

# REPORT TO SHAREHOLDERS

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

Sino-Forest is pleased to report strong financial performance in the first quarter of 2009. Revenue from continuing operations of \$177.2 million grew 30.8%, compared to last year. Overall gross profit increased 42.0% to \$66.8 million, EBITDA rose 54.3% to \$114.9 million and net income was up 58.4% to \$23.0 million over the same period in 2008. Diluted EPS from continuing operations increased 60.9% to \$0.15 in the first quarter of 2009.

**Wood Fibre Operations** includes plantation fibre and other fibre (imported wood products and wood logs).

- Sales of plantation fibre increased \$25.3 million or 24.6% to \$128.0 million in the first quarter of 2009, mainly due to increased volume of fibre sold.
- Sales of imported wood products increased \$13.6 million or 56.6% to \$37.7 million from \$24.1 million mainly due to higher volume of wood logs traded.

**Manufacturing and Other Operations** includes engineered wood flooring, oriented strand board, sawn timber, finger-joint board, block board and nursery businesses.

- Revenue increased 33.2% in the first quarter of 2009 to \$11.5 million.

As China's economy continued to grow at an annualized rate of 6% in the first quarter and forest product market conditions rebounded from the fourth quarter of 2008 due to the positive effects of government economic stimulus spending, we recorded strong performance in all of our financial metrics. The primary contributor to the 31% increase in revenue was 25% higher sales from our plantation fibre.

Although the first quarter is typically our slowest of the year and economic growth is lower in China, we are very pleased to report strong double-digit sales increases in all of our business segments in the first quarter of 2009. With demand bolstered by the effects of government spending on infrastructure and housing, customers are gradually replenishing their inventories.

Given harvesting typically occurs in the second half of the year, and given the softening in log prices we observed in late Q4 2008 and early Q1 2009, our efforts were primarily focused on sales of purchased plantations. On the acquisition front, we were able to take advantage of the uncertainty in the market and acquire fibre at lower prices than specified in our Master Agreements.

## Outlook

The positive effects of China's stimulus plan and the rebuilding of the Sichuan area should help to sustain economic growth while benefiting numerous industries. We are optimistic about the associated positive ramifications for the forestry sector and the demand for wood fibre. Although fibre prices softened in late Q4 2008/early Q1 2009, we have seen signs of a rebound as prices have moved up recently. However, we do not anticipate prices will reach the overall levels realized in 2008 until the latter part of 2009 or early 2010.

The positive aspect to softer fibre prices is that we see some acquisition opportunities at lower prices which we hope to take advantage of before markets rebound to 2008 levels. Even as one of the industry leaders in commercial forest plantations, Sino-Forest only has a 5% market share in China. Therefore, we will pursue certain attractive growth opportunities to strengthen our position in key markets. We will remain vigilant and prudent in assessing such opportunities, as we are committed to developing a critical mass of fibre that is sustainable and profitable in the long term.

Allen T.Y. Chan  
Chairman and Chief Executive Officer

May 11, 2009

# **Management's Discussion and Analysis**

**May 11, 2009**

Management's Discussion and Analysis (MD&A) relates to the financial condition and results of Sino-Forest Corporation's operations for the three months ended March 31, 2009. Throughout this MD&A, unless otherwise specified, "Sino-Forest", "Company", "we", "us" and "our" refer to Sino-Forest Corporation and its subsidiaries. Except where otherwise indicated, all financial information reflected herein is determined on the basis of Canadian generally accepted accounting principles (GAAP). This MD&A should be read in conjunction with Sino-Forest's audited consolidated financial statements and notes thereto. The United States dollar is our reporting and functional currency and all figures contained herein are in United States dollars unless otherwise indicated.

Additional information relating the Company, including our annual information form and other statutory reports, are available on SEDAR at [www.sedar.com](http://www.sedar.com).

## **FORWARD-LOOKING STATEMENTS**

This MD&A contains forward-looking statements which reflect management's expectations regarding Sino-Forest's future growth, results of operations, performance, business prospects and opportunities. Words such as "expects", "anticipates", "intends", "plans", "believes", "estimates", or similar expressions, are forward-looking statements within the meaning of securities laws. Forward-looking statements include, without limitation, the information concerning possible or assumed future results of operations of Sino-Forest. These statements are not historical facts but instead represent only Sino-Forest's expectations, estimates and projections regarding future events. These statements are not guarantees of future performance and involve assumptions and risks and uncertainties that are difficult to predict. Therefore, actual results may differ materially from what is expressed, implied or forecasted in such forward-looking statements. In addition to the factors Sino-Forest currently believes to be material such as, but not limited to, our ability to acquire rights to additional standing timber, our ability to meet our expected plantation yields, the cyclical nature of the forest products industry and price fluctuation in and the demand and supply of logs, our reliance on local plantation land owners and/or plantation land use rights holders, authorized intermediaries, key customers, suppliers and third party service providers, our ability to operate our production facilities on a profitable basis, changes in currency exchange rates and interest rates, evaluation of our provision for income and related taxes and economic, political and social conditions and government policy in the PRC, other factors not currently viewed as material could cause actual results to differ materially from those described in the forward-looking statements. Although Sino-Forest has attempted to identify important risks and factors that could cause actual actions, events or results to differ materially from those described in forward-looking statements, there may be other factors and risks that cause actions, events or results not to be anticipated, estimated or intended. Accordingly, readers should not place any undue reliance on forward-looking statements. The Company does not undertake any obligation to update or release any revisions to these forward-looking statements to reflect events or circumstances after the date of this report.

## **OVERVIEW OF BUSINESS**

### **About Sino-Forest**

We are a leading commercial forestry plantation operator in the PRC. As at March 31, 2009, we had approximately 410,000 hectares of forestry plantations located primarily in southern and eastern China.

Our principal businesses include the ownership and management of forestry plantation trees, the sale of standing timber and wood logs, and the complementary manufacturing of downstream engineered-wood products.

# **Management's Discussion and Analysis**

## **Strategic Business Units**

Sino-Forest's operations are comprised of two core business segments - **Wood Fibre Operations** is the major revenue contributor, while our **Manufacturing & Other Operations** enable us to add value to our fibre by producing downstream products.

Revenue from Wood Fibre Operations is derived from the following sources:

### *Plantation Fibre*

- we acquire, cultivate and sell standing timber or harvested logs from our purchased, integrated and planted plantation business models in eight provinces and regions across China.

### *Other Fibre*

- Wood logs – we source logs from PRC suppliers and sell them in the domestic PRC market; and
- Imported wood products – we source logs, veneer, sawn timber and other wood-based products globally and sell them in the domestic PRC market.

Our Manufacturing & Other Operations include:

- engineered wood flooring produced in Jiangsu province and sold through over 200 stores nationwide in the PRC;
- oriented strand board manufactured in Heilongjiang province;
- sawn timber produced in Yunnan province;
- finger joint board and block board produced in Hunan province; and
- greenery & nursery operation based in Jiangsu province.

## **Our Vision and Strategy**

Our vision is to become the leading commercial forestry plantation operator and preferred supplier of wood fibre to downstream consumers in the wood panel, furniture, construction, interior decoration and pulp and paper industries in the PRC.

Our strategy is to build on our competitive strengths and seize business opportunities in the PRC in order to become a leading plantation developer and wood resource supplier with established operations in or close to PRC regional markets, providing wood fibre to downstream consumers in the wood panel, furniture, construction, interior decoration and pulp and paper industries. The following are the key elements for executing our strategy:

- expand geographically, invest in additional tree plantations to gain access to long-term supplies of wood fibre, and develop regional wood fibre markets in the PRC by providing quality logs and value-added manufacturing products;
- build integrated manufacturing operations to supply value-added, wood-based products to the PRC market and further diversify our revenue streams;
- improve the yields of our tree plantations by continued investment in research and development and application of advanced forestry management techniques;
- practice sustainable and environmentally responsible forestry and manufacturing; and
- strengthen management processes and information systems to support the growth of our multi-faceted businesses.

## **Other Key Factors Affecting Our Business**

Our results of operations are, and will continue to be, affected by the cyclical nature of the forest products industry. Market prices and demand for standing timber, wood logs and wood products have been, and in the future are expected to be, subject to cyclical fluctuations. The pricing in the forestry market is affected by the prices of the ultimate wood products produced from logs in the PRC, including furniture, construction

## **Management's Discussion and Analysis**

materials, interior decoration materials and pulp and paper products. The prices of wood products are also affected by the availability of wood substitutes. The market for wood products is sensitive to changes in industry capacity and output levels, general timber industry conditions and cyclical changes in the world and PRC economies, any of which can have a significant impact on selling prices of wood products. The demand for wood products is also substantially affected by the level of new construction activity, which is subject to fluctuations that may or may not correspond to overall economic trends. Decreases in the level of construction activity generally reduce demand for wood products. The demand for wood products is also affected by the level of interior decoration activity and the demand for wood chips in the pulp and paper markets. These activities are, in turn, subject to fluctuations due to, among other factors:

- changes in domestic and international economic conditions;
- interest rates;
- government regulations and policies;
- population growth and changing demographics; and
- seasonal weather cycles (e.g. dry or hot summers, wet or cold winters) and other factors affecting tree growth.

Cyclical changes in the forest products industry, including changes in demand and pricing for our products and the other factors described above, could have a material adverse effect on our business, financial condition and results of operations.

Our decisions and abilities to develop and operate future forestry plantations are subject to various factors and uncertainties. Should we be unable to exercise our rights to obtain additional forestry plantations, our business, financial condition and results of operations could be materially and adversely affected.

The success of our business depends upon the productivity of our forestry plantations and our ability to realize our expected yields. Forestry plantation yields depend on a number of factors, many of which are beyond our control. These include damage by disease, pests and other natural disasters, and weather, climate and soil conditions. Our ability to maintain and improve our yields will depend on these factors and the results of our research and development efforts.

We rely on our relationships with local plantation land owners and/or plantation land use rights holders, authorized intermediaries, key customers, suppliers and third party service providers for our forestry plantations and trading activities. We rely on a number of large suppliers for a significant percentage of our timber supply. We rely to a significant extent on third party service providers for day-to-day operations of our plantations.

We are heavily dependent on the expertise of our senior management in the forest industry, research and development in forest plantation management practice, wood-based products manufacturing production processes and relationships cultivated by them with our major customers and others.

We are subject to regulation under a variety of PRC national and local laws and regulations. Violations of PRC laws or regulations, including PRC environmental policies and programs that apply to our forestry plantations, could result in civil and criminal penalties, including the revocation of licenses required for our business.

The forestry industry is susceptible to weather conditions, timber growth cycles and natural disasters outside of our control. The occurrence of these or other natural disasters may disrupt or reduce the supply of trees available for harvesting in the areas of the PRC where our forestry plantations are located.

Our manufacturing plants are in an early stage of development and have a short operating history. Our manufacturing plants may not be profitable or successful and are subject to the risks inherent in establishing a new business, including competitive pressures, which could have a material adverse effect on our business, financial condition and results of operations.

We report our financial statements in United States dollars, while substantially all of our revenue is denominated in Renminbi. Any significant fluctuation in the exchange rates between the Renminbi and other

## **Management's Discussion and Analysis**

currencies, such as the United States dollar, the Canadian dollar and the Hong Kong dollar, or in the United States dollar against the Renminbi, the Canadian dollar or the Hong Kong dollar, may have an adverse impact on our results of operations and may adversely affect the value, translated or converted into United States dollars, Canadian dollars or otherwise, of our revenue and net income.

### **Significant Accounting Policies and Interpretation**

#### *Costs of Sales*

Our costs of sales consist of: (1) depletion of timber holdings as they are sold; (2) the costs of logs acquired in the domestic PRC market; (3) the costs of imported logs and wood-based products acquired in our sales and trading activities of these products; and (4) the costs incurred at our manufacturing plants.

#### *Depletion of Timber Holdings*

Timber holdings include acquisition costs for standing timber (young and mature trees) and planting and maintenance costs, which are capitalized at cost in our financial statements until the trees are sold. Planting and maintenance costs include the following: planning, operations design, site preparation, terracing, fertilization, planting, thinning, tending, protection, forestry administrative charge, overhead and lease costs. Timber holdings from plantation fibre sales are depleted when the significant risks and rewards of ownership have been transferred to the buyer, which occurs when the contract for sale is entered into.

#### *EBITDA*

Defined as income from continuing operations for the period after adding back depreciation and amortization, as well as depletion of timber holdings from cost of sales, for the period. EBITDA is presented as additional information because we believe that it is a useful measure for certain investors to determine our operating cash flow and historical ability to meet debt service and capital expenditure requirements. EBITDA is not a measure of financial performance under Canadian GAAP and should not be considered as an alternative to cash flows from operating activities, a measure of liquidity or an alternative to net income as indicators of our operating performance or any other measures of performance derived in accordance with Canadian GAAP.

### **SIGNIFICANT BUSINESS ACTIVITIES**

Significant activities that have occurred during the three months ended March 31, 2009 and to the date of this report were as follows:

#### *Sino-Forest increased Investment in Omnicorp Limited*

In February 2009, the Company entered into an agreement to acquire 55,000,000 ordinary shares and approximately \$21.7 million (equivalent to approximately HK\$168 million) 4% secured convertible bonds of Omnicorp Limited ("Omnicorp") from various vendors. The purchase price consisted of cash of approximately \$4.3 million and approximately 2,700,000 common shares of the Company. Total consideration was approximately \$25.8 million (equivalent to approximately HK\$201 million). Among the vendors were a director of the Company and an entity controlled by such director the aggregate value of whose Omnicorp ordinary shares and convertible bonds represented approximately 5.5% of the aggregate value of the overall transaction.

#### *Sino-Forest entered into Agreement to dispose equipment at Gaoyao Plant*

In March 2009, a subsidiary of the Company signed an agreement to sell the particleboard manufacturing equipment at its plant in Gaoyao for total consideration of approximately \$30 million. The Company will retain the ownership of the manufacturing building and property. The purchaser will lease these Gaoyao premises from the Company and operate the equipment in the premises, subject to final terms and conditions of the lease agreements.

#### *Sino-Forest released independent 2008 Forest Asset Valuation Report*

## Management's Discussion and Analysis

In April 2009, the Company had released its yearly, independent forest valuation report conducted by Pöyry Forest Industry Consulting Limited ("Pöyry"). Pöyry has estimated the valuation of the Company's existing forest assets as at December 31, 2008 based on a single rotation was \$1.64 billion, and on a perpetual rotation was \$1.69 billion (using a pre-tax discount rate of 11.5%). Pöyry's original 2007 valuation, based on a perpetual rotation, included forest assets assumed to be acquired under the three master agreements in Hunan, Yunnan and Guangxi Provinces (the "Master Agreements"). Pöyry's revised 2007 valuation, based on a perpetual rotation, excluding forest assets assumed to be acquired under the three Master Agreements, was \$1.47 billion. Pöyry's 2008 valuations represent increases of 32% based on a single rotation and 15% based on a perpetual rotation, compared to the revised 2007 valuations.

A full copy of the valuation report is posted on our website at [www.sinoforest.com](http://www.sinoforest.com) under "Investor Relations, Filings" and is also available on SEDAR at [www.sedar.com](http://www.sedar.com).

### SELECTED CONSOLIDATED FINANCIAL INFORMATION

#### First Quarter Financial Information

The following selected financial information has been derived from our unaudited consolidated financial statements for the three months ended March 31, 2009 and 2008 and our financial positions as at March 31, 2009 and December 31, 2008:

| <i>(in thousands, except earnings per share)</i>             | <b>2009</b>    | 2008    |
|--|----------------|---------|
|  | \$             | \$      |
| <b>Operating Results</b>                                     |                |         |
| Revenue  | <b>177,234</b> | 135,495 |
| Cost of sales  | <b>110,398</b> | 88,421  |
| Gross profit <sup>(1)</sup>                                  | <b>66,836</b>  | 47,074  |
| Net income from continuing operations                        | <b>27,922</b>  | 17,243  |
| Net income   | <b>23,005</b>  | 14,527  |
| EBITDA <sup>(2)</sup>  | <b>114,926</b> | 74,492  |
| Earnings per share from continuing operations <sup>(3)</sup> |                |         |
| Basic  | <b>0.15</b>    | 0.09    |
| Diluted  | <b>0.15</b>    | 0.09    |
| Earnings per share <sup>(3)</sup>                            |                |         |
| Basic  | <b>0.12</b>    | 0.08    |
| Diluted  | <b>0.12</b>    | 0.08    |

| <i>(in thousands, except cash dividends declared per share and common shares outstanding)</i> | <b>As at<br/>March 31,<br/>2009</b> | As at<br>December 31,<br>2008 |
|---|-------------------------------------|-------------------------------|
|   | \$                                  | \$                            |
| <b>Financial Position</b>   |                                     |                               |
| Current assets  | <b>670,718</b>                      | 811,457                       |
| Non-current assets  | <b>1,985,465</b>                    | 1,792,467                     |
| Total assets  | <b>2,656,183</b>                    | 2,603,924                     |
| Current liabilities (including current portion of long-term debt)                             | <b>307,995</b>                      | 290,692                       |
| Long-term debt (net of current portion)   | <b>705,573</b>                      | 714,468                       |
| Total shareholders' equity (net assets)   | <b>1,642,615</b>                    | 1,598,764                     |
| Cash dividends declared per share   | <b>Nil</b>                          | Nil                           |
| Common shares outstanding   | <b>185,779,062</b>                  | 183,119,072                   |

# Management's Discussion and Analysis

## RESULTS OF OPERATIONS – Q1 2009 vs Q1 2008

### Revenue

The following table sets forth the breakdown of our total revenue for the three months ended March 31, 2009 and 2008:

|   | 2009           |              | 2008    |       |
|---|----------------|--------------|---------|-------|
|   | \$'000         | %            | \$'000  | %     |
| <b>Wood Fibre Operations</b>              |                |              |         |       |
| Plantation Fibre                          | 127,968        | 72.2         | 102,670 | 75.8  |
| Other Fibre                               | 37,758         | 21.3         | 24,187  | 17.9  |
| <b>Manufacturing and Other Operations</b> | <b>11,508</b>  | <b>6.5</b>   | 8,638   | 6.3   |
| <b>Total</b>                              | <b>177,234</b> | <b>100.0</b> | 135,495 | 100.0 |

Our revenue increased 30.8% to \$177.2 million in the first quarter of 2009. The increase in revenue was due primarily to the increase in sales of wood fibre operations.

### Wood Fibre Operations Revenue

#### Plantation Fibre

The following table sets forth revenue from plantation fibre operation for the three months ended March 31, 2009 and 2008:

| Plantation Model       | Hectares      | 2009              |                | Hectares | 2008              |               |
|------------------------|---------------|-------------------|----------------|----------|-------------------|---------------|
|                        |               | Sales per hectare | Total revenue  |          | Sales per hectare | Total revenue |
|                        |               | \$                | \$'000         |          | \$                | \$'000        |
| Purchased plantations  | 13,773        | 9,169             | 126,284        | 9,175    | 5,476             | 50,244        |
| Integrated plantations | —             | —                 | —              | 4,254    | 12,306            | 52,349        |
| Planted plantations    | 1,705         | 988               | 1,684          | 64       | 1,203             | 77            |
| <b>Total</b>           | <b>15,478</b> | <b>8,268</b>      | <b>127,968</b> | 13,493   | 7,609             | 102,670       |

Revenue from sales of plantation fibre increased 24.6% to \$128.0 million in the first quarter of 2009, mainly due to an increased volume of fibre sold in 2009.

The total volume of fibre sold during the three months ended March 31, 2009 was approximately 2.1 million m<sup>3</sup> from purchased and planted plantations. During the same period last year, we sold a total of approximately 1.4 million m<sup>3</sup>, with approximately 863,000 m<sup>3</sup> from purchased and planted plantations and approximately 509,000 m<sup>3</sup> from integrated plantations.

The average yield of fibre sold under the purchased and planted plantations in the first quarter of 2009 was 137 m<sup>3</sup> per hectare compared to 93 m<sup>3</sup> per hectare in the same quarter last year and obtained an average selling price of \$60 per m<sup>3</sup> compared to \$58 per m<sup>3</sup> – an increase of 3.2% (including 4.9% appreciation of the Renminbi versus US dollars).

The average yield of harvested logs sold under the integrated plantations in the first quarter of 2008 was 120 m<sup>3</sup> per hectare and it commanded an average selling price of \$103 per m<sup>3</sup>.

Plantation fibre sales comprised 72.2% of total revenue in the three months ended March 31, 2009, compared to 75.8% in the same period in 2008.

## **Management's Discussion and Analysis**

### *Other Fibre*

Revenue from sales of imported wood products increased 56.6%, from \$24.1 million in the three months ended March 31, 2008 to \$37.7 million in the same period in 2009. This increase was primarily due to higher volume of imported logs sold.

Revenue from sales of wood logs decreased 37.4% to \$77,000 in the three months ended March 31, 2009 from \$123,000 in the same period in 2008.

Other fibre sales comprised 21.3% of total revenue in the three months ended March 31, 2009, compared to 17.9% of total revenue in the same period in 2008.

### ***Manufacturing and Other Operations Revenue***

Revenue from our manufacturing and other operations increased 33.2% from \$8.6 million in the three months ended March 31, 2008 to \$11.5 million in the same period in 2009, mainly due to an increase in revenue from greenery projects.

### **Gross Profit**

Gross profit increased 42.0%, from \$47.1 million in the first quarter of 2008 to \$66.8 million in the same quarter of 2009. Gross profit margin, being gross profit expressed as a percentage of revenue, increased from 34.7% in the first quarter of 2008 to 37.7% in the same quarter of 2009, mainly due to increased sales from plantation fibre operations which earn a higher gross profit margin than our other business segments.

### *Wood Fibre Operations Gross Profit*

Gross profit margin from sales of purchased and planted plantations decreased from 63.0% in the first quarter of 2008 to 49.8% in the first quarter of 2009, mainly due to the sales of plantations with a higher fibre cost per m<sup>3</sup> as compared to the same period in 2008.

The gross profit margin for sales of logs under the integrated plantations operations was 27.7% or \$28 per m<sup>3</sup> in the first quarter of 2008.

Gross profit margin from sales of imported wood products increased from 2.8% in the first quarter of 2008 to 3.9% in the same quarter of 2009.

Gross profit margin from sales of wood logs increased from 4.9% in the first quarter in 2008 to 9.1% in the same quarter of 2009 as a result of the change in mix of species of wood logs sold as compared to 2008.

### *Manufacturing and Other Operations Gross Profit*

Gross margin from our manufacturing and other operations increased from 2.2% in the first quarter of 2008 to 13.8% in the same quarter of 2009, primarily due to an improvement from nursery segments.

### **Selling, General and Administration Expenses**

Our selling, general and administration expenses increased 51.5%, from \$10.6 million in the first quarter of 2008 to \$16.1 million in the same quarter of 2009, due primarily to additional staff complement, increased incentive accrued compensation and increased research & development expenses.

### **Depreciation and Amortization**

Depreciation and amortization increased 68.0%, from \$0.7 million in the three months ended March 31, 2008 to \$1.1 million in the same period in 2009, mainly due to increased capital assets.



# **Management's Discussion and Analysis**

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## **Income from Operations**

Income from operations increased 38.7%, from \$35.8 million in the three months ended March 31, 2008 to \$49.6 million in the same period in 2009, due to the factors explained above. Our income from operations as a percentage of revenue increased from 26.4% in the first quarter of 2008 to 28.0% in the same quarter of 2009.

## **Interest Expense**

Interest expense increased 60.3%, from \$10.5 million in the three months ended March 31, 2008 to \$16.8 million in the same period in 2009, due primarily to the interest on the 5% convertible senior notes issued in the third quarter of 2008.

## **Interest Income**

Our interest income decreased 33.9%, from \$2.9 million in the three months ended March 31, 2008 to \$1.9 million in the same period in 2009, due primarily to the decrease in the interest rate earned on deposits in 2009, being partially offset by the accretion of interest income on the convertible bonds of Omnicorp.

## **Exchange Losses**

The Company incurred an exchange loss of \$0.1 million in the three months ended March 31, 2009 mainly due to the weakening of Renminbi versus U.S. dollar in 2009.

## **Loss on Changes in Fair Value of Financial Instrument**

In the three months ended March 31, 2009, the Company recorded a loss of \$1.0 million related to changes in fair value of financial instruments, which resulted from a loss of \$0.4 million on the embedded conversion option of the convertible bonds issued by Omnicorp and a loss of \$0.6 million on the foreign currency swap.

## **EBITDA**

EBITDA increased 54.3%, from \$74.5 million in the first quarter of 2008 to \$114.9 million in the same quarter of 2009, as a result of the increase in revenue in 2009.

## **Provision for Income Taxes**

In 2009, the provision for income taxes was \$5.9 million compared to \$4.3 million in 2008; the increase was due primarily to the higher income earned during the period.

## **Net Income for the Period**

As a result of the foregoing, net income for the period increased 58.4%, from \$14.5 million in the first quarter of 2008 to \$23.0 million in the same quarter of 2009. Overall net income for the period as a percentage of revenue increased from 10.7% in the first quarter of 2008 to 13.0% in the first quarter of 2009.

# Management's Discussion and Analysis

## Cash Flows

The following table sets forth a condensed summary of our statements of cash flows:

| Three months ended March 31,<br><i>(in millions)</i>               | 2009<br>\$ | 2008<br>\$ |
|--|------------|------------|
| Cash flows from operating activities of continuing operations      |            |            |
| Net cash provided by operations <sup>(4)</sup>                     | 99.2       | 64.4       |
| Net change in working capital <sup>(5)</sup>                       | 68.4       | (30.4)     |
| Total  | 167.6      | 34.0       |
| Cash flows used in operating activities of discontinued operations | (2.8)      | (1.9)      |
| Cash flows used in investing activities                            | (243.4)    | (122.0)    |
| Cash flows used in investing activities of discontinued operations | (1.0)      | —          |
| Cash flows from (used in) financing activities                     | 5.7        | (9.7)      |
| Cash flows used in financing activities of discontinued operations | —          | (0.3)      |
| Effect of exchange rate changes on cash and cash equivalents       | (0.3)      | 1.4        |
| Net decrease in cash and cash equivalents                          | (74.2)     | (98.5)     |

### *Cash Flows from Operating Activities of Continuing Operations*

Net cash provided from operating activities increased from \$34.0 million in the first quarter of 2008 to \$167.6 million in the same quarter of 2009. The increase was due to the increase in cash provided by operations and cash provided by working capital that resulted from the decrease in accounts receivables of wood fibre operations.

### *Cash Flows Used in Investing Activities*

In the three months ended March 31, 2008 and 2009, cash flows used in investing activities were primarily used for capital expenditures to obtain additional forestry plantations, investments in manufacturing facilities and other assets. Our cash outlays for our forestry plantations amounted to \$83.6 million in the first quarter of 2008 and \$233.9 million in the same quarter of 2009. Our cash outlays for our manufacturing facilities and other capital assets amounted to \$10.0 million in the first quarter of 2008 and \$3.3 million in the same quarter of 2009. Our cash outlays for other assets amounted to \$22.4 million in the first quarter of 2008 and \$5.3 million in the same quarter of 2009. The increase in non-pledged short-term deposits was \$3.9 million in the first quarter of 2008 and \$0.9 million in the same quarter of 2009. In addition, we paid \$1.9 million in three months ended March 31, 2008 in business acquisitions and \$0.2 million during the acquisition of convertible bonds of Omnicorp in the three months ended March 31, 2009.

### *Cash Flows From (Used in) Financing Activities*

In 2009, cash flows from financing activities consisted of a decrease in pledged short-term deposits of \$0.2 million and an increase in bank indebtedness of \$8.3 million, offset by the payment on derivative financial instrument of \$2.9 million. In 2008, cash flows used in financing activities consisted of a decrease in bank indebtedness of \$6.5 million, an increase in pledged short-term deposits of \$1.9 million and payment on derivative financial instrument of \$2.1 million, offset by an increase in long-term debt of \$0.9 million.

## Issued and Outstanding Share Capital

The authorized capital of the Company consists of an unlimited number of common shares and an unlimited number of preference shares issuable in series, of which 185,779,062 common shares were issued and outstanding as of the date of this MD&A. On a diluted basis, the Company has 206,905,291 common shares outstanding as of the date of this MD&A, assuming the exercise of 4,118,626 outstanding stock options and the issuance of 17,007,603 common shares upon the conversion of the \$345,000,000 convertible senior notes.

# Management's Discussion and Analysis

## Liquidity and Capital Resources

Our primary sources of funding have been short-term and long-term borrowings, equity offerings and cash provided by operating activities. Our primary uses of funding have been to obtain new forestry plantations in the form of standing timber to develop our existing forestry plantations, for imported logs trading, for working capital requirements, to service our short-term and long-term borrowings and to invest in and develop our manufacturing facilities.

The Company begins 2009 with a strong financial position. Cash and cash equivalents of \$367.0 million allows Sino-Forest to manage the pace of its vision and strategies during the current global recession, the duration of which is difficult to predict. Sino-Forest continually assesses the quality of its accounts receivable, cash and cash equivalent and other assets and will take appropriate actions in response to changing market conditions.

## Financing Arrangements and Contractual Obligations

As of March 31, 2009, we had secured and unsecured short-term borrowings of \$81.5 million (including \$6.0 million from discontinued operations), comprising \$42.1 million of short-term bank loans and \$39.4 million of trust receipt loans. We had long-term debt, including its current portion, of \$718.1 million. Our borrowings were mainly denominated in U.S. dollars and Renminbi.

### Short-Term Borrowings

As of March 31, 2009, we had \$186.1 million short-term credit facilities with banks in Hong Kong and the PRC to fund short-term working capital requirements. Pursuant to the non-convertible senior notes' covenants, the maximum amount of the short-term borrowings allowed is \$100 million. As of March 31, 2009, \$81.5 million in respect of bank indebtedness and \$5.3 million in respect of other bank instruments were utilized. Interest is payable on these short-term borrowings at a weighted average rate of 4.9% per annum, and the borrowings are either repayable on demand or due in less than one year. As of March 31, 2009, the short-term credit facilities were secured by certain of our land-use rights, buildings and timber holdings having an aggregate net book value of approximately \$31.2 million and certain bank deposits of \$16.4 million.

### Other Contractual Obligations

As of March 31, 2009, we had other contractual obligations relating to: (1) approximately \$44.3 million in respect of capital contributions to our Wholly Foreign Owned Enterprises ("WFOEs"); (2) \$8.9 million of capital commitments with respect to buildings and plant and machinery; (3) \$3.0 million of purchase commitments mainly regarding logs; (4) commitments under operating leases of approximately \$55.2 million; and (5) \$718.1 million long-term convertible and non-convertible guaranteed senior notes and syndicated loans.

### Scheduled Maturity of Contractual Obligations

The following table presents the scheduled maturities of our contractual obligations as of March 31, 2009:

|   | <u>Total</u><br>\$'000 | Payment Due by Period        |   |   |                                   |
|---|------------------------|------------------------------|---|---|-----------------------------------|
|   |                        | Within<br>one year<br>\$'000 | In the second<br>and third year<br>\$'000 | In the fourth<br>and fifth year<br>\$'000 | After the<br>fifth year<br>\$'000 |
| Long-term debt <sup>(6)</sup>             | 718,073                | 12,500                       | 431,901                                   | 273,672                                   | —                                 |
| Capital contributions                     | 44,250                 | —                            | 4,250                                     | 40,000                                    | —                                 |
| Capital commitments <sup>(7)</sup>        | 8,935                  | 8,935                        | —   | —   | —                                 |
| Purchase commitments                      | 3,019                  | 3,019                        | —   | —   | —                                 |
| Operating leases <sup>(8)</sup>           | 55,228                 | 3,046                        | 4,792                                     | 3,853                                     | 43,537                            |
| <b>Total contractual cash obligations</b> | <b>829,505</b>         | <b>27,500</b>                | <b>440,943</b>                            | <b>317,525</b>                            | <b>43,537</b>                     |

## Management's Discussion and Analysis

Under the master agreement entered in July 2006 to secure at least 1.5 million m<sup>3</sup> of wood fibre annually over a 12-year period in Inner Mongolia, the Company has acquired 17,000 m<sup>3</sup> of wood fibre as at March 31, 2009.

Under the master agreements entered in September and December 2006 to acquire 400,000 hectares of plantation trees over a 14-year period in Hunan, the Company has acquired 112,940 hectares of plantation trees for \$450.2 million as at March 31, 2009.

Under the master agreement entered in March 2007 to acquire 200,000 hectares of plantation trees over a 10-year period in Yunnan, the Company has acquired 53,115 hectares of plantation trees for \$274.3 million as at March 31, 2009.

Under the master agreement entered in December 2007 to acquire 150,000 hectares of plantation trees over a 5-year period in Guangxi, the Company has acquired 79,092 hectares of plantation trees for \$361.3 million as at March 31, 2009.

Under the master agreement entered in August 2008 to acquire 200,000 hectares of plantation trees over a 10-year period in Fujian, the Company has not acquired any hectares of plantation trees as at March 31, 2009.

### *Guarantees*

We also periodically issue guarantees to third parties in relation to the debt of our subsidiaries. As of March 31, 2009, we had provided guarantees of approximately \$121.4 million to banks in connection with credit facilities granted to our subsidiaries. These guarantees expire at the maturity of the underlying debt, which are for varying terms of less than one year, unless the underlying debt is renewed.

### **Historical and Planned Capital Expenditures**

The following table sets forth the breakdown of our capital expenditures for the first quarters ended March 31, 2009 and 2008:

|  | 2009     |              | 2008     |             |
|--|----------|--------------|----------|-------------|
|  | Hectares | \$'million   | Hectares | \$'million  |
| Tree acquisition – Purchased plantations   | 75,977   | 245.6        | 27,706   | 77.9        |
| Re-planting and maintenance of plantations |          | 5.8          |          | 4.4         |
| Manufacturing and other operations         |          | 5.2          |          | 10.0        |
| <b>Total</b>                               |          | <b>256.6</b> |          | <b>92.3</b> |

Capital expenditures incurred at our plantations were for the acquisition of a variety of mature and immature trees, and various plantation management costs, including land lease costs, the costs of planting, developing seedlings, fertilization, insecticide, labor and plantation maintenance service fees. Capital expenditures for manufacturing plants included the costs of constructing the facilities and purchasing and installing production line equipment. The difference between the cash outlays for our forestry plantations in the consolidated statements of cash flows and the above capital expenditure on plantations was due to non-cash transactions movement of accounts payable and capitalization of deposit paid for acquisition of plantations from other assets to timber holdings.

For fiscal 2009, capital expenditures are expected to be approximately \$700 million for plantation acquisitions, replanting and maintenance, and approximately \$30 million for the development of manufacturing facilities integrated with plantation operations. These acquisition levels will be adjusted as necessary given future changes in the economic climate in the PRC.

## Management's Discussion and Analysis

### Aging of Accounts Receivable

#### Plantation Fibre Operations

We recognize revenue from plantation fibre when the buyer has signed the sales contract and the significant risks and rewards of ownership have been transferred to the buyer. After the buyer has entered into the sales contract, we generally give the buyers of standing timber extended credit terms to log and haul the timber from the plantations. Based on a twelve-month period, on average, customers repay outstanding balances in approximately three months.

|                      | Total Accounts<br>Receivable<br>\$'000 | Aging Analysis           |                         |                         |                          |                           |                            |
|----------------------|--|--------------------------|-------------------------|-------------------------|--------------------------|---------------------------|----------------------------|
|                      |  | 0-30<br>Days<br>\$'000   | 31-60<br>Days<br>\$'000 | 61-90<br>Days<br>\$'000 | 91-180<br>Days<br>\$'000 | 181-360<br>Days<br>\$'000 | Over One<br>Year<br>\$'000 |
|                      |  | <b>At March 31, 2009</b> | <b>90,038</b>           | <b>49,714</b>           | <b>16,552</b>            | <b>5,616</b>              | <b>10,266</b>              |
| At December 31, 2008 | 182,307                                | 73,527                   | 74,586                  | 14,653                  | 19,489                   | 52                        | —                          |

#### Other Fibre Operations, Manufacturing and Other Operations

We recognize revenue from the sale of logs and other products when the significant risks and rewards of ownership of the logs and other products have been transferred to the customer, usually on the delivery of the goods. Revenue from wood product and nursery contracts are recognized based on percentage-of-completion method.

|                      | Total Accounts<br>Receivable<br>\$'000 | Aging Analysis           |                         |                         |                          |                           |                            |
|----------------------|--|--------------------------|-------------------------|-------------------------|--------------------------|---------------------------|----------------------------|
|                      |  | 0-30<br>Days<br>\$'000   | 31-60<br>Days<br>\$'000 | 61-90<br>Days<br>\$'000 | 91-180<br>Days<br>\$'000 | 181-360<br>Days<br>\$'000 | Over One<br>Year<br>\$'000 |
|                      |  | <b>At March 31, 2009</b> | <b>41,027</b>           | <b>9,669</b>            | <b>5,384</b>             | <b>5,581</b>              | <b>16,760</b>              |
| At December 31, 2008 | 43,446                                 | 22,895                   | 8,431                   | 4,400                   | 2,792                    | 2,320                     | 2,608                      |

Currently, there is no indication that the Company's accounts receivables are non-collectible thus, an allowance has not been set up. To mitigate the risk on these receivables, the Company has established relationships with customers who have a very good credit rating and solid reputation.

### Off-Balance Sheet Arrangements

Sino-Forest does not have any outstanding derivative financial instruments or off-balance sheet guarantees. In addition, we are not otherwise engaged in hedging activities and had no forward exchange contracts outstanding as of March 31, 2009. In the ordinary course of business, we enter into operating lease commitments, capital commitments and other contractual obligations. These transactions are recognized in our financial statements in accordance with Canadian GAAP and are more fully discussed above.

# **Management's Discussion and Analysis**

## **Transactions with Related Parties**

Pursuant to the respective service agreements, Sino-Forest pays the salaries of the Chairman and Chief Executive Officer and the President in the form of consultancy fees to companies controlled by the noted executive officers. The consultancy fees incurred for the three months ended March 31, 2009 amounted to \$153,000 [2008 – \$152,000] and were recorded at an exchange amount as agreed upon by the related parties.

In addition, as at March 31, 2009, we had an aggregate amount of \$4,900,000 accrued [December 31, 2008 – \$4,900,000] for consultancy fees payable to these related companies.

As described above under “Significant Business Activities”, Simon Murray, a director of the Company and an entity controlled by Mr. Murray were among the vendors in the February 6, 2009 Omnicorp transaction.

## **Non-GAAP Measures**

EBITDA, gross profit, sales per hectare, price per m<sup>3</sup> and gross margin per m<sup>3</sup> are measures used by the Company that do not have a standardized meaning prescribed by GAAP and may not be comparable to similar measures used by other companies. Included at the end of this MD&A are tables calculating or reconciling these non-GAAP measures where applicable.

EBITDA, gross profit, sales per hectare, price per m<sup>3</sup> and gross margin per m<sup>3</sup> are included in this MD&A because these statistics are key performance indicators that management uses to monitor performance. Management uses these statistics to assess how well the Company is performing compared to budget and to make strategic decisions. Management believes that the inclusion of these statistics in the MD&A helps investors and analysts to assess the Company's ability to grow its timber holdings, to forecast future results, to assess our current and future operating results and to make investment decisions. The data is intended to provide additional information and should not be considered in isolation or as a substitute for measures of performance prepared in accordance with GAAP.

## **Quarterly Financial Information**

Our business is seasonal. Generally, the third and fourth quarters together account for approximately 60% of annual revenue, while the first and second quarters together account for approximately 40% of annual revenue. This reflects the preference of timber companies to take advantage of the peak growing seasons in the spring and summer before harvesting the trees, and the difficulty in the logging and hauling of timber during the rainy season in the first half of the year.

## Management's Discussion and Analysis

The following table is a summary of our selected quarterly financial information for each of the eight quarters ended March 31, 2009:

| (in thousands, except per share amounts) | Revenue<br>\$  | Net Income<br>\$ | Earnings Per Share <sup>(3)</sup> |               |
|--|----------------|------------------|-----------------------------------|---------------|
|  |                |                  | Basic<br>\$                       | Diluted<br>\$ |
| <b>2009</b>                              |                |                  |                                   |               |
| <b>March 31</b>                          | <b>177,234</b> | <b>23,005</b>    | <b>0.12</b>                       | <b>0.12</b>   |
| 2008                                     |                |                  |                                   |               |
| December 31*                             | 282,485        | 95,490           | 0.52                              | 0.51          |
| September 30*                            | 295,548        | 75,175           | 0.41                              | 0.40          |
| June 30*                                 | 187,125        | 43,401           | 0.24                              | 0.24          |
| March 31                                 | 135,495        | 14,527           | 0.08                              | 0.08          |
| 2007                                     |                |                  |                                   |               |
| December 31*                             | 310,850        | 55,470           | 0.30                              | 0.30          |
| September 30*                            | 161,475        | 63,383           | 0.35                              | 0.35          |
| June 30*                                 | 128,764        | 21,910           | 0.13                              | 0.13          |

\* The quarterly financial information has not been restated for the discontinued particleboard operations as the effect of the change on net income for the period is insignificant.

### Critical Accounting Estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting policies requires management to make estimates and assumptions that affect amounts reported in the consolidated financial statements and accompanying notes. Sino-Forest's significant accounting policies are described in note 1 to the consolidated financial statements for the year ended December 31, 2008. Each policy involves a number of estimates and assumptions made by management. The Company bases its estimates on historical experience and various other assumptions that are believed to be reasonable in the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities. On an ongoing basis, the Company evaluates its estimates. Different accounting policies, or changes in estimates or assumptions, could potentially have a material impact, positive or negative, on Sino-Forest's financial position and results of operations. It is reasonably possible that circumstances may arise which cause actual results to differ from management estimates. The Company believes its most critical policies and estimates are those related to revenue recognition of standing timber, asset impairment of timber holdings, and capital assets and income tax provision.

#### Asset Impairment

##### Timber Holdings

Timber holdings represented 69.3% of the Company's consolidated total assets as at March 31, 2009. Timber holdings are carried on the Company's consolidated balance sheet at cost which includes cost of young trees, standing timber, and planting and maintenance costs. The Company reviews the recoverability of the carrying value of its timber holdings on an annual basis or whenever events or changes in circumstances indicate that the carry amount may not be recoverable. If the sum of the future undiscounted cash flows expected to result from the asset is less than the asset's carrying value, asset impairment must be recognized. Impairment losses on timber holdings are measured as the amount by which the carrying value of the asset exceeds its fair value.

The Company believes that accounting estimates related to timber holding impairment assessments are critical accounting estimates because: (i) they are subject to significant measurement uncertainty and are susceptible to change as management is required to make forward looking assumptions regarding timber market demand and pricing, cost of production such as harvesting costs, transportation costs, taxes and overhead costs, plantation risk such as fire, pest and disease, frost and typhoons, plantation growth and yield, future yield development and the Company's weighted average cost of capital; and (ii) any resulting impairment loss could have a material impact on the Company's consolidated income statement and the reported timber holdings amount in the Company's consolidated balance sheet.

## **Management's Discussion and Analysis**

To assist with its impairment assessments, the Company engages an outside consultant to help derive cash flow estimates and to estimate the fair value of its existing timber holdings using a discounted cash flow valuation model. If management's best estimate of key assumptions were to change significantly and the associated estimated future cash flows were to materially decrease, Sino-Forest could potentially experience future impairment charges and such charges could be material.

### **Capital Assets**

The Company evaluates the recoverability of the carrying value of its capital assets whenever indicators of impairment exist. Indicators of impairment include prolonged operating losses or a decision to dispose of, or otherwise change the use of, an existing capital asset. If the sum of the future undiscounted cash flows expected to result from the asset is less than the asset's carrying value, asset impairment must be recognized. Impairment losses on capital assets are measured as the amount by which the carrying value of the asset exceeds its fair value.

The Company believes that estimates related to capital assets impairment assessments are critical accounting estimates because: (i) they are subject to significant measurement uncertainty and are susceptible to change as management is required to make forward looking assumptions regarding the impact of improvement plans on current operations, other new business opportunities, forecasted production volumes and cost of production assumptions on current and future business; and (ii) any resulting impairment loss could have a material impact on the Company's consolidated financial statements and the reported capital asset amount in the consolidated balance sheet.

### **Revenue Recognition**

#### **Standing Timber**

Sino-Forest sells standing timber at various stages of maturity to domestic wood dealers from its tree plantations. Standing timber revenue represents a significant portion of the Company's consolidated revenue. The timing of recognition of revenue from standing timber sales is dependent on the terms and conditions of the Company's contractual arrangements with its customers. To date, substantially all of the Company's standing timber revenue has been recognized when the Company and the buyer enter into a binding sales agreement. Typically, prior to entering into the agreement, the Company and the buyer will have negotiated the approximate timber volume and the expected harvest yield associated with a specified plantation area. The sales agreement typically provides the buyer with a fixed period of time over which the buyer is entitled to harvest the timber on the specified plantation area and amounts due from the buyer are fixed at the time of entering into the agreement and are not subject to adjustment based on the actual amount of timber harvested by the buyer. Harvesting and all related costs have to date been the responsibility of the buyer and the Company has not been responsible for any further significant acts of performance under the sales agreement. The buyer has borne all risks and rewards related to the timber on the specified plantation area over the harvest period.

A future change to the typical contractual arrangements for timber sales could materially impact the timing and manner in which revenue is recognized.

### **Provision for Tax Related Liabilities**

Our principal operating subsidiaries incorporated in the British Virgin Islands (the "BVI Subsidiaries") are engaged in the sale of standing timber and earning income ("Authorized Sales Activities") in the PRC through authorized intermediaries ("AI") that are domestic enterprises of the PRC. In accordance with the PRC laws and regulations relating to PRC enterprise income tax, foreign companies such as the BVI Subsidiaries, deriving income from sources in the PRC are subject to enterprise income tax. This also applied to income and commission revenue that the BVI Subsidiaries received from the sale of wood chips in prior years. The wood chips and commission operations were discontinued in 2007.

Under the terms of the master agreements, relevant sales and purchase contracts and commission agreements ("AI Agreements") made with the AI, the AI are responsible for remitting relevant PRC taxes that arise from



## **Management's Discussion and Analysis**

the Authorized Sales Activities. It is a question of fact whether the PRC tax authorities may be successful in establishing that the BVI Subsidiaries are subject to enterprise income tax due to the Authorized Sales Activities. Management has concluded that based upon all available evidence it is appropriate to record in the accounts a reserve for tax benefits representing management's estimate, based upon cumulative probabilities, of the amount the PRC tax authorities might seek to recover.

Included in accounts payable and accrued liabilities including discontinued operations as at March 31, 2009 is the balance of the tax provision for the tax related contingency amounting to \$95,876,000 [December 31, 2008 – \$89,909,000] provided on the profits of the Authorized Sales Activities earned by the BVI Subsidiaries for the current three months and in the four previous years.

### **Contingencies for Tax Related Liabilities**

The provision for income taxes and tax related liabilities and whether tax filings are required is subject to a number of different factors, estimates and judgment made by management. A change in the facts and these estimates and judgment could have a material effect on the Company's tax expense. The Company has operations in various countries (mainly in the PRC, Canada and Hong Kong) that have different tax laws and rates. Income tax and other taxes are subject to audit by all relevant tax authorities. The effective tax rate may change from year to year based on the mix of income among the different tax jurisdictions in which the Company operates, changes in tax laws in these jurisdictions, and changes in tax treaties between various tax jurisdictions in which the Company operates. It is possible that profits already taxed by one tax jurisdiction could be taxed by another tax jurisdiction or multiple jurisdictions. Should the PRC tax authorities recover income tax, business tax and value-added tax directly from the BVI Subsidiaries, they might do so together with related tax surcharges and tax penalties on applicable income or profits of the Authorized Sales Activities from the BVI Subsidiaries for a period from three to five years in practice. Under prevailing PRC tax rules, the tax surcharge is calculated at 0.05% per day on the tax amount overdue while the tax penalties can range from 50% to 500% of taxes underpaid. Under the Hong Kong tax regulations, assessments are open for up to six years in practice and tax penalties can be up to treble amount of the tax underpaid.

Significant estimates and judgment are applied by management to determine the appropriate amount of tax related liabilities and contingencies for tax related liabilities to be recognized and disclosed in the financial statements respectively. Changes in the amount of the estimates could materially increase or decrease the provision for tax related liabilities and the extent of disclosures of contingencies for tax related liabilities in a period.

Management evaluates the provision for tax related liabilities on a quarterly basis or as necessary and believes that an adequate provision for tax related liabilities has been recognized in the financial statements.

### **Changes in Accounting Policies**

On January 1, 2009, the Company adopted the following new Canadian Institute of Chartered Accountants ("CICA") accounting standard and Emerging Issues Committee ("EIC") abstract.

Section 3064 Goodwill and Intangible Assets, which replaced previous guidance. The standard establishes guidelines for the recognition, measurement, presentation and disclosure of goodwill and intangible assets subsequent to initial recognition. The standard had no impact on the Company's consolidated financial statements.

EIC 173 Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. This guidance clarified that an entity's own credit risk and the credit risk of the counterparty should be taken into account in determining the fair value of financial assets and financial liabilities including derivative instruments. Adoption of this guidance had no impact on the Company's consolidated financial statements.

### **Future Accounting Standards**

The CICA has issued the following Handbook Sections which apply commencing with the Company's fiscal years noted below.

## **Management's Discussion and Analysis**

In January 2009, the CICA issued Section 1601 Consolidations and Section 1602 Non-controlling Interests. CICA 1601 establishes standards for the preparation of consolidated financial statements. CICA 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. These standards are applicable to interim and annual financial statements of the Company beginning on January 1, 2011. The Company is in the process of evaluating the impact of these standards.

In January 2009, the CICA issued Section 1582, Business Combinations replacing Section 1581 Business Combinations. The new section improves the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects. The section is applicable to the annual and interim financial statements of the Company beginning on or January 1, 2011, with early adoption permitted. The Company is in the process of evaluating the impact of this standard.

### **International Financial Reporting Standards**

In February 2008, the CICA confirmed that Canadian reporting issuers will be required to report under International Financial Reporting Standards ("IFRS") effective January 1, 2011. Reporting issuers will be required to provide IFRS comparative information for the previous year. IFRS uses a conceptual framework similar to Canadian GAAP, but there are significant differences on recognition, measurement and disclosures. In the period leading up to the changeover, the AcSB will continue to issue accounting standards that are converged with IFRS such as IAS 2 "Inventories" and IAS 38 "Intangible assets", thus mitigating the impact of adopting IFRS at the changeover date.

The Company commenced its IFRS conversion project in 2008. The project consists of four phases: diagnostic, design and planning, solution development and implementation. The Company will invest in training and resources throughout the transition period to facilitate a timely conversion.

The diagnostic phase was completed during the latter part of 2008. This work involved a high-level review of the major differences between current Canadian GAAP and IFRS. While a number of differences have been identified, the areas of highest potential impact are as follows: timber holdings, property, plant and equipment; impairment of assets; income taxes and foreign exchange accounting. The Company expects the transition to IFRS to impact financial reporting, business processes, internal controls and information systems.

During 2009, the Company will initiate the design and planning phase that will involve establishing issue-specific work teams to focus on generating options and making recommendations in the identified risk areas. During the design and planning phase, the Company will establish a staff communications plan, begin to develop staff training programs, and evaluate the impacts of the IFRS transition on other business activities.

### **Risk and Uncertainties**

There are no significant changes to the risk and uncertainties as described in the 2008 annual information form of the Company, which is available on SEDAR at [www.sedar.com](http://www.sedar.com).

### **Disclosure Controls and Procedures and Internal Controls over Financial Reporting**

The Company's Chief Executive Officer ("CEO") and Senior Vice President and Chief Financial Officer ("CFO") are responsible for designing disclosure controls and procedures ("DC&P") and internal controls over financial reporting ("ICFR") as defined in National Instrument 52-109 – Certification of Disclosure in Issuers' Annual and Interim Filings. The control framework used in the design of both DC&P and ICFR is the internal control integrated framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

The design and effectiveness of internal controls over financial reporting was assessed as of December 31, 2008. Based on that evaluation, the Company concluded that the design and effectiveness of the Company's DC&P and ICFR was ineffective due to the weakness discussed below with respect to ICFR.

## **Management's Discussion and Analysis**

The success of the Company's vision and strategy of acquiring and selling forestry plantations and access to a long-term supply of wood fibre in the PRC is dependent on senior management. As such, senior management plays a significant role in maintaining customer relationships, negotiating and finalizing the purchase and sale of plantation fibre contracts and the settlement of accounts receivable and accounts payable associated with plantation fibre contracts. This concentration of authority, or lack of segregation of duties, creates risk in terms of measurement and completeness of transactions as well as the possibility of non-compliance with existing controls, either of which may lead to the possibility of inaccurate financial reporting. During 2009, management will take steps to address this deficiency and will continue to monitor and mitigate this weakness.

Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues have been detected. A control system, no matter how well conceived or operated, can only provide reasonable, not absolute, assurance that the objectives of the control system are met.

There has been no change in the design of the Company's internal controls over financial reporting during the quarter ended March 31, 2009, that would materially affect, or is reasonably likely to materially affect, Sino-Forest's internal controls over financial reporting.

## Management's Discussion and Analysis

- (1) Gross profit for any period is defined as total revenue less cost of sales. Gross profit is presented as additional information because we believe that it is a useful measure for certain investors to determine our operating performance. Gross profit is not a recognized term under Canadian GAAP and should not be considered as an alternative to net income as an indicator of our operating performance or any other measure of performance derived in accordance with Canadian GAAP. Because it is not a Canadian GAAP measure, gross profit may not be comparable to similar measures presented by other companies.
- (2) EBITDA for any period is defined as income from operations for the period after adding back depreciation and amortization, impairment of capital assets as well as depletion of timber holdings from cost of sales, for the period. EBITDA is presented as additional information because we believe that it is a useful measure for certain investors to determine our operating cash flow and historical ability to meet debt service and capital expenditure requirements. EBITDA is not a measure of financial performance under Canadian GAAP and should not be considered as an alternative to cash flows from operating activities, a measure of liquidity or an alternative to net income as indicators of our operating performance or any other measures of performance derived in accordance with Canadian GAAP.

EBITDA is calculated as follows:

|                                     | Three months ended<br>March 31, |               |
|-------------------------------------|---------------------------------|---------------|
|                                     | 2009                            | 2008          |
|                                     | \$'000                          | \$'000        |
| Income from continuing operations   | 49,592                          | 35,766        |
| Plus: depreciation and amortization | 1,129                           | 672           |
| depletion of timber holdings        | 64,205                          | 38,054        |
|                                     | <b>114,926</b>                  | <b>74,492</b> |

- (3) Earnings per share is calculated using the weighted average number of common shares outstanding during each period.
- (4) Represents net income as adjusted for depletion of timber holdings, interest earned from Mandra, depreciation and amortization, amortization of deferred financing costs, stock-based compensation, impairment of capital assets, changes in fair value of financial instrument and other assets, exchange gains and others.
- (5) Represents decreases (increases) in accounts receivable, inventories, prepaid expenses and other assets and increases (decreases) in accounts payable and accrued liabilities and income taxes payable.
- (6) Represents the U.S. dollar denominated debts (after deduction of unamortized deferred financing costs) due in 2010 and 2011.
- (7) Represents commitments to invest in buildings, plant and machinery for investments in the manufacturing plants and timber holdings.
- (8) These represent mainly leases of plantation land.

## CONSOLIDATED STATEMENTS OF INCOME AND RETAINED EARNINGS

[Expressed in thousands of United States dollars, except for earnings per share information] [Unaudited]

| Three months ended March 31,                                 | 2009<br>\$      | 2008<br>\$ |
|--|-----------------|------------|
| <b>Revenue</b>   | <b>177,234</b>  | 135,495    |
| <b>Costs and expenses</b>                                    |                 |            |
| Cost of sales  | <b>110,398</b>  | 88,421     |
| Selling, general and administration                          | <b>16,115</b>   | 10,636     |
| Depreciation and amortization                                | <b>1,129</b>    | 672        |
|  | <b>127,642</b>  | 99,729     |
| Income from operations before the undernoted                 | <b>49,592</b>   | 35,766     |
| Interest expense   | <b>(16,795)</b> | (10,475)   |
| Interest income  | <b>1,904</b>    | 2,881      |
| Exchange losses  | <b>(93)</b>     | (2,513)    |
| Loss on changes in fair value of financial instruments, net  | <b>(981)</b>    | (4,535)    |
| Other income   | <b>221</b>      | 393        |
| Income before income taxes                                   | <b>33,848</b>   | 21,517     |
| Provision for income taxes <i>[note 13]</i>                  | <b>(5,926)</b>  | (4,274)    |
| <b>Net income from continuing operations</b>                 | <b>27,922</b>   | 17,243     |
| <b>Net loss from discontinued operations <i>[note 7]</i></b> | <b>(4,917)</b>  | (2,716)    |
| <b>Net income for the period</b>                             | <b>23,005</b>   | 14,527     |
| <b>Earnings per share <i>[note 14]</i></b>                   |                 |            |
| Basic  | <b>0.12</b>     | 0.08       |
| Diluted  | <b>0.12</b>     | 0.08       |
| <b>Earnings per share from continuing operations</b>         |                 |            |
| Basic  | <b>0.15</b>     | 0.09       |
| Diluted  | <b>0.15</b>     | 0.09       |
| <b>Loss per share from discontinued operations</b>           |                 |            |
| Basic  | <b>(0.03)</b>   | (0.01)     |
| Diluted  | <b>(0.03)</b>   | (0.01)     |
| <b>Retained earnings</b>                                     |                 |            |
| Retained earnings, beginning of period                       | <b>769,557</b>  | 540,964    |
| Net income for the period                                    | <b>23,005</b>   | 14,527     |
| <b>Retained earnings, end of period</b>                      | <b>792,562</b>  | 555,491    |

*See accompanying notes*

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

[Expressed in thousands of United States dollars] [Unaudited]

|   | 2009           | 2008   |
|---|----------------|--------|
| Three months ended March 31,  | \$             | \$     |
| <b>Net income for the period</b>  | <b>23,005</b>  | 14,527 |
| <b>Other comprehensive (loss) income, net of tax:</b>                                     |                |        |
| Unrealized losses on financial assets designated as available-for-sale, net of tax of nil | (1,210)        | (949)  |
| Unrealized (losses) gains on foreign currency translation of self-sustaining operations   | (736)          | 62,746 |
| <b>Other comprehensive (losses) income</b>  | <b>(1,946)</b> | 61,797 |
| <b>Comprehensive income</b>   | <b>21,059</b>  | 76,324 |

*See accompanying notes*

## CONSOLIDATED BALANCE SHEETS

[Expressed in thousands of United States dollars] [Unaudited]

|   | As at<br>March 31,<br>2009<br>\$ | As at<br>December 31,<br>2008<br>\$ |
|---|----------------------------------|-------------------------------------|
| <b>ASSETS</b>   |                                  |                                     |
| <b>Current</b>  |                                  |                                     |
| Cash and cash equivalents                                     | 367,002                          | 441,171                             |
| Short-term deposits <i>[note 4(b)]</i>                        | 46,414                           | 45,784                              |
| Accounts receivable   | 131,065                          | 225,753                             |
| Inventories <i>[note 3]</i>                                   | 45,858                           | 43,200                              |
| Prepaid expenses and other                                    | 27,385                           | 21,768                              |
| Convertible bonds <i>[note 6(c)]</i>                          | 25,044                           | 2,659                               |
| Assets of discontinued operations <i>[note 7]</i>             | 27,950                           | 31,122                              |
| <b>Total current assets</b>                                   | <b>670,718</b>                   | <b>811,457</b>                      |
| Timber holdings   | 1,839,829                        | 1,653,306                           |
| Capital assets, net <i>[note 5]</i>                           | 67,490                           | 63,704                              |
| Other assets <i>[note 6]</i>                                  | 78,146                           | 75,457                              |
|   | <b>2,656,183</b>                 | <b>2,603,924</b>                    |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                   |                                  |                                     |
| <b>Current</b>  |                                  |                                     |
| Bank indebtedness <i>[note 4]</i>                             | 75,493                           | 67,188                              |
| Current portion of long-term debt <i>[note 9]</i>             | 12,500                           | —                                   |
| Accounts payable and accrued liabilities <i>[note 13]</i>     | 180,430                          | 179,903                             |
| Income taxes payable  | 6,626                            | 6,383                               |
| Derivative financial instrument <i>[note 9(a)]</i>            | 2,916                            | 5,214                               |
| Liabilities of discontinued operations <i>[note 7]</i>        | 30,030                           | 32,004                              |
| <b>Total current liabilities</b>                              | <b>307,995</b>                   | <b>290,692</b>                      |
| Long-term debt <i>[note 9]</i>                                | 705,573                          | 714,468                             |
| <b>Total liabilities</b>                                      | <b>1,013,568</b>                 | <b>1,005,160</b>                    |
| Commitments and Contingencies <i>[notes 19 and 20]</i>        |                                  |                                     |
| <b>Shareholders' equity</b>                                   |                                  |                                     |
| Equity portion of convertible senior notes <i>[note 9(c)]</i> | 70,462                           | 70,462                              |
| Share capital <i>[note 10]</i>                                | 561,021                          | 539,315                             |
| Contributed surplus <i>[note 11]</i>                          | 8,685                            | 7,599                               |
| Accumulated other comprehensive income <i>[note 12]</i>       | 209,885                          | 211,831                             |
| Retained earnings   | 792,562                          | 769,557                             |
| <b>Total shareholders' equity</b>                             | <b>1,642,615</b>                 | <b>1,598,764</b>                    |
|   | <b>2,656,183</b>                 | <b>2,603,924</b>                    |

*See accompanying notes*

## CONSOLIDATED STATEMENTS OF CASH FLOWS

[Expressed in thousands of United States dollars] [Unaudited]

| Three months ended March 31,   | 2009            | 2008            |
|--|-----------------|-----------------|
|  | \$              | \$              |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                      |                 |                 |
| Net income for the period  | 23,005          | 14,527          |
| Net loss from discontinued operations  | 4,917           | 2,716           |
| Add (deduct) items not affecting cash  |                 |                 |
| Depletion of timber holdings included in cost of sales                           | 64,205          | 38,054          |
| Depreciation and amortization  | 1,129           | 672             |
| Accretion of convertible senior notes  | 2,859           | —               |
| Stock-based compensation   | 1,086           | 1,133           |
| Loss on changes in fair value of financial instruments, net                      | 981             | 4,535           |
| Interest income from Mandra  | (300)           | (300)           |
| Other  | 1,294           | 529             |
| Exchange gains (losses)  | (19)            | 2,497           |
|  | 99,157          | 64,363          |
| Net change in non-cash working capital balances <i>[note 15]</i>                 | 68,428          | (30,366)        |
| <b>Cash flows from operating activities of continuing operations</b>             | <b>167,585</b>  | <b>33,997</b>   |
| <b>Cash flows used in operating activities of discontinued operations</b>        | <b>(2,789)</b>  | <b>(1,905)</b>  |
| <b>CASH FLOWS USED IN INVESTING ACTIVITIES</b>                                   |                 |                 |
| Additions to timber holdings   | (233,861)       | (83,637)        |
| Increase in other assets   | (5,257)         | (22,411)        |
| Additions to capital assets  | (3,263)         | (10,044)        |
| Increase in non-pledged short-term deposits                                      | (864)           | (3,947)         |
| Business acquisition <i>[note 8]</i>   | —               | (1,928)         |
| Acquisition of convertible bonds   | (200)           | —               |
| Proceeds from disposal of capital assets   | —               | 1               |
|  | (243,445)       | (121,966)       |
| <b>Cash flows used in investing activities of discontinued operations</b>        | <b>(929)</b>    | <b>—</b>        |
| <b>CASH FLOWS FROM (USED IN) FINANCING ACTIVITIES</b>                            |                 |                 |
| Increase in long-term debt   | —               | 855             |
| Increase (decrease) in bank indebtedness   | 8,311           | (6,471)         |
| Decrease (increase) in pledged short-term deposits                               | 228             | (1,938)         |
| Payment on derivative financial instrument                                       | (2,891)         | (2,100)         |
|  | 5,648           | (9,654)         |
| <b>Cash flows from (used in) financing activities of discontinued operations</b> | <b>(1)</b>      | <b>(348)</b>    |
| <b>Effect of exchange rate changes on cash and cash equivalents</b>              | <b>(238)</b>    | <b>1,408</b>    |
| <b>Net decrease in cash and cash equivalents</b>                                 | <b>(74,169)</b> | <b>(98,468)</b> |
| Cash and cash equivalents, beginning of period                                   | 441,171         | 328,690         |
| <b>Cash and cash equivalents, end of period</b>                                  | <b>367,002</b>  | <b>230,222</b>  |
| <b>Supplemental cash flow information</b>  |                 |                 |
| Cash payment for interest charged to income                                      | 24,569          | 16,458          |
| Interest received  | 681             | 2,595           |

*See accompanying notes*



## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

### **1. BASIS OF PRESENTATION**

The interim consolidated financial statements are unaudited and follow the accounting policies as outlined in note 1 of the notes to the consolidated financial statements for the year ended December 31, 2008 with the exception of certain changes in accounting policies as mentioned in note 2 below. These interim consolidated financial statements do not conform in all respects to the requirements of Canadian generally accepted accounting principles for annual financial statements and should therefore be read in conjunction with the consolidated financial statements and notes for the year ended December 31, 2008.

The quarterly results are not necessarily indicative of results to be expected for the entire year. Revenue is typically the lowest in the first quarter of the year and represents approximately 15% of the entire year. This reflects the preference of timber companies to take advantage of the peak growing seasons in the spring and summer before harvesting the trees, and the difficulty in the logging and hauling of timber during the rainy season in the first half of the year.

### **2. CHANGES IN ACCOUNTING POLICIES**

On January 1, 2009, the Company adopted the following new Canadian Institute of Chartered Accountants (“CICA”) accounting standard and Emerging Issues Committee (“EIC”) abstract.

Section 3064 Goodwill and Intangible Assets, which replaced previous guidance. The standard establishes guidelines for the recognition, measurement, presentation and disclosure of goodwill and intangible assets subsequent to initial recognition. The standard had no significant impact on the Company's consolidated financial statements.

EIC 173 Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. This guidance clarified that an entity's own credit risk and the credit risk of the counterparty should be taken into account in determining the fair value of financial assets and financial liabilities including derivative instruments. Adoption of this guidance had no significant impact on the Company's consolidated financial statements.

#### **Future Accounting Standards**

The CICA has issued the following Handbook Sections which apply commencing with the Company's fiscal years noted below.

In January 2009, the CICA issued Section 1601 Consolidations and Section 1602 Non-controlling Interests. CICA 1601 establishes standards for the preparation of consolidated financial statements. CICA 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. These standards are applicable to interim and annual financial statements of the Company beginning on January 1, 2011. The Company is in the process of evaluating the impact of these standards.

In January 2009, the CICA issued Section 1582 Business Combinations, replacing Section 1581 Business Combinations. The new section improves the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects. The section is applicable to the annual and interim financial statements of the Company beginning on or January 1, 2011, with early adoption permitted. The Company is in the process of evaluating the impact of this standard.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

**3. INVENTORIES**

Inventories consist of the following:

|                  | <b>March 31,<br/>2009</b> | December 31,<br>2008 |
|------------------|---------------------------|----------------------|
|                  | \$                        | \$                   |
| Raw materials    | <b>3,417</b>              | 3,111                |
| Work in progress | <b>6,739</b>              | 6,481                |
| Finished goods   | <b>5,995</b>              | 5,481                |
| Timber logs      | <b>20,756</b>             | 20,929               |
| Nursery          | <b>8,951</b>              | 7,198                |
|                  | <b>45,858</b>             | 43,200               |

The amount of inventories recognized as an expense and included in cost of sales for the three months ended March 31, 2009 was \$46,146,000 [2008 – \$50,367,000]. The amount charged to the statements of income and retained earnings and included in selling, general and administration expenses for the write down of inventories for valuation issues for the three months ended March 31, 2009 was \$1,311,000 [2008 – \$186,000].

**4. BANK INDEBTEDNESS**

Certain of the Company's banking facilities are collateralized by:

- [a] charges over certain of the Company's land-use rights, buildings and timber holdings which have an aggregate net book value at March 31, 2009 of \$31,249,000 [December 31, 2008 – \$20,656,000]; and
- [b] certain short-term deposits at March 31, 2009 of \$16,381,000 [December 31, 2008 – \$16,608,000].

Total interest expense on bank indebtedness for the three months ended March 31, 2009 was \$948,000 [2008 – \$992,000].

**5. CAPITAL ASSETS**

Capital assets consist of the following:

|  | <b>March 31, 2009</b> |  | December 31, 2008 |  |
|--|-----------------------|--|-------------------|--|
|  | <b>Cost</b>           | <b>Accumulated<br/>depreciation,<br/>amortization<br/>and impairment</b> | Cost              | Accumulated<br>depreciation,<br>amortization<br>and impairment |
|  | \$                    | \$   | \$                | \$   |
| Machinery and equipment  | <b>26,053</b>         | <b>9,811</b>   | 25,361            | 9,406  |
| Buildings  | <b>40,028</b>         | <b>3,333</b>   | 37,900            | 3,106  |
| Land-use rights  | <b>9,703</b>          | <b>1,107</b>   | 7,820             | 1,056  |
| Office furniture and equipment                                 | <b>3,208</b>          | <b>1,577</b>   | 3,109             | 1,441  |
| Vehicles   | <b>6,489</b>          | <b>2,163</b>   | 6,413             | 1,890  |
|  | <b>85,481</b>         | <b>17,991</b>  | 80,603            | 16,899   |
| Less: accumulated depreciation,<br>amortization and impairment | <b>(17,991)</b>       |  | (16,899)          |  |
| <b>Net book value</b>  | <b>67,490</b>         |  | 63,704            |  |

Buildings, machinery and equipment of \$20,345,000 [December 31, 2008 – \$18,101,000] are not being depreciated as the production facilities are under construction and have not yet been put into commercial operation. No interest was capitalized to capital assets in the current and prior periods.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

**6. OTHER ASSETS**

Other assets consist of the following:

|  | <b>March 31,<br/>2009</b> | December 31,<br>2008 |
|--|---------------------------|----------------------|
|  | \$                        | \$                   |
| Investment in Mandra Holdings [a]              | <b>2</b>                  | 2                    |
| Subordinated loan and interest receivable [a]  | <b>19,667</b>             | 19,366               |
| Prepaid plantation costs and lease rentals [b] | <b>41,869</b>             | 40,380               |
| Investment in Omnicorp and Greenheart [c]      | <b>5,954</b>              | 2,872                |
| Deposit for purchase of logs [d]               | <b>8,000</b>              | 8,000                |
| Other  | <b>2,654</b>              | 4,837                |
|  | <b>78,146</b>             | 75,457               |

- [a] The Company entered into a series of agreements with Mandra Resources Limited and certain of its subsidiaries (collectively, “Mandra”) that are start-up companies formed to acquire, grow, harvest and replant standing timber on commercial forestry plantations (the “Plantations”) located in Anhui province in the PRC (the “Mandra Project”). Subject to certain conditions, the Company will have an option to acquire all other outstanding shares of Mandra Forestry Holdings Limited (“Mandra Holdings”) at their then fair market value.

The subordinated loan carries an interest rate of 8% per annum and will be repaid 30 days after the full repayment of Mandra’s \$195 million of debt securities due in May 2013. The subordinated loan is secured by a 75% equity interest in Mandra Holdings. Included in the balance of the subordinated loan and interest receivable is accrued interest of \$4,667,000 [December 31, 2008 – \$4,367,000]. The Company’s maximum exposure to loss from Mandra is limited to the Company’s investment in Mandra and subordinated loan and related interest receivable.

- [b] These represented prepaid land leases of plantation land in PRC and prepaid expenses for planted plantations.

- [c] In July 2007, the Company invested \$6.0 million to acquire approximately 13% of the equity interests in Greenheart. In August 2007, Omnicorp Limited (“Omnicorp”), a listed company in Hong Kong, entered into an agreement with the existing shareholders of Greenheart to acquire approximately 60.3% of the equity interests in Greenheart with an option to acquire the remaining equity interests within 18 months after the completion of the sale. The transaction was completed on November 8, 2007 for consideration to the Company consisting of 7,860,000 ordinary shares of Omnicorp, convertible bonds at a principal amount of \$3,975,000 (equivalent to HK\$31,047,000) issued by Omnicorp which mature on November 9, 2009 and cash of \$302,000 (equivalent to HK\$2,358,000) resulting in a gain of \$3,369,000 being recorded in other income.

In October 2007, the Company acquired convertible bonds issued by Omnicorp for \$1,756,000 (equivalent to HK\$13,650,000) from other bondholders.

In February 2009, the Company acquired 55,000,000 ordinary shares of Omnicorp and approximately \$21,700,000 (equivalent to HK\$167,631,000) convertible bonds issued by Omnicorp. The purchase price consisted of cash of approximately \$4,300,000 (equivalent to HK\$33,000,000) for the Omnicorp shares and approximately 2,659,990 common shares of the Company for the Omnicorp convertible bonds.

The above bonds are convertible at HK\$2.00 of face value per Omnicorp ordinary share. The convertible bonds were assessed under CICA Handbook 3855 as containing an embedded derivative financial instrument. The Company is required to bifurcate the embedded conversion option and

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

account for it as a derivative asset. The derivative asset was adjusted to its fair value of \$586,000 using the Black Scholes model as at March 31, 2009 resulting in a charge of \$388,000 [2008 – \$2,021,000] recorded in the statements of income and retained earnings.

The following assumptions were used to estimate the fair value of the conversion options as at:

|                                 | <b>March 31,<br/>2009</b> | December 31,<br>2008 |
|---------------------------------|---------------------------|----------------------|
| Risk-free interest rate         | <b>0.62%</b>              | 0.49%                |
| Expected option life (in years) | <b>0.67</b>               | 0.85                 |
| Dividend yield                  | <b>0.0%</b>               | 0.0%                 |
| Volatility                      | <b>147.39%</b>            | 146.21%              |

The disbursements paid on receipts of the convertible bonds were first allocated to the fair value of the bifurcated embedded derivative financial instrument, with the remaining disbursement allocated to the convertible bonds, resulting in the discounted convertible bonds being recorded at \$766,000 (equivalent to HK\$5,912,000) and \$21,181,000 (equivalent to HK\$163,564,000) on the completion dates of November 8, 2007 and February 6, 2009, respectively. These discounts, together with the stated interest on the convertible bonds, are being accreted using the effective interest rate method over the convertible bonds' remaining term. For the three months ended March 31, 2009, the Company recorded accretion income of \$944,000 [2008 – \$286,000] in the statements of income and retained earnings.

- [d] The amount represents a refundable deposit of \$10.0 million out of which \$2.0 million has been reclassified to current assets, paid to a third party in connection with wood fibre to be purchased by the Company under the twelve-year wood fibre supply Master Agreement with Inner Mongolia Forest and Timber Resources Company Limited and Erlianhot Lianhe Forestry Bureau to secure an annual supply of at least 1.5 million m<sup>3</sup> of wood fibre by the Company. The deposit will be refunded in equal instalments over five years after commencement of operations under the contract.

**7. DISCONTINUED OPERATIONS**

During the third quarter of 2007, wood chips and commission revenue ceased due to the lack of wood chipping capacity available to the Company. The results of operations from wood chips and commission are detailed below and shown as discontinued operations.

In March 2009, the Company committed to a plan to dispose certain machinery and equipment of the Company's particleboard operations due to continued losses over the years. On March 30, 2009, a subsidiary of the Company entered into an agreement to dispose the capital assets of Gaoyao particleboard operation for proceeds of approximately \$29,550,000 (equivalent to RMB202,000,000). The consideration will be paid in four instalments over a nine-month period. The transfer of capital assets is subject to certain conditions including consecutive 30 days of trial run of machinery and equipment. Accordingly, the results of operations of the Company's particleboard operations are detailed below and shown as discontinued operations.

As a result, the statements of income and retained earnings and balance sheets have been reclassified from statements previously presented.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

The results of the discontinued operations are as follows:

| Three months ended March 31,               | 2009<br>\$     | 2008<br>\$     |
|--|----------------|----------------|
| <b>Revenue</b>                             | <b>173</b>     | 642            |
| <b>Cost and expenses</b>                   |                |                |
| Cost of sales                              | 318            | 837            |
| Selling , general and administration       | 276            | 686            |
| Depreciation and amortization              | 215            | 329            |
|  | <b>809</b>     | 1,852          |
| Loss from operations before the undernoted | (636)          | (1,210)        |
| Interest expenses                          | (90)           | (96)           |
| Exchange gains (losses)                    | 1              | (326)          |
| Impairment of assets held for sale         | (3,487)        | —              |
| Other income                               | —              | 3              |
| Loss before income taxes                   | (4,212)        | (1,629)        |
| Provision for income taxes                 | (705)          | (1,087)        |
| Net loss from discontinued operations      | <b>(4,917)</b> | <b>(2,716)</b> |

Assets and liabilities of discontinued operations consist of the following:

|   | March 31,<br>2009<br>\$ | December 31,<br>2008<br>\$ |
|---|-------------------------|----------------------------|
| <b>Assets of discontinued operations</b>                  |                         |                            |
| Accounts receivables                                      | 68                      | 703                        |
| Inventories   | 1,724                   | 2,155                      |
| Prepaid expenses and others                               | 1,345                   | 676                        |
| Assets held for sale                                      | 24,813                  | 27,588                     |
|   | <b>27,950</b>           | 31,122                     |
| <b>Liabilities of discontinued operations</b>             |                         |                            |
| Bank indebtedness   | 5,968                   | 5,970                      |
| Accounts payable and accrued liabilities <i>[note 13]</i> | 24,062                  | 26,034                     |
|   | <b>30,030</b>           | 32,004                     |

The statements of cash flows of discontinued operations are as follows:

| Three months ended March 31,            | 2009<br>\$   | 2008<br>\$ |
|---|--------------|------------|
| Cash flows used in operating activities | 2,789        | 1,905      |
| Cash flows used in investing activities | 929          | —          |
| Cash flows used in financing activities | 1            | 348        |
|   | <b>3,719</b> | 2,253      |

The other comprehensive income of the discontinued operations for the three months ended March 31, 2009 and 2008 are insignificant.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

**8. BUSINESS ACQUISITION**

In January 2008, the Company completed the acquisition of 100% of the equity interests of a limited company incorporated in the PRC for cash, which is principally engaged in the greenery and nursery operations.

The acquisition has been accounted for by the purchase method. The fair values of net assets acquired were as follows:

|  | \$           |
|--|--------------|
| Cash and bank balances                   | 132          |
| Accounts receivable                      | 989          |
| Other receivables                        | 458          |
| Inventories                              | 751          |
| Capital assets                           | 318          |
| License [a]                              | 636          |
| Accounts payable and accrued liabilities | (1,224)      |
| <b>Purchase price</b>                    | <b>2,060</b> |

[a] The purchase price in excess of the net tangible assets acquired of \$636,000 was allocated to the identified intangible asset, being the license. The license enables the Company to tender for greenery projects in the PRC. The fair value of the license was based on the related discounted cash flows. The license is not amortized as it does not have a definite useful life.

**9. LONG-TERM DEBT**

Long-term debt consists of the following:

|                                      | March 31,<br>2009 | December 31,<br>2008 |
|--------------------------------------|-------------------|----------------------|
|                                      | \$                | \$                   |
| Senior Notes [a]                     | <b>300,000</b>    | 300,000              |
| Syndicated Loans [b]                 | <b>150,000</b>    | 150,000              |
| Convertible Senior Notes [c]         | <b>280,250</b>    | 277,391              |
| Unamortized deferred financing costs | <b>(12,177)</b>   | (12,923)             |
|                                      | <b>718,073</b>    | 714,468              |
| Less: Current portion                | <b>(12,500)</b>   | —                    |
|                                      | <b>705,573</b>    | 714,468              |

[a] On August 17, 2004, the Company issued \$300,000,000 non-convertible guaranteed senior notes (the "Senior Notes"). The Senior Notes bear interest at a rate of 9.125% per annum and payable semi-annually. The Senior Notes mature on August 17, 2011. The Senior Notes are:

- general obligations of the Company;
- guaranteed by the Subsidiary Guarantors (as defined in the indenture which governs the Senior Notes) on a senior basis subject to certain limitations;
- senior in right of payment to any existing and future obligations of the Company which are expressly subordinated in right of payment to the noteholders;
- at least *pari passu* in right of payment with all other unsecured, unsubordinated indebtedness of the Company subject to any priority rights of such unsubordinated indebtedness pursuant to applicable law; and
- secured by pledge of the shares of the Subsidiary Guarantors.

On August 16, 2004, the Company entered into a currency swap contract. Under the terms of the contract, the Company hedged RMB113,290,070 on each of August 17 and February 17 in exchange

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

for \$13,687,500. The U.S. dollars will be used to fully pay the Company's interest payments on the \$300,000,000 Senior Notes due on those dates. The term of the contract is five years. Management estimates that a loss of \$2,916,000 [December 31, 2008 – \$5,214,000], being the fair value of the contract, would be realized if the contract was terminated on March 31, 2009. The change in fair value of \$593,000 [2008 – \$2,514,000] has been recorded in loss on changes in fair value of financial instruments in the statements of income and retained earnings.

The derivative financial instrument was classified as current liabilities as at March 31, 2009.

Total interest expense on the Senior Notes for the three months ended March 31, 2009 was \$7,196,000 [2008 – \$7,164,000].

- [b] On February 24, 2006, the Company entered into a \$150 million syndicated term loan facility. The facility carries an interest margin of between 0.80% and 1.50% over LIBOR per annum, depending on the Company's ratio of consolidated total debt to consolidated EBITDA, with the current margin bearing 1.1% per annum. EBITDA is defined as consolidated net income plus consolidated interest expense, income taxes, depreciation expense, amortization and all other non-cash items reducing consolidated net income (except depletion of timber holdings) less all non-cash items increasing consolidated net income. The facility is guaranteed by the Subsidiary Guarantors and ranks at least *pari passu* with the claims of all other unsecured, unsubordinated creditors of the Company and the Subsidiary Guarantors, subject to any priority rights pursuant to applicable law. The facility will be primarily used for the acquisition of additional standing timber and logs, and for general corporate purposes. Principal of \$37,500,000 will be repayable in 2010 and the remaining balance in 2011. As at March 31, 2009, principal of \$12,500,000 [December 31, 2008 – \$nil] was reclassified to current portion of long-term debt.

Total interest expense on the syndicated loans for the three months ended March 31, 2009 was \$1,450,000 [2008 – \$2,408,000].

- [c] On July 17, 2008, the Company closed an offering of convertible guaranteed senior notes (the "Convertible Notes") for gross proceeds of \$300,000,000. The Convertible Notes will mature on August 1, 2013 and bear interest at a rate of 5.0% per annum and payable semi-annually. The Convertible Notes are convertible into common shares of the Company, at the option of the holder, at any time prior to the maturity date at an initial conversion rate of 49.2974 common shares per \$1,000 principal amount of Convertible Notes. If a Fundamental Change, as defined in the indenture which governs the Convertible Notes, occurs prior to the maturity date, the Company will be required to make an offer to each holder to purchase for cash all or a portion of the Convertible Notes at the holder's option and the conversion rate may be adjusted. Upon conversion without a Fundamental Change, at the Company's option, the Company may elect to deliver, in lieu of common shares of the Company, cash or a combination of cash and common shares of the Company.

On August 5, 2008, the Company issued an additional \$45,000,000 of the Convertible Notes pursuant to the exercise of the over-allotment option granted to the underwriters in connection with the offering, increasing the gross proceeds to \$345,000,000. The Company has allocated \$272,621,000 of the face value of the Convertible Notes to the liability component and \$72,379,000 to the equity component. The fair value of the liability component was estimated by discounting the future payments of interest and principal and will be accreted to the \$345,000,000 face value using the estimated effective interest rate of 11.1%. The residual carrying value of \$70,462,000, net of issue cost, attributed to the equity component of the Convertible Notes was classified as equity component of convertible notes. The total issue cost of \$9,135,000 has been prorated against the liability and equity components. The Convertible Notes are:

- general senior unsubordinated obligations of the Company;
- guaranteed by the Subsidiary Guarantors (as defined in the indenture which governs the Convertible Notes) on a senior basis subject to certain limitations;

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

- senior in right of payment to any existing and future obligations of the Company which are expressly subordinated in right of payment to the noteholders;
- at least *pari passu* in right of payment with all other unsecured, unsubordinated indebtedness of the Company subject to any priority rights of such unsubordinated indebtedness pursuant to applicable law; and
- effectively subordinated to all existing and future obligations of the Initial Non-Guarantor Subsidiaries (as defined in the indenture which governs the Convertible Notes).

Total interest expense of the Convertible Notes for the three months ended March 31, 2009 was \$7,290,000 [2008 – \$nil].

- [d] Under the terms of the above debt agreements in [a] and [b], the Company has met the financial and non-financial covenants affecting the Company and the restricted subsidiaries (as defined in the debt agreements), including limitation on dividend and other payment restrictions; short-term borrowings and letters of credit or similar instruments not to exceed \$100,000,000.

**10. SHARE CAPITAL**

Share capital consists of the following:

|  | <b>Three months ended<br/>March 31, 2009</b> |  | Twelve months ended<br>December 31, 2008 |                                  |
|--|--|--|--|----------------------------------|
|  | <b>Number of<br/>Common<br/>Shares</b>       | <b>Common<br/>Share<br/>Capital<br/>\$</b> | Number of<br>Common<br>Shares            | Common<br>Share<br>Capital<br>\$ |
| <b>Authorized</b>  |  |  |  |                                  |
| Unlimited common shares, without par value                         |  |  |  |                                  |
| Unlimited preference shares, issuable in series, without par value |  |  |  |                                  |
| <b>Issued</b>  |  |  |  |                                  |
| Balance, beginning of period                                       | <b>183,119,072</b>                           | <b>539,315</b>                             | 182,592,961                              | 537,141                          |
| Issue of shares  | <b>2,659,990</b>                             | <b>21,706</b>                              | —  | —                                |
| Exercise of options  | —  | —  | 526,111                                  | 1,591                            |
| Transfer from contributed surplus                                  | —  | —  | —  | 583                              |
| <b>Balance, end of period</b>                                      | <b>185,779,062</b>                           | <b>561,021</b>                             | 183,119,072                              | 539,315                          |

In February 2009, the Company completed the issuance of 2,659,990 common shares to acquire approximately \$21,700,000 (equivalent to approximately HK\$167,631,000) 4% secured convertible bonds of Omnicorp.



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

In January and March 2009, options to acquire up to 654,618 common shares were granted to executives and employees at exercise prices ranging from Cdn.\$8.01 to Cdn.\$10.12. The options granted will vest over one to three years and expire in five years. The total fair value of the stock options granted was estimated to be \$2,219,000 on the respective dates of grant using the Black Scholes option-pricing model with the following assumptions:

|  | January 5, 2009 | March 10, 2009 | March 31, 2009 |
|--|-----------------|----------------|----------------|
| Number of options (in number)                                | 75,000          | 75,000         | 504,618        |
| Exercise price (in Cdn.\$)                                   | \$10.12         | \$8.20         | \$8.01         |
| Date of expiry   | January 5, 2014 | March 10, 2014 | March 31, 2014 |
| Dividend Yield   | 0.0%            | 0.0%           | 0.0%           |
| Volatility   | 60.2%           | 60.8%          | 58.7%          |
| Risk-free interest rate                                      | 1.61%           | 1.85%          | 1.69%          |
| Option's expected life (in years)                            | 5.0             | 5.0            | 5.0            |
| Weighted average fair value of each option (in U.S. dollars) | \$4.41          | \$3.35         | \$3.24         |

As at March 31, 2009, outstanding options to purchase 1,007,041 common shares remain available to be granted.

**Deferred Stock Unit Plan**

On March 10, 2009, the Company approved a non-executive directors' Deferred Stock Unit Plan ("DSU Plan"), which became effective on March 31, 2009. Under the DSU Plan, non-executive directors of the Company shall receive their annual retainer (but not in substitution for) in the form of deferred stock unit awards ("DSUs") and may elect to receive all or a part of their annual retainer in the form of DSUs. On the last business day of each quarter of the Company's fiscal year, such number of DSUs is equal to: (a) 25% of the aggregate of: (i) the annual awarded amount as determined by the Committee (which shall initially be equal to the amount of annual retainer fees earned by the respective non-executive director); and (ii) the amount of annual retainer fees, if any, that such non-executive director has elected to receive in the form of DSUs; divided by (b) the Fair Market Value (as defined in the DSU Plan as the closing price of the common shares on the Toronto Stock Exchange), and shall be credited to the participants deferred stock unit account. The DSUs can be redeemed for cash or, at the election of the non-executive director, in the form of common shares acquired by the Company on the open market on such director's behalf through an independent broker, when the holder ceases to be a director of the Company. As of March 31, 2009, no DSUs have been granted.

**11. CONTRIBUTED SURPLUS**

The contributed surplus represents stock-based compensation and options granted over the vesting period which was charged to the statements of income and retained earnings.

|                                     | Three months ended<br>March 31, 2009 | Twelve months ended<br>December 31, 2008 |
|-------------------------------------|--------------------------------------|--|
|                                     | \$                                   | \$                                       |
| Balance, beginning of period        | 7,599                                | 3,906                                    |
| Stock-based compensation            | 1,086                                | 4,276                                    |
| Transfer to share capital [note 10] | —                                    | (583)                                    |
| <b>Balance, end of period</b>       | <b>8,685</b>                         | <b>7,599</b>                             |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

**12. ACCUMULATED OTHER COMPREHENSIVE INCOME**

The changes in accumulated other comprehensive income were as follows:

|                                     | 2009           | 2008           |
|-------------------------------------|----------------|----------------|
|                                     | \$             | \$             |
| Three months ended March 31,        |                |                |
| Balance, beginning of period        | 211,831        | 105,287        |
| Other comprehensive (losses) income | (1,946)        | 61,797         |
| <b>Balance, end of period</b>       | <b>209,885</b> | <b>167,084</b> |

Accumulated other comprehensive income comprises the following amounts:

|   | March 31,<br>2009 | December 31,<br>2008 |
|---|-------------------|----------------------|
|   | \$                | \$                   |
| Unrealized gains on translation of financial statements of self-sustaining foreign operations | 213,327           | 214,063              |
| Unrealized losses on financial assets designated as available-for-sale, net of tax of nil     | (3,442)           | (2,232)              |
| <b>Balance, end of period</b>   | <b>209,885</b>    | <b>211,831</b>       |

Unrealized translation adjustments arise on the translation to U.S. dollars of assets and liabilities of the Company's self-sustaining foreign operations. For the three months ended March 31, 2009, the Company incurred unrealized foreign currency translation losses of \$736,000 [2008 – gains of \$62,746,000], primarily from the weakening of Renminbi against U.S. dollars.

**13. PROVISION FOR TAX RELATED LIABILITIES**

The Company's operating subsidiaries incorporated in the British Virgin Islands (the "BVI Subsidiaries") are engaged in the sale of standing timber and earning income ("Authorized Sales Activities") in the PRC through authorized intermediaries ("AI") that are domestic enterprises of the PRC. In accordance with the PRC laws and regulations relating to PRC enterprise income tax, foreign companies such as the BVI Subsidiaries, deriving income from sources in the PRC are subject to enterprise income tax. This also applied to income and commission revenue that the BVI Subsidiaries received from the sale of wood chips in prior years. The wood chips and commission operations were discontinued in 2007.

Under the terms of the master agreements, relevant sales and purchase contracts and commission agreements ("AI Agreements") made with the AI, the AI are responsible for remitting relevant PRC taxes that arise from the Authorized Sales Activities. It is a question of fact whether the PRC tax authorities may be successful in establishing that the BVI Subsidiaries are subject to enterprise income tax due to the Authorized Sales Activities. Management has concluded that based upon all available evidence it is appropriate to record in the accounts a reserve for tax benefits representing management's estimate, based upon cumulative probabilities, of the amount the PRC tax authorities might seek to recover.

Included in accounts payable and accrued liabilities including discontinued operations as at March 31, 2009 is the balance of the tax provision for the tax related contingency amounting to \$95,876,000 [December 31, 2008 – \$89,909,000] provided on the profits of the Authorized Sales Activities earned by the BVI Subsidiaries for the current three months and in the four previous years.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

**14. EARNINGS PER SHARE**

Earnings per share from continuing operations are calculated as follows:

| Three months ended March 31,                                 | Earnings<br>\$'000 | 2009<br>Weighted<br>average no.<br>of shares<br>'000 | Earnings<br>per share<br>\$ | Earnings<br>\$'000 | 2008<br>Weighted<br>average no.<br>of shares<br>'000 | Earnings<br>per share<br>\$ |
|--|--------------------|--|-----------------------------|--------------------|--|-----------------------------|
| Net income from continuing operations                        | 27,922             | —  |                             | 17,243             | —  |                             |
| Weighted average number of shares outstanding                | —                  | 184,715  |                             | —                  | 182,593  |                             |
| <b>Basic earnings per share from continuing operations</b>   | <b>27,922</b>      | <b>184,715</b>                                       | <b>0.15</b>                 | 17,243             | 182,593  | 0.09                        |
| Effect of dilutive securities:                               |                    |  |                             |                    |  |                             |
| - stock options  | —                  | 1,005  |                             | —                  | 1,899  |                             |
| - convertible senior notes                                   | 7,290              | 17,008   |                             | —                  | —  |                             |
|  | 35,212             | 202,728  |                             | 17,243             | 184,492  |                             |
| Deduct anti-dilutive impact:                                 |                    |  |                             |                    |  |                             |
| - convertible senior notes                                   | (7,290)            | (17,008)   |                             | —                  | —  |                             |
| <b>Diluted earnings per share from continuing operations</b> | <b>27,922</b>      | <b>185,720</b>                                       | <b>0.15</b>                 | 17,243             | 184,492  | 0.09                        |

**15. STATEMENTS OF CASH FLOWS**

The net change in non-cash working capital balances comprises the following:

| Three months ended March 31,                 | 2009<br>\$    | 2008<br>\$      |
|--|---------------|-----------------|
| <b>Cash provided by (used for):</b>          |               |                 |
| Accounts receivable                          | 94,133        | (22,710)        |
| Inventories                                  | (3,765)       | (2,949)         |
| Prepaid expenses and other                   | (5,629)       | (2,402)         |
| Accounts payable and accrued liabilities [a] | (16,555)      | (2,762)         |
| Income taxes payable                         | 244           | 457             |
|  | <b>68,428</b> | <b>(30,366)</b> |

[a] As at March 31, 2009, the Company had an aggregate amount of \$45,192,000 [December 31, 2008 – \$27,948,000] payable in respect of timber holdings during the period which was included in accounts payable and accrued liabilities. In addition, certain additions of capital assets and plantation investments of approximately \$2,191,000 were transferred from other assets during the period ended March 31, 2009.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

**16. FINANCIAL INSTRUMENTS**

Under Canadian generally accepted accounting principles, all financial instruments must be classified into a defined category, namely, held-to-maturity investments, held-for-trading financial assets or financial liabilities, loans and receivables, available-for-sale financial assets, and other financial liabilities. The carrying values of the Company's financial instruments are classified into the following categories:

|  | <b>March 31,<br/>2009</b> | December 31,<br>2008 |
|--|---------------------------|----------------------|
|  | <b>\$</b>                 | <b>\$</b>            |
| Held for trading [a]                   | <b>413,416</b>            | 486,955              |
| Loans and receivables [b]              | <b>175,258</b>            | 248,232              |
| Available for sale assets [c]          | <b>5,956</b>              | 2,874                |
| Other financial liabilities [d]        | <b>908,150</b>            | 903,654              |
| Derivative (foreign currency swap) [e] | <b>2,916</b>              | 5,214                |
| Embedded derivative [f]                | <b>586</b>                | 249                  |

- [a] Cash and cash equivalents and short-term deposits, measured at fair value.  
 [b] Accounts receivable in continuing and discontinued operations, subordinated loans and convertible bonds are measured at amortized cost.  
 [c] Investment in Omnicorp is measured at fair value; investments in Greenheart and Mandra Holdings are measured at cost.  
 [d] Bank indebtedness, accounts payable and accrued liabilities in continuing and discontinued operations, excluding provision for tax related liabilities, and long-term debts are measured at amortized cost.  
 [e] Foreign currency swap contract is measured at fair value.  
 [f] Conversion option embedded in convertible bonds is measured at fair value.

***Fair value of financial instruments***

The fair value of financial instruments represents the amounts that would have been received from or paid to counterparties to settle these instruments. The carrying amount of all financial instruments classified as current approximates their fair value because of the short maturities and normal trade terms of these instruments. The fair value of syndicated loans approximate their carrying values. The fair value of other financial instruments disclosed in the financial statements are based on the Company's best estimates using present value, quoted market prices and other valuation techniques that are significantly affected by the assumptions used concerning the amounts and timing of estimated cash flows and discount rates which reflect varying degrees of risk.

The fair value of the Senior Notes and Convertible Notes are based on quoted market prices. The Company has no plans to prepay these instruments prior to maturity. The fair value and carrying amounts of the Senior Notes as at March 31, 2009 were \$277,500,000 and \$300,000,000, respectively [December 31, 2008 – \$195,000,000 and \$300,000,000, respectively]. The fair value and carrying amounts of Convertible Notes as at March 31, 2009 were \$244,950,000 and \$280,250,000, respectively. The fair value of the Convertible Notes approximated their carrying values as at December 31, 2008.

***Foreign currency swap contract and convertible bonds***

The Company uses financial instruments, including variable rate debts, to finance its operations and to manage risks associated with its interest rate risk. With respect to the Senior Notes, the Company has entered into a currency swap agreement to meet interest payments at \$27.4 million per annum. The Company does not otherwise engage in other hedging transactions with respect to its foreign exchange risk or interest rate risk.

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

The Company has convertible bonds issued by Omnicorp which will mature on November 9, 2009. The Company is required to bifurcate the embedded conversion option and account for it as a derivative asset. The change in fair value of these financial instruments for the three months ended March 31, 2009 was an unrealized loss of \$388,000 [2008 – \$2,021,000] which has been charged to the statements of income and retained earnings.

### ***Risks arising from financial instruments and risk management***

The Company is exposed to various types of market risks, including changes in foreign exchange rates, interest rates and the prices of wood-based products and standing timber, in the normal course of business. The Company's overall risk management program focuses on mitigating these risks on a cost-effective basis. The Company uses derivative financial instruments to reduce its exposure to foreign currency risk associated with its long-term debts. The Company's policy is to use derivatives for managing existing financial exposures and not for trading or speculative purposes.

### ***Exchange Rate Risk***

The Company conducts its business primarily in Renminbi, and partly in U.S. dollars and Hong Kong dollars. For the three months ended March 31, 2009 and 2008, 80.8% and 87.3% of the sales were received in Renminbi respectively and 19.2% and 12.7% of the sales were received in U.S. dollars and Euro respectively. The Company translates its results of self-sustaining foreign operations into U.S. dollars using the current rate method. It is expected in the future that substantially all of the sales will be received in Renminbi. The majority of the Company's operating expenses are denominated in Renminbi and Hong Kong dollars. Substantial exposure to currency risk is on its net investment in self-sustaining foreign operations, for which foreign currency translation gains or losses have been recorded under accumulated other comprehensive income.

A portion of the Company's revenue in Renminbi is converted into other currencies to meet financial obligations denominated in currencies other than Renminbi. The Company has a substantial amount of indebtedness denominated in U.S. dollars. Foreign currency based earnings are translated into U.S. dollars each period. As a result, fluctuations in the value of the U.S. dollar relative to other currencies will impact reported net income. Such exchange rate fluctuations have historically not been material year over year relative to the overall earnings or financial position of the Company. A fluctuation of +/-1%, provided as an indicative range in currency movement, on financial instruments that are denominated in foreign currency other than U.S. dollars, would, everything else being equal, have an effect on net income after tax and other comprehensive income for the three months ended March 31, 2009 of approximately \$5.1 million and \$nil, respectively.

Many foreign currency exchange transactions involving Renminbi, including foreign exchange transactions under the Company's capital account, are subject to foreign exchange controls and require the approval of the PRC State Administration of Foreign Exchange. Developments relating to the PRC's economy and actions taken by the PRC government could cause future foreign exchange rates to vary significantly from current or historical rates. The Company cannot predict nor give any assurance of its future stability. Future fluctuations in exchange rates may adversely affect the value, translated or converted into U.S. dollars of the Company's net assets, net profits and any declared dividends. The Company cannot give any assurance that any future movements in the exchange rates of Renminbi against the U.S. dollar and other foreign currencies will not adversely affect its results of operations, financial condition and cash flows.

As of March 31, 2009, the Company had Renminbi denominated bank accounts of RMB437.4 million (equivalent to \$64.0 million) [December 31, 2008 – RMB531.5 million, equivalent to \$77.8 million], U.S. dollar denominated bank accounts of \$347.5 million [December 31, 2008 – \$403.1 million], Canadian dollar denominated bank accounts of Cdn.\$1.9 million (equivalent to \$1.5 million) [December 31, 2008 – Cdn.\$5.4 million, equivalent to \$4.4 million], Hong Kong dollar denominated bank accounts of HK\$2.7 million (equivalent to \$0.4 million) [December 31, 2008 – HK\$0.8 million, equivalent to \$0.1 million] and Euro denominated bank accounts of €15,000 (equivalent to \$20,000) [December 31, 2008 – €1.1 million,

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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equivalent to \$1.6 million]. The Company also had U.S. dollar denominated accounts receivable of \$15.3 million [December 31, 2008 – \$15.2 million] and Renminbi denominated accounts receivable of RMB791.3 million (equivalent to \$115.8 million) [December 31, 2008 – RMB1,444.0 million, equivalent to \$211.3 million].

The Company mainly incurred U.S. dollar denominated debt for capital expenditures primarily relating to the development and acquisition of its forestry plantations and investment in its manufacturing plants. If the U.S. dollar fluctuates against any of these currencies, it would correspondingly affect the repayment costs on these debts.

**Credit Risk**

The Company is exposed to credit risk with respect to accounts receivable from customers. Accounts receivable as at March 31, 2009 included \$47,191,000 due from three customers [December 31, 2008 – \$79,058,000 due from three customers] representing 36.0% [2008 – 34.9%] of outstanding receivables. The Company undertakes credit evaluations on customers as necessary and has monitoring processes intended to mitigate credit risks and maintain appropriate provisions for potential credit losses. Historically the Company has made arrangements with its debtors to settle amounts payable with respect to the purchase of standing timber on behalf of the Company. As at March 31, 2009, \$38,550,000 [December 31, 2008 – \$27,444,000] or 29.4% [December 31, 2008 – 12.1%] of accounts receivable, were aged more than 90 days. The Company has no significant allowance for doubtful accounts for the three months ended March 31, 2009.

The Company is exposed to credit risk with respect to cash equivalents and accounts receivable. The carrying amount of assets included on the balance sheet represents the maximum credit exposure.

The cash equivalents consist mainly of short-term investments, such as money market deposits. None of the cash equivalents were in asset backed commercial paper products. The Company has deposited the cash equivalent in banks that meet minimum requirements for quality and liquidity as stipulated by the Company's Board of Directors. Management believes the risk of loss to be remote.

**Liquidity Risk**

Liquidity risk is the risk that the Company may encounter difficulties in meeting obligations associated with financial liabilities. The Company's growth strategy requires significant financial resources which are derived from cash flows provided by operations, additional debt, the issuance of equity or a combination thereof. As at March 31, 2009, the Company was holding cash and cash equivalents of \$367.0 million. The Company has determined that continued cash flow from operations in fiscal 2009 together with the cash and cash equivalents from previous financings will be more than sufficient to fund its requirements for investments in working capital, timber holdings and capital assets.

The following is an analysis of the contractual maturities of the Company's financial liabilities as at March 31, 2009:

|   | Payment Due by Period    |                                       |                                       |                               | Total<br>\$    |
|---|--------------------------|---------------------------------------|---------------------------------------|-------------------------------|----------------|
|   | Within<br>one year<br>\$ | In the second<br>and third year<br>\$ | In the fourth<br>and fifth year<br>\$ | After the<br>fifth year<br>\$ |                |
| Bank indebtedness <sup>(1)</sup>                              | <b>81,461</b>            | —                                     | —                                     | —                             | <b>81,461</b>  |
| Accounts payable and accrued<br>liabilities <sup>(1)(2)</sup> | <b>108,616</b>           | —                                     | —                                     | —                             | <b>108,616</b> |
| Long-term debt <sup>(3)</sup>                                 | <b>12,500</b>            | <b>431,901</b>                        | <b>273,672</b>                        | —                             | <b>718,073</b> |
|   | <b>202,577</b>           | <b>431,901</b>                        | <b>273,672</b>                        | —                             | <b>908,150</b> |

(1) Including continuing and discontinued operations.

(2) Excluding the tax provision for tax related contingency.

(3) Including current portion of long-term debt.

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[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

### ***Interest Rate Risk***

The Company is exposed to interest rate risk resulting from fluctuations in interest rates on its debts, primarily on its bank indebtedness and syndicated notes. Upward fluctuations in interest rates increase the cost of new debt and the interest cost of outstanding variable rate borrowings and financial instruments. As at March 31, 2009, \$191 million or 23.9% of the Company's total debt is subject to variable in interest rates. A +/-1% change in interest rates, which is indicative of the change in the prime lending rate over the preceding twelve-month period, would have an impact on income after taxes for the year of approximately \$1.0 million. The Company does not currently use any derivative instruments to modify the nature of its debts so as to manage its interest rate risk. The Company minimizes its interest rate risk by managing its portfolio of variable and fixed rate debt, as well as managing the term to maturity.

The Company is also exposed to interest rate risk on cash equivalents. The Company does not use financial instruments to mitigate this risk.

### ***Commodity Price Risk***

The Company is exposed to fluctuations in the prices of standing timber and wood-based products. The Company imports wood-based products from suppliers outside of China. Such purchases are made at market prices. In addition, all the sales of standing timber and wood-based products are made at market prices. Therefore, fluctuations in the prices of standing timber and wood-based products have a significant effect on the Company's business, results of operations, financial condition and cash flows.

The Company does not enter into any futures contracts to hedge its sales or purchases of standing timber and wood-based products.

## **17. CAPITAL MANAGEMENT**

The Company's objectives in managing capital are to maintain an optimal capital structure to reduce the overall cost of capital and to safeguard the Company's ability to continue to deploy capital to pursue its strategy of growth and provide returns to shareholders and other stakeholders.

In the management of capital, the Company includes bank indebtedness of \$81,461,000 (including discontinued operations of \$5,968,000), long-term debt of \$718,073,000 and shareholders' equity of \$1,642,615,000. The Board of Directors does not establish a quantitative return on capital criteria for management but promotes year-over-year sustainable earnings growth targets. The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. There were no changes in the Company's approach to capital management during the period.

The Company is subject to externally imposed minimum capital requirements relating to the bank credit facilities, senior notes and syndicated loans and exceeds the minimum requirements during the period. The Company's capital is subject to PRC foreign currency exchange controls which may limit the ability to repatriate funds. As at March 31, 2009, the Company has retained earnings of approximately \$793 million in the PRC which may be restricted.

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[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

### **18. SEGMENTED INFORMATION**

The Company's segmented information is presented by industry. In determining the Company's geographical segments, revenues are attributed to the segments based on the location of the customers, and assets are attributed to the segments based on the location of the assets.

The Company's operating businesses are structured and managed separately, according to the nature of their operations and the products and services they provide. Each of the Company's industry segments represents a strategic business unit that offers products and services which are subject to risks and returns that are different from those of the other industry segments. The segments were organized to reflect the Company's role as a key wood fibre supplier and provider of value-added wood products through its manufacturing operations. Summary details of the industry segments are as follows:

- [a] the plantation fibre segment engages in the sale of standing timber and harvested logs;
- [b] the other fibre segment engages in the sale of domestic and imported wood products; and
- [c] the manufacturing segment engages in the sale of manufacturing operation's products and other.

Corporate assets, corporate income and costs are included in the Company's corporate segment to differentiate its risks and returns from other business segments.



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

By Industry Segment

|  | March 31, 2009            |                      |                     |                 |             |
|--|---------------------------|----------------------|---------------------|-----------------|-------------|
|  | Plantation<br>Fibre<br>\$ | Other<br>Fibre<br>\$ | Manufacturing<br>\$ | Corporate<br>\$ | Total<br>\$ |
| <b>Revenue</b>   |                           |                      |                     |                 |             |
| Sale of standing timber and harvested logs   | 127,968                   | —                    | —                   | —               | 127,968     |
| Sale of imported wood products   | —                         | 37,681               | —                   | —               | 37,681      |
| Sale of wood logs  | —                         | 77                   | —                   | —               | 77          |
| Sale of manufacturing operations' products and other   | —                         | —                    | 11,508              | —               | 11,508      |
|  | 127,968                   | 37,758               | 11,508              | —               | 177,234     |
| Income (loss) from continuing operations before interest, other income, exchange losses and changes in fair value of financial instruments | 62,189                    | 897                  | (4,934)             | (8,560)         | 49,592      |
| Net loss from discontinued operations  | —                         | 705                  | 4,212               | —               | 4,917       |
| Interest income  | 37                        | 279                  | 276                 | 1,312           | 1,904       |
| Interest expense   | 194                       | 373                  | 289                 | 15,939          | 16,795      |
| Depreciation and amortization  | 101                       | 56                   | 925                 | 47              | 1,129       |
| Provision for income taxes   | 5,283                     | 546                  | 97                  | —               | 5,926       |
| Identifiable assets  | 2,003,114                 | 284,409              | 294,173             | 74,487          | 2,656,183   |
| Depletion of timber holdings included in cost of sales   | 64,205                    | —                    | —                   | —               | 64,205      |
| Additions to timber holdings and capital assets  | 251,512                   | 80                   | 4,946               | 21              | 256,559     |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

|  | March 31, 2008            |                      |                     |                 |             |
|--|---------------------------|----------------------|---------------------|-----------------|-------------|
|  | Plantation<br>Fibre<br>\$ | Other<br>Fibre<br>\$ | Manufacturing<br>\$ | Corporate<br>\$ | Total<br>\$ |
| <b>Revenue</b>   |                           |                      |                     |                 |             |
| Sale of standing timber and harvested logs   | 102,670                   | —                    | —                   | —               | 102,670     |
| Sale of imported wood products   | —                         | 24,064               | —                   | —               | 24,064      |
| Sale of wood logs  | —                         | 123                  | —                   | —               | 123         |
| Sale of manufacturing operations' products and other   | —                         | —                    | 8,638               | —               | 8,638       |
|  | 102,670                   | 24,187               | 8,638               | —               | 135,495     |
| Income (loss) from continuing operations before interest, other income, exchange losses and changes in fair value of financial instruments | 45,133                    | 370                  | (3,980)             | (5,757)         | 35,766      |
| Net loss from discontinued operations  | —                         | 1,087                | 1,629               | —               | 2,716       |
| Interest income  | 166                       | 66                   | 505                 | 2,144           | 2,881       |
| Interest expense   | 151                       | 487                  | 263                 | 9,574           | 10,475      |
| Depreciation and amortization  | 63                        | 11                   | 555                 | 43              | 672         |
| Provision for income taxes   | 3,850                     | 117                  | 252                 | 55              | 4,274       |
| Identifiable assets  | 1,448,940                 | 81,443               | 221,166             | 163,489         | 1,915,038   |
| Depletion of timber holdings included in cost of sales   | 37,158                    | —                    | 896                 | —               | 38,054      |
| Additions to timber holdings and capital assets  | 82,364                    | 5                    | 9,761               | 25              | 92,155      |

*By Geographic Segment*

The Company conducts substantially all of its operations in PRC. During the three months ended March 31, 2009, sales to customers in the PRC and other countries amounted to approximately \$176,189,000 [March 31, 2008 – \$135,747,000] and \$1,218,000 [March 31, 2008 – \$390,000], respectively.

As at March 31, 2009, all of the Company's timber holdings and approximately \$91,573,000 [December 31, 2008 – \$90,525,000] of the Company's capital assets and assets held for sale in discontinued operations were located in the PRC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

### 19. CAPITAL CONTRIBUTIONS AND COMMITMENTS

Capital contributions and commitments for the Company's principal business activities are as follows:

#### [a] Capital contributions

As at March 31, 2009, the Company has capital commitments in respect of capital contributions to our WFOEs of \$44,250,000 [December 31, 2008 – \$75,000,000].

#### [b] Capital commitments

As at March 31, 2009, the Company has capital commitments with respect to buildings and plant and machinery of \$8,935,000 [December 31, 2008 – \$15,020,000].

#### [c] Purchase commitments

As at March 31, 2009, the Company has purchase commitments mainly regarding logs of \$3,019,000 [December, 31 2008 – \$6,400,000].

#### [d] Operating leases

Commitments under operating leases for land and buildings are as follows:

|                     | \$     |
|---------------------|--------|
| 2009                | 3,046  |
| 2010                | 2,454  |
| 2011                | 2,338  |
| 2012                | 2,106  |
| 2013                | 1,747  |
| 2014 and thereafter | 43,537 |
|                     | 55,228 |

#### [e] Wood fibre

Under the master agreement entered in July 2006 to secure at least 1.5 million m<sup>3</sup> of wood fibre annually over a 12-year period in Inner Mongolia, the Company has acquired 17,000 m<sup>3</sup> of wood fibre as at March 31, 2009.

Under the master agreements entered in September and December 2006 to acquire 400,000 hectares of plantation trees over a 14-year period in Hunan, the Company has acquired 112,940 hectares of plantation trees for \$450,170,000 as at March 31, 2009.

Under the master agreement entered in March 2007 to acquire 200,000 hectares of plantation trees over a 10-year period in Yunnan, the Company has acquired 53,115 hectares of plantation trees for \$274,283,000 as at March 31, 2009.

Under the master agreement entered in December 2007 to acquire 150,000 hectares of plantation trees over a 5-year period in Guangxi, the Company has acquired 79,092 hectares of plantation trees for \$361,265,000 as at March 31, 2009.

Under the master agreement entered in August 2008 to acquire 200,000 hectares of plantation trees over a 10-year period in Fujian, the Company has not acquired any hectares of plantation trees as at March 31, 2009.

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

[Tabular figures expressed in thousands of United States dollars, unless otherwise indicated.] [Unaudited]

### **20. CONTINGENCIES FOR TAX RELATED LIABILITIES**

The provision for income taxes and tax related liabilities and whether tax filings are required is subject to a number of different factors, estimates and judgment made by management. A change in the facts and these estimates and judgment could have a material impact on the Company's tax expense. The Company has operations in various countries (mainly in the PRC, Canada and Hong Kong) that have different tax laws and rates and are subject to audit by all relevant tax authorities. The effective tax rate may change from year to year based on the mix of income among the different tax jurisdictions in which the Company operates, changes in tax laws in these jurisdictions, and changes in tax treaties between various tax jurisdictions in which the Company operates. It is possible that profits already taxed by one tax jurisdiction could be taxed by another tax jurisdiction or multiple jurisdictions. Should the PRC tax authorities recover income tax, business tax and value-added tax directly from the BVI Subsidiaries, they might do so together with related tax surcharges and tax penalties on applicable income or profits of the Authorized Sales Activities from the BVI Subsidiaries for up to a period from three to five years in practice. Under prevailing PRC tax rules, the tax surcharge is calculated at 0.05% per day on the tax amount overdue while the tax penalties can range from 50% to 500% of taxes underpaid. Under the Hong Kong tax regulations, assessments are open for up to six years in practice and tax penalties can be up to treble amount of the tax underpaid.

Significant estimates and judgment are applied by management to determine the appropriate amount of tax related liabilities and contingencies for tax related liabilities to be recognized and disclosed in the financial statements respectively. Changes in the amount of the estimates could materially increase or decrease the provision for tax related liabilities and the extent of disclosures of contingencies for tax related liabilities in a period.

Management evaluates the provision for tax related liabilities on quarterly basis or as necessary and believes that adequate provision for tax related liabilities has been recognized in the financial statements.

### **21. RELATED PARTY TRANSACTIONS**

- [a] Pursuant to the respective service agreements, the Company pays the salaries of certain executive officers in the form of consultancy fees to companies controlled by the executive officers. The consultancy fees incurred for the three months ended March 31, 2009 amounted to \$153,000 [2008 – \$152,000] and were recorded at an exchange amount as agreed by the related parties.
- [b] In addition, as at March 31, 2009, the Company had an aggregate amount of \$4,900,000 [December 31, 2008 – \$4,900,000] for consultancy fees payable to these related companies. The amount is included in accounts payable and accrued liabilities in the financial statements.
- [c] On February 6, 2009, the Company entered into an agreement to acquire 55,000,000 ordinary shares and approximately \$21,700,000 (equivalent to approximately HK\$167,631,000) 4% secured convertible bonds of Omnicorp from various vendors. Total consideration was approximately \$25,775,000 (equivalent to approximately HK\$200,631,000). Among the vendors were a director of the Company and an entity controlled by such director the aggregate value of whose Omnicorp ordinary shares and convertible bonds represented approximately 5.5% of the aggregate value of the overall transaction.

### **22. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS**

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the consolidated financial statements for the three months ended March 31, 2009.