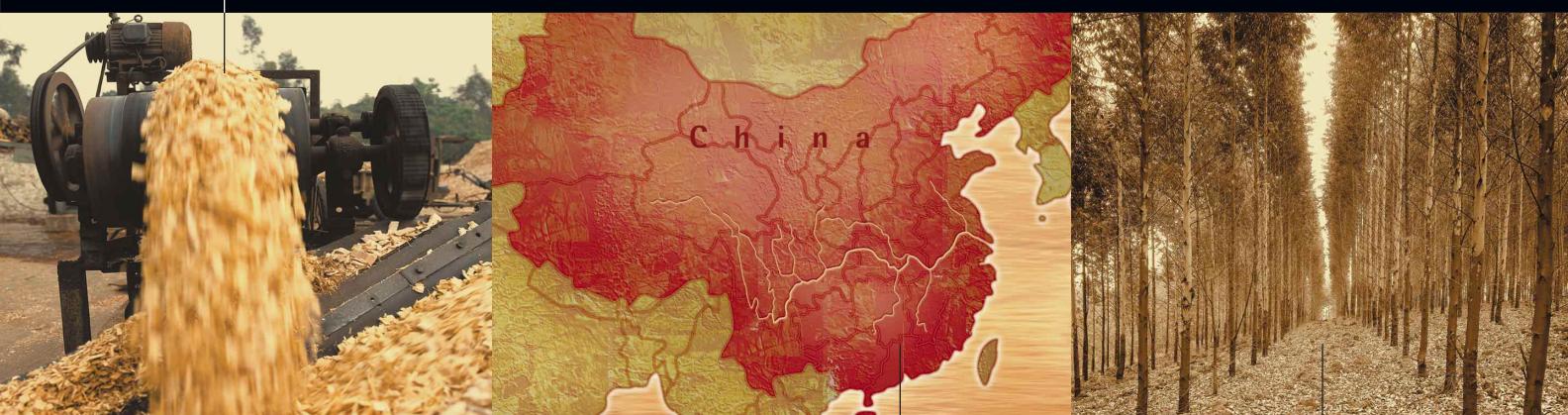
Sino-Forest continues to focus on diversifying its operations as opportunities present themselves to meet the demand for forest products in Asia. The solid foundation Sino-Forest has established in China strongly positions the Company to reach its ultimate goal of becoming the dominant supplier to the forest products industry throughout Asia.

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STRENGTH

Solid Business Foundation Laid - Efficient, Reliable Supplier of Raw Materials •
Growing Timber Asset Base • Management Expertise – Doing Business in China •
Financial Strength • First-in Advantage



OPPORTUNITY

Major Forest Products Supply/Demand Gap in China •
Leading the Diversification of China's Forest Products
Industry • Asia - Major Emerging Marketplace

GROWTH

Continuing Strong Demand for Forest Products in
China Fueled by Paper Consumption and Residential
Construction • Export Markets • International
Sourcing of Forest Products and Technology •
Manufacturing Value-Added Wood-Based Products



Report to Shareholders

[All amounts are expressed in U.S. dollars, unless otherwise indicated]

Strength in Numbers - Five Years of Profitable Growth

In 1998, Sino-Forest celebrated its fifth anniversary as a public forest products company. We are very proud of our success and prosperity, clearly demonstrated by Sino-Forest's strength in numbers throughout the five-year period.

On track for 20 consecutive quarters - and counting

For twenty consecutive quarters, our financial performance met or exceeded expectations. Over the five years, we grew our revenue by over 350%, from \$20.5 million in 1994 to \$92.7 million in 1998. Over the same period, net income increased from \$3.0 million to \$21.4 million, an increase of over 600%, producing fully diluted earnings per share of \$0.26 (Cdn\$0.39) in 1998 compared with \$0.08 (Cdn\$0.11) in 1994.

Achieved greater than 10-fold increase in wood chip production

Operationally, over the five years we increased our wood chip production by more than ten times, from 156,000 BDMT in 1994 to 1,603,900 BDMT in 1998.

Captured significant share of the Chinese domestic market

In 1994, 100% of our production was exported, whereas in 1998, 85% was shipped domestically in China, and 15% was exported. In 1998, domestic wood chip shipments rose to 1,358,400 BDMT, a 28-fold increase over domestic shipments of 46,200 BDMT in 1995. In other words, over a relatively short

time frame, Sino-Forest has been very successful in establishing a strong presence in China's domestic market.

Building the logistics to meet production growth

One of Sino-Forest's most important achievements over the 1994-1998 period was our success in building the logistics to meet the 10-fold increase in production. This is a major accomplishment, especially when one considers the significant growth in the Company over the last five years. Selecting the lands to be phased-in, harvesting and planting, securing adequate chipping plant capacity, winning new customers and market share, all require careful planning and a concerted team effort.

1998: Continued Positive Performance

We are also very pleased with Sino-Forest's continued strong performance in 1998. Despite the economic slowdown experienced in China and all of East Asia in 1998, supply/demand conditions continued in our favour in China and we achieved our targetted financial and operational goals.

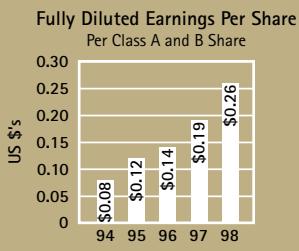
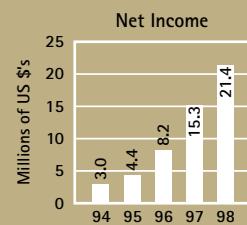
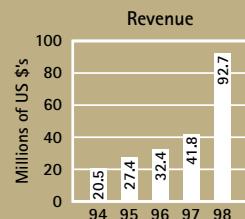
Revenue up 122%; Net Income up 40%

Year-over-year, Sino-Forest increased revenue by 122% to \$92.7 million compared with \$41.8 million in 1997. Net income rose from \$15.3 million in 1997 to \$21.4 million in 1998, representing a 40% year-over-year increase.



Allen T.Y. Chan
Chairman &
Chief Executive
Officer

5-YEAR FINANCIAL HIGHLIGHTS



- 20 consecutive quarters of positive financial performance, meeting or exceeding expectations
- Over 900% increase in Shareholders' Equity
- Over 350% increase in Revenue
- Over 600% increase in Net Income producing 225% increase in Earnings Per Share on a fully-diluted basis

Outlook: Strong Long-Term Growth Potential

In the coming year, we will continue to focus our resources on the best opportunities. Our two primary objectives are to build on our strong core plantation business by growing our timber asset base, and expanding our activities in lumber and wood products trading.

Ideally positioned through strong core plantation business

Our successful partnering with China has enabled us to achieve the first objective in our growth strategy: to position Sino-Forest as an efficient, reliable, long-term supplier of raw materials. Through our plantation program, over the last five years we have acquired rights to prime plantation lands in China, optimized yields, put in place the distribution logistics and secured adequate chipping capacity.

Target: 4 million BDMT sustainable wood chip production

In 1998, we completed the first five years of our plantation program. Over the next six years, we plan to phase-in the remaining 603,000 hectares of plantation lands. When all the contractual plantation lands are phased-in, we expect to produce a sustainable 4 million BDMT of wood chips annually.

For year-end 1999, our goal is to produce at least 2 million BDMT of wood chips, of which approximately 60% should be sold on a principal basis. Our wood chip production over the next few years is expected to increase by at least 400,000 BDMT to 500,000 BDMT per year until the target of 4 million BDMT is attained.

Increasing principal sales

We continue to increase our activities on a principal versus an agency basis and are pleased to report that we exceeded our goals in 1998, transacting 41% of our sales on a principal basis compared to our 25% target. In 1999, we expect principal sales to reach 60%. Our goal for the year 2000 is to have 90% of our sales of wood chips made on a principal basis.

Lumber and wood products trading: A promising new opportunity

Sino-Forest's 20% equity interest in Shanghai Jin Xiang Timber Ltd. ("SJXT" or the Shanghai Timber Market) represents a very significant development for our lumber and wood products trading business. The market is prospering and continues to look very promising. Phase I, consisting of 100 shops, is completed. Phases II and III are expected to be completed by the year 2000. This expansion would triple the size of the Shanghai Timber Market.

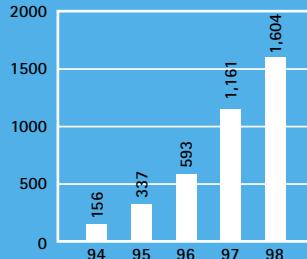
The Shanghai Timber Market is important to Sino-Forest as a generator of significant new revenue. In addition to supplying various forest products to the market from our own operations, our direct participation in SJXT increases our activities in sourcing a wide range of other wood products both from inside China and internationally.

The Shanghai Timber Market is also very beneficial to the development of the forest products industry in China because it is the first forest products national sub-market in the eastern region of the country.

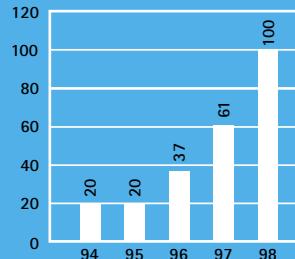
In October 1998, we announced an Agency Agreement with SJXT, under which Sino-Forest will provide 130,000 m³ of various wood products to SJXT over an 18 month

5-YEAR OPERATIONAL HIGHLIGHTS

Wood Chip Shipments/Production
BDMT (Thousands)



Plantations Phased-In
Total Hectares (Thousands)



- Achieved a more than 10-fold increase in wood chip production from 156,000 BDMT in 1994 to 1,603,900 BDMT in 1998.
- Increased the total plantation lands phased-in from 20,000 hectares in 1994 to approximately 100,000 hectares by the end of 1998.
- Built our timber asset base from over \$2 million in 1994 to \$67 million by year-end 1998.
- In five years, successfully met the challenges of putting in place all the processing, sales and marketing, and distribution logistics required to handle our 10-fold increase in wood chip production.
- Over the four-year period between 1995 and 1998, successfully established our presence in China, supplying more than 85% of our total wood chip production to the domestic market in 1998 compared to 14% in 1995.



The 1,603,900 BDMT of wood chips produced in 1998 represented only about 3% of China's total estimated potential requirement

period. Based on current market prices, we expect this contract to generate significant revenue for Sino-Forest amounting to approximately \$40 million.

The market also greatly facilitates Sino-Forest's networking activities, enabling us to build new industry relationships and add to our market intelligence, all of which increasingly leverage our ability to act as principal in our dealings.

A quality operation confirmed

The ISO 9002 Quality Management System certification of plantations managed by our Guangxi Co-operative Joint Venture, awarded in June 1998, further signifies the success of our partnership with China. This international endorsement of our high standards in managing and operating our plantations is a very valuable business designation which will assist Sino-Forest in gaining new customers and expanding its export markets.

Asia: Growth drivers remain unchanged

We founded Sino-Forest five years ago to meet the growing demand for forest products in China and other parts of Asia. We believe that the forces driving the demand for new and better housing, paper and other forest products have become a permanent feature of the region's landscape, only temporarily slowed by the recent economic challenges. As a leading forest products company in this part of the world, Sino-Forest is ideally positioned to seize opportunities when improving economic conditions reinvigorate markets and refuel the demand for wood-based materials.

China: A major market by any measure

China has historically been a major importer of wood because of a shortage of supply within its own borders. Over the last ten years the government's commitment to its Reform Program has resulted in new demand for higher quality paper, housing and other forest products.

To put the wood-based paper supply/demand situation in China into perspective, consider that in 1998, the 1,603,900 BDMT of wood chips produced by Sino-Forest represented only about 3% of China's total estimated potential need for wood chips.

As a result of the flooding in China last year, a ban on the logging of natural forests was imposed in September 1998. We believe that this restriction will likely remain in place for the next couple of years, having positive implications for both our wood chip and lumber and wood products trading businesses.

Vision: Moving Towards Vertical Integration

Our ultimate mission is to position Sino-Forest as a fully integrated, leading company supplying the forest products industry throughout Asia. Our focus on growing our timber asset base and increasing our activities in lumber and wood products trading are two initiatives we have underway to move our operations towards vertical integration. Lumber and wood products trading is an important new business channel for us because it diversifies our revenue base and provides a high return, as well as further expanding our position in the ever-growing wood products market in Asia.

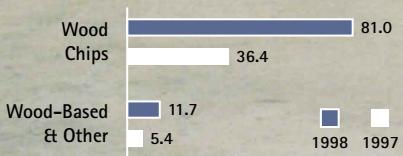


市场是个家

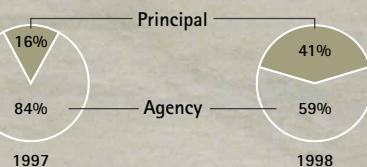
1998 OPERATIONAL HIGHLIGHTS

Revenue by Segment

Millions of US \$'s



Principal Versus Agency Sales



- Principal shipments increased over 260% from 184,400 BDMT in 1997 to 664,500 BDMT in 1998.
- Increased our activities in lumber and wood products trading through our participation in the prospering Shanghai Timber Market, which completed the first stage of its development in 1998 and has two additional expansions planned.

- Entered into Agency Agreement with SJXT, expected to generate approximately \$40 million over 18 months.
- Awarded the international ISO 9002 Quality Management Systems certification on the Guangxi CJV plantation operation in June 1998.

Our focus is to continue to grow our timber asset base and to further expand our activities in lumber and wood products trading

Our plan to establish a wood-based panel manufacturing business for the sale of value-added wood products in China has been delayed as a result of the volatile and weak financial markets. Wood-based panel manufacturing represents a logical downstream integration business for Sino-Forest and we will continue to explore options for this new venture.

We are constantly pursuing opportunities to increase our timber asset base, including acquiring standing timber and completing plantation agreements with built-in flexibility. For example, in response to the increase in demand for aspen logs through our lumber and wood products trading business, we are pursuing plantation lands in those geographic locations best suited to growing these trees. Accordingly, in March 1999, we decided to cancel the agreements signed in November 1997 with local forestry bureaus in Fujian Province and Hainan Province. Given Sino-Forest's positive relationship with forestry officials, we are optimistic that we will be able to replace these plantation lands by securing additional aspen plantations in greater Shanghai and central China, equal to or greater than the 200,000 hectares covered in our previous agreements with Fujian Province and Hainan Province.

Our strong core plantation business has resulted in considerable growth in our operations because of the major marketplace China represents. Looking to the future, this solid foundation gives us an excellent base from which to launch further growth and realize our ultimate goal for Sino-Forest: to

become the dominant supplier to the forest products industry in Asia.

STRENGTH + OPPORTUNITY = GROWTH

In conclusion, we are very proud of Sino-Forest's solid five-year performance, and are confident in our vision. We anticipate continued profitable growth in the coming year and beyond based on our first-in advantage and superior competitive position as an established and reputable forest products supplier in China.

Acknowledgements

Sino-Forest would not have as many accomplishments to celebrate on its fifth anniversary were it not for the dedicated commitment and conscientious efforts of its Board of Directors, management, and employees. I thank you all for your contributions and I look forward to another five years of significant progress and achievement together.

On behalf of management and the Board of Sino-Forest, I would also like to extend a sincere thank you to our shareholders for their continued support. We believe in the strong potential Sino-Forest has to achieve sustained, profitable growth, and we remain committed to increasing shareholder value.



Allen T.Y. Chan

Chairman & Chief Executive Officer



PRESIDENT'S MESSAGE

Time is the real test of value.

Five years might not be very

long but it is at least long enough to

test the value of a new-born com-

pany – *the critical first five years.*

Over these years we have worked

very hard. By now, we believe we

have already proven that, like the

trees we planted, weathering all

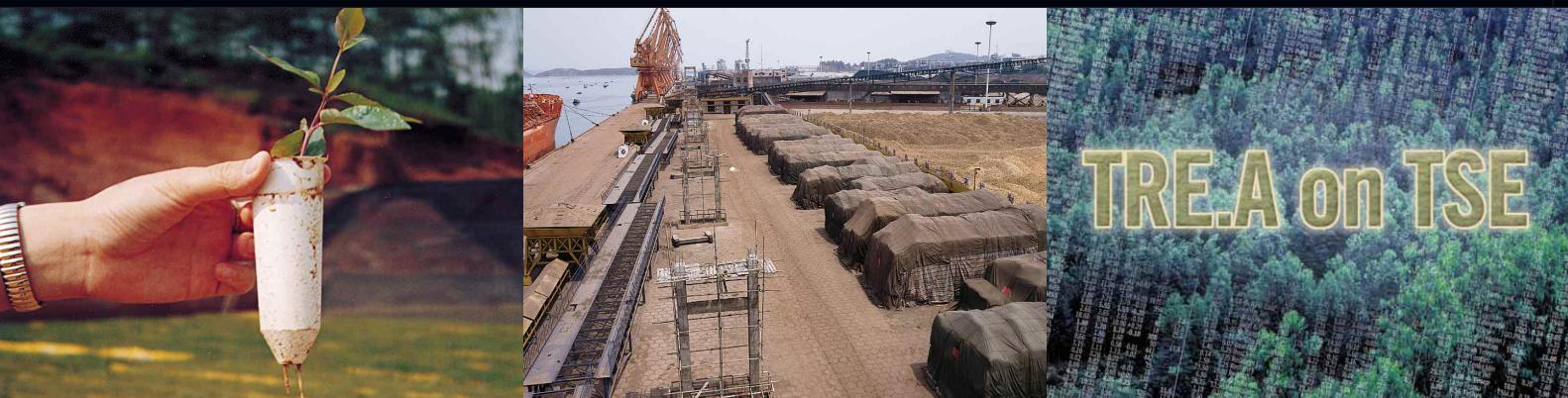
weathers, we are standing firm.

Kai Kit Poon

President

总裁
潘家鈞
立

路遠知马力，日見人心。五年雖非很
長，但又以老齡不新生之歲的範計。
此了矣。篤的五年，自公司成立以來。
吾等一直努力不懈，點點耕耘，而
年年有成。嘉慶和嘉慶的樹苗
經得起千般考驗，穩立中國大地上。



STRENGTH

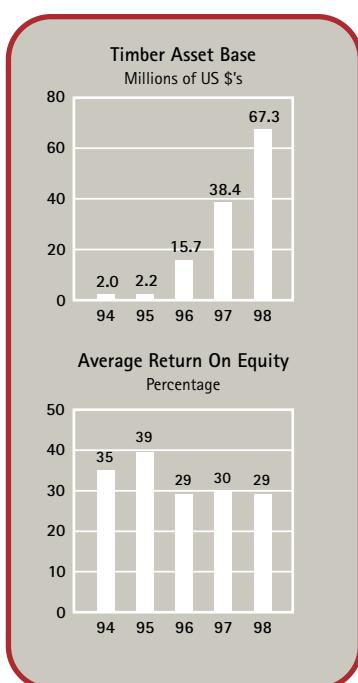
A Strong Growth Foundation Established

Sino-Forest's considerable plantation management expertise and successful partnering with China over the last five years have enabled the Company to establish a solid foundation for future growth as a leading forest products supplier in Asia.

Over the 1994-1998 period, Sino-Forest acquired rights to manage and operate 603,000 hectares of prime plantation lands in China for up to 50 years. The Company has optimized yields through improved agriculture and genetic engineering, put in place all the sales, distribution and processing logistics including securing adequate wood chipping capacity, and established its own timber asset base. Sino-Forest's standing timber will begin maturing for harvesting in 2001.

In 1998, Sino-Forest exceeded its target production of 1,600,000 BDMT of wood chips. The total 1,603,900 BDMT produced represents more than ten times 1994's wood chip production and a 38% increase over 1997 production. 1998 domestic shipments, amounting to 1,358,400 BDMT and representing a 60% increase over 1997, accounted for only about 3% of China's total estimated potential wood chip requirement.

Sino-Forest's established financial track record over the 1994 to 1998 period and a strong balance sheet with very little debt provide a solid financial position for the Company's future growth. Over the past five years, Sino-Forest raised substantial capital to finance the growth and expansion of its operations, and met or exceeded all financial performance targets demonstrating management's ability to achieve sustained, profitable growth.



Shanghai Timber Market

Lumber and wood products trading

Hong Kong



OPPORTUNITY

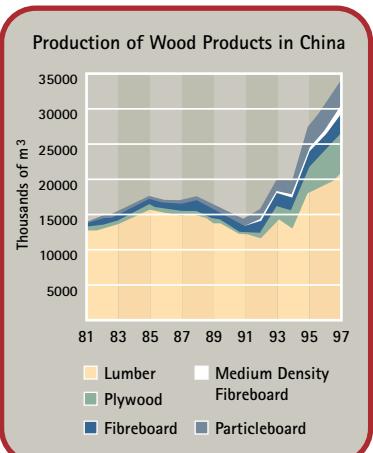
Established Presence in Major Marketplaces

Now a well established, leading participant in Asia's forest products industry, Sino-Forest was created five years ago to capitalize on the growing need for lumber and wood products of the region's major population groups in China, Japan, Taiwan and other areas. Although the onset of economic challenges in 1998 affected most of Asia, renewed demand for better housing, paper and other forest products is expected as conditions continue to improve in the years ahead.

In contrast to other parts of Asia, demand for forest products continues to be strong in China, as a result of the government's Reform Program, which has been underway for the last ten years, and the country's chronic lack of wood within its borders. In 1998, 85% or 1,358,400 BDMT of Sino-Forest's shipments of wood chips, used for paper production, were sold domestically in China. Although this amount represents a more than 28-fold increase in Sino-Forest's domestic wood chip shipments over the 1995 to 1998 period, and a 60% increase over 1997's domestic shipments, it satisfied only about 3% of China's total estimated potential requirement for wood-based paper production.

In 1999, Sino-Forest expects to increase its activities in the lumber and wood products trading business. Sino-Forest anticipates significant growth in its sales of logs and lumber, meeting demand through its international network of industry contacts and investment in the Shanghai Timber Market.

Sino-Forest remains committed to developing the wood panel manufacturing business in order to capitalize on the attractive opportunity this downstream integration project represents. Alternatives are actively being reviewed and discussions are ongoing with a number of potential partners to determine the best strategies for financing and proceeding with this operation.



Source: Jaakko Pöyry Consulting

The production of wood products in China accelerated during the 1990's. As a result of this continuing trend, further increases are forecasted as producers strive to match the country's strong demand for lumber and wood products.

1994

Established the first foreign equity joint venture plantation operation (20,000 hectares) in China
In first year, shipped 156,000 BDMT of wood chips



1995

Developed plantation business plan and new CJV structure for plantation agreements
Established 5 CJVs in three provinces of southern China to manage 603,000 hectares of plantation lands over a 10-year plantation phasing-in program

Shipped 337,000 BDMT of wood chips



1996

Shipped over 593,000 BDMT of wood chips
Raised approximately \$25 million in financing to implement the plantation business plan

Five Years of Progress and Achievement

GROWTH

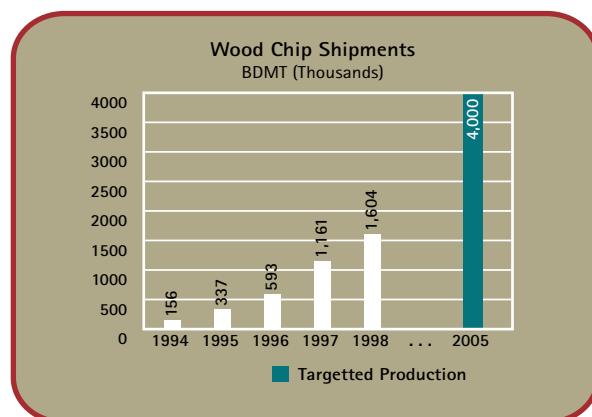
Ideally Positioned to Further Penetrate the Asian Markets and Seize New Opportunities

As a major plantation operator in China with a strong established timber sourcing network both domestically and through imports, Sino-Forest is in an advantageous position to realize long term benefits as the preferred supplier of wood as feedstock for both pulp and building material manufacturers in the country and East Asia.

In China, because of the conversion of non-wood pulp to traditional wood pulp, as well as increasing paper and board consumption due to population growth and rising literacy rates, the projected demand for domestic wood chips indicates a shortage of supply over the next decade. In addition, the ban on logging of natural forests imposed by the Chinese government in 1998 will further reduce timber output in the country for years to come.

In other parts of Asia, opportunities are expected to resurface as economic conditions improve, giving Sino-Forest a second major marketplace where it can leverage its established presence to achieve new growth.

Sino-Forest will continue to focus on growing its timber asset base and increasing its activities in lumber and wood products trading, as well as finding the best solution for expanding into the wood panel manufacturing business. Building on its first-in advantage and superior competitive position in the forest products industry in China, Sino-Forest is confident in its strength to capitalize on the opportunities in its marketplaces, and expects additional attractive increases in revenue and net income in 1999, and continued profitable growth in the years to come.



**1997**

Shipped 1,160,560 BDMT of wood chips, achieving new record production levels and exceeding target
Made initial investment in Shanghai Timber Market

**1998**

Record 1,603,900 BDMT of wood chips shipped, exceeding target
Awarded ISO 9002 Quality Management System certification on the Guangxi CJV plantation operation
Established and expanded on the lumber and wood products trading business



Tree Descriptions

Plantation Trees - Specifications and Characteristics

	Eucalyptus	Aspen	China Southern Pine
Plantation Cycle	5 years	5 years	12 years
Cost of Plantation Program (US\$ per hectare)	\$ 767	\$1,005	\$ 704
Standing Timber Yield per Hectare per Cycle	90 m ³	128 m ³	135 m ³
Annual Growth Rate per Year	18 m ³	25.6 m ³	11.25 m ³
Wood Chip Yield per Hectare per Cycle	40.2 BDMT	42 BDMT	52 BDMT



MANAGEMENT DISCUSSION AND ANALYSIS

[All amounts are expressed in U.S. dollars, unless otherwise indicated]

Review of Operating Results

A summary of the results of operations of the Company by segment for the years ended December 31, 1998 and 1997 is as follows:

[Thousands of US \$'s]	Year Ended December 31, 1998			Year Ended December 31, 1997		
Revenue	Wood Chips	Wood-Based & Other	Total	Wood Chips	Wood-Based & Other	Total
Sales	66,793	9,368	76,161	21,735	1,800	23,535
Commission income	14,228	2,321	16,549	14,688	3,560	18,248
	81,021	11,689	92,710	36,423	5,360	41,783
Income from operations	21,213	2,833	24,046	14,631	3,615	18,246

Income from operations for the year ended December 31, 1998 was \$24.0 million, an increase of 32% compared to income from operations of \$18.2 million for 1997. Earnings per share on a fully diluted basis increased 37% to \$0.26 per share compared to \$0.19 per share attained in 1997. Income from the wood chip operations increased by 45% from \$14.6 million in 1997 to \$21.2 million in 1998. Income from wood-based and other business decreased by approximately 22% to \$2.8 million compared to \$3.6 million in 1997 due primarily to lower commission income earned on lumber trading. The significant increase in earnings on the wood chip operations is attributable to the continuing increase in wood chip shipments in 1998 which is in line with the Company's planned phase-in of the contractual plantation lands, increase in principal sales and increase in wood products trading. Sales from wood products trading increased 422% to \$9.4 million compared to \$1.8 million in 1997. The increase in wood products trading is primarily attributable to a full year of operation in 1998 as compared to three months trading in 1997. Lumber trading on an agency basis has

decreased 36% from \$3.6 million in 1997 to \$2.3 million in 1998 as a result of a shift in resources to establish the wood products principal trading business.

The average price of wood chips in 1998, net of VAT, decreased marginally to \$100 per BDMT from \$101 per BDMT attained in 1997. Continuing strong demand for wood chips in the domestic PRC market helped strengthen the 1998 average price. The average price of wood chips in the domestic PRC market was \$101 per BDMT compared to \$99 per BDMT attained on export sales. With respect to sales in which the Company acted as an agent, the Company earned an average of \$15.15 per BDMT in 1998 compared to \$15.70 per BDMT earned in 1997.

In 1998, wood chip shipments totalled 1,603,900 BDMT compared to 1,160,560 BDMT shipped in 1997, an increase of approximately 38%. Of the total wood chips shipped in 1998, 245,500 BDMT were exported to Japan and Taiwan and 1,358,400 BDMT were sold in the domestic PRC market. Export and domestic shipments for 1997 were 311,300 BDMT and 849,260 BDMT respectively. For the year ended

December 31, 1998, the Company acted as principal on 664,500 BDMT compared to 184,400 BDMT in 1997, an increase of 260%. In 1998, no shipments were recorded from Leizhou EJV as it had ceased operations in 1997 compared to shipments of 45,000 BDMT recorded in 1997. Export shipments have decreased approximately 21% from 311,300 BDMT in 1997 to 245,500 BDMT in 1998 as a result of the continuing weak economy in Japan and the economic downturn in Asia. Demand for wood chips in China remains strong and was the reason for the significant increase in shipments from 849,260 BDMT in 1997 to 1,358,400 BDMT in 1998, an increase of 60%.

A summary of the wood chip shipments for the year ended December 31, 1998 compared to 1997 is set out in the table below:

Wood Chip Shipments for the Year Ended December 31 [Thousands of BDMT]								
Market	Principal		Agency		Leizhou EJV		Total	
	1998	1997	1998	1997	1998	1997	1998	1997
Export	—	—	245.5	266.3	—	45.0	245.5	311.3
PRC domestic	664.5	184.4	693.9	664.9	—	—	1,358.4	849.3
Total	664.5	184.4	939.4	931.2	—	45.0	1,603.9	1,160.6

Wood-Based Panel

The Company is in the process of establishing a wood-based panel manufacturing business for the sale of value-added wood products in the PRC. These operations, when implemented, will be carried out through Sino-Panel (Gaoyao) Limited ["Sino-Panel"], a wholly-owned subsidiary of the Company. Sino-Panel has established an EJV with a local PRC company in which Sino-Panel's equity interest is 85%. Under the EJV agreement, the EJV is formed for a 50 year period and Sino-Panel is required to contribute \$10,064,000 for its 85% equity interest, of which \$1,510,000 was required to be made within three months from the date of issue of busi-

ness license. The remaining capital contribution of \$8,554,000 is to be contributed depending on the needs of the EJV operation. Sino-Panel's capital contribution commitment was fully satisfied in 1998 by the contribution of certain machinery and equipment to the EJV with an aggregate fair value of approximately \$11,021,000. The EJV is currently in negotiations with several parties with respect to completing the development of this wood-based panel manufacturing project.

SJXT

In 1997, the Company acquired a 20% equity interest in Shanghai Jin Xiang Timber Ltd. ("SJXT"), an EJV that was formed by the Ministry of Forestry in China. The purpose of the investment is to establish strategic partnerships with key local wood product suppliers

and to build a strong distribution network for the lumber and wood products trading and wood-based panel businesses. The total investment of SJXT is estimated to be \$9,662,000 (Chinese renminbi 80 million) of which the Company's required capital contribution was approximately \$1,932,000. As at December 31, 1998, the Company has made capital contributions to SJXT in the amount of \$1,037,000 [1997 - \$1,037,000].

The purpose of SJXT is to organize and manage the first and only national sub-market for timber and log trading in eastern China. The investment in SJXT will provide the Company good accessibility to a large base of potential customers and companies in the

timber and log businesses in eastern China. In the fourth quarter of 1998, the Company announced that it had entered into an Agency Agreement to supply 130,000 m³ of various wood products to SJXT over an 18 month period. The contract is estimated to have a sales value of approximately \$40.0 million based on current market prices. The Company is expected to earn a 10% - 15% commission income on this contract when the products are delivered in 1999 and 2000.

Liquidity and Capital Resources

Cash flows from operations in 1998 were \$15.3 million, which together with cash and cash equivalents of \$5.7 million and the bank credit facility available, were sufficient to finance investment in capital assets of \$22.9 million in 1998. Investment in capital assets are largely made up of plantation costs and acquisition of young trees.

As at December 31, 1998, the Company had cash and cash equivalents of \$0.9 million and approximately \$4.0 million available under its credit facility with the Deutsche Bank. As at December 31, 1998, the Company's total debt was \$5.7 million, compared with \$6.7 million at the end of 1997. The reduction in debt was due to the conversion of Deutsche Bank's debenture of \$3.0 million into equity of the Company in accordance with the terms of the loan agreement and an increase in short term bank borrowing for trust receipt loans of \$2.0 million. On December 31, 1998, the Company's debt to equity ratio was 0.07:1 compared with 0.11:1 at the end of 1997.

Subsequent to the year end, Sino-Wood Partners, Limited ["Sino-Wood"] entered into an Agreement to issue an aggregate of \$20.0 million Guaranteed Exchangeable Redeemable Notes.

Approximately \$11.0 million of the net proceeds will be used as working capital for the purchase of standing timber in the PRC. The funding available will allow the Company

to purchase approximately 600,000 m³ of timber in 1999. Based on current market conditions, additional revenue in 1999 from these timber sales is expected to be approximately Chinese renminbi 262 million (which is equivalent to approximately \$32 million). Based on current market prices and conditions, the Company expects to earn a margin of 25% - 30% on these timber sales. The remainder of the net proceeds will be used for further establishment, development and expansion of the lumber and wood products trading business. The Company has been involved, on a smaller scale, in the lumber and wood products trading business since its formation in 1994. With this additional working capital and the businesses developed through its SJXT investment, the Company expects to generate additional revenue in 1999 from lumber and wood products trading of approximately Chinese renminbi 410 million (which is equivalent to approximately \$50 million). Based on current market prices and conditions, the Company expects to earn a margin of 10% - 15% on its lumber and wood products trading business.

The acquisition of standing timber (aspen) and the significant expansion of the lumber and wood products trading business should lead to a significant increase in revenue, earnings and cash flow in 1999.

CJVs Capital Contribution Commitments

Sino-Wood's subsidiaries are committed to contribute an aggregate of \$14,200,000 of capital to the five existing CJVs which was subsequently reduced to \$12,200,000 upon approval by the Commission of Foreign Trade and Economic Co-operation in February 1999. As at December 31, 1998, a total capital contribution of \$8,769,000 had been made. Accordingly, the remaining capital contribution outstanding as at December 31, 1998 is \$3,431,000. A further capital contribution of \$2,069,000 was made subsequent to the year end.

In November 1997, the Company signed

agreements with the local PRC companies in the Fujian Province and the Hainan Province to increase its plantation lands by 100,000 hectares in each of the provinces on similar terms and conditions as its existing CJs. In 1998, the Company decided not to proceed with the establishment of these new CJs due to a change in plan to secure more aspen plantations in central China. Accordingly, pursuant to the agreements signed between the Company's subsidiaries and the local PRC companies, the agreements signed in November 1997 were cancelled in March 1999. As these CJs have not been formed, no capital contributions were required to be made by the Company's subsidiaries.

Year 2000 Computer Issue

Certain computer programs and microprocessors use two digits to specify the year rather than four. Any computer programs that have date-sensitive software and microprocessors may recognize a date using "00" as the year 1900 rather than the year 2000. This could cause many computer applications to fail or to create erroneous results unless corrective measures are taken before the year 2000. The Company currently utilizes software and related computer technologies that are largely standalone standard software packages, which are Year 2000 compliant. Accordingly, management does not expect the Year 2000 Computer Issue to have a material adverse impact on the Company's operations or financial condition. The Company is currently assessing the Year 2000 Computer Issue to determine the impact computer programs employed by its suppliers and customers may have on the Company. Management believes that the nature of the transactions it currently conducts with its suppliers and customers is not heavily dependent on computer programs and accordingly, should not have a

material adverse impact on the Company's operations.

Outlook

The demand for wood chips in the domestic market (PRC) is expected to remain strong despite an expected economic slowdown in 1999 due to Asia's economic turmoil. Paper and board consumption in China is expected to continue increasing mainly due to population growth, increasing literacy rates and the conversion of non-wood pulp to traditional wood pulp. Supply of wood chips in China over the next decade is expected to lag behind the projected strong growth in demand for wood chips.

In 1998, as a result of serious flooding experienced in central China, the Chinese government announced a ban on logging of natural forests. This ban will further reduce timber output in the PRC and will enhance the Company's competitive ability to supply wood products in the PRC. This measure, taken by the Chinese government to ban logging of natural forests, is expected to have a profound impact on the domestic supply of timber in the PRC in the years to come. According to Chinese government sources, by the year 2000, domestic supply of timber is expected to be approximately 50% short of expected consumption of 120 million m³ per year. This increased shortage of timber caused by the ban on logging of natural forests, is expected to have a significant impact on imports and prices of timber products. As a major plantation operator in the PRC (as opposed to a logger of natural forests), with a strong established timber sourcing network both domestically and through imports, Sino-Forest is in an advantageous position to be the preferred supplier of wood as feedstock for both pulp and building material manufacturers in the PRC.

MANAGEMENT REPORT

The consolidated financial statements contained in this Annual Report have been prepared by management in accordance with generally accepted accounting principles. The financial information contained elsewhere in the Annual Report is consistent with the consolidated financial statements.

Management maintains systems of internal accounting and administrative controls to provide reasonable assurance as to the reliability of the financial records and the safeguarding of the Company's assets.

The Audit Committee, which is mainly comprised of outside directors, meets periodically with management to discuss the adequacy of the system of internal controls and the integrity of the Company's financial reporting.

The consolidated financial statements have been reviewed by the Audit Committee prior to submission to the Board of Directors. The consolidated financial statements have also been audited by Arthur Andersen LLP, who have full access to the Audit Committee with and without the presence of management to discuss the scope of their audit, the adequacy of the system of internal controls and the adequacy of financial reporting.



Allen T. Y. Chan

Chairman and
Chief Executive Officer



Kee Y. Wong

Executive Vice President and
Chief Financial Officer

AUDITORS' REPORT

To the Shareholders of Sino-Forest Corporation

We have audited the consolidated balance sheet of Sino-Forest Corporation as at December 31, 1998 and the consolidated statement of income and retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1998 and the results of its operations and its cash flows for the year then ended in accordance with generally accepted accounting principles.

The consolidated financial statements as at December 31, 1997 and for the year then ended were audited by other auditors who expressed an opinion without reservation on those statements in their report dated May 4, 1998.



Chartered Accountants

Toronto, Canada
April 10, 1999

CONSOLIDATED BALANCE SHEETS

[Expressed in thousands of U.S. dollars]

As at December 31	1998	1997
ASSETS		
Current		
Cash and cash equivalents	912	5,683
Accounts receivable [note 3]	2,643	4,037
Other receivables and prepaid expenses	1,929	2,337
Due from PRC CJV partners [note 6]	11,748	7,634
Inventories	—	9
Total current assets	17,232	19,700
Capital assets, net [note 4]	78,880	48,320
Deposits [note 5]	2,250	2,250
Jiangxi Investments [note 2(c)]	1,070	1,500
SJXT Investment [note 2(b)]	1,037	1,037
Goodwill, net	32	33
	100,501	72,840
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	5,396	4,134
Income taxes payable	4,227	1,984
Bank indebtedness [note 7(b)]	1,997	—
Current portion of long-term debt [note 8]	370	—
Total current liabilities	11,990	6,118
Long-term debt [note 8]	3,340	3,710
Convertible debenture [note 7(a)]	—	3,000
Total liabilities	15,330	12,828
Commitments [notes 2 and 14]		
Shareholders' equity		
Share capital [note 9]	32,989	29,302
Retained earnings	52,182	30,818
Cumulative translation adjustment	—	(108)
Total shareholders' equity	85,171	60,012
	100,501	72,840

See accompanying notes

On behalf of the Board:

Allen T. Y. Chan
Director

William Rosenfeld
Director

CONSOLIDATED STATEMENTS OF INCOME AND RETAINED EARNINGS

[Expressed in thousands of U.S. dollars, except for earnings per share information]

Years ended December 31	1998	1997
Revenue	92,710	41,783
Costs and expenses		
Cost of sales	62,675	17,401
Selling, general and administration	5,898	5,068
Depreciation, amortization and depletion	91	717
Research and development	—	351
	68,664	23,537
Income from operations	24,046	18,246
Equity in losses of Jiangxi Investments	(430)	(418)
Net interest (expense) income [note 7(a)]	(9)	64
Other expense	—	(140)
Income before income taxes	23,607	17,752
Provision for income taxes - current [note 10]	(2,243)	(1,849)
Income before non-controlling interests	21,364	15,903
Non-controlling interests	—	(606)
Net income for the year	21,364	15,297
Retained earnings, beginning of year	30,818	15,521
Retained earnings, end of year	52,182	30,818
Earnings per share [note 11]		
Basic	\$0.29	\$0.23
Fully diluted	\$0.26	\$0.19

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

[Expressed in thousands of U.S. dollars]

Years ended December 31	1998	1997
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income for the year	21,364	15,297
Add (deduct) items not affecting cash		
Reduction in amount due from CJV partners		
in exchange for timber holdings	(7,770)	(2,762)
Equity in losses of Jiangxi Investments	430	418
Depreciation, amortization and depletion	91	717
Non-controlling interests	—	606
	14,115	14,276
Net change in non-cash working capital balances	1,202	291
Cash flows from operating activities	15,317	14,567
CASH FLOWS FROM FINANCING ACTIVITIES		
Issuance of share capital, net	687	2,231
Issuance of long-term debt	—	3,710
Cash flows from financing activities	687	5,941
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in capital assets	(22,880)	(28,931)
Cash released from escrow	—	11,042
Deposits	—	(2,250)
Investment in SJXT	—	(1,037)
Cash flows used in investing activities	(22,880)	(21,176)
Effect of exchange rate changes on cash	108	(367)
Net decrease in cash and cash equivalents during the year	(6,768)	(1,035)
Cash and cash equivalents, beginning of year	5,683	6,718
Cash, cash equivalents and bank indebtedness, end of year	(1,085)	5,683

See accompanying notes

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[Tabular figures expressed in thousands of U.S. dollars, unless otherwise indicated]

1. SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of Sino-Forest Corporation (“Sino-Forest” or the “Company”) have been prepared in United States dollars and in accordance with accounting principles generally accepted in Canada. The significant accounting policies are as follows:

Basis of consolidation

These consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated on consolidation.

The Company’s investments in Sino-foreign co-operative joint ventures (each a “PRC CJV”, collectively, the “PRC CJVs”) are accounted for on the proportionate consolidation basis. Accordingly, the accounts reflect the Company’s pro-rata share of the assets, liabilities, revenue, expenses and cash flows of its PRC CJVs.

The Company’s investments in Sino-foreign equity joint ventures and equity joint ventures (collectively, the “EJVs”) which are controlled by the Company are accounted for on the consolidation basis. Investments in EJVs over which the Company exercises significant influence are accounted for under the equity method.

Translation of foreign currencies

Foreign currency transactions and balances, and the financial statements of integrated foreign operations, are translated into United States dollars using the temporal method. Under this method, monetary items are translated at the rate of exchange in effect at the consolidated balance sheet dates. Non-monetary items are translated at the historical exchange rate. Revenue and expense items are translated at the average exchange rates prevailing during the year, except for depreciation, amortization and depletion which are translated at the same exchange rates as the assets to which they relate. Exchange gains and losses are included in income in the current year.

Inventories

Inventories, consisting primarily of finished goods, are stated at the lower of cost and net realizable value.

Capital assets

Timber holdings include acquisition costs for young trees and standing timber, planting, maintenance and harvesting costs, which are capitalized over a period of 5 to 12 years based on the growth cycle of the type of trees. Timber holdings are depleted when the trees are harvested on the basis of the volume of timber cut.

Other capital assets are recorded at cost including interest capitalized on assets under construction. Repairs and maintenance expenditures are charged to income; major betterments and replacements are capitalized. Depreciation and amortization are provided on a straight-line basis to reduce the original cost of capital assets to estimated residual values over the following estimated useful lives:

Machinery and equipment	15 years
Office furniture and equipment	5 to 10 years
Vehicles	5 to 10 years

Goodwill

Goodwill is amortized over forty years on a straight-line basis.

Revenue recognition

Revenue from the sale of wood chips and other products is recognized when the products are shipped. Commission income relating to wood chip and other product sales is recognized as revenue when the products are shipped and services rendered.

Research and development costs

The Company expenses all research costs as incurred. Development costs are expensed in the year incurred unless a development project meets the criteria under generally accepted accounting principles in Canada for deferral and amortization. No amounts have been capitalized.

Income taxes

Income taxes are accounted for using the deferral method. Under this method, timing differences between accounting and taxable income result in deferred income taxes.

Use of estimates

The preparation of consolidated financial statements in accordance with generally accepted accounting principles in Canada requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses for the period reported. Actual results could differ from those estimates.

Fair value of financial instruments

The Company estimates the fair value of its financial instruments based on current interest rates, market value and current price of financial instruments with similar terms. Unless otherwise disclosed herein, the carrying value of financial instruments, especially those with current maturities such as cash, accounts receivable and accounts payable, is considered to approximate their fair value.

Adoption of new accounting standard

In 1998, the Company adopted the recommendations of CICA Handbook Section 1540, "Cash Flow Statements". The prior year's statement of changes in financial position has been restated to conform with the requirements of this Section.

2. ORGANIZATION AND OPERATIONS

The Company's principal business activities include the management and operation of tree plantations, sales and trading of logs, lumber and wood chips in the People's Republic of China (the "PRC"), and other Asia-Pacific markets. Apart from these, the Company also provides agency services for the sale of logs, lumber and wood chips in the PRC and other Asia-Pacific markets. Details of the Company's principal business activities are as follows:

(a) Tree plantation and wood chip operations

PRC CJVs

In 1995, the Company, through wholly-owned subsidiaries of Sino-Wood Partners, Limited ("Sino-Wood"), entered into agreements to form five PRC CJVs. Under the terms of the agreements,

the CJV partners are required to provide the PRC CJVs with land use rights for up to 603,000 hectares of land for tree plantations. The land use rights are for a period of 50 years and will be phased-in over a number of years. Sino-Wood's subsidiaries are responsible for providing funds to the PRC CJVs for all planting, maintenance and harvesting costs incurred on the phased-in land. The subsidiaries are entitled to 70% of the timber harvested on the phased-in land and the CJV partners are entitled to the balance. The CJV partners retain ownership of the land use rights and accordingly, no value is assigned to the land use rights for accounting purposes.

Sino-Wood's subsidiaries were committed to contribute an aggregate of \$14,200,000 of capital to the five PRC CJVs, which was subsequently reduced to \$12,200,000 upon approval by the Commission of Foreign Trade and Economic Co-operation in February 1999. Up to December 31, 1998, the Company had made capital contributions of \$8,769,000 to meet costs for planting, maintenance and harvesting of the PRC CJVs' tree plantations. Accordingly, the outstanding capital contribution required with respect to these five PRC CJVs as at December 31, 1998 is \$3,431,000. Subsequent to the year end, a further capital contribution of \$2,069,000 was made by the Company.

The major components of the Company's interests in these five PRC CJVs are as follows:

US \$	1998	1997
Consolidated balance sheets		
Current assets	1,848	1,376
Long-term assets	8,621	10,740
Current liabilities	(1,000)	(616)
Long-term liabilities	—	—
Consolidated statements of income		
Revenue	—	16,138
Costs and expenses	—	(12,428)
Net income	—	3,710
Consolidated statements of cash flows		
Cash flows from operating activities	489	3,422
Cash flows from financing activities	1,678	4,290
Cash flows used in investing activities	(2,417)	(8,606)

In 1998, sales made on a principal basis were carried out by a subsidiary of the Company. In 1997, these sales were carried out by one of its PRC CJVs.

In November 1997, the Company's subsidiaries signed agreements with local PRC companies in the Fujian Province and the Hainan Province to increase its plantation lands by 100,000 hectares in each of the above provinces on similar terms and conditions as the above PRC CJVs. In 1998, the Company has decided not to proceed with the formation of these two new PRC CJVs due to a change in plan to secure more aspen plantations in central China. Accordingly, pursuant to the agreements signed between the Company's subsidiaries and the local PRC companies in March 1999, the agreements signed in November 1997 were cancelled. As these PRC CJVs have not been formed, no capital contributions were required to be made by the Company's subsidiaries.

Leizhou EJV

The Company held until October 1, 1997, a 53% equity interest in the Leizhou EJV which carried on tree plantation activities and had wood chip production facilities. In the fourth quarter of 1997, Sino-Wood agreed with the Leizhou Forestry Bureau (the "LFB"), its EJV partner in the Leizhou EJV, to cease operations, pursuant to which the LFB voluntarily withdrew its entire interest in the Leizhou EJV effective as at October 1, 1997. As a result of this agreement, the net assets

of the Leizhou EJV were distributed to the respective partners in proportion approximately to their respective interests and the amount due from LFB previously accounted for as a long-term asset was settled. The agreement relating to this transaction was formally executed in April 1998.

A summary of the net assets distributed was as follows:

US \$	
Net assets distributed	
Capital assets	18,012
Due from LFB	16,755
Current assets	815
	35,582
Income taxes payable	(1,727)
Current liabilities	(212)
Non-controlling interests	(21,213)
Sino-Wood's interest in the net assets	12,430

As part of the agreement with the LFB, the LFB agreed to exchange Sino-Wood's interest in the net assets of Leizhou EJV for 730,440 cubic meters of standing timber owned by the LFB. The standing timber is to be provided by the LFB to Sino-Wood over a three year period as required by Sino-Wood. Sino-Wood is responsible for harvesting and transportation costs. The Company has recorded its interest in the standing timber as timber holdings.

(b) Wood-based panel and other operations

In June 1997, Sino-Panel (Gaoyao) Limited ("Sino-Panel"), a wholly-owned subsidiary of the Company, established an EJV with a local PRC company. Sino-Panel has an 85% equity interest in this EJV. The principal business activity of this EJV is to be the manufacture of wood-based panel. Under the EJV agreement, the EJV is formed for a period of 50 years and Sino-Panel was required to contribute \$10,064,000 for its 85% equity interest in the EJV, of which \$1,510,000 was required to be made within three months from the date of issue of business license. The remaining capital contribution of \$8,554,000 has to be contributed depending on the needs of the EJV operation. Sino-Panel's capital contribution commitment was fully satisfied in 1998 by the contribution of certain machinery and equipment to the EJV with an aggregate value of approximately \$11,021,000.

In 1997, the Company acquired a 20% equity interest in Shanghai Jin Xiang Timber Ltd. ("SJXT"). SJXT is a startup entity that will primarily organize trading of timber and logs in the PRC market. The total investment of SJXT is estimated to be \$9,662,000 (Chinese renminbi 80 million) of which the Company will be required to contribute approximately \$1,932,000 representing 20% of the registered capital. As at December 31, 1998, the Company has made contributions in the amount of \$1,037,000 (1997 - \$1,037,000) to SJXT.

(c) Forestry chemical operations

The Company's investment in the forestry chemical businesses consists of a 30% equity interest in each of the five forestry chemical EJVs (collectively, the "Jiangxi Investments"). As at December 31, 1998, the carrying value of the Jiangxi Investments amounted to approximately \$1,070,000 (1997 - \$1,500,000).

3. ACCOUNTS RECEIVABLE

The Company reviews its outstanding accounts receivable and records an allowance for doubtful accounts when accounts are determined to be uncollectible. As at December 31, 1998 and 1997, no allowance had been recorded by the Company. Accounts receivable as at December 31, 1998 included \$1.7 million due from one customer (1997 - \$2.9 million).

4. CAPITAL ASSETS

Capital assets consist of the following:

US \$	1998		1997	
	Cost	Accumulated depreciation, amortization and depletion	Cost	Accumulated depreciation, amortization and depletion
Timber holdings	67,332	—	38,355	—
Machinery and equipment	11,021	—	9,384	—
Office furniture and equipment	520	192	491	95
Vehicles	255	56	211	26
	79,128	248	48,441	121
Less accumulated depreciation, amortization and depletion	(248)		(121)	
Net book value	78,880		48,320	

Machinery and equipment amounting to approximately \$11,021,000 (1997 - \$9,384,000) is not being depreciated as the production facilities are under construction and have not yet been put into operation.

5. DEPOSITS

The Company, through two of its PRC CJV partners, has entered into an agreement with chipping plant operators to acquire equity interests in their facilities. Under the terms of the agreement, the Company has provided a deposit of \$2,250,000 which will be applied against the Company's future investment. The Company has until December 31, 1999 to complete its investment negotiations.

6. DUE FROM PRC CJV PARTNERS

The amounts due from PRC CJV partners relate primarily to commission income and accounts receivable related to wood chips trading and sales during the year and for reimbursement of office expenses. The amounts are unsecured, non-interest bearing and have no fixed terms of repayment.

7. DEUTSCHE BANK

(a) Convertible Debenture

On January 15, 1996, Sino-Wood entered into a \$3,000,000 convertible loan agreement with Deutsche Bank A.G. of Hong Kong. The convertible loan agreement provides that from January 15, 1998 until repayment of the loan, the loan is convertible into Class A Subordinate-Voting Shares of the Company based upon specified terms.

The loan is for a period of 5 years and may be called by the bank after four years. Interest is payable, at the option of Sino-Wood, either quarterly or semi-annually based on the three-month or six-month U.S. dollar deposit rate or LIBOR plus 2%. During the year, the interest rate on the loan was 7.63% (1997 - 7.84%). The loan is guaranteed by the Company and is collateralized by a first fixed and floating charge on the assets of the Company.

Interest expense for the year amounted to approximately \$60,000 (1997 - \$235,000).

During the year, Deutsche Bank A.G. of Hong Kong elected to convert the \$3,000,000 convertible debenture into 5,994,228 Class A Subordinate-Voting Shares of the Company in accordance with the terms of the convertible loan agreement.

(b) Credit Facility

A subsidiary of the Company has established a revolving line of credit facility of \$6,000,000 with the Deutsche Bank A.G. of Hong Kong. The credit facility bears interest at the prevailing prime rate in Hong Kong and is repayable on demand. Sino-Forest and Sino-Wood have provided guarantees in the amount of \$6,000,000 each in connection with this facility. As at December 31, 1998, the subsidiary had utilized the credit facility for trust receipt loans and letter of credits in the amount of approximately \$1,997,000 (1997 - \$nil) and \$nil (1997 - \$1,090,000) respectively.

8. LONG-TERM DEBT

In November 1997, Sino-Wood entered into two loan agreements with the Finnish Export Credit Ltd. for credit facilities in the amount of \$4,505,000 to purchase certain machinery and equipment in connection with the construction of two particleboard mills in China. As at December 31, 1998, \$3,710,000 (1997 - \$3,710,000) has been disbursed under the facilities. The balance of \$795,000 will be disbursed upon the issuance of Certificates of Acceptance after installation of the machinery and equipment. The loans are repayable in ten equal consecutive semi-annual instalments commencing on June 15, 1999. Sino-Wood may repay the loans at any time with 30 days written notice. The loans bear interest at LIBOR plus 0.625% payable semi-annually. As at December 31, 1998, the interest rate on the long-term debt was approximately 6.6% (1997 - 6.6%).

Interest capitalized as part of the cost of asset under development for the year amounted to approximately \$254,000 (1997 - \$19,000).

Principal repayments on the debt for the next five years are as follows:

US \$	
1999	370
2000	740
2001	740
2002	740
2003	740
	3,330

9. SHARE CAPITAL

Share capital consists of the following:

US \$	1998	1997
Authorized		
Unlimited Class A Subordinate-Voting Shares		
6,000,000 Class B Multiple-Voting Shares		
Unlimited Preference Shares, issuable in series		
Issued		
74,677,228 [including 4,519,000 issued under share purchase loans] Class A Subordinate- Voting Shares [1997 - 67,569,000, including 4,204,000 issued under share purchase loans]	32,989	29,302
6,000,000 Class B Multiple-Voting Shares [1997 - 6,000,000]	-	-
	32,989	29,302

The legal stated capital of the Company's Class A Subordinate-Voting Shares differs from the carrying value reflected in these consolidated financial statements. The legal stated capital as at December 31, 1998 is Cdn. \$66,801,329 (1997 - Cdn. \$61,082,578).

Authorized

Except with respect to voting, dividends and the rights of conversion described below, each Class A Subordinate-Voting Share and each Class B Multiple-Voting Share have the same rights and are equal in all respects:

- each holder of Class A Subordinate-Voting Shares is entitled to one vote per share whereas each holder of Class B Multiple-Voting Shares is entitled to five votes per share;
- the Class A Subordinate-Voting Shares rank in priority to the Class B Multiple-Voting Shares as to the payment of dividends; however, no dividends may be declared or paid on the Class B Multiple-Voting Shares in any fiscal year unless in that fiscal year dividends shall have been declared or paid on Class A Subordinate-Voting Shares in an amount per share at least equal to or equivalent to the amount of the dividend per share proposed to be declared or paid on Class B Multiple-Voting Shares;
- each holder of Class B Multiple-Voting Shares is entitled at any time and from time to time to have all or any part of the Class B Multiple-Voting Shares held converted into Class A Subordinate-Voting Shares on a share-for-share basis; and
- as a condition of the issue of any Class B Multiple-Voting Share, the registered holder will be required to execute a Coattail Agreement under which the holder will agree not to effect a transfer of any Class B Multiple-Voting Share unless such transfer is made in accordance with the terms thereof and is a Permitted Transfer, as defined in the provisions attaching to the Class B Multiple-Voting Shares.

The Preference Shares may from time to time be issued in one or more series, each series of which will have the rights and other features fixed by the Board of Directors of the Company. The Preference Shares of each series will rank equally with the Preference Shares of every other series with respect to priority in payment of dividends and return of capital in the event of the liquidation, dissolution or winding-up of the Company and have a preference over the Class A Subordinate-Voting and the Class B Multiple-Voting Shares.

Changes in issued share capital

On October 2, 1996, the Company issued 24,000,000 special warrants at Cdn. \$1.25 per special warrant for aggregate gross proceeds of Cdn. \$30,000,000. The net proceeds of the special warrants issue were \$20,197,000 after deducting issue costs of approximately \$1,826,000. The Company received half of the gross proceeds on October 2, 1996 and the balance was held in escrow pending the issue of receipts for a final prospectus. All receipts for a final prospectus were received in January 1997 and the 24,000,000 special warrants were converted into Class A Subordinate-Voting Shares on a one-for-one basis. The Cdn. \$15,000,000 of cash held in escrow was released to the Company in February 1997.

The Company granted brokers' special warrants to the underwriters to acquire non-assignable compensation options. The compensation options entitle the holders thereof to purchase an aggregate of 2,400,000 Class A Subordinate-Voting Shares at an exercise price of Cdn. \$1.44 for each Class A Subordinate-Voting Share at any time on or before October 2, 1998. During the year, 199,000 (1997 - 1,651,000) of these compensation options were exercised for total proceeds of approximately \$198,000 (1997 - \$1,712,000). The remaining 550,000 compensation options were not exercised and expired after October 2, 1998.

During the year, options to purchase 915,000 (1997 - 4,768,000) Class A Subordinate-Voting Shares were exercised under the terms of the Company's stock option plan (the "Plan"). The Company made interest free loans during the year amounting to \$699,000 (1997 - \$4,380,000) to certain officers, pursuant to the terms of the Plan to finance the acquisition of 765,000 (1997 - 4,204,000) Class A Subordinate-Voting Shares. The average purchase price of the shares acquired subject to share purchase loans was \$0.91 (1997 - \$1.04). In accordance with the terms of the Plan, the shares acquired are pledged to the Company and the indebtedness is repayable upon the sale of the pledged shares. The Company has recorded the share purchase loans as a reduction in share capital. As at December 31, 1998, \$4,353,000 (1997 - \$4,380,000) of these loans

remained outstanding. Gross proceeds on the 150,000 (1997 - 564,000) options exercised in 1998 and not subject to share purchase loans were approximately \$57,000 (1997 - \$519,000). \$431,000 of the share purchase loans outstanding was repaid during the year.

During the year, Deutsche Bank A.G. of Hong Kong converted the \$3,000,000 convertible debentures into 5,994,228 Class A Subordinate-Voting Shares of the Company in accordance with the terms of the convertible loan agreement (note 7(a)).

Stock options

The Company has reserved 10,000,000 Class A Subordinate-Voting Shares for issuance under its stock option plan.

As at December 31, 1998, 629,000 options granted to certain officers and directors of the Company, as well as an employee of Sino-Wood, were outstanding. These options allowed the officers, directors and employee to purchase Class A Subordinate-Voting Shares of the Company at prices ranging from Cdn. \$0.55 to Cdn. \$2.79 per share. 50,000 of these options expire in 1999, 254,000 options expire in 2001, 225,000 options expire in 2002 with the remaining 100,000 options expiring in 2003.

10. INCOME TAXES

The provision for income tax expense differs from that obtained by applying the statutory rates as a result of the following:

US \$	1998	1997
Income before income taxes	23,607	17,752
Expected statutory rate	44.6%	44.6%
Expected income tax provision	10,529	7,917
Increase (decrease) in income taxes resulting from		
Unrecognized income tax losses arising from		
losses of the Company and subsidiaries	1,933	2,161
Income tax at different rates in		
foreign jurisdictions	(9,999)	(8,230)
Permanent differences	(220)	-
Other	—	1
	2,243	1,849

The PRC CJVs, Leizhou EJV and Gaoyao EJV are governed by the Income Tax Laws of the PRC concerning Foreign Investment Enterprises and Foreign Enterprises and various local income tax laws (the "Income Tax Laws"). Pursuant to the Income Tax Laws, Sino-foreign equity and co-operative joint venture enterprises are subject to income tax at an effective rate of 33% (30% state income taxes plus 3% local income taxes) on income as reported in their statutory financial statements. The PRC CJVs, Leizhou EJV and Gaoyao EJV are eligible for an exemption from state and local income taxes for two years starting from the first profitable year of operations, followed by a 50% exemption for the next three years.

Hong Kong profits tax has been provided at the rate of 16% (1997 - 16.5%) on the estimated assessable profits arising in Hong Kong during the year. Taxes on profits assessable elsewhere have been calculated at the rate of taxation prevailing in the countries in which the Company operates.

As at December 31, 1998, the Company has income tax losses of approximately \$2,333,000 which can be applied against future years' taxable income in Canada, the benefit of which has not been recorded in these consolidated financial statements. Approximately \$161,000 of these tax losses will expire in 2001, \$236,000 in 2002, \$204,000 in 2003, \$665,000 in 2004 and the remainder will expire in 2005.

11. EARNINGS PER SHARE

Earnings per share are calculated using the weighted average number of Class A Subordinate-Voting and Class B Multiple-Voting Shares outstanding during each year. The weighted average number of Class A Subordinate-Voting and Class B Multiple-Voting Shares outstanding were as follows:

WEIGHTED AVERAGE		
	Basic	Fully diluted
December 31, 1998	74,221,000	81,260,000
December 31, 1997	65,718,000	81,631,000

12. RELATED PARTY TRANSACTIONS

(a) Corporate management services were provided during the year by three companies in which directors of Sino-Wood have an interest. These services were provided at an aggregate cost of approximately \$1,684,000 (1997 - \$1,405,000).

(b) During the year, commission income earned from a PRC CJV partner in Guangxi amounted to approximately \$14,228,000 (1997 - \$14,688,000).

(c) During the year, a subsidiary of the Company entered into an agreement with its CJV partner in Heyuan (the "Partner") pursuant to which the subsidiary purchased timber from the Partner and contracted the Partner to process the timber purchased into wood chips. As part of the agreement, the Partner agreed to act as the subsidiary's agent to sell wood chips in the PRC for a fee equal to 15% of the net profit of the sales. During 1998, sale of wood chips and purchase of timber and chipping charges under this arrangement totalled \$66,793,000 and \$53,819,000 respectively.

In 1997, the above transactions were carried out by one of its PRC CJVs. In 1997, sale of wood chips and purchase of timber and chipping charges under this arrangement totalled \$18,982,000 and \$14,617,000 respectively. The Company had accounted for these transactions in 1997 on the proportionate consolidation basis.

(d) During the year, sale of logs and lumber to SJXT amounted to approximately \$537,000 (1997 - \$nil).

13. SEGMENTED INFORMATION

US \$	1998			1997		
	Wood Chips	Wood-Based & Other	Total	Wood Chips	Wood-Based & Other	Total
BY INDUSTRY SEGMENT						
Revenue from external customers						
Sales	66,793	9,368	76,161	21,735	1,800	23,535
Commission income	14,228	2,321	16,549	14,688	3,560	18,248
	81,021	11,689	92,710	36,423	5,360	41,783
Income from operations	21,213	2,833	24,046	14,631	3,615	18,246
Identifiable assets	84,654	15,847	100,501	55,292	17,548	72,840
Interest income	51	—	51	299	—	299
Interest expense	60	—	60	235	—	235
Depreciation, amortization and depletion	91	—	91	717	—	717
Investment in capital assets	29,013	1,637	30,650	22,309	9,384	31,693

BY GEOGRAPHIC SEGMENT

The Company conducts substantially all of its operations in one geographic area, East Asia. During the year, export sales from the PRC to Japan, Korea and Taiwan amounted to approximately \$2,926,000 (1997 - \$4,117,000), \$nil (1997 - \$726,000) and \$801,000 (1997 - \$4,018,000), respectively.

14. COMMITMENTS

As at December 31, 1998, the Company has various commitments to make capital contributions to the CJVs and EJV, the details of which are disclosed in note 2.

The Company's future annual commitment under operating leases is as follows:

US \$	
1999	142
2000	65
	207

In connection with the wood chip trading arrangement made with its CJV partner in Heyuan, the Company had a commitment to purchase timber from the CJV partner of \$672,000 as at December 31, 1998 (1997 - \$nil).

15. UNCERTAINTY DUE TO THE YEAR 2000 ISSUE

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect an entity's ability to conduct normal business operations. It is not possible to be certain that all aspects of the Year 2000 Issue affecting the entity, including those related to the efforts of customers, suppliers, or other third parties, will be fully resolved.

16. COMPARATIVE FINANCIAL STATEMENTS

The comparative financial statements have been reclassified from statements previously presented to conform to the presentation of the December 31, 1998 financial statements.

17. SUBSEQUENT EVENT

On January 22, 1999, Sino-Wood entered into an Agreement to issue an aggregate of \$20 million Guaranteed Exchangeable Redeemable Notes (the "Notes"). The Notes are for a period of five years from January 29, 1999 to January 28, 2004, and bear interest at a rate of 5% per annum payable semi-annually in arrears.

The Notes are exchangeable in minimum amounts of \$1 million into Class A Subordinate-Voting Shares of the Company at a price of \$1.11 (equivalent of Cdn. \$1.72) per share during the period from January 29, 2000 to January 28, 2002 and at a price of \$1.21 (equivalent of Cdn. \$1.88) during the period from January 29, 2002 to January 28, 2004. Sino-Wood is entitled, at any time between January 29, 2000 to January 28, 2002 to require the Noteholders to exchange no more than \$10 million of the Notes into Class A Subordinate-Voting Shares provided that the weighted average price per share of the Company on The Toronto Stock Exchange for the 60 trading days and the 7 trading days immediately preceding the date of such exchange shall both exceed 2.0 times the exchangeable price then in effect. Outstanding Notes not exchanged into Class A Subordinate-Voting Shares of the Company on the maturity date are entitled to interest for the entire five-year period at a rate of 15% per annum compounded annually less any interest already paid on the Notes.

DIRECTORS & OFFICERS

Directors

Allen T.Y. Chan 1 2
Chairman and Chief Executive Officer

K.K. Poon
President

Kee Y. Wong, F.C.A.
Executive Vice President and
Chief Financial Officer

John (Jack) Lawrence 2
Chairman of Lawrence & Company

William Rosenfeld 1 2 3
Partner of Goodman Phillips & Vineberg

Edmund Mak 1 2 3
Real Estate Marketing,
Re/Max Select Properties

Simon Murray 4
Chairman of GEMS
General Enterprise Management
Services Limited

Officers

Allen T.Y. Chan
Chairman and Chief Executive Officer

K.K. Poon
President

Leslie Chan
Executive Vice President

Kee Y. Wong, F.C.A.
Executive Vice President and
Chief Financial Officer

Jay Lefton
Corporate Secretary

1 Member of The Audit Committee

2 Member of The Compensation Committee

3 Member of The Corporate Governance Committee

4 Nominated to join the Board of Sino-Forest at the upcoming Annual General Meeting

Corporate and Shareholder Information

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Website www.sinoforest.com

Exchange Listing

The Class A Subordinate-Voting Shares of the Company are listed on The Toronto Stock Exchange under the symbol TRE.A

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Legal Counsel

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Annual Shareholders' Meeting

*Tuesday June 15th, 1999
4:00 p.m.*

*The Royal York Hotel
Upper Canada Room, 18th Floor
100 Front Street West
Toronto, Ontario M5J 1E3*

