ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

Record Insider Selling Continues at Lower Prices
Louisiana-Pacific Corp. (NYSE:LPX) Update

July 7, 2004

Contact: Bob Gabele (954) 779-3974 or bgabele@3DAdvisors.com

Louisiana-Pacific Corporation is a manufacturer and distributor of building products used primarily in new home construction, repair and remodeling and manufactured housing. The Company delivers these products to the retail, wholesale, home building and industrial markets predominantly in North America. It also sells and distributes its products to the light industrial and commercial construction markets, and runs an export business for some of its specialty building products to Asia, Europe and South America. Louisiana-Pacific operates in four principal segments: Oriented Strand Board (OSB), Composite Wood Products, Plastic Building Products and Engineered Wood Products (EWP). In addition to its United States operations, the Company also maintains manufacturing facilities in Canada and Chile through foreign subsidiaries and joint ventures.

Summary of 3DAdvisors Findings for LPX

- **Insider Trading:** Selling and holdings reductions continue at lower prices
- **Accounting:** Softening OSB market provides context for executive behavior
- **Accounting:** Plant shut down due to softness, needed investments, or both?
- **Governance:** Executive compensation plans worth examining
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Discussion of 3DAdvisors Findings

As we mentioned in our first report on LP (03/26/04), the Company's concentration on the Oriented Strand Board (OSB) market and its related exposure to OSB price fluctuations has been a point of interest to us this year because it provides context and explanation for certain executive behavior. With OSB representing 65% of Q1 2004 sales (vs. just 35% in 2002), the Company's fortunes are inexorably linked to the volatile OSB prices that until recently have been moving in LP's favor.

The Company gives no indication that it expects its considerable windfall gains from strong OSB pricing to continue indefinitely and, in fact, has been gaining praise for its efforts to build cash reserves in anticipation of an eventual price reversal. Also, through continued asset sales and repurchases of outstanding debt, LP has been successful at easing some of the restrictive financing covenants that stemmed from mistakes of the past and a resulting weak financial condition. While the Company has improved its balance sheet and convinced many of its ability to weather any coming downturn, we remain intrigued that certain management behavior seems to suggest that the road ahead may not be a smooth one. A disclosure from the prepared text included in the Q1 conference call says much: "…we can buy back stock opportunistically. If the share price moves down, when OSB prices normalize, then our stock will likely be a good investment and our Board has approved a 20 million share authorization."

Now we're certain that the above statement was not meant to imply that the shares are not a "good investment" at current levels, but there seems to be an implicit message here that management is anticipating that the shares will move lower as OSB prices soften. The trading behavior of management speaks volumes as well: even with the recent share price pullback from the $26 - $27 highs, the unprecedented pace of insider selling continues to show no signs of slowing.

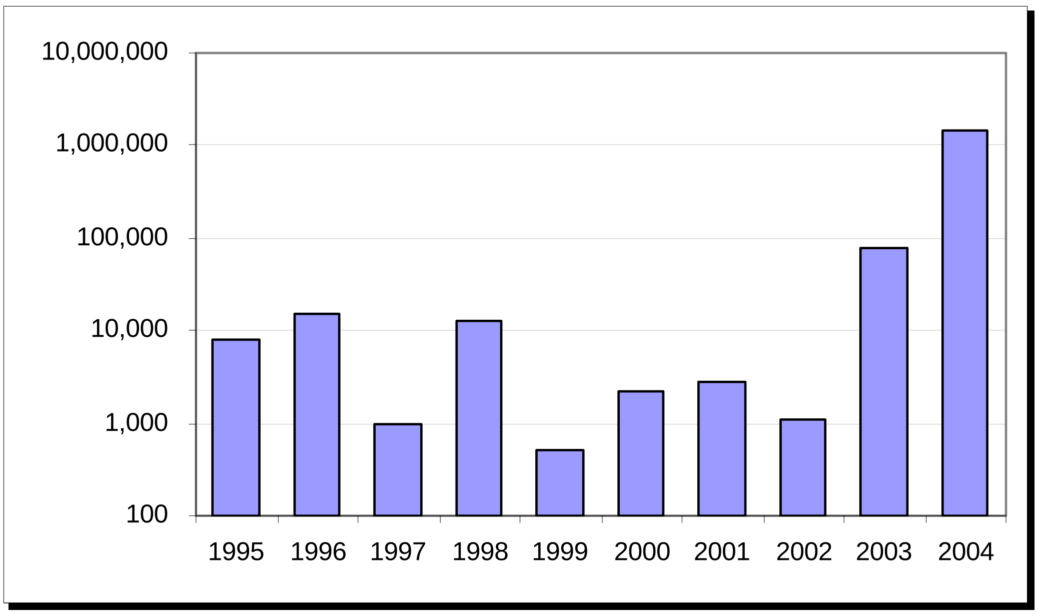
Insider Trading: Selling and holdings reductions continue at lower prices

This year's insider selling in LP shares coincided with the attainment of the final price target of the Company's Executive Loan Program which caused the final forgiveness, on January 23rd, of over $6.4 million in loans and interest to key executives when LP shares remained over $20 for a required period of five days. Within weeks of the target price attainment, participants in this plan moved quickly to sell shares in earnest. What initially caught our eye, however, was the fact that most of the sellers at that time, in clearing out of over 854,000 shares, had sold far more shares than they had bought through the Company loan program (see our first LP report on 03/26/04).

Figure 1. LPX Price Chart, July 1, 2003 through July 2, 2004. Blue shaded areas represent time periods where described insider sales took place; Blue diamond is the date of our first LPX report (03/26/04). Sources: Reuters and Vickers.

Since that time, 418,633 additional shares have been sold, between March 29th and June 29th, at prices ranging from $23.00 to $25.20. While the first round of sales was executed into the share price's upward momentum, these recent shares were sold as the issue trended down off the April highs of $27. What's more, the sales have further reduced the holdings of Company Chairman, CEO **Mark Suwyn** and CFO **Curtis Stevens**, and include a new seller, Director **Lee Simpson**, who made his largest sale to date.

Figure 2. Shares Sold by Insiders, 1995 through July 2, 2004. (Note: Logarithmic scale is used.) Source: Vickers.



While the selling volume is significant, the attention grabber here is the sizeable holdings reductions. Since January, a total of ten insiders (including four of the top five execs listed in the Proxy) have sold off between 42% and 91% of their holdings (exercisable options plus common stock held). Typically, reductions of this degree signify an insider's departure from a company, but this doesn't appear to be the case at LP. There have been no reports from the Company of any execs leaving, and all directors were re-elected at the May 5th annual shareholder's meeting.

- **Mark Suwyn (61)** – Chairman, CEO. At the time, Suwyn's first quarter sales didn't seem all that noteworthy except for the fact that he was part of a collective group of sellers. Those earlier sales, which included the exercise of options and restricted stock, have a new significance with the addition of the 278,633 shares he sold on May 4th and June 14th at just over $23. Since January, Suwyn has **reduced his actionable holdings (common stock plus exercisable options) by 42%**. The aggressiveness of this year's activity is also highlighted by the fact that since 1995, Suwyn only sold once – a 162,134-share sale in August 2003 at $12.55.

- **Curtis Stevens (51)** – Executive V.P. Administration, CFO. Like Suwyn, Stevens has escalated his selling volume over the past year. After having sold only 200 shares between the time he registered as a Section 16 filing insider in 1997 and 2002, he then dumped 79,805 shares during the second half of 2003. More recently, he made his largest sale to date on May 4th, selling 75,000 shares at $23.63. The sale increased his year-to-date sales to 184,353 shares, but more importantly, he has **reduced his holdings by 45%** since the beginning of the year.

- **Lee Simpson (69)** – Director. As sporadically as LP execs have sold in the past, its directors have been even less reluctant to sell. Since joining the board in 1995, Simpson had only sold 11,243 shares through 2003. This infrequent selling is even more intriguing considering Simpson had been a Company exec between 1972 and 1991, was interim president and COO in 1995 and 1996, and is now serving his second term as a board member (he was a director from 1977 to 1993). Despite his extensive tenure with LP, Simpson owned 76,800 shares at the time of the Proxy (record date: March 5, 2004), which he halved with a March 29th disposition of 45,000 shares at $25.20. To be more exact, the sale **trimmed his actionable position by 59%**. Directors are granted 9,000 options annually which vest at a rate of 10% every three months following the grant date, and also receive restricted stock grants valued at $20,000 (market price at grant date) which vest on the fifth anniversary of the grant. A possible explanation for Simpson's large sale is that he will be asked to step down at the 2005 stockholders meeting due to a Company policy which prohibits directors from serving past the age of 70.

- **Brenda Lauderback (53)** – Director. Lauderback sold 20,000 shares on June 29th at $23, marking her first sale since joining the board in 1999. The sale **monetized 55% of her actionable holdings**. Lauderback is also a director at Big Lots (NYSE: BLI), Irwin Financial (NYSE: IFC), Wolverine World Wide (NYSE: WWW), and Select Comfort (NASDAQ: SCSS), but hasn't sold stock in any of the other companies during the past two years.

Accounting: Softening OSB market provides context for executive behavior

While we don't always delve into industry fundamentals, sometimes we do because certain aspects of the fundamentals provide vital context and meaning to executive behavior. Such is the case with the fundamentals and dynamics of the Oriented Strand Board (OSB) market and pricing because it provides important clues as to what is driving executive behavior at LP.

OSB prices have softened rather considerably in recent weeks and the potential impact on the Company's performance is significant. In fact, in its most recent 10-K, LP discloses "a $1 change in the annual average price on (OSB) 7/16" basis would change annual pre-tax profits by approximately $5.0 million." From the $410 level (price for 7/16 per 1,000 square ft.) in mid-June, OSB prices wrapped up a volatile June 25th week in the $300 range, and this after registering sales, in some regions, as low as $250 during the week. The pre-holiday week ending July 2 showed no change in the OSB market as prices continued, in quiet trading, in the $300 range. When you look at year over year comparisons, things still look good. According to trade publication *Random Lengths*, the average price for June of this year of about $350 per 1,000 sq. ft (7/16") is still well above the $266 levels for June of 2003. But when you consider that OSB was in the $500 range earlier this year as the building boom peaked, it's not hard to see why LP insiders may have decided to take profits given how dependent the Company has become on the OSB market.

Is the apparent softness in OSB related to the cooling of demand, excess supply, competition from other materials, or some combination of each? Our checks with the editors of *Random Lengths* suggest that it may not be overcapacity or softening demand that caused recent volatility in OSB pricing as much as the threat of Brazilian plywood imports. These imports are causing near-term pressure on OSB prices as certain end-users are finding it advantageous to switch to plywood, which has become competitive as an alternative to OSB. *Random Lengths* reports that very large shipments of Brazilian plywood are on their way to the U.S. as of this writing.

Accounting: Plants shut down due to softness, needed upgrades, or both?

In a move that apparently had nothing to do with slack demand and softening prices or the threat from cheap plywood imports, LP announced the last week in June that it was shutting down seven of its OSB mills "for capital projects and extraordinary maintenance", incurring 47 days of downtime in the process. The LP announcement, which came on Wednesday of that week, implied a reduction of 50 million square feet of capacity from the market. This caused short covering by wholesalers and helped firm the falling OSB prices which, by the week's end, had stabilized in the $300 area.

It is well known that LP's OSB plants experience rolling shutdowns on a regular basis. With resin accounting for 14% of OSB production costs, LP has been implementing a $250 million investment program designed to modernize its existing mills to be less dependent on rising oil and energy costs. The program is essential to LP, not only from a production standpoint but also because if such improvements did not take place and the plants were no longer competitive, the Company might be forced to take impairment write offs on the assets. In the Potential Impairment section in its recent 10-K, LP states that it (bolding and italics are ours for emphasis) "believes we have adequate support for the carrying value of each of these assets based upon the anticipated cash flows that result from our estimates of future demand, pricing and production costs ***assuming certain levels of planned capital expenditures***. However, should the markets for our products deteriorate to levels significantly below cycle average pricing or ***should we decide to invest capital in alternative projects, it is possible that we will be required to record further impairment charges.***"

While the necessity of rolling plant closures is evident, certain timing decisions to do so are not as clear: We found the recent LP closure announcement curious in that one of the plants slated to close was LP's Woodland Maine facility, which had shut down in December of 2003 due to a log shortage and had been scheduled to reopen in June, according to the comments made by **Rick Frost**, Louisiana-Pacific's EVP Commodity Products, Procurement during the Q1 conference call. When asked whether LP should be running with less downtime, in Q2, as opposed to Q1, Frost commented with "we expect to bring Woodland up probably in late June." How curious then, that on June 23rd, LP announced that Woodland was one of the plants to be shut down for maintenance. It would seem that, with Woodland having been shut down since December, any necessary capital improvements could have been performed at that time, not in late June at the height of the building season.

In past years, Louisiana-Pacific has generally timed its plant closures for the winter months, when building slows. The most notable exceptions to this occurred back in 2001, when there were a number of summer closures that the Company termed as "market related" and were enacted in order to adjust production to customer demand. With regards to the recently announced LP closures, there has been no reference to "market related" issues. We find it interesting though that one of the most dramatic OSB price declines in almost a year may have been stemmed when one of the market's largest players announced that it was cutting back production.

<u>Governance: Executive compensation plans worth examining</u>

Making the current insider sale picture at Louisiana-Pacific even more interesting is the fact that recent Company proposals indicate the Company's intent to grant fewer stock options in lieu of more incentive shares (restricted stock units) due in part to past and anticipated changes in accounting for stock options. This planned reduction in the level of future options grants make the current stock sales that much more significant in that insiders who are trimming their holdings will have less opportunity for rebuilding them in the near future.

We also note an interesting disconnect with regards to Company's incentive share program. An underlying objective of stock options is to promote employee retention, which is encouraged in LP's case by its options having a three-year vesting period (employees typically do not receive unvested options if they leave the firm). Yet, the restricted shares granted by the Company allow for the acceleration of the vesting period in the event that the stock hits certain preset price targets that are not disclosed until after vesting has already occurred. While we agree that restricted share grants could end up being the preeminent form of compensation in the future, this type of plan runs the risk of encouraging executive decisions based on near term performance goals at the expense of long-term strategy.

We also found Suwyn's bonus structure to be very interesting. The bonuses for execs are based on 60% EPS growth and 40% on their individual performance and business unit growth. Suwyn's is more complicated. In addition to using such measurements as EBITDA and sales and productivity growth, he also receives compensation from rarely used metrics as safety measures, settlement of class action litigation, and sale of certain business operations. The fact that many of LP's recent asset sales have generated transaction losses makes this particular metric quite interesting. During 2003, Suwyn was awarded a special $600,000 bonus for his contributions to LP's Corporate Restructuring Program. Three other executives also received restructuring bonuses of $200,000 each, based on similar metrics. Rarely do we see executives compensated in this fashion for, in effect, executing defensive strategies.

<u>Accounting: Miscellaneous noteworthy items</u>

- LP received about 2.5 cents/share in Q1 (quarter ending March 31) from the liquidation of certain of its LIFO inventories due to reduced log inventories at sites to be either sold or closed. This gain was not discussed in the conference call.

- During Q1, employees exercised options totaling $22 million. This exceeded the total for the entire year of 2003. These option exercises reflect the broader employee base than simply those filing Section 16 (read: insider) filings and are indications that broader employee selling is running at historically high levels, as are sales of filing insiders. It has been our experience over the years that employees, when exercising options, typically sell all or most of their optioned-for shares. Consequently, we view cases where employee stock option exercises are on the rise as situations where their selling is also active.

- LP has a large exposure to the Canadian dollar with regards to its $927 million in inter-company debt between its Canadian and U.S. subsidiaries. This is because the debt is denominated in Canadian dollars and is then subject to translation gains or losses when quoted in U.S. dollar terms. Though any related gains or losses are eliminated in consolidation for financial reporting purposes, the tax effect is not because the transfer occurs outside of the tax reporting entities. The related tax difference translates to a tax expense change of $3.6 million for each $0.01 change in the Canadian dollar.

- In our prior LP report, we noted that under-accrual for contingent liabilities could come back to burn the company. Prompting our comment on this subject was the fact that, for three consecutive years, payouts charged to the Contingency Reserves had exceeded the Company estimate for its current portion for each period. In other words, losses exceeded estimates for three years running. In 2003, for instance, the Company's estimated current portion of its Contingency Reserves ($43.7 million) was exceeded by its actual payouts of $52.4 million. In 2002, the payouts, of $52.3 million, significantly exceeded the Company's current portion estimate of $20 million. As of March 31, the Company reports its total Contingency Reserve to be at $99.1 million with $49 million of the total estimated to be the current portion. Thus far, into 2004, contingency payouts have only totaled $4.3 million. This is consistent with Q1 of last year when such payments totaled just $5.4 million only to swell to $52.4 million by year-end. Likewise, it is reasonable to expect a similar expansion of contingency payouts as 2004 progresses, possibly in excess of the reserves.