POTLATCH CORP
Form 10-Q
November 07, 2006
**Table of Contents**

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# Form 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the quarterly period ended September 30, 2006**

**Or**

¨ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the transition period from to**

**Commission file number 1-32729**

# POTLATCH CORPORATION

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **82-0156045** |
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |
| **601 West Riverside Ave., Suite 1100 Spokane, Washington** | **99201** |
| **(Address of principal executive offices)** | **(Zip Code)** |

**(509) 835-1500**

**Registrant s telephone number, including area code**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The number of shares of common stock of the registrant outstanding as of September 30, 2006 was 38,747,457.

**Table of Contents**

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Index to Form 10-Q

**Table of Contents**

PART I

**ITEM 1. Financial Statements**
Potlatch Corporation and Consolidated Subsidiaries

Statements of Operations

Unaudited (Dollars in thousands - except per-share amounts)

| | Quarter Ended September 30 | | Nine Months Ended September 30 | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Revenues | $ 398,108 | $ 405,540 | $ 1,215,212 | $ 1,110,923 |
| Costs and expenses: | | | | |
| Depreciation, depletion and amortization | 22,989 | 21,729 | 67,995 | 60,404 |
| Materials, labor and other operating expenses | 334,625 | 340,359 | 1,028,248 | 932,169 |
| Selling, general and administrative expenses | 23,206 | 18,999 | 68,946 | 61,284 |
| | 380,820 | 381,087 | 1,165,189 | 1,053,857 |
| Earnings from operations | 17,288 | 24,453 | 50,023 | 57,066 |
| Interest expense | (7,229) | (7,236) | (21,911) | (21,722) |
| Debt retirement costs | 53 | | 53 | |
| Interest income | 355 | 514 | 1,452 | 1,827 |
| Earnings before taxes | 10,467 | 17,731 | 29,617 | 37,171 |
| Provision (benefit) for taxes (Note 4) | (13,765) | 6,641 | (65,386) | 14,125 |
| Net earnings | $ 24,232 | $ 11,090 | $ 95,003 | $ 23,046 |
| Net earnings per common share (Note 5): | | | | |
| Basic | $ .63 | $ .38 | $ 2.66 | $ .79 |
| Diluted | .62 | .38 | 2.65 | .79 |
| Distributions per common share (annual rate)(1) | 1.96 | .60 | 1.96 | .60 |
| Average shares outstanding (in thousands): | | | | |
| Basic | 38,724 | 29,179 | 35,688 | 29,055 |
| Diluted | 38,858 | 29,401 | 35,870 | 29,238 |

(1) Distributions for 2006 reflect the annualized rate, after adjustment for a special earnings and profit distribution of $15.15 per common share paid in the first quarter.

Certain 2005 amounts have been reclassified to conform to the 2006 presentation.

The accompanying notes are an integral part of these financial statements.

**Table of Contents**

Potlatch Corporation and Consolidated Subsidiaries

Condensed Balance Sheets

Unaudited (Dollars in thousands - except per-share amounts)

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| Assets | | |
| Current assets: | | |
| Cash | $ 7,315 | $ 6,133 |
| Short-term investments | 9,437 | 57,700 |
| Receivables, net | 117,191 | 114,641 |
| Inventories (Note 7) | 160,192 | 209,696 |
| Prepaid expenses | 17,077 | 15,006 |
| Total current assets | 311,212 | 403,176 |
| Land, other than timberlands | 8,556 | 8,507 |
| Plant and equipment, at cost less accumulated depreciation | 566,261 | 589,161 |
| Timber, timberlands and related logging facilities | 393,781 | 400,595 |
| Other assets | 253,664 | 227,358 |
| | $ 1,533,474 | $ 1,628,797 |
| Liabilities and Stockholders Equity | | |
| Current liabilities: | | |
| Current installments on long-term debt | $ 3,157 | $ 2,357 |
| Accounts payable and accrued liabilities | 163,856 | 144,943 |
| Total current liabilities | 167,013 | 147,300 |
| Long-term debt | 324,464 | 333,097 |
| Other long-term obligations | 252,392 | 245,867 |
| Deferred taxes | 124,610 | 197,385 |
| Stockholders equity | 664,995 | 705,148 |
| | $ 1,533,474 | $ 1,628,797 |
| Stockholders equity per common share | $ 17.16 | $ 24.01 |
| Working capital | $ 144,199 | $ 255,876 |
| Current ratio | 1.9:1 | 2.7:1 |

Certain 2005 amounts have been reclassified to conform to the 2006 presentation.

The accompanying notes are an integral part of these financial statements.

3

**Table of Contents**

Potlatch Corporation and Consolidated Subsidiaries

Condensed Statements of Cash Flows

Unaudited (Dollars in thousands)

| | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|---|---|
| Cash Flows From Operations | | |
| Net earnings | $ 95,003 | $ 23,046 |
| Adjustments to reconcile net earnings to net operating cash flows: | | |
| Depreciation, depletion and amortization | 67,995 | 60,404 |
| Deferred taxes | (72,775) | |
| Cost of permit timber harvested | 3,229 | 3,747 |
| Equity-based compensation expense | 2,970 | 1,628 |
| Employee benefit plans | (981) | (2,907) |
| Working capital changes | 60,569 | (42,040) |
| Funding of qualified pension plans | (18,092) | |
| Net cash provided by operating activities | 137,918 | 43,878 |
| Cash Flows From Investing | | |
| Decrease in short-term investments | 48,263 | 60,917 |
| Additions to plant and properties | (37,243) | (91,162) |
| Other, net | (4,514) | (6,430) |
| Net cash provided by (used for) investing activities | 6,506 | (36,675) |
| Cash Flows From Financing | | |
| Change in book overdrafts | 3,228 | 837 |
| Issuance of common stock | 6,261 | |
| Repayment of long-term debt | (7,833) | (1,078) |
| Issuance of treasury stock | 513 | 10,880 |
| Purchase of treasury stock | | (1,868) |
| Distributions to common stockholders | (146,112) | (13,103) |
| Income tax benefit resulting from the exercise of employee stock options | 1,233 | |
| Other, net | (532) | 491 |
| Net cash used for financing activities | (143,242) | (3,841) |
| Increase in cash | 1,182 | 3,362 |
| Cash at beginning of period | 6,133 | 8,646 |
| Cash at end of period | $ 7,315 | $ 12,008 |

Net interest payments (net of amounts capitalized) for the nine months ended September 30, 2006 and 2005 were $15.3 million and $15.1 million, respectively. Net income tax payments (refunds) for the nine months ended September 30, 2006 and 2005 were ($1.5) million and $15.9 million, respectively.

Certain 2005 amounts have been reclassified to conform to the 2006 presentation.

The accompanying notes are an integral part of these financial statements.

**Table of Contents**

Potlatch Corporation and Consolidated Subsidiaries

Notes to Consolidated Financial Statements

Unaudited (Dollars in thousands)

NOTE 1. GENERAL - The accompanying Condensed Balance Sheets at September 30, 2006 and December 31, 2005, the Statements of Operations for the quarters and nine months ended September 30, 2006 and 2005, and the Condensed Statements of Cash Flows for the nine months ended September 30, 2006 and 2005 have been prepared in conformity with accounting principles generally accepted in the United States of America. We believe that all adjustments necessary for a fair statement of the results of such interim periods have been included. All adjustments were of a normal recurring nature; there were no material nonrecurring adjustments.

This Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the Securities and Exchange Commission.

For purposes of this report, any reference to Potlatch, the company, we , us, and our means Potlatch Corporation and all of its wholly owned subsidiaries, except where the context indicates otherwise.

NOTE 2. RECENT ACCOUNTING PRONOUNCEMENTS - In February 2006, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards (SFAS) No. 155, Accounting for Certain Hybrid Financial Instruments. Under this Statement, companies may elect to measure at fair value entire financial instruments containing embedded derivatives that would otherwise have to be accounted for separately. The Statement also requires companies to identify interests in securitized financial assets that are freestanding derivatives or contain embedded derivatives that would have to be accounted for separately, clarifies which interest- and principal-only strips are not subject to SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and amends SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, to revise the conditions of a qualifying special purpose entity due to the new requirement to identify whether interests in securitized financial assets are freestanding derivatives or contain embedded derivatives. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. We currently do not have any of the financial instruments that would fall under the provisions of this Statement and therefore believe that adoption of the Statement on its effective date will not have a material effect on our financial condition or results of operations.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently reviewing the Interpretation to determine the effect it will have on our financial condition, results of operations and disclosure requirements.

In June 2006, the FASB Emerging Issues Task Force (EITF) ratified issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation). The scope of EITF 06-3 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer. This issue provides that a company may adopt a policy of presenting taxes either gross within revenue or on a net basis. If taxes subject to this issue are significant, a company is required to disclose its accounting policy for presenting taxes and the amount of such taxes that are recognized on a gross basis. We do not believe the adoption of EITF 06-3 will have a material effect on our financial condition and results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are currently reviewing this Statement to determine what effect, if any, it will have on our financial condition and results of operations.

In September 2006, the FASB also issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R). This Statement requires a company to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity. This Statement also requires a company to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions.

SFAS No. 158 requires a company that is a business entity and sponsors one or more single-employer defined benefit plans to:

- Recognize the funded status of a benefit plan measured as the difference between plan assets at fair value (with limited exceptions) and the benefit obligation in its statement of financial position. For a pension plan, the benefit obligation is the projected benefit obligation; for any other postretirement benefit plan, such as a retiree health care plan, the benefit obligation is the accumulated postretirement benefit obligation.

- Recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to SFAS No. 87, Employers Accounting for Pensions, or SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions. Amounts recognized in accumulated other comprehensive income, including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of Statements 87 and 106, are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements.

- Measure defined benefit plan assets and obligations as of the date of the employer s fiscal year-end statement of financial position (with limited exceptions).

- Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation.

This Statement amends SFAS No. 87, SFAS No. 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, SFAS No. 106, SFAS No. 132 (revised 2003), Employers Disclosures about Pensions and Other Postretirement Benefits, and other accounting literature. Upon initial application of this Statement and thereafter, a company should continue to apply the provisions in Statements 87, 88 and 106 in measuring plan assets and benefit obligations as of the date of its statement of financial position and in determining the amount of net periodic benefit cost.

Table of Contents

For a company with publicly traded equity securities, SFAS No. 158 is effective for fiscal years ending after December 15, 2006. We are currently assessing the effect of the Statement on our Consolidated Financial Statements. However, based on the funded status of the company s defined benefit pension and postretirement benefit plans as of December 31, 2005 (our most recent measurement date), it is expected that the adoption of SFAS No. 158 will have a material impact on our Consolidated Balance Sheet and Consolidated Statement of Stockholders Equity. The ultimate amounts to be recorded are highly dependent on a number of actuarial assumptions, most significantly the discount rates in effect at December 31, 2006 and the actual rate of return on our pension assets for 2006 as well as the tax effects of the adjustment. Changes in assumptions and actual asset performance from expectations as of the last measurement date could impact the effect of implementing SFAS No. 158 in our Consolidated Financial Statements at December 31, 2006.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108 (Topic 1N), Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements. It requires registrants to quantify errors using both the balance sheet and income statement approaches and to evaluate whether either approach results in quantifying a misstatement as material in light of relevant quantitative and qualitative factors. When the effect of initial adoption is determined to be material, SAB 108 allows registrants to record that effect as a cumulative effect adjustment to beginning-of-year retained earnings. SAB 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. We have not yet determined the effect, if any, the adoption of this SAB will have on our financial condition and results of operations.

In September 2006, the FASB issued FASB Staff Position (FSP) No. AUG AIR-1, Accounting for Planned Major Maintenance Activities. This FSP prohibits companies from recognizing planned major maintenance costs under the accrue-in-advance method, which allowed the accrual of a liability over several reporting periods before the maintenance is performed. FSP AUG AIR-1 is applicable to entities in all industries for fiscal years beginning after December 15, 2006, and must be retroactively applied. We are in the process of determining the effect this FSP will have on our financial condition and results of operations.

NOTE 3. REIT CONVERSION - Effective January 1, 2006, we restructured our operations to qualify for treatment as a real estate investment trust, or REIT, for federal income tax purposes. The REIT tax rules require that we derive most of our income, other than income generated by a taxable REIT subsidiary, from investments in real estate, which for us primarily includes income from the sale of standing timber. Accordingly, prior to our REIT conversion, we transferred to our wholly owned taxable REIT subsidiary, Potlatch Forest Products Corporation, which we refer to in this report as Potlatch TRS, substantially all of our non-timberland assets, consisting primarily of Potlatch s manufacturing facilities engaged in the manufacturing of wood products, pulp and paperboard and tissue products, assets previously used by Potlatch for the harvesting of timber and the sale of logs, and selected land parcels that Potlatch expects will be sold or developed for higher and better use purposes. Our use of Potlatch TRS, which is taxed as a C corporation, enables us to continue to engage in these non-REIT qualifying businesses without violating the REIT requirements. In connection with this restructuring, our subsidiary that holds our timberlands has agreed to sell standing timber to Potlatch TRS at fair market prices.

As a consequence of our conversion to a REIT, we were not permitted to retain earnings and profits accumulated during years when we were taxed as a C corporation. Therefore, in order to remain qualified as a REIT, we distributed these earnings and profits by making a one-time special distribution to stockholders, which we refer to as the special E&P distribution, on March 31, 2006. The special E&P distribution, with an aggregate value of $445 million, consisted of $89 million in cash and approximately 9.1 million shares of Potlatch common stock valued at $356 million.

**Table of Contents**

NOTE 4. INCOME TAXES - As a REIT, generally we will not be subject to federal corporate income taxes on ordinary taxable income and capital gains income from real estate investments that we distribute to our stockholders. If certain requirements are met, only our taxable REIT subsidiaries are subject to corporate-level income taxes. We will, however, be subject to corporate taxes on built-in gains (the excess of fair market value over tax basis at January 1, 2006) on sales of real property (other than timber) held by the REIT during the first ten years following the REIT conversion. We will continue to be required to pay federal corporate income taxes on earnings from our non-real estate investments, principally our manufacturing operations, which are now held by Potlatch TRS.

For the quarter ended September 30, 2006, an income tax benefit of $13.8 million was recorded, compared to an income tax provision of $6.6 million recorded in the third quarter of 2005. The third quarter of 2006 included a net tax benefit of $9.2 million primarily related to an agreement reached with the Internal Revenue Service regarding tax issues pertaining to open tax years. Excluding this net tax benefit, the company recorded an income tax benefit of $4.6 million, which was due to a pre-tax loss for Potlatch TRS. The income tax provision for the third quarter of 2005 reflected the adjustment of the estimated tax rate to 38.0% from 38.5% used for the first half of 2005. The estimated effective tax rate was reduced in the third quarter of 2005 to incorporate the anticipated effect of the Qualified Domestic Production Activity deduction and the estimated effect of changes to state tax apportionments.

For the nine months ended September 30, 2006, we recorded an income tax benefit of $65.4 million. The tax benefit was largely due to the reversal of $51.2 million in timber-related deferred tax liabilities that were no longer necessary as a result of the company s REIT conversion, as well as the $9.2 million net tax benefit discussed above. Excluding these net tax benefits, the company recorded an income tax benefit of $5.0 million. During the first nine months of 2005, an estimated tax rate of 38.0% was used to derive an income tax provision of $14.1 million, calculated on our income from operations, before taxes, of $37.2 million.

NOTE 5. EARNINGS PER COMMON SHARE  Earnings per common share are computed by dividing net earnings by the weighted average number of common shares outstanding in accordance with SFAS No. 128,  Earnings Per Share.  The following table reconciles the number of common shares used in the basic and diluted earnings per share calculations:

| | Quarter Ended September 30 | | Nine Months Ended September 30 | |
|---|---|---|---|---|
| **(Dollars in thousands - except per-share amounts)** | **2006** | **2005** | **2006** | **2005** |
| Net earnings | $ 24,232 | $ 11,090 | $ 95,003 | $ 23,046 |
| Basic average common shares outstanding | 38,723,804 | 29,179,174 | 35,688,377 | 29,055,127 |
| Incremental shares due to: | | | | |
| Common stock options | 55,971 | 209,720 | 74,922 | 174,758 |
| Performance shares | 78,456 | | 105,955 | |
| Restricted stock units | | | 580 | |