- Non-trading loss in fiscal 2001 consisted primarily of a $183 million ($110 million after tax) charge for the write-off of the assets and costs relating to the Mobile mill closure, and a charge of $9 million relating to the write-off of deferred finance costs relating to the refinancing of the $250 million S.D. Warren term loan and revolving credit facility in 2001.

Net Finance Costs

Net finance costs consist of interest expense, net of interest received, interest capitalised, foreign exchange gains and losses and mark-to-market effects of financial instruments.

Net finance costs increased to $90 million in fiscal 2003 from $74 million in fiscal 2002, following higher levels of borrowings in respect of the Potlatch acquisition in May 2002, which impacted fiscal 2003 for the full year. Gross finance costs increased by $31 million over fiscal 2002 to $150 million as a result of higher levels of borrowings and the fixed rate bonds which on average bore interest of 7% during most of fiscal 2003. Our issuance of $750 million of public bonds at fixed interest rates in June 2002, had a limited impact in fiscal 2002, and a greater impact this fiscal year. Between March 2003 and July 2003 contracts were concluded to swap the fixed rate exposure to floating rates. The full impact of these swaps in the form of reduced interest costs will be evident in fiscal 2004, assuming short-term interest rates remain at current levels. Net finance costs were also positively impacted by a $6 million gain relating to the mark-to-market effects of financial instruments (fiscal 2002—$11 million charge).

Net finance costs decreased to $74 million in fiscal 2002 from $92 million in fiscal 2001, despite the increased finance costs resulting from the approximately $483 million of additional indebtedness incurred to finance the Potlatch Acquisition and a $11 million charge relating to mark-to-market effects of financial instruments. The decrease in net finance costs in fiscal 2002 resulted primarily from the refinancing of certain higher cost loans, lower levels of borrowings for the period prior to the Potlatch acquisition and a net foreign exchange gain of $4 million.

Net finance cost before finance costs capitalised ($113 million) was covered 6.0 times by cash generated by operations ($675 million) in fiscal 2003, compared to 7.2 times for fiscal 2002, after having increased from 6.2 times in fiscal 2001. The reduction in fiscal 2003 is mainly due to lower levels of profits and increased borrowings and finance costs in fiscal 2003.

Finance costs capitalised in fiscal 2003 were $23 million, down from $29 million in fiscal 2002 and $33 million in fiscal 2001. Finance costs capitalised related mainly to the holding cost of forests and capitalised interest on major projects under construction. The reduction in the amount capitalised is mainly due to the reduction in actual finance costs incurred in fiscal 2003 by our southern African operations. Changes in accounting rules will prevent the capitalisation of interest for holding costs of forests with effect from fiscal 2004. In the future, movements in the fair value of plantations will impact operating income. This change could lead to increased volatility going forward. This policy will be effective from our Fiscal 2004 year. For further information see note 2 of our Group annual financial statements included elsewhere in this Annual Report.

Taxation

Total taxation amounted to $20 million in fiscal 2003, $78 million in fiscal 2002 and $9 million in fiscal 2001. Total taxation in fiscal 2003 decreased by $58 million, mainly due to lower levels of profit, the result of an income allocation mix in our different tax regimes as well as a deferred tax credit ($13 million) resulting from the Westbrook asset impairment charge. Total taxation in fiscal 2002 increased by $69 million, mainly due to the $73 million tax credit relating to the Mobile closure charge in fiscal 2001.

The effective tax rate was 11.9%, 26.1% and 6.2% for fiscal 2003, fiscal 2002 and fiscal 2001, respectively. The decrease in the effective tax rate in fiscal 2003 is primarily the result of an income allocation mix in different tax jurisdictions and partly from a deferred tax credit resulting from the Westbrook asset impairment charge. The effective tax rate in fiscal 2003 for ongoing operations excluding the impact of the Westbrook asset impairment is 16.2%. The increase in the effective tax rate in fiscal 2002 is mainly the result of the $73 million tax credit relating to the Mobile closure charge in fiscal 2001. The effective tax rate for ongoing operations excluding Mobile was approximately 25% for fiscal 2001.

Certain of our companies are subject to taxation queries, which could give rise to additional taxation costs. While amounts have been provided for such costs in addition to amounts disclosed as contingent liabilities, management currently believes, based on legal counsel opinion, that no further material costs will arise. See note 29 to our Group annual financial statements included elsewhere in this Annual Report.

Sappi International S.A. ("SISA"), our group treasury, operates in Belgium under a co-ordination centre licence, a special licence granted by the Belgium government that includes an alternative method of calculating the taxation liability of a co-ordination centre. This licence was renewed in July 2003 and preserves the tax status until at least September 2005. Pending negotiations between Belgium and the European Commission regarding the tax status of co-ordination centres in Belgium, there is a possibility that Belgium will be compelled to remove, or substantially amend, the beneficial tax regime applicable to co-ordination centres. According to the new rules applicable to Belgian co-ordination centres as legislated by Belgium, but not yet fully agreed to by the European Commission, the tax base could in future be determined on a cost plus basis, replacing the current alternative method. Clarity on the acceptability of these proposals to the EU Commission is expected early in 2004.

It is generally assumed that any change in the tax status will not occur before the end of calendar 2005, and the Belgium government has taken a strong stance on this by instituting court proceedings against the European Commission in the European Court of Justice. The potential negative outcome of these proposed changes, is, based on current proposals and estimates, not expected to have a material impact on taxation payable by the Group in the short-term. This assessment is based on the current form of the new co-ordination regime proposals. This conclusion may change if the EU commission recommends changes to the current proposals. We are assessing alternatives in the event that the EU does not accept the current proposals.

Residence Based Taxation. Prior to fiscal 2001, South Africa levied tax on receipts and accruals from a South African source (subject to certain specific rules which essentially taxed passive income of residents on a worldwide basis). However, with effect from years of assessment commencing on or after January 1, 2001 South Africa has a dual tax system in terms of which residents are taxed on their worldwide receipts and accruals and non-residents are taxed on their South African source income. South Africa has a network of double tax treaties with a number of countries in terms of which these general rules may be adapted.

A company is regarded as South African tax resident if it is incorporated, established, formed or has its place of effective management in South Africa and is not, under a double tax treaty with another country, treaty resident in such other country.

Subject to certain exemptions, the net income of a controlled foreign company ("CFC"), i.e. a foreign company, the rights to participate directly or indirectly in the share capital, share premium or reserves of which are more than 50% held by a South African resident or residents, is imputed to its South African resident participants/shareholders in the proportion of their participation rights in the CFC. For purposes of imputing the amount to be included in the SA resident shareholders taxable income, the net income of a CFC is calculated in accordance with South African tax principles. The most important exemption from the CFC imputation rules is where a CFC has an active business establishment outside South Africa and certain other requirements are met.

Foreign dividends are, in principle, not exempt from tax in the hands of South African resident recipients. Dividends declared by certain foreign listed companies of which more than 10% of the equity share capital is held by South African residents, qualify for exemption. There are also other exemptions in this regard.

To the extent that a South African resident company in the Sappi Group receives a taxable foreign dividend, it will in principle be permitted to credit against any South African tax due, foreign company and withholding taxes paid on the profits from which the foreign dividend is paid. South African companies are not able to claim taxable foreign dividends as a credit in the calculation of their liability for secondary tax on companies.

Transfer pricing and thin capitalization provisions also apply to cross-border transactions.

Capital Gains Tax. Tax on capital gains was implemented in South Africa with effect from October 1, 2001, based on increases in the values of qualifying assets after that date, and triggered by gains made on disposals of the relevant assets. Affected capital assets for companies include virtually all business assets, the disposal of which has not attracted normal income tax. Companies are liable to normal tax on 50% of the net capital gain. At the current corporate tax rate of 30%, the effective tax rate on net capital gains is therefore 15%. Capital losses may only be offset against capital gains.

For further information see "Item 10—Additional Information—Taxation".

Net profit

Net profit decreased by $71 million (32.3%) to $149 million in fiscal 2003, from $220 million in fiscal 2002, mainly due to lower levels of operating profit as a result of the continued depressed trading conditions in our industry, which resulted in lower average prices realised in our major markets, as well as an after tax charge of $19 million relating to the Westbrook asset impairment. Net profit in fiscal 2002 increased by $82 million (59%), to $220 million in fiscal 2002, from $138 million in fiscal 2001 principally because fiscal 2001 net profit was negatively impacted by the $110 million after tax charge resulting from the closure of the Mobile mill. Excluding this charge, fiscal 2002 net profit was lower mainly due to lower selling prices. Net profit was $138 million in fiscal 2001.

Liquidity and Capital Resources

Operations

Net cash retained from operating activities amounted to $451 million in fiscal 2003, $450 million in fiscal 2002 and $543 million in fiscal 2001. Despite the lower profitability, cash retained from operating activities in fiscal 2003 was similar when compared to fiscal 2002, and reflects lower levels of cash generated by operations ($69 million), an increase in working capital of $79 million and an increase in finance costs of $10 million in fiscal 2003, offset by lower taxation paid ($122 million). Taxation was

lower due to the recovery of tax by our North American operations and lower taxation due to decreased levels of profit. The working capital increase consisted of increased inventories ($93 million) and receivables ($12 million), mainly at our North American operations, partly offset by increased payables ($26 million), mainly at our Forest Products division. Inventories increased mainly in anticipation of increased demand in North America, which did not materialise as expected. Payables increased as a result of accruals for capital expenditure. The decrease in net cash retained from operating activities in fiscal 2002 as compared to fiscal 2001 is primarily attributable to lower levels of operating profit and an increase in working capital (increased receivables and decreased payables, partly offset by decreased inventories) in fiscal 2002, offset by lower finance costs paid. The increase in receivables in fiscal 2002 is as a result of reduced securitisation of certain receivables due to lower concentration limits. The decrease in payables is mainly due to the payments in fiscal 2002 in respect of the Mobile closure costs accrued at the end of fiscal 2001.

Investing

Cash utilised in investing activities was $340 million in fiscal 2003, $701 million in fiscal 2002, and $303 million in fiscal 2001. Cash utilised in investing activities in fiscal 2003 related mainly to capital expenditure on non-current assets of $327 million, as well as an increase of $21 million in investments and loans. Capital expenditure, excluding acquisitions, increased in fiscal 2003 to $296 million from $180 million in the prior year. Capital expenditure was lower in fiscal 2002, mainly because we contained expenditure as a result of the Potlatch acquisition. Cash utilised in investing activities in fiscal 2002 related mainly to capital expenditure on non-current assets of $205 million, $483 million relating to the Potlatch acquisition, as well as an increase of $16 million in investments and loans. Cash utilised in investing activities in fiscal 2001 related mainly to capital expenditure investment in non-current assets of $319 million, reduced by a decrease of $12 million in investments and loans.

Financing

Net cash raised from financing activities was $147 million in fiscal 2003 and $13 million in fiscal 2002 compared to net cash used in financing activities of $91 million in fiscal 2001. The increase in net cash raised in fiscal 2003 as compared to fiscal 2002 is primarily attributable to the proceeds of a $575 million Oesterreichische Kontrollbank ("OeKB") syndicated loan facility drawn in May 2003, a portion of which was used to repay $287 million of the A Tranche of the 2001 €900 million syndicated loan facility ("Syndicated loan A tranche") and $87 million of other short-term borrowings. The decrease in net cash used in fiscal 2002 as compared to fiscal 2001 is primarily attributable to the $831 million net proceeds from interest bearing borrowings, which includes a $750 million bond issue in June 2002, reduced by the $769 million net repayments of interest bearing borrowings, a decrease of $23 million in bank overdrafts as well as the $12 million of share buy backs. The decrease in net repayment of interest bearing borrowings in fiscal 2002 is primarily due to the repayment of the $243 million 7.5% Convertible Notes issued through Sappi BVI Finance ("the $243 million convertible notes"), the repayment of the $140 million North American 14% Debentures ("the $140 million debentures") in December 2001, the repayment of an approximately $162 million European Investment Bank loan (€166 million) as well as the repayment of a $250 million Syndicated loan B tranche facility, offset by the utilisation of $245 million of the Syndicated loan A tranche facility at the end of fiscal 2002. Certain items on our balance sheet and cash flow statement, for prior years, which relates to cash on hand and overdraft, were restated. For further information see note 2 to our Group annual financial statements included elsewhere in this Annual Report.

In the third quarter of fiscal 2001, we arranged a €900 million ($770 million) syndicated multi-currency loan facility through Citibank International plc which comprises two tranches, on an unsecured basis at between 55 and 70 basis points above the relevant short-term rate. The A tranche of this facility ("Syndicated loan A tranche") is a €562.5 million five-year revolving credit facility for general

corporate purposes. The B tranche of €337.5 million ("Syndicated loan B tranche") was partly utilised in September 2001 when we completed the refinancing of the S.D. Warren term loan and revolving credit facility ($250 million). This resulted in the write-off of $9 million of deferred finance costs and in lower ongoing cash finance costs. We refinanced the $140 million debentures with the remainder of the "Syndicated loan B tranche" facility, short-term overdrafts and cash on hand. We have utilised the "Syndicated loan A tranche" facility to pay the purchase price for the Potlatch Acquisition. The Syndicated loan A tranche is at our disposal on a revolving basis until 2006 and the Syndicated loan B tranche was permanently repaid in fiscal 2002 as described below.

In June 2002, Sappi Papier Holding AG issued $500 million 6.75% Guaranteed Notes due 2012 and $250 million 7.50% Guaranteed Notes due 2032 ("the Notes"), both fully and unconditionally guaranteed on an unsecured basis by each of Sappi Limited and Sappi International S.A., a corporation incorporated in Belgium. The Notes were offered and sold within the United States to "Qualified Institutional Buyers", as defined in Rule 144 A under the Securities Act, and outside the United States in accordance with Regulation S under the Securities Act. The interest on the Notes is payable semi-annually on June 15 and December 15 of each year, which commenced on December 15, 2002. The Notes are redeemable, at a premium, in whole or in part at any time by Sappi Papier Holding AG, Sappi Limited or Sappi International S.A.'s option. We used the proceeds of this issuance to repay permanently the Syndicated loan B tranche facility, to repay short-term facilities and to make a partial repayment of the Syndicated loan A tranche facility, thereby extending the maturity of our borrowings. Between March and July 2003 we concluded contracts to swap the fixed rate exposure to floating rates, linked to USD Libor. Based on current short-term interest rates the benefit of the reduced finance cost resulting from the swaps will increase by approximately $16 million to $24 million in fiscal 2004, when compared to fiscal 2003. In the event that short-term rates increase, the benefit will reduce accordingly and could result in additional interest cost if rates increase significantly.

In May 2003, Sappi Papier Holding AG raised a facility in the amount of $575 million, repayable in 2 tranches, from OeKB. Tranche A ("OeKB A tranche") of $115 million is repayable in a single payment on December 31, 2004 and Tranche B ("OeKB B tranche") of $460 million in a single payment on December 31, 2010. The OeKB A tranche bears interest at the OeKB floating rate plus an applicable margin of 0.5% and the OeKB B tranche attracts interest at an agreed fixed rate of 4.10%. Interest is payable quarterly in arrears on both tranches. The proceeds were partly used to repay the $287 million outstanding balance of the 2001 €900 million Syndicated loan A tranche, and $87 million of other short-term borrowings. The balance of $201 million was invested with several financial institutions in short-term deposits.

During fiscal 2003, Sappi Manufacturing concluded a framework agreement in South Africa for the issuance of a domestic Commercial Paper facility. The programme facility is R500 million (approximately $70 million), of which R300 million (approximately $42 million) was utilised at the end of September 2003. The average interest rate that the Commercial Paper facility currently attracts is JIBAR plus 30bps.

As of September 2003, we had aggregate unused borrowing facilities of $1,118 million ($179 million in South Africa and $939 million in Europe) compared to $777 million ($183 million in South Africa and $594 million in Europe) at the end of fiscal 2002. The $341 million increase over fiscal 2002 is due to the full repayment of the Syndicated loan A tranche in fiscal 2003. At the end of fiscal 2001, we had aggregate unused borrowing facilities of $985 million ($188 million in South Africa, $79 million in the United States and $718 million in Europe). The $208 million decrease in aggregate unused borrowing facilities as of September 2002 as compared to fiscal 2001 is mainly due to the utilisation of $245 million of the Syndicated loan A tranche facility, the permanent repayment of the Syndicated loan B tranche ($59 million), offset by an increase of $96 million of general short term facilities.

The maturity profile of long-term interest bearing borrowings of the Group has been extended substantially in the past 2 years. Average duration for long-term interest bearing borrowings at the end of fiscal 2001 was 4.7 years, whereas the duration is 9.8 years at the end of fiscal 2003. This is largely due to the issue of 10 and 30-year bonds in fiscal 2002 ($750 million), and the OeKB 8-year syndicated loan facility (€500 million—$575 million) arranged in fiscal 2003. The Group also has substantial unutilised short-term facilities, both in terms of cash resources, and committed and uncommitted banking facilities. At the end of September 2003 we had $584 million of cash resources and unutilised available banking facilities of $1,118 million (of which $645 million is committed).

The continued availability of uncommitted facilities could be impacted by factors such as:

- Liquidity problems in the banking market that result in restricted availability or non-availability of uncommitted banking facilities.

- A downgrade of Sappi's public debt ratings, which could result in banks reviewing the availability of uncommitted facilities.

We have access to capital from a range of external sources. In accessing external sources of funds, consideration is given to the following factors:

- *age profile of repayment of borrowings;*

- *cost of financing;*

- *availability of sources;*

- *availability of natural and artificial hedges against currency and/or interest rate fluctuations;*
- *availability of tax efficient structures to moderate financing costs; and*
- *certain limits of interest bearing borrowings as a percentage of shareholders' equity are maintained depending on where we are in the cycle, except when we undertake large capital projects or acquisitions.*

Our borrowings are not seasonal and we mainly borrow in the currencies in which we operate, and accordingly our interest bearing borrowings and cash and cash equivalents are mainly denominated in US dollars, euro and Rand. See note 17 to our Group annual financial statements included elsewhere in this Annual Report. For a profile of our borrowings repayment schedule, see note 17 to our Group annual financial statements included elsewhere in this Annual Report.

For a description of financial instruments and our treasury/funding policies, see note 33 to our Group annual financial statements included elsewhere in this Annual Report.

All external loans raised in currencies other than the domestic operating currency of the entity to which the funds are applied, are protected by forward exchange contracts or currency swaps. We also have a policy of maintaining a balance between fixed rate and variable rate loans that enables us to minimise, on a cost effective basis, the impact on reported earnings, while maintaining a reasonably competitive, market-related cost of funding. The specific balance is determined separately for our European, North American and southern African businesses to reflect more accurately the different interest rate environments in which these businesses operate. We monitor market conditions and may utilise interest rate derivatives to alter the existing balance between fixed and variable interest loans in response to changes in the interest rate environment. At the end of fiscal 2003, 45% of our interest bearing borrowings and overdraft was at fixed rates as compared to 70% at the end of fiscal 2002. This decrease in fixed interest rates was achieved by swapping the fixed interest rates of the public bonds to floating interest rates linked to USD LIBOR. See note 33 to our Group annual financial statements included elsewhere in this Annual Report.

Our expansion, mainly through acquisitions, had been demanding on our capital resources and on the profile and mix of the funding actually used. At the end of September 2003, our interest bearing borrowings and overdraft, was $2.1 billion compared to $1.7 billion at the end of fiscal 2002. This increase is mainly due to the new OeKB loan of $575 million (a portion of which was used to repay $287 million of the 2001 €900 million Syndicated loan A tranche and $87 million of other short-term borrowings), and partly due to currency movements of $203 million. There was however a compensating increase in cash and cash equivalents of $331 million over fiscal 2002. At the end of September 2002, our interest bearing borrowings and overdraft was $1.7 billion, up by $0.1 billion, from $1.6 billion at September 30, 2001. The increase in fiscal 2002 was primarily attributable to the $483 million Potlatch acquisition, offset by strong internal cash generation, despite the difficult market conditions. The Group has adequate working capital, cash on hand and short and long-term banking facilities to meet our short-term commitments.

There are at present some limitations on our ability to utilise facilities in any one of our divisions to finance activities, or refinance indebtedness, of any other division due to covenant restrictions and South African exchange controls. These limitations have been significantly reduced following the refinancing of our various North American debt instruments. These restrictions include limitations on our ability to significantly increase the borrowings of our subsidiaries. A constraint applicable to South African companies is the application of exchange controls, which inhibit the free flow of funds from South Africa. See "—South African Exchange Controls". This affected the geographic distribution of our borrowings. As a result, our acquisitions in the United States and Europe were financed initially with indebtedness incurred by companies in these regions. We now have access to and have extensively utilised long-term borrowings of generally unsecured nature (except in the case of asset-linked finance). Interest rates reflect the long-term rates for the currencies being borrowed. Short-term borrowings are generally freely available at commercial rates in all countries in which we operate and are used mainly to finance working capital.

While reduction of borrowings is a priority, opportunities to grow within our core businesses will continue to be evaluated. The financing of any future acquisition may involve the incurrence of additional indebtedness or the use of proceeds from asset dispositions.

Off-Balance Sheet Arrangements

We have entered into certain asset-related finance arrangements, that we believe have been structured such that various obligations, which are significant, and related assets are not included in our Group annual financial statements under generally accepted accounting principles. These Off-Balance Sheet Arrangements include lease arrangements described in note 28, securitisation facilities described in note 13 and an equity accounted investment described in note 12, in each case to our Group annual financial statements included elsewhere in this Annual Report, and are detailed as follows:

Lease Arrangements. In 1997 we sold one of our paper machines at our Somerset mill for $150 million and entered into a leaseback arrangement. This transaction diversified our sources of funding and provides a longer-term horizon to our repayment profile. We have taken the position that the leaseback is an operating lease under the applicable accounting principles. The lease expires after 15 years, and we have an option to repurchase the paper machine at its fair market value at the end of the lease term. An option also exists to repurchase at an earlier date of January 29, 2008. The future minimum obligations under this lease are included in the amounts presented in note 28 to our Group annual financial statements included elsewhere in this Annual Report.

In 1982 a cogeneration facility was installed adjacent to our Westbrook mill at a cost of $86 million, to supply steam and electricity to the mill on a take-or-pay basis. We have taken the position that this is an operating lease under the applicable accounting principles. An unrelated investor owns the facility. The agreement expires in 2008 and we have an option to purchase the facility

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at the end of the basic term or any renewal term, at its fair market value at that time. We also have a right of first refusal to buy the facility should the owner elect to sell it. The future minimum obligations under this lease are included in the amounts presented in note 28 to our Group annual financial statements included elsewhere in this Annual Report.

Although those lease arrangements are a method of financing, a leasing arrangement that qualifies for accounting treatment as operating lease results in neither debt nor the relevant assets being reflected on our balance sheet.

Trade Receivables Securitisation. To improve our cash flows in a cost-effective manner, we sell at a discount to face value, between 86% and 90% of our eligible trade receivables on a non-recourse basis to special purpose entities ("SPEs") that are owned and controlled by third party financial institutions. These SPE are funded in the Commercial Paper market. For the purpose of liquidity requirements, banks with a short term S&P rating of A1 provide a standby liquidity facility to meet these liquidity needs. In the event that such a bank is downgraded, a replacement bank with a rating of A1 needs to be appointed to ensure continuity of the securitisation programme. These SPEs are not limited to transactions with us but securitise assets on behalf of their sponsors for a diverse range of unrelated parties. We have a servicing agreement with the entities acquiring our receivables, acting as agent for the collection of cash and administration of the trade receivables sold.

We have taken the position that these sales constitute true sales and that we do not control the SPE under applicable accounting principles. We retain some of the economic risk in the receivables we transfer to these entities via first tier loss provisions, which limits our loss exposure on the receivables to a predetermined amount. To this extent, the receivables remain on our balance sheet. As at the end of September 2003 this amounted to $63 million (September 2002: $58 million). We have no obligation to repurchase any receivables which may default and do not guarantee the recoverability of any amounts over and above the first tier loss provisions mentioned above. The total amount of trade receivables sold at the end of September 2003 amounted to $450 million (September 2002: $365 million). Details of these securitisation programmes at the end of fiscal 2003 and 2002 are described in the tables in note 13 to our Group annual financial statements included elsewhere in this Annual Report.

If these securitisation facilities were to be terminated, we would discontinue further sales of trade receivables and would not incur any losses in respect of receivables previously sold in excess of our first tier loss amounts. There are a number of events which may trigger termination of the facility, amongst others, an unacceptable amount of defaults, terms and conditions of the agreements not being met or breaches of various credit insurance ratios. The impact on liquidity varies according to the terms of the agreement, however, generally future trade receivables would be recorded on balance sheet until a replacement agreement was entered into.

Although the sale of receivables at a discount is a method of financing, an arrangement that qualifies as a true sale for accounting purposes results in neither debt nor the related receivables being reflected on our balance sheet.

An allowance for doubtful debts has been recorded for any trade receivables on our balance sheet which may be uncollectable.

Equity Accounted Investment. In 1998, a subsidiary holding our interests in Timberlands located in Maine and certain equipment and machinery were sold to a third party timber company, Plum Creek, in exchange for cash of $3 million and three promissory notes receivable in the aggregate amount of $171 million. A bankruptcy remote special purpose entity, in which we indirectly hold 90% of the equity, acquired the notes receivable from the company in exchange for a note of $156 million and an equity contribution. The special purpose entity repaid us the note of $156 million in cash which it funded through the issue of notes payable to a consortium of institutional investors, pledging the Plum

Creek notes as collateral. The special purpose entity is bankruptcy remote and serves to protect the investors in the notes from any credit risk relating to Sappi Limited by isolating cash flows from the Plum Creek notes receivable. The structure was set up to monetise the promissory notes.

Interest is collected quarterly on the Plum Creek Notes and paid semi-annually to the entity's noteholders. The entity earns annual profits on the interest spread between the notes receivable and notes payable. There are three tranches of notes receivable and notes payable with term dates of February 2007, 2009 and 2011. We have not guaranteed the obligations of the entity and the holders of the notes payable issued by the entity have no recourse to us.

We have taken the position that the entity should not be consolidated in our financial statements under applicable accounting principles because it is controlled by an unrelated investor which has sufficient equity capital at risk. Our investment of $21 million (September 2002: $24 million) in the entity is included in our financial statements on an equity-accounted basis. This is the maximum amount of our exposure to any possible loss and we have no funding commitments for the entity.

The structure was set up to monetarise the promissory notes in a manner that would not result in either debt or the Plum Creek notes being reflected on our balance sheet.

Capital Expenditures

Capital expenditures in fiscal 2003, fiscal 2002 and fiscal 2001 were as follows:

	Year Ended September		
	2003	2002	2001
	(US$ in millions)		
Sappi Fine Paper			
Sappi Fine Paper North America	78	49	99
Sappi Fine Paper Europe	104	96	116
Sappi Fine Paper South Africa	13	6	35
Total	195	151	250
Sappi Forest Products	101	29	43
Consolidated Total(1)	296	180	293

(1) Excludes investment in plantations. In fiscal 2003, fiscal 2002 and fiscal 2001, investment in plantations amounted to $31 million, $25 million and $28 million, respectively.

We operate in an industry that requires high capital expenditures and, as a result, we need to devote a significant part of our cash flow to capital expenditure programmes, including investments relating to maintaining operations. Capital spending for investment relating to maintaining operations during fiscal 2003, fiscal 2002 and fiscal 2001 amounted to approximately $164 million, $85 million and $154 million, respectively. Capital expenditure to maintain operations in fiscal 2002 was contained as a result of the Potlatch acquisition. The capital expenditure programme for these fiscal years was funded primarily through internally generated funds.

Our mills are generally well invested. Sappi Fine Paper North America's prior corporate parent invested approximately $1 billion on capital and investment expenditures from 1988 to 1994. In addition, there were approximately NLG 1,383 million of capital expenditures by KNP Leykam in the two years preceding our acquisition of that company in December 1997, which included the commissioning of PM 11 at Gratkorn. Consequently, during fiscal 1997 to fiscal 2003, capital spending incurred related mainly to maintaining existing operations and selected high-return capacity expansion or quality-enhancing projects. At Muskegon in North America, Gratkorn in Europe, and Stanger in South Africa, major projects were completed to upgrade operating equipment. These projects will

improve product quality, reduce costs and increase capacity. Potlatch spent approximately $525 million on the Cloquet mill during the period 1993 to 2000, resulting in a substantially new pulp mill. Capital expenditure by Potlatch in calendar 2000 and 2001 was $15.1 million and $6.1 million respectively, mainly on pulp mill optimisation and general mill maintenance.

The capital expenditure during 2003 included major projects at our southern African Tugela mill, our North American Somerset mill and our European Gratkorn and Lanaken mill. Total capital spending including the investment in plantations, for the Sappi Group during fiscal 2003 amounted to 83% of depreciation, amortisation and fellings, down from a planned level of 100% of depreciation, cut back because of weak market conditions. Capital spending for the Sappi Group during fiscal 2004 is expected to be similar to fiscal 2003. Capital spending is expected to be funded primarily through internally generated funds. For further details about our capital commitments, see note 28 to our Group annual financial statements included elsewhere in this Annual Report.

Contractual Obligations

We have various obligations and commitments to make future cash payments under contracts, such as debt instruments, lease arrangements, supply agreements and other contracts. The following table includes information contained within the Group annual financial statements included elsewhere in this Annual Report, as well as information regarding purchase obligations. The tables reflect those contractual obligations at the end of fiscal 2003 that can be quantified.

	Payments Due by Period				
	Total	**Less than 1 year**	**1–3 years**	**3–5 years**	**After 5 years**
Long-Term Borrowings[1]	1,834	138	297	91	1,308
Capital Lease Obligations[1]	78	32	44	2	
Operating Leases[2]	346	60	94	69	123
Unconditional Purchase Obligations[3]	226	79	119	11	17
Other Long-Term Liabilities on Balance Sheet[4]	23	2	5	3	13
Total	2,507	311	559	176	1,461

(1) Refer to note 17.
(2) Operating leases are future minimum obligations under operating leases. Refer to note 28.
(3) Unconditional Purchase Obligations are obligations to transfer funds in the future for fixed or minimum amounts or quantities of goods or services at fixed or minimum prices (for example, as in take-or-pay contracts or throughput contracts, relating to among others, timber and power).
(4) In addition to the Other Long-Term Liabilities of $23 million on Balance sheet, the company has an additional amount of $259 million of liabilities recorded on Balance sheet relating to post-employment benefits, post-retirement benefits other than pension obligations, workmen's compensation, and other items which do not have a payment profile. Refer to note 18.

Note references in the notes to the tables above are references to the notes to the Group annual financial statements included elsewhere in this Annual Report.

Share Buy Back

Following an initial approval by our shareholders on December 15, 2000 of purchases by our subsidiaries of Sappi common shares, at the annual general meeting of shareholders held on March 3, 2003, a special resolution granting authority to Sappi Limited or Sappi subsidiaries to buy back up to 10% of the issued shares of Sappi Limited in any one fiscal year, was approved. Pursuant to this approval, Sappi Limited or its subsidiaries may buy back shares from time to time. This authority is valid until the next annual general meeting. Under the South African Companies Act, subsidiaries may not hold more than 10% of the issued share capital of the parent company.

Following the initial approval in December 2000, our cumulative buy back by Group entities, at the end of fiscal 2003, is approximately 17.2 million shares (or approximately 7.2% of our issued shares) at an average price of $9.13 (R73.32) per share, of which 5.0 million shares had been utilised by the Sappi Limited Share Incentive Trust to meet its obligations. During fiscal 2003 we acquired approximately 4.2 million shares for a total consideration of approximately $55 million. We held approximately 12.2 million treasury shares (or approximately 5.1% of our issued shares) at the end of fiscal 2003. As at December 8, 2003, the Sappi share price was $12.75 (R81.80).

The JSE Securities Exchange South Africa listing requirements changed during 2003. Under the revised rules a company may not repurchase its shares during a closed period, which is defined as the period between the end of a financial reporting period and the publication of the results for that period and any period during which the company is trading under a cautionary announcement. Previously this was restricted for periods of 40 trading days prior to the announcement of half-year and full-year results.

Dividends

Sappi Limited declared total cash dividends in respect of the ordinary shares of $0.29 per share in fiscal 2003, $0.28 per share in fiscal 2002 and $0.26 per share in fiscal 2001. Dividends paid in years prior to fiscal 2000 have been paid in South African Rand, and have been converted to US dollar at the rate of exchange at the date of declaration of the dividend.

The current dividend policy of Sappi Limited is to provide regular annual dividend payments which incorporate, over time, real growth for shareholders by providing dividend payments varying in line with changes in the business cycle, but our current intention is to maintain a long-term average dividend "cover" of three times net profit. Our dividends were covered 2.3, 3.4 and 2.3 times in fiscal 2003, 2002 and 2001, respectively.

Mill Closures, Acquisitions and Dispositions

Westbrook machine closure. Subsequent to detailed investigations and product testing completed during the latter part of our fiscal, we announced in November 2003 that we will close the number 14 paper machine and related assets at our Westbrook mill in Maine, North America. This follows our decision to take out capacity to improve the supply demand balance in the US. The machine being closed is our highest cost paper machine. It has an annual capacity of 80,000 metric tonnes and will be closed in the next few months. The brands produced on this machine will be transferred to other Sappi mills and we plan not only to maintain service levels but also to improve the product characteristics by producing on more modern facilities. The Westbrook mill will in future focus on our Ultracast® and casting release paper business.

We have written off the assets and related inventory in the last quarter of 2003 and have taken a charge of $19 million after tax ($32 million pre-tax). We expect to take a further charge of approximately $15 million pre-tax in the first quarter of fiscal 2004 in respect of the closure costs.

We expect expense savings before tax of approximately $18 million in a full year once the paper machine and related assets have been closed. The net impact on operating profit is expected to be favourable from the March quarter of 2004.

This closure will result in the loss of approximately 170 jobs at Westbrook.

Clan Sawmill. We ceased operations at Clan sawmill (South Africa) in the last quarter of 2003 and expect to close the mill before December 2003. The mill, with a log intake of 80,000 m^3, uses old technology and does not have a competitive log supply. The closure will not have a material impact on our results, but will result in the loss of approximately 300 jobs.

Potlatch Acquisition. On May 13, 2002, we acquired Potlatch Corporation's coated fine paper business by purchasing Potlatch's Cloquet, Minnesota pulp and paper mill as well as the brands, order books and working capital of the Cloquet mill and the brands, order books and inventories of Potlatch's Brainerd, Minnesota paper mill for an aggregate purchase price of $483 million. The purchase consideration was funded from cash and existing Group facilities. We did not acquire Potlatch's Brainerd mill. The Brainerd mill previously had a production capacity of 140,000 metric tonnes of coated fine paper and serviced a customer base that in the future we intend to service from the Cloquet mill and other Sappi mills. The coated fine paper business of Potlatch sold 330,000 metric tonnes of coated paper in 2001. The Cloquet pulp and paper mill has a capacity of 232,000 metric tonnes of coated paper production capacity and a state-of-the-art pulp mill with a production capacity of 410,000 metric tonnes. We employed approximately 200 fewer people when we acquired the Cloquet mill than were previously employed there. We have reimbursed Potlatch approximately $3.5 million for certain costs in respect of severance payments.

The Cloquet mill includes a hydroelectric facility that is licensed by the Federal Energy Regulatory Commission. The acquisition of the hydroelectric facility from Potlatch was completed on June 25, 2002, upon the approval of the Federal Energy Regulatory Commission to the transfer of the license from Potlatch to Sappi becoming final. In addition to generating a portion of its own power, the Cloquet mill has entered into a co-generation agreement with Minnesota Power and has entered into a take-or-pay agreement to purchase a portion of its power from Minnesota Power, which terminates in 2008.

In connection with the acquisition, we agreed to assume Potlatch's obligations under several long-term cross-border leases involving a substantial portion of the Cloquet assets we are acquiring. Under the lease arrangements, Potlatch sold assets to an unrelated third party, leased them back and received an upfront payment. There are no further lease payments foreseen; however, we have agreed to indemnify other parties to the lease arrangements for specified liabilities, including tax liabilities, that could be substantial if they arise. In addition, we are subject to a number of risks, which could affect our use of the assets or require payment of substantial amounts. Potlatch has agreed generally to indemnify us against losses resulting from these risks, but we cannot assure you that Potlatch will or will be able to fulfil its indemnity obligations. While these lease arrangements are in place, we will be subject to significant restrictions on our use of and ability to transfer our rights in the leased assets. These restrictions will limit our flexibility in conducting our business and could impair our ability to operate our business in the most efficient manner.

Closure of Transcript Mill. On October 9, 2001, we announced the intention to close the Transcript mill in Scotland, and ceased production in the quarter ended March 2002. In connection with the closure, we provided a $9 million charge for the write-off of the assets and closure costs in fiscal 2002. This facility produced carbonless paper products which is non-core and being rapidly replaced by other products or electronic media.

Closure of Mobile Mill. In fiscal 2001, we provided a $110 million after tax charge for the write-off of the assets and closure costs for the Mobile mill in Alabama and ceased production at the mill in December 2001. Of this charge, $4 million after tax was released in fiscal 2002. The Mobile mill is located on a multi-user site and was dependent on sharing facilities with other producers to maintain an efficient cost structure. The closure of a nearby pulp mill resulted in dramatically increased energy costs. Because we were unable to invest on the site without a better overall cost structure, we decided to close the mill.

Pension fund

Actual returns for the Group pension funds during 2003 were significantly better than actuarial projections in the North American and United Kingdom funds, but marginally worse in Europe and

negative in the South African fund. Discount rates are drawn from corporate bond yield indices with terms similar to those of fund liability profiles.

Discount rate and expected return assumptions have been adjusted downwards in all funds, reflecting prevailing lower interest rates. This has increased the net unfunded status of Group funds by $83 million to $333 million at the end of September 2003.

The key assumptions used to compile plan assets and liabilities at September 2003 were as follows:

	Europe		United States		United Kingdom		South Africa	
	2003	2002	2003	2002	2003	2002	2003	2002
	%	%	%	%	%	%	%	%

Discount rate	4.97	5.75	5.85	6.51	5.25	5.50	9.50	11.50
Return on assets	5.50	5.52	8.50	9.00	6.00	6.25	10.00	12.50
Inflation rate	2.00	2.50	3.00	3.00	2.50	2.50	5.00	12.50
Salary increase	3.10	2.97	4.00	4.00	4.00	4.00	7.00	9.00

As a result of the foregoing, the Group's income statement pension cost is expected to rise by approximately $10 million pre-tax in 2004. Cash flow is expected to be in line with 2003 levels (approximately $60 million) with increases in North American funding requirements being offset by reductions in Europe.

A 1% change in discount rates would impact the liability by approximately $142 million and the related pension cost by approximately $8.4 million after tax per annum.

For further information of the different treatment of unrecognised actuarial losses under US and SA GAAP, refer note 38 to our Group annual financial statements included in this Annual Report.

For further information see note 30 and 31 to our Group annual financial statements included elsewhere in this Annual Report.

Insurance

The Group has an active programme of risk management in each of our geographical operating regions to address and to reduce exposure to property damage and business interruption. All production and distribution units are audited regularly and are subject to risk assessments, which receive the attention of senior management. The risk programmes are co-ordinated at Group level in order to achieve a harmonisation of methods. Work on improved enterprise risk management is progressing well and aims to lower the risk of incurring losses from uncontrolled incidents.

Furthermore we follow a practice of insuring our assets against unavoidable loss arising from catastrophic events. These include fire, flood, explosion, earthquake and machinery breakdown. Insurance also covers the business interruption costs which may result from these events. Specific environmental risks are also insured. In line with the previous year the Board decided not to take separate cover for losses from acts of terrorism, which is consistent with current practice in the paper manufacturing industry.

We have a global insurance structure and the majority of insurance is placed with our own captive insurance company which in turn reinsures the vast majority of the risk with third-party insurance companies.

The events of September 11, 2001, and property damage losses seriously affected the insurance industry, and led to significant premium increases over the last few years in some of the components of our insurance structure. However, we successfully placed the renewal of our fiscal 2004 insurance cover in November 2003 at rates substantially lower than fiscal 2003. Self-insured deductibles for any one

property damage occurrence have remained at $25 million, with a reduced aggregate limit of $40 million for fiscal 2004, compared to an aggregate limit of $75 million in fiscal 2003. For property damage and business interruption, we were again not able to cover to full value, however we believe the loss limit cover of $1 billion to be well in excess of what has been determined as our maximum foreseeable loss for any single claim.

Insurance cover for credit risks currently applies to our European and South African domestic trade receivables.

Critical accounting policies and estimates

The preparation of financial statements in conformity with SA GAAP requires management to make estimates and assumptions about future events that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgement based on various assumptions and other factors such as historical experience, current and expected economic conditions, and in some cases, actuarial techniques. The Group constantly re-evaluates these significant factors and makes adjustments where facts and circumstances dictate. Historically, actual results have not significantly deviated from those determined using the estimates described above, except for post-employment benefits. The Group believes that the following accounting policies are critical due to the degree of estimation required.

Post-employment benefits. The Group accounts for its pension benefits and its other post retirement benefits using actuarial models. These models use an attribution approach that generally spreads individual events over the service lives of the employees in the plan. Examples of "events" are changes in actuarial assumptions such as discount rate, expected long-term rate of return on plan assets, and rate of compensation increases. The principle underlying the required attribution approach is that employees render service over their service lives on a relatively consistent basis and, therefore, the income statement effects of pension benefits or post retirement healthcare benefits are earned in, and should be expensed in the same pattern.

Numerous estimates and assumptions are required, in the actuarial models, to determine the proper amount of pension and other post retirement liabilities to record in the Group's consolidated financial statements. These include discount rate, return on assets, salary increases, health care cost trends, longevity and service lives of employees. Although there is authoritative guidance on how to select these assumptions, our management and its actuaries exercise some degree of judgement when selecting these assumptions. Selecting different assumptions, as well as actual versus expected results, would change the net periodic benefit cost and funded status of the benefit plans recognised in the financial statements.

The impact on the future financial results of the Group in relation to post-employment benefits is dependent on economic conditions, employee demographics and investment performance.

Asset impairments. The Group periodically evaluates its long-lived assets for impairment, including identifiable intangibles and goodwill, whenever events or changes in circumstance indicate that the carrying amount of the asset may not be recoverable. Our judgements regarding the existence of impairment indicators are based on market conditions and operational performance of the business. Future events could cause management to conclude that impairment indicators exist.

In order to assess if there is any impairment, we estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the carrying amount exceeds the recoverable amount (being the greater of the discounted expected future cash flows and the net selling price of the asset) of the asset, we will recognise an impairment loss for the difference. Considerable management judgement is necessary to estimate discounted future cash flows. Accordingly, actual outcomes could vary significantly from such estimates. Factors such as changes in the planned use of buildings, machinery or equipment or closing of facilities or lower than anticipated sales for products could result in shortened useful lives or impairment. These changes can have either a positive or negative impact on our estimates of impairment and can result in additional charges. In addition, further changes in the economic and business environment can impact our original and ongoing assessments of potential impairment.

Plantations. We state our plantations at the lower of cost less depletions and realisable value. Cost includes all expenditure incurred on acquisition, forestry development, establishment and maintenance of plantations, and finance charges. Depletions include the cost of timber felled, including finance charges, which is determined on the average method, plus amounts written off standing timber to cover loss or damage caused, for example, by fire, disease and stunted growth. Assumptions and estimates are used in the recording of plantation cost and depletion. Changes in the assumptions or estimates used in these calculations may affect the Group's results, in particular, plantation and depletion costs. For further information see note 38 of our Group annual financial statements included elsewhere in this Annual Report.

Deferred taxation. The Group estimates its income taxes in each of the jurisdictions in which it operates. This process involves estimating its current tax liability together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within the consolidated balance sheet. The Group then assesses the likelihood that the deferred tax assets will be recovered from future taxable income, and, to the extent recovery is not likely, a valuation allowance is established. Management's judgement is required in determining the provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against the net deferred tax assets. Where management believes that it is more likely than not that the deferred tax assets will be realised through the recognition of future taxable income, deferred tax assets have been recognised. Although the deferred tax assets for which valuation allowances have not been provided are considered realisable, actual amounts could be reduced if future taxable income is not achieved. This can materially affect our reported net profit and financial position.

Hedge accounting for financial instruments. For the purposes of hedge accounting, we classify hedges into two categories: (a) fair value hedges which hedge the exposure to changes in the fair value of a recognised asset or liability; and (b) cash flow hedges, which hedge exposure to variability in cash flows that is either attributable to a particular risk associated with a recognised asset or liability or a forecasted transaction.

In relation to fair value hedges, which meet the conditions for hedge accounting, any gain or loss from remeasuring the hedging instrument to fair value is recognised immediately against income. Any gain or loss on the hedged item attributable to the hedged risk is adjusted against the carrying amount of the hedged item and recognised against income. The designation of a derivative instrument as a fair value hedge in this manner can affect our reported net income.

In relation to cash flow hedges, which meet the conditions for hedge accounting, the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in shareholders' equity and the ineffective portion is recognised in income. The gains or losses, which are recognised directly in shareholders' equity, are transferred to income in the same period in which the hedged transaction affects income. The designation of a derivative instrument as a cash flow hedge in this manner can also materially affect our reported net income.

Provisions. Provisions are recorded when the Group has a present legal or constructive obligation as a result of past events, for which is probable that an outflow of economic benefits will occur, and where a reliable estimate can be made of the amount of the obligation. Where the effect of discounting

is material, provisions are discounted. The discount rate used is pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

The establishment of the provisions requires significant judgement by management related to the amounts to be recorded and the likelihood of future payments. If the amounts vary from these initial estimates the provisions may be revised materially, up or down, based on the facts.

Changes in Accounting Policies

There was one accounting policy change in fiscal 2003 and no accounting policy change in fiscal 2002. During fiscal 2003 we changed our accounting policy with regard to the translation of equity categories to conform with the requirements of AC 430 (Reporting currency—Translation from Measurement Currency to Presentation Currency), the effects of which are negligible on net profit or equity for fiscal 2003 or prior years.

There were a number of accounting policy changes in fiscal 2001. This was mainly due to the numerous changes to the South African accounting standards. We changed our accounting policy with respect to leases, events after the balance sheet date (dividends), employee benefits, discontinuing operation, impairment of assets, intangible assets, provisions, contingent liabilities and contingent assets, business combinations, Group annual financial statements and accounting for investments in subsidiaries, financial instruments: recognition and measurement, government grants, consolidation: special purpose entities, and Share capital—reacquired own equity instruments (treasury shares). These changes had no material effect on current year and comparable period earnings, but had the effect of decreasing equity by $3 million at the beginning of fiscal 2001.

Data for prior fiscal years has been restated to reflect these changes in accounting policy where required by the appropriate accounting standards.

We state our plantations at the lower of cost less depletions and realisable value. Cost includes all expenditure incurred on acquisition, forestry development, establishment and maintenance of plantations, and finance charges. The South African Accounting Practices Board issued a new statement AC 137 Agriculture in November 2001. This statement becomes operative for annual financial statements covering periods beginning on or after 1 January 2003. The objective of this statement is to prescribe the accounting treatment, financial statement presentation and disclosures related to agricultural activity. This requires changes to the way we account for our plantations. In future we will not capitalise silvicultural expenses and finance costs to plantations nor will we amortise plantations to the income statement. In future, movements in the fair value of plantations will impact operating profit. This change could lead to increased volatility going forward. This policy will be effective from our Fiscal 2004 year.

For US GAAP purposes, goodwill was previously amortised. From October 1, 2002 the Group no longer amortise goodwill, which is now subject to an annual impairment test.