



Potlatch Corporation is a real estate investment trust (REIT) that owns and manages around 1.5 million acres of timberland in Arkansas, Idaho, Minnesota, Wisconsin, and Oregon. Through Potlatch Forest Products Corporation, the firm's taxable REIT subsidiary, Potlatch operates 13 manufacturing facilities in Arkansas, Idaho, Illinois, Michigan, Minnesota, and Nevada that produce lumber, plywood, particleboard, bleached paperboard, and private-label consumer tissue products, including bathroom tissue, facial tissue, paper towels, and napkins. Potlatch sells its products mainly in the United States, but is a major international supplier of bleached paperboard. The company, which was established in the mountainous, evergreen forests of northern Idaho in 1903, reorganized itself as a REIT at the beginning of 2006 in order to take advantage of the special tax treatment for REITs.

### **EARLY HISTORY**

The early history of Potlatch is closely tied to the more general history of the U.S. logging industry. In the United States logging began in New England, where forests were cleared, often carelessly, to make room for the country's first towns and farms and to provide lumber for buildings, fuel, and furniture. Once thought to be a virtually inexhaustible resource, these forests were nearly depleted by the mid-1800s, and logging companies thus began to spring up in the Midwest, especially in the "North Woods" of Wisconsin, Michigan, and Minnesota. By the 1890s much of these vast midwestern pine forests also were cleared, forcing lumbermen to look to the South and to the far Northwest for new regions of forested land.

Also in the 19th century the railroads were spreading their tracks to the outer edges of the nation. The Utah Northern extended its line in 1874 just across the southern Idaho border and several years later began to lay additional tracks to reach the mining communities farther north. By 1883 Northern Pacific had built a line from St. Paul, Minnesota, to Tacoma, Washington, which wound its way through such towns in northern Idaho as Bonner's Ferry and Sandpoint. Without the railroads to carry logs and lumber products, dreams of harvesting Idaho's evergreen forests would never have been realized.

As the railroads brought settlers to the Western frontier, stories of the land's riches were carried back east. Northern Idaho, cut off from the southern part of the state by the deep gorge of the Salmon River, was uncharted for the most part, but many midwestern timbermen began to hear of the area's towering stands of white pine and other valuable trees. Frederick Weyerhaeuser of St. Paul, Minnesota, a powerful lumber capitalist and one of the founders of Potlatch, saw an exhibit of Idaho timberland at Chicago's 1893 World's Fair, and it was he who led the charge of Midwest lumber companies to the Northwest. He did this with the help of the "Weyerhaeuser syndicate," a group of midwestern businessmen who had long worked together to secure timber for their individual mills. In 1900 his syndicate bought an astonishing

900,000 acres of timberland in the Pacific Northwest, thus forming Weyerhaeuser Timber Company, and that year Weyerhaeuser himself toured on horseback northern Idaho's stands of white pine. Soon the syndicate was buying additional Northwest timberland from railroads, state auctions, and homesteaders; other midwestern companies, trusting Weyerhaeuser's judgment, quickly followed.

In northern Idaho's Palouse, Potlatch, and Elk River basins, thousands of acres of timberland were being purchased by midwestern companies, but most went to just two men: William Deary of Northland Pine Company, a firm established by the Weyerhaeuser syndicate, and Henry Turrish of Wisconsin Log & Lumber Company. Although competitors, Deary and Turrish were by 1902 buying land together, in part for convenience but also to keep land prices lower. The owners of Northland and Wisconsin Log & Lumber soon recognized the value of this collaboration, and the following year they decided to merge their Idaho timberland under a new firm, which they called Potlatch Lumber Company. When the company was formed it owned more than 100,000 acres, but it quickly gained additional land, as well as two mills, when it bought nearby Palouse River Lumber Company and Codd Lumber Company in 1903 and 1904, respectively.

Backed with an initial \$3 million in capital, Potlatch Lumber Company was established with great hopes but with little recognition of the difficulties posed by the area's rugged environment. Its name, derived from the northwest Indian word *patshatl*, which referred to an elaborate ceremony of gift-giving, was selected because the Potlatch River cut through the company's land. The first president of Potlatch was Weyerhaeuser's son, Charles, and the vice-president was Turrish, but the dominant personality of the company was Deary, who was appointed general manager. One of the first goals of Potlatch was to plan and build a magnificent new sawmill, which Deary decided to place along the Palouse River about 15 miles north of Moscow, Idaho. Opened on September 11, 1906, the structure was some 300 feet long, 100 feet wide, and 70 feet tall, and its giant Corliss engine gave the mill an annual capacity of 135 million board feet. Production began with 125 employees.

To house these employees, the company decided to build a town on two hills overlooking the sawmill. By the mill's opening day there were 128 completed homes, and soon there was also a hotel, two churches, a large general store, and an elementary and high school. Called Potlatch, this attractive, well-designed town was a great source of pride for the company but also a considerable drain on funds. The company continued to own and maintain the town until the 1950s.

Another major investment by the early company was its 45-mile railroad line, which, when completed in 1907, ran from Palouse, Washington, east through Potlatch and other towns, ending in Bovill, Idaho. It was used to carry logs from the company's timberland to the new mill, as well as to transport finished lumber to connecting railroads at Palouse and Bovill.

## **COMPANY PERSPECTIVES**

Reinventing a 103-year-old company is a big job. So this year, we got right to work. First, we made good on our promise to deliver more value to shareholders through our new structure as a real estate investment trust, or REIT. In 2006, we distributed \$165 million in cash and \$356 million in stock to our shareholders. Next, we looked hard at how to get the most value from every acre of land we own. The result: a clear strategy for selling our higher-value, nonstrategic holdings. Of course, some things didn't change. As a verified forest practices leader, we continue to be recognized for our environmental

stewardship. And even as we looked to our land holdings for new opportunities, our manufacturing operations continued to provide substantial value to the company. In short, Potlatch's first year as a REIT was a remarkable success.

Despite Potlatch Lumber Company's high-quality timber, modern sawmill, and new railway, its early years were disappointing and often marked by losses. The first dividend was not paid until 1911, and even that was just 3 percent, a low figure in the high-risk lumber business. A few years later the company was paying 10 percent, but the average dividend from 1903 to 1923, when the company's holdings had reached some 170,000 acres, was just 3.6 percent. Before his death in 1914, Frederick Weyerhaeuser reportedly said the company was appropriately called Potlatch because he had given it so much money with little return. Other Idaho timber companies had similarly poor records.

The company's tree-cutting policy contributed to this shaky financial picture. Instead of selectively cutting the area's white pine, ponderosa pine, and Douglas fir—the species most in demand—the company cut all trees in its path, even those, such as tamarack, that often cost more to harvest than was economical. Other problems included the company's high capital costs (for the railway, mill, and town), rugged terrain and inaccessible timber areas, deep winter snow, the relatively few trees per acre, and heavy state taxes. The 1914 opening of the Panama Canal had an especially harsh impact on Potlatch and other Idaho timber companies. Before the canal's opening, Potlatch benefited from rail costs cheaper than those paid by its Pacific Coast rivals, who were hundreds of miles farther from the major Eastern markets. After 1914 companies located on the Pacific Coast were able to send their timber to these markets by boat, at a cost one-third cheaper than rail, thus undercutting the price of lumber sold by Potlatch and other Idaho timber firms.

### **GREAT DEPRESSION: CRISIS AND MERGER**

As early as 1926 the entire Northwest lumber industry was suffering from overproduction and declining prices. When the Great Depression hit the country in 1929, causing a precipitous drop in new building construction, Potlatch found itself facing potential bankruptcy, as did northern Idaho's other major timber companies, Clearwater Timber Company and Edward Rutledge Timber Company, which had been established in 1900 and 1902, respectively, by the Weyerhaeuser syndicate. The Clearwater mill was located just south of Potlatch in the town of Lewiston, and the mill of Edward Rutledge was found farther north in Coeur d'Alene.

### **KEY DATES**

#### **1903:**

William Deary and Henry Turrish merge their Idaho timberland in a new company called Potlatch Lumber Company.

#### **1906:**

Potlatch opens a sawmill near Moscow, Idaho.

#### **1931:**

Potlatch merges with Clearwater Timber Company and Edward Rutledge Timber Company to form Potlatch Forests, Inc.

#### **1950:**

Company pioneers in the production of bleached paperboard from wood waste.

- 1956:**  
Company merges with Arkansas-based Southern Lumber Company.
- 1964:**  
Company expands into Minnesota with the acquisition of Northwest Paper Company.
- 1965:**  
Headquarters shifts to San Francisco.
- 1971:**  
Richard B. Madden becomes CEO and begins trimming the company to concentrate on four core areas and initiates a capital expenditure program.
- 1973:**  
Company changes its name to Potlatch Corporation.
- 1981:**  
Company builds the first U.S. plant to make oriented strand board.
- 1994:**  
John M. Richards is named chairman and CEO.
- 1997:**  
Corporate headquarters relocates to Spokane, Washington.
- 1999:**  
A deal with Anderson-Tully Company to form Timberland Growth Corporation, a timber-based REIT, falls apart; L. Pendleton Siegel is named chairman and CEO.
- 2002:**  
Potlatch divests its printing paper operations.
- 2004:**  
Company sells its oriented strand board plants in Minnesota.
- 2006:**  
Potlatch is converted to a real estate investment trust; Michael J. Covey is brought on-board as CEO.

After considerable debate among stockholders, the financial crisis was resolved by merging the three companies into an organization called Potlatch Forests, Inc. The new corporation, headquartered in Lewiston, was headed initially by John Philip Weyerhaeuser, Jr., a grandson of Frederick Weyerhaeuser, and later, in 1935, by the older Rudolph M. Weyerhaeuser, one of the founder's sons. Effective April 29, 1931, the merger did not remove the companies' common problem of a weak market but did provide for better efficiency. Some timber in the Clearwater land, for example, could be taken more economically to the Potlatch mill. Expensive machinery could be shared between the three concerns. The merger also allowed for a more ambitious attempt at selective cutting, which Clearwater had begun in 1929. The goal of selective cutting was to fell only mature or diseased trees, allowing the younger, healthy ones to stand for future generations of logging. Reforestation, however, did not begin until 1954.

Despite these gains, the Depression remained a difficult period for Potlatch, which was forced to cut its prices and the wages of its workers. The Coeur d'Alene mill was closed for some time beginning in 1932,

and that year its operations in the town of Potlatch were open only to ship lumber held in storage. Losses were reported in all but two years of the 1930s, resulting in a total deficit of \$8.7 million for the decade. During this period, however, the company did develop an important new product, Pres-to-logs, a slow-burning, virtually smokeless fuel made of compressed sawdust, wood chips, and splinters. The logs were ideal for fireplaces located in homes or on railcars, where smoke had to be kept to a minimum. A first in the industry, Pres-to-logs were made by a process involving extreme heat, high pressure, and moisture.

### **POSTWAR ERA: NEW PRODUCTS AND GEOGRAPHIC EXPANSION**

World War II brought increased demand for lumber to build houses, military camps, and other facilities for soldiers, and Potlatch, benefiting from booming lumber orders, gained badly needed profits. From 1940 to 1945 the company's after-tax profits surpassed \$5 million, of which \$1.2 million was placed in a reserve fund for future upgrading of its mills and machinery and for introducing new products. By the war's end, the company was poised for strong, sustained growth, which would be overseen by George F. Jewett, a grandson of the founder, who became president of Potlatch in 1946. Three years later Jewett was elected the company's first chairman of the board, a position that was filled later by Edwin Weyerhaeuser Davis, another grandson, in 1957 and then by Benton R. Cancell in 1962.

The company's profitable postwar era was distinguished by its large number of new products. The first to be introduced was veneer, or thin sheets, of white pine, which Potlatch hoped would be popular for home paneling. To make this product, giant logs of white pine had to be peeled and then made into rolls. In 1949, after three years of developing the process, the company began making white pine veneer, but the project quickly came to be too expensive and problematic. By 1952 the operations were successfully converted to make a different product, plywood, which was made from layers of Douglas fir, white pine, Ponderosa pine, or larch.

An especially important new product for Potlatch was paperboard, a thick paper with a variety of uses, such as making milk cartons and other containers. To manufacture the product, the company in 1950 built a new bleach kraft pulp and paper mill, located in Lewiston, which was the first in the United States to produce bleached paperboard from sawmill wood waste, namely chips. Within the next few years Potlatch introduced "Lock-Deck" laminated decking, "Pure-Pak" cartons for milk, and additional paperboard items, such as paper plates and meat trays. By the early 1960s the company had also purchased a mill for folding paperboard and entered a new line of products by acquiring Clearwater Tissue Mills, Inc.

To obtain the raw materials for these new products, Potlatch began to expand its timber reserves. In 1956 it merged with Southern Lumber Company, an Arkansas firm founded by the Weyerhaeuser syndicate in 1882. With the subsequent purchase of Bradley Lumber Company, also located in Arkansas, Potlatch controlled more than 100,000 acres of Arkansas timberland, mostly of southern yellow pine, oak, and other hardwoods. Directing its sights to Minnesota, Potlatch merged in 1964 with another Weyerhaeuser creation, Northwest Paper Company, a producer of printing and writing paper. Established in 1898, Northwest owned about 220,000 acres of forested land in Minnesota, where jack pine, aspen, red pine, and balsam fir were the most common species. With these mergers, Potlatch had become a national company, and the small town of Lewiston subsequently proved to be a difficult place from which to manage its new holdings. As a result, the company's headquarters were moved to San Francisco in

1965, and a few years later, in 1973, the company changed its name from Potlatch Forests, Inc., to Potlatch Corporation.

### **THE MADDEN ERA, 1971-94: REFOCUSING AND CAPITAL EXPENDITURES**

By 1971, when Richard B. Madden became CEO, the company had diversified into some 20 separate product lines, including modular housing and corrugated boxes, and its sales had reached \$356 million. Potlatch also was investing millions of dollars to reduce its air and water pollution. Not simply taking over the reins, Madden spent much of his first year developing what became the company's guiding business philosophy: "Potlatch will be a company characterized by a growing profit and reasonable rate of return that is achieved by talented, well-trained, and highly motivated people. It will be a company that is properly supported by a sound financial structure and will feature a keen sense of social responsibility." Using this simple statement, Madden then initiated an intensive review of the company's many components. The result was a decision to sell its less profitable activities and to concentrate on just four product lines: wood products (lumber, plywood, and particleboard), printed papers, pulp and paperboard, and tissue products. Moreover, the company decided to focus on "higher-value-added" products, or those that had a relatively high value compared with the cost of the raw materials. Such products tended to be less affected by recurring business cycles. In printed papers, for example, Potlatch concentrated on high grades of coated paper, the type commonly used for annual reports and advertising brochures. Beginning in the mid-1970s and extending into the 1980s and 1990s, the company combined these shifting priorities with a new program of capital expenditures. In 1981, for example, Potlatch built in Minnesota the first U.S. plant to make oriented strand board (OSB). An alternative to plywood, OSB was a multilayered board made from strands of aspen "oriented" in various directions; the strands were held together by a mixture of wax and resin and compressed under intense heat. By 1991 the company was making more than a billion square feet of OSB in two varieties: Oxboard, with five layers, and Potlatch Select, with three. Although capital projects were curtailed during the recession of the early 1980s, by the late 1980s Potlatch was again spending large sums of money to retool its plants and machinery. Projects completed by the early 1990s included a \$40 million upgrade of the Lewiston sawmill and log processing center; a \$400 million modernization of the Lewiston pulp and paperboard mill; a new \$27 million lumber mill in Warren, Arkansas; and, as part of a \$107 million upgrade of its tissue operations, a new "twin wire" tissue machine in Lewiston. In 1993 Potlatch completed construction of a new \$25 million tissue complex in North Las Vegas, Nevada, to service the southwestern market; that year, the company also began a multiyear, \$525 million expansion of its pulp and printing paper mill in Cloquet, Minnesota. This program of capital expenditures was reflected in the company's skyrocketing sales and healthy profit margins. Total sales jumped from \$356 million in 1971, the year Madden became chairman of the board, to \$504 million in 1975, \$820 million in 1980, \$950 million in 1985, and \$1.37 billion in 1993, Madden's last full year as chairman. Even during the down years of the cyclical forest products industry, Potlatch managed to stay in the black. In the early 1990s earnings were highest in its wood products, such as lumber and oriented strand board, and, owing to difficult market conditions, considerably lower in printing paper and pulp and paperboard.

### **NEW LEADERSHIP**

In May 1994 John M. Richards, president and COO, was named to replace Madden as chairman and CEO. L. Pendleton Siegel was promoted to Richards's former position. Capital expenditures continued in 1994, as Potlatch opened a new \$27 million sawmill in Warren, Arkansas. Also in 1994, Potlatch expanded into northeastern Oregon when it began developing a 22, 000-acre plantation for the growing of hybrid poplar trees, which could be harvested in six years, rather than the usual 50 to 70 years. The trees were slated to supply the bleached pulp mill in Lewiston beginning in the early 21st century and were viewed as a method to reduce the company's dependence on outside fiber sources. In December 1995 the company filed suit against Beloit Corporation alleging that Beloit had installed a defective pulp washer system at the Lewiston pulp mill. In June 1997 a jury awarded Potlatch damages of \$95 million, but the judgment was thrown out in 1999 by the Idaho Supreme Court, which returned the suit to a lower court. Potlatch's continued pursuit of the case was halted when Beloit filed for bankruptcy protection.

In a cost-saving move, Potlatch in 1997 relocated its corporate headquarters to Spokane, Washington, the closest city to Lewiston with a major airport. The following year Potlatch began planning a complex merger of its Arkansas timberland with that of Anderson-Tully Company located in Mississippi and Arkansas into a newly formed real estate investment trust (REIT) called Timberland Growth Corporation. This deal fell apart during 1999, however, following the weakening of markets in Asia and the United States. In the middle of that year, Richards retired as chairman and CEO, with Siegel taking over those positions. Late in the year Potlatch completed the costly expansion of its Cloquet mill. The firm posted profits of \$40.9 million for 1999 on net sales of \$1.68 billion.

### **EARLY 21ST CENTURY: RESTRUCTURING AND A NARROWING FOCUS**

Potlatch optimistically entered the 21st century under new leadership and with a 15-year \$2 billion capital improvement program behind it, only to face a sharp market downturn that sent it into the red. For the first time in 30 years, prices for both wood and paper products were depressed at the same time, a situation compounded by rising energy costs. Burdened by a heavy debt load of more than \$800 million that had been swollen in part to fund the large capital expenditures of the 1990s, Potlatch was forced to restructure. By early 2001, the company had trimmed about 9 percent of its workforce, or around 600 workers, and shut down its Jaype plywood plant near Pierce, Idaho. Restructuring charges of \$28.3 million contributed to a net loss for 2000 of \$33.2 million, the firm's first money-losing year since 1993.

Potlatch fared little better in 2001 when the economic downturn and competition from overseas hurt sales. As a result of continued low prices, the firm's printing paper business operated at a loss for the year, contributing to an overall loss of \$79.4 million. By early 2002, when its debt load had ballooned to more than \$1 billion, Potlatch announced its plan to divest the printing paper unit, an admission that its upgrade of the Cloquet mill had been a costly mistake. In May of that year, the company sold the Cloquet mill to the South African firm Sappi Limited for \$485.5 million in cash and at the same time shut down its printing paper mill in Brainerd, Minnesota. The Brainerd mill was subsequently sold in early 2003 for \$4.4 million. Potlatch also closed down its Bradley hardwood mill in Warren, Arkansas, in 2002, as it exited from the hardwood lumber business. In disposing of these properties, the company incurred pretax charges of \$276.2 million, which largely contributed to a net loss for the year of \$234.4 million. The divestments cut revenues to \$1.29 billion, down from the previous year's total of \$1.81 billion, while also enabling the debt load to be substantially reduced to \$638.3 million. One bright spot during the year was the strength of the

firm's consumer products division. In the fall, Potlatch launched a \$66 million expansion of its tissue-conversion plant in Las Vegas.

In 2003, while celebrating its 100-year anniversary, Potlatch returned to the black, posting profits of \$50.7 million on surging revenues of \$1.51 billion. Among the factors helping the company were higher prices for its consumer products, an easing of oversupplied markets, and a softening of the U.S. dollar against foreign currencies, which favored U.S. producers rather than overseas importers. Facing few opportunities to grow its consumer products division in the West, where Potlatch produced 90 percent of the private-label tissue products sold in grocery stores, the company in 2003 laid plans to expand the division into the Midwest. In the middle of the following year, production commenced at a new tissue-converting plant in Elwood, Illinois, near Chicago. Also during this period, Potlatch was working to burnish its image as a responsible environmental steward of its large timber holdings. For example, in the spring of 2004 the nonprofit Forest Stewardship Council (FSC) gave its seal of approval to Potlatch's Idaho forestland following a rigorous environmental audit. Later, Potlatch became the first public company whose lands were 100 percent certified by the FSC.

Seeking to pay down its debt still further, Potlatch in September 2004 sold its three oriented strand board plants in Minnesota to Ainsworth Lumber Co. Ltd. of Vancouver, British Columbia, for approximately \$452 million in cash. By the end of 2004, the firm was able to cut its debt load to \$336.5 million. Proceeds from the sale also went toward a special dividend of \$2.50 per share distributed to company stockholders. A \$163.1 million after-tax gain on the sale pushed 2004 profits up to \$271.2 million. Within its narrower product lines—which encompassed lumber, plywood, particleboard, bleached paperboard, and tissue products—Potlatch was pushing to develop new products. For instance, in 2005 the firm introduced fire-resistant cedar decking, a product created in response to the increasing number of wildfires that had been blazing across the West. Also debuting in 2005 was an RV-friendly toilet paper called SepticSure, which was able to break down within 30 seconds after a flush. Potlatch also expanded its lumber operations in May 2005 via the acquisition of a sawmill in Gwinn, Michigan, from Louisiana-Pacific Corporation.

### **2006: CONVERSION TO REIT**

At the beginning of 2006 Potlatch joined an industry trend by converting to a real estate investment trust, mainly for tax reasons. Prior to the conversion, the company transferred all of its manufacturing operations into Potlatch Forest Products Corporation, a taxable REIT subsidiary. Whereas the operations of this subsidiary remained subject to federal corporate income taxes, earnings from the 1.5 million acres of timberland owned by the parent, principally the sale of standing timber, were no longer subject to these taxes. Soon after the conversion, Potlatch nearly tripled the regular quarterly dividends it paid to shareholders and also completed a special one-time distribution to shareholders amounting to \$165 million in cash and \$356 million in stock. The conversion to a REIT also coincided with a shift in leadership. In February 2006 Siegel stepped down as company president and CEO while remaining chairman. Brought onboard as Siegel's successor was Michael J. Covey, who had been an executive vice-president at Plum Creek Timber Company, Inc., where he had played a key role in that firm becoming the nation's first timber REIT in 1999. At the end of 2006 Covey took over the Potlatch chairmanship as well.

In its first year as a REIT, Potlatch posted earnings of \$139.1 million on revenues of \$1.61 billion. Going forward, the company planned to be much more active in buying and selling property, as the REIT structure made such maneuvers more tax efficient. Following an acre-by-acre review of its holdings, Potlatch found that as much as 20 percent of its timber holdings, or about 300,000 acres of land, were more valuable for recreation cabins, trophy homes, and hunting grounds than for growing trees; this land was therefore earmarked for sale over a ten-year period. In the meantime, the company began scouting for timberland to add to its portfolio. In January 2007 Potlatch completed its first land acquisition as a REIT, and its first significant such purchase in 13 years, buying 76, 000 acres of hardwood forest located in north-central Wisconsin. Seeking to derive additional value out of its landholdings, Potlatch in April 2007 began charging for recreational access to most of its 665, 000 acres of forestland in Idaho.