

Viridis Energy Inc. CAN45c
 Leading Producer of Wood Pellets, A Biofuel
 Growth Market

8 October 2010

Share Price: CAN45c



12m High: 70c

12m Low: 41c

Market Cap: CAN\$18m

Shares in Issue: 34.28m + warrants after latest acquisition

NAV/Share: 14c ex intangibles at 30 June 2010

Gearing: 63% inc. goodwill, 140% ex goodwill at 30 June 2010.

Interest Cover: n.a.

EPIC Code: TSX: VRD.V

Sector: Forest Products

Market: Toronto TSX Venture Exchange (move to Main Board planned). Also OTC QX.

Broker: To be announced

PR: -

Website: www.viridisenergy.ca

Description: Manufacturer and distributor of carbon neutral wood pellets for domestic heating and commercial power generation.

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Viridis is the most direct route available for investment in the most logical and economically viable of the biofuels – wood pellets. It is probably the only quoted company in any market to be totally dedicated to the wood pellet marketplace, and is a 'consolidation vehicle' the first two components of which have an established presence in the industry, a good reputation for quality and performance, and above all have a record of profitability.

Key investment points are:

- The wood pellet industry in North America grew at a rate of 25% p.a. between 2005 and 2009.
- There is no other quoted company with this level of exposure to the industry.
- A rash of new plant-building in 2009 has led to low prices and overcapacity. We see both problems as temporary. It gives an opportunity for consolidation by buying production capacity cheaply from financially distressed operators, and building a very significant business grouping with economies of scale.
- The group as at present structured will have sales of c. \$20m in 2011, and be profitable.
- A further capital raise is likely in order to enable the group to fund a higher level of inventory over future summer months – this is a winter driven, highly seasonal business. *The lead institutions support this capital raise.*

Key environmental points are:

- Wood pellets are carbon neutral – they are currently made from a waste product, and increasingly will be made from 'beetle kill' – the millions of dead trees that have been killed off by beetle borne disease in Western North America.
- They gain carbon credits in Europe.
- No food production is displaced.
- They stand on their own economically, without any need for Government subsidies.

Viridis is in the process of transferring to the Toronto Main Market from the Toronto TSX-V Market. Its appeal will spread far wider than purely Canada, however, we expect this to become an international company. It is a 'must see' for every environmental, ethical and utility fund, in all major financial centres.

Y/E	Sale	Declared Pre-tax Profit	Adjusted Pre-tax Profit	EPS	P/E	Divi	Yield
Dec	CAN\$ m	CAN\$m	CAN\$m	c.	X	c.	%
2009A	0					-	-
2010A	10.0	1.1	-1.7	-8.6	-	-	-
2011E	19.3	0.7	0.7	1.4	32.1	-	-
2012E	35.5	2.9	2.9	4.0	11.2	-	-

Assumes additional capital raising in Jan 2011

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SWOT ANALYSIS

STRENGTHS

Well known branding and market presence
Established sales record with continuing business with a wide number of outlets
Quality product with premium characteristics
Efficient factory
Product is carbon neutral, and qualifies for carbon credits
Product is ethically sound, unlike some other common biofuels it does not displace food production
High quality pellets
Production plant probably of above average efficiency
Vertical integration following recent acquisition is unusual and gives competitive advantage
Strong board of directors with considerable forestry experience
Not unionised

WEAKNESSES

A small company in a market where at least one other company is selling at least ten times its volume (although that company sells no more than Viridis in the domestic market)
Minimal economies obtained to date from the merger of the three constituent companies
Has only limited control over pricing
Existing plant at West Kelowna has limited room for expansion
Limited barriers to entry
Cyclical pricing low means that business is currently only profitable in the peak season
Control of the market probably lies with the suppliers of the raw material, the timber mills
Will need additional funding before its acquisition programme can be extended
No qualified accountant at board level

OPPORTUNITIES

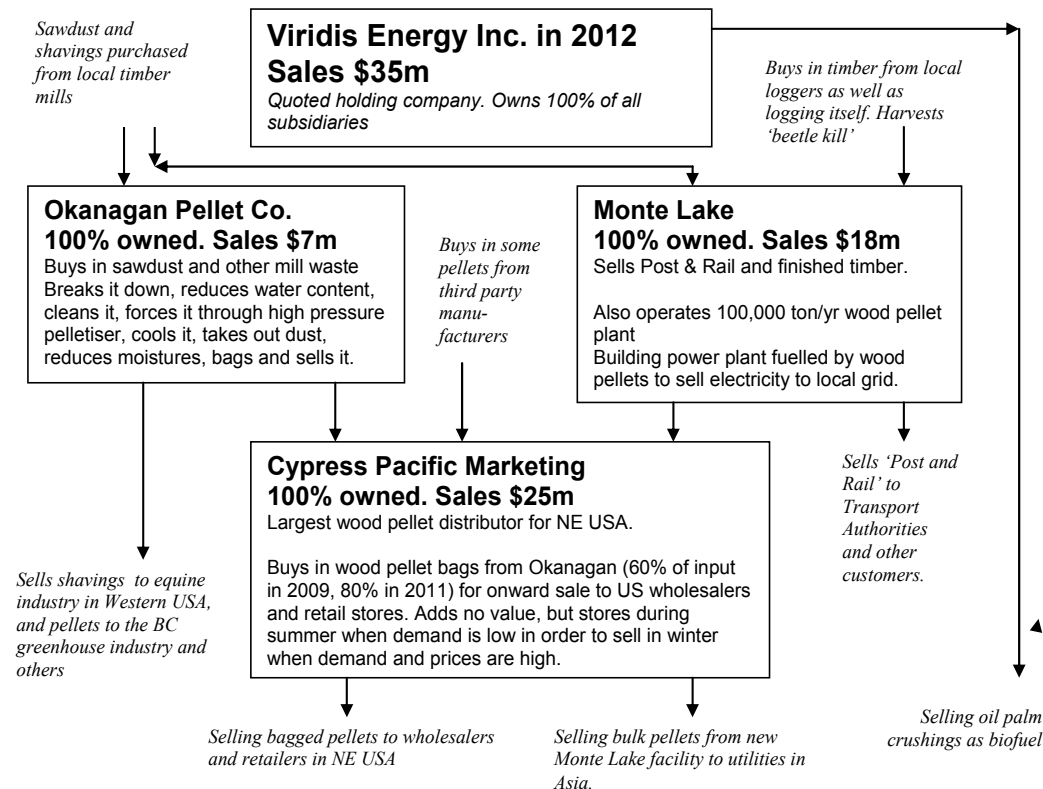
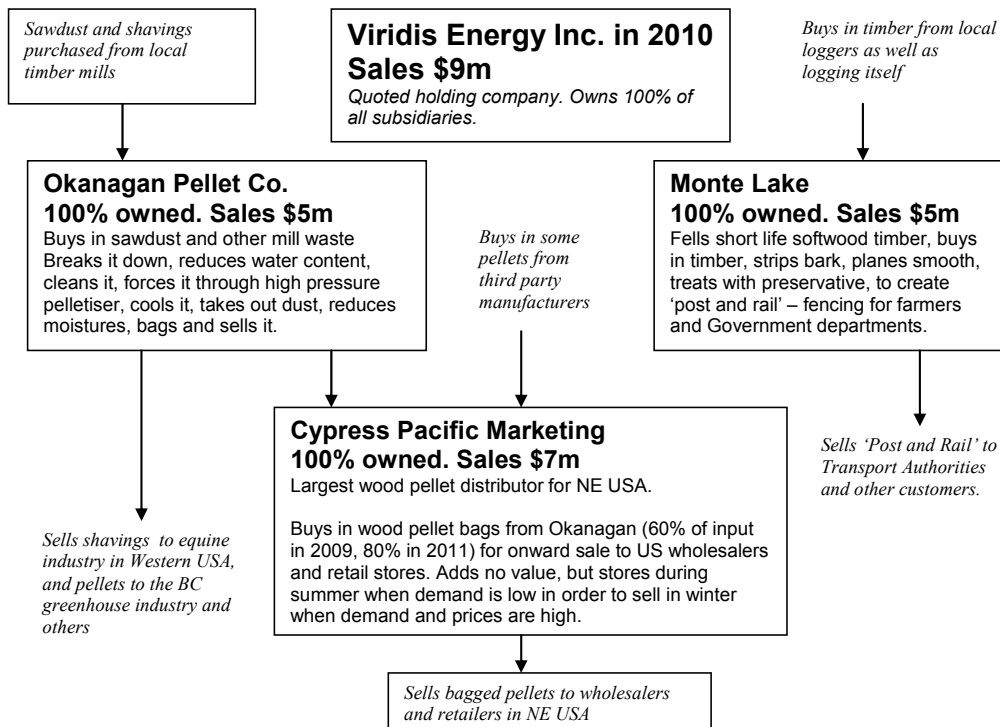
The wood pellet market for fuel is growing rapidly at present – the current cyclical overcapacity will very shortly get absorbed by higher demand
A strong 'green' emphasis in its selling proposition
At present Viridis has no major power station contracts, at a time when coal fuelled power plants are being converted to wood pellet and co-generation
Ideally geographically positioned to supply the Asian markets
Unlimited supplies of raw material available medium term from the considerable quantities of diseased timber that currently have no other uses
A fragmented market, there are huge opportunities for a consolidation play
The largest company in the market has little branding and little retail market presence

THREATS

Current small market share could make it vulnerable to competitive attack from a larger company
Further price falls for wood pellets, particularly in the key winter months, would undermine the economics of the business
As a single plant site (at least in the short term) Viridis is vulnerable to fire risk, which is a major issue for the entire industry
Current cheap/fluctuating prices for gas along West Coast of North America could undermine demand for wood chip in this market
Large Provincial and Government subsidies for less economic green fuels, such as wind farms, could undermine marketing efforts
A collapse of the global political consensus on global warming could lead to a resurgence in energy production from coal, which would limit growth prospects

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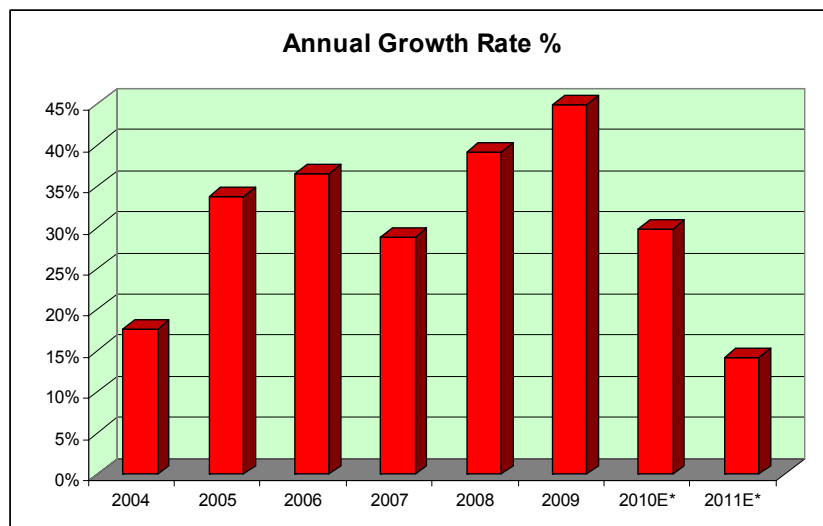
The sum of the sales of the individual subsidiaries is substantially higher than consolidated group sales because of the elimination of inter-company trading.

The Wood Pellet Industry

Canada is the fourth largest producer of wood pellets for fuel in the world. Germany, Sweden and the USA are larger. The average mill in Canada has a production of 50-60,000 tons/year, however, while average mill size in Europe is much smaller, probably in the region of 7,000 tons.

Global wood pellet production in 2008 was 11 million tons, has been growing rapidly, and most observers expect it to continue to do so. Canadian plants produce 30% of all North American wood pellets, and to date the majority of all Canadian pellet production has been sold within the USA, primarily to the North-Eastern states where wood pellet stoves and industrial heating systems are popular. Canada currently has 29 wood pellet plants with a combined capacity of approximately 2.2m tons; the average capacity per plant is 76,000 tons p.a. currently, because of a considerable increase in capacity in both North America and Europe during the last two years, a number of mills are working below capacity.

Global wood pellet production has been growing rapidly



The rate of growth in wood pellet production capacity in North America in recent years has been phenomenal for two countries where the annual rate of GDP growth is relatively pedestrian. Actual production, and consumption, lag theoretical production capacity, partly because of the inability of producers to obtain finance to hold stock over the slow summer months, partly because of raw material issues and inefficient production.

This has been a rapidly growing industry. In every year since 2005, North American production capacity has increased by more than 25%. There are no reliable industry statistics for demand, but we perceive this as a demand driven expansion because of:

- The growing popularity of wood burning stoves among retail consumers and small businesses
- Consumer awareness of global warming and the damage caused by coal burning
- Awareness that wood burning is carbon neutral, and qualifies for carbon credits in Europe
- A move towards co-generation in industrial and power plants, and in some cases to a replacement of coal power generation by biomass, particularly wood pellets.

We perceive this as demand driven expansion

US consumption is approximately 3.5m tons, and European consumption 5m tons, of which more than 10% is imported from Canada, primarily British Columbia via bulk shipments through the Panama Canal.

North American Wood Pellet Production Capacity									
	2003	2004	2005	2006	2007	2008	2009	2010E*	2011E*
Northern (Central) US	12	25	59	183	357	424	702	802	902
Southern US	122	122	158	344	502	964	1855	2555	2855
Western US	281	308	354	458	473	589	711	846	846
Northeastern US	140	143	180	253	416	589	1056	1516	1516
Eastern Canada	146	146	196	232	232	366	411	731	981
Western Canada	390	540	770	874	1039	1270	1357	1457	1927
TOTAL	1091	1284	1717	2344	3019	4202	6092	7907	9027

Source: US Department of Agriculture
* Hardman & Co Estimates

In tonnes per year.

As far as Viridis is concerned, overwhelmingly its most important market at present is the USA, in particular the North-East States. While pellet sales figures by both the US and the Canadian industry trade associations lack some precision, the figures for hearth appliances – the burners needed in order to burn pellets, show a compelling trend.

With the exception of 2007, when sales of all forms of hearth appliance tumbles because of the impact of the US housing and financial crises (the US housing collapse started earlier than the European one, and remember the sub-prime mortgage disaster was the trigger for the entire financial crisis that followed) pellet hearth sales rose every year from 2002 to 2008. The rise was dramatic, and with the exception of rogue year 2007 consistent, with 2008 pellet hearth appliance sales being over four times those on 2002. These sales were at the expense of cordwood, and to a lesser extent gas, burning appliances, but still only left wood pellet burning stoves accounting for less than 10% of new appliance sales in that year.

The impact of the runaway wood pellet prices and the product shortages and rationing then had a calamitous impact. Who is going to switch to wood pellet burning if it is impossible to buy the pellets, or the price in the key winter months is double what the hearth salesman led you to expect? In 2009, wood pellet hearth appliance sales were less than half those in 2008. It needs to be borne in mind that the entire market for all kinds of hearth appliances was down, by around 35%, because of an almost total absence of new house sales and a lack of finance for homeowners to undertake make-overs. But even so, this illustrates very clearly that the market was experiencing a once-in-a-lifetime hit.

The US Department of Agriculture estimates that North American pellet production capacity was 6.2m metric tonnes – 5.5m long tons – in 2009. Most plants are small, which the USDA interprets as being less than 100,000 tonnes/year capacity. A number of new mills have been built in the USA to process chipped roundwood, however, and have a capacity of three to four times this. The USDA states that “the wood pellet industry and the use of wood pellets as energy are in their relative infancy in North America. There are fewer than 20 plants in North America with a capacity of over 100,000 metric tonnes a year. Only four of these have a capacity of in excess of 200,000 metric tonnes a year.

The Source Of The Raw Materials

Wood pellet factories are constrained in terms of output and size because of their need for an economic feed of raw material – the sawdust and shavings from timber mills cutting raw logs into, primarily, planks and board for the timber trade. The days when this material was obtainable free have long since disappeared, and pellet producers now have to pay to obtain supplies, and sign term contracts in order to get some kind of security of supply.

Additionally, there are significant logistical issues. The mill waste is very low in density, and it is not economic to transport this more than approximately 50 miles (80 kilometres). A pellet plant situated close to a sawmill, or sawmills, will be able to produce pellets at a lower cost than one situated further away.

Pellet plants in British Columbia have a great advantage over those in the USA because of

By 2008 pellet hearth appliance sales were four times those of 2002

The USDA states that the use of wood pellets is in its relative infancy in North America

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this factor. BC is the world's forestry capital, and has more sawmills per sq. km than anywhere else. Pellet plants in BC are therefore able to get raw materials from several different sawmills, and indeed this helps prevent a pellet plant getting hung out to dry by demands for higher prices from any one raw material supplier.

A typically sized sawmill produces 100 million board feet of timber a year. This yields approximately 25,000 tonnes of sawdust and shavings. This limits the practical size of any wood pellet production plant to 100,000 tonnes/year (taking the entire feed from four sawmills working at maximum capacity), although in the interior of BC some plants are bigger.

Additional complications are caused by the moisture content. Fire is the biggest operational problem facing pellet factories. For processing, moisture must be contained within a range of 12% to 17% of total weight. If too dry, the heat build up induced by friction in the pelletiser burns the surfaces and can also cause a fire when the hot dry pellets are ejected into the next stage of the process. If too wet, steam pressure builds up in the pelletiser, stressing joints, causing machinery breakdowns, increasing downtime for breakages, and increasing the amount of dust and sub-standard product to come out of the process.

These plants have clear limitations. Their size is necessarily small, limiting economies of scale, and the dependence upon the sawmills is a negative factor, not just because a mill might switch its supplies to a rival pellet factory bidding a higher price, but because if the sawmill goes down (has a fire for example, or goes onto part time working because of poor demand for its main product from the construction industry), then there are obvious knock-on effects at the pellet plant.

Supplies of wood residue in North America peaked in the period 2004 – 2006, at around 22m tonnes in each year. This was a time when the lumber industry was working flat out to cater for booming house construction demand, and the twin economies of the USA and Canada were growing rapidly. Since then, the sawmills have been on part time working, and a number of them have shut. Wood residue availability is probably now more than 14m tonnes, a fall of 30%.

This has kept raw material prices high. The US Department of Agriculture has estimated that excluding transport costs, bark free in-wood pine chips were US\$31-39 a tonne. Delivery to the pellet plant can cost up to a further \$20/tonne.

The alternative is to build new plants that process roundwood, using feed direct from the forests, either in competition to the sawmills (who then find the competition for raw material on the other foot) or using the vast quantity of beetle kill timber that exists in Northern BC in particular. Two plants in Colorado have recently been built to take advantage of beetle kill timber in the Southern Rockies (Confluence Energy in 2008, and Shore in 2009).

A roundwood plant is not constrained by supply issues. It can cut down as many dead trees as it likes to feed its appetite for raw material. The production process is more complex, however. There are many more steps in the production process, including debarking, chipping, drying (raw timber has a 50% moisture content) and hammermilling the chips into a form where they can be processed by the pelletiser. The removal of bark is a critical element. While bark has a high BTU element and burns well, it produces a lot of ash, and pellets containing bark have been responsible for a lot of the problems some users have reported with wood pellets as a fuel source.

These larger plants have (or will have) much more complex production processes, but will have lower manning costs because the additional volume will be handled by only a small increase in the number of operatives and most of the processes in the more complex production line are automated. Even though there are as yet very few roundwood fed pellet plants in existence, this will be the future for the industry.

Sawmills provide the raw material and have been on part time working

Beetle kill timber exists in vast quantities

The Competitive Position

According to the US Department of Agriculture, there were 111 wood pellet production plants either in operation or about to start operation in 2009. Much of the new capacity has

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come on stream in the USA, and appears to be relatively small scale. The USDA states that BC production plants accounted for 50% of North American production in the early 2000s, but by 2009 that market share had dropped to 28%. 80% of US produced pellets, and 90% of Canadian shipments, are exported. In the case of the USA, exports are primarily to Europe; in the case of BC, pellets are exported both to Europe and to a lesser extent North-East USA. Over 80% of Canadian export volume is shipped in bulk, which requires volumes of at least 10,000 tonnes.

Plant Economics – A Comparison

	Okanagan (Viridis)	Burns Lake (Pinnacle)	Monte Lake New (Viridis)
Nameplate Capacity (long tons)	60,000 tons/yr	400,000 tons/yr	100,000 tons/yr (proposed)
Capital Cost	\$5.25m (of purchase)	\$30m	\$11m
Cost per metric of Capacity	\$88	\$75	\$110
Manual Employees	15	20+	15 - 20
Operation days/hrs a week	24/5	24/7	24/5
Market	Retail, NE USA	Power Generators, Europe	Power Generators, Asia
Cost of Production	\$90/tonne	Not available, \$70/tonne?	Est \$80 - \$85/tonne?

The largest single company in the marketplace is the privately owned Pinnacle Renewable Energy Group. Its annual production capacity is 760,000 tonnes, or 56% of Canada's total production. Part of this production is at the Canadian Forest Products (CanFor) sawmill at Houston BC, which is 30% owned by Pinnacle, 60% by Canadian Forest Products (so the sawmill becomes majority owner) and 10% by the local First Nations group, the Moricetown Indian Band. It has five plants in total, so its average plant size is well above the industry average. It is currently constructing a new plant at Burns Lake, which will become its sixth. The Burns Lake plant will use beetle kill wood, and have a capacity of 400,000 tons/yr. It is due for completion before the end of 2010. The economies of scale obtainable from this are demonstrated by the fact that the plant will have only 20 full time employees; 50 spin-off jobs will be created in servicing the plant. Output from Burns Lake will be entirely exported, in bulk, to European and Asian power generation markets.

Large plants give economies of scale

Interestingly as 90% of its product is shipped bulk, Pinnacle is no larger than Viridis in the packaged wood pellet market for local consumption; it sells only 50,000 tons/yr this way. Specifications for standard Pinnacle product are very similar to those for Viridis, with calorific value of 5 Mwh per tonne, <5% moisture and ash content of <1%.

Demand From Power Plants

In the USA, there are 80 power plants in 16 States using biomass as fuel, according to the Biomass Power Association. Wood pellets are slightly more expensive than coal or gas at present, particularly in the Western US where new gas shale exploitation has driven down the price of gas relative to other energy sources. However, wood pellets are proving very popular for co-generation with coal, because the price penalty versus coal is only minor, and up to 15% of the energy input can be substituted without incurring major equipment or modification costs. Up to this level, there are no practical problems with ash generation, slag, boiler fouling or corrosion. As wood pellets are chlorine and sulphur free, there are in fact advantages in adding them to a coal mix, particularly low quality coal. Other agricultural biomass can give problems in these areas.

Beyond an 85/15 mix, significant problems arise. Because wood pellets burn at a much lower temperature than coal, the burning chamber for wood needs to be significantly larger. The build-up of volatile gases can be a problem with coal – stove manufacturers caution against using coal in wood burning domestic stoves because wood burning stoves often do not have sufficient ventilation and there can be an explosion hazard. The sulphur in most coal creates an acid gas that demands different construction methods. Also, coal produces 10 – 20 times the quantity of ash/clinker.

Coal The Dominant Fuel Source

Coal supplies 49% of the electricity generated in the USA, and 7bn tons a year are used worldwide (but is responsible for 83% of the carbon emissions caused by electricity generation). The USA is the world's largest user of coal, still using slightly more than China. There are 1,493 coal fuelled power stations in the USA, with a nominal capacity of 335 GW and an actual generating output of 227 GW (many of these power stations are shut down in summer when demand is weaker). The USA consumes 1.02bntonnes of coal annually, 92% of it for electricity generation. Contrary the trend in Europe, the number of power stations burning coal increased by 40% between 2000 and 2006. In 2007, 152 new coal fired plants were in the planning stages, although there is an increasing trend for new fired coal planning stations to run into planning problems and energy policy in the USA is now moving significantly towards exploitation of the new gas shale deposits.

Comparisons, Wood Pellets v. Other Fuels

The most important comparison to be made with wood pellets is coal. This is because of the ability to mix wood with coal in large power generation plants, and the ratio of this mix can be changed (from 100-0 to a maximum 85-15) at very short notice and with no engineering work necessary. Coal is priced according to its energy content, and while the price of pellets will fluctuate wildly in the short term, over time the prices will tend to come together.

Wood pellets can be co-burned with coal

	Wood Pellets	Coal (Pittsburgh Seam and Nut Coal)
Price, retail at gate	\$200/ton	\$250/ton
BTU/lb	7850	13,440
US c./BTU	2.5c.	1.9c.
Ash Content	0.4%	9.1%
Carbon Content	52%	60% - 80%
Moisture Content	4%	5%
Temperature of Burn (Adiabatic)	1,980 °C (262 °C actual burn)	2,200 °C
Chlorine Content	126 ug/g	Up to 1%
Sulphur Content	0.013%	2.2%
Uranium	Nil	Up to 10ppm

The table above should be treated with some caution because:

- There is a huge difference in the types of coal available. For example, Anthracite, the top grade of thermal coal, contains 86% to 98% carbon, and in terms of energy generation produces 13,500 – 15,600 BTU/lb. Bitumous coal, however, can contain as little as 46% carbon, and its energy output can drop as low as 8,300 BTU/lb – not much different to wood pellets. Ash content can go as high as 15%, sulphur content to 3%. Wood pellets also differ, but the main issue in wood pellet quality is the quantity of ash produced and the moisture content rather than power output.
- There is a huge difference in the price of coal, in terms of discounts for quantity and in terms of location. This is primarily a factor of transport cost. The standard quoted price for the API#2 contract, the price that is used for most coal futures contracts, is considerably lower than the gate price for a small industrial user sending his own truck to the seam gate in Pittsburgh. The same is true of gas, where the price used for futures trading, Henry Hub, is considerably lower than the price users pay in NE USA, and where there is considerable difference in gas prices between NE USA, where there is a pipeline shortage, and West Coast, where there is newly discovered surplus shale gas driving down the price.

North American Wood Pellet Production By Region

Region	No. of Open + Closed Mills	No. of Open Mills	Capacity 2009 000 tonnes	Capacity Growth 2004-9	Capacity Growth 2007-9	Capacity Operating 2008	Average Size of Mill Tons/yr
US North	24	23	702	+2,700%	+97%	77%	30,000
US South	33	32	1,855	+1,400%	+270%	61%	58,000
US West*	21	19	711	+130%	+50%	80%	37,000
US Northeast	28	26	1,056	+640%	+153%	73%	40,000
Canada E of Rockies	12	11	411	+181%	+77%	75%	37,000
BC and Alberta*	13	13	1,357	+151%	+31%	90%	104,000
TOTAL	131	124	6,092	+718%	+101%	77%	46,000

* Excludes Pinnacle's Burns Lake plant, 400,000 tonnes under construction

Not all plants that were started were a success.

Wood pellet production is not a new technology, it has been taking place since the 1930s. In the early 2000s, however as the twin concerns about carbon burning and the rising price of oil combined, demand took off, and in the five years 2004-2009 both demand and production capacity has increased by 50% a year.

Such chaotic growth inevitably leads to an imperfect market. Not all of the new plants started in this period were a success. In addition to seven mills that have closed completely, one burned down (after a year of operation) and at least one became insolvent and was then started up again by a new owner.

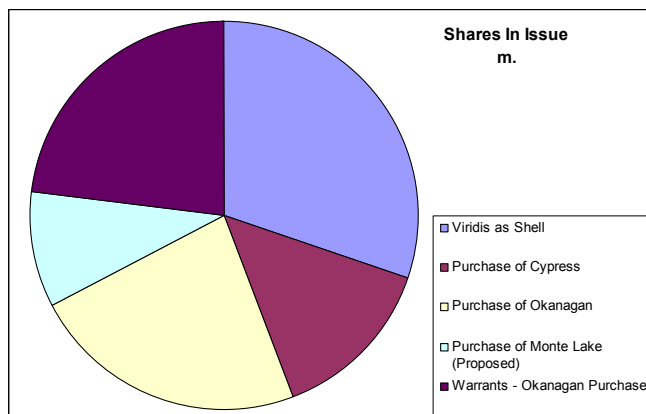
There have been huge variations in output, part of which can be put down to plants being unable to operate at nameplate capacity due to technical factors or poor operating procedures. In 2008, a year when there was strong demand with prices reaching an all-time peak in December, the average pellet mill appeared to be operating at only 77% of capacity – a function largely of plant shutdowns during summer months when demand is low. If the market had been perfect and all manufacturers had access to sufficient capital for stockbuilding during summer, capacity would have been 100%. No industry production figures are available for 2009, but if the 2008 production figures are applied to the 2009 capacity figures, the industry would be working at 53% of capacity.

The rate of installation of new capacity appears to have fallen off

For 2010, the rate of installation of new capacity appears to have fallen off, and we estimate that possibly only 1.4m tons of new capacity will come on stream his year. A third of that is in the Southern US states, where plants export almost all their production to Europe. We believe that demand growth is running faster than that.

Viridis – Structure and Recent History

For all practical purposes, Viridis was formed on March 8 2010, when a ‘shell’ company listed on the secondary Toronto exchange, Viridis, purchased the long established wood pellet distributor, Cypress. While Viridis had a trading history, it entirely related to a business that was sold in 2009. At the time of the Cypress deal, Viridis had cash of 0.14m, no employees and minimal overheads. At the time of purchase of Cypress, the directors of Cypress also became directors of Viridis.



On April 30 2010, a second company, Westwood Fibre Products, a wood pellet manufacturer in West Kelowna, in the Okanagan region of British Columbia, was purchased. Westwood, since renamed Okanagan Pellet, was Cypress’s largest single supplier. Cypress was Westwood’s largest single customer. The current Viridis is in essence a merger of two businesses, manufacturer and distributor, in order to take extra margin from vertical integration, and eliminate operational efficiencies that came from running the two businesses separately.

A third company, Monte Lake, is being purchased. Monte Lake brings a small timber mill into the group, providing a source of wood residue and savings, space for a second wood pellet production plant, space for a potential medium sized wood pellet fuelled power plant to link into the Province electricity grid, and the capacity to increase local logging for much greater vertical integration. Monte Lake also has its own railhead, unlike Okanagan/Westwood. This makes it an ideal site for a plant to ship in bulk, for Asian power generation markets.

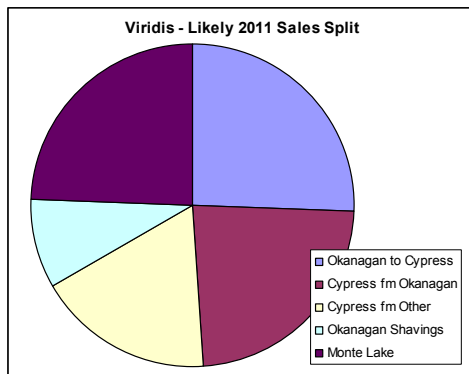
Monte Lake has its own railhead

	Cypress	Okanagan	Monte Lake
Site Area	Nil – office facilities in Downtown Vancouver	Close to Okanaga Centre. Residential area nearby creates planning issues for expansion. Limited space for storage and expansion – most storage off site, incurring double handling costs.	In forest area away from habitation, ample land for expansion and for summer stockpiling.
Railhead		No – railhead at offsite storage area 10 miles away.	Yes.
Site Management	Strong	Strong in parts – no finance capability on site	Strong in parts
Sales & Marketing	Strong, particularly with NE US retailers	Weak, though recently strengthened for local (BC) markets	Non-existent
Profitability	Strong	Strong in past, loss-making in late 2009-early 2009 because of industry overcapacity and warm winter 2009/10 on W Coast	Good until 2008 and collapse of North American construction industry, its main customer for post and rail.

Sales and marketing at two of the companies was weak

Seasonality

Viridis's business is intensely seasonal. Summer demand for wood pellets from its mainstream retail/small business customers in the NE USA is minimal. Because wood pellets bags are prone to damage if double handled, and because this is a low value high volume commodity, wholesalers and retailers are reluctant to buy stock in the summer when prices are lower, which exacerbates the seasonal price peaks and troughs.

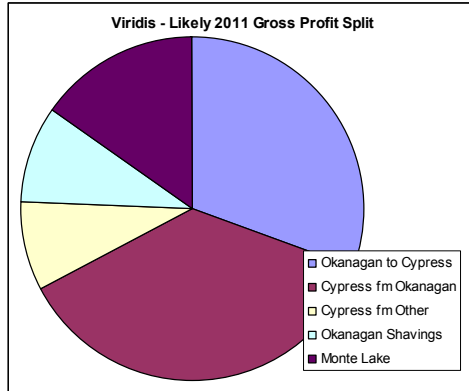


A manufacturer, such as Okanagan, will ideally continue producing pellets throughout the spring and summer, in order to keep the plant at full utilisation, but will stockpile as much of the output as its finances (and its storage facilities) will allow. Steady, full capacity working means lower overall production costs, and hence a bigger profit margin. Its ideal position will leave it operating at a significant loss during the spring and summer months, but making a much larger profit in the winter months. Summer profits

Summer months and losses are irrelevant to a wood pellet manufacturer

and losses are utterly irrelevant to a wood pellet manufacturer; indeed they can be taken as a sign of weakness, indicating lack of confidence by bankers/financiers and a profit potential for the following winter that will almost certainly be sub-optimal.

A distributor, such as Cypress, will only buy in the spring and summer months to the extent to which it can make an adequate return allowing for the costs of double handling and the risk of stock damage.



The two parts of the Viridis business, therefore, have in the past had very different seasonal imperatives. For the future, however, the strategy is very clear. The Okanagan factory (and the Monte Lake factory when built) must operate at full capacity throughout the year in order to gain maximum benefit from fixed costs and have the lowest possible cost per ton of finished product. Cypress must stockpile this product for sale at peak prices during the winter, in order to give the highest possible profit margin.

Seasonality in 2010 has been considerably exaggerated, over and above normal trends. This is for the following reasons:

- The winter of 2009/10 was exceptionally mild, leading to much reduced demand for all heating fuels, wood pellets included. The unusual nature of the winter was shown at the Winter Olympics, held in BC, where artificial snow had to be generated to enable some of the events to take place, and rain and slush were a significant issue for spectators and competitors alike.
- Surplus stock being unloaded on the market, following the capacity expansion of 2009 coupled with a shortage of bank finance for those holding inventory and companies just having completed new plant.

Seasonality from 2011 onwards may be reduced somewhat by exports to bulk markets overseas that do not experience the same seasonality.

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Viridis As A Shell

Until mid-2009, Viridis was known as Grid Sense Systems, and was a failed 'penny stock' trading on the Toronto second tier exchange that had accumulated losses of \$8.6m over its lifetime. A new management sold its operating subsidiaries, leaving net cash in the business of \$0.14m. There were at that time 12.28m shares in issue. This clean shell, by then renamed Viridis Energy Inc, became the vehicle for the new acquisitions.

It is intended that Viridis will undertake some 'clean energy' trade, for example in palm oil pressings and other biofuels. Some negotiations have taken place, but no contracts have been signed. We think it quite feasible that Viridis will complete some business in this field, and make a profit from it. However, we have not included anything in our forecasts.

Viridis may do some 'clean energy trading, for example in palm oil pressings and other biofuels

Okanagan Pellet Company

Okanagan Pellet Company, which at the time was known as Westwood Fibre Products, was purchased effective April 30, 2010. The initial purchase agreement, which requirement payment to be made in cash, the majority upon completion, was renegotiated to \$2.65m in cash plus the repayment of \$2m of loans. Viridis assumed \$1.6m of short term debt with the acquisition, so the total Enterprise Value of the business acquired was \$6.25m.

Okanagan Pellet owns a wood pellet mill with 50,000 tons/year capacity. In recent months this mill has been operating at 98% capacity, and has been managing to produce in excess of its theoretical maximum in the short term, with monthly output exceeding 5,000 tons.

It also processes and supplies wood shavings to the equine establishment in California and other Western US states. The correct type of softwood shavings make magnificent bedding for horses in stables, and Okanagan supplied 600,000 bales of shavings last year, 90% of them going to California. The margins obtained on these are treble the margins than can currently be obtained in the temporarily saturated wood pellet market. Management believes there are substantial prospects to increase these sales and is currently initiating an intensive marketing campaign to take a larger share of this market. Okanagan does not have as much competition as might be expected in this market, because it has access to a source of shavings that is particularly soft, from a mill that is operating in a way that is particularly suited to this product.

The mill is average size for the Canadian industry, but has two particularly strong factors running in its favour:

- Its pellets are very high quality, in an industry sometimes known for its variable quality.
- It is well above average in terms of efficiency, operating with far fewer employees than most Canadian wood pellet mills.

Okanagan's pellets have a calorific value of 7,847 BTU/lb (18.25 MJ/kg, 4,359 Kcal/kg). On a dry basis, this rises to 8,789 BTU/lb. This is exceptionally high for the pellet industry, and is equivalent to what is obtained from some medium grade coals.

Its pellets have a moisture content of only 4.3% (moisture content is one of the major factors in limiting the power output of wood pellets). Ash content is 0.4%. A low ash content cuts maintenance costs, because it means the boiler has to be cleaned and emptied less frequently.

The pellets have a low ash content

Sulphur and chlorine content are minimal, at 0.04% and 0.013% respectively. By contrast, coal can run at up to 2% sulphur and/or chlorine content, giving rise to major pollution problems and the formation of acid rain.

The 'fines' content, i.e. dust, is 0.2%. This is particularly important in a retail context, because to the domestic user, dust will not produce energy and will also prove intensely irritating. (In a commercial boiler or a power generation plant the dust will be contained by the automatic hopper feed and some will be converted into energy)..

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Extraordinarily, Okanagan/Westwood in the past has made to attempt to capitalise upon the superiority of its product by obtaining higher prices. Okanagan has been consistently rated highly in bulletin board discussions and tests, and considering the variable (indeed suspect) quality of some competitive wood pellets, there is considerable scope for benefiting from this.

Okanagan is able to deliver a consistently high quality pellet partly because of its mix of fibres – it excludes all bark from its product and uses a variety of different softwoods – and partly because of its plant, which includes supplementary dryers that are not used by some other manufacturers.

The Okanagan factory is heavily computer controlled, with automatic hopper feed and a sophisticated (for the industry) bagging line. The entire plant runs, on a 24 hour day 5 days a week with some weekend working in addition, with only 4 professional and 15 manual labour staff. Because of this its production costs are low, and we estimate that its costs per ton of production are probably no more than CAN\$80 - \$90. It is difficult to be more precise, because of the sales of shavings to California that share the same overhead base but do not go through the same manufacturing process. Costs are volume related; if the plant is not running at 100% capacity fixed costs become more important and overall costs go up. It is important therefore to keep the plant running at full capacity and regulate demand by pricing rather than by withholding product in slack times.

Production costs are low

In Okanagan, Viridis has purchased a particularly profitable company.

The calendar year to December 2009 was a bad one for almost the entire North American wood pellet industry. The influx of a large number of new plants had, as we have seen, resulted in a supply surplus that drove down prices and pushed many companies to the wire. Yet Okanagan, at the time using the name Westwood, had a record year. Its EBIT before exceptional items rose from \$0.61m to \$1.07m, a gain of 75%. Its sales rose by 9% - sales is the dominant pellet division rose by 22%. Pellet Gross Margins rose from 23.4% to 32.1%, which is a high figure for the industry even in normal times. Shavings Division Gross Margin, while down, were still impressive for a product that requires only limited processing. They were 36.4% vs 41.7%.

Westwood's product delivery costs are placed under 'administration' rather than 'cost of sales', a policy dictated by the requirements of US GAAP accounting. Shavings products, being shipped down to California, bore rather higher delivery costs than pellets, because most pellets were either sold at the gate or to local markets where freight costs are low.

The Westwood 2009 accounts are interesting in other respects also. They show a massive increase in inventory, from \$0.3m to \$1.0m. This was equivalent to six weeks' sales, and is highly unusual for end-December, when demand is at its strongest and the plant should be working flat out to satisfy winter demand. Also, the accounts show that of the receivables figure of \$0.6m, 53% was due from a single customer, which was Cypress Pacific Marketing. The conclusion we draw from this is that the sales negotiations had taken the previous owners' attention from the day to day management of the business, something that would benefit Viridis/Cypress when it came to agreeing final terms.

It is possible to take a cynical view of these accounts, and suggest that during the fall and early winter of 2009 Westwood was manufacturing for inventory rather than for genuine customers, and therefore that its sales figures were overstated. We point out, however, that even if the entire increase in inventory were to be deducted from the Pellet Division sales figure, pellet sales would still have risen by 8%.

The accounts also show how aware the management is of the need to securely tie in raw material supplies. During the year \$0.4m was invested in pre-paid raw materials, largely in association with equipment at a logging company to facilitate the supply of the correct quality shavings for the Californian horse market.

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Cypress Pacific Marketing

Cypress Pacific Marketing is the core business within Viridis. It is solely a marketing and distribution company, and last year 96% of its revenue was derived from wood pellet sales. It has supplied all the key operational management to Viridis.

A change in financial accounting periods makes comparisons difficult with Cypress. Its last full twelve month accounting period was to February 2009, a good twelve months for the wood pellet industry, but by now rather ancient history. Sales in this twelve months were \$6.17m. The accounting period-end was then switched to December, and for the ten months to December 2009 sales were higher, at \$6.80m. As the three missing months, December January and February, are three of the highest shipping months of the year, it is fair to assume that Cypress was continuing to grow rapidly in spite of the cyclical downturn that was harming so many competitors. We have examined management's monthly tonnage and price figures that suggest this indeed the case, and that Cypress's sales on an annual basis were running at at least \$8m.

As a distribution business, with no processing or even re-bagging to undertake, gross margins are low. They were 14.8% for y/e February 2009 and 16.1% for the part-year to November 2009. Closing inventory at November 2009 was significantly higher than it had been in February, but we put this down to seasonality rather than any structural issue. It was probably running at around 8 weeks' underlying sales.

EBIT after stripping out foreign exchange gains was not high at \$0.32m for the year to February 2009, and \$0.47m for the nine months to November 2009, giving EBIT margins of 5.2% and 6.9% respectively. But this is a distribution company, a rapid turn round business with a speedy and efficient use of capital. Return on capital (shareholders equity, shareholder advances and bank debt) was 27% and 15% for these two periods respectively, which was certainly a good use of investment money. It is interesting to note that whereas at the end-February accounting cut-off Accounts Payable exceeded Accounts Receivable by \$0.5m, nine months later by the end-November 2009 cut-off the position had reversed, and Cypress was bankrolling its customers rather than the other way round. We put this down to seasonal factors.

Monte Lake

Viridis has reached agreement to buy the private timber business Monte Lake. The agreement, first reached on April 7 2010 and then amended on July 12, is by a 'binding letter of intent', and the purchase price is to be 4m shares. At the current market price of 40c, that is equivalent to \$1.6m. Up to a maximum of a further 1.375m shares will be issued to a debt guarantor unless the debt is replaced from commercial sources. Debt at present is \$2.4m, suggesting an Enterprise Value for the business of \$4.0m. No date has been set for the completion of the transaction, and the deal is subject to final approval from the Toronto Stock Exchange, which is still under negotiation.

The business has an annual sales revenue of \$5m, and made a small loss. For the current year, Monte Lake's management is projecting sales revenue of \$5.9m and a loss of \$276,000.

Monte Lake is being purchased for its potential, rather than for what it has at the moment. It owns a 36 acre site in central British Columbia that abuts an electricity substation, as well as a main road and a railway siding. Viridis intends, subject to planning approval and the raising of sufficient equity finance, to use the spare land on this site for two purposes:

- The construction of a wood pellet plant with a capacity of 100,000 tonnes/yr, using the technical process currently being operated at the Okanagan plant and trebling the group's manufacturing capacity, and
- A co-generation electrical power generation plant, running largely on the site's own manufactured wood chip.

The three 'missing' months are three of the highest shipping months of the year

Monte Lake is being purchased for its potential rather than for what it has at the moment

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At present the site manufactures fencing. It obtains the raw material from this partly from its own forestry concessions.

All forestry land in BC is owned by the Province, and permits to log are granted, enabling companies to have security of supply, but not ownership of the underlying land. All forestry permits come with a 10 year requirement to return the land to either replant or scarify to facilitate an acceptable level of natural re-seeding after logging has taken place.

The logs are stripped of bark, planed smooth and cut to size, and treated with preservative before selling as post and rail to farmers and Government organisations. Annual sales had grown to in excess of \$8m a year, and the business made a good profit, until the collapse of the US housebuilding industry in 2008 forced all lumber factories in North America to find new markets for their product, and hence a much more competitive market in post and rail.

Monte Lake's post and rail occupies a premium position in the market, because of the clean and smooth appearance of the product. There is no reason why, when the market recovers, that the post and rail business should not return to a sound level of profit, and indeed sales to the USA, which used to be responsible for a third of sales, have risen strongly in over the summer.

Monte Lake has invested heavily in the last five years in keeping its plant up to date. It is one of only 56 sites in Canada to have CPRD certification for wood preservation treatment, 95% of its output is sold treated, and there are 9 wells on site monitoring groundwater quality. The wood preservation treatment plant can take logs up to 80ft in length. It is one of only two only post and rail manufacturers in British Columbia with its own certified treatment plant.

There are grounds for optimism about the current businesses on the site. The first of these is that the unit has never had a salesman; for its first three years in its current configuration, it had a struggle keeping pace with the orders that were coming in. The past two years have been occupied with hectic downsizing, from its peak of 75 employees to the current 21 in the factory, some of whom are part time, plus a further 10 in the forestry and logging crew.

The proposed new woodchip plant and co-generation plant will between them require a considerable increase in logging capacity, with possibly half the timber required being provided by beetle kill. The bark stripped from the rail and post timber (and from the wood chip timber) will go to the power generation facility.

The electric power generating plant will have a capacity of 25 – 30 MW, of which 10 MW will be wood chip generated, and will be subject to the award of a 'call for power' contract with the Province's power supply organisation, BC Hydro (see our previous research notes for details of BC Hydro and the Call For Power). It will also be eligible for "ICE" grant funding under the British Columbia Province Clean Energy Bill. It will utilise \$2.1m new technology steam dryers from Sweden. An informal assurance has been received from the Ministry of Forests that a sufficient supply of timber will be made available.

The co-generation plant will have a cost of \$50m, and will generate revenue of \$12m/yr. It will be mostly bank financed; discussions are as yet at an early stage and there can of course be no guarantee that the go-ahead for this plant will be given.

The new wood pellet plant will cost \$11m.

Monte Lake carries with it a significant amount of debt. This indebtedness is being worked off, however, at a greater rate than would be expected given its current lack of profitability. A prime reason for this is the high level of depreciation and amortisation on the relatively new plant and equipment. Monte Lake operates with an April year end. At end-April 2009 debt stood at \$3.3m. This had been worked down to \$2.6m at April 2010, has been reduced further since then and is projected to stand at \$2.1m at end-April 2011. Cash flow and profitability will be further aided by the ending of a \$10,000 lease commitment from April 2011.

There are grounds for optimism

A new power generating plant is a possibility

A new wood pellet plant is planned

Forecasts

The Viridis reported results for the first two quarters of 2010 are no help whatsoever in forecasting what happens from now on. Cypress was only included from March 8, and Okanagan Pellet from April 30, so the make-up of the reported numbers is as follows:

- Q1: the shell, 3 weeks of Cypress, none of Okanagan. Because the preceding winter had been so mild, these three weeks were effectively summer, with very little demand and low prices.
- Q2, the shell, 3 months of Cypress, 2 months of Okanagan. All trading in the weak summer months when ideally both companies should be storing production for sale at higher prices in the following winter.

For Cypress, the sales split, in terms of tonnage, was relatively even during 2009, running 24%, 25%, 30%, 20% for the four quarters. The volumes were high in the summer months because Cypress was unloading stock on falling prices – a wise decision as it turned out, because the warm winter resulted in a poor Q4 because the distribution pipeline was clogged up.

It is important to bear in mind that the sales figures for the newly structured Viridis group will be lower than the combined total that the two companies were producing when independent. This is because Cypress has been taking 60% of the output of Okanagan, and these sales must not be double counted. Where Viridis will gain, however, is in the broader margin. The combined group ought to be able to manage a GM of approaching 50% from the fourth quarter onwards. General and Administrative expenses will rise, because Okanagan has been run on far too tight a budget until now, in particular not having sufficient sales and marketing spend, and there is very little overlap between the two companies to allow economies to be made.

We have assumed that the combined businesses will be able to sell at a level to enable the Okanagan plant to run at virtually full capacity in 2011 and 2012. This is a considerably higher level of than either company has managed on its own. But previously Okanagan has been constrained by a lack of sales outlets and Cypress has been constrained by uncertainty over supplies, and both companies have been constrained by lack of capital to carry them over the quiet summer months. All these issues should now be resolved. Our assumed selling price for the Okanagan-Cypress pellets over these years is \$200/ton. The sales team is currently concluding sales considerably in excess of that.

If the capital raising is successful, then from the beginning of 2012 a second pellet plant at Monte Lake will come on stream. This will sell into the wholesale/power generation markets where prices are lower. We have assumed sales of virtually the full 100,000 ton/year capacity, but at a substantially lower price, \$150/ton.

We expect this new plant to generate \$15m of sales and \$3.5m of gross profit a year. The operating profit is likely to be c.\$2.5m, which suggests a return on capital of over 20%.

Wood pellet profits are extraordinarily sensitive to price movements, and any increase in prices beyond the levels we have assumed will largely drop through to the bottom line. On full production, a \$10/ton rise in prices would increase sales by \$1.6m a year and profits by well over \$1m a year. In a scenario of rising prices, the most serious possible negative would be a shortage (or rising prices) of raw materials.

When pellet prices fall, of course, there is a squeeze on profitability.

Our forecasts suggest that even in 2012, if it is to maximise its annual profitability, Viridis Energy is likely to make a small loss in the two summer quarters, Q2 and Q3.

The 2010 results will show only part years for the two main trading companies

We have assumed that the Okanagan plant will run at virtually full capacity in 2011 and 2012

Cash Flow and Balance Sheet

At end-June 1010 Viridis Energy Inc had shareholders' equity of \$8.8m, and debt of \$5.6m, most of which was short term. This gave gearing of 63%. The goodwill element of the balance sheet was \$4.8m, so if goodwill is deducted from shareholders' equity gearing would be over 100%. Subsequently a further \$1.4m of shareholder equity has been raised, at 50c/share (plus out-of-the-money options) This has reduced gearing to 41%. At end-June, debt is seasonally relatively high because inventory is being funded ahead of the key Autumn selling season.

The acquisition of Monte Lake brings in \$2.4m of new debt, \$2m of new equity. Additionally, the new pellet plant at Monte Lake will cost \$11m, approximately 25% of which we expect to be financed by debt. A new equity capital raising will take place in late 2010/early 2011 in order to maintain a sensible balance. Existing institutional investors are, we understand, supportive of this. The size and price of this issue has yet to be finalised.

We expect year-end gearing (debt/equity) to peak at c.65% in December 2011, immediately before the new Monte Lake plant comes on stream. In practice, deferred payments to equipment suppliers may keep the gearing figure lower than that. Gearing in mid-summer may be higher because of inventory financing considerations.

We expect the debt/equity ratio to peak at c. 65%

Viridis Energy Inc. Key Balance Sheet Items

	6/2010A	12/2010E	12/2011E	12/2012E
Start Total Debt	-5.60	-5.60	-4.51	-14.77
Unwinding of Summer Inventory		2.00		
Debt in Monte Lake		-2.40		
Cost of new Monte Lake plant			-11.00	
Cash Payments to Monte Lake vendors		0.00		
Cash Flow H2 2010		0.09		
Cash Flow 2011			0.74	
Cash Flow 2012				2.19
July 2010 Private Share Placement		1.40		
Total Debt	-5.60	-4.51	-14.77	-12.58
	6/2010A	12/2010E	12/2011E	12/2012E
Start Shareholders' Equity	8.80	8.80	11.94	22.68
Loss For H2 2010		-0.06	-0.06	-0.06
Retain Profit for 2011			0.80	
Retained Profit for 2012				2.80
July 2010 Private Placement		1.20		
Shares Issued for Monte Lake*		2.00		
Shares issued end2010/early 2011			10.00	
Total Shareholders' Equity	8.80	11.94	22.68	25.42
Gearing (Debt/Equity %)	64%	38%	65%	49%
<i>*4m shares value 50c each, co. purchased at fair value</i>				
Shares In Issue	27.40	27.40	34.28	54.28
July 2010 Private Placement		2.88		
Shares Issued for Monte Lake*		4.00		
Shares issued end2010/early 2011			20.00	
Total Shares In Issue	27.40	34.28	54.28	54.28

Conclusion

The wood pellet industry should have a good future ahead of it, with further growth coupled to a recovery in prices, evidence of which is already starting to be seen. Viridis is an interesting company with a good business model, that has presented a good case for capital investment and which ought to be generating profits from 2011 onwards.

A good case for capital investment

This company will be of great interest to value investors and the environmental fund management community.

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	Full	Years	
CAN\$m	2010E	2011E	2012E
Sales	10.00	19.30	35.50
Cost of Sales	6.65	11.34	22.67
Gross Income	3.35	7.97	12.84
Gross Margin	34%	41%	36%
Expenses			
Amortisation of Deferred Development Costs	0.00	0.00	0.00
Amortisation of Intangible Assets	0.00	0.00	0.00
Amortisation of Property Plant & Equipment	0.30	0.54	1.40
Consulting	0.05	0.12	0.08
Filing and Transfer Fees	0.04	0.00	0.00
General, Selling and Administrative	1.45	2.10	3.00
Investor Relations	0.24	0.04	0.04
Management Fees	0.25	0.48	0.48
Professional Fees	0.41	0.24	0.29
Rent	1.09	2.00	2.00
Research & Development	0.00	0.40	0.40
Returns & Discounts	0.00	0.00	0.00
Salaries and Benefits	0.76	0.96	1.27
Stock Based Compensation	0.32	0.00	0.00
Travel and Promotion	0.10	0.24	0.44
Total Continuing Expenses	5.01	7.27	9.60
Operating Profit/Loss	-1.66	0.70	3.24
Operating Margin %	-17%	4%	9%
Other Items			
Foreign Exchange Profit/Loss	0.00	0.00	0.00
Gain on Acquisition of Business Operations	2.77	0.00	0.00
Interest	-0.29	-0.36	-0.72
Sundry Income	0.26	0.40	0.40
Total Other Items	2.73	0.04	-0.32
Pre-tax Profit/Loss	1.07	0.74	2.92
Tax Charge \$	0.00	0.00	0.73
Tax Charge %			
After Tax Profit	1.07	0.74	2.19
Wtd Ave No. of Shares Diluted m.	19.83	52.52	54.30
EPS (CAN Cents)	5.40	1.40	4.03
Pre-tax Profit/Loss Adjusted	-1.70	0.74	2.92
After Tax Profit/Loss Adjusted	-1.70	0.74	2.19
EPS (CAN Cents) Adjusted	-8.57	1.40	4.03

Gross Margins rise in 2011 a full winter (busy season) of sales will be included. In 2012 gross margins will fall because the new Monte Lake pellet plant, will have lower gross margins than the existing business.

Management	Major Shareholders
<p>Chairman: Robert Gardner QC. He is also chairman of Stealth Energy.</p> <p>Chief Financial Officer: Isaac Moss. He is also a director of Syntaris Power, a developer of hydro-electric power projects in British Columbia.</p> <p>Chief Executive Officer: Chris Robertson, founder of Cypress Pacific Marketing, the largest subsidiary of Viridis Energy. Previously an executive with Forest City, a NYSE listed company.</p> <p>Chief Operating Officer: Michele Rebiere. 18 years senior management experience. Studied finance at Wharton.</p> <p>Vice President Sales and Marketing: Geordie Munro, part of the Cypress Pacific management team for five years.</p> <p>Export Manager: Bob Wood, part of Cypress Pacific management team.</p> <p>Non-Executive Directors:</p> <p>Brian Smith QC. A Director of British Columbia Hydro. A past Minister of Energy and Mines of the Province of British Columbia and former Attorney General of BC. Also former chairman of Canadian National Railways.</p> <p>John Heimbecker, Vice President of Parrish & Heimbecker, an agricultural company with \$1.7bn of sales. Also chairman of Canada Ports Clearing Association.</p> <p>Alphonse Plaktis, Principal of Soho Ventures Inc.</p>	<p>Cornwall Investments Ilc of New Jersey 14.8%</p> <p>Jesson Chen 5.4%</p> <p>Insider Shareholdings: 34%</p>
Key Dates	Key Milestones
<p>Late November: Release of Q3 Results</p> <p>November: London Investor Roadshow</p> <p>Late March: Release of Full Year 2009 Results</p>	<p>June 2009: Sale of Grid Sense Systems, its previous business leaving a clean shell. Change of name to Viridis Energy.</p> <p>March 8 2010: Acquisition of Cypress Pacific Marketing, a wood pellet distribution company.</p> <p>April 30, 2010: Acquisition of Okanagan Pellet Company (known at the time as Westwood Fibre Products), a wood pellet producer in BC.</p> <p>October 2010: Finalisation of acquisition of Monte Lake, a log processing specialist and post and rail producer.</p>

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