

POTLATCH CORP  
Form 10-Q  
July 30, 2009  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended June 30, 2009

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  
(State or other jurisdiction of  
incorporation or organization)

82-0156045  
(I.R.S. Employer  
Identification No.)

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601 West 1st Ave., Suite 1600  
Spokane, Washington  
(Address of principal executive offices)

(509) 835-1500

99201  
(Zip Code)

(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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)  Smaller reporting company

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

The number of shares of common stock of the registrant outstanding as of June 30, 2009 was 39,745,368.

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**POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES**

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## ITEM 1.

**Financial Statements**

Potlatch Corporation and Consolidated Subsidiaries

Consolidated Condensed Statements of Operations and Comprehensive Income

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

|  | Quarter Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|--|---------------------------|------------|------------------------------|------------|
|  | 2009                      | 2008       | 2009                         | 2008       |
| Revenues   | \$ 78,782                 | \$ 103,024 | \$ 208,375                   | \$ 215,583 |
| Costs and expenses:  |                           |            |                              |            |
| Depreciation, depletion and amortization   | 4,906                     | 5,130      | 11,518                       | 12,537     |
| Materials, labor and other operating expenses  | 63,113                    | 65,835     | 141,006                      | 137,303    |
| Selling, general and administrative expenses   | 10,139                    | 10,093     | 19,316                       | 22,749     |
|  | 78,158                    | 81,058     | 171,840                      | 172,589    |
| Earnings from continuing operations before interest and taxes  | 624                       | 21,966     | 36,535                       | 42,994     |
| Interest expense   | (4,880)                   | (5,392)    | (9,714)                      | (10,673)   |
| Interest income  | 8                         | 126        | 38                           | 454        |
| Earnings (loss) from continuing operations before taxes  | (4,248)                   | 16,700     | 26,859                       | 32,775     |
| Income tax benefit   | 7,940                     | 2,172      | 5,604                        | 9,384      |
| Earnings from continuing operations  | 3,692                     | 18,872     | 32,463                       | 42,159     |
| Discontinued operations:   |                           |            |                              |            |
| Gain (loss) from discontinued operations (including losses on disposal of \$-, \$(916), \$-, and \$(20,016))           | 130                       | 3,990      | (6,424)                      | (18,071)   |
| Income tax benefit (provision)   | (56)                      | (1,383)    | 2,547                        | 7,649      |
|  | 74                        | 2,607      | (3,877)                      | (10,422)   |
| Net earnings   | \$ 3,766                  | \$ 21,479  | \$ 28,586                    | \$ 31,737  |
| Other comprehensive income (loss), net of tax  |                           |            |                              |            |
| Defined benefit pension and other postretirement benefit plans:  |                           |            |                              |            |
| Amortization of actuarial loss included in net periodic cost, net of tax of \$627, \$613, \$1,254, and \$1,576         | \$ 981                    | \$ 957     | \$ 1,961                     | \$ 2,464   |
| Amortization of prior service credit included in net periodic cost, net of tax of \$(16), \$(168), \$(32), and \$(335) | (25)                      | (261)      | (50)                         | (523)      |
| Curtailment loss, net of tax of \$77, \$24, \$77, and \$531  | 121                       | 37         | 121                          | 830        |
| Other comprehensive income, net of tax   | 1,077                     | 733        | 2,032                        | 2,771      |

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|   |          |           |           |           |
|---|----------|-----------|-----------|-----------|
| Comprehensive income  | \$ 4,843 | \$ 22,212 | \$ 30,618 | \$ 34,508 |
| <b>Earnings per common share from continuing operations:</b>          |          |           |           |           |
| Basic   | \$ 0.09  | \$ 0.48   | \$ 0.82   | \$ 1.07   |
| Diluted   | 0.09     | 0.48      | 0.81      | 1.06      |
| <b>Earnings (loss) per common share from discontinued operations:</b> |          |           |           |           |
| Basic   | \$       | \$ 0.06   | \$ (0.10) | \$ (0.26) |
| Diluted   |          | 0.06      | (0.09)    | (0.26)    |
| <b>Net earnings per common share:</b>                                 |          |           |           |           |
| Basic   | \$ 0.09  | \$ 0.54   | \$ 0.72   | \$ 0.81   |
| Diluted   | 0.09     | 0.54      | 0.72      | 0.80      |
| Distributions per common share  | \$ 0.51  | \$ 0.51   | \$ 1.02   | \$ 1.02   |
| <b>Average shares outstanding (in thousands):</b>                     |          |           |           |           |
| Basic   | 39,745   | 39,459    | 39,743    | 39,389    |
| Diluted   | 39,869   | 39,696    | 39,876    | 39,633    |

Certain 2008 amounts have been reclassified to conform to the 2009 presentation.

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

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Potlatch Corporation and Consolidated Subsidiaries

Consolidated Condensed Balance Sheets

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

|   | June 30,<br>2009 | December 31,<br>2008 |
|---|------------------|----------------------|
| <b>ASSETS</b>   |                  |                      |
| Current assets:   |                  |                      |
| Cash  | \$ 2,178         | \$ 885               |
| Short-term investments  | 2,112            | 3,034                |
| Receivables, net  | 28,665           | 38,750               |
| Restricted cash   | 106,250          |                      |
| Note receivable   |                  | 100,000              |
| Inventories   | 28,244           | 36,686               |
| Other assets  | 17,310           | 16,423               |
| Total current assets  | 184,759          | 195,778              |
| Land, other than timberlands                                      | 3,521            | 3,521                |
| Plant and equipment, at cost less accumulated depreciation        | 78,642           | 82,613               |
| Timber, timberlands and related deposits, net                     | 547,104          | 553,913              |
| Deferred tax assets   | 74,905           | 74,653               |
| Other assets  | 27,374           | 27,843               |
|   | \$ 916,305       | \$ 938,321           |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                        |                  |                      |
| Current liabilities:  |                  |                      |
| Current installments on long-term debt                            | \$ 100,007       | \$ 100,410           |
| Current notes payable   | 121,300          | 129,100              |
| Accounts payable and accrued liabilities                          | 68,818           | 57,635               |
| Total current liabilities   | 290,125          | 287,145              |
| Long-term debt  | 220,937          | 220,927              |
| Liability for pensions and other postretirement employee benefits | 212,597          | 216,926              |
| Other long-term obligations                                       | 14,797           | 15,089               |
| Stockholders' equity  | 177,849          | 198,234              |
|   | \$ 916,305       | \$ 938,321           |
| Stockholders' equity per common share                             | \$ 4.47          | \$ 4.99              |
| Working capital   | \$ (105,366)     | \$ (91,367)          |
| Current ratio   | 0.6:1            | 0.7:1                |

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

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Potlatch Corporation and Consolidated Subsidiaries

Consolidated Condensed Statements of Cash Flows

Unaudited (Dollars in thousands)

|   | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--------------------------------------|-------------|
|   | <b>2009</b>                          | <b>2008</b> |
| <b>CASH FLOWS FROM CONTINUING OPERATIONS</b>  |                                      |             |
| Net earnings  | \$ 28,586                            | \$ 31,737   |
| Adjustments to reconcile net earnings to net operating cash flows from continuing operations: |                                      |             |
| Loss (gain) from discontinued operations  | 3,877                                | (1,788)     |
| Loss on disposal of discontinued operations   |                                      | 12,210      |
| Depreciation, depletion and amortization  | 11,518                               | 12,537      |
| Proceeds from sales deposited with a like-kind exchange intermediary                          | (2,030)                              | (30,011)    |
| Basis of real estate sold   | 6,864                                | 5,793       |
| Deferred taxes  | (12,304)                             | (2,042)     |
| Equity-based compensation expense   | 1,798                                | 1,875       |
| Employee benefit plans  | (1,729)                              | (308)       |
| Other   | (43)                                 | 98          |
| Working capital changes   | 718                                  | (13,217)    |
| Net cash provided by operating activities from continuing operations                          | 37,255                               | 16,884      |
| <b>CASH FLOWS FROM INVESTING</b>  |                                      |             |
| Change in short-term investments  | 19,199                               | 26,299      |
| Additions to plant and properties   | (6,079)                              | (24,567)    |
| Deposits on timberlands   |                                      | (27,328)    |
| Other, net  | (201)                                | 839         |
| Net cash provided by (used for) investing activities from continuing operations               | 12,919                               | (24,757)    |
| <b>CASH FLOWS FROM FINANCING</b>  |                                      |             |
| Change in book overdrafts   | 380                                  | (3,675)     |
| Increase (decrease) in notes payable  | (7,800)                              | 19,000      |
| Issuance of common stock  | 91                                   | 3,310       |
| Repayment of long-term debt   | (392)                                | (188)       |
| Distributions to common stockholders  | (40,540)                             | (40,252)    |
| Other, net  | (40)                                 | (1,837)     |
| Net cash used for financing activities from continuing operations                             | (48,301)                             | (23,642)    |
| Cash flows provided by (used for) continuing operations                                       | 1,873                                | (31,515)    |
| Cash flows of discontinued operations:  |                                      |             |
| Operating cash flows  | (580)                                | 35,257      |
| Investing cash flows  |                                      | (7,176)     |
| Financing cash flows  |                                      | 994         |
| Increase (decrease) in cash   | 1,293                                | (2,440)     |
| Cash at beginning of period   | 885                                  | 9,047       |
| Cash at end of period   | \$ 2,178                             | \$ 6,607    |

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Not included in the cash flows from financing activities for the six months ended June 30, 2009 is a non-cash transaction totaling \$106.3 million, as described in Note 5.

Net interest paid in the six months ended June 30, 2009 and 2008 was \$16.1 million and \$17.1 million, respectively. Net income tax refunds in the six months ended June 30, 2009 and 2008 were \$0.6 million and \$4.2 million, respectively.

Not included in additions to plant and properties for the six months ended June 30, 2009 and 2008, are non-cash transactions totaling \$0.2 million and \$26.6 million, respectively, for the purchase of timberlands.

Certain 2008 amounts have been reclassified to conform to the 2009 presentation.

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



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Potlatch Corporation and Consolidated Subsidiaries

Notes to Consolidated Financial Statements

Unaudited (Dollars in thousands)

NOTE 1.

**General**

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.

Potlatch is 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 consists of income from the sale of standing timber. Through our wholly owned taxable REIT subsidiary, which we refer to in this report as Potlatch TRS, we also operate a real estate sales and development business and six manufacturing facilities that produce lumber, plywood and particleboard.

The accompanying Consolidated Condensed Balance Sheets at June 30, 2009 and December 31, 2008, the Consolidated Condensed Statements of Operations and Comprehensive Income for the quarters and six months ended June 30, 2009 and 2008, and the Consolidated Condensed Statements of Cash Flows for the six months ended June 30, 2009 and 2008 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. We evaluated events and transactions occurring subsequent to the balance sheet date of June 30, 2009 for items that should potentially be recognized or disclosed in these financial statements. The evaluation was conducted through July 30, 2009, the date these financial statements were issued.

On December 16, 2008, we completed the tax-free spin-off of Clearwater Paper Corporation, or Clearwater Paper, which owns and operates our former pulp-based manufacturing businesses, consisting of our former pulp and paperboard and consumer products segments, as well as our wood products operations located in Lewiston, Idaho. Our results of operations, as presented in this quarterly report, classify the businesses owned by Clearwater Paper as discontinued operations.

In March 2008, we announced the permanent closure of our Prescott, Arkansas lumber mill due to poor market conditions. The mill permanently ceased operations in May 2008. As a result, the Prescott operation is classified as discontinued operations in the financial statements for the quarter and six months ended June 30, 2009 and 2008.

During the quarter ended June 30, 2009, we recognized an income tax benefit resulting from the Federal tax credit allowed with respect to electricity produced from qualified energy resources and sold to an unrelated party. See Note 3 for additional information about this tax credit. Financial information for the periods presented in this report also includes adjustments to the carrying value of the Prescott operations in 2008, made in conjunction with the closure and pursuant to Financial Accounting Standards Board, or FASB, Statement of Financial Accounting Standards, or SFAS, No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, and the legal settlement with Ainsworth, described in Note 12. All other adjustments were of a normal recurring nature.

This Quarterly Report on Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2008, as filed with the Securities and Exchange Commission on March 2, 2009.

NOTE 2.

**Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, or GAAP, 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 (as amended by FASB Staff Position, or FSP, FAS No. 157-2) is effective for financial statements issued for fiscal years beginning after

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November 15, 2007, and interim periods within those fiscal years, for financial assets and liabilities, and nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). For nonfinancial assets and nonfinancial liabilities that are not remeasured at fair value on a recurring basis in the financial statements, the statement is effective for fiscal years beginning after November 15, 2008. With the exception of the deferred portion of SFAS No. 157, we adopted this Statement effective January 1, 2008, which did not have a material effect on our financial condition and results of operations. Adoption of the deferred portion of this Statement on January 1, 2009 did not have a material effect on our financial condition and results of operations.

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In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* an amendment of ARB No. 51. This Statement requires all companies to report noncontrolling or minority interests in subsidiaries as equity in the consolidated financial statements. The intention of SFAS No. 160 is to eliminate the diversity in practice regarding the accounting for transactions between a company and noncontrolling interests. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Adoption of this Statement did not have a material effect on our financial condition and results of operations.

In December 2007, the FASB also issued SFAS No. 141 (Revised 2007), *Business Combinations*. This revised Statement, which we refer to as SFAS No. 141R, is intended to simplify existing guidance and converge rulemaking under U.S. GAAP with international accounting rules. SFAS No. 141R will significantly change the accounting for business combinations in a number of areas, including the treatment of contingent consideration, contingencies, acquisition costs and restructuring costs. Also under this Statement, changes in deferred tax asset valuation allowances and acquired income tax uncertainties in a business combination after the measurement period will have an impact on income tax expense. SFAS No. 141R is effective for business combinations occurring in fiscal years beginning after December 15, 2008. Adoption of this Statement did not have a material effect on our financial condition and results of operations.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an amendment of SFAS No. 133. This Statement amends and expands the disclosure requirements by requiring qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of, and gains and losses on, derivative instruments, and disclosures about credit risk-related contingent features in derivative agreements. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Adoption of this Statement did not have a material effect on our financial condition and results of operations.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*. This Statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP in the United States. This Statement was effective November 15, 2008 and did not result in a change in our current practice.

In December 2008, the FASB issued Staff Position FAS 132(R)-1 amending SFAS 132(R), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, which, among other things, expands the required disclosures regarding assets in an employer's pension and postretirement benefit plans. The primary changes are to add the fair value hierarchy disclosures required by SFAS No. 157 as it relates to the underlying assets of the pension and postretirement benefit plans. The disclosures required by this position are effective for fiscal years ending after December 15, 2009. This position will only have an impact on our financial statement disclosures and will have no impact on our financial position or results of operations.

In April 2009, the FASB issued Staff Position, or FSP, No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, which clarifies the determination of fair value in SFAS No. 157 for assets and liabilities that may be involved in transactions that would not be considered orderly as defined in the position statement. In April 2009, the FASB also issued FASB Staff Position No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*. This FSP provides additional guidance in determining whether a debt security is other-than-temporarily impaired and how entities should record the impairment in the financial statements. The standard would require credit losses, as defined, to be recorded through the statement of operations and the remaining impairment loss to be recorded through accumulated other comprehensive income. Both of these staff positions are effective for the quarter and six months ended June 30, 2009. These FSPs did not have a material impact on our financial position or results of operations.

In April 2009, the FASB issued Staff Position No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. This FSP requires companies to provide, on an interim basis, disclosures that are required in annual statements for the fair value of financial instruments. This FSP is effective for the quarter and six months ended June 30, 2009 and disclosures have been included accordingly.

In June 2009, the FASB issued SFAS No. 165, *Subsequent Events*, which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. SFAS No. 165 is effective for the quarter and six months ended June 30, 2009. This statement only impacts our financial statement disclosures and has no impact on our financial position or results of operations.

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In June 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of SFAS No. 162. On July 1, 2009, the FASB Codification became the source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. This statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Codification will not change GAAP. Management does not expect this statement to have an impact on our financial position or results of operations.

NOTE 3.

### **Income Taxes**

As a REIT, if we meet certain requirements, we generally will not be subject to federal and state corporate income taxes on our ordinary and capital gains income from our real estate investments that we distribute to our shareholders. We will, however, be subject to corporate taxes on built-in gains (the excess of fair market value at January 1, 2006 over tax basis on that date) with respect to the sale of any real property owned at such date by the REIT within the first ten years following our conversion to a REIT. The built-in gains tax is eliminated or deferred if sale proceeds are reinvested in like-kind property in accordance with the like-kind exchange provisions of the Internal Revenue Code. The built-in gains tax is not applicable to the sale of timber pursuant to a stumpage sale agreement or timber deed.

During the quarter and six months ended June 30, 2009, we sold several REIT properties resulting in gains that were not deferred in accordance with the like-kind exchange provisions of the Internal Revenue Code. For the quarter and six months ended June 30, 2009, we recorded income tax expense of \$0.8 million and \$12.1 million, respectively, related to these sales. We had no sales in the comparable 2008 periods that resulted in a built-in gains tax.

We continue to incur federal and state corporate income taxes on earnings from our wood products manufacturing operations and the real estate sales and development activities conducted by Potlatch TRS. For the quarters ended June 30, 2009 and 2008, we recorded income tax benefits related to the continuing operations of Potlatch TRS of \$3.0 million and \$2.5 million, respectively, which were due to pre-tax losses in that entity. For the six months ended June 30, 2009 and 2008, we recorded income tax benefits related to the continuing operations of Potlatch TRS of \$11.9 million and \$9.8 million, respectively, which were due to pre-tax losses in that entity.

During the quarter ended June 30, 2009, we recognized an income tax benefit of \$5.8 million, classified within continuing operations, attributable to the years 2005 through 2008, resulting from the Federal tax credit allowed with respect to electricity produced from qualified energy resources and sold to an unrelated party. This tax credit is set to expire at the end of 2009. The \$0.2 million income tax benefit associated with the six months ended June 30, 2009 is reflected in the income tax benefit for continuing operations for both the quarter and six month period.

We reviewed the company's tax positions at June 30, 2009, pursuant to the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, and determined that no uncertain tax positions were taken during the first six months of 2009, and that no new information was available at that time that would require derecognition of previously taken positions.

We reflect accrued interest related to tax obligations, as well as penalties, in our provision for income taxes. During the quarters and six month periods ended June 30, 2009 and 2008, no such amounts were reflected in our provision for income taxes.

NOTE 4.

### **Discontinued Operations**

The results of discontinued operations for the quarter ended June 30, 2009, included oriented strand board, or OSB, related legal expenses of \$0.1 million. The results of discontinued operations for the six months ended June 30, 2009, included a pre-tax charge of \$5.75 million for the legal settlement related to the sale of our OSB manufacturing facilities in 2004, as well as \$0.8 million of OSB-related legal expenses. The results of discontinued operations for the quarter ended June 30, 2008, included a pre-tax charge of \$0.3 million related to our settlement with the indirect purchaser class in the OSB antitrust lawsuit and \$1.0 million of OSB-related legal expenses. The results of discontinued operations for the six months ended June 30, 2008, included pre-tax charges totaling \$2.7 million and \$0.3 million, respectively, related to settlements with the direct and indirect purchaser classes in the OSB antitrust lawsuit and \$2.2 million of OSB-related legal expenses.

On December 16, 2008, we completed the spin-off of the Clearwater Paper businesses. The results of these operations, plus other corporate and administrative costs directly attributable to the Clearwater Paper businesses, are classified as discontinued operations.

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In March 2008, we announced the permanent closure of our Prescott, Arkansas lumber mill due to poor market conditions. The mill continued processing its remaining inventory of logs and permanently ceased operations in May 2008, affecting approximately 182 employees. As a result of the announced closure, we recorded an after-tax charge of \$11.7

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million in the first quarter of 2008. Revenues for the Prescott operation, which were previously included in our Wood Products segment revenues, were \$5.4 million and \$18.7 million for the quarter and six months ended June 30, 2008, respectively.

The assets associated with the Prescott lumber mill, which include storeroom inventory and property, plant and equipment, are recorded at fair value less costs to sell and are presented within current Other assets on the Consolidated Condensed Balance Sheets. Pension and other postretirement benefit obligations associated with former Prescott employees are included within the applicable items on the accompanying balance sheets.

NOTE 5.

**Restricted Cash**

Restricted cash increased by \$106.3 million and the note receivable decreased by \$100.0 million in offsetting transactions related to payments under the Retained Obligation Agreement. In June 2009, Clearwater Paper deposited \$106.3 million with the indenture trustee to satisfy all remaining principal and future interest due on the credit sensitive debentures. Consequently, the note receivable was deemed to have been paid. Until the December 1, 2009 maturity date of the debentures, the funds deposited with the indenture trustee will be reflected on our Consolidated Condensed Balance Sheet as restricted cash.

NOTE 6.

**Like-Kind Exchanges**

In order to acquire and sell assets, primarily timberlands, in a tax efficient manner, we enter into like-kind exchange, or LKE, tax-deferred transactions. There are two main types of LKE transactions: forward transactions, in which property is sold and the proceeds are reinvested by acquiring similar property; and reverse transactions, in which property is acquired and similar property is subsequently sold by us. Both forward and reverse transactions must be completed within prescribed time periods under Internal Revenue Code section 1031.

We use a qualified intermediary to facilitate LKE transactions. Proceeds from forward transactions are held by the intermediary and are classified as restricted cash, within non-current assets, because the funds must be reinvested in similar properties. If the acquisition of suitable LKE properties is not completed within 180 days of the sale of the company-owned property, the proceeds are distributed to us by the intermediary and are reclassified as available cash and applicable income taxes are determined. Proceeds from reverse transactions are not restricted because the funds are not subject to significant risk, earn interest and are available upon demand; therefore, these proceeds are included in short-term investments. In the case of reverse transactions in which we have not yet completed LKE sales of company-owned land to match with property purchased on our behalf by the intermediary, the amount associated with the property purchased on our behalf but not yet matched with LKE sales is classified as a long-term asset and included in Timber, timberlands and related deposits, net in our Consolidated Condensed Balance Sheets and as Deposits on timberlands in the investing activities section of our Consolidated Condensed Statements of Cash Flows. Amounts deposited with a third party towards the potential future purchase of property that are not matched with LKE sales are also included in Timber, timberlands and related deposits, net in our Consolidated Condensed Balance Sheets and as Deposits on timberlands in our Consolidated Condensed Statements of Cash Flows.

At June 30, 2009, we had \$2.4 million of proceeds from land sales deposited with a qualified LKE intermediary, with \$2.1 million classified as short-term investments and \$0.3 million classified as other long-term assets on the Consolidated Condensed Balance Sheets. At December 31, 2008, we had \$3.3 million of proceeds from land sales deposited with a qualified LKE intermediary, with \$3.0 million classified as short-term investments and \$0.3 million classified as other long-term assets on the Consolidated Condensed Balance Sheets. These proceeds, when received from the qualified LKE intermediary, are included as non-cash adjustments to net earnings from continuing operations in the Consolidated Condensed Statements of Cash Flows.

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NOTE 7.

**Earnings per Common Share**

Earnings per common share from continuing operations are computed by dividing earnings from continuing operations 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 calculating the basic and diluted earnings per share from continuing operations:

| (Dollars in thousands, except per-share amounts)             | Quarter Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|--|---------------------------|------------|------------------------------|------------|
|  | 2009                      | 2008       | 2009                         | 2008       |
| Earnings from continuing operations                          | \$ 3,692                  | \$ 18,872  | \$ 32,463                    | \$ 42,159  |
| Basic average common shares outstanding                      | 39,744,604                | 39,459,079 | 39,743,463                   | 39,389,459 |
| Incremental shares due to:                                   |                           |            |                              |            |
| Common stock options   | 19,366                    | 63,512     | 14,159                       | 57,688     |
| Performance shares   | 78,877                    | 144,166    | 90,208                       | 158,970    |
| Restricted stock units                                       | 26,611                    | 29,722     | 27,787                       | 27,076     |
| Diluted average common shares outstanding                    | 39,869,458                | 39,696,479 | 39,875,617                   | 39,633,193 |
| Basic earnings per common share from continuing operations   | \$ 0.09                   | \$ 0.48    | \$ 0.82                      | \$ 1.07    |
| Diluted earnings per common share from continuing operations | \$ 0.09                   | \$ 0.48    | \$ 0.81                      | \$ 1.06    |

For the quarter ended June 30, 2009, 112,269 performance shares, 2,500 restricted stock units and options to purchase 126,178 shares of common stock were excluded from the computation of diluted earnings per share because their effect was anti-dilutive. Options to purchase 86,426 shares of common stock were also excluded from the computation of diluted earnings per share for the quarter ended June 30, 2009, because the per share exercise prices of the stock options were greater than the average market price of Potlatch's common stock during this period. For the quarter ended June 30, 2008, 2,000 restricted stock units and options to purchase 83,447 shares of common stock were excluded from the computation of diluted earnings per share because their effect was anti-dilutive.

For the six months ended June 30, 2009, 112,269 performance shares, 21,720 restricted stock units and options to purchase 126,178 shares of common stock were excluded from the computation of diluted earnings per share because their effect was anti-dilutive. Options to purchase 86,426 shares of common stock were also excluded from the computation of diluted earnings per share for the six months ended June 30, 2009, because the per share exercise prices of the stock options were greater than the average market price of Potlatch's common stock during this period. For the six months ended June 30, 2008, 76,243 performance shares and options to purchase 83,447 shares of common stock were excluded from the computation of diluted earnings per share because their effect was anti-dilutive.

NOTE 8.

**Equity-Based Compensation**

At June 30, 2009, we had three stock incentive plans, the 1995, 2000 and 2005 plans, under which stock option, performance share or restricted stock unit, or RSU, grants were outstanding. All of these plans have received shareholder approval. We were originally authorized to issue up to 1.7 million shares, 1.4 million shares and 1.6 million shares under our 1995 Stock Incentive Plan, 2000 Stock Incentive Plan and 2005 Stock Incentive Plan, respectively. At June 30, 2009, no shares were available for future issuance under the 1995 Stock Incentive Plan, while approximately 100,000 and 682,000 shares were authorized for future issuance under the 2000 and 2005 Stock Incentive Plans, respectively. We issued new shares to pay stock option exercises and to settle performance share awards and RSU awards.

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During the quarter ended June 30, 2009, we recorded equity-based compensation expense of \$0.9 million, of which \$0.8 million related to performance shares and \$0.1 million related to RSUs. During the quarter ended June 30, 2008, we recorded equity-based compensation expense of \$1.0 million, of which \$0.8 million related to performance shares and \$0.2 million related to RSUs. During the six months ended June 30, 2009, we recorded equity-based compensation



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expense of \$1.8 million, of which \$1.5 million related to performance shares and \$0.3 million related to RSUs. During the six months ended June 30, 2008, we recorded equity-based compensation expense of \$1.9 million, of which \$1.5 million related to performance shares and \$0.4 million related to RSUs. All outstanding stock options were fully vested prior to January 2006. The net income tax benefit associated with our equity-based compensation expense totaled less than \$0.1 million and \$0.4 million for the quarters ended June 30, 2009 and 2008, respectively, and \$0.4 million and \$0.7 million for the six months ended June 30, 2009 and 2008, respectively.

Our outside directors are granted an annual award of common stock units that are credited to an account established on behalf of each director. These accounts are then credited with additional common stock units equal in value to the distributions that are paid on the same amount of common stock. Upon separation from service as a director, the common stock units held by the director in his or her stock unit account will be converted to cash based upon the then market price of the common stock and paid to the director.

Our outside directors also can each elect to defer compensation in the form of common stock units. We record compensation expense or income during each reporting period based on the amount of compensation deferred during the period and the increase or decrease in the value of the company's common stock. We recorded director deferred compensation expense totaling \$0.2 million and \$0.5 million for the quarters ended June 30, 2009 and 2008, respectively. We recorded director deferred compensation income totaling less than \$0.1 million for the six months ended June 30, 2009 and expense totaling \$0.9 million for the six months ended June 30, 2008.

As required by SFAS No. 123 (Revised 2004), Share-Based Payment (SFAS No. 123R), \$0 and \$0.9 million of cash flows for the six months ended June 30, 2009 and 2008, respectively, representing the realized tax benefit related to the excess of the deductible amount over the compensation cost recognized, have been classified as a financing cash inflow from continuing operations in the Consolidated Condensed Statements of Cash Flows.

**STOCK OPTIONS**

All outstanding stock options were granted with an exercise price equal to the market price on the date of grant, were fully exercisable after two years and expire not later than 10 years from the date of grant. No new stock options were granted in 2009 or 2008.

A summary of outstanding stock options and changes during the six months ended June 30, 2009, is presented below:

| (Dollars in thousands, except exercise prices) | Shares  | Weighted Avg.<br>Exercise<br>Price | Aggregate<br>Intrinsic Value |
|--|---------|------------------------------------|------------------------------|
| Outstanding at January 1                       | 412,001 | \$ 21.44                           |                              |
| Shares exercised                               | (4,293) | 21.13                              | \$ 30                        |
| Outstanding and exercisable at June 30         | 407,708 | 21.45                              | 1,732                        |

The aggregate intrinsic value of stock options exercised during the six months ended June 30, 2008 was \$2.4 million.

The following table summarizes information about stock options outstanding at June 30, 2009:

| Range of Exercise Prices | Options Outstanding and Exercisable |  |                                    |
|--------------------------|-------------------------------------|--|------------------------------------|
|                          | Outstanding                         | Weighted Avg.<br>Remaining<br>Contractual Life | Weighted Avg.<br>Exercise<br>Price |
| \$13.8594 to \$16.6452   | 88,266                              | 3.02 years                                     | \$ 15.26                           |
| \$18.6083 to \$19.2569   | 173,986                             | 3.26 years                                     | 19.01                              |
| \$24.0131 to \$30.9204   | 145,456                             | 3.39 years                                     | 28.12                              |
| \$13.8594 to \$30.9204   | 407,708                             | 3.25 years                                     | 21.45                              |

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Cash received from stock option exercises for the six months ended June 30, 2009 and 2008 was less than \$0.1 million and \$3.3 million, respectively. The actual tax benefit realized for the tax deductions from option exercises totaled \$0 and \$0.8 million for the quarters ended June 30, 2009 and 2008, respectively, and \$0 and \$0.9 million for the six months ended June 30, 2009 and 2008, respectively.

**Table of Contents****PERFORMANCE SHARES**

Performance share awards granted under our stock incentive plans have a three-year performance period, and shares are issued after the end of the period if the performance measure is met. The performance measure is a comparison of the percentile ranking of our total shareholder return compared to the total shareholder return performance of a selected peer group. The number of shares actually issued, as a percentage of the amount subject to the performance share award, could range from 0% to 200%. Performance share awards granted under our stock incentive plans do not have voting rights unless and until shares are issued upon settlement. If shares are issued at the end of the three-year performance measurement period, the recipients will receive dividend equivalents at the time of settlement equal to the distributions that would have been paid on the shares earned had the recipient owned the shares during the three-year period. The dividend equivalents are paid in shares.

The fair value of all performance share awards is estimated using a Monte Carlo simulation model. A summary of outstanding performance share awards as of June 30, 2009, and changes during the six months ended June 30, 2009 is presented below:

| (Dollars in thousands, except grant date fair value) | Shares  | Weighted Avg.<br>Grant Date<br>Fair Value | Aggregate<br>Intrinsic Value |
|--|---------|---|------------------------------|
| Unvested shares outstanding at January 1             | 131,108 | \$ 50.51                                  |                              |
| Granted  | 112,269 | 33.32                                     |                              |
| Forfeited  |         |   |                              |
| Unvested shares outstanding at June 30               | 243,377 | 42.58                                     | \$ 5,409                     |

As of June 30, 2009, there was \$4.9 million of unrecognized compensation cost related to non-vested performance share awards. The cost is expected to be recognized over a weighted average period of 1.7 years.

**RESTRICTED STOCK UNITS**

Our 2005 Stock Incentive Plan also allows for awards to be issued in the form of RSUs. During 2009 and 2008, certain officers and other select employees of the company were granted RSU awards that will accrue dividend equivalents based on distributions paid during the RSU vesting period. The dividend equivalents will be converted into additional RSUs that will vest in the same manner as the underlying RSUs to which they relate. The terms of certain of the awards state that 20% of the RSUs vest on each of the first and second anniversaries of the grant date of the awards, with the remaining 60% vesting on the third anniversary. The terms of certain other RSUs provide for vesting upon the expiration of a set period of approximately three years.

A summary of the status of outstanding RSU awards as of June 30, 2009, and changes during the six months ended June 30, 2009, is presented below:

| (Dollars in thousands, except grant date fair value) | Shares   | Weighted Avg.<br>Grant Date<br>Fair Value | Aggregate<br>Intrinsic Value |
|--|----------|---|------------------------------|
| Unvested shares outstanding at January 1             | 39,711   | \$ 45.38                                  |                              |
| Granted  | 21,720   | 24.34                                     |                              |
| Vested   | (15,641) | 52.45                                     |                              |
| Forfeited  |          |   |                              |
| Unvested shares outstanding at June 30               | 45,790   | 32.99                                     | \$ 1,112                     |

For RSU awards granted during the period, the fair value of each share was estimated on the date of grant using the grant date market price. The total fair value of RSU awards vested during the six months ended June 30, 2009 was \$0.8 million.

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As of June 30, 2009, there was \$0.8 million of total unrecognized compensation cost related to non-vested RSU awards. The cost is expected to be recognized over a weighted average period of 1.7 years.

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NOTE 9.

**Inventories**

Inventories at the balance sheet dates consist of:

| (Dollars in thousands)                      | June 30, 2009 | December 31, 2008 |
|---|---------------|-------------------|
| Lumber and other manufactured wood products | \$ 13,080     | \$ 14,471         |
| Logs and residuals                          | 5,216         | 12,281            |
| Land inventory                              | 5,985         | 6,971             |
| Materials and supplies                      | 3,963         | 2,963             |
|   | \$ 28,244     | \$ 36,686         |

NOTE 10.

**Pension and Other Postretirement Employee Benefit Plans**

The following tables detail the components of net periodic costs (benefit) of our pension and other postretirement employee benefit, or OPEB, plans for the quarters and six months ended June 30, 2009 and 2008:

Quarters ended June 30:

| (Dollars in thousands)                      | Pension Benefit Plans |            | Other Postretirement<br>Employee Benefit Plans |          |
|---|-----------------------|------------|--|----------|
|   | 2009                  | 2008       | 2009   | 2008     |
| Service cost                                | \$ 1,424              | \$ 2,836   | \$ 406   | \$ 612   |
| Interest cost                               | 5,781                 | 9,439      | 1,930  | 3,683    |
| Expected return on plan assets              | (8,929)               | (15,427)   |  |          |
| Amortization of prior service cost (credit) | 205                   | 513        | (246)  | (942)    |
| Amortization of actuarial loss              | 1,065                 | 1,017      | 543  | 554      |
| Curtailments                                | 198                   | 268        |  |          |
| Net periodic cost (benefit)                 | \$ (256)              | \$ (1,354) | \$ 2,633                                       | \$ 3,907 |

Six months ended June 30:

| (Dollars in thousands)                      | Pension Benefit Plans |            | Other Postretirement<br>Employee Benefit Plans |          |
|---|-----------------------|------------|--|----------|
|   | 2009                  | 2008       | 2009   | 2008     |
| Service cost                                | \$ 2,848              | \$ 5,672   | \$ 812   | \$ 1,296 |
| Interest cost                               | 11,562                | 18,878     | 3,860  | 8,008    |
| Expected return on plan assets              | (17,857)              | (30,854)   |  |          |
| Amortization of prior service cost (credit) | 410                   | 1,026      | (492)  | (1,884)  |
| Amortization of actuarial loss              | 2,130                 | 2,035      | 1,085  | 2,006    |
| Curtailments                                | 198                   | 268        |  |          |
| Net periodic cost (benefit)                 | \$ (709)              | \$ (2,975) | \$ 5,265                                       | \$ 9,426 |

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The pension and OPEB amounts reported above for the quarter and six months ended June 30, 2008, include information for both continuing and discontinued operations. The pension benefits presented above do not include a \$1.3 million pre-tax charge related to the closure of the Prescott lumber mill. That amount is included in Loss from discontinued operations in the Consolidated Condensed Statements of Operations and Comprehensive Income for the six months ended June 30, 2008.

Of the \$1.1 million reported as Other comprehensive income, net of tax, on our Consolidated Condensed Statements of Operations and Comprehensive Income for the quarter ended June 30, 2009, \$0.9 million and \$0.2 million related to our defined benefit pension plans and OPEB plans, respectively. Of the \$2.0 million reported as Other comprehensive income, net of tax, on our Consolidated Condensed Statements of Operations and Comprehensive Income for the six months ended June 30, 2008, \$1.7 million and \$0.3 million related to our defined benefit pension plans and OPEB plans, respectively.

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We reported in our 2008 Annual Report on Form 10-K that, due to the steep downturn in the stock market in the fourth quarter of 2008, our two company-sponsored tax-qualified defined benefit pension plans were underfunded at December 31, 2008, and, as a result, we would be required to make estimated contributions to our tax-qualified pension plans by September 2010. However, a recent Internal Revenue Service pronouncement provided significant funding relief to single-employer defined benefit plan sponsors. Consequently, we are not required to make contributions for 2009 to our defined benefit plans. However, we estimate contributions will total approximately \$1.4 million in 2009 to our non-qualified pension plan. As of June 30, 2009, \$0.8 million of contributions had been made. We do not anticipate funding our OPEB plans in 2009 except to pay benefit costs as incurred during the year by plan participants.

NOTE 11.

**Fair Value Measurements**

Estimated fair values of our financial instruments are as follows:

| (Dollars in thousands)                           | June 30, 2009   |            | December 31, 2008 |            |
|--|-----------------|------------|-------------------|------------|
|  | Carrying Amount | Fair Value | Carrying Amount   | Fair Value |
| Cash, restricted cash and short-term investments | \$ 110,540      | \$ 110,540 | \$ 3,919          | \$ 3,919   |
| Note receivable                                  |                 |            | 100,000           | 100,000    |
| Current notes payable                            | 121,300         | 121,300    | 129,100           | 129,100    |
| 9.125% credit sensitive debentures               | 100,000         | 78,000     | 100,000           | 78,000     |
| Other long-term debt                             | 220,944         | 140,578    | 221,337           | 140,984    |

For cash, restricted cash and short-term investments, the carrying amount approximates fair value. Our note receivable was from Clearwater Paper, associated with its obligation related to the credit sensitive debentures. Its fair value was estimated to be the same as the carrying amount. Our current notes payable consist of borrowings under our secured bank credit facility revolving line of credit. Due to the short maturities of these borrowings, fair value is estimated to be the same as the carrying amount. The fair value of the credit sensitive debentures and our long-term debt is estimated based upon the quoted market prices for the same or similar debt issues. For long-term debt for which there is no quoted market price, fair value is estimated based on average market prices for comparable liquid revenue bonds.

NOTE 12.

**Contingencies**

The following updates information included in the 2008 Annual Report on Form 10-K:

We sold our oriented strand board, or OSB, manufacturing facilities to Ainsworth Lumber Co. Ltd. in September 2004. In September 2006, Ainsworth filed a complaint in the Supreme Court of the State of New York for the County of New York alleging breaches of representations and warranties in the asset purchase agreement whereby Ainsworth purchased our OSB facilities. Although we believe we had meritorious defenses to this claim, in April 2009 we reached a settlement with Ainsworth for \$5.75 million, solely to avoid the further expense and burden of the ongoing litigation. The settlement was finalized and the lawsuit was dismissed in July 2009.

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NOTE 13.

**Segment Information**

(Dollars in thousands)

|   | Quarter Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|---|---------------------------|------------|------------------------------|------------|
|   | 2009                      | 2008       | 2009                         | 2008       |
| <b>Segment Revenues</b>                                 |                           |            |                              |            |
| Resource  | \$ 27,288                 | \$ 44,586  | \$ 74,494                    | \$ 105,341 |
| Real Estate   | 4,697                     | 15,308     | 52,733                       | 36,448     |
| Wood Products   |                           |            |                              |            |
| Lumber  | 34,771                    | 38,949     | 62,636                       | 75,006     |
| Plywood   | 7,950                     | 13,923     | 14,023                       | 28,008     |
| Particleboard   | 3,223                     | 5,293      | 5,672                        | 9,721      |
| Other   | 8,757                     | 12,437     | 17,199                       | 23,084     |
|   | 54,701                    | 70,602     | 99,530                       | 135,819    |
|   | 86,686                    | 130,496    | 226,757                      | 277,608    |
| Elimination of intersegment revenues                    | (7,904)                   | (27,472)   | (18,382)                     | (62,025)   |
| Total consolidated revenues                             | \$ 78,782                 | \$ 103,024 | \$ 208,375                   | \$ 215,583 |
| <b>Intersegment revenues or transfers</b>               |                           |            |                              |            |
| Resource  | \$ 7,904                  | \$ 23,129  | \$ 18,382                    | \$ 54,230  |
| Wood Products   |                           | 4,343      |                              | 7,795      |
| Total intersegment revenues or transfers                | \$ 7,904                  | \$ 27,472  | \$ 18,382                    | \$ 62,025  |
| <b>Operating Income (Loss)</b>                          |                           |            |                              |            |
| Resource  | \$ 4,525                  | \$ 12,161  | \$ 15,371                    | \$ 29,356  |
| Real Estate   | 1,507                     | 11,316     | 43,019                       | 27,967     |
| Wood Products   | (2,993)                   | 2,604      | (14,176)                     | (3,846)    |
| Eliminations and adjustments                            | 4,336                     | 1,555      | 5,087                        | 3,228      |
|   | 7,375                     | 27,636     | 49,301                       | 56,705     |
| Corporate   | (11,623)                  | (10,936)   | (22,442)                     | (23,930)   |
| Earnings (loss) from continuing operations before taxes | \$ (4,248)                | \$ 16,700  | \$ 26,859                    | \$ 32,775  |

Certain 2008 amounts have been reclassified to conform to the 2009 presentation.



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ITEM 2.

**Management's Discussion and Analysis of Financial Condition and Results of Operations**

**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION**

This report contains, in addition to historical information, certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including without limitation, statements regarding future revenues, cash flows, the nature of our REIT income, dividend distributions, compliance with REIT tax rules, costs, manufacturing output, capital expenditures, timber harvest levels, the funding of our pension plans, tax refunds, future land sales and acquisitions, like-kind exchanges and tax consequences, and other timber supply issues. Words such as anticipate, expect, will, intend, plan, target, project, believe, seek, schedule, estimate, could, can, may, and might are intended to identify such forward-looking statements. These forward-looking statements reflect management's current views regarding future events based on estimates and assumptions, and are therefore subject to known and unknown risks and uncertainties and are not guarantees of future performance. Our actual results of operations could differ materially from those expressed or implied by forward-looking statements contained in this report. Important factors that could cause or contribute to such differences include those factors discussed in Item 1A of our Annual Report on Form 10-K, as well as the following:

changes in timber harvest levels on our lands

changes in timber prices

changes in timberland values

changes in policy regarding governmental timber sales

changes in the United States and international economies

changes in the level of residential and commercial construction and remodeling activity

changes in tariffs, quotas and trade agreements involving wood products

changes in demand for our products

changes in production and production capacity in the forest products industry

competitive pricing pressures for our products

unanticipated manufacturing disruptions

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changes in general and industry-specific environmental laws and regulations

unforeseen environmental liabilities or expenditures

weather conditions

changes in raw material and other costs

collectability of amounts owed by customers

the ability to satisfy complex rules in order to remain qualified as a REIT

changes in tax laws that could reduce the benefits associated with REIT status

Forward-looking statements contained in this report present management's views only as of the date of this report. Except as required under applicable law, we do not intend to issue updates concerning any future revisions of management's views to reflect events or circumstances occurring after the date of this report.

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### **OVERVIEW**

We are a real estate investment trust, or REIT, with approximately 1.6 million acres of timberlands in Arkansas, Idaho, Minnesota and Wisconsin. Through a wholly owned taxable subsidiary, which we refer to in this report as Potlatch TRS, we also operate a real estate sales and development business and six manufacturing facilities that produce lumber, plywood and particleboard.

On December 16, 2008, we completed the tax-free spin-off of Clearwater Paper Corporation, or Clearwater Paper, which owns and operates our former pulp-based manufacturing businesses, consisting of our former pulp and paperboard and consumer products segments, as well as our wood products operations located in Lewiston, Idaho. Our results of operations, as presented in this quarterly report, classify the businesses owned by Clearwater Paper as discontinued operations.

In March 2008, we announced the permanent closure of our Prescott, Arkansas lumber mill due to poor market conditions. The mill permanently ceased operations in May 2008. As a result, the Prescott operation is classified as discontinued operations in the periods covered by this report.

As of June 30, 2009, our business was organized into three segments:

The business of the Resource segment consists of the management of our timberlands to optimize the value of all possible revenue producing opportunities while at the same time adhering to our strict stewardship standards. Management activities include planting trees, harvesting trees, building and maintaining roads, development of management plans and recreation lease management. For the first six months of 2009, Resource segment revenues were \$74.5 million, representing approximately 33% of our revenues from continuing operations, before elimination of intersegment revenues. Intersegment revenues were \$18.4 million for the period.

In July 2009, we entered into a \$50.2 million timber deed agreement to sell 50,700 acres of pre-merchantable timber located in southern Arkansas to Forest Investment Associates L.P., a timber investment management organization. The sale, which does not include the underlying land, is expected to close in September 2009. The age class of the trees ranges from 0 to 10 years, with the average age being just under 7 years. Full use of the land reverts back to us after a full harvest cycle is completed, and no later than 30 years after the trees were initially planted. These proceeds will qualify as REIT income so there will be no taxes due upon the sale.

The business of the Real Estate segment consists primarily of the sale of selected non-core timberland real estate. From time to time, we also take advantage of opportunities to sell timberland to meet various financial and strategic objectives. The segment plays an active role in negotiations for all timberland acquisitions, and engages in real estate development activities through Potlatch TRS. Results for the segment depend on the demand for our non-core timberlands, the timing of closing of sales of properties and our ability to match sales of property with acquisitions in LKE transactions. Consequently, revenues for the segment are seldom comparable or predictable between periods. Real Estate segment revenues for the first six months of 2009 were \$52.7 million, which represented approximately 23% of our revenues from continuing operations, before elimination of intersegment revenues. The segment did not have intersegment revenues during the period.

The Wood Products segment manufactures lumber, plywood and particleboard at six mills located in Arkansas, Idaho, Michigan and Minnesota. The segment's products are largely commodity products, which are sold to wholesalers primarily for use in home building and other construction activity. Wood Products segment revenues were \$99.5 million for the first six months of 2009, representing approximately 44% of our revenues from continuing operations, before elimination of intersegment revenues. The segment did not have intersegment revenues during the period.

### **FACTORS INFLUENCING OUR RESULTS OF OPERATIONS AND CASH FLOWS**

The operating results of our timberlands, real estate and wood products manufacturing businesses have been and will continue to be influenced by a variety of factors, including the cyclical nature of the forest products industry, changes in timber prices and in harvest levels from our timberlands, timberland valuations, demand for our non-strategic timberland for higher and better use purposes, competition, the efficiency and level of capacity utilization of our wood products manufacturing operations, changes in our principal expenses, such as log costs, asset dispositions or acquisitions, and other factors.

**Fluctuating Timber Prices.** Our results of operations and cash flows are materially affected by the fluctuating nature of timber prices. A variety of factors affect prices for timber, including factors affecting demand, such as changes in economic conditions, construction activity levels, interest rates, credit availability, population growth and weather conditions, as well as changes in timber supply and other factors. All of these factors can vary by region and by timber type, such as sawlogs or pulpwood logs. In the first six months of 2009, average sawlog prices were approximately 28% lower in the Northern region and 12% lower in the Southern region compared to the same period in 2008, due primarily to a reduced demand for lumber for housing construction and the subsequent curtailments and closures of lumber mills across the U.S.

Timber prices are also affected by changes in timber availability at the local and national level. Our timberland ownership is currently concentrated in Arkansas, Idaho, Minnesota and Wisconsin. In Arkansas and Minnesota, most timberlands are privately owned. Historically, increases in timber prices have often resulted in substantial increases in harvesting on private timberlands, including lands not previously made available for commercial timber operations, causing a short-term increase in supply that has tended to moderate price increases. Decreases in timber prices have often resulted in less harvesting activity, causing short-term decreases in supply that have tended to moderate price decreases. In Idaho, where a greater proportion of timberland is government owned, any substantial increase in timber harvesting from government-owned lands could significantly reduce timber prices, which could harm our results of operations. For more than twenty-five years, environmental concerns and other factors have limited timber sales by federal agencies, which historically had been major suppliers of timber to the United States forest products industry, particularly in the West. Any reversal of policy that substantially increases timber sales from government lands could have a materially adverse effect on our results of operations and cash flows. On a local level, timber supplies can fluctuate depending upon factors such as changes in weather conditions and harvest strategies of local forest products industry participants, as well as occasionally high timber salvage efforts due to events such as storm damage, unusual pest infestations or fires.

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**Harvest Levels.** Changes in harvest levels on our timberlands also may have a significant impact on our results of operations, due in part to the low cost basis of much of our timber from timberlands that we acquired many years ago. Over the long term, we manage our timberlands on a sustainable yield basis to achieve a balance between timber growth and timber harvests. From time to time, however, we may choose, consistent with our environmental commitments, to harvest timber at levels above or below our estimate of sustainability for various reasons. In 2008, the overall harvest from our timberlands was 4.4 million tons. In our 2008 Form 10-K, we projected our timber harvest to be between 4.2 million and 4.4 million tons in 2009. However, in May 2009, we announced a reduction in our planned timber harvest, primarily in Idaho, of approximately 0.5 million tons of sawlogs, or 18 percent of our planned 2009 sawlog harvest. Current markets for softwood lumber remain depressed, which has applied downward pressure on log pricing across the country, especially in the West. We believe these markets will come back at more favorable prices when the housing market recovers, at which time we will increase harvest levels.

On a short-term basis, we also experience seasonally lower harvest activity during the winter and spring due to weather conditions. Longer term, our timber harvest levels will be affected by acquisitions of additional timberlands, such as the Idaho timberlands purchased in September 2007 and January 2008 and the Wisconsin timberlands purchased in January 2007, and sales of existing timberlands. In addition to timberland acquisitions and sales, future timber harvest levels may be affected by changes in estimates of long-term sustainable yield because of genetic improvements and other silvicultural advances, natural disasters, fires and other hazards, regulatory constraints and other factors beyond our control.

**Demand for Real Estate.** A number of factors, including tightening of credit, a slowing of real estate development, changes in population growth patterns and changes in demographics could reduce the demand for our real estate. In addition, changes in the interpretation or enforcement of current laws, or the enactment of new laws, regarding the use and development of real estate or changes in the political composition of governmental bodies could lead to new or greater costs, delays and liabilities that could materially adversely affect our real estate business. The timing of real estate sales is a function of many factors, including the general state of the economy, demand in local real estate markets, the number of properties listed for sale, the seasonal nature of sales, the plans of adjacent landowners, and our expectations of future price appreciation. Delays in the completion of transactions or the termination of potential transactions may be beyond our control. These events could adversely affect our operating results.

**Cyclical Wood Products Markets.** The operating results of our wood products manufacturing operations are cyclical. Historical prices for our wood products have been volatile, and we, like other manufacturers in the forest products industry, have limited direct influence over the timing and extent of price changes for our products. The demand for our wood products is affected by the level of new residential construction activity and, to a lesser extent, home repair and remodeling activity, which are subject to fluctuations due to changes in economic conditions, interest rates, population growth, weather conditions and other factors.

The profitability of our Wood Products segment depends largely on our ability to operate our facilities efficiently and at or near full capacity. Our operating results can be adversely affected if market demand does not justify operating at these levels or if our operations are inefficient or suffer significant interruption for any reason.

The forest products industry in general and the wood products business in particular were adversely affected in 2008 and the first six months of 2009 by the national decline in home building and the subsequent weak demand and lower prices for wood products. As a result of these weak market conditions, we permanently closed our lumber mill at Prescott, Arkansas in May 2008. Our Minnesota lumber mill operated at approximately 75% of normal production in the first two months of 2009, then returned to a full production level in March 2009. Our Idaho lumber mill also operated at approximately 75% of normal production from the beginning of 2009 through mid-April when it returned to a full production schedule. Our Idaho plywood facility operated at approximately 60% of normal production from the beginning of 2009, returning to full production in early May. Our Idaho particleboard plant was shut down for the month of January 2009, and has since been running as scheduled at 50% of normal production levels to better balance production with the available fiber supply and demand for particleboard. We do not expect a meaningful recovery in the wood products markets in the near term.

One of the most significant expenses of our wood products segment is the cost of sawlogs and wood fiber needed to supply our manufacturing facilities. The cost of logs that supply our lumber mills has at times fluctuated greatly as a result of the factors discussed above affecting the price of our timber. Selling prices of our wood products have not always increased in response to log price increases, nor have log prices always decreased in conjunction with declining wood products prices. The results of operations of our wood products business have been and may in the future be adversely affected if we are unable to pass cost increases through to our customers.

**Competition.** The markets for our timber and wood products are highly competitive, and companies that have substantially greater financial resources than we do compete with us in each of our lines of business. Logs and other fiber from our timberlands, as well as our wood products, are subject to competition primarily from timberland owners and wood products manufacturers in North America.



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**Acquisitions.** Among the reasons for our REIT conversion is that we are better able to compete for acquisitions of timberlands against other entities that use tax-efficient structures. It is uncertain whether any timberland acquisitions we make will perform in accordance with our expectations. In addition, we anticipate financing acquisitions through Internal Revenue Code section 1031 like-kind exchanges, cash from operations, borrowings under our credit facility or proceeds from equity or debt offerings. Our inability to finance future acquisitions on favorable terms or the failure of any acquisition to perform as we expect could harm our results of operations.

### **CRITICAL ACCOUNTING POLICIES**

Our principal accounting policies are discussed on pages 56-63 of our Annual Report on Form 10-K for the year ended December 31, 2008. Our accompanying consolidated condensed financial statements have been prepared in conformity with accounting principles generally accepted in the United States, which require management to make estimates that affect the amounts of revenues, expenses, assets and liabilities reported. The following are critical accounting matters which are both very important to the portrayal of our financial condition and results of operations and which require some of management's most difficult, subjective and complex judgments. The accounting for these matters involves forming estimates based on current facts, circumstances and assumptions which, in management's judgment, could change in a manner that could materially affect management's future estimates with respect to such matters and, accordingly, could cause our future reported financial condition and results of operations to differ materially from financial results reported based on management's current estimates. Changes in these estimates are recorded periodically based on updated information. Our critical accounting policies are discussed below.

**Timber and timberlands.** Timber and timberlands are recorded at cost, net of depletion. Expenditures for reforestation, including all costs related to stand establishment, such as site preparation, costs of seeds or seedlings and tree planting, are capitalized. Expenditures for forest management, consisting of regularly recurring items necessary to the ownership and administration of our timber and timberlands, are accounted for as current operating expense. Our depletion is determined based on costs capitalized and the related current estimated recoverable timber volume. Recoverable volume does not include anticipated future growth, nor are anticipated future costs considered.

There are currently no authoritative accounting rules relating to costs to be capitalized in the timber and timberlands category. We have used relevant portions of current accounting rules, industry practices and our judgment in determining costs to be capitalized or expensed. Alternate interpretations and judgments could significantly affect the amounts capitalized. Additionally, models and observations used to estimate the current recoverable timber volume on our lands are subject to judgments that could significantly affect volume estimates.

Following are examples of factors that add to the complexity of the assumptions we make regarding capitalized or expensed costs:

harvest cycles can vary by geographic region and by species of timber;

weather patterns can affect annual harvest levels;

environmental regulations and restrictions may limit our ability to harvest certain timberlands;

changes in harvest plans may occur;

scientific advancement in seedlings and timber growing technology may affect future harvests;

land sales and acquisitions may affect volumes available for harvest; and

major forest fire events, storm damage and pest infestations can significantly affect future harvest levels.

Different assumptions for either the cost or volume estimates, or both, could have a significant effect upon amounts reported in our statements of operations and financial condition. Because of the number of variables involved and the interrelationship between the variables, sensitivity

analysis of individual variables is not practical.

**Long-lived assets.** A significant portion of our total assets are invested in our timber and timberlands and our wood products manufacturing facilities. The cyclical patterns of our businesses cause cash flows to fluctuate by varying degrees from period to period. As a result, long-lived assets are a material component of our financial position with the potential for material change in valuation if assets are determined to be impaired. We account for impairment of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable, as measured by its undiscounted estimated future cash flows. We use our operational budgets to estimate future cash flows. Budgets are inherently uncertain estimates of future performance due to the fact that all inputs, including revenues, costs and capital spending, are subject to frequent change for many different



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reasons, including the reasons previously described above under Factors Influencing our Results of Operations and Cash Flows. Because of the number of variables involved, the interrelationship between the variables and the long-term nature of the impairment measurement, sensitivity analysis of individual variables is not practical. Budget estimates are adjusted periodically to reflect changing business conditions, and operations are reviewed, as appropriate, for impairment using the most current data available. To date, this process has not resulted in an impairment charge for any of our assets associated with our continuing operations.

**Deferred tax assets.** We believe it is more likely than not that we will have sufficient future taxable income to realize our deferred tax assets. The ultimate realization of deferred tax assets depends on the generation of future taxable income during the periods in which temporary differences are deductible. We consider the scheduled reversal of deferred tax liabilities (including the impact of available carryforward periods), projected taxable income, and tax planning strategies in making this assessment. In order to fully realize the deferred tax assets, we will need to generate future taxable income before the expiration of the deferred tax assets as prescribed under the Internal Revenue code. Based on projected taxable income for Potlatch TRS, over the periods for which the deferred tax assets are deductible, as well as certain tax planning strategies that management has undertaken, we believe that it is more likely than not that we will realize the benefits of these deductible differences, net of the existing valuation allowances at June 30, 2009. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced and management is unable to implement one or more of the tax planning strategies that it has identified. Such tax planning strategies include the transfer of income-producing timberlands from the REIT to Potlatch TRS to generate income sufficient to fund our pension and other post-employment obligations, and thus realize our deferred tax assets.

**Restructuring charges and discontinued operations.** In December 2008, our pulp-based operations were spun off into an independent public company, Clearwater Paper Corporation. In May 2008, our lumber mill in Prescott, Arkansas, was permanently shut down. These events required us to record estimates of liabilities at the time of the events. In making these judgments, we considered contractual obligations, legal liabilities and possible incremental costs incurred as a result of these restructuring transactions. Our estimated liabilities could differ materially from actual costs incurred, with resulting adjustments to future period earnings for any differences.

**Environmental liabilities.** We record accruals for estimated environmental liabilities that are not within the scope of SFAS No. 143, Accounting for Asset Retirement Obligations, and FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, in accordance with SFAS No. 5, Accounting for Commitments and Contingencies. These estimates reflect assumptions and judgments as to the probable nature, magnitude and timing of required investigation, remediation and monitoring activities. In making these estimates, we consider, among other things, the activities we have conducted at any particular site, information obtained through consultation with applicable regulatory authorities and third parties, and our historical experience at other sites that are judged to be comparable. We must also consider the likelihood of changes in governmental regulations, advancements in environmental technologies and changing legal standards regarding liability. Due to the numerous uncertainties and variables associated with these assumptions and judgments, and changes in governmental regulations and environmental technologies, our accruals are subject to substantial uncertainties, and our actual costs could be materially more or less than the estimated amounts.

**Pension and postretirement employee benefits.** The determination of pension plan expense and the requirements for funding our pension plans are based on a number of actuarial assumptions. Two critical assumptions are the discount rate applied to pension plan obligations and the rate of return on plan assets. For other postretirement employee benefits, or OPEB, plans, which provide certain health care and life insurance benefits to qualified retired employees, critical assumptions in determining OPEB expense are the discount rate applied to benefit obligations and the assumed health care cost trend rates used in the calculation of benefit obligations.

Note 12 to our 2008 Annual Report on Form 10-K consolidated financial statements includes information on the components of pension and OPEB expense and the underlying actuarial assumptions used to calculate periodic expense for the three years ended December 31, 2008, as well as the funded status for our pension and OPEB plans as of December 31, 2008 and 2007. Note 10, Pension and Other Postretirement Employee Benefit Plans, of this Form 10-Q includes information on the components of pension and OPEB expense for the quarters and six months ended June 30, 2009 and 2008.

The discount rate used in the determination of pension benefit obligations and pension expense is a weighted average benchmark rate based on high-quality fixed income investment interest rates. At December 31, 2008 and 2007, we calculated obligations using discount rates of 6.15% and 6.40%, respectively. To determine the expected long-term rate of return on pension assets, we employ a process that analyzes historical long-term returns for various investment categories, as measured by appropriate indices. These indices are weighted based upon the extent to which plan assets are invested in the particular categories in arriving at our determination of a composite expected return. The assumed long-term rates of return on pension plan assets used for the years ended December 31, 2008 and 2007 were 8.5% and 9.0%, respectively.



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Total periodic pension plan income in 2008 was \$5.0 million. An increase in the discount rate or the rate of expected return on plan assets, all other assumptions remaining the same, would increase pension plan income, and conversely, a decrease in either of these measures would decrease plan income. As an indication of the sensitivity that pension income has to the discount rate assumption, a 25 basis point change in the discount rate would affect annual plan income by approximately \$0.8 million. A 25 basis point change in the assumption for the expected return on plan assets would affect annual plan income by approximately \$1.1 million. The actual rates of return on plan assets may vary significantly from the assumption used because of unanticipated changes in financial markets.

We reported in our 2008 Annual Report on Form 10-K that, due to the steep downturn in the stock market in the fourth quarter of 2008, our two company-sponsored tax-qualified defined benefit pension plans were underfunded at December 31, 2008, and, as a result, we would be required to make estimated contributions to our tax-qualified pension plans by September 2010. However, a recent Internal Revenue Service pronouncement provided significant funding relief to single-employer defined benefit plan sponsors. Consequently, we are not required to make contributions for 2009 to our defined benefit plans. However, we estimate contributions will total approximately \$1.4 million in 2009 to our non-qualified pension plan. As of June 30, 2009, \$0.8 million of contributions had been made. We do not anticipate funding our OPEB plans in 2009 except to pay benefit costs as incurred during the year by plan participants.

For our OPEB plans, expense for 2008 related to continuing operations was \$10.3 million. The OPEB expense for 2008 for both continuing and discontinued operations was \$18.5 million. The discount rate used to calculate OPEB obligations, which was determined using the same methodology we used for our pension plans, was 6.15% and 6.40% at December 31, 2008 and 2007, respectively. The assumed health care cost trend rate used to calculate OPEB obligations and expense for 2008 was a 9% increase over the previous year, with the rate of increase scheduled to decline one percent annually to a long-term ultimate rate increase assumption of 6% for 2011 and thereafter.

As an indication of the sensitivity that OPEB expense has to the discount rate assumption, a 25 basis point change in the discount rate would affect plan expense by approximately \$0.3 million. A 1% change in the assumption for health care cost trend rates would have affected 2008 plan expense by approximately \$0.9 to \$1.1 million and the total OPEB obligation by approximately \$11.6 to \$13.5 million. The actual rates of health care cost increases may vary significantly from the assumption used because of unanticipated changes in health care costs.

Periodic pension and OPEB expense are included in Materials, labor and other operating expenses and Selling, general and administrative expenses in the Consolidated Condensed Statements of Operations and Comprehensive Income. The expense is allocated to all business segments. At June 30, 2009, and December 31, 2008, liabilities are recorded for underfunded plans. The funded status of a benefit plan is measured as the difference between plan assets at fair value and the benefit obligation. For underfunded plans, the estimated liability to be payable in the next twelve months is recorded as a current liability, with the remaining portion recorded as long-term. See Note 12 to our 2008 Form 10-K consolidated financial statements for further discussion.

**RESULTS OF OPERATIONS**

As noted above, our business is organized into three reporting segments: Resource; Real Estate; and Wood Products. Sales or transfers between segments are recorded as intersegment revenues based on prevailing market prices. Because of the role of the Resource segment in supplying our Wood Products segment with a portion of its wood fiber needs, intersegment revenues can represent a significant portion of the Resource segment's total revenues. Our other segments generally do not generate intersegment revenues.

In the period-to-period discussion of our results of operations below, when we discuss our consolidated revenues, contributions by each of the segments to our revenues are reported after elimination of intersegment revenues. In the Discussion of Business Segments section below, segment revenues are presented before elimination of intersegment revenues.

**Table of Contents****Quarter Ended June 30, 2009 Compared to Quarter Ended June 30, 2008**

The following table sets forth period-to-period changes in items included in our Consolidated Condensed Statements of Operations and Comprehensive Income for the quarters ended June 30, 2009 and 2008.

| (Dollars in thousands)  | Quarters Ended<br>June 30, |            | Increase<br>(Decrease) |
|---|----------------------------|------------|------------------------|
|   | 2009                       | 2008       |                        |
| Revenues  | \$ 78,782                  | \$ 103,024 | \$ (24,242)            |
| Costs and expenses:   |                            |            |                        |
| Depreciation, depletion and amortization                      | 4,906                      | 5,130      | (224)                  |
| Materials, labor and other operating expenses                 | 63,113                     | 65,835     | (2,722)                |
| Selling, general and administrative expenses                  | 10,139                     | 10,093     | 46                     |
|   | 78,158                     | 81,058     | (2,900)                |
| Earnings from continuing operations before interest and taxes | 624                        | 21,966     | (21,342)               |
| Interest expense  | (4,880)                    | (5,392)    | 512                    |
| Interest income   | 8                          | 126        | (118)                  |
| Income tax benefit  | 7,940                      | 2,172      | 5,768                  |
| Earnings from continuing operations                           | 3,692                      | 18,872     | (15,180)               |
| Discontinued operations, net of tax                           | 74                         | 2,607      | (2,533)                |
| Net earnings  | \$ 3,766                   | \$ 21,479  | \$ (17,713)            |
| Other comprehensive income, net of tax                        | 1,077                      | 733        | 344                    |
| Comprehensive income  | \$ 4,843                   | \$ 22,212  | \$ (17,369)            |

Certain 2008 amounts have been reclassified to conform to the 2009 presentation.

**Revenues** Revenues decreased \$24.2 million, or 24%, in the quarter ended June 30, 2009, compared to the same period in 2008, due to decreased revenues from all three business segments. A more detailed discussion of revenues follows in Discussion of Business Segments.

**Depreciation, depletion and amortization** Depreciation, depletion and amortization expense decreased \$0.2 million, or 4%, in the second quarter of 2009 compared to the same period in 2008 due to minimal decreases in depreciation and depletion from each of the business segments.

**Materials, labor and other operating expenses** Materials, labor and other operating expenses decreased \$2.7 million, or 4%, in the quarter ended June 30, 2009, compared to the quarter ended June 30, 2008. The lower expenses were primarily related to lower logging and hauling costs within the Resource segment due to reduced harvest levels and decreased log costs at the lumber mills.

**Selling, general and administrative expenses** Selling, general and administrative expenses increased by less than \$0.1 million in the quarter ended June 30, 2009 compared to the same period in 2008.

**Interest expense** Interest expense decreased \$0.5 million, or 9%, from the same period in 2008, primarily due to lower levels of borrowings outstanding under our bank credit facility during the quarter ended June 30, 2009 compared to the quarter ended June 30, 2008, partially offset by higher interest rates paid on the borrowings in 2009.

**Interest income** Interest income decreased \$0.1 million from the same period in 2008, primarily due to lower levels of short-term investments during the quarter ended June 30, 2009 compared to the same period in 2008 and lower interest rates received on short-term investments in

2009.

**Income tax benefit** We recorded income tax benefits related to our continuing operations of \$7.9 million and \$2.2 million for the quarters ended June 30, 2009 and 2008, respectively. The income tax benefit in the second quarter of 2009 resulted from pre-tax losses from Potlatch TRS and a federal tax credit associated with electricity produced from qualified energy resources and sold to an unrelated party, partially offset by built-in gains taxes on land sales in the period that we were not able to match for Section 1031 purposes. (See Note 3 to the financial statements for additional information related to the federal tax credit associated with the sale of electricity produced from qualified energy resources.) The income tax benefit in the second quarter of 2008 was due to pre-tax losses from Potlatch TRS.

**Discontinued operations** The results of discontinued operations for the quarter ended June 30, 2008, included a pre-tax charge of \$0.3 million related to our settlement with the indirect purchaser class in the OSB antitrust lawsuit and \$1.0 million of OSB-related legal expenses. Discontinued operations for both the 2009 and 2008 periods included the operations of the Clearwater Paper businesses spun off in December 2008 and the Prescott mill closed in May 2008.

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**Other comprehensive income, net of tax** We recorded other comprehensive income, net of tax, of \$1.1 million for the quarter ended June 30, 2009, compared to \$0.7 million for the quarter ended June 30, 2008.

**DISCUSSION OF BUSINESS SEGMENTS**

| (Dollars in thousands)                                    | Quarters Ended |                  | Increase<br>(Decrease) |
|---|----------------|------------------|------------------------|
|   | 2009           | June 30,<br>2008 |                        |
| <b>Revenues:</b>  |                |                  |                        |
| Resource  | \$ 27,288      | \$ 44,586        | \$ (17,298)            |
| Real Estate   | 4,697          | 15,308           | (10,611)               |
| <b>Wood Products:</b>                                     |                |                  |                        |
| Lumber  | 34,771         | 38,949           | (4,178)                |
| Plywood   | 7,950          | 13,923           | (5,973)                |
| Particleboard   | 3,223          | 5,293            | (2,070)                |
| Other   | 8,757          | 12,437           | (3,680)                |
|   | 54,701         | 70,602           | (15,901)               |
| Total revenues, before eliminations                       | \$ 86,686      | \$ 130,496       | \$ (43,810)            |
| <b>Operating Income (Loss):</b>                           |                |                  |                        |
| Resource  | \$ 4,525       | \$ 12,161        | \$ (7,636)             |
| Real Estate   | 1,507          | 11,316           | (9,809)                |
| Wood Products   | (2,993)        | 2,604            | (5,597)                |
| Total operating income, before corporate and eliminations | \$ 3,039       | \$ 26,081        | \$ (23,042)            |

Operating income for our Resource segment decreased \$7.6 million, or 63%, for the second quarter of 2009 from the same period in 2008. Revenues for the segment decreased \$17.3 million, or 39%, during the second quarter of 2009 from the second quarter of 2008. The decrease in revenues was primarily due to lower sales prices in both the Northern and Southern regions, combined with 20% lower overall selling volumes, primarily from the Northern region due to our planned reduction in harvest levels. In the Northern region, sawlog prices and sales volumes decreased approximately 33% and 47%, respectively, as depressed softwood lumber markets continued to contribute to weak log demand and decreased log production. Also in the Northern region, prices for pulpwood decreased 7% and sales volumes decreased 31%. In the Southern region, sawlog prices decreased 9%, while sales volumes increased 18% and prices for pulpwood decreased 6%, while sales volumes increased 1%. Expenses for the segment decreased \$9.7 million, or 30%, during the second quarter of 2009 from the same period in 2008. The decrease in expenses was primarily related to lower logging and hauling costs due to reduced harvest levels and cost control measures implemented within the Resource operations at the beginning of the year.

Operating income for our Real Estate segment decreased \$9.8 million, or 87%, for the quarter ended June 30, 2009, compared to the same period in 2008. Revenues for the segment decreased \$10.6 million for the second quarter of 2009 from the same period in 2008. During the second quarter of 2009, we sold 628 acres of higher and better use, or HBU, property for approximately \$1.4 million, or \$2,278 per acre. In addition, we sold 2,927 acres of rural recreational property for approximately \$3.3 million, for an overall average price of \$1,116 per acre. During the second quarter of 2008, we sold 19,362 acres of non-strategic timberland in Minnesota at an average price of \$383 per acre. In the second quarter of 2008, HBU land sales totaled approximately 890 acres at an average price of \$2,044 per acre and rural recreational land sales totaled 4,222 acres at an average price of \$1,439 per acre. Results for the segment depend to a large extent on the timing of closings of transactions for properties we sell and the types of properties sold. Real Estate segment expenses decreased \$0.8 million, or 20%, in the second quarter of 2009 compared to the same period in 2008. The decreased expenses were primarily due to a lower cost basis of the land sold in 2009.

The Wood Products segment reported an operating loss of \$3.0 million for the second quarter of 2009, compared to operating income of \$2.6 million in the same period of 2008. Revenues for the segment decreased \$15.9 million, or 23%, from the second quarter of 2008. Lumber revenues decreased \$4.2 million, or 11%, in the second quarter of 2009 from the same period in 2008. The lower lumber revenues were due to

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selling prices 22% lower than the previous year, partially offset by a 15% increase in sales volumes. Plywood revenues decreased \$6.0 million, or 43%, during the second quarter of 2009 from the same period in 2008. The decrease was due to selling prices 11% lower than the previous year and a 36% decrease in sales volumes. Our Idaho plywood facility operated at approximately 60% of normal production at the beginning of the second quarter of 2009, but returned to full production in early May. Particleboard revenues decreased \$2.1 million, or 39%, for the second quarter of 2009 from the same period in 2008. The lower revenues were due to a 47% decrease in sales volumes that was partially offset by 14% higher selling prices. During the second quarter, our Idaho particleboard plant operated as scheduled at 50% of normal levels to better balance production with the available fiber supply and demand for particleboard. Other revenues for the segment, which consist primarily of the sale of

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lumber mill by-products such as residuals and chips, decreased \$3.7 million, or 30%, during the second quarter of 2009 from the same quarter of 2008, primarily due to lower production from our lumber mills resulting in fewer by-products. Expenses for the segment decreased \$10.3 million, or 15%, for the second quarter of 2009 from the same period of 2008. The decrease in expenses was primarily due to lower log costs associated with reduced lumber sales.

**Six Months Ended June 30, 2009 Compared to Six Months Ended June 30, 2008**

The following table sets forth period-to-period changes in items included in our Consolidated Condensed Statements of Operations and Comprehensive Income for the six months ended June 30, 2009 and 2008.

| (Dollars in thousands)  | Six Months Ended<br>June 30, |            | Increase<br>(Decrease) |
|---|------------------------------|------------|------------------------|
|   | 2009                         | 2008       |                        |
| Revenues  | \$ 208,375                   | \$ 215,583 | \$ (7,208)             |
| Costs and expenses:   |                              |            |                        |
| Depreciation, depletion and amortization                      | 11,518                       | 12,537     | (1,019)                |
| Materials, labor and other operating expenses                 | 141,006                      | 137,303    | 3,703                  |
| Selling, general and administrative expenses                  | 19,316                       | 22,749     | (3,433)                |
|   | 171,840                      | 172,589    | (749)                  |
| Earnings from continuing operations before interest and taxes | 36,535                       | 42,994     | (6,459)                |
| Interest expense  | (9,714)                      | (10,673)   | 959                    |
| Interest income   | 38                           | 454        | (416)                  |
| Income tax benefit  | 5,604                        | 9,384      | (3,780)                |
| Earnings from continuing operations                           | 32,463                       | 42,159     | (9,696)                |
| Discontinued operations, net of tax                           | (3,877)                      | (10,422)   | 6,545                  |
| Net earnings  | \$ 28,586                    | \$ 31,737  | \$ (3,151)             |
| Other comprehensive income, net of tax                        | 2,032                        | 2,771      | (739)                  |
| Comprehensive income  | \$ 30,618                    | \$ 34,508  | \$ (3,890)             |

Certain 2008 amounts have been reclassified to conform to the 2009 presentation.

**Revenues** Revenues decreased \$7.2 million, or 3%, in the six months ended June 30, 2009, compared to the same period in 2008, primarily due to decreased revenues from the Resource and Wood Products segments, partially offset by increased revenues from our Real Estate segment. A more detailed discussion of revenues follows in Discussion of Business Segments.

**Depreciation, depletion and amortization** Depreciation, depletion and amortization expense decreased \$1.0 million, or 8%, in the first six months of 2009 compared to the same period in 2008. A 10% decrease in harvest levels by the Resource operations contributed to decreased depletion expense.

**Materials, labor and other operating expenses** Materials, labor and other operating expenses increased \$3.7 million, or 3%, in the first six months of 2009 compared to the first six months of 2008. The higher expenses were primarily due to increased costs associated with increased sales of logs to external customers and a higher cost basis for the acreage sold in 2009.

**Selling, general and administrative expenses** Selling, general and administrative expenses decreased \$3.4 million, or 15%, in the first six months of 2009 compared to the same period in 2008. The decrease was due primarily to higher compensation-related expenses in the first half of 2008.



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**Interest expense** Interest expense decreased \$1.0 million, or 9%, from the same period in 2008, primarily due to lower levels of borrowings outstanding under our bank credit facility during the first half of 2009 compared to 2008, partially offset by higher interest rates paid on the borrowings in 2009.

**Interest income** Interest income decreased \$0.4 million from the same period in 2008, primarily due to lower levels of short-term investments during the first six months of 2009 compared to the same period in 2008 and lower interest rates received on short-term investments in 2009.

**Income tax benefit** We recorded income tax benefits related to our continuing operations of \$5.6 million and \$9.4 million for the six month periods ended June 30, 2009 and 2008, respectively. The income tax benefit in the 2009 period resulted from pre-tax losses from Potlatch TRS and a federal tax credit associated with electricity produced from qualified energy resources and sold to an unrelated party, partially offset by built-in gains taxes on land sales in the period that we were not able to match for Section 1031 purposes. (See Note 3 to the financial statements for additional information related to the federal tax credit associated with the sale of electricity produced from qualified energy resources.) The income tax benefit in the 2008 period was due to pre-tax losses from Potlatch TRS.

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**Discontinued operations** The results of discontinued operations for the six months ended June 30, 2009, included a pre-tax charge of \$5.75 million for the legal settlement related to the sale of our oriented strand board, or OSB, manufacturing facilities in 2004, as well as \$0.8 million of OSB-related legal expenses. The results of discontinued operations for the six months ended June 30, 2008, included pre-tax charges totaling \$2.7 million and \$0.3 million, respectively, related to settlements with the direct and indirect purchaser classes in the OSB antitrust lawsuit and \$2.2 million of OSB-related legal expenses. Discontinued operations for both periods also included the operations of the Clearwater Paper businesses spun off in December 2008 and the Prescott mill closed in May 2008.

**Other comprehensive income, net of tax** We recorded other comprehensive income, net of tax, of \$2.0 million for 2009, compared to \$2.8 million for 2008.

**DISCUSSION OF BUSINESS SEGMENTS**

| (Dollars in thousands)                                    | Six Months Ended<br>June 30, |            | Increase<br>(Decrease) |
|---|------------------------------|------------|------------------------|
|   | 2009                         | 2008       |                        |
| <b>Revenues:</b>  |                              |            |                        |
| Resource  | \$ 74,494                    | \$ 105,341 | \$ (30,847)            |
| Real Estate   | 52,733                       | 36,448     | 16,285                 |
| <b>Wood Products:</b>                                     |                              |            |                        |
| Lumber  | 62,636                       | 75,006     | (12,370)               |
| Plywood   | 14,023                       | 28,008     | (13,985)               |
| Particleboard   | 5,672                        | 9,721      | (4,049)                |
| Other   | 17,199                       | 23,084     | (5,885)                |
|   | 99,530                       | 135,819    | (36,289)               |
| Total revenues, before eliminations                       | \$ 226,757                   | \$ 277,608 | \$ (50,851)            |
| <b>Operating Income (Loss):</b>                           |                              |            |                        |
| Resource  | \$ 15,371                    | \$ 29,356  | \$ (13,985)            |
| Real Estate   | 43,019                       | 27,967     | 15,052                 |
| Wood Products   | (14,176)                     | (3,846)    | (10,330)               |
| Total operating income, before corporate and eliminations | \$ 44,214                    | \$ 53,477  | \$ (9,263)             |

Operating income for our Resource segment decreased \$14.0 million, or 48%, for the first six months of 2009, from the same period in 2008. Revenues for the segment decreased \$30.8 million, or 29%, during the first six months of 2009 compared to the same period of 2008. The decrease in revenues was primarily due to lower sales prices for sawlogs and pulpwood in both the Northern and Southern regions, combined with 10% lower overall sales volumes, primarily in the Northern region. In the Northern region, sawlog prices and sales volumes both decreased 28%, primarily due to depressed softwood lumber markets. Also in the Northern region, prices for pulpwood decreased 1% and sales volumes decreased 28%. In the Southern region, prices for sawlogs and pulpwood decreased 12% and 8%, respectively, while sales volumes increased 22% and 23%, respectively. Expenses for the segment decreased \$16.9 million, or 22%, during the first six months of 2009 from the same period in 2008. The decrease in expenses was primarily related to lower logging and hauling costs due to reduced harvest levels and cost control measures implemented in the segment.

Operating income for our Real Estate segment increased \$15.1 million, or 54%, for the first six months of 2009 compared to the same period in 2008. Revenues for the segment increased \$16.3 million, or 45%, for the first six months of 2009 over the same period of 2008. We sold 24,549 acres of non-strategic timberland in Arkansas in January 2009 for \$43.3 million, or \$1,762 per acre. In addition, we had one other non-strategic timberland sale of 3,002 acres for \$1.5 million, or \$500 per acre. Other land sales in the first six months of 2009 totaled 1,060 HBU acres at an average price of \$2,128 per acre and 4,953 rural recreational acres at an average price of \$1,156 per acre. We sold 42,571 acres of non-strategic timberland in Minnesota in the first six months of 2008 at an average price of \$376 per acre. Other land sales in the first six months of 2008 totaled 2,742 HBU acres at an average price of \$2,553 per acre and 8,179 acres of rural recreational land at an average price of \$1,637 per acre.

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Results for the segment depend to a large extent on the timing of closings of transactions for properties we sell and the types of properties sold. Real Estate segment expenses increased \$1.2 million, or 15%, in the first six months of 2009 compared to the same period of 2008, primarily due to a higher cost basis on land sales in 2009.

The Wood Products segment reported an operating loss of \$14.2 million for the first six months of 2009 compared to a loss of \$3.8 million in the same period of 2008. Revenues for the segment decreased \$36.3 million, or 27%, from the first six months of 2008. Lumber revenues decreased \$12.4 million, or 16%, in the first six months of 2009 from the same period in 2008. The lower lumber revenues were due to 16% lower sales prices, partially offset by a 1% increase in sales

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volumes. Our Minnesota lumber mill operated at approximately 75% of normal production in the first two months of 2009, then returned to a full production level in March 2009. Our Idaho lumber mill also operated at approximately 75% of normal production at the beginning of 2009, then returned to full production in mid-April. Plywood revenues decreased \$14.0 million, or 50%, during the first six months of 2009 from the same period of 2008. The decrease was due to 47% lower sales volumes and 6% lower sales prices. Our Idaho plywood facility operated at approximately 60% of normal production at the beginning of 2009, then returned to full production in early May. Particleboard revenues decreased \$4.0 million, or 42%, for the first six months of 2009 from the same period in 2008. The lower revenues were due to a 48% decrease in sales volumes that was partially offset by 10% higher sales prices. Our Idaho particleboard plant was shut down for the month of January 2009, but has now been running as scheduled at 50% of normal levels to better balance production with the available fiber supply and demand for particleboard. Other revenues for the segment, which consist primarily of the sale of lumber mill by-products such as residuals and chips, decreased \$5.9 million, or 25%, during the first six months of 2009 from the same period of 2008, primarily due to lower production from our lumber mills resulting in fewer by-products. Expenses for the segment decreased \$26.0 million, or 19%, for the first six months of 2009 from the same period of 2008. The decrease in expenses was primarily due to lower log costs, lower labor and supply costs associated with reduced production levels, and decreased lumber shipments.

**LIQUIDITY AND CAPITAL RESOURCES**

At June 30, 2009, our financial position included long-term debt of \$320.9 million, including current installments on long-term debt of \$100.0 million, and current notes payable of \$121.3 million. Long-term debt at June 30, 2009 (including current installments) decreased \$0.4 million from the \$321.3 million balance at December 31, 2008. Notes payable at June 30, 2009, decreased \$7.8 million from the December 31, 2008, balance of \$129.1 million due to reduced borrowings under our bank credit facility. Stockholders' equity for the first six months of 2009 decreased \$20.4 million due to regular quarterly cash distributions to common stockholders of \$40.5 million and establishment of a \$13.3 million deferred tax liability related to the contribution of property from the REIT to TRS, partially offset by net earnings of \$28.6 million. The ratio of long-term debt (including current installments) to stockholders' equity was 1.80 to 1 at June 30, 2009, compared to 1.62 to 1 at December 31, 2008.

Long-term debt includes \$100.0 million of credit sensitive debentures due in December 2009. In June 2009, Clearwater Paper deposited \$106.3 million with the indenture trustee to satisfy all remaining principal and future interest due on the credit sensitive debentures. See discussion below for additional information about Clearwater Paper's obligation related to the credit sensitive debentures. Scheduled payments due on long-term debt during each of the five years subsequent to December 31, 2009, are as follows:

| <b>(Dollars in thousands)</b> |        |
|-------------------------------|--------|
| 2010                          | \$ 11  |
| 2011                          | 5,011  |
| 2012                          | 21,656 |
| 2013                          | 8,413  |
| 2014                          | 21,000 |

**Table of Contents****Cash Flows Summary**

The following table presents information regarding our cash flows for the six months ended June 30, 2009 and 2008.

| (Dollars in thousands)   | Six Months Ended<br>June 30, |                 |
|--|------------------------------|-----------------|
|  | 2009                         | 2008            |
| <b>Cash flows from continuing operations:</b>                  |                              |                 |
| Net cash provided by operations                                | \$ 37,255                    | \$ 16,884       |
| Net cash provided by (used for) investing                      | 12,919                       | (24,757)        |
| Net cash used for financing                                    | (48,301)                     | (23,642)        |
| <b>Cash flows provided by (used for) continuing operations</b> | <b>1,873</b>                 | <b>(31,515)</b> |
| Cash flows of discontinued operations                          | (580)                        | 29,075          |
| <b>Increase (decrease) in cash</b>                             | <b>1,293</b>                 | <b>(2,440)</b>  |
| Cash at beginning of period                                    | 885                          | 9,047           |
| <b>Cash at end of period</b>                                   | <b>\$ 2,178</b>              | <b>\$ 6,607</b> |

Working capital totaled negative \$105.4 million at June 30, 2009, a decrease of \$14.0 million from the December 31, 2008 balance of negative \$91.4 million. The significant changes in the components of working capital are as follows:

Accounts payable and accrued liabilities increased \$11.2 million primarily due to the \$5.75 million OSB settlement associated with discontinued operations, which was paid in July, and the \$6.3 million of deferred interest related to the credit sensitive debentures.

Receivables decreased \$10.1 million primarily due to payment of the \$16.6 million accounts receivable balance from Clearwater Paper recorded on our balance sheet at December 31, 2008, partially offset by increased trade and tax receivables.

Log inventories decreased \$7.1 million and lumber and other manufactured wood products inventories decreased \$1.4 million.

Notes payable totaled \$121.3 million at June 30, 2009, compared to \$129.1 million at December 31, 2008, a decrease of \$7.8 million, due to reduced borrowings under our bank credit facility.

Restricted cash increased by \$106.3 million and the note receivable decreased by \$100.0 million as a result of Clearwater Paper's deposit in June 2009 of \$106.3 million with the indenture trustee to satisfy all remaining principal and future interest due on the credit sensitive debentures. Consequently, the note receivable was deemed to have been satisfied. Until the December 1, 2009 maturity date of the debentures, the funds deposited with the indenture trustee will be reflected on our Consolidated Condensed Balance Sheet as restricted cash. See discussion below for additional information about Clearwater Paper's obligation related to the credit sensitive debentures. Net cash provided by operating activities from continuing operations for the first six months of 2009 totaled \$37.3 million, compared to \$16.9 million for the same period in 2008. The increase was due to more proceeds deposited with the LKE intermediary and decreased cash from working capital changes in the first six months of 2008.

Net cash provided by investing activities from continuing operations was \$12.9 million for the six months ended June 30, 2009. Net cash used for investing activities from continuing operations was \$24.8 million for the six months ended June 30, 2008. In the first six months of 2009, a \$19.2 million increase in short-term investments was partially offset by \$6.1 million of capital expenditures. In the first six months of 2008, we

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used \$27.3 million for deposits on timberlands and \$24.6 million for capital expenditures, including \$16.4 million in cash for the acquisition of timberlands in Idaho. The deposits on timberlands represent the portion of timberlands that were purchased on our behalf by a section 1031 like-kind exchange qualified intermediary and held by the intermediary until matched with sales of company-owned properties through our like-kind exchange process. These uses of cash in the first six months of 2008 were partially offset by a net cash inflow of \$26.3 million from a change in our short-term investments. Capital expenditures of \$6.1 million in the first six months of 2009 were primarily for forestland activities and various smaller projects designed to improve product quality and manufacturing efficiency.

Net cash used for financing activities from continuing operations totaled \$48.3 million and \$23.6 million for the six months ended June 30, 2009 and 2008, respectively. Net cash used for financing activities in the first six months of 2009 was primarily for payment of our regular quarterly cash distributions to shareholders of \$40.5 million and paying down the outstanding balance of our bank credit facility by \$7.8 million. Net cash used for financing activities in the first six months of 2008 was primarily for payment of our regular quarterly cash distributions to common stockholders of \$40.3 million, partially offset by an increase of \$19.0 million in the balance of our bank credit facility.

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Our regular quarterly cash distributions totaled \$40.5 million in the first six months of 2009. Based on our outlook for 2009 and taking into account planned harvest activities, we expect to fund a significant portion of our 2009 annual cash distributions using the cash flows from our REIT-qualifying timberland operations and real estate sales. Any shortfall between cash available for distribution from REIT operations and our 2009 distributions to stockholders is expected to be funded through cash on hand, bank borrowings, revenues from sales of timberlands or a combination thereof. Our ability to fund distributions through bank borrowings is subject to our continued compliance with debt covenants, as well as the availability of borrowing capacity under our lending arrangements. If we do not generate sufficient cash flows primarily from our timberland operations and real estate sales and we are unable to borrow, or elect not to do so, we may be required to reduce our quarterly distributions. Significant decreases in timber or timberland prices or other factors that have a materially adverse effect on the cash flows from our REIT operations could result in our inability to maintain our current distribution rate.

In addition, the rules with which we must comply to maintain our status as a REIT limit our ability to use dividends from our wood products manufacturing business for the payment of stockholder distributions. In particular, at least 75% of our gross income for each taxable year as a REIT must be derived from sales of our standing timber and other types of real estate income. No more than 25% of our gross income may consist of dividends from Potlatch TRS and other non-qualifying types of income. This requirement may limit our ability to receive dividends from Potlatch TRS and may impact our ability to fund distributions to stockholders using cash flows from Potlatch TRS.

Our board of directors, in its sole discretion, will determine the actual amount of distributions to be made to stockholders based on consideration of a number of factors, including, but not limited to, our results of operations, cash flow and capital requirements, economic conditions in our industry and in the markets for our products, tax considerations, borrowing capacity, debt covenant restrictions, timber prices and harvest levels on our timberlands.

Our current secured bank credit facility, which expires in December 2013, provides for a revolving line of credit of up to \$250 million, including a \$35 million subfacility for letters of credit and a \$20 million subfacility for swing line loans. Usage under either or both subfacilities reduces availability under the revolving line of credit. Availability under the credit facility was previously reduced by \$100 million until the \$100 million principal amount of credit sensitive debentures due in December 2009 were paid by Clearwater Paper, as discussed below. In June 2009, Clearwater Paper deposited with the indenture trustee a sum sufficient to satisfy all remaining principal and future interest due on the credit sensitive debentures. Consequently, our obligations under the indenture governing the credit sensitive debentures have been fully discharged and the \$100 million limitation on availability under our secured bank credit facility has been removed. Subject to certain conditions and agreement of the lenders, the facility may be increased by up to an additional \$100 million. As of June 30, 2009, there were \$121.3 million of borrowings outstanding under the revolving line of credit, and \$7.4 million of the letter of credit subfacility was being used to support several outstanding letters of credit. Available borrowing capacity at June 30, 2009 was \$121.3 million. Loans under the credit facility bear interest at LIBOR plus between 3.0% and 4.0% for LIBOR loans, and a base rate effectively equal to the bank's prime rate plus between 3.0% and 4.0% for other loans. As of June 30, 2009, we are eligible to borrow under the credit facility at LIBOR plus 3.50%. As of June 30, 2009, the weighted average interest rate on the \$121.3 million of borrowings outstanding under the revolving line of credit was approximately 4.0%.

The credit facility is secured by a pledge of the capital stock of our subsidiaries and by a portion of our timberlands in Idaho necessary to satisfy the minimum collateral coverage ratio, as described below. This pledge is on an equal rights of payment and level of seniority basis with the \$22.5 million principal amount of 6.95% debentures due 2015, the \$100.0 million principal amount of credit sensitive debentures due 2009 and the \$48.8 million principal amount of medium-term notes due 9 months to 30 years from the date of issuance.

The agreement governing our credit facility contains certain covenants that limit our ability and that of our subsidiaries to create liens, merge or consolidate, dispose of assets, incur indebtedness and guarantees, repurchase or redeem capital stock and indebtedness, make certain investments or acquisitions, enter into certain transactions with affiliates or change the nature of our business. The credit facility also contains financial maintenance covenants establishing a minimum interest coverage ratio, a minimum collateral coverage ratio and a maximum funded indebtedness to capitalization ratio. We will be permitted to pay distributions under the terms of the credit facility so long as we remain in pro forma compliance with the financial covenants.

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The table below sets forth the most restrictive covenants in the credit facility and our status with respect to these covenants as of June 30, 2009.

|   | <b>Covenant Requirement</b> | <b>Actual Ratio at June 30, 2009</b> |
|---|-----------------------------|--------------------------------------|
| Minimum Interest Coverage Ratio                     | 2.50 to 1.00                | 4.80 to 1.00                         |
| Minimum Collateral Coverage Ratio                   | 2.25 to 1.00                | 3.87 to 1.00                         |
| Maximum Funded Indebtedness to Capitalization Ratio | 60.0%                       | 51.6%                                |

Events of default under the credit facility include, but are not limited to, payment defaults, covenant defaults, breaches of representations and warranties, cross defaults to certain other material agreements and indebtedness, bankruptcy and other insolvency events, material adverse judgments, actual or asserted invalidity of security interests or loan documentation, and certain change of control events.

We and several of our subsidiaries are parties to the credit agreement and eligible to borrow thereunder, subject to the specified borrowing limits and continued compliance with debt covenants. Any borrowings by one of these entities under the credit facility reduces the credit available for all the entities. As a result, borrowings by Potlatch TRS under the credit facility will, until repaid, reduce the amount of borrowings otherwise available to us for purposes such as the funding of quarterly distributions.

In 2005, the entity now known as Clearwater Paper assumed the obligation to pay all principal and interest on the \$100 million principal amount of credit sensitive debentures previously issued by our wholly owned subsidiary, Potlatch Forest Holdings, Inc. The debentures become due and payable in full on December 1, 2009. In connection with the spin-off, we entered into the Retained Obligation Agreement with Clearwater Paper, which provided that Clearwater Paper would continue to be obligated to make all payments of principal and interest on the debentures to the holders of the debentures. Despite Clearwater Paper's payment obligations under the debentures, holders of the debentures continued to have legal recourse against our subsidiary, Potlatch Forest Holdings, Inc., for any failure to make payments when due. In June 2009, Clearwater Paper deposited with the indenture trustee a sum sufficient to satisfy all remaining principal and future interest due on the credit sensitive debentures. Consequently, our obligations under the indenture governing the credit sensitive debentures have been fully discharged. Until the December 1, 2009 maturity date of the debentures, the \$106.3 million deposited with the indenture trustee will be reflected on our Consolidated Condensed Balance Sheet as restricted cash and the \$100 million principal amount and \$6.3 million deferred interest will be classified as current liabilities.

We believe that our cash, cash flows from continuing operations and available borrowings under our credit facility will be sufficient to fund our operations, regular stockholder distributions, capital expenditures and debt service obligations for the next twelve months. We cannot assure, however, that our business will generate sufficient cash flow from operations or that we will be in compliance with the financial covenants in our credit facility so that future borrowings thereunder will be available to us. Thus, our ability to fund our operations and stockholder distributions will be dependent upon our future financial performance, which will be affected by general economic, competitive and other factors, including those discussed above under the heading "Factors Influencing our Results of Operations and Cash Flows," many of which are beyond our control.

ITEM 3.

**Quantitative and Qualitative Disclosures About Market Risk**

Our exposure to market risks on financial instruments includes interest rate risk on our short-term investments and secured bank credit facility, and credit rate risk on our credit sensitive debentures.

Our short-term investments are invested in time or demand deposits, certificates of deposit and U.S. Treasury and U.S. government agency obligations, all of which have very short maturity periods, and they therefore earn an interest rate commensurate with low-risk instruments. We do not attempt to hedge our exposure to interest rate risk for our short-term investments. All short-term investments are made in compliance with the requirements of the Internal Revenue Code with respect to qualifying REIT investments.

As of June 30, 2009, we had \$121.3 million of borrowings outstanding under our secured bank credit facility. The interest rates applied to borrowings under the credit facility are adjusted often and therefore react quickly to any movement in the general trend of market interest rates. For example, a 1% increase or decrease in interest rates, based on our outstanding credit facility borrowings of \$121.3 million at June 30, 2009, would have a \$1.2 million annual effect on interest expense. We do not attempt to mitigate the effects of short-term interest rate fluctuations on our credit facility borrowings through the use of derivative financial instruments.





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All of our long-term debt is fixed rate and therefore changes in market interest rates do not expose us to interest rate risk for these financial instruments.

We currently have \$100.0 million of credit sensitive debentures outstanding that pay interest to the debt holder based upon our credit ratings as established by S&P or Moody's. See the discussion of our Retained Obligation Agreement with Clearwater Paper above for more information regarding these securities. The following table denotes the interest rate applicable to the credit sensitive debentures based on various credit ratings:

| Ratings     |  |             | Applicable Rate (%) |
|-------------|--|-------------|---------------------|
| S&P         |  | Moody's     |                     |
| AAA         |  | Aaa         | 8.825               |
| AA+ AA-     |  | Aa1 Aa3     | 8.925               |
| A+ BBB      |  | A1 Baa2     | 9.125               |
| BBB-        |  | Baa3        | 9.425               |
| BB+         |  | Ba1         | 12.500              |
| BB          |  | Ba2         | 13.000              |
| BB-         |  | Ba3         | 13.500              |
| B+ or lower |  | B1 or lower | 14.000              |

In December 2008, S&P raised our senior unsecured debt rating to BB+, resulting in an interest rate decrease to 12.5% on our credit sensitive debentures. Since October 2004, Moody's has rated our senior unsecured debt at Ba1. Moody's affirmed this rating, with a stable outlook, in June 2009.

**QUANTITATIVE INFORMATION ABOUT MARKET RISKS**

(Dollars in thousands)

|                       | Expected Maturity Date (as of June 30, 2009) |       |          |           |          |            | Total      |
|-----------------------|--|-------|----------|-----------|----------|------------|------------|
|                       | 2009   | 2010  | 2011     | 2012      | 2013     | Thereafter |            |
| Long-term debt:       |  |       |          |           |          |            |            |
| Fixed rate            | \$ 100,000                                   | \$ 11 | \$ 5,011 | \$ 21,656 | \$ 8,413 | \$ 185,853 | \$ 320,944 |
| Average interest rate | 12.5%  | 6.5%  | 8.6%     | 8.3%      | 7.5%     | 6.7%       | 8.7%       |
| Fair value at 6/30/09 |  |       |          |           |          |            | \$ 218,578 |

ITEM 4.

**Controls and Procedures**

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities and Exchange Act of 1934, or the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of disclosure controls and procedures is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Subject to the limitations noted above, our management, with the participation of our CEO and CFO, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the fiscal quarter covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the CEO and CFO have concluded that, as of such date, our disclosure controls and procedures were effective to meet the objective for which they were designed and operated at the reasonable assurance level.

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As part of the spin-off of the Clearwater Paper businesses, we entered into a Transition Services Agreement with Clearwater Paper whereby certain internal control processes will be monitored for a period of time by former Potlatch

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employees who became Clearwater Paper employees as of December 16, 2008. There were no changes in our internal control over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Part II**

ITEM 1.

**Legal Proceedings**

We sold our oriented strand board, or OSB, manufacturing facilities to Ainsworth Lumber Co. Ltd. in September 2004. In September 2006, Ainsworth filed a complaint in the Supreme Court of the State of New York for the County of New York alleging breaches of representations and warranties in the asset purchase agreement whereby Ainsworth purchased our OSB facilities. Although we believe we had meritorious defenses to this claim, in April 2009 we reached a settlement with Ainsworth for \$5.75 million, solely to avoid the further expense and burden of the ongoing litigation. The settlement was finalized and the lawsuit was dismissed in July 2009.

We believe there is no pending or threatened litigation that would have a material adverse effect on our financial position, operations or liquidity.

ITEM 1A.

**Risk Factors**

In Part I, Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2008, titled Risk Factors, under Risks Related to Our Spin-off, we discussed the obligation represented by the credit sensitive debentures that remains our liability until paid and noted that if Clearwater Paper failed to meet its payment obligations under the Retained Obligation Agreement, holders of the debentures would have legal recourse against us. This risk is no longer applicable since Clearwater Paper deposited with the indenture trustee a sum sufficient to satisfy all remaining principal and future interest due on the credit sensitive debentures. There are no other material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2008.

ITEM 4.

**Submission of Matters to a Vote of Security Holders**

At the annual meeting of stockholders of the company held on May 4, 2009, the company's stockholders voted on two proposals as follows:

**Proposal 1**

Election of Directors

|                     | For        | Against   | Abstain |
|---------------------|------------|-----------|---------|
| Boh A. Dickey       | 31,206,769 | 654,749   | 27,145  |
| William L. Driscoll | 30,263,957 | 1,572,959 | 51,747  |
| Judith M. Runstad   | 31,075,661 | 761,671   | 51,331  |

Directors whose terms of office also continued after the annual meeting are Michael J. Covey, Ruth Ann M. Gillis, Jerome C. Knoll, John S. Moody, Lawrence S. Peiros and Gregory L. Quesnel.

**Proposal 2**

Ratification of the Appointment of Independent Auditor

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|         |            |
|---------|------------|
| For     | 30,513,380 |
| Against | 1,341,437  |
| Abstain | 33,846     |

ITEM 6.

**Exhibits**

The exhibit index is located on page 31 of this Form 10-Q.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

POTLATCH CORPORATION  
(Registrant)

By /s/ Eric J. Cremers  
Eric J. Cremers  
Vice President, Finance and

Chief Financial Officer  
(Duly Authorized; Principal Financial Officer)

By /s/ Terry L. Carter  
Terry L. Carter  
Controller and Treasurer  
(Duly Authorized; Principal Accounting Officer)

Date: July 30, 2009

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POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

**EXHIBIT INDEX**

| <b>EXHIBIT<br/>NUMBER</b> | <b>DESCRIPTION</b>  |
|---------------------------|---|
| (4)                       | Registrant undertakes to furnish to the Commission, upon request, any instrument defining the rights of holders of long-term debt.  |
| (10)(cc)*                 | Consent, dated June 23, 2009, to the Credit Agreement, dated December 8, 2008, by and among the Registrant and its wholly owned subsidiaries, as borrowers, Bank of America, N.A., as administrative agent, swing line lender, L/C issuer and collateral agent, the Guarantors from time to time party thereto and the Lenders from time to time party thereto, filed as Exhibit 10.1 to the Current Report on Form 8-K filed by the Registrant on June 24, 2009. |
| (31)                      | Rule 13a-14(a)/15d-14(a) Certifications.  |
| (32)                      | Furnished statements of the Chief Executive Officer and Chief Financial Officer under 18 U.S.C. Section 1350.   |

\* Incorporated by reference.