Usutu mill impairment charge in 2005 accounting for US$14 per metric tonne.

Operating Loss/Profit

Group operating income amounted to US$125 million in 2006, compared to an operating loss of US$109 million in 2005. The operating loss of our Fine Paper division decreased by US$137 million; and Forest Products operating profit increased by US$92 million.

The group operating margin was positive 2.5% compared to negative 2.2% in 2005. This reflects the effect of the non-reoccurrence of the impairment charges (US$233 million) in 2005 and the reversal of the Usutu mill impairment of US$40 million in 2006.

Sappi Fine Paper. Operating loss for Sappi Fine Paper decreased by US$137 million to a loss of US$49 million in 2006 primarily due to decreased operating losses at Sappi Fine Paper North America (US$243 million) and Sappi Southern Africa (US$5 million), partly offset by a US$111 million decrease in operating income to a loss of US$27 million at Sappi Fine Paper Europe in 2006. Operating margin was for Sappi Fine Paper negative 1.2% in 2006 as compared to negative 4.6% in 2005.

Sappi Fine Paper North America incurred operating losses of US$16 million in 2006 and US$259 million in 2005. This improvement in 2006 is mainly due to the non-reoccurrence of the Muskegon impairment charge (US$183 million) and restructuring charges (US$22 million) in 2005 and the pension provision release (US$18 million) in fiscal 2006, partly offset by the impact of lower selling prices (US$18 million) and higher raw material and energy costs (US$32 million) in 2006.

Sappi Fine Paper Europe operating profit decreased by US$111 million to a loss of US$27 million in 2006. Operating margin decreased to negative 1.2% in 2006 from positive 3.8% in 2005. The decrease was mainly attributable to increased raw material and energy cost (US$47 million), reduced sales due to currency and pricing (US$66 million) and increased restructuring charges (US$40 million), partly offset by the benefit of increased sales volumes (US$21 million).

Sappi Fine Paper South Africa operating loss decreased US$5 million to a loss of US$6 million; in 2006. The improvement was mainly attributable to pricing (US$9 million), partly offset by increased costs.

Sappi Forest Products. Sappi Forest Products operating profit increased by US$92 million to US$175 million in 2006. The increase was mainly due to improved volume, pricing and mix (US$135 million), reduced SG&A costs (US$14 million), reduced other expenses (US$87 million), mainly impairment reversal, partly offset by increased operating costs (US$102 million), adverse fair value pricing adjustment (US$22 million) and the impact of currency translation (US$12 million). US$40 million of the Usutu impairment charge (US$50 million) in 2005 was reversed in 2006. Operating margin was 17.7% in 2006, compared to 8.3% in 2005.

Corporate. Corporate operating expenses decreased by US$5 million.

Net Finance Costs

Net finance costs consists of gross interest and other finance costs net of interest received, interest capitalised, foreign exchange gains and losses and change in fair value of financial instruments. Net finance costs were US$130 million in 2006 compared to US$80 million in 2005. Gross interest cost remained largely unchanged from 2005, increasing by US$1 million to US$162 million. Net interest-bearing debt of US$2,113 million in 2006 increased by US$105 million compared to US$2,008 million in 2005. Net finance costs also included fair value adjustments for which 2005 included gains of US$13 million due to an

accounting mismatch, as a result of our inability to apply hedge accounting in respect of interest rate swaps during the third quarter in 2005. As a result of IFRS adoption, the prior year was restated by a US$22 million gain due to cash flow hedges, previously accounted for in equity no longer qualifying for hedge accounting under IAS 39. These instruments are now recognized at fair value through profit and loss.

Cash interest cover (cash generated by operations divided by net finance costs (before capitalised interest)) decreased to 3.6 times in 2006 compared to 7.1 times for 2005. The decrease in 2006 is mainly due to lower cash generated by operations as well as higher net finance costs as a result of the fair value adjustments, which were gains in 2005.

Finance costs capitalised were US$2 million in 2006 and US$1 million in 2005. Finance costs capitalised relate primarily to the capitalised interest on major projects under construction.

Taxation

The 2006 taxation credit was taxation credit of US$1 million in fiscal 2006, compared to a credit of US$5 million in fiscal 2005. The effective taxation rate this year was 14.9% (2.8% in 2005). Despite the loss in fiscal 2006, the decrease in the taxation benefit and the increase in the effective taxation rate in fiscal 2006 were primarily as a result of taxation losses carried forward, arising in North America and Austria, not being recognized under applicable accounting rules. Our North American operations, where the nominal taxation rate is 39.5%, reported a net loss before taxation of US$79 million, with the Austrian operations reporting a loss of US$87 million. In addition a provision for Secondary Tax on Companies (STC) of US$9 million, being 12.5% of dividends declared, was provided. Tax risk provisions to the value of US$13 million have been raised in Europe. Offsetting the negative consequences of losses not being tax relieved and the risk provisions raised was the release of risk provisions against matters which have now been finalised and settled, the recognition of taxation assets in Belgium and the effect of the Usutu impairment reversal not being tax effected, due to the prior non-recognition of the deferred tax asset.

The effective taxation rate of 2.8% in fiscal 2005 was primarily affected by the net loss before taxation of US$327 million for Sappi Fine Paper North America not being fully recognized and the non-relief of the impairment charges relating to the Usutu mill. This was, however, partially offset by tax rate reductions in the Netherlands and South Africa.

Taxation liabilities are calculated according to the tax laws applicable to the jurisdiction in which a legal entity has fiscal residence. Certain jurisdictions apply group taxation and the taxation liabilities of legal entities trading in such jurisdictions are calculated in accordance with group taxation principles. In certain cases entities are subject to taxation in more than one jurisdiction. Where the entity is entitled to a corresponding taxation credit in the country of fiscal residence, this entitlement is reflected in the taxation charge. Should there not be any entitlement to a taxation credit, the foreign taxation paid is included as part of the taxation charge for an entity.

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 that no further material costs will arise. See note 24.4 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 license granted by the Belgium government that includes an alternative method of calculating the taxation liability of the co-ordination centre. This license was renewed in July 2003 and it is our current understanding that this license will be renewed until the end of 2010. The Belgian government legislated a new general tax measure with effect from January 1, 2006. This tax measure allows for a tax deduction on the notional cost of a company’s equity. This will apply to Sappi once the co-ordination centre status expires and will result in similar benefits.

Sappi accounts for taxation using the undistributed taxation rate for IFRS and using the distributed rate for US GAAP. This is reflected as a reconciling item in the annual financial statements (refer note 35 to our Group Annual Financial Statements included elsewhere in this Annual Report). The company currently has an after tax Secondary Tax on Companies (STC) credit of US$18 million (fiscal 2005 US$31 million). Deferred tax assets are recognised for unused STC credits to the extent that they will be utilised in the future. When STC credits are utilised with declaration of dividends, it will result in the recognition of a deferred tax charge for STC in the income statement in the period that the dividend is declared.

Basis of Income Taxation

South Africa has a dual income tax system in terms of which residents are taxed on their worldwide income and non-residents are taxed on their South African source (or deemed source) income. Certain categories of income and activities are exempt from taxation.

Residence, in the case of natural persons, is established either by being ordinarily resident in South Africa or by satisfying a physical presence test in terms of which they become residents by virtue of their being physically present in South Africa for certain prescribed periods of time. In the case of legal entities, residence is established by virtue of incorporation or formation, or having a place of effective management in South Africa. Excluded from the definition of “resident” are persons or entities which are, in terms of double taxation agreements entered into by South Africa, not treated as resident in South Africa.

Resident companies of South Africa are subject to corporate income tax at a rate of 29%. The South African tax law exempts dividends received from domestic entities from taxation, in part to avoid double taxation of corporate earnings. However, resident companies are subject to Secondary Tax on Companies (STC) upon the declaration of a dividend, equal to 12.5% of such dividend, net of the STC tax liability. Any excess of dividends received by a company in a relevant dividend cycle, excluding those foreign dividends which are not exempt from South African income tax, over the dividends paid in such cycle is carried forward by the company to the succeeding dividend cycle as an STC credit.

The imposition of STC, together with the corporate income taxes, effectively imposes a dual corporate tax system in South Africa, with a liability for both the 12.5% STC and the 29% corporate income tax. This creates an effective tax rate on South African companies of 36.9% on distributed earnings. STC tax on companies is however only recognised under current IFRS when a dividend is distributed. The STC becomes payable one month after the end of the month in which the dividend was declared.

Dividends received by or accruing to South African residents from companies which are not tax resident in South Africa are subject to tax, but certain foreign dividends are exempt from tax, including:

- Foreign dividends declared by a company listed on a stock exchange licensed in South Africa or on an exchange recognised by the Minister of Finance in the Government Gazette to a shareholder if more than 10% of the equity share capital of the listed company at the time of declaration is held by South African residents;
- Foreign dividends to residents holding a certain minimum interest (currently 20% of the total equity shares and voting rights) in the foreign company declaring the dividend, however certain dividends are excluded from this exemption in terms of certain anti-avoidance measures;
- Foreign dividends declared out of profits that are subject to tax in the hands of the South African resident recipient of the dividend in terms of South Africa’s controlled foreign company legislation;
- Foreign dividends declared out of profits that are subject to full South African tax; and
- Foreign dividends declared by a company out of profits which arose from dividends declared to such company by a South African resident company.

South African residents, who are natural persons earning interest and non-exempt dividends from foreign sources, are allowed an exemption on the first R2,500 of such income (the exemption is firstly to be applied to foreign dividends and only if they do not exceed R2,500, the excess is to be applied to foreign interest). There is also an exemption applicable to the first R16,500 of the aggregate of any interest received from local sources and any dividends which are not exempt from tax (other than foreign dividends), however, this exemption will be reduced by the amount of the exemption which may be applicable to foreign interest or dividends referred to above.

Income Tax and Capital Gains Tax

Profits derived from the sale of shares in a South African company will generally only be subject to income tax (at a corporate rate of 29% and a maximum individual rate of 40% based on a sliding scale) in South Africa if the seller carries on business in South Africa as a share dealer, and the profits are realised in the ordinary course of that business.

Capital Gains Tax was introduced with effect from October 1, 2001 and has been introduced in the Income Tax Act 58 of 1962 by way of the incorporation of the Eighth Schedule therein (“Eighth Schedule”). Under the Eighth Schedule, all natural persons, legal persons and trusts resident in South Africa are liable to pay capital gains tax on the disposal of a capital asset. The definition of an asset is very wide and includes assets that are movable, immovable, corporeal or incorporeal, but excludes certain limited items. Non-residents of South Africa will not be subject to capital gains tax except in respect of the disposal of immovable property situated in South Africa (or any interest or right in such immovable property) and any assets of his/its permanent establishment through which a trade is being carried on in South Africa. Profits derived from the sale of South African shares held by non-residents as long-term investments will generally not be subject to capital gains tax in South Africa. However, the sale of South African shares held by a non-resident will attract capital gains tax in the event that the shares comprise an asset of that non-resident’s permanent establishment in South Africa, or if the foreign shareholder (alone or together with any connected persons) holds more than 20% of the issued share capital of the South African company and more than 80% of the net asset value of that company is attributable to immovable property situated in South Africa. An American Depository Share will be regarded as a share for the purpose of Capital Gains Tax in South Africa. The Treaty only permits the imposition of South African tax on capital gains of a United States resident seller from the sale of shares where such shares form part of the business property of a permanent establishment which the seller has in South Africa or pertain to a fixed base available to the seller in South Africa for the purpose of performing independent personal services. Companies will be liable to capital gains tax on 50% of the net capital gain. At the current corporate tax rate of 29%, the effective tax rate on net capital gains will therefore be 14.5%.

For further information see “Item 10—Additional Information—Taxation”.

Net Loss

Net loss decreased to US$4 million in 2006 from a net loss of US$184 million in 2005, primarily due to the non-reoccurrence of the Muskegon and Usutu impairment charges of US$233 million pre-tax. Lower selling prices, higher raw material and energy costs, especially in our North American and European operations continue to place margins under pressure. A weakening of the Euro and ZAR against the US$ impacts margins of our European and southern African businesses favourably. Restructuring charges in Europe were partly offset, in fiscal 2006, by the reversal of impairment of our Usutu Mill at Sappi