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

Haunted by Past and Current Problems, Insiders Exit Louisiana-Pacific Corp. (NYSE:LPX)

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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:** Some officers and directors drop the majority of their positions
- **Accounting:** A long history of environmental problems, and lingering liabilities
- **Accounting:** Likely to be burned by under accrued contingent liabilities - again
- **Accounting:** Access to financing appears very constrained
- **Accounting:** What happens when the building boom ends?

Discussion of 3DAdvisors Findings

Rarely do we see insiders behaving as they have at Louisiana-Pacific Corporation (LP). Significant executive selling and a loan program where interest and principle were being forgiven originally drew our attention. More recently, the selling has accelerated to the point where a group of key officers and directors have now sold the majority of their positions, including exercising options that are not due to expire anytime soon, in some cases exercising very close to the strike price and taking little profit in the process. It is exceptionally rare to see insiders converging in such a dramatic fashion.

Scrutiny of the Company's history and the observance of other indicative behaviors have provided a possible explanation for this unusual trading behavior. The key points are that this is a company that continues to feel the weight of environmental litigation from prior years; continues to find access to capital difficult; continues to face a long list of contingent liabilities for which it has not adequately made reserves (mostly related to asset sales) and has come to rely heavily on a single hot product that might soon run out of gas.

To some analysts, many of the Company's problems seem to have been addressed, at least with regard to financing, by management efforts at raising cash by selling off assets and paring down debt. Indeed, these efforts have yielded positive results in that S&P recently raised LP's rating to investment grade (BBB- with a stable outlook). While some treat LP shares as if most of their troubles are behind them, we believe executive behavior emphatically implies otherwise.

Insider Trading: Some officers and directors drop the majority of their positions

Our *Insider Research Bulletin* of March 4th highlighted LP insider sales occurring in February. Since then, a large number of new sales (and some new sellers) emerged in March. Putting an exclamation point on the activity is the fact that five of the eight sellers were dropping between 48% and 91% of their entire actionable positions (exercisable options plus common shares). Between February 9th and March 5th, seven insiders have now sold almost 854,000 shares at prices between $23.21 and $25.17 each. This is all-time high selling volume for insiders at the Company. More importantly, we rarely see so many insiders clearing out so much of their individual holdings during the same time frame.

The first spike in selling seemed to occur when the final price target of an Executive Loan Program was achieved. The program, deigned to provide loans to executives to purchase shares in the Company, was set up prior to the passage of Sarbanes-Oxley. The loans were unsecured and granted with the intention of forgiving both principle and interest depending on the borrower's tenure (if they left early, the loans and interest would be forgiven on a pro-rated basis), the length of time they held the related shares and if certain price targets were reached. Should LP shares trade above $20 for five consecutive days during 2004, all of the principle and interest would be forgiven, as long as the executives were still working for the Company and held the shares bought under the loan plan. Consequently, on January 23rd and with the shares having traded above $20 for over five days, all principal and interest related to the loans was forgiven. This wasn't lost on the participants who moved quickly to dump the shares when the opportunity arose and began selling in early February. Interestingly enough, most of the sellers sold way more shares than they had bought with monies "borrowed" from LP.

As we mentioned at the outset, we have seldom seen a situation where both officers and directors have trimmed their holdings as dramatically as this. All sales below occurred in the above-mentioned February 9th to March 6th period:

- **Richard Frost (52)** – Executive V.P., Commodity Products, Procurement & Engineering. Frost dropped 208,055 shares at prices in the $23 to $24 range, far more than the 51,612 shares he purchased with borrowed funds from the Company under the loan program. The sense of urgency to his actions is evidenced by the fact that he cleared out his entire position in five of the six options series he exercised, selling the underlying shares in the process. None of these options were close to expiration (expiration dates ranged from May of 2006 to February 2013). Making matters more interesting, his last option exercise cleared out his entire position of $21.99 options (expiring in May of 2006), selling the underlying shares for $25 each which certainly isn't much profit considering the time left until expiration. The most telling fact, however, is that **he dropped 81% of his holdings with the trades.**

- **Joseph Kastelic (40)** – Executive V.P., Specialty Products and Sales. Though Kastelic did not clear out the majority of his options as Frost did (above), he did exercise options across four separate series, none of which were to expire until between February 2009 and February 2013. Like Frost, he also sold in excess of the 29,357 he had borrowed for under the loan program. In all, Kastelic sold 85,989 shares, which **dropped his holdings by 54%.**

- **Russell Pattee (age not disclosed)** – Assistant Treasurer (principal accounting officer), Corporate Controller. Pattee cleared out of virtually everything he could during the period, exercising options for 19,416 shares and selling 23,927. This left him with just 250 shares in his 401K plan plus exercisable options totaling 2,166 shares for $21.27 each. Succinctly put, **he has reduced his holdings by 91%**. Pattee has been with the Company since at least 1988. The fact that he is the principal accounting officer is not wasted on us.

- **Curtis Stevens (51)** – Executive V.P., CFO. Stevens has exhibited prescience with his past sales, having sold in May of 1999, just ahead of a four-month 44% slide, then purchasing, after the drop, prior to a 15% rebound. He recently has cleared out of 95,517 shares (prices between $22 and $25 each), more than the 62,000 shares he had borrowed for. **These recent sales trimmed his holdings by 23%.**

- **Archie Dunham (65)** – Director, Chairman of Audit Committee. Dunham, a director since 1996, had never sold an LP share until March 5th when he exercised options across three separate, non-expiring option series (expiring between September 2006 and September 2012) and sold the underlying 59,400 shares at prices in the $25 range. **The transactions lobbed off 85% of his holdings.**

- **Colin Watson (62)** – Director, Member of Audit Committee. Watson, a director since 2000, exercised options for 25,200 shares on March 2nd, selling the underlying shares at prices around $25 each. Like the others, his options were nowhere near expiration (2011 to 2013). **The sale, his first-ever, slashed his holdings by 73%.**

- **Paul Hanson (52)** – Director, Member of Environmental and Compliance Committee. Hanson, a director since1999, acted similarly to his peers. In his first-ever sale, he exercised options for 18,000 shares and sold them, **trimming his holdings by 48% in the process.**

- **Mark Suwyn (61)** Chairman, CEO. Suwyn, CEO since 1996, recorded his largest-ever sale by exercising options for, and selling, 337,450 shares at prices in the $23 range. **He trimmed his holdings by 17% in the process.**

Accounting: A long history of environmental problems, and lingering liabilities

In order to fully put in context the trading behavior of executives at LP, we think the best place to start is to consider a history of management behavior that led to environmental litigation for which the Company paid dearly. Here are a few highlights:

- In 1998, the Company pled guilty to fraud and environmental crimes in a federal court in Denver. The Company was charged with tampering with air pollution monitoring devices, falsifying reports made to the EPA, and providing false information to EPA inspectors. The associated fines totaled $37 million.

- In 1995, LPX pled guilty to 14 criminal violations for intentionally polluting the waters of Southeast Alaska. The associated fines totaled $6.1 million

- In 1993, LPX was required to install an additional $70 million in pollution control equipment at a plant near Denver. The Company paid $11 million in associated fines to the EPA, related to this matter, plus another $2.9 million to families that had left their homes as a result of the air pollution problem.

These problems led to the firing of LP's CEO at the time, Harry Merlo. Although it would seem that LP's sub-par eco-history is behind it, we find that it continues to haunt the Company in the form of related indemnifications (for environmental issues) that it must offer buyers of various property assets that have been sold during LP's almost completed cash raising strategy. Most of the following indemnity agreements have not been accrued for. If they have, and the related disclosure is sketchy, any accruals were based on what was considered probable and reasonably estimable as of 12/31/02. What is clear is that no provision has been made for any new indemnities recorded after 12/31/02:

- Sale of LP's Texas and Louisiana plywood mills to Georgia-Pacific (2002) – Indemnity totaling $14.5 million

- Sale of LP's particleboard mill (Missoula, MT) to Roseburg Forest Products (2003) – Indemnity totaling $16.7 million

- Sale of LP's particleboard mill (Arcata, CA) to Hambro Forest Products (2002) – No limit, seven year duration, expiring in 2009

- Sale of LP's pulp mill (Samoa, CA) to SPC. (2001) – Multiple indemnifications, some without dollar limit. Indemnifications include environmental issues and third party and personal injury claims, government-imposed changes to the wastewater treatment process, liability for lease payments and potential restoration of certain California tidelands and "various other matters". SPC has recently been forced into foreclosure by a creditor and sold to another company. This resulted in a $16 million charge (about $0.136 per share pre-tax) in Q4 of F/Y 2003 due to the fact that LP had guaranteed certain of SPC's notes receivable. In addition, there are "several contingent liabilities (primarily environmental in nature) associated with these operations that, under certain circumstances, could become liabilities of LP."

- Sale of various LP sawmills to Riley Creek Lumber Company, Idaho (2003) – Three-year indemnity, expiring in September of 2006, for unknown environmental claims, capped at the undisclosed purchase price.

Accounting: Likely to be burned by under accrued contingent liabilities - again

LP maintains reserves for contingent liabilities associated with Environmental, OSB Siding, Hardboard siding reserves and other matters. The reserve totaled 98.6 million as of 12/31/03 and breaks down as follows:

Reserves for Contingent Liabilities

(Millions of $, Source: LPX SEC Filings)

	2003	2002	2001
Environmental	$ 17.9	$ 25.7	$ 40.5
OSB Siding	$ 16.7	$ 39.0	$ 78.2
Hardboard Siding	$ 43.7	$ 49.6	$ 30.0
Other	$ 20.3	$ 11.8	$ 6.4
Total Contingencies	$ 98.6	$ 126.1	$ 155.1
Current Portion	$ (43.7)	$ (20.0)	$ (20.0)
Long-Term Portion	$ 55.6	$ 106.1	$ 135.1

Payouts charged to the reserve were $52.4 million (2003), $52.3 million (2002) and $36.4 million (2001). The 2003 payouts greatly exceeded the $20 million listed as the current portion as of 12/31/02. This same situation existed in F/Y 2002 as the $52.3 million paid out that year greatly exceeded the $20 million estimated as the current portion at 12/31/2001. So it is clear that actual loss experience has exceeded estimates as to current payouts for the past three years.

In addition to this, LP has recorded no valuation allowance for a currently active class action matter, which it refers to as Nature Guard Cement Shakes (fiber cement shakes used in roofing). This matter has received class action status (as of 11/5/2002) and is currently an active case in the California State Court of Appeals. Since the complaint does not quantify relief sought by the plaintiffs and since discovery has not been completed, LP claims that it has not been able to predict the potential impact of this action and thus has recorded no related reserves concerning the matter.

In addition to the above, we highlight LP's March 2nd announcement that, due to an adverse court ruling concerning the Minnesota State Court of Appeals, a previously rendered court judgment of $20.1 million was held against the Company. This case involved Lester Building Systems (a division of Butler Manufacturing Co.). Due to this decision, LP adjusted its fourth quarter and full year profits, released just one-month prior, to reflect the additional reserves. The adjustment dropped LP's Q4 and full year net figures by almost $(0.08) per share, not to mention the collateral damage to LPX share prices, which dropped almost 10% on the news. Interestingly enough, LP's prior disclosures implied that this matter had been adequately reserved for. According to the LP 2002 10K: "Based on the information currently available, we believe that any exposure related to this case is adequately covered under our reserves…".

Now even as recently as Q3, 2003, LP had been maintaining that, in the Minnesota case, any exposure was adequately covered under its reserves, making the subsequent shortfall all that much more revealing in that it exposes the Company's vulnerability to other contingencies that, in spite of LP's disclosures to the contrary, may also be under-reserved for.

To this we would add that, although it would seem that the Company has made good faith efforts to record liabilities for future claims, there is much room for surprise. The Company seems to avoid the reserves issue in some cases by claiming that since many exposures are un-quantifiable, it simply monitors its estimated exposure to contingencies and, as additional information becomes known, may change its estimates significantly. However, even though possible unrecorded future liabilities are not readily determinable or possibly not determinable at all, the fact should not be ignored that significant future liabilities are virtually a certainty and may well have a greater impact on the Company's financial position than would currently be apparent. The point is that executive behavior in this area has become predictable: there is a long history of consistently under accruing for contingent liabilities, which can set up investors for some nasty surprises.

Accounting: Access to financing appears very constrained

When drilling deeper into LP, it became very apparent that its bankers have the Company on a very short leash. Most telling were the details of the Company's $187 million secured revolving credit facility which required LP to put all proceeds from asset sales in a reserve cash account which could be used only to reduce debt (including contingency reserves), make capital expenditures and fund acquisitions. Prior to using these funds for capital expenditures, at least $150 million of debt must be repaid. After $150 million of debt was repaid, up to 50% of the funds could be used to make capital expenditures and after $200 million of debt was repaid, funds may also be used for acquisitions. Covenants under this facility required Shareholders' Equity to be at least $1 billion (nearly violated in early 2003), Debt to Capital Ratio of 50% (also nearly violated in early 2003).

In September of 2003, LP converted the above facility to a secured Letter of Credit Only Facility, which relaxed the prior restrictive covenants and released the cash restrictions on the proceeds from asset sales. The new facility provided letters of credit for up to $125 million but required that LP pledge, as security for its reimbursement obligation under the facility, cash collateral in an amount equal to 110% of the face amount of the letters of credit outstanding under the facility. The Company explained the reduction in the new facility's size by saying that it didn't need one as large as the prior's $187 million. It's interesting to note though that this new facility is becoming tight. At 12/31/2003, LP had $91 million in Letters of Credit outstanding under the facility, resulting in about $111 million in restricted cash.

The 110% restricted cash requirement for the above facility may exist because of the Company's securitization efforts. A major Company funding vehicle is the QSPE that Louisiana Pacific has set up to handle certain receivables generated from the Company's asset sales. LP contributes the receivables to the QSPE who then, in turn sells bonds (using the receivables as collateral) to outside investors. LP retains what seems to be about a 10% retained interest in the QSPE's assets. Shielding the receivables from creditors, in this fashion, is probably the only way the Company could have securitized these instruments to raise cash. Conversely, the fact that the new "Letter of Credit Only Facility" requires the 110% restricted cash commitment is most likely the only reason the lenders would allow the asset sale related receivables to be put into the safe harbor that is the QSPE.

The Company has been dependent on selling off major portions of its timber, timberland and lumber mill assets in its efforts to raise cash and reduce debt. The contribution to cash, from these sales, has been material. In F/Y 2003, LP raised $495 million in cash from these sales. This accounted for 63% of the increase in the Company's 12/31/03 cash balances to $926 million vs. $137 million at 12/31/02. Most of those sales have now been completed; leaving conventional financing alternatives to be the main source of capital, outside of generated cash flow.

Accounting: What happens when the building boom ends?

After selling off many of its traditional assets, LP finds itself relying more and more heavily on the Oriented Strand Board (OSB) market for sales and cash flow. So far, the bet has paid off as OSB price increases neared 130% in February over the same month the year prior. Though capacity restraints remain a key issue in the current inelastic behavior of OSB pricing, the situation could change downstream. Although the industry has not added new capacity since 2001, several new competitive OSB plant facilities are expected to come on stream later this year (two owned by Georgia Pacific). LP has no additional capacity coming on until late in 2005 at the earliest. And what happens when interest rates do finally begin to rise and this housing market slows substantially?

The reliance on the OSB market could be a major factor influencing the Company's financing in the future. The new credit facility has been largely tapped; the ability to raise additional cash from asset sales is now limited; and contingent liabilities are probably not adequately reserved for and will likely burn the Company again. And what happens when the building boom ends, or significant supply comes on stream and price competition heats up, or both? All of these factors might well be major considerations in lenders' willingness to provide financing.