

SAPPI LTD  
Form 20-F  
December 20, 2005  
As filed with the Securities and Exchange Commission on December 20, 2005

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 20-F**

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

**OR**

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

**For the fiscal year ended October 2, 2005**

**OR**

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

**For the transition period from** \_\_\_\_\_ **to** \_\_\_\_\_

**Commission file number 1-14872**

**SAPPI LIMITED**

(Exact name of Registrant as specified in its charter)

**Not Applicable**

(Translation of Registrant's name into English)

**Republic of South Africa**

(Jurisdiction of incorporation or organisation)

**48 Ameshoff Street  
Braamfontein  
Johannesburg 2001  
Republic of South Africa  
(Telephone: +27-11-407-8111)**

(Address and telephone number of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act.

**American Depositary Shares, evidenced by  
American Depositary Receipts, each representing  
1 Ordinary Share**

(Title of each class)

Edgar Filing: SAPPI LTD - Form 20-F

**New York Stock Exchange  
Ordinary Shares, par value R1.00 per Share\***

(Name of each exchange on which registered)

Securities registered or to be registered pursuant to Section 12(g) of the Act.

**None**

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

**None**

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

**239,071,892 Ordinary Shares**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

**YES**  **NO**

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

**YES**  **NO**

Note: Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

**YES**  **NO**

Indicate by check mark which financial statements item the registrant has elected to follow.

**ITEM 17**  **ITEM 18**

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

**YES**  **NO**

\* Not for trading but only in connection with the registration of the American Depositary Shares, pursuant to the requirements of the Securities and Exchange Commission.

## TABLE OF CONTENTS

	<b>Page</b>
<u>Our Use of Terms and Conventions in this Annual Report</u>	ii
<u>Accounting Periods and Principles</u>	iv
<u>Currency of Presentation and Exchange Rates</u>	iv
<u>Forward-Looking Statements</u>	iv
<b><u>PART I</u></b>	
<u>Item 1.</u>	<u>Identity of Directors, Senior Management and Advisers</u>
	1
<u>Item 2.</u>	<u>Offer Statistics and Expected Timetable</u>
	1
<u>Item 3.</u>	<u>Key Information</u>
	1
<u>Item 4.</u>	<u>Information on the Company</u>
	9
<u>Item 5.</u>	<u>Operating and Financial Review and Prospects</u>
	43
<u>Item 6.</u>	<u>Directors, Senior Management and Employees</u>
	94
<u>Item 7.</u>	<u>Major Shareholders and Related Party Transactions</u>
	103
<u>Item 8.</u>	<u>Financial Information</u>
	105
<u>Item 9.</u>	<u>The Offer and Listing</u>
	107
<u>Item 10.</u>	<u>Additional Information</u>
	109
<u>Item 11.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>
	126
<u>Item 12.</u>	<u>Description of Securities Other than Equity Securities</u>
	126
<b><u>PART II</u></b>	
<u>Item 13.</u>	<u>Defaults, Dividend Arrearages and Delinquencies</u>
	127
<u>Item 14.</u>	<u>Material Modifications to the Rights of Security Holders and Use of Proceeds</u>
	127
<u>Item 15.</u>	<u>Controls and Procedures</u>
	127
<u>Item 16A.</u>	<u>Audit Committee Financial Expert</u>
	128
<u>Item 16B.</u>	<u>Code of Ethics</u>
	128
<u>Item 16C.</u>	<u>Principal Accountant Fees and Services</u>
	129
<u>Item 16D.</u>	<u>Exemptions from the Listing Standards for Audit Committees</u>
	129
<u>Item 16E.</u>	<u>Purchases of Equity Securities</u>
	130
<b><u>PART III</u></b>	
<u>Item 17.</u>	<u>Financial Statements</u>
	131
<u>Item 18.</u>	<u>Financial Statements</u>
	131
<u>Item 19.</u>	<u>Exhibits</u>
	132

**OUR USE OF TERMS AND CONVENTIONS IN THIS ANNUAL REPORT**

Unless otherwise specified or the context requires otherwise in this Annual Report on Form 20-F ( Annual Report ):

- references to Sappi , Sappi Group , Group , we , us and our are to Sappi Limited together with its subsidiaries;
- references to southern Africa are to the Republic of South Africa, the Kingdom of Swaziland, the Kingdom of Lesotho, the Republic of Namibia and the Republic of Botswana;
- references to North America are to the United States, Canada and the Caribbean;
- references to Latin America are to the countries located on the continent of South America and Mexico;
- references to Rand , ZAR and R are to South African Rand and references to SA cents are to South African cents, the currency of South Africa;
- references to US dollar(s) , dollar(s) , US\$ , \$ and US cents are to United States dollars and cents, the currency of the United States;
- references to euro , EUR and € are to the currency introduced at the start of the third stage of the European Economic and Monetary Union pursuant to the Treaty establishing the European Economic Community, as amended by the Treaty on the European Union;
- references to Guilders and NLG are to Dutch Guilders, the former currency of the Netherlands;
- references to Deutsche marks and DEM are to German Deutsche marks, the former currency of Germany;
- references to UK pounds sterling and GBP are to United Kingdom pounds sterling, the currency of the United Kingdom;
- references to m<sup>2</sup> are to square metres and references to hectares or ha are to a land area of 10,000 square metres or approximately 2.47 acres;
- references to tonnes are to metric tonnes (approximately 2,204.6 pounds or 1.1 short tonnes);
- references to market share are based upon sales volumes in a specified geographic region during the fiscal year ended September 26, 2004; and
- references to the Potlatch acquisition are to the acquisition on May 13, 2002 of Potlatch Corporation's coated fine paper business in an asset purchase. The acquisition included Potlatch's Cloquet, Minnesota pulp and paper mill as well as the brands, order book and working capital of the Cloquet mill and the brands, order book and inventories of Potlatch's Brainerd, Minnesota paper mill for an aggregate purchase price of \$483 million. We did not acquire Potlatch's Brainerd mill, which Potlatch has closed.

Except as otherwise indicated, in this Annual Report the amounts of capacity or production capacity of our facilities or machines are based upon our best estimates of production capacity at the date of filing of this Annual Report. Actual production by machines may differ from production capacity as a result of products produced, variations in product mix and other factors.

Certain market share information and other statements presented herein regarding our position relative to our competitors with respect to the manufacture or distribution of particular products are not



based on published statistical data or information obtained from independent third parties, but reflect our best estimates. We have based these estimates upon information obtained from our customers, trade and business organisations and associations and other contacts in our industries.

Unless otherwise provided in this Annual Report, trademarks identified by ® are registered trademarks of Sappi Limited or our subsidiaries.

iii

---

## ACCOUNTING PERIODS AND PRINCIPLES

Unless otherwise specified, all references in this Annual Report to a fiscal year and year ended of Sappi Limited refer to a twelve-month financial period. All references in this Annual Report to fiscal 2005, fiscal 2004, fiscal 2003, fiscal 2002 or fiscal 2001 or the year ended September 2005, 2004, 2003, 2002 or 2001 refer to Sappi Limited's twelve-month financial periods ended on October 2, 2005, September 26, 2004, September 28, 2003, September 29, 2002 and September 30, 2001, respectively; references in this Annual Report to fiscal 2006 refer to the period beginning October 3, 2005 and ending October 1, 2006. Our Group annual financial statements included elsewhere in this Annual Report have been prepared in conformity with South African generally accepted accounting principles ( South African GAAP or SA GAAP ), which differ in certain significant respects from United States generally accepted accounting principles ( United States GAAP or US GAAP ); see note 42 to our Group annual financial statements included elsewhere in this Annual Report. On May 13, 2002, we acquired the coated fine paper business of Potlatch Corporation. Our Group annual financial statements for the year ended September 2002 include the results for the acquired coated fine paper business since its acquisition.

## CURRENCY OF PRESENTATION AND EXCHANGE RATES

We publish our Group annual financial statements and all financial data presented in this Annual Report in US dollars on a nominal (non-inflation adjusted) basis. For information regarding the conversion to US dollars in fiscal 2005, 2004 and 2003, see note 2 to our Group annual financial statements included elsewhere in this Annual Report.

## FORWARD-LOOKING STATEMENTS

In order to utilise the Safe Harbor provisions of the United States Private Securities Litigation Reform Act of 1995 (the Reform Act ), we are providing the following cautionary statement. Except for historical information contained herein, statements contained in this Annual Report may constitute forward-looking statements within the meaning of the Reform Act. The words believe , anticipate , expect , intend , estimate , assume , positioned , will , may , should , risk and other similar expressions, which are predictions of or indicate future events and future trends which do not relate to historical matters identify forward-looking statements. In addition, this document includes forward-looking statements relating to our potential exposure to various types of market risks, such as interest rate risk, foreign exchange rate risk and commodity price risk. You should not rely on forward-looking statements because they involve known and unknown risks, uncertainties and other factors which are in some cases beyond our control and may cause our actual results, performance or achievements to differ materially from anticipated future results, performance or achievements expressed or implied by such forward-looking statements (and from past results, performance or achievements). Certain factors that may cause such differences include but are not limited to: the highly cyclical nature of the pulp and paper industry; pulp and paper production, production capacity, input costs (including raw materials, energy and employee costs) and pricing levels in North America, Europe, Asia and southern Africa; any major disruption in production at our key facilities; changes in environmental, tax and other laws and regulations; adverse changes in the markets for our products; any delays, unexpected costs or other problems experienced with any business acquired or to be acquired and achieving expected savings and synergies; consequences of our leverage; adverse changes in the South African political situation and economy or the effect of governmental efforts to address present or future economic or social problems; and the impact of future investments, acquisitions and dispositions (including the financing of investments and acquisitions) and any delays, unexpected costs or other problems experienced in connection with dispositions.

These factors are fully discussed in this Annual Report. For further discussion on these factors, see Item 3 Key Information-Selected Financial Data , Item 3 Key Information-Risk Factors , Item 4 Information on the Company , Item 5 Operating and Financial Review and Prospects Operating Results , Item 10 Additional Information Exchange Controls and note 37 to our Group annual financial statements included elsewhere in this Annual Report. You are cautioned not to place undue reliance on these forward-looking statements. These forward-looking statements are made as of the date of the filing of this Annual Report and are not intended to give any assurance as to future results. We undertake no obligation to publicly update or revise any of these forward-looking statements, whether to reflect new information or future events or circumstances or otherwise.

v

---



**PART I**

**ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not applicable.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**ITEM 3. KEY INFORMATION**

**Selected Financial Data**

## Edgar Filing: SAPPI LTD - Form 20-F

The selected financial data set forth below has been derived from our Group annual financial statements and are qualified by reference to, and should be read in conjunction with, our Group annual financial statements and the notes thereto, which are included elsewhere in this Annual Report, and Item 5 Operating and Financial Review and Prospects .

We prepare our Group annual financial statements according to South African generally accepted accounting principles. There are significant differences between these principles and those applied in the United States. You can read about the principal differences in note 42 to our Group annual financial statements included elsewhere in this Annual Report.

	<b>Year Ended September</b>				
	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
	<b>(US\$ million, except per share and number of shares data)</b>				
<b>Consolidated Income Statement Data:</b>					
<b>South African GAAP:</b>					
Sales(1)	5,018	4,728	4,299	3,729	4,184
Operating (loss) profit(4)	(137 )	188	272	402	239
Net (loss) profit(5)	(213 )	95	143	217	132
Basic (loss) earnings per share (US cents)(5)	(94 )	42	62	94	57
Diluted (loss) earnings per share (US cents)(5)	(94 )	42	62	93	56
Dividends per share (US cents)(3)	30	30	29	28	26
<b>United States GAAP:</b>					
Sales(1)	5,018	4,728	4,299	3,729	4,184
Operating (loss) profit(2)(7)	(232 )	120	272	402	273
Extraordinary items(2)				6	5
Net (loss) profit(7)	(332 )	46	148	237	130
Basic (loss) earnings per share (US cents)(7)	(148 )	20	65	103	56
Diluted (loss) earnings per share (US cents)(7)	(148 )	20	64	102	56
Dividends per share (US cents)(3)	30	30	29	28	26
<b>Consolidated Balance Sheet Data:</b>					
<b>South African GAAP:</b>					
Total assets(5)	5,708	6,144	5,855	4,752	4,594
Operating assets(4)	5,269	5,576	5,192	4,468	4,046
Total long-term borrowings	1,600	1,693	1,742	1,455	1,012
Shareholders' equity(5)	1,881	2,157	1,983	1,622	1,537
<b>United States GAAP:</b>					
Total assets(7)	5,808	6,419	6,090	4,931	4,766
Operating assets(5)(7)	5,369	5,889	5,465	4,672	4,258
Total long-term borrowings(7)	1,643	1,904	1,869	1,559	1,111
Shareholders' equity(7)	1,579	1,979	1,908	1,581	1,561

**Other Information:**

**South African GAAP:**

EBITDA(6)	353	653	667	740	590
Weighted average number of ordinary shares in issue (in million)	225.8	226.3	229.1	230.2	232.8

**United States GAAP:**

EBITDA(6)(7)	239	570	656	745	618
Weighted average number of ordinary shares in issue (in million)	224.7	225.0	227.6	228.8	231.0

---

- (1) Sales are defined in note 2 to our Group annual financial statements included elsewhere in this Annual Report.
- (2) Certain items, which are included under Operating profit under SA GAAP, are included under Extraordinary items for US GAAP. For more information refer to note 42 to our Group annual financial statements included elsewhere in this Annual Report.
- (3) The dividends per share were, in each case, declared after the end of the year indicated. For further information on our dividend policy, see Item 8 Financial Information Dividend Policy .
- (4) Operating assets are defined in note 38 to our Group annual financial statements included elsewhere in this Annual Report.
- (5) Net (loss) profit, basic (loss) earnings per share, diluted (loss) earnings per share, total assets and shareholders equity has been restated under SA GAAP to take into account the requirements of AC 501 Accounting for Secondary Tax on Companies (STC) which became effective from the beginning of the current financial year. The effect on net (loss) profit is a decrease of US\$3 million, US\$4 million and US\$6 million for 2004, 2002 and 2001 respectively. The effect on basic (loss) earnings per share is a decrease of 1 US cents, 2 US cents and 2 US cents for 2004, 2002 and 2001 respectively. The effect on diluted (loss) earnings per share is a decrease of 1 US cents, 2 US cents and 3 US cents for 2004, 2002 and 2001 respectively. The effect on total assets and shareholders equity is an increase of US\$38 million, US\$38 million, US\$25 million and US\$40 million for 2004, 2003, 2002 and 2001 respectively.
- (6) In connection with the U.S. Securities Exchange Commission ( SEC ) rules relating to Conditions for Use of Non-GAAP Financial Measures , we have reconciled EBITDA to net profit rather than operating profit and recalculated EBITDA. As a result our definition has been amended to retain non-trading profit/loss and minority interest as part of EBITDA. EBITDA represents earnings before interest (net finance costs), tax, depreciation and amortisation (including fellingings). We use EBITDA as an internal measure of performance and believe it is a useful and commonly used measure of financial performance in addition to operating profit and other profitability measures under SA GAAP or US GAAP. EBITDA is not a measure of performance under SA GAAP or US GAAP. EBITDA should not be construed as an alternative to operating profit as an indicator of the company s operations in accordance with SA GAAP or US GAAP. EBITDA is also presented to assist our shareholders and the investment community in interpreting our financial results. This financial measure is regularly used as a means of comparison of companies in our industry by removing certain differences between companies such as depreciation methods, financing structures and taxation regimes. However, EBITDA is presented on a Group basis, and there are regulatory and contractual limitations on our businesses ability to transfer funds among each other. We may also incur tax costs with these transfers. As a result, EBITDA generated by one business may not be

available to make payments on borrowings by another business. Different companies and analysts may calculate EBITDA differently, so making comparisons among companies on this basis should be done very carefully. See the Group income statement to our Group annual financial statements included elsewhere in this Annual Report for an explanation of the computation of net finance costs.

(7) Operating (loss) profit, net (loss) profit, basic (loss) earnings per share, diluted (loss) earnings per share, total assets, operating assets, total long-term borrowings, shareholders' equity and EBITDA under US GAAP have been restated for certain changes identified under US GAAP. For more information on this restatement refer to Item 15 of this Annual Report and note 42 to our Group annual financial statements included elsewhere in this Annual Report.

The following table reconciles net (loss) profit to EBITDA.

	Year Ended September				
	2005	2004	2003	2002	2001
	(US\$ million)				
<b>South African GAAP:</b>					
<b>Net (loss) profit</b>	<b>(213 )</b>	<b>95</b>	<b>143</b>	<b>217</b>	<b>132</b>
Add back:					
Depreciation and amortisation (fellings)	490	465	395	338	351
Net finance costs	87	110	111	102	92
Taxation	(11 )	(17 )	18	83	15
<b>EBITDA</b>	<b>353</b>	<b>653</b>	<b>667</b>	<b>740</b>	<b>590</b>
<b>United States GAAP:</b>					
<b>Net (loss) profit</b>	<b>(332 )</b>	<b>46</b>	<b>148</b>	<b>237</b>	<b>130</b>
Add back:					
Depreciation and amortisation (fellings)	470	450	385	349	350
Net finance costs	55	93	90	74	92
Taxation	46	(19 )	33	85	46
<b>EBITDA</b>	<b>239</b>	<b>570</b>	<b>656</b>	<b>745</b>	<b>618</b>

## Risk Factors



## Edgar Filing: SAPPI LTD - Form 20-F

*In addition to other information contained in this Annual Report, you should carefully consider the following factors before deciding to invest in our ordinary shares and American Depositary Shares ( ADSs ). There may be additional risks that we do not currently know of or that we currently deem immaterial based on the information available to us. Our business, financial condition or results of operations could be materially adversely affected by any of these risks, resulting in a decline in the trading price of our ordinary shares and ADSs.*

### **Risks Related to Our Industry.**

*We operate in a highly cyclical industry, which has in the past resulted in substantial fluctuations in our results.*

## Edgar Filing: SAPPI LTD - Form 20-F

The markets for our pulp and paper products are significantly affected by changes in industry capacity and output levels and by cyclical changes in the world economy. As a result of periodic supply/demand imbalances in the pulp and paper industry, these markets historically have been highly cyclical, with volatile pulp and paper prices. The timing and magnitude of price increases or decreases in the pulp and paper market have generally varied by region and by type of pulp and paper.

The selling prices of the majority of the products manufactured and purchase prices of many of our raw materials used generally fluctuate in line with commodity cycles; however, as occurred in fiscal 2005, we may not be able to increase selling prices sufficiently or in time to offset the effects of increased costs,

3

---

which has an adverse impact on our profitability. Other than maintaining a high level of pulp integration, no hedging techniques related to our raw materials and products are applied. Movements in prices of pulp and paper products are difficult to predict. Also, there may be periods during which demand for our products is insufficient to enable us to operate our production facilities in an economical manner. A sustained period of weak demand or excess supply would be likely to adversely affect pulp and paper prices which could have a material adverse effect on our operating rates and financial results.

Despite a relatively high level of pulp integration on a Group-wide basis, a significant increase in the prices for pulp or pulpwood could adversely affect our non-integrated and partially integrated operations if they are unable to raise paper prices sufficiently to offset the effects of increased costs.

The majority of our fine paper sales consist of sales to merchants. The pricing of products for merchant sales can generally be changed upon between 30 to 90 days advance notice to the merchant. Sales to converters may be subject to longer notice periods for price changes. Such notice periods generally would not exceed 6 to 12 months. In southern Africa, we have entered into longer-term fixed-price agreements of between 6 to 12 months duration for primarily packaging paper and newsprint sales with domestic customers. Such agreements accounted for less than 5% of consolidated sales during fiscal 2005.

Most of our chemical cellulose (dissolving pulp) sales contracts are multi-year contracts. The pricing is generally based on a formula linked to the NBSK price and reset on a quarterly basis.

For further information, see Item 4 Information on the Company Business Overview The Pulp and Paper Industry .

*The markets for pulp and paper products are highly competitive, and many of our competitors have advantages that may adversely affect our ability to compete with them, particularly in North America.*

## Edgar Filing: SAPPI LTD - Form 20-F

We compete against a large number of pulp and paper producers located around the world. A recent trend towards consolidation in the pulp and paper industry has created larger, more focused pulp and paper companies. Some of these companies benefit from greater financial resources or operate mills that are lower cost producers of pulp and paper products than our mills. We cannot assure you that each of our mills will be competitive. Furthermore, we cannot assure you that we will be able to take advantage of consolidation opportunities which may arise, or that any failure to exploit opportunities for growth would not make us less competitive. Increased competition, including import duties decrease in accordance with the terms of free trade agreements, could cause us to lose market share, increase expenditures or reduce pricing, any of which could have a material adverse effect on the results of our operations. In addition, competition may result in our being unable to increase selling prices of our products sufficiently or in time to offset the effects of increased costs without losing market share, as occurred in Europe in fiscal 2005, which has an adverse impact on profitability.

Our North American business has experienced significant losses in recent years due to competition, and it may face additional competitive challenges to returning to profitability. There was a significant amount of coated fine paper capacity added in China in 2005. Some of this capacity may be exported to the US, depressing domestic operating rates and potentially also depressing prices. While we believe our North American business is competitive compared to our US competitors, the assets of our North American business are small in comparison to new world-scale coated fine paper machines. The cost position of our machines in relation to imports from both Asia and Europe may be less competitive due to a variety of factors including currency, fuel costs, shipping charges, duties and market pulp prices. A significant strengthening of the US dollar in comparison to the euro could attract a significant amount of imports from Europe.

4

---

***The cost of complying with environmental regulation may be significant to our business.***

Our operations are subject to a wide range of environmental requirements in the various jurisdictions in which we operate. We expect to continue to incur significant expenditures and may face operational constraints to maintain compliance with applicable environmental laws, to upgrade equipment at our mills and to meet new regulatory requirements, including those in the United States, South Africa and Europe. Expenditures to comply with future environmental laws and regulations could have a material adverse effect on our business and financial condition.

For further information, see Item 4 Information on the Company Business Overview Environmental and Safety Matters Environmental Matters and Item 5 Operating and Financial Review and Prospects Operating Results .

***The availability and cost of Insurance cover can vary considerably from year to year as a result of events beyond our control, and this can result in our paying higher premiums and periodically being unable to maintain the levels or types of insurance carried.***

## Edgar Filing: SAPPI LTD - Form 20-F

The events of September 11, 2001, and more recently the Asian Tsunami and hurricanes in the United States have resulted in substantial property damage losses seriously affecting the insurance industry, which has led to significant increases in premiums and self-insured deductibles over the last few years in some of the components of our insurance structure and may lead to future increases.

Although we have successfully placed the renewal of our 2006 insurance cover at rates lower than 2005 and self-insured deductibles for any one property damage occurrence have remained at \$25 million, with an unchanged aggregate limit of \$40 million, we are unable to predict whether past or future events will result in less favourable terms. For property damage and business interruption, there generally does not seem to be cost effective cover available to full value, however, the directors believe that the loss limit cover of \$1 billion should be adequate for what they have determined as the reasonably foreseeable loss for any single claim.

While we believe our insurance provides adequate coverage for reasonably foreseeable losses, we continue working on improved enterprise risk management to lower the risk of incurring losses from uncontrolled incidents. We are unable to assure you that actual losses will not exceed our coverage or that such excess will not be material.

*New technologies or changes in consumer preferences may affect our ability to compete successfully.*

## Edgar Filing: SAPPI LTD - Form 20-F

We believe that new technologies or novel processes may emerge and that existing technologies may be further developed in the fields in which we operate. These technologies or processes could have an impact on production methods or on product quality in these fields. Unexpected rapid changes in employed technologies or the development of novel processes that affect our operations and product range could render the technologies we utilise or the products we produce obsolete or less competitive in the future. Difficulties in assessing new technologies may impede us from implementing them and competitive pressures may force us to implement these new technologies at a substantial cost. Any such development could materially and adversely impact our revenues or net profits or both.

Consumer preferences may change as a result of the availability of alternative products or of services such as electronic media or the internet, which could impact consumption of our products.

5

---



## **Risks Related to Our Business**

### *Our indebtedness may impair our financial and operating flexibility.*

Our ratio of total interest-bearing borrowings to shareholders' equity has improved significantly in recent years, from 142% at September 1999, to 99% at September 2005. At September 2005, our total interest-bearing borrowings were \$1,870 million. While reduction of borrowings is a priority, opportunities to grow within our businesses will continue to be evaluated, and the financing of any future acquisition may include the incurrence of additional indebtedness.

We are subject to South African exchange controls, which partially inhibit the free flow of funds from South Africa and can restrict activities of subsidiaries of the Sappi Group. These exchange controls have affected the geographic distribution of our debt. As a result, acquisitions in the United States and Europe were financed with indebtedness incurred by companies in those regions. The level of our debt has important consequences. For example, our ability to obtain additional financing may be limited, which could limit, among other things, our ability to exploit growth opportunities; a substantial portion of our cash flow from operations may be required to make debt service payments; we are exposed to increases in interest rates because a portion of our debt bears interest at variable rates; we may be more leveraged than certain of our competitors; we may be more vulnerable to economic downturns and adverse changes in our business; and our ability to withstand competitive pressure may be more limited.

In addition, certain of our financing arrangements contain covenants and conditions that restrict the activities of certain Group companies.

Exchange control restrictions may restrict the transfer of funds directly or indirectly between our subsidiaries or between the parent company and our subsidiaries. We may also incur significant tax costs in connection with these transfers of funds. As a consequence, the ability of Sappi Limited or any of our subsidiaries to make scheduled payments on its debt will depend on its financial and operating performance, which will depend on various factors beyond our control, such as prevailing economic and competitive conditions. If Sappi Limited or any of our subsidiaries is unable to achieve operating results or otherwise obtain access to funds sufficient to enable it to meet its debt service obligations, it could face substantial liquidity problems. As a result, it might need to delay investments or dispose of material assets or operations. The timing of and the proceeds to be realised from any such disposition would depend upon circumstances at the time.

### *Labour agreements are under negotiation at several of our mills.*

The Westbrook, Somerset and Muskegon Mills United Steelworkers union contracts that expired in May 2002, June 2003 and August 2005 respectively are under negotiation, and the Cloquet USW contract expires in April 2006. Collective labour agreements have been renegotiated for all sites in Europe during the fiscal 2004, with minor disruption to operations at only one site. At our southern African mills wage negotiations occur annually and in 2005 negotiations were conducted without any industrial action, despite several industry wide wage related strikes. While we hope to reach agreements on new contracts at all affected sites, in the event that agreements cannot be reached and a prolonged work stoppage that results in a curtailment of output ensues at any or all such sites, our business could be adversely affected.

***Fluctuations in the value of currencies, particularly the Rand and the euro, in relation to the US dollar have in the past had and could in the future have a significant impact on our earnings in these currencies.***

Exchange rates fluctuations have in the past, and may in the future, affect the competitiveness of our products in relation to the products of pulp and paper companies based in other countries.

Fluctuations in the exchange rate between currencies, particularly the Rand and euro, in relation to the US dollar have in the past significantly affected and could in the future significantly affect our earnings.

Since the adoption of the euro by the European Union on January 1, 1999 (when the euro was trading at approximately \$1.18 per euro), it has fluctuated against the US dollar to approximately \$1.20, \$1.23 and \$1.15 per euro at the end of fiscal 2005, 2004 and 2003, respectively. It reached a low of approximately \$0.83 per euro on October 25, 2000 and, on December 7, 2005, was trading at approximately \$1.17 per euro.

In recent years, the value of the Rand against the US dollar has fluctuated considerably. It has moved against the US dollar to approximately R6.37, R6.43 and R7.13 per US dollar at the end of fiscal 2005, 2004 and 2003, respectively. The Rand reached a low of approximately R13.90 per US dollar on December 21, 2001. Since then, it has appreciated and on December 7, 2005 was trading at approximately R6.30 per US dollar.

For further information, see notes 21 and 37 to our Group annual financial statements included elsewhere in this Annual Report and Item 5 Operating and Financial Review and Prospects Operating Results Foreign Exchange, Inflation and Interest Rates .

***There are risks relating to South Africa that could affect your investment in our Company.***

We are incorporated in South Africa and own operations in southern Africa. As a result, there are risks relating to South Africa, that could affect an investment in our Company. These risks arise from the fact that we are subject to various economic, fiscal, monetary, regulatory, operational and political policies and factors that affect South African companies and their subsidiaries generally. See Item 5 Operating and Financial Review and Prospects South African Economic and Political Environment and Item 5 Operating and Financial Review and Prospects South African Exchange Controls . While certain of these risks, for example regulatory and operational risks, are limited by the fact that in fiscal 2005, 26% of our sales emanated from southern Africa, 45% from Europe and 29% from North America, and 36% of our operating assets were located in southern Africa, 37% in Europe and 27% in North America, in fiscal year 2005 our operations outside southern Africa had an operating loss of \$194 million and our operations in southern Africa had an operating profit of \$57 million.

***We face certain risks in dealing with HIV/AIDS which may have an adverse effect on our southern African operations.***

There is a serious problem with HIV/AIDS infection among our southern African workforce, as there is in southern Africa generally. Although the HIV/AIDS infection rate of our southern African workforce is significantly lower than the national average, it is expected to increase over the next decade. While we have several programmes designed to mitigate the impact of the disease on our business, the costs and lost worker s time associated with HIV/AIDS may adversely affect our southern African operations.

***Several customers account for a significant amount of our revenues.***

We sell a significant portion of our products to several major customers, including PaperlinX Ltd which acquired Buhrmann Paper Merchant Division in November 2003, Unisource Worldwide Inc. and International Paper Company. Any adverse development affecting our principal customers or our relationships with our principal customers could have an adverse effect on our business and results of

operations. See [Item 4 Business Review Marketing and Distribution Sappi Fine Paper Customers](#) and [Item 4 Business Review Marketing and Distribution Sappi Forest Products Customers](#) .

***Because of the nature of our business and workforce, we are facing challenges in the retention and succession planning of management that could adversely affect our business.***

We are facing an aging demographic work profile among our management due to the mature nature of our industry and the rural and often remote location of our mills, together with generally long tenure of employees at the mills. As a result we are likely to experience groups of employees leaving the company within a relatively short space of time of one another and may have difficulty attracting qualified replacements. The potential risks we face are a loss of institutional memory, skills, experience and management capabilities. Although we have put in place a number of initiatives to mitigate this risk, including implementing programs to promote phased retirement and transfer of knowledge, creating flexibility in career and job design and focussing greater effort on succession planning and talent review and effective skills training and leadership development we may be unable to attract and retain sufficient qualified replacements when and where necessary to avoid an adverse impact on our business.

#### **Risks Related to Our Shares**

***Your ability to sell a substantial number of ordinary shares may be restricted by the limited liquidity of shares traded on the JSE Limited.***

The principal trading market for the ordinary shares of Sappi Limited is the JSE Limited ( [JSE](#) ) (formerly the JSE Securities Exchange South Africa). Historically, trading volumes and liquidity of shares listed on the JSE have been low in comparison with other major international markets. In fiscal 2005, 264 million ordinary shares of Sappi Limited were traded on the JSE and 83 million ADSs were traded on the New York Stock Exchange. See [Significant shareholders may be able to influence the affairs of our Company](#) , [Item 7 Major Shareholders and Related Party Transactions Major Shareholders](#) , [Item 9 The Offer and Listing Offer and Listing Details](#) and [Item 9 The Offer and Listing Markets](#) .

***Significant shareholders may be able to influence the affairs of our Company.***

Although our investigation of beneficial ownership of our shares identified only four beneficial owners of more than 5% of our ordinary shares, holding approximately 25.1%, as shown in our shareholders register at September 30, 2005, the five largest shareholders of record, four of which are nominees that hold shares for a multitude of beneficial owners, owned approximately 94.7% of our ordinary shares. See [Item 7 Major Shareholders and Related Party Transactions Major Shareholders](#) .

#### ITEM 4. INFORMATION ON THE COMPANY

##### HISTORY AND DEVELOPMENT OF THE COMPANY

Sappi Limited is a public company incorporated in the Republic of South Africa. Its principal executive offices are located at 48 Ameshoff Street, Braamfontein, Johannesburg 2001, Republic of South Africa and its telephone number is +27-11-407-8111.

Sappi Limited was founded and incorporated in 1936 in South Africa and is a corporation organised under the Companies Act 61 of 1973 of the Republic of South Africa.

Until 1990, we primarily expanded our operations within southern Africa. Since 1990, we have grown through acquisitions outside of southern Africa. In December 1994, Sappi and a group of financial investors acquired S.D. Warren Company, the market leader in the United States in coated fine paper and a major producer of other speciality paper products. It now conducts business as Sappi Fine Paper North America. In December 1997, we acquired a 91.5% ownership interest in KNP Leykam, the leading European producer of coated fine paper. KNP Leykam now conducts business as Sappi Fine Paper Europe. On May 13, 2002, we acquired Potlatch Corporation's coated fine paper business and have integrated it in Sappi Fine Paper North America.

In December 2004 we acquired 34% of Jiangxi Chenming Paper Company, a joint venture which commissioned in mid-2005 a coated mechanical paper machine, mechanical pulp mill and deinked pulp mill in China.

For information on our principal investments and capital expenditures, see the description of our business in [Business Overview](#) and [Item 5 Operating and Financial Review and Prospects Liquidity and Capital Resources](#).

We currently have our primary listing on the JSE and have secondary listings on the New York and London Stock Exchanges.

##### BUSINESS OVERVIEW

###### Business Strategy

Our objective for the coming years is to build on our position as the global leader in the coated fine paper market, which was from the beginning of the 1990's one of the fastest growing market sectors in the paper industry, and to explore opportunities across the broad spectrum of coated paper to utilise our experience in paper coating as well as the chemical cellulose (dissolving pulp) market and to support this with a high level of economic pulp integration. These represent our core products and sectors in the paper and forest products industry. We will continue to invest in our southern African businesses which have important market shares. The key elements of our business strategy are and have been as follows:

*Strengthen our leadership position in our core businesses through organic growth and selective acquisitions.*

We believe that opportunities for further consolidation remain in our sector. We intend to be at the forefront of this consolidation, aiming to strengthen our position in Europe, North America, and eventually Asia. We intend to focus on investment and acquisition opportunities that fit our strategies, that offer a potential return that exceeds our expected cost of capital and that in the medium term are more advantageous than buying back our shares.

***Maintain a global presence.***

One of Sappi's key strengths is our geographically diverse business base. We have a significant presence in each of Europe, North America and Africa, and a modest presence in Asia. The presence in Europe and North America has been built up over the past ten years, largely through strategic acquisitions. We will continue to pursue a strategy of geographic diversification supported by leading market positions.

***Maintain a high level of economic pulp integration.***

We intend to maintain a high level of economic pulp integration, which helps reduce the impact of pulp price volatility on our earnings.

***Maintain cost efficient asset base and invest to increase efficiency/productivity.***

We believe our asset base has some of the lowest cost and most efficient assets in the coated fine paper sector in the world. We maintain a rigorous focus on costs, and actively manage our asset base, including divesting or closing non-performing assets. We have closed 13 paper machines since 1995, including the recent closure of the Number 4 paper machine at Muskegon Mill.

We maintain an investment policy that is focused on high return projects. A significant portion of our investments are designed to increase production capacity, reduce costs and improve product quality.

***Drive growth through market focus and innovation.***

The Sappi Group operations represent the originators of many of the major innovations in the industry in the last century. We continue to maintain a focus on innovation through our research and development centres in Europe, North America and South Africa and have established multi-regional, multi-discipline teams to ensure that we transfer knowledge throughout the Group and implement best practice and that our research and development efforts are market oriented. We intend to allocate additional resources to marketing, innovation and technology. This includes the recent creation of multi-regional marketing teams and their links with the relevant technology teams.

Through our partnership with a leading global software provider, we are focused on developing unique information technology solutions that satisfy our customers' requirements and production capabilities, resulting in improved service delivery and operational efficiency.

**The Pulp and Paper Industry**

The paper industry is generally divided into the printing and writing paper segment, consisting of newsprint, groundwood paper and fine paper, and the packaging segment, consisting of containerboard, boxboard and sackkraft.

Long-term, paper and board consumption has grown in line with overall economic growth, but consumption patterns are also influenced by short-term economic developments. Pricing largely is influenced by the supply/demand balance for individual products, which is partially dependent on capacity and inventory levels in the industry. The ability to adapt capacity changes in response to shorter-term fluctuations in demand is limited, as large amounts of capital are required for the construction or upgrade of production facilities and as lead times are long between the planning and completion of new facilities. Industry-wide over-investment in new production capacity has in the past led to situations of significant oversupply, which has caused product prices to decrease. This has been exacerbated by inventory speculation, as purchasers have sought to benefit from the price trend. As a result, financial performance has deteriorated during periods of significant oversupply to again improve when demand has increased to levels that support the implementation of price increases.

In recent years the industry has experienced significant strategic changes. The high costs associated with building new paper mills and establishing and growing market share has led to companies focusing on acquisition, rather than construction, of new capacity. This development has led to a reduction in events of significant dislocations in the supply/demand balance typically associated with the entry of new production capacity into established markets. Another result of this trend has been a greater concentration of production capacity among fewer producers. Many leading industry producers now focus on fewer core grades and have divested non-core assets that are not part of the industry or which have been considered not consistent with long-term strategies. The regional and global market shares of leading producers have increased significantly over the past decade.

The following table shows a breakdown and description of the major product categories Sappi participates in the products in these categories and the typical uses for such products. We have produced and sold each of these products in each of our last three fiscal years.

Major Product Categories	Description and Typical Uses
<b><i>Fine Paper:</i></b>	
Coated paper	Higher level of smoothness than uncoated paper achieved by applying a coating (typically clay based) on the surface of the paper. As a result, higher reprographic quality and printability is achieved. Uses include brochures, catalogues, corporate communications materials, direct mail promotions, educational textbooks, luxury advertising, magazine covers and upscale magazines.
Uncoated paper	Uses include business forms, business stationery, general printing paper, tissue and photocopy paper.
Speciality paper	Can be either coated or uncoated. Uses include bags, labels, packaging and release paper for casting textured finishes (e.g., artificial leather).
<b><i>Packaging products:</i></b>	
Packaging paper	Heavy and lightweight grades of paper and board primarily used for primary and secondary packaging of fast moving consumer goods, agricultural and industrial products. Products include containerboard (corrugated shipping containers), sack kraft (multi-walled shipping sacks) and machine glazed kraft (grocers bags). Can be coated to enhance barrier and aesthetics properties.
<b><i>Groundwood products:</i></b>	
Newsprint	Manufactured from groundwood and bleached chemical pulp. Uses include advertising inserts and newspapers. Demand is highly dependent on newspaper circulation and retail advertising.
Coated groundwood paper	A coated groundwood fibre based paper, primarily used for magazines, catalogues and advertising material. Manufactured from mechanical pulp.
<b><i>Pulp:</i></b>	
Paper pulp	Main raw material used in production of printing, writing and packaging paper. Pulp is the generic term that describes the cellulose fibre derived from wood. These cellulose fibres may be separated by mechanical, thermo-mechanical or chemical processes. The chemical processes involve removing the glues (lignins) which bind the wood fibres to leave cellulose fibres. Paper made from chemical pulp is generally termed woodfree. Uses include paper, paperboard and tissue.

Chemical cellulose (dissolving pulp) Manufactured by similar processes to paper pulp, but purified further to leave virtually pure cellulose fibres. Chemical cellulose is used in the manufacture of a variety of cellulose textile and non-woven fibre products, including viscose staple fibre (rayon), solvent spun fibre (lyocell) and filament. It is also used in various other cellulose-based applications in the food, cigarette, chemical and pharmaceutical industries. These include the manufacture of acetate tow microcrystalline cellulose, cellophane, ethers and moulding powders. The various grades of chemical cellulose are manufactured in accordance with the specific requirements of customers in different market segments. The purity of the chemical cellulose is one of the key determinants of its suitability for particular applications with the purer grades of chemical cellulose generally supplied into the speciality segments.

**Timber products:** Sawn timber for construction and furniture manufacturing purposes.

The following table sets forth selected pulp and paper prices in certain markets for the periods presented.

	Year Ended September		2004		2003	
	2005 Low	High	Low	High	Low	High
<b>Coated Fine Paper</b>						
100 gsm delivered Germany (euro per metric tonne) <sup>(1)</sup>	845	845	820	855	845	906
60 lb. delivered US (US\$ per short tonne) <sup>(2)</sup>	870	920	735	840	740	755
<b>Uncoated Fine Paper</b>						
50 lb. delivered US (US\$ per short tonne) <sup>(3)</sup>	700	770	575	750	590	730
<b>Paper Pulp</b>						
NBSK (US\$ per metric tonne) <sup>(4)</sup>	585	655	540	660	420	560
<b>Chemical cellulose</b>						
92 alpha (US\$ per metric tonne) <sup>(5)</sup>	600	780	600	780	500	630

- (1) 100 gsm sheets, Pulp & Paper International (PPI).  
(2) 60 lb. Coated Web, PPI.  
(3) 50 lb. Offset, PPI.  
(4) Northern Bleached Softwood Kraft Pulp CIF Northern Europe, PPI.  
(5) Selected indicative prices, Sappi.

#### **Fine Papers**

Our fine paper activities are divided into coated and uncoated fine paper and speciality paper grades. Our coated fine paper market share in the United States, Europe and southern Africa is approximately 24%, 20% and 60%, respectively, making us the largest producer of coated fine paper in the world.

*Coated Fine Paper.* Coated fine paper has been one of the fastest growing market sectors in the paper industry through the 1980s and 1990s. Major end uses include high-end magazines, catalogues, brochures, annual reports and commercial printing. Coated fine paper is made from chemical pulp and is coated on one or both sides for use where high reprographic quality is required. The majority of coated fine paper production is coated on two sides, permitting quality printing on both sides of the paper. Paper





that is coated on one side is used in special applications such as consumer product and mailing label applications.

Our 2005 North American coated fine paper sales volume was 31% in sheet form and 69% in reel form. The sheet volume is largely influenced by brochure and general commercial printing activities and printers using mainly sheetfed offset lithographic printing processes, which are not particularly seasonal, and corporate annual reports, which result in heaviest demand during the first calendar quarter. Reels volume is heavily influenced by catalogue and text book activity, which results in heaviest demand during the third calendar quarter, and publication printer activity, which is not particularly seasonal. These printers principally use heatset web offset printing processes.

Our 2005 European business sales volumes of coated fine paper were 74% in sheet form and 26% in reels form. Due to the diversity in languages in the European market, the print editions of brochure and general commercial printing activities are considerably smaller than in the US market. This translates into a significantly higher volume in sheets. The seasonal patterns of both sheets and reels are mostly influenced by the catalogue business. This segment has its highest seasonal activity in the spring, when the fashion catalogues come out, and the autumn, when the Christmas catalogues and holiday brochures are printed. Commercial print and publishing business provide a more steady demand in this market.

See Item 5 Operating and Financial Review and Prospects Markets .

*Uncoated Paper.* Uncoated fine paper represents the largest industry fine paper grade in terms of both global capacity and consumption. Uncoated fine paper is used for bond/writing and offset printing papers, photocopy papers, writing tablets (e.g., legal pads), speciality lightweight printing paper (e.g., bibles) and thin paper.

The market for uncoated paper products generally follows cyclical trends, which do not necessarily coincide with cycles for coated paper but are impacted by capacity changes in uncoated fine paper output levels.

*Speciality Paper.* The high value-added speciality paper markets in which Sappi Fine Paper operates generally follow trends in the respective end use sectors in addition to changes in production capacity, output levels and cyclical changes in the world economy. Largely due to the highly specialised nature of speciality paper, price fluctuations have historically tended to lag and be less precipitous than price changes in the uncoated fine paper market.

#### ***Packaging Products***

Our range of forest products comprises a variety of packaging papers produced in southern Africa at the Tugela, Cape Kraft and Ngodwana mills. We are one of the two major suppliers of packaging papers in South Africa.

*Packaging Paper.* As with fine paper, the market for packaging papers is affected by cyclical changes in the world economy, local economic growth, retail sales and by changes in production capacity and output levels. The southern African containerboard market has been positively affected by gross domestic product growth and corresponding growth in retail sales. Demand for sack kraft is largely driven by the demand for cement, potatoes, sugar and milling products. Sappi's market share was negatively affected by lower priced imported products and production constraints in 2005.

Over the past decade, kraft linerboard prices have ranged from \$325 to \$685 per metric tonne (CIF) in Northern Europe. As of October 2005, kraft linerboard prices were approximately \$448 per metric tonne in Northern Europe. In the southern Africa domestic market, we have entered into medium-term contractual commitments with converters of boxes, sacks and bags. These commitments include certain volume targets and, in some cases, as is customary in the market, fixed prices for periods of 12 months.

### *Groundwood Products*

*Newsprint.* The Ngodwana mill produces newsprint. The worldwide market for newsprint is a low growth sector in the paper industry and was adversely affected during the early 1990s by substantial increased capacity and stagnating demand from, and cost-cutting measures imposed by, major newsprint end-users. Over the past decade, the price of newsprint has ranged from a low of \$420 per metric tonne in the second quarter of 1992 to a high of \$750 per metric tonne in the fourth quarter of 1995 and the first quarter of 1996. In recent years, a significant increase in industry consolidation has stabilised the newsprint market and reduced segment over-capacity. As a result of the slowing economy, newsprint prices started to decline in the middle of 2001 from a peak of \$625 in April 2001, to a low of \$445 in July 2002. As of October 2005, the price of newsprint (delivered East Coast USA) had increased to approximately \$630 per metric tonne.

*Coated Groundwood.* Coated groundwood paper, primarily used for magazines, catalogues and advertising materials, has been one of the fastest growing paper grades in the paper industry in recent years. The segment is also one of the most consolidated segments of the paper industry. Demand for coated magazine paper is influenced by magazine circulation and demand for advertising, and by the price difference relative to coated fine paper and to uncoated groundwood paper as substitution between these grades is possible, depending on quality requirements and price levels. Western European producers are the leading producers of coated groundwood globally. Rapid capacity expansion by leading producers in the early 1990s led to volatile pricing and the development of a significant export business from Europe, primarily to North America and Asia. Pricing development has been more stable in the past three years, but prices have declined recently due to weaker demand and the start-up of new capacity in the industry.

### *Pulp*

We produce chemical cellulose, as well as a wide range of paper pulp grades, including groundwood pulp used in newsprint, unbleached kraft pulp, bleached kraft pulp and bleached sulphite pulp.

*Paper Pulp.* The market pulp industry is highly competitive and is sensitive to changes in industry capacity, producer inventories, demand for paper and cyclical changes in the world economy. The market price per metric tonne of northern bleached softwood kraft (NBSK) pulp, a pulp principally used for the manufacture of fine paper, is a benchmark widely used in the industry for comparative purposes. Over the past decade, the price of NBSK has ranged from \$395 per metric tonne in November 1993 to \$925 per metric tonne in September 1995, only to decline to \$450 per metric tonne by March 1996.

NBSK market pulp prices, which increased steadily through the second half of fiscal 1997, were adversely affected during fiscal 1998 by declining pulp demand resulting from the Asian economic crisis. Pulp prices at the end of 1998 were 22% lower than at the beginning of the year. During the first quarter of 1999, pulp prices remained relatively stable at \$460 per metric tonne, the lowest level since 1993. Since the end of March 1999, pulp prices increased significantly based on improved demand and limited net capacity growth. At the start of the third quarter of 2000, the NBSK market pulp price in Europe reached \$710 per metric tonne. In line with the global economy, pulp demand has been low throughout 2002 and 2003 and price fluctuations have been driven primarily by supply management and the consequent impact on inventories. Accordingly, pulp prices fluctuated considerably with a difference of \$125 per metric tonne between the high and low of the NBSK price during fiscal 2003. The NBSK price fluctuated between \$540 and \$660 in fiscal 2004 compared to \$435 and \$560 in fiscal 2003. Indications are that the pulp market is improving as a result of production discipline and declining market pulp inventories with the NBSK price edging up to \$601 per metric tonne in November 2005.

Market unbleached kraft pulp (UKP) is used in the production of packaging papers, including kraft linerboard and sack kraft and for certain niche products such as oil and air filters. The market price of UKP generally follows the price trends of other paper pulp grades.



*Chemical cellulose (dissolving pulp).* The viscose staple fibre (VSF) industry which manufactures textile and non-woven fibres is the largest market segment for chemical cellulose. Prices of VSF grade chemical cellulose generally follow those of the European NBSK. Over the past decade, the price of VSF grade chemical cellulose has ranged from a high of over \$1,000 per metric tonne in the fourth quarter of 1995, to a low of \$470 per metric tonne in the second quarter of 2002. During the past year, prices of VSF grade chemical cellulose continued to trend upwards from this 2002 low, reaching a high of \$788 per metric tonne in the quarter ended June 2005 but they have subsequently begun to retreat from that level. Prices of the higher purity chemical cellulose used in applications other than for VSF products tend to be more stable and are largely unrelated to the price of NBSK. The manufacture of cellulose acetate flake (used in the manufacture of acetate tow for cigarette filter tips) is the second largest application for chemical cellulose after viscose staple fibre. The market price for chemical cellulose used for cellulose acetate flake production has increased to levels above \$900 per metric tonne and is set by competitive forces within this specific market.

#### **Timber Products**

Our timber products operations are concentrated in South Africa and consist of sawn timber for the building industry and components for the furniture and packaging industry.

#### **Business Review**

We are the world's largest producer of coated fine paper, with a market share of approximately 24% in the United States, 20% in Europe and greater than 60% in southern Africa. In addition, we are the world's largest producer of chemical cellulose, with a market share of approximately 15%.

We are a geographically diverse global paper company with significant manufacturing operations on three continents and sales in over 100 countries. During fiscal 2005, we had sales of \$5,018 million, operating loss of \$137 million and net loss of \$213 million. We currently have a paper production capacity of approximately 5.1 million metric tonnes per annum, chemical cellulose production capacity of 600,000 metric tonnes per annum and paper pulp production capacity of 3.4 million metric tonnes per annum.

Our operations are currently structured around two business units (segments):

- Sappi Fine Paper, which has fine paper and related paper pulp businesses in North America, Europe and South Africa. Pursuant to the reorganisation of our North American and European fine paper shareholding, our fine paper interests are now held by Sappi Papier Holding GmbH in Austria; and
- Sappi Forest Products, which produces commodity paper products (newsprint and packaging papers), pulp (including chemical cellulose and hardwood and softwood pulp) and forest and timber products (including pulpwood, sawlogs and sawn timber) for southern Africa and export markets. Sappi Forest Products is based in Johannesburg, South Africa.

We also operate a trading network for the international marketing and distribution of our products outside our core operating regions of North America, Europe and southern Africa. Our trading operation, which we refer to as Sappi Trading, co-ordinates our shipping and other logistical functions for exports from southern Africa, Europe and North America through subsidiaries in South Africa, Europe and in the United States, respectively. All sales and costs associated with Sappi Trading are allocated to the two business units.

The markets for our pulp and paper products are significantly affected by changes in industry capacity and output levels and by cyclical changes in the world economy. For further information, see [Information on the Company Business Overview The Pulp and Paper Industry](#) and [Item 5 Operating and Financial Review and Prospects Operating Results](#).

## Edgar Filing: SAPPI LTD - Form 20-F

The chart set forth below represents the operational rather than the legal or ownership structure of Sappi as of November 2005. Units shown are not necessarily legal entities.

The following table sets forth certain information with respect to our operations for, or as at the end of, the year ended September 2005.

	<b>Sappi Fine Paper</b>			<b>Sappi</b>	<b>Corporate</b>	
	<b>North</b>	<b>Europe</b>	<b>South</b>	<b>Forest</b>	<b>And</b>	
	<b>America</b>		<b>Africa</b>	<b>Products</b>	<b>Other</b>	<b>Total</b>
	(US\$ million, metric tonnes in thousands)					
Sales volume (metric tonnes)	1,433	2,427	317	3,302		7,479
Sales	1,458	2,239	323	998		5,018
Operating profit	(270 )	76	(12 )	73	(4 )	(137 )
Operating assets(1)	1,426	1,963	215	1,558	107	5,269

(1) Operating assets as defined in note 38 to our Group annual financial statements included elsewhere in this Annual Report.

## **SAPPI FINE PAPER**

### **Overview**

Sappi Fine Paper is the largest business sector of Sappi and contributed over 80% of our sales in fiscal 2005. It has the capacity to produce 4.2 million metric tonnes of paper per annum at its 15 paper and related paper pulp mills located on three continents. Sappi Fine Paper manages its business in three principal regions: Sappi Fine Paper North America, Sappi Fine Paper Europe and Sappi Fine Paper South Africa. Sappi Fine Paper also manages the Nash mill in the United Kingdom, which operates as a separate business.

The following chart sets forth certain information with respect to the mills and principal products of Sappi Fine Paper as of November 2005.



## Edgar Filing: SAPPI LTD - Form 20-F

The following table sets forth approximate annual production capacity with respect to Sappi Fine Paper's products.

	Annual Production Capacity			Total
	North America(1)	Europe(2)	South Africa	
Production capacity (000s metric tonnes):				
Fine paper				
Coated(3)	1,190	2,585	80	3,960
Uncoated(4)		70	270	340
Total	1,190	2,655	350	4,195
Paper pulp	900	670	160	1,730
Percentage paper pulp integration(5)	102 %	44 %	62 %(6)	65 %

- (1) Excludes the Number 4 paper machine and the mothballed pulp mill at Muskegon.
- (2) Includes the Nash mill under uncoated.
- (3) Includes coated fine paper, coated groundwood paper and speciality papers.
- (4) Includes 30,000 metric tonnes of tissue manufactured at the Stanger mill in South Africa and 14,000 metric tonnes of kraft manufactured at the Enstra and Adamas mills in South Africa.
- (5) Includes pulp used internally and pulp sold.
- (6) Sappi Forest Products provides most of the additional pulp requirements of our South African fine paper operations.

### Facilities and Operations

#### *Sappi Fine Paper North America*

Sappi Fine Paper North America is a leading producer and supplier of coated fine paper in the United States with a market share of approximately 24%. Sappi Fine Paper North America also produces a variety of other fine paper, including coated speciality paper.

Sappi Fine Paper North America is headquartered in Boston, Massachusetts, and operates four paper mills in the United States in Somerset, Maine; Muskegon, Michigan; Westbrook, Maine; and Cloquet, Minnesota. These four mills have a total annual production capacity of approximately 1.2 million metric tonnes of paper and a capacity of approximately 0.9 million metric tonnes of paper pulp, which represents approximately 102% of Sappi Fine Paper North American pulp requirements. This significantly reduces Sappi Fine Paper North America's exposure to fluctuations in the price of market pulp that are not driven by fluctuations in wood or other major raw material prices. In July 2005, we announced the closure of the Number 4 paper machine and the mothballing of the pulp mill at Muskegon, which had an annual production capacity of 105,000 metric tonnes of paper and 110,000 metric tonnes of pulp, respectively.

Coated paper accounted for approximately 79% of Sappi Fine Paper North America's sales in fiscal 2005. Speciality paper and pulp accounted for the remaining 21%.



Edgar Filing: SAPPI LTD - Form 20-F

The following table sets forth sales by product for our North American operations, including contribution from the closed Muskegon assets.

	Year Ended September		
	2005	2004	2003
Sales (US\$ million):(1)			
Coated fine paper	1,148	1,068	1,061
Speciality paper and other(2)	310	305	323
Total	1,458	1,373	1,384

- (1) Includes sales for the Number 4 paper machine at Muskegon mill.
- (2) Other consists primarily of market pulp.

For the year ended September 2005, Sappi Fine Paper North America sold approximately 1,433,000 metric tonnes of paper and pulp products. The following table sets forth, as of September 2005, the production capacity, number of paper machines, products, pulp integration and capital expenditures at each of our continuing mills in North America.

Production capacity (000s metric tonnes)	Mill Locations			
	Somerset	Muskegon	Westbrook	Cloquet
Paper	760	170	30	260
Market pulp	70			280
Number of paper machines	3	1	1	2
Products:				
Paper	Coated Fine Paper	Coated Fine Paper	Casting release paper	Coated fine paper
Market pulp	Bleached kraft pulp			Bleached kraft pulp
Percentage pulp integration(1)	87 %	None	None	231 %
Capital expenditures (October 2002-September 2005) (US\$ million)	67	29	16	67

- (1) Includes pulp sold to third parties.

*Cloquet.* The Cloquet mill has two paper machines and an offline coater, producing premium coated paper. The newest machine and coater were installed in 1988 and 1989, respectively. The pulp mill started up by the previous owner in 2000 at a total cost of \$525 million and is the newest pulp mill in the United States. The Cloquet paper machines have an annual production capacity of 260,000 metric tonnes of coated paper, and the state-of-the-art pulp mill has an annual production capacity of 410,000 metric tonnes.

*Somerset.* The Somerset mill is a low-cost producer and has an annual production capacity of approximately 760,000 metric tonnes of paper and approximately 490,000 metric tonnes of pulp. The pulp mill was built in 1976, and Somerset became an integrated facility with the completion of Paper Machine 1 (PM1) in 1982. Each of the three paper machines at the Somerset facility employs Sappi Fine Paper North America's patented on-line coating and finishing technology. This technology combines the three steps (paper making, coating and finishing) in the manufacture of coated paper into one continuous process. It is well suited for the lightweight coated papers produced at Somerset, because it allows the production of high gloss, consistent quality products at high speeds.

*Muskegon.* The Muskegon mill consists of one continuing paper machine with an annual winder capacity of approximately 170,000 metric tonnes of text and cover weight coated paper using Sappi Fine Paper North America's on-line finishing technology. On July 28, 2005, we announced the closure of the Number 4 paper machine and the mothballing of the pulp mill at Muskegon, which had an annual production capacity of 105,000 metric tonnes of paper and 110,000 metric tons of pulp, respectively.

*Westbrook.* Westbrook is Sappi Fine Paper North America's original mill, with origins dating back to 1854. After the closure of one of its paper machines, the mill is primarily a speciality paper production facility with an annual capacity of 30,000 metric tonnes of coated fine and casting release paper. Its paper machine primarily produces base paper, which is coated off-line. Westbrook also has six speciality coaters, including four employing Sappi Fine Paper North America's patented Ultracast® process. This process uses an electron beam to cure coating against a finely engraved steel roll, resulting in a virtually exact replication of the roll pattern. Sappi Fine Paper North America also has a research and development facility at Westbrook.

Sappi Fine Paper North America also operates a coated paper sheeting and distribution facility in Allentown, Pennsylvania, which was completed in 1994 and has an annual sheeting capacity of approximately 100,000 metric tonnes. The Allentown facility produces sheet paper primarily for the Cloquet mill.

***Sappi Fine Paper Europe***

Sappi Fine Paper is a leading producer of coated fine paper in Europe with a market share of approximately 20% and a producer of commercial printing paper, coated groundwood paper and speciality paper used in packaging, labelling and laminating and a branded range of uncoated printing and business paper. Sappi Fine Paper Europe's operations consist of seven mills with an aggregate annual production capacity of approximately 2.7 million metric tonnes of paper and 670,000 metric tonnes of related paper pulp. Sappi Fine Paper Europe's headquarters are located in Brussels, Belgium.

The following table sets forth sales by product for our Sappi Fine Paper Europe operations, including contribution from the Nash mill.

	Year Ended September		
	2005	2004	2003
Sales (US\$ million): <sup>(1)</sup>			
Coated fine paper <sup>(2)</sup>	1,934	1,869	1,663
Uncoated fine paper	35	33	33
Speciality coated paper and other	270	225	207
Total	2,239	2,127	1,903

(1) Includes sales for the Nash mill, which contributed \$42 million of sales (31,651 metric tonnes) in fiscal 2005, \$44 million of sales (33,650 metric tonnes) in fiscal 2004 and \$41 million of sales (33,820 metric tonnes) in fiscal 2003.

(2) Includes coated mechanical paper produced at Lanaken mill.

Edgar Filing: SAPPI LTD - Form 20-F

For the year ended September 2005, Sappi Fine Paper Europe sold approximately 2,427,000 metric tonnes of paper and pulp products. The following table sets forth the annual production capacity, number of paper machines, products, pulp integration and capital expenditures at each of Sappi Fine Paper Europe's mills in Europe.

	Mill Location									
	Germany		Austria		Netherlands		Belgium		United Kingdom	
	Alfeld	Ehingen	Gratkorn	Maastricht	Nijmegen	Lanaken	Blackburn			
Paper capacity (000s metric tonnes)	360	235	860	320	240	490	120			
Number of paper machines	5	1	2	2	1	2	1			
Products	Coated fine paper, coated specialities and uncoated fine paper	Coated fine paper and uncoated fine paper	Coated fine paper and uncoated fine paper	Coated fine paper and coated speciality paper	Coated fine paper	Coated groundwood paper and coated fine paper	Coated fine paper			
Percentage pulp integration <sup>(1)</sup>	59 %	75 %	58 %	None	None	52 %	None			
Capital expenditures (October 2002 - September 2005) (US\$ million)	38	52	88	33	17	58	6			

(1) Includes pulp sold to third parties.

*Alfeld.* The Alfeld mill is located to the south of Hannover, Germany, and its origins date back to 1706. It has a paper production capacity of approximately 360,000 metric tonnes and a pulp production capacity of approximately 120,000 metric tonnes per annum. It produces coated fine and speciality paper products, which are mainly coated and have a variety of finishes. In 1995 a major rebuild of Alfeld's Paper Machine 3 (PM3) was completed, enhancing the production of low substance flexible packaging papers. Alfeld's PM3 employs a fully integrated concept of in-line coating and calendaring. The Alfeld mill produces totally chlorine-free (TCF) bleached sulphite pulp for its own use. In early 2002, a rebuild of Alfeld's Paper Machine 2 (PM2) was completed. Alfeld spent approximately 50 million on the rebuild of PM2.

*Ehingen.* The Ehingen mill is located to the southeast of Stuttgart, Germany, and was acquired by Hannover Papier, predecessor entity to Sappi Alfeld, in 1987. A paper machine with a capacity of 180,000 metric tonnes per annum of coated fine paper was commissioned in July 1991, expanding Ehingen from a market pulp mill into an integrated pulp and paper mill. During 1994 the construction of a high-rack warehouse was completed. As a result of upgrades during 1994 and 1996, Ehingen's total paper capacity was increased to 235,000 metric tonnes per annum. The pulp mill's capacity is currently 135,000 metric tonnes per annum of TCF bleached sulphite pulp. The pulp is produced mainly for internal use, but is also sold to third party customers.

*Gratkorn.* Paper has been produced at the Gratkorn, Austria, site for more than four centuries. In course of a major expansion and renovation project the Gratkorn mill has been transformed from a five-machine mill into a two-machine mill. As a result of this project, Gratkorn now has an annual capacity of 860,000 metric tonnes of triple-coated fine paper on just two paper machines and 250,000 metric tonnes of

TCF chemical pulp. The machines at Gratkorn are among the largest and most efficient paper machines in the world. After recent extension of Gratkorn's sheeting plant it also has an annual sheet finishing capacity of 800,000 metric tonnes.

*Maastricht.* The Maastricht, Netherlands, mill has the capacity to produce over 320,000 metric tonnes per annum of coated fine paper and board and one-side coated paper used primarily for printing labels. Paper was first produced in Maastricht in 1852. Paper Machine 6 (PM6), which was installed at Maastricht in 1962, was first rebuilt in 1977. In 1996, PM6 underwent an extensive NLG224 million (€102 million) rebuild. Maastricht specialises in high basis-weight triple-coated fine paper and board for graphics applications. PM6's production complements that of the Gratkorn mill, which produces lower weight coated fine paper. Paper Machine 5 (PM5) at Maastricht was constructed in 1952. It underwent a rebuild in 1995, when it was reconfigured at a total cost, including the related upgrade of PM5's entire line, of \$13 million and a further upgrading in 2001. Following the reconfiguration, PM5 is utilised as a dedicated one-side coated speciality paper machine.

*Nijmegen.* The Nijmegen, Netherlands, mill began operations in 1955 and operates one paper machine. The mill specialises in the production of reels of coated fine paper for web offset printing. It also produces special coated fine paper for use in digital printing. The Nijmegen mill was upgraded in 2001. The upgrade increased its capacity by 40,000 metric tonnes per annum. With an annual production capacity of 240,000 metric tonnes, the Nijmegen mill is one of Europe's largest suppliers of coated fine web offset paper. Rotary, or web, offset paper is used for commercial printing and publishing.

Nijmegen and Neusiedler AG, an Austrian, paper company, terminated their joint venture to operate an 80,000 metric tonnes capacity sheeting centre in the course of 2001 and have closed the related facility.

*Lanaken.* The Lanaken, Belgium, mill began commercial operations in 1966. It produces coated groundwood paper and lower weight wood-containing coated paper for offset printing. Coated groundwood paper for web offset presses is used primarily in the production of advertising materials and magazines. Lanaken's two paper machines have a total annual capacity of 490,000 metric tonnes. One machine principally produces coated groundwood paper. It was completely overhauled in 1992, and an additional off-line coater was installed to provide triple coating capability. The other paper machine produces lower-weight wood-containing paper. Its capacity was increased to 285,000 metric tonnes per annum as a result of an optimisation process during the mid-1990s. Lanaken produces chemo-thermo-mechanical pulp (CTMP) in an integrated plant which has been extended to an annual capacity of 165,000 metric tonnes in 2003. This enables the mill to supply approximately 52% of its fibre requirements for paper production.

*Blackburn.* The Blackburn, England, mill was established in 1875, and has been a major producer of cast coated paper. The Blackburn mill was rebuilt completely in 1996. In May 2000, we sold our Astralux brand of cast coated papers produced at the mill to the Favini Group in Italy. The production of cast coated papers at the Blackburn mill ceased at the end of May 2000. The Blackburn mill will continue to focus on its main business, the production of coated fine paper in reels.

*Nash.* The Nash mill in Hemel Hempstead, England, has been operating as a paper mill since the 1800s and manufactures a variety of different grades of paper and board. The mill's principal products are its branded and watermarked business papers, sold under the Croxley brand name, and its wide range of white and coloured boards, sold under the Vanguard brand name. The mill has the capacity to produce 30,000 metric tonnes of paper and board per annum.

*Mill Ownership.* Until mid-2003 we held our German mills through a 99.9% interest in Sappi Alfeld, formerly known as Hannover Papier. Sappi Ehingen, which owned the Ehingen mill, was 95% owned by Sappi Alfeld. Notwithstanding that the remaining interests were publicly held, an agreement between Sappi Alfeld and Sappi Ehingen provided us

with effective control over the cash flow in these businesses.

22

---

In mid-2003, we acquired the minority holdings in the German mills and now hold 100% ownership interests in the Alfeld, Ehingen, Gratkorn, Lanaken, Maastricht, Nijmegen, Blackburn and Nash mills.

**Sappi Fine Paper South Africa**

Sappi Fine Paper, through Sappi Fine Paper South Africa, produces and markets a wide range of coated, uncoated and speciality papers as well as creped tissue and fibreboard in South Africa. Sappi Fine Paper South Africa is headquartered in Johannesburg. In the uncoated fine paper sector, where we have approximately 53% market share, Sappi Fine Paper operates one integrated pulp and uncoated paper mill, Enstra (located near Johannesburg). Stanger (located north of Durban) uses bagasse (the fibrous residue of sugar cane) to produce coated fine paper and tissue. A smaller paper mill, Adamas (located in Port Elizabeth) utilises pulp from our pulp mills and waste paper to produce speciality paper and some kraft products. Sappi Fine Paper South Africa is the only producer of coated fine paper in South Africa.

The following table sets forth sales by product for our Sappi Fine Paper South Africa operations.

	Year Ended September		
	2005	2004	2003
Sales (US\$ million):			
Coated fine paper	67	58	46
Uncoated fine paper	188	192	172
Speciality paper and other	68	61	52
Total	323	311	270

The following table sets forth the annual paper production capacity, number of machines, products, pulp integration and capital expenditures at each of the mills of Sappi Fine Paper South Africa.

	Mill Locations		
	Enstra	Stanger	Adamas
Paper capacity (000s metric tonnes)	200	110	40
Number of paper machines	3	2	2
Products	Uncoated fine paper	Coated fine paper, coated label paper and tissue	Prestige stationary, envelope paper and corrugated medium
Percentage pulp integration	66 %	76 %	None
Capital expenditures (October 2002-September 2005) (US\$ million)	23	17	4

*Enstra.* The Enstra mill is the largest mill of Sappi Fine Paper South Africa, with a capacity of approximately 200,000 metric tonnes of elemental chlorine-free uncoated fine paper products per annum. In 1996, the Enstra mill completed a \$96 million capital expenditure programme. This programme increased capacity by 50,000 metric tonnes per annum and has resulted in improved production efficiency and product quality. The product range at the Enstra mill caters to the business forms, scholastic, office, envelope and general printing industries. The mill has a capacity of 100,000 metric tonnes per annum of bleached hardwood pulp. The mill uses an oxygen bleaching process, which is a process that was developed at the mill in the 1970s and has since become the industry standard.

*Stanger.* The Stanger mill commenced operations in 1976. It is unique in South Africa in that it uses bagasse as its basic raw material to produce high quality matte and gloss coated art papers and tissue. Art paper is used for high quality books and magazines, brochures, annual reports and labels. A \$26 million upgrade of the mill's paper machine was completed in August 2001, increasing the coated paper capacity to

80,000 metric tonnes per annum. The mill also produces 30,000 metric tonnes of tissue per annum and has a capacity of 60,000 metric tonnes of bleached bagasse pulp per annum.

*Adamas.* The Adamas mill is a small speciality mill. It produces high quality, uncoated prestige papers and boards in a variety of colours and embossing patterns. The mill also produces packaging and industrial grades from waste paper. The mill has a capacity of 40,000 metric tonnes of paper per annum. This mill purchases wastepaper and bleached pulp from other mills in the Sappi Group.

## **Marketing and Distribution**

### *Overview*

The further integration of our international marketing and distribution efforts is one of our main strategic objectives. In order to attain this objective, we have adopted a system whereby the marketing and distribution of our fine paper products is performed by our operating business in the respective region, supplemented by a trading network outside these core regions.

Our trading network, Sappi Trading, co-ordinates the international marketing and distribution of our fine paper products outside our core regions. Sappi Trading operates in Hong Kong (China), Sydney (Australia), Johannesburg (South Africa), Shanghai (China), Singapore, Zurich (Switzerland), Sao Paulo (Brazil), Mexico City (Mexico), Kenya and Zimbabwe. It also manages a network of agents around the world handling exports to over 100 countries.

We sell the vast majority of our coated and uncoated fine paper through merchants. We also sell paper directly to converters. We generally deliver products sold to converters from the mill or via a distribution warehouse. Electronic business-to-business interaction has become more important to us, and we will continue to focus on increasing service and efficiency through business-to-business interaction. The systems and structures have been put in place to actively continue these efforts.

Merchants are authorised to distribute Sappi Fine Paper's products by geographic area and to carry competitors' product lines to cover all segments of the market. Merchants perform numerous functions, including holding inventory, sales promotion and marketing, taking credit risk on sales and delivery, and distribution of the products. Merchants buy paper from Sappi Fine Paper and resell it, placing a mark-up on their purchase price. A merchant may either deliver to the customer from its own stock or arrange for delivery directly from the mill or one of Sappi Fine Paper distribution warehouses.

### *Sappi Fine Paper North America*

Sappi Fine Paper North America's coated paper sales structure is organised in 6 regions with sales representatives located in all major market areas, and 7 technical representatives located in different regions in North America supporting the sales effort.

Approximately 6.0% of Sappi Fine Paper North America's coated fine paper sales for fiscal 2005 were outside North America. Sappi Fine Paper North America's sales outside North America are handled in southern Africa by Sappi Fine Paper South Africa, in Europe by Sappi Fine Paper Europe and by Sappi Trading outside those regions.

In 2005, the Sappi Fine Paper North America sales force sold coated graphic paper to approximately 400 merchant distribution locations. By selling exclusively through merchant channels, Sappi Fine Paper North America believes it has created a loyal group of merchant customers. Rather than competing with merchant distributors, the Sappi Fine Paper North America sales force focuses on generating demand with key printers, publishers and end users, which are then serviced by the merchant distributors.

In the United States, we market speciality paper through a dedicated speciality paper sales team directly to customers. Sappi Fine Paper North America also sells paper directly to large users of coated

technical products utilising a dedicated sales team. The special end-use requirements often require a paper made to fit the customer's specific application.

#### ***Sappi Fine Paper Europe***

As part of the formation of Sappi Fine Paper in April 1998, the sales and marketing operations of Sappi Fine Paper Europe were reorganised into graphic paper, comprising printing and writing paper, and speciality paper, comprising paper for labelling, packaging and other speciality uses.

The sales division of the graphic paper unit is responsible for all sales of coated fine and groundwood papers in Europe. This includes European sales on behalf of Sappi Fine Paper North America and Sappi Fine Paper South Africa. It is also responsible for export sales to markets outside Europe. Sappi Fine Paper Europe's graphic products are distributed primarily by merchants. The export sales office manages exports to markets outside Europe through Sappi Trading, Sappi Fine Paper North America and Sappi Fine Paper South Africa.

Sappi Fine Paper Europe's centralised logistics department was formed in early 1998. It is responsible for the development and optimisation of the logistics of the graphic and speciality papers business units and the re-engineering of the supply chain.

#### ***Sappi Fine Paper South Africa***

Sappi Fine Paper South Africa has a marketing and sales and technical support team based in four major centres in South Africa. Approximately 22% of the sales of Sappi Fine Paper South Africa in fiscal 2005 were outside of southern Africa to markets in Europe, Africa, Asia and North and Latin America. The products of Sappi Fine Paper South Africa are distributed in southern Africa primarily through merchants. In addition, some large volume orders are sold directly to printers and converters.

#### **Customers**

Sappi Fine Paper sells its products to a large number of customers, many of whom have long-standing relationships with us. These customers include merchants, converters and other direct consumers.

The most significant merchant customers, based on sales during fiscal 2005, include:

*North America:* Xpedx (a division of International Paper Company), Unisource Worldwide, Inc. (a majority interest of which was sold to Bain Capital Corporation) and Lindenmeyr Paper Company (owned by Central National Gottesman Inc.) and a select number of regionally strong merchants;

*Europe:* **PaperlinX (acquired the Buhrmann Paper Merchant Division in November 2003), IGEPA (Germany), Antalis Limited (a subsidiary of the Worms & Cie) and IGEPA group (including Pap de France and Scaldia NL); and**

*Southern Africa:* **Antalis SA (Pty) Limited, Peters Papers and Finwood Papers (a division of Buhrmann Paper Merchant Division).**

Only one of these merchant distributors, PaperlinX (who acquired the Buhrmann Paper Merchant Division in November 2003), represented more than 10% of our total sales during fiscal 2005. See note 37 to our Group annual financial statements included elsewhere in this Annual Report for more information.

Sappi Fine Paper's converter customers include both multinational and regional converters. The most significant converter customers, based on sales during fiscal 2005, include: VanLeer, Fasson, Jackstadt, VAW Flexible Packaging, Alcan, UCB Transpac, Lawson Mardon Packaging and Perstop. These customers use our products in the production of pressure sensitive and other types of labels as well as flexible packaging. Nampak, the CTP Group of companies, Paarl Media:Lithotech, Merpak and Freedom





and Silvery are also significant converter customers. These companies use our products in the production of packaging products. No converter customer, however, represented more than 10% of our total sales during fiscal 2005.

Merchant sales constitute the majority of our fine paper sales. Pricing of fine products is generally subject to change upon notice of 30 days with longer notice periods (typically 3 to 6 months) for some large end-use customers. Sales to converters may be subject to longer notice periods, which would generally not exceed 12 months. We have long-standing relationships with most of our customers, with volume and pricing generally agreed on a quarterly basis.

## **Competition**

### *Overview*

Although the markets for pulp and paper have regional characteristics, they are highly competitive international markets involving a large number of producers located around the world.

Pulp and paper are subject to relatively low tariff protection in major markets, with existing tariff protections being further reduced under the World Trade Organization ( *WTO* ). In South Africa, for example, no tariffs are imposed on imports of pulp and newsprint. Tariffs on most other paper products under the WTO are 7% and will decline to 5% over time.

In 1999, South Africa entered into a free trade agreement with the European Union, which is intended to remove tariffs on 90% of bilateral trade over a twelve-year period. The implementation of this agreement has commenced. We do not anticipate that the agreement will have any material impact on our business in the short term. In the long term, however, we expect that the agreement will lead to increasing pricing pressure from imports, which could have a material impact on our pricing structure in South Africa. Pursuant to the agreement, import duties on coated and uncoated woodfree fine products from member states of the European Union currently stands at 0%, as per the current Jacobsens Import Tariffs. Corresponding duties on South African products imported in member states of the European Union will also be phased out over a period of seven to twelve years.

Competition in markets for our products is primarily based on price, quality, service, breadth of product line, product innovation and sales and distribution support. The speciality paper market puts greater emphasis on product innovation and quality as well as technical considerations. The packaging paper and newsprint markets place more emphasis on price.

### *North America*

The major domestic coated fine producers which compete with Sappi Fine Paper in North America are NewPage (formerly part of MeadWestvaco and now owned by Cerberus), Stora Enso and International Paper Company. In addition, approximately 29% of US consumption is supplied by foreign producers, primarily Asian and European.

### *Europe*

Recent merger and acquisition activity in the European pulp and paper industry includes: in 2004, the merger of Italian papermakers Cartiere Burgo and Holding Gruppo Marchi, now known as the Burgo-Marchi Group, and in 2002, M-real's (previously Metsä-Serla) consolidation of its ownership of Zanders to 100%; the Italian Marchi Group's acquisition of more than 23% equity stake in Cartiere Burgo, M-real's sale of its 50% share in Albruck paper mill to Myllykoski; and UPM-Kymmene's acquisition of Haindl (a German magazine paper producer).

The market leaders in coated fine paper production in Europe are Sappi, M-real, Stora Enso, Burgo-Marchi Group, UPM-Kymmene and CVC Partners (Lecta).

*Southern Africa*

Mondi Paper Company Limited is a significant competitor of Sappi Fine Paper in southern Africa in the uncoated fine paper sector. Coated fine imports, primarily from Europe and Asia, have gained an increased share of the southern African fine paper market, after the lifting of sanctions and boycotts against South Africa in the early 1990s and as a result of declining import duties. A substantial part of the imports originate from Sappi Fine Paper's European mills.

27

---

## **SAPPI FOREST PRODUCTS**

### **Overview**

Sappi Forest Products, headquartered in Johannesburg, South Africa, is an integrated pulp, packaging paper and timber products producer. Sappi Forest Products operates five pulp and paper mills and one sawmill and is managed in three operating divisions: Sappi Saiccor, Sappi Kraft and Sappi Forests.

Sappi Forest Products is a major pulp and paper producer in Africa with a production capacity of 830,000 metric tonnes of paper, 600,000 metric tonnes of chemical cellulose and 1,090,000 metric tonnes of paper pulp per annum. It is also a major timber grower and manages approximately 541,000 hectares of forestland, of which, approximately 395,000 hectares is planted with primarily pine and eucalyptus. This represents about 28% of the southern African timberlands and supplies approximately 78% of our southern African pulpwood and sawlog requirements.

The following chart sets forth certain information with respect to the mills and principal products of Sappi Forest Products as of November 2005.



The following table sets forth sales by product for Sappi Forest Products operations:

	Year Ended September		
	2005	2004	2003
Sales (US\$ million):			
Commodity paper products <sup>(1)</sup>	430	401	339
Chemical cellulose <sup>(2)</sup>	360	349	267
Paper pulp <sup>(2)</sup>	118	97	83
Timber and timber products	90	70	53
Total	998	917	742

(1) Includes newsprint and packaging products.

(2) Excludes sales related to paper pulp produced by Sappi Fine Paper facilities.

Sappi Forest Products sold approximately 3,302,000 metric tonnes of paper, pulp and forest products during the year ended September 2005.

The following table sets forth annual production capacity with respect to Sappi Forest Products products:

Production capacity (000s metric tonnes):			
Paper products			
Packaging paper		690	
Newsprint		140	
Total		830	
Pulp			
Chemical cellulose		600	
Paper pulp <sup>(1)</sup>		1,090	
Total		1,690	
Timber products		41	(2)
Percentage paper pulp integration		141	% <sup>(3)</sup>

(1) Excludes production capacity related to paper pulp produced by Sappi Fine Paper facilities.

(2) Represents 78,000 cubic metres.

(3) Excludes pulp produced by Sappi Saiccor. Our southern African operations are net sellers of pulp.

## Facilities and Operations

### *Sappi Saiccor*

Sappi Saiccor was established in 1951 and acquired by us in 1988. It is a low-cost producer and the world's largest single producer of chemical cellulose. In 1995, we completed an approximately \$221 million expansion project to increase capacity by one third to approximately 600,000 metric tonnes per annum. Capital expenditures during the period from October 2002 to September 2005 were approximately \$39 million.

Virtually all of Sappi Saiccor's chemical cellulose production is exported from South Africa and marketed and distributed internationally by Sappi Trading. The pulp we principally produce is the type used in the manufacture of a variety of cellulose products, including viscose staple fibres (rayon) and solvent spun fibres (lyocell). Both viscose and lyocell fibres are used in the manufacture of fashion and decorating textiles which have a soft, natural feel and excellent breathing properties. Given their

particularly high absorbency properties, these fibres are also used in non-woven applications in the healthcare, industrial and disposable product markets. Chemical cellulose is also used in the manufacture of acetate flake, which is used in products such as filter tow for cigarette filters, and high quality yarns and fabrics. It is also used to manufacture microcrystalline cellulose, which is used as a rheological modifier in the food industry, a tableting agent in the pharmaceutical industry, and in various ethers for the chemical industry. It is also used to manufacture cellophane film for use in a variety of packaging applications.

The mill's timber consumption is comprised primarily of eucalyptus hardwoods. These fast growing trees are grown in relatively close proximity to the mill, which contributes to Sappi Saiccor's position as a low cost producer of chemical cellulose.

### ***Sappi Kraft***

Based upon volume sold in fiscal 2005, Sappi Kraft supplies approximately 55% of South Africa's packaging paper requirements, other than cartonboard, from its Ngodwana, Tugela and Cape Kraft mills.

The following chart sets forth the annual paper production capacity, number of machines, products, pulp integration and capital expenditures at each of Sappi Kraft's mills in South Africa.

	Mill Locations in South Africa		
	Ngodwana	Tugela	Cape Kraft
Paper capacity (000s metric tonnes)	380	390	60
Number of paper machines	2	4	1
Products	Newsprint, kraft linerboard, white top linerboard, plasterboard and bleached and unbleached market pulp	Kraft linerboard, corrugating medium, sackkraft and machine glazed kraft	Linerboard, corrugating medium and coated products
Percentage pulp integration <sup>(1)</sup>	134 %	100 %	None (2)
Capital expenditures (October 2002-September 2005) (US\$ million)	89	43	3

(1) Excludes pulp produced from recycled paper by the respective plants at the mills.

(2) Cape Kraft's raw material requirements are met from waste fibre supplied by Sappi Waste Paper.

*Ngodwana.* Ngodwana was expanded between 1981 and 1985 from an unbleached kraft mill with a capacity of 100,000 metric tonnes per annum to a modernised mill with a capacity of approximately 240,000 metric tonnes of linerboard and 140,000 metric tonnes of newsprint per annum. The linerboard machine also produces White Top Liner (included in total linerboard capacity). The mill produces nearly 410,000 metric tonnes of bleached and unbleached pulp and 100,000 metric tonnes of groundwood pulp annually. The mill markets paper and excess pulp locally and in the export market. The mill is a large consumer of waste paper, which is used in the production of packaging paper. In 1995 the mill commissioned the world's first ozone bleaching plant, thus eliminating the use of elemental chlorine and significantly reducing mill effluent.

*Tugela.* Tugela is Sappi Kraft's largest integrated unbleached kraft mill, with a capacity of approximately 390,000 metric tonnes of packaging paper per annum. The mill supplies kraft linerboard and corrugating medium and most of South Africa's requirements for sackkraft, used in the production of multiwall sacks. Machine glazed packaging papers are also produced at the mill. The Kraft Linerboard

machine was upgraded in 1996 at a cost of approximately \$81 million and the Sack Kraft machine and components of the pulp plant were upgraded in 2003/4 at a cost of approximately \$50 million. It is the only mill in South Africa to offer high performance containerboard packaging and extensible Sack Kraft.

*Cape Kraft.* The Cape Kraft mill was built during 1980, commissioned in 1981 and upgraded in 1995. The mill presently has a capacity of 60,000 metric tonnes of linerboard and corrugating medium per annum, which it sells principally to the corrugating industry in the Western Cape. The mill uses approximately 67,000 metric tonnes per annum of waste paper to produce 60,000 metric tonnes per annum of paper. The fact that the mill's product is produced from 100% recycled paper can provide a competitive edge in our markets, which are becoming increasingly environmentally aware.

*Usutu Pulp.* As of October 2000, we have a 100% ownership interest in the Usutu Pulp Company Limited. Usutu Pulp began production in 1961 and has been managed by us since 1989. The mill was upgraded during 1995 and 1996 at a cost of approximately \$69 million. During the period from October 2002 to September 2005, an additional \$16 million was invested. The mill has a capacity of 230,000 metric tonnes of unbleached kraft pulp and supplies approximately 9% of the world market for unbleached market kraft pulp (based upon tonnes sold in 2005). The mill is situated in Swaziland and is surrounded by 70,000 hectares of forestlands, which it leases from the Swazi nation under a long-term lease extendable to 2089. The location of these forestlands, combined with the very compact areas the trees are planted on, provides for low wood delivery costs. See *-Supply Requirements-Southern Africa-Wood* for more information.

Sappi Kraft also manages Sappi Waste Paper. Sappi Waste Paper collected approximately 217,000 metric tonnes of waste paper in fiscal 2005. Most of the waste paper collected was supplied to our mills. Waste represents approximately 30% of the fibre requirements of our packaging grades.

### ***Sappi Forests***

Sappi Forests, together with Usutu Forests, supplies or procures all of Sappi Forest Products' and Sappi Fine Paper South Africa's domestic pulpwood requirements of approximately 6 million metric tonnes per annum. 87% of the pulpwood comes from owned or contracted sources. Together they manage or control, through contracts, about 541,000 hectares of land situated in Mpumalanga (44%), KwaZulu-Natal (43%) and Swaziland (13%). Securing raw material for the future is a vital element in the long-term planning of Sappi Forest Products' business. Sappi Forests has an extensive research operation which concentrates on programmes to improve the yield per hectare of forestland used. Significant progress has been made in developing faster-growing trees with enhanced fibre yields. Sophisticated nurseries have been developed to accommodate the seedling requirements of Sappi Forest Products' operations. Approximately 48 million seedlings are grown annually at Sappi Forests' and Usutu Forests nurseries.

Sappi Forests and Usutu Forests have invested approximately \$127 million in maintaining, acquiring and expanding plantations and an additional \$9 million in other capital expenditure projects in the period from October 2002 to September 2005.

As of October 1, 2000, following the sale of Novobord, Sappi Timber Industries ceased to exist, and the mining timber and sawmill divisions were incorporated into Sappi Forests. The sawmill division operates one mill with a total production capacity of 78,000 cubic metres per annum of structural timber for the building industry and components for the furniture and packaging industry.

Pursuant to our strategy of disposing of non-core assets, the mining timber division, which produced mine support systems for the South African mining industry, was sold on October 1, 2000 to Business Venture Investment No. 336 (Pty) Ltd, a company owned by the mining timber division management. We



also sold Boskor sawmill on February 10, 2003 to a Cape-based door and window manufacturer and shut down Clan sawmill on September 30, 2003.

## **Marketing and Distribution**

### *Overview*

Each of Sappi Forest Products' divisions with major South African markets has its own marketing and sales team. Sappi Trading manages the exports of the Sappi Forest Products' divisions, in particular the marketing and distribution of the market pulp produced at Saiccor and Usutu.

### *Customers*

Sappi Forest Products sells its products to a large number of customers, including merchants, converters, printers and other direct customers, many of whom have long-standing relations with us.

The most significant converter customers, based on sales in fiscal 2005, include: The CTP Group and Media 24, which uses Sappi Forest Products' newsprint; Nampak Limited; Mondipak; APL (Pty) Ltd and Houers Co-operative. A significant number of the viscose staple fibre manufacturers around the world purchase chemical cellulose from Sappi Forest Products, including large groups such as the Aditya Birla Group and the Lenzing Group. Most of our chemical cellulose (dissolving pulp) sales contracts are multi-year contracts with pricing generally based on a formula linked to the NBSK price and reset on a quarterly basis.

Approximately 51% of the total sales of Sappi Forest Products during fiscal 2005 consisted of export sales.

### **Competition**

Mondi Paper Company Limited is a significant competitor in most of the markets in which Sappi Forest Products operates in southern Africa. In recent years the regional recycled containerboard capacity has increased by approximately 60,000 metric tonnes. Due to exchange rate fluctuations a number of offshore containerboard suppliers have also entered the southern African packaging markets. In respect of chemical cellulose, competitors include Borregaard ChemCell Atisholz, Tembec Inc., Western Pulp Inc., Buckeye Technologies Inc. and Rayonier Inc.

## SUPPLY REQUIREMENTS

### Overview

The principal supply requirements for the manufacture of our products are wood, pulp, energy and chemicals. Large amounts of water are also required for the manufacture of pulp and paper products. See Environmental and Safety Matters Environmental Matters Southern Africa . We believe that we have adequate sources of these and other raw materials and supplies necessary for the manufacture of pulp and paper for the foreseeable future.

### North America

#### *Wood*

In connection with the 1998 sale of our US timberlands to Plum Creek Timber Company L.P., Sappi Fine Paper North America and Plum Creek are parties to a fibre supply agreement with an initial term expiring in December 2023 and with three five-year renewal options. Under the supply agreement, Sappi Fine Paper North America is required to purchase from Plum Creek and Plum Creek is required to sell to Sappi Fine Paper North America a guaranteed annual minimum of 318,000 metric tonnes of hardwood pulpwood, or approximately 10% of Sappi Fine Paper North America's annual requirements, at prices calculated based on a formula tied to market prices. Sappi Fine Paper North America has the option to purchase additional quantities of hardwood pulpwood harvested from these timberlands at prices generally higher than the ones paid for the guaranteed quantities. The remainder of Sappi Fine Paper North America's wood requirements is met through market purchases.

#### *Pulp*

Sappi Fine Paper North America's mills, taken together, are fully integrated on an economic basis with respect to hardwood pulp usage. Mills that are not fully integrated make market purchases, and mills that produce more pulp than they utilise make market sales.

Sappi Fine Paper North America currently offers recycled products in most coated grade lines. It uses reprocessed fibres recovered from its existing operations and purchases de-inked post consumer waste pulp to meet market requirements for recycled products.

Sappi Fine Paper North America manufactures, in aggregate, pulp and fibre equivalent to approximately 98% of its own pulp and fibre requirements. This vertical integration reduces its exposure to fluctuations in the market price for pulp.

#### *Energy Requirements*

Sappi Fine Paper North America's energy requirements are satisfied through wood and by-products derived from the pulping process, coal, oil, purchased electricity, purchased steam, natural gas and other sources.

A substantial majority of Sappi Fine Paper North America's electricity requirements are satisfied through its own electricity generation or co-generation agreements. In July 2002, Sappi Fine Paper North America entered a series of contracts with Central Maine Power ( CMP ) and a third party energy provider. The contracts provide that Somerset sell all of its excess generated power to CMP and purchase all of its power needs beyond its generation capacity from the third party provider, each at market rates. The agreements expire in 2012. Sappi Fine Paper North America also has an agreement, expiring on February 28, 2007, with a third party pursuant to which the Westbrook mill sells any excess electricity it co-generates.

The Cloquet mill, is supplied partly with internally generated electricity. The Cloquet mill includes a hydroelectric facility that is licensed by the Federal Energy Regulatory Commission. In addition to generating a portion of its own power, the Cloquet mill has entered into a take-or-pay agreement to purchase a portion of its power from Minnesota Power, which terminates in 2008.

### ***Chemicals***

Major chemicals used by Sappi Fine Paper North America include clays, carbonates, latices and plastic pigments, titanium dioxide, caustic soda, other pulping and bleaching chemicals and chemicals for the specialty business. Sappi Fine Paper North America purchases these chemicals from a variety of suppliers. There are generally adequate sources of supply, and in no case is Sappi Fine Paper North America dependent upon a sole source of supply. However, chemical supplies have tightened due to the rationalization of capacity over the last several years. In addition, some suppliers have limited supplies of chemicals as a result of the hurricanes in the south eastern United States during the fall of 2005. Most of these chemicals are subject to price fluctuations based upon a number of factors, including energy and crude oil prices and transportation costs, and commodity demand vs. supply imbalances.

### **Europe**

#### ***Wood***

Sappi Fine Paper Europe purchases approximately 2,500,000 cubic metres of pulpwood per annum for its pulp mills. The wood is purchased both on contract and in the open market. Wood supply contracts are fixed for one year in terms of volumes. Price agreements range from three months for wood chips to one year for logwood.

The wood logs and wood chips used in the Gratkorn TCF pulp mill are purchased through the Papierholz Austria GmbH joint venture arrangement amongst Sappi, the Norske Skog Bruck mill and the Frantschach Group. We hold a 42.5% ownership interest in Papierholz.

The wood chips used in the Lanaken CTMP plant are purchased through Sapin S.A. ( Sapin ), a 50%-50% joint venture company operated together with Norske Skog. Sapin was initially formed on November 25, 1986, pursuant to a joint venture agreement between Sappi Lanaken and Parenco. Under the agreement, as amended in September 2003, the parties agree to utilise Sapin exclusively to furnish the entire wood requirements of the joint venture partners' affiliated mills.

#### ***Pulp***

Sappi Fine Paper Europe produces approximately 45% of its pulp requirements. The remainder is supplied through open market purchases and, to a lesser extent, supply agreements.

### ***Energy Requirements***

Sappi Fine Paper Europe's energy requirements are generally met by internally generated sources and purchases of electricity, gas and, to a lesser extent, oil. In Germany, Sappi Fine Paper Europe internally generates approximately 65% of the electricity used at its mills. Approximately 45% of the energy requirements for the Gratkorn mill are internally generated. The remaining requirements are met by purchasing electricity, oil, coal and gas in accordance with various supply agreements.

Substantially all of the electricity requirements of the Maastricht mill are satisfied by a 60 megawatt combined heat/power plant operated through a joint venture with Essent. All surplus electrical energy is supplied to the public electricity grid. We hold an ownership interest of 50% in the VOF Warmte/Kracht Maastricht Mill, the joint venture, which was formed in 1992, and are obligated to purchase all of the steam and electricity requirements of the Maastricht mill from the joint venture facility under a long-term

supply agreement. Essent purchases the surplus electrical energy of the VOF. The Maastricht mill also purchases natural gas pursuant to a contract with a natural gas supplier.

Nijmegen mill's electricity requirements are largely satisfied by its co-generation power plant. The Nijmegen mill additionally purchases natural gas from Gasunie, a local supplier.

Lanaken mill's energy requirements are generally met by purchases of natural gas and electricity. Certain of the energy requirements of the Lanaken mill are furnished by a combined heat and power unit constructed and operated pursuant to the Albertcentrale N.V. joint venture arrangement between Sappi, the Belgian power company Electrabel and Rabo Energy. Sappi holds a 49% ownership interest in the Albertcentrale facility and is obligated to purchase 85% of the plant's energy requirements from the joint venture facility under a long-term supply agreement. The facility commenced operations in April 1997.

### ***Chemicals***

Major chemicals used by Sappi Fine Paper Europe include clays, carbonates, latexes and starches and chemicals for the specialty business. Sappi Fine Paper Europe purchases most of these chemicals from a portfolio of suppliers, and in only one case is Sappi Fine Paper Europe dependent on a sole source of supply. There are generally adequate sources of supply in the market. Most of these chemicals are subject to price fluctuations based upon a number of factors, including energy and crude oil prices and transportation costs, and commodity demand vs. supply imbalances.

### **Southern Africa**

#### ***Wood***

Sappi Forest Products manages approximately 541 000 hectares of forestland in southern Africa, of which approximately 395 000 hectares are forested, which produces approximately 78% of the timber required for its operations. Sappi Forests owns approximately 373,000 hectares and manages the majority of the remainder. Usutu Pulp owns 55,000 hectares of pine on 70,000 hectares of land that is leased from the Swazi nation on a long-term lease, which we have the option to extend until 2089. Sappi Forests presently has supply contracts for the timber from approximately 90,000 hectares of plantations planted by small growers with our technical and financial support. Approximately 10% of the timber requirements of Sappi Forest Products is bought under a long-term contract with Safcol, the South African state-owned forestry company which is in the process of privatising. The remaining timber requirements are met through a number of significant medium-term contracts and open market purchases. The privatisation of Safcol is still subject to Competition Commission approval. We are unable to predict whether the privatisation of Safcol or the purchase of Safcol's plantations in KwaZulu Natal by another bidder will have an adverse impact on our ability to continue to purchase timber from Safcol.

#### ***Pulp***

Sappi Forest Products and Sappi Fine Paper South Africa in aggregate manufacture all of the pulp required in their respective papermaking operations, except minimal quantities of specialised pulps, and together are a net seller of bleached and unbleached paper pulp. This vertical integration substantially reduces our exposure to fluctuations in the market price for pulp.

#### ***Energy Requirements***

Our energy requirements in southern Africa are met principally by purchases of coal and electricity supplemented by purchases of fuel oil and gas. Much of the energy demand is met by internally generated biomass and spent liquors from the pulping process. Electricity is supplied by Eskom, the state-owned electricity company, or generated internally. The electricity generated by our plants in southern Africa is

equivalent to approximately 43% of our total electricity requirements. Coal, both for steam raising and gas production, and oil are purchased on contract.

*Chemicals*

Major chemicals used by Sappi Forest Products and Sappi Fine Paper South Africa include caustic soda, calcium carbonates, latexes and starches and sulphur and sulphuric acid. Sappi Forest Products and Sappi Fine Paper South Africa purchase these chemicals from a variety of South African and overseas suppliers. There are generally adequate sources of supply, and in only one case is Sappi Fine Paper South Africa dependent upon a sole source of supply. Most of these chemicals are subject to price fluctuations based upon a number of factors, including energy and crude oil prices and transportation costs, and commodity demand vs. supply imbalances.

## ENVIRONMENTAL AND SAFETY MATTERS

### Environmental Matters

We are subject to a wide range of environmental laws and regulations in the various jurisdictions in which we operate, and these laws and regulations have tended to become more stringent over time. Environmental compliance is an increasingly important consideration in our businesses, and we expect to continue to incur significant capital expenditures and operational and maintenance costs related to reductions in air emissions (including greenhouse gases), wastewater discharges and waste management. We constantly monitor the potential for changes in the laws regulating air emissions and other pollution control laws and take actions with respect to our operations accordingly. See note 41 to our Group annual financial statements included elsewhere in this Annual Report for more information.

#### *North America*

Sappi Fine Paper North America is subject to stringent environmental laws in the United States. These laws include the Federal Clean Air Act, the Clean Water Act, the Resource Conservation and Recovery Act and their respective state counterparts. In December 2003, Sappi Fine Paper North America received a notice of violation and a finding of violation from the US Environmental Protection Agency, alleging violations of the Clean Air Act's new source performance standards in connection with repairs performed at the Muskegon pulp mill in the early 1990s. In July 2005, Sappi announced its decision to cease operations at the Muskegon pulp mill. Sappi Fine Paper North America is currently in settlement discussions with the US Environmental Protection Agency, and expects to settle the matter pursuant to a consent decree in which Sappi agrees (i) to more stringent permit requirements should the pulp mill ever start up again and (ii) to pay a fine of approximately \$580,000.

The US is a non-signatory of the Kyoto Protocol, but we maintain a watching brief on State and Federal Greenhouse Gas (GHG) initiatives.

#### *Europe*

Our European facilities are subject to extensive environmental regulation in the various countries in which they operate. For example:

- In Germany, where two Sappi Fine Paper Europe mills are located, the Federal Emission Control Act, the Federal Water Act and the Federal Ground Act regulate air emissions, wastewater discharges and liability for contaminated sites, respectively.
- In the Netherlands, where two Sappi Fine Paper Europe mills are located, paper manufacturers, including Sappi, have made an agreement with the national government to improve environmental management and further limit emissions.
- In Austria and Belgium, water emissions and waste disposal requirements similar to those in Germany, the United Kingdom and the Netherlands apply to our facilities.
- In the United Kingdom, our mills received permits required under the Pollution Prevention and Control Regulations, which were enacted to implement the EC Directive 96/61/EC on Integrated Pollution Prevention and Control.
- At our Nijmegen mill, we are subject to a potential damage charge of approximately \$203,611 (euro 208,000), representing the alleged cost of cleaning up contaminated pulp from the local sewer system. The proposed charge relates to a discharge of pulp from our Nijmegen mill in 2000. We are pursuing a settlement of this matter with the local authorities.

- The Sappi Fine Paper Europe organisation is certified according to the international standard of environmental management systems (ISO 14001), and seven mills are certified according to the European EMAS (Eco-Management and Audit Scheme). We expect that the Lanaken mill will be certified in 2006. All the European mills publish their environmental reports on an annual basis.
- The countries within which we operate in Europe are all signatories of the Kyoto Protocol and we have developed a GHG strategy in line with this protocol. Our European mills have been set CO<sub>2</sub> emission limits for the allocation period 2005 to 2007. Based upon in depth analysis of our mill production by a Sappi Fine Paper Europe task force it is unlikely that Sappi will exceed their CO<sub>2</sub> emission limits. Consequently in July 2005 Sappi Fine Paper Europe sold 90,000 surplus CO<sub>2</sub> credits to the value of \$2.5 million (euro 2.0 million) on the European Climate Exchange.

#### *South Africa*

The primary South African environmental laws affecting our operations have been substantially revised. For example:

- The National Water Act, effective October 1998, addresses the water shortages in South Africa in a manner that we believe will not significantly impact our manufacturing and forestry operations. Abstraction of water, discharge of effluent and management of forests are all regulated under a new license system in which first allocations go to, among other things, human consumption, before allocations are made to agriculture, industry and forestry. All water use is now subject to a charge. We expect to incur additional costs over the next decade to comply with the National Water Act, but are unable to quantify these at this time.
- The National Environmental Management Act, effective January 1998, adopted the philosophy of integrated environmental management, which provides for the integration of environmental considerations into all stages of any development process. The Act includes a number of significant principles, such as private prosecution of companies in the interest of the protection of the environment and the establishment of aggressive waste reduction goals. We expect to incur additional costs to comply with the National Environmental Management Act, which is not expected to be material.
- The National Environmental Management Act ( Air Quality Bill ) was promulgated in the beginning of 2005. The Air Quality Act will eventually replace the 1965 Atmospheric Pollution Prevention Act and will impose stringent compliance standards on our operations when implemented, including those related to carbon dioxide and sulphur dioxide air emissions. Limited sections of the Act were implemented in September 2005. We expect to incur additional costs to comply with the Air Quality Act, which we believe will not be material.
- South Africa is also a signatory of the Kyoto Protocol. We are initiating Clean Development Mechanism projects at various of our mills.

The requirements under these statutes may result in additional expenditures and operational constraints. Although we are in frequent contact with regulatory authorities during the phasing in of the legislation, we are uncertain as to the ultimate effect on our operations. Our current assessment of the legislation is that any compliance expenditures or operational constraints will not be material to our financial condition.

#### **Safety Matters**

The forestry, timber and pulp and paper industries involve inherently hazardous activities including, among other things, the operation of heavy machinery. Nearly all countries in which we have significant manufacturing operations including South Africa, the United States and European countries, regulate





health and safety in the workplace. We actively seek to reduce the frequency of accidents in our workplaces and to improve health and safety conditions by extensive training and educational programmes.

During March 2005, we launched Project Zero, a concerted safety drive. Project Zero symbolises the goal of no injuries and involves standardising behaviour-based safety programmes throughout the group and focusing on the particular activities which have resulted in injuries or fatalities.

In the United States, Sappi Fine Paper North America must comply with a number of federal and state regulations regarding health and safety in the workplace. The most important of these regulations is the Federal Occupational Safety and Health Act.

In Europe, we participate in various governmental worker accident and occupational health insurance programmes. In Austria, Belgium, the United Kingdom and the Netherlands, these programmes are funded by mandatory contributions by employers and employees. In Germany, we participate in a similar mandatory contribution scheme controlled by the German government, which permits employer and employee participation in its administration. The Safety and Health issues are integrated into the management systems.

In South Africa, we must comply with the Occupational Health and Safety Act (Number 85 of 1993) and related regulations. Our South African businesses have instituted safety rating system, which sets standards for safety and facilitates the monitoring of compliance with applicable governmental laws and regulations.

**ORGANISATIONAL STRUCTURE**

Sappi Limited is the ultimate holding company of the Sappi Group. The following table sets forth the more significant subsidiaries and joint ventures owned directly or indirectly by Sappi Limited.

Name of Company	Trading Name	Country of Incorporation	Type of Company	% Holding and Voting Power
<b>North America</b>				
S.D. Warren Company	Sappi Fine Paper	United States	Operating	100
Sappi Cloquet LLC	Sappi Fine Paper	United States	Operating	100
<b>Europe</b>				
Sappi Alfeld GmbH	Sappi Fine Paper	Germany	Operating	100
Sappi Austria Produktions GmbH & Co KG	Sappi Fine Paper	Austria	Operating	100
Sappi Ehingen GmbH	Sappi Fine Paper	Germany	Operating	100
Sappi Esus Beteiligungs-verwaltungs GmbH	Sappi Esus	Austria	Holding	100
Sappi Europe SA	Sappi Fine Paper	Belgium	Operating	100
Sappi Holding GmbH	Sappi Holding	Austria	Holding	100
Sappi International SA	Sappi International	Belgium	Finance	100
Sappi Lanaken NV	Sappi Fine Paper	Belgium	Operating	100
Sappi Lanaken Press Paper NV	Sappi Fine Paper	Belgium	Operating	100
Sappi Maastricht BV	Sappi Fine Paper	Netherlands	Operating	100
Sappi Nijmegen BV	Sappi Fine Paper	Netherlands	Operating	100
Sappi Papier Holding GmbH	Sappi Papier Holding or Sappi Fine Paper	Austria	Holding and Operating	100
Sappi U.K. Ltd.	Sappi Fine Paper	United Kingdom	Operating	100
<b>Southern Africa</b>				
Sappi Management Services (Pty) Ltd.	Sappi Management Services (Pty) Ltd.	South Africa	Management	100
Sappi Manufacturing (Pty) Ltd.	Sappi Manufacturing or Sappi Forest Products or Sappi Fine Paper or Sappi Saiccor or Sappi Kraft or Sappi Forests or Sappi Waste Paper	South Africa	Operating	100
Usutu Pulp Co. Ltd.	Sappi Usutu	Swaziland	Operating	100
<b>Asia</b>				
Jiangxi Chenming Paper Co Ltd	Jiangxi Chenming Paper Co Ltd	China	Operating Joint Venture	34
<b>Guernsey</b>				
Lignin Insurance Co. Ltd.	Lignin Insurance Co. Ltd.	Guernsey	Finance	100

**PROPERTY, PLANT AND EQUIPMENT**

For a description of the production capacity of our mills, see Sappi Fine Paper Facilities and Operations and Sappi Forest Products Facilities and Operations .

For a description of the timberlands we own or have recently sold, see Sappi Fine Paper Facilities and Operations Sappi Fine Paper North America , Sappi Forest Products Facilities and Operations Sappi Forests and Supply Requirements .

For a description of our capital expenditures, see Item 5 Operating and Financial Review and Prospects Liquidity and Capital Resources .

The following table sets forth the location and use of our principal headquarters, manufacturing and distribution facilities. These facilities are owned unless otherwise indicated.

Location	Use	Approximate Size(1)
	<b>Sappi Limited</b>	
Johannesburg, South Africa	Sappi Headquarters <sup>(2)</sup>	15,078 m <sup>2</sup>
	<b>Sappi Fine Paper</b>	
<b>Sappi Fine Paper North America<sup>(3)</sup></b>		
Boston, Massachusetts	Headquarters <sup>(4)</sup>	38,620 sq ft
Skowhegan, Maine (Somerset Mill)	Manufacturing facility: coated paper, softwood and hardwood pulp	2,355 acres
Muskegon, Michigan	Manufacturing facility: coated paper and a warehouse <sup>(5)</sup>	5,185,000 sq ft
Westbrook, Maine	Manufacturing facility: speciality and high bulk coated paper and research and development facility	275 acres
	Storage and shredding facility	13,446 sq ft
	Roll coating facility	13,575 sq ft
Allentown, Pennsylvania	Coated paper sheeting facility	30 acres
Dayton, New Jersey	Distribution centre <sup>(6)</sup>	607,489 sq ft
Alsip, Illinois	Distribution centre <sup>(7)</sup>	392,618 sq ft
Cloquet, Minnesota	Manufacturing facility: coated paper and pulp <sup>(10)</sup>	650 acres
South Portland, Maine	Shared financial and customer service office <sup>(11)</sup>	48,433 sq ft
<b>Sappi Fine Paper Europe</b>		
Brussels, Belgium	Headquarters <sup>(9)</sup>	3,836 m <sup>2</sup>
Gratkorn, Austria	Manufacturing facility: coated paper and pulp	999,053 m <sup>2</sup>
Maastricht, Netherlands	Manufacturing facility: coated paper and research and development facility	14.7 ha
Nijmegen, Netherlands	Manufacturing facility: coated paper	10.7 ha
Lanaken, Belgium	Manufacturing facility: coated paper and pulp	35.0 ha
Alfeld, Germany	Manufacturing facility: coated paper, uncoated paper and pulp	332,503 m <sup>2</sup>
Ehingen, Germany	Manufacturing facility: coated paper and pulp	358,092 m <sup>2</sup>
Blackburn, England	Manufacturing facility: coated paper	36.0 ha
Wesel, Germany	Distribution centre <sup>(8)</sup>	6.2 ha

Edgar Filing: SAPPI LTD - Form 20-F

Hemel Hempstead, England (Nash Mill)	Manufacturing facility: business paper and printing paper and board	5.0 ha
<b>Sappi Fine Paper South Africa</b>		
Enstra, South Africa	Manufacturing facility: uncoated paper and hardwood pulp <sup>(10)</sup>	582.7 ha
Stanger, South Africa	Manufacturing facility: coated paper, tissue and bagasse pulp <sup>(10)</sup>	55.4 ha
Adamas, South Africa	Manufacturing facility: uncoated paper and recycled packaging paper	7.2 ha
<b>Sappi Forest Products</b>		
Johannesburg, South Africa	Headquarters	Included under Sappi Limited headquarters
<b>Sappi Saiccor</b>		
Umkomaas, South Africa	Manufacturing facility: chemical cellulose <sup>(10)</sup>	159.4 ha
<b>Sappi Kraft</b>		
Ngodwana, South Africa	Manufacturing facility: linerboard, newsprint and kraft pulp	1,282.9 ha
Tugela, South Africa	Manufacturing facility: linerboard, corrugating medium, sackkraft and industrial kraft	914.4 ha
Cape Kraft, South Africa	Manufacturing facility: linerboard and corrugating medium	9.5 ha
Bunya, Swaziland (Usutu Pulp Mill)	Manufacturing facility: kraft pulp	45.0 ha
<b>Sappi Forests</b>		
Barberton, South Africa (Lomati Sawmill)	Sawmill	24.6 ha

- (1) The approximate size measurement relates to, in the case of manufacturing and distribution facilities, the perimeter of the property on which the principal manufacturing or distribution facilities are situated and, in the case of offices, the interior offices space owned or leased.
- (2) Subject to a lease expiring in 2015.
- (3) All of Sappi Fine Paper North America principal properties are pledged as collateral under Sappi Fine Paper North America's credit facilities.
- (4) Subject to a lease expiring in 2006.
- (5) Subject to a lease that operates on a month-to-month basis.
- (6) Subject to a lease expiring in 2010.
- (7) Subject to a lease expiring in 2006.
- (8) Of the total 6.2ha, 8,800m<sup>2</sup> is subject to a lease expiring at the end of 2005.
- (9) Subject to leases expiring in 2008.
- (10) Substantial assets are leased pursuant to capital lease agreements.

(11) Subject to a lease expiring in 2015.

42

---

**ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

You should read the following discussion and analysis together with our Group annual financial statements, including the notes, included elsewhere in this Annual Report. Certain information contained in the discussion and analysis set forth below and elsewhere in this Annual Report includes forward-looking statements that involve risk and uncertainties. See *Forward-Looking Statements*, *Item 3 Key Information Selected Financial Data*, *Item 3 Key Information Risk Factors*, *Item 4 Information on the Company*, *Item 10 Additional Information Exchange Controls* and notes 2, 3, 12, 14, 16, 18, 21, 22, 23, 31, 32, 33, 34, 35, 37, 42 and 43 to our Group annual financial statements included elsewhere in this Annual Report for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in this Annual Report. The following discussion and analysis are based on the results of operations prepared in accordance with South African Statements of Generally Accepted Accounting Practice ( SA GAAP ), which differ from United States Generally Accepted Accounting Principles ( US GAAP ).

Fiscal 2005 included 53 accounting weeks, compared to 52 accounting weeks in fiscal 2004 and fiscal 2003. Our fiscal years operate on a 52 accounting week cycle, except every 6th fiscal year which includes an additional accounting week ( additional accounting week ). The following discussion of our operating and financial review and prospects refers to the impact of the additional accounting week in fiscal 2005 on our sales, raw material and other input costs of manufacturing, operating expenses and, selling, general and administration expense ( SG&A expense ), based on average sales and costs.

**Company and Business Overview**

We are a global Company that through acquisitions in the 1990s has been transformed into the global market leader in coated fine paper. Two acquisitions were pivotal in establishing us as a global Company, namely the acquisition in 1994 of S.D. Warren Company, now known as Sappi Fine Paper North America, and the acquisition in 1997 of KNP Leykam, now integrated into Sappi Fine Paper Europe. Opportunities to grow within our core businesses will continue to be evaluated.

We have integrated our fine paper acquisitions into a single fine paper business, which operates under the name Sappi Fine Paper. We are organised into two operating business units: Sappi Fine Paper and Sappi Forest Products. We also operate a trading network called Sappi Trading for the international marketing and distribution of chemical cellulose and market pulp throughout the world and of the group's other products in areas outside our core operating regions of North America, Europe and southern Africa.

Sappi Fine Paper generated approximately 80% of our sales during fiscal 2005 and fiscal 2004. Of our sales for fiscal 2005 and fiscal 2004, approximately 84% were made in US dollars, euro and other non-Rand denominated currencies. Our South African business sells approximately 42% of its products in US dollars. See *Inflation and Foreign Exchange* and note 37 to our Group annual financial statements included elsewhere in this Annual Report. Our sales by source and destination in fiscal 2005 and fiscal 2004 were as follows:

	Sales by Source 2005		Sales by Source 2004		Sales by Destination 2005		Sales by Destination 2004	
North America	29	%	29	%	30	%	31	%
Europe	45	%	45	%	40	%	41	%
Southern Africa	26	%	26	%	15	%	15	%
Far East and others					15	%	13	%
<b>Total</b>	<b>100</b>	<b>%</b>	<b>100</b>	<b>%</b>	<b>100</b>	<b>%</b>	<b>100</b>	<b>%</b>

Sappi Fine Paper has a total paper production capacity of 4.2 million metric tonnes per annum. We are the global leader in the coated fine paper business with a capacity of 3.9 million metric tonnes of coated fine paper per annum and with a market share of approximately 24% in the United States,

approximately 20% in Europe and greater than 60% in southern Africa. Our market share in the United States declined during fiscal 2003 as a result of our long-term branded merchant distribution rationalisations, following the Potlatch acquisition, which resulted in discontinuing certain products and merchant relationships, as well as pricing actions of competitors in response to difficult market conditions. Our market share stabilised in fiscal 2004 and after declining earlier during fiscal 2005, our North American market share increased towards the end of fiscal 2005 to slightly above fiscal 2004 levels. After also declining during fiscal 2005, our European market share increased in recent months to similar levels as at the end of fiscal 2004. In addition, we are the world's largest producer of chemical cellulose (dissolving pulp), with a market share of approximately 15%. The Sappi Group is now more than 100% integrated on a net basis in terms of pulp usage, meaning that, while some of our facilities are market buyers of pulp and others are market sellers, in the aggregate we produce slightly more pulp than we utilise. By region, the southern African operations are net sellers of pulp, Sappi Fine Paper North America is fully integrated and the European operations are approximately 44% self-sufficient for pulp in Continental Europe, but entirely dependent on market pulp in the United Kingdom. We supply approximately 78% of the wood requirements for our South African businesses from sources we own or manage. Both our North American and European operations are dependent on outside suppliers of wood for their production requirements.

In recent years, we have sought to internationalise our shareholder base and increase our exposure in the world's major financial markets. On November 5, 1998, our American Depositary Receipts commenced trading on the New York Stock Exchange. We believe that, as at the end of fiscal 2005, based on registered addresses and disclosure by nominee companies, 46% of our shares excluding the shares owned by a subsidiary of Sappi, were held beneficially in North America, 42% of our shares were held beneficially in southern Africa and 12% of our shares were held beneficially in Europe and elsewhere. We believe that, compared to the shareholding of our shares at the end of fiscal 2004, the North American shareholding of our shares has increased from 36% and the southern African shareholding has decreased from 51%, while the European shareholding remained unchanged.

#### **Principal Factors Impacting on our Results**

The results of operations of our business are affected by numerous factors. Given the high fixed cost base of pulp and paper manufacturers, industry profitability is highly sensitive to changes in prices. Prices are significantly affected by changes in industry capacity and output levels, customer inventory levels and cyclical changes in the world economy. Profitability in our industry is, however, also influenced by factors such as sales volume, the level of raw material and other input costs, exchange rates, and operational efficiency.

The principal factors that have impacted our business during the financial periods presented in the following discussion and analysis and that are likely to continue to impact our business are:

- a) cyclical nature of our industry and its impact on sales volume;
- b) movement in market prices for our products;
- c) sensitivity to currency movements;
- d) movement in market prices for raw materials and other input costs of manufacturing; and
- e) other significant factors impacting costs, including new acquisitions, restructuring and cost reduction initiatives.

Because many of the factors are beyond our control and certain of these factors have historically been volatile, past performance will not necessarily be indicative of future performance and it is difficult to predict future performance with any degree of certainty.

## Markets

The markets for our pulp and paper products are cyclical, with prices significantly affected by factors such as changes in industry capacity and output levels, customer inventory levels and cyclical changes in the world economy. The pulp and paper industry has often been characterised by periods of imbalances between supply and demand, causing prices to be volatile. Prices also vary significantly by geographic region and product while our core coated paper products are used for many types of publications. The highly cyclical advertising market is a major driver of our business.

## Coated Fine Paper

Paper demand has fluctuated significantly in recent years. From fiscal 2002 to fiscal 2004, the upswing in world economic growth and advertising markets resulted in a significant increase in demand for coated fine papers. The increase in demand was particularly pronounced in Europe where coated fine paper demand remained buoyant with a growth rate of 8.2% during fiscal 2004 despite their retreating rate of economic growth. North American demand growth improved during this period and reached 4.7% in fiscal 2004, reflecting the growth in the wider economy. However, growth rates were very volatile due to end-user inventory movement, increasing from negative 13.1% in the first quarter of fiscal 2004 to positive 18.0% in the third quarter of fiscal 2004.

Increases in industry capacity in Europe and North America were limited during this period, with companies reluctant to undertake major new capital projects in these regions due to the large amount of excess capacity already present. Despite global overcapacity, high Asian demand growth rates and freely available funding led to significant coated fine paper capacity additions between fiscal 2000 and fiscal 2005 in Asia, particularly in China. This wave of expansion finished by the end of calendar 2005 and as of early December 2005 no new machines were under construction or in the final stages of planning anywhere in the world.

Despite increased demand, operating rates were low in fiscal 2002 through the first half of fiscal 2004 due to excess capacity, causing price erosion in both Europe and North America. Despite the weakening US dollar during this period, net imports into the United States continued to grow, putting further pressure on prices. Prices in North America, however, did start to improve in the latter half of fiscal 2004 due to a sharp increase in demand which was probably spurred by inventory increases at the end-user level. These tight supply/demand conditions in North America continued into the first quarter of fiscal 2005, and further price increases were achieved. In the second quarter, growth rates turned sharply negative and this persisted until the end of fiscal 2005. End-use indicators such as advertising pages and printer consumption of coated fine paper were largely positive through this period, suggesting that actual demand did not decline in line with apparent demand. In total, North American apparent consumption grew by 1.0% in fiscal 2005.

In Europe, demand for coated fine paper grew by 4.4% in fiscal 2005, a significant decline on the previous years' growth of 8.2%. Despite demand growth and sharp increases in input costs, our attempt to increase prices in the European market in fiscal 2005 was unsuccessful due to intense competition for market share.



**US vs Total European Apparent Consumption of Coated Fine Paper**

**Source: AF&PA & Cepifine**

**US short tonnes converted to metric tonnes**

## Edgar Filing: SAPPI LTD - Form 20-F

The recent price history for benchmark coated woodfree grades in North America and Europe is shown in the following chart:

### **US and European Fine Paper Prices**

**Prices are list prices. Actual transaction prices could differ from prices depicted in graph**

**Source: PPI**



*Pulp*

Pulp prices tend to display higher volatility than paper prices. The price of the benchmark pulp grade, Northern Bleached Softwood Kraft pulp ( NBSK ) has ranged from a low of \$395 (Nov-1993) to a high of \$925 (Sept-1995) per metric tonne.

Throughout fiscal 2003 and fiscal 2004, global demand for pulp was low in comparison to fiscal 2002 and price fluctuations were driven primarily by currency changes and inventory movement.

High pulp demand during the first half of fiscal 2005 resulted in an increase of \$55 per metric tonne, but resulted in prices retreating during the latter part of the year due to destocking and a seasonal demand slowdown.

The traditional softwood pulp price premium to hardwood was disrupted in fiscal 2005 as a result of pulp mills shifting from hardwood to softwood production, and hardwood pulp mills closing temporarily. This led to hardwood pulp prices exceeding that of softwood in the final quarter of fiscal 2005. However, during October 2005 softwood price premiums were restored as some softwood mills closed in Eastern Canada, while hardwood supply increased during the latter part of fiscal 2005 as an additional 1.9 million metric tonnes came on stream with large expansions at Hainan Island in China and Veracel in Brazil.

Since Sappi sells roughly as much pulp as is purchased, fluctuations in market pulp prices have a negligible direct impact on the company's overall profitability. At a divisional level, pulp prices do, however, affect profitability since Sappi Fine Paper is a net buyer of hardwood pulp and Sappi Forest Products is a net seller of softwood pulp.

The price of NBSK and Northern Bleached Hardwood Kraft pulp ( NBHK ) pulp is depicted in the following chart:

**Northern Bleached Softwood and Hardwood Kraft Pulp**

**Source: PIX**

Chemical cellulose (dissolving pulp) accounts for the majority of Sappi's third party pulp sales. The chemical cellulose (dissolving pulp) we produce is used principally as an input in the production of various synthetic textiles and acetate flake used in the manufacturing of acetate tow for cigarette filter tips.



The movement in price of certain chemical cellulose (dissolving pulp) grades is linked to the price of NBSK. Higher technical specifications allow chemical cellulose (dissolving pulp) to typically trade at a premium to NBSK. BHK (bleached hardwood kraft) generally sells at a lower price than NBSK.

We diversified our range of chemical cellulose (dissolving pulp) products and secured significant new agreements to supply customers in the acetate sector during fiscal 2003. Also, a significant competitive source of supply was removed from the industry when International Paper closed its Natchez plant in fiscal 2003. Demand from all of the market segments in which Saiccor is active remained strong throughout fiscal 2004 with prices also increasing steadily. Saiccor's capacity during fiscal 2005 continued to be fully booked with overall demand steady, despite a general fall off in the demand for chemical cellulose (dissolving pulp) from China during the year. Our chemical cellulose (dissolving pulp) business, which is 100% export-based, maintained a strong market position in the key Viscose Staple Fibre segment but also posted record sales of its higher alpha products, which are primarily sold into the acetate tow segment.

Based on a growing demand for Saiccor's products, we announced, in the last quarter of fiscal 2005, that we are considering, subject to the completion of an environmental impact assessment and board approval, a project to expand the mill's annual capacity by 200,000 metric tonnes. During the latter part of fiscal 2005, Weyerhaeuser announced the closure, effective early in calendar 2006, of its Cosmopolis mill in North America, a speciality pulp mill producing 125,000 metric tonnes per annum.

### Currency Fluctuations

The principal currencies in which our subsidiaries conduct business are the US dollar, euro and Rand. Although our reporting currency is the US dollar, a significant portion of our sales and purchases is made in currencies other than the dollar. In Europe and North America, sales and expenses are generally denominated in euro and US dollars, respectively; however, pulp purchases in Europe are primarily also denominated in US dollars. In southern Africa, costs incurred are generally denominated in Rand, as are local sales. Exports to other regions, which represent approximately 42% of sales in fiscal 2005, are denominated primarily in US dollars.

We made sales in a range of foreign currencies in fiscal 2005, fiscal 2004 and fiscal 2003 as follows:

Percentage of Sales	2005	2004	2003
US dollar	44.8	42.3	46.7
Euro	30.5	38.3	36.6
Rand	15.7	14.8	13.2
Other	9.0	4.6	3.5
Total	100.0	100.0	100.0

The increased proportion of the US dollar denominated sales and decreased proportion of euro denominated sales in fiscal 2005, is primarily the result of increased sales for our North American operations and also the effect of the Rand strengthening more on average in fiscal 2005 against the US dollar, compared to the strengthening of the euro on average against the US dollar.

The appreciation of the Rand or the euro against the US dollar tends to diminish the value of exports from southern Africa and Europe in local currencies, while depreciation of these currencies against the US dollar will have the opposite impact. Since expenses are generally denominated in local currencies, the depreciation of the US dollar has a negative effect on gross margins on exports and such domestic sales, which are priced relative to international US dollar prices. The appreciation of the US dollar will have the opposite impact. European importers of pulp denominated in US dollars have benefited in terms of local currency. Our consolidated financial position, results of operation and cash flows may be materially affected by movements in the exchange rate between the US dollar and the respective local currencies to which our subsidiaries are exposed. The principal currencies in which our subsidiaries conduct business

that are subject to the risks described in this paragraph are the US dollar, euro and Rand. The following table depicts the average and year end exchange rates for the Rand and euro against the US dollar used in the preparation of our financial statements in fiscal 2005, fiscal 2004 and fiscal 2003:

	2005	2004	2003
Average Exchange Rate <sup>(1),(2)</sup>			
Rand <sup>(3)</sup>	6.2418	6.6824	8.3300
Euro <sup>(3)</sup>	1.2659	1.2152	1.0804
Year end Exchange Rate <sup>(1),(2)</sup>			
Rand <sup>(3)</sup>	6.3656	6.4290	7.1288
Euro <sup>(3)</sup>	1.2030	1.2309	1.1475

(1) Source: audited Group annual financial statements of Sappi Limited.

(2) At December 15, 2005, based upon the Rand Noon Buying Rate and the euro Noon Buying Rate in New York City for cable transfers as certified for customs purposes by the Federal Reserve Bank of New York, the exchange rates were as follows: Rand 6.4300 per \$1.00 and euro 1.1965 per \$1.00. Source: Federal Reserve Statistical Release.

(3) US\$1 = Rand, euro 1 = US dollar.



Since the adoption of the euro by the European Union on January 1, 1999, when the euro was trading at approximately \$1.18 per euro, the euro depreciated against the US dollar to a low of approximately \$0.83 per euro on October 25, 2000, and recovered to approximately \$0.98 at the end of fiscal 2002 and to approximately \$1.15 per euro at the end of fiscal 2003. It reached a high of approximately \$1.29 per euro on February 18, 2004 and was approximately \$1.23 at the end of fiscal 2004. It reached a high of approximately \$1.36 per euro on December 28, 2004, but declined subsequently to approximately \$1.20 per euro at the end of fiscal 2005. On December 7, 2005 it was trading at approximately \$1.17 per euro. During fiscal 2000, the Rand traded at levels around R6.55 per US dollar, and weakened to approximately R8.94 per US dollar at the end of fiscal 2001. It continued to weaken significantly and reached an all time low of approximately R13.90 per US dollar on December 21, 2001. The Rand has recovered since then and was trading at approximately R10.54 per US dollar at the end of fiscal 2002 and approximately R7.13 per US dollar at the end of fiscal 2003. During fiscal 2004 it reached a high of approximately R5.90 per US dollar on July 19, 2004. The Rand was trading at approximately R6.43 per US dollar at the end of fiscal 2004. It has strengthened since then to a level of approximately R5.59 per US dollar on December 27, 2004, but weakened again to R6.91 per US dollar on June 6, 2005. The Rand was trading at approximately R6.37 per US dollar at the end of fiscal 2005. It has strengthened since then to a level of approximately R6.30 on December 7, 2005. The profitability of certain of our southern African operations is directly dependent on the Rand proceeds of the US dollar exports. Furthermore, prices in the local market are also influenced by import parity competition. Should the Rand continue at the current levels or further strengthen against the US dollar, we would anticipate that certain operations would continue to incur losses while others could start incurring losses during the new fiscal year. The following graph depicts currency movements for the Rand and euro against the US dollar:

**Daily euro and ZAR Exchange Rates against the US dollar**

US\$1 = Rand, euro 1 = US dollar.

**Raw Material and Other Input Costs of Manufacturing**

Our business is sensitive to fluctuations in market prices of raw materials used in the manufacture of our products. These comprise mainly purchased materials, (such as wood and caustic soda), pulp, energy

and chemicals (including calcium carbonate and latex). Total raw materials (excluding pulp purchases) of approximately \$1,433 million purchased in fiscal 2005, increased by \$130 million (10.0%) from fiscal 2004, and consisted of 45.5% chemicals, 29.0% wood and 25.5% energy. The additional accounting week in fiscal 2005 accounted for \$27 million of the \$130 million increase, based on average weekly costs. Chemicals constitute the largest component of raw materials and chemical price increases impacts our business more than price increases of wood and energy. During fiscal 2005 we experienced significant increases in the cost of chemicals (11.7%), wood (3.9%) and energy (14.5%). For every 1% change in the price of chemicals and energy, our earnings per share will increase/decrease by \$0.02 cents and \$0.01 cent, respectively, based on our fiscal 2005 earnings. Our energy and chemical raw material costs, especially coating chemicals, are driven to a large extent by oil prices. The average cost of Brent Crude Oil increased on average by 52.9% during fiscal 2005, to \$52 per barrel, from \$34 per barrel during fiscal 2004. The cost of our raw materials, on a constant US dollar per metric tonne basis in fiscal 2005, increased by 5.0% (\$12 per metric tonne) over fiscal 2004.

During fiscal 2005, the impact of price increases on purchased wood, energy and chemical costs increases was \$71 million in our North American operations. This increase is largely due to significant increases in chemical costs (\$37 million), energy costs (\$20 million) and wood costs (\$14 million).

European purchased materials, energy and chemical costs increased by \$55 million in fiscal 2005, \$47 million of which was price increases, and \$8 million was the result of volume, mix and the impact of the currency translation effect. Average raw materials costs in euro per metric tonne increased by 3.3% to euro 211 per metric tonne in fiscal 2005, compared to fiscal 2004.

For Sappi Fine Paper South Africa the cost of purchased materials, energy and chemicals in Rand per metric tonne terms increased by 2.1%, which was mainly due to higher chemical costs. Our Forest Products operations experienced price increases in all the categories of raw materials (\$18 million) during fiscal 2005, comprising the majority of the \$20 million increase in total cost of purchased materials, energy and chemical costs in fiscal 2005.

### **Restructuring**

During fiscal 2003 we took a number of actions in response to continuing weak markets and rising costs. These included the production downtime in our North American and European regions, as well as reducing capacity to improve the supply/demand balance in the United States and a range of other initiatives to reduce fixed costs in all regions.

We announced the closure of the number 14 paper line at our Westbrook mill in Maine, North America in November 2003. This followed our decision to take out capacity to improve the supply/demand balance in the United States. The machine that was closed was our highest cost of manufacturing paper machine. In the last quarter of fiscal 2003 we wrote off the assets and related inventory and took a charge of \$19 million after tax (\$32 million pre-tax). We also incurred a further charge of approximately \$16 million pre-tax in the first quarter of fiscal 2004 in respect of severance, retrenchment and related costs. The total number of employees affected by this closure was 145 people.

During fiscal 2004 we restructured the Fine Paper division to simplify reporting lines. As a result the chief executive officers of Sappi Fine Paper Europe and Sappi Fine Paper North America report directly to the chief executive officer of Sappi Limited. As a consequence the Fine Paper office in London was closed, and the position of chief executive officer for Sappi Fine Paper no longer exists. A charge of \$5 million pre-tax was incurred for the closure of the Fine Paper office in London during fiscal 2004. The total number of employees affected by this closure was 8 people.

In addition, in order to counteract the effect of rapidly increasing benefit costs, we also reduced our staffing levels by a further 85 people in North America, 49 people in Europe and 211 people at our Forest

Products operations during fiscal 2004. We incurred a pre-tax charge of approximately \$11 million during fiscal 2004 in respect of this.

We announced the restructuring and impairment of our North American Muskegon mill during the third quarter of fiscal 2005, to eliminate high cost capacity and to position the mill as a high quality, low cost mill. This is part of our ongoing plan to achieve acceptable returns in our North American operations. We recorded impairment charges of \$183 million in the third and fourth quarter of fiscal 2005. We closed PM4, which had an annual capacity of 105,000 metric tonnes of coated fine paper and closed and mothballed the pulp mill, which had an annual capacity of 110,000 metric tonnes of bleached chemical pulp. We also restructured our North American regional overhead structure to reduce selling, general and administrative expenses ( SG&A ), and in the fourth quarter of fiscal 2005 we recorded a restructuring charge of approximately \$21 million, mainly in respect of manpower reduction. The combined effect of the Muskegon restructuring and impairment and SG&A restructuring is expected to result in a reduction of approximately 420 people or 14% of our North American headcount, and is expected to result in a pre-tax benefit of approximately \$50 million compared to fiscal 2005.

During the first quarter of fiscal 2005 we announced the impairment of our Usutu mill. The Usutu mill is an unbleached kraft pulp mill and forms part of the Sappi Forest Products reporting segment. Due to continued losses an impairment review was conducted which led to the recognition of impairment charges of \$50 million. A detailed discussion of this impairment is contained in the section Mill Closures, Acquisitions, Dispositions and Impairment; and Joint Venture , elsewhere in this Operating and Financial Review and Prospects.

For further information see note 23 to our Group annual financial statements included elsewhere in this Annual Report.

### **South African Economic and Political Environment**

Sappi Limited, as a South African company and with ownership of significant operations in southern Africa, operates within a framework of various economic, fiscal, monetary, regulatory, operational (including labour-relations) and political policies and factors that affect South African companies and their subsidiaries generally. The impact of certain of these policies and factors, for example regulatory and operational factors, is limited by the geographic diversity of our sales by source and the geographic diversity of our operating assets, of which Europe represented 37%, North America represented 27% and southern Africa represented 36% at the end of fiscal 2005. However, of our consolidated operating loss of \$137 million in fiscal 2005, our operations outside South Africa generated an operating loss of \$194 million and our operations in southern Africa generated an operating profit of \$57 million.

South Africa features a highly developed sophisticated first world infrastructure at the core of its economy. The South African economy is expected to grow at approximately 4.5% in calendar 2005. South Africa currently has long-term foreign currency investment ratings of Baa1 from Moody's Investor Services Inc. and BBB+ from Standard & Poor's Rating Service ( S&P ). While exchange controls have been relaxed in recent years and are continuing to be relaxed, South African companies remain subject to restrictions on their ability to raise and deploy capital outside of the Southern African Common Monetary Area. See Liquidity and Capital Resources Financing .

South Africa celebrated 10 years of democracy in calendar 2004; however the country continues to face challenges in overcoming substantial differences in levels of economic and social development among its people. Access to land, poverty and unemployment, crime and a growing prevalence of HIV/AIDS are some of the social and economic factors that affect businesses operating in this country.

The southern African region has one of the highest infection rates of HIV/AIDS in the world. In 1992, Sappi established a programme to address the effects of HIV/AIDS and its impact on our employees and

our business. Our aim is to ensure that our programme prevents new infections. Accordingly, in 2005, we became a member of the Global Business Coalition (GBC) on HIV/AIDS, a global partnership focused on developing an integrated strategy for dealing with the disease. Each of our operating units in southern Africa has an elected HIV/AIDS committee and a workplace HIV/AIDS prevention programme which are adapted to suit the needs of each particular business unit. Each Sappi operation in southern Africa has also identified the relevant role players in their geographical area and is working with them on the implementation of a comprehensive HIV/AIDS programme, eliminating duplication, making optimum use of relevant resources and ensuring sustainability. Following an initial anonymous voluntary study in 2003, a second comprehensive study was conducted in 2005. Based on a participation rate of greater than 80% at the operating units tested, we estimate that the overall infection rate in our southern African operations is approximately 13.7%. Our HIV/AIDS response strategy places special emphasis on testing and counselling. Since August 2002, our medical care for employees has included treatment to prevent mother to child transmission. Anti-retroviral treatment has been offered to HIV-infected permanent employees from the beginning of 2003. Thirty-four percent of the estimated population of HIV positive employees are actively engaged in an HIV/AIDS managed care programme, which is a significant improvement on the prior year's participation rate. Of these employees actively engaged in a care programme, 40% are receiving anti-retroviral treatment.

The government and organised business have taken a number of steps in recent years to increase the participation of Black people in the South African economy. To this end, the Employment Equity Act (No 55 of 1998), the Skills Development Act (No 97 of 1998) and the Preferential Procurement Policy Framework Act (No 5 of 2000) were promulgated. More recently, the Broad-Based Black Economic Empowerment Act (No 53 of 2003) has formalised the country's approach to distributing skills, employment and wealth more equitably between races and genders. Broad-Based Black Economic Empowerment (BBBEE) focuses on increasing equity in ownership, management and control of businesses, and improving Black representation in all levels of employment. It also promotes the development of skills within a business, the nurturing of Black entrepreneurship through preferential procurement and enterprise development, and the uplifting of communities through social investment.

Our South African businesses have formulated a BBBEE scorecard, based on guidelines set out by the Codes of Good Practice from the government Department of Trade and Industry. The scorecard set out in the following table was verified by Empowerdex, a leading BBBEE rating agent and reflects our significant achievements in the categories of empowerment, equity, skills development, preferential procurement, enterprise development and social development. Furthermore, the scorecard provides us with a basis on which to make future plans to extend our efforts. In general, targets for improvement in the various categories in the scorecard are set to be achieved by 2015.

Sappi's rating

**BBBEE factor status\***

Equity in ownership	E
Equity in management	D
Employment equity	C
Skills development	B
Preferential procurement	C
Enterprise development	B
Social development	A

\* A is the highest score.

The shares of Sappi are widely held by South African and international investors. The company does not currently intend to undertake an empowerment transaction in respect of these shares. We will consider

empowerment transactions related to specific southern African assets or business units where they add to the value of our business and meet our empowerment criteria.

The representation of Black people, particularly Black women, in management and all levels of employment within the company is a focus within the organisation, driven by employment equity targets set in each occupational category. Skills development initiatives, particularly programmes aimed at improving management and leadership skills, are geared to meet these targets. Where practical, Sappi purchases goods and services from Black-owned businesses and seeks opportunities to develop future Black vendors. Sappi is committed to the support of its Project Grow initiative through financial and technical input, as well as by providing a secure market during the start-up phase of these small tree farming enterprises. This initiative has been extended to encourage aspirant tree farmers who wish to undertake forestry activities on a larger scale. We have a number of enterprise development initiatives and have established programmes to train new entrepreneurs. These initiatives involve the transfer of business skills, technical assistance, financial support and preferential payment terms to assist new enterprises to enter the market. Sappi has a history of investment in the communities in which it operates. Initiatives to promote education, health and welfare, arts and culture, and rural and community development, amongst others, are regularly undertaken.

The South African constitution guarantees ownership rights of assets, and it is the stated intent of the Bill that transfer of ownership will occur at market prices. It should be noted that BBBEE equity participation need not necessarily occur at the corporate level, and can be effected at divisional, business unit or lower levels. Because the BBBEE Bill sets forth a framework for plans rather than specific requirements or goals, it is not possible to predict whether or how our business or assets may be impacted.

### Inflation and Interest Rates

The following table sets forth South African inflation for fiscal 2005, fiscal 2004 and fiscal 2003:

	2005	2004	2003
Inflation <sup>(1)</sup>	4.4 %	1.3 %	3.7 %

(1) South African Consumer Price Index (CPI). The CPI is for the Sappi fiscal years.

After having peaked at levels in excess of 20% in the 1990s the South African prime overdraft interest rates declined to 13.0% in September 2001, the lowest level in 13 years. The South African inflation rate (as measured by inflation less mortgage interest rates), increased from 6.5% in December 2001, to 14.5% in October 2002, mainly due to the significant weakening of the Rand against the US dollar in the quarter ended December 2001. Accordingly, prime overdraft interest rates increased by 4% to 17% by the end of fiscal 2002. Since reaching its lowest levels against the US dollar in December 2001, the Rand has strengthened to its current levels of around R6.30. Partly due to the stronger Rand during fiscal 2005 and fiscal 2004, the South African inflation rate decreased significantly to 1.3% at the end of fiscal 2004, but increased to 4.4% as at the end of fiscal 2005, within the target range of 3-6% as set by the South African Reserve Bank (the SARB). This increase is largely the effect of the impact of higher oil prices on the South African economy. The SARB reduced its repurchase rate from 13.5% in November 2002 to 7.0% in April 2005, and as at December 7, 2005 it was 7.0%. The repurchase rate is the rate at which the SARB lends assistance to the banking sector and therefore represents the cost of credit to the banking sector. When the repurchase rate is changed, the interest rates on overdrafts and other loans extended by the banks also change. In this way the Reserve Bank indirectly affects interest rates in the economy. Although South African interest rates impact the cost of our South African borrowings, the majority of our borrowings have been incurred by subsidiaries outside southern Africa, denominated in either US dollars or euro.

In the US and Europe inflation rates were relatively stable in recent years, and accordingly had a lesser impact on our North American and European businesses. The three-month LIBOR interest rate for the US dollar reached 6.8%, in May 2000 and remained unchanged through to the end of fiscal 2000. Fiscal 2001 saw a period of significant rate reductions to 2.6% at the end of fiscal 2001. The rate reduced further to 1.14% at the end of fiscal 2003. Since then it increased to 1.96% by the end of fiscal 2004 and increased further to 4.06% by the end of fiscal 2005. On December 7, 2005 it was 4.48%.

The three-month Euribor interest rate in Europe decreased sharply from 4.9% at the end of fiscal 2000 and was 2.13% at the end of fiscal 2003 and 2.12% at the end of fiscal 2004. It increased slightly to 2.17% at the end of fiscal 2005 and on December 7, 2005 it was 2.45%. The relatively low interest rates in the United States and Europe continue to represent a significant interest rate differential when compared to South Africa's 7.0% repurchase rate as determined by the SARB, and could result in further short-term strengthening of the Rand.

We borrow in the currencies of the countries in which we invest. As a result, finance costs are related to the location of our activities and not our domicile.

Our foreign exchange policy consists of the following principal elements:

- External borrowings are taken up in the functional currency of the operating company concerned and, if not, then the exposure is hedged. Where appropriate we aim, in accordance with SA GAAP, to apply hedge accounting treatment to avoid volatility in our results due to mark-to-market effects of such hedging instruments.
- Any receivables or payables not in the operating currency of the mill are hedged. Sales are hedged from the time of invoicing, purchases from the time of capex approval in the case of capex, and all other purchases are hedged in most instances at the time the order is placed.
- These exposures are hedged through our central treasury, where external hedging instruments are contracted after netting the various exposures.
- Variations in this policy are considered from time to time, but any deviations from the central treasury policy are always subject to prior board approval.
- No speculative positions are permitted.

Translation risks are not hedged. As a general rule we manage our relative debt and equity ratios by financing our investments in different currencies with similar debt to asset ratios.

External dollar borrowings for our North American operations (with the exception of \$107 million public long-term bonds) were replaced during fiscal 2002 by inter-group financing from Sappi Papier Holding GmbH ( SPH ), our European holding company. Accordingly, there is a larger proportion of external borrowings in our European operations when compared to the position before fiscal 2002. We have a current policy of not hedging translation risks. Our South African and European operations use the South African Rand and the euro as their respective functional currencies. Any translation of the value of these operations into US dollars result in foreign exchange translation differences as the Rand and the euro exchange rates move against the US dollar. These changes are booked to the foreign currency translation reserve account. We prefer not to hedge this exposure with financial instruments, as this results in cash settlements which impact our results on a permanent basis. Borrowings taken up in a currency other than the functional currency of the borrowing entity is specifically hedged with financial instruments, such as currency swaps and forward exchange contracts. With regard to interest rate swaps, hedge accounting is permitted when the hedging relationship between the hedge and the underlying debt meets the requirements of the relevant accounting statements in accordance with SA GAAP and International Financial Reporting Standards. For example, on our public bonds we have fixed to variable swaps. The terms of the swaps match the terms of the bonds exactly in respect of interest settlements and capital

repayments etc. With regard to maturity, the 10-year bond is hedged to full maturity, the 30-year bond for the first ten years. If the relationship between the hedge and the debt is not matched, hedge accounting cannot be applied. We only enter interest rate swaps when hedge accounting can be applied or any volatility due to the mark-to-market movements of the swaps to the income statement avoided. For a description of hedge accounting with regard to interest rate swaps in accordance with United States GAAP, see note 42 to our Group annual financial statements included elsewhere in this Annual Report. For a description of our interest and exchange rate risks, see note 37 to our Group annual financial statements included elsewhere in this Annual Report.

### Financial Condition and Results of Operations

Our operations are organised into two business units:

*Sappi Fine Paper, which consists of Sappi Fine Paper North America, Sappi Fine Paper Europe and Sappi Fine Paper South Africa; and*

*Sappi Forest Products, which consists of Sappi Kraft, Sappi Saiccor and Sappi Forests.*

The following table sets forth sales and operating profit for Sappi, Sappi Fine Paper by region, and Sappi Forest Products, in US dollars, and as a percentage of sales for fiscal 2005, fiscal 2004 and fiscal 2003. Operating profit percentages are expressed as a percentage of sales of the applicable business unit.

	2005	% of	2004	% of	2003	% of
	Amount	Sales	Amount	Sales	Amount	Sales
	(\$ million)					
<b>Sales:</b>						
<b>Sappi Fine Paper</b>						
Sappi Fine Paper North America	1,458	29.1	1,373	29.0	1,384	32.2
Sappi Fine Paper Europe	2,239	44.6	2,127	45.0	1,903	44.2
Sappi Fine Paper South Africa	323	6.4	311	6.6	270	6.3
Total	4,020	80.1	3,811	80.6	3,557	82.7
<b>Sappi Forest Products</b>	998	19.9	917	19.4	742	17.3
<b>Group Sales</b>	5,018	100.0	4,728	100.0	4,299	100.0
<b>Operating (Loss) Profit:</b>						
<b>Sappi Fine Paper</b>						
Sappi Fine Paper North America	(270 )	(18.5 )	(92 )	(6.7 )	11	0.8
Sappi Fine Paper Europe	76	3.4	83	3.9	118	6.2
Sappi Fine Paper South Africa	(12 )	(3.7 )	15	4.8	35	13.0
Total	(206 )	(5.1 )	6	0.2	164	4.6
<b>Sappi Forest Products</b>	73	7.3	191	20.8	113	15.2
<b>Corporate</b>	(4 )		(9 )		(5 )	
<b>Group Operating (Loss) Profit</b>	(137 )	(2.7 )	188	4.0	272	6.3

Our results for fiscal 2005 have been impacted by the additional accounting week in fiscal 2005, compared to fiscal 2004 and fiscal 2003. The following illustrates the impact of the additional accounting week on sales and operating expenses.

Group volumes sold in fiscal 2005 increased by 286,000 metric tonnes (4.0%) and consolidated group sales increased by \$290 million (6.1%) over fiscal 2004. The additional accounting week accounted for a sales volume increase of 141,000 metric tonnes and a \$95 million increase in sales, in each case based on the average weekly sales of the 53 accounting weeks, or average sales .

Group operating expenses (comprising cost of goods sold, SG&A expenses and other expenses) increased by \$615 million (13.5%) to \$5,155 million in fiscal 2005. This increase consisted of increases in cost of goods sold of \$381 million, other expenses of \$223 million (mainly impairments) and SG&A expenses of \$11 million. The additional accounting week accounted for an increase in cost of goods sold of \$85 million and for an increase in SG&A expenses of \$7 million, in each case based on the average weekly expenses of the 53 accounting weeks, or average expenses .

A more detailed discussion and explanation of the material factors that affect our results of operations described below, is contained in the sections Markets , Principal Factors Impacting our Results , Currency Fluctuations , Raw Material and Other Input Costs of Manufacturing , Restructuring , Inflation and Interest Rates and Mill Closures, Acquisitions, Dispositions and Impairment; and Joint Venture , elsewhere in this Operating and Financial Review and Prospects. These factors include market fluctuations, exchange rates, taxation, net finance costs, impairment costs and significant cost factors, including raw material and other input costs of manufacturing as well as restructuring and cost reduction initiatives.

#### ***Year Ended September 2005 Compared to Year Ended September 2004***

North American coated fine paper apparent demand growth slowed in fiscal 2005 in comparison to fiscal 2004, despite continued economic and advertising growth. Demand for coated woodfree paper grades grew 1.0% in comparison to 4.7% growth in fiscal 2004. Sappi Fine Paper North America's average price realised increased by 6.9% to \$1,017 per metric tonne in fiscal 2005, mainly due to price increases realised for sales of web and market pulp. Sheet prices also increased, however, the overall average sheet prices realised in fiscal 2005 was flat compared to fiscal 2004 due to a mix shift from premium products to lower grades. Prices for other grades, including the speciality grades, were stable. In Europe, demand for coated woodfree paper grew by 4.4% in fiscal 2005, which was slower compared to growth of 8.2% in fiscal 2004. Despite sharp input costs increases and significant temporary capacity closures during fiscal 2005, prices in Europe were flat. Market pulp demand increased in fiscal 2005, mainly due to demand from China's growing paper industry. This increased demand did not result in price increases until after the end of fiscal 2005 as customers initially reduced inventories.

Due to weak market conditions in fiscal 2005 and to contain rising costs, the company continued its restructuring initiatives as described in the Company and Business Overview section.

The US dollar weakened during fiscal 2005 by 4.2% against the euro and by 6.6% against the Rand. The translation of our results from local currencies to US dollar for reporting purposes tends to distort comparisons between periods when currencies are volatile. For example, as a result of the weakening of the average US dollar rate against the euro and the Rand during fiscal 2005, a 0.6% decrease in average selling price per metric tonne realised in euro translates to a 3.6% increase in average selling price per metric tonne realised in US dollar, and a 2.7% decrease in average selling price per metric tonne realised in Rand translates to a 4.2% increase in average selling price per metric tonne realised in US dollar. We refer to this as the currency translation effect in the following discussion of our financial condition and results of operations.

#### ***Sales***

Sales represent the net sales value of all products sold to outside parties. For a full description see our revenue recognition policy in note 2 of our Group annual financial statements included elsewhere in this Annual Report.



In fiscal 2005, the volume of products sold increased by 286,000 metric tonnes (4.0%) to 7.5 million metric tonnes, from 7.2 million metric tonnes in fiscal 2004. Based on average sales, the additional accounting week in fiscal 2005 accounted for 141,000 metric tonnes of the increase. The increase of 286,000 metric tonnes in volume of products sold consisted of increased volume sold for Sappi Fine Paper Europe (39,000 metric tonnes) and Sappi Forest Products (259,000 metric tonnes), and decreased volume sold for Sappi Fine Paper North America (11,000 metric tonnes) and for Sappi Fine Paper South Africa (1,000 metric tonnes).

Group sales increased by \$290 million to \$5,018 million in fiscal 2005 from \$4,728 million in fiscal 2004 (6.1%). Based on average sales, the additional accounting week in fiscal 2005 accounted for \$95 million of the increase. The increase of \$290 million in Group sales consisted of increased sales for our Fine Paper division of \$209 million and Forest Products division of \$81 million. The increase of \$290 million in Group sales is primarily due to the impact of the currency translation effect (\$177 million) and increased volumes resulting from the additional accounting week. Group sales also increased due to higher selling prices realised of \$12 million. However, in local currencies, selling prices realised decreased at all our regions, except at North America.

*Sappi Fine Paper.* The total volume sold by Sappi Fine Paper (including pulp) in fiscal 2005 increased by 27,000 metric tonnes (0.7%) to 4,177 million metric tonnes, notwithstanding the impact of the additional accounting week in fiscal 2005, which accounted for 79,000 metric tonnes based on average sales. For Sappi Fine Paper North America, volumes sold decreased by 11,000 metric tonnes (0.8%), to 1.4 million metric tonnes, despite the additional accounting week which accounted for 27,000 metric tonnes in fiscal 2005, based on average sales. Industry demand for coated fine paper in North America increased at an annualised rate of 1.0% in fiscal 2005. Sappi Fine Paper Europe's volumes sold increased by 39,000 metric tonnes to 2.4 million metric tonnes. Excluding the impact of the additional accounting week in fiscal 2005, which accounted for 46,000 metric tonnes based on average sales, volumes decreased by 7,000 metric tonnes, largely due to lower volumes sold resulting from our loss of market share and pricing issues, compared with industry-wide coated fine paper growth of 4.4% in fiscal 2005. The market share lost in Europe in the second and third quarters of fiscal 2005 was regained by Sappi Fine Paper Europe in the last fiscal quarter of fiscal 2005. Sappi Fine Paper South Africa maintained market share in fiscal 2005 and volumes sold decreased by 1,000 metric tonnes despite the additional accounting week which accounted for 6,000 metric tonnes in fiscal 2005, based on average sales.

Total sales for Sappi Fine Paper (including pulp) increased by \$209 million (5.5%) to \$4,020 million in fiscal 2005. Based on average sales, the additional accounting week in fiscal 2005 accounted for \$76 million of the increase. The \$209 million increase is due primarily to the currency translation effect (\$111 million), higher average selling prices realised in local currencies (\$75 million) and increased volume (\$23 million). Average prices realised in US dollar terms in fiscal 2005 increased by \$44 per metric tonne (4.8%) to \$962 per metric tonne, up from \$918 per metric tonne in fiscal 2004.

Sales for Sappi Fine Paper North America increased by \$85 million (6.2%) to \$1,458 million in fiscal 2005. Based on average sales, the additional accounting week in fiscal 2005 accounted for \$28 million of the increase. Increased selling prices improved sales by \$95 million, and despite the additional volume sold due to the additional accounting week, lower volumes contributed to a decrease of \$10 million in sales. The average price realised increased by 6.9% to \$1,017 per metric tonne in fiscal 2005, despite the pressure from continued imports into the United States.

Sappi Fine Paper Europe sales increased by \$112 million (5.3%) to \$2,239 million in fiscal 2005. Based on average sales, the additional accounting week in fiscal 2005 accounted for \$42 million of the increase. The \$112 million increase is due to the currency translation effect (\$90 million) and increased volumes, (\$35 million), reduced by decreased selling prices in euro terms (\$12 million). Excluding the impact of the additional volume of 46,000 metric tonnes sold due to the additional accounting week, based on average

sales, volume decreased compared to fiscal 2004, which resulted in a decrease in sales value. This decrease in volume sold was mainly the effect of our lower market share in the second and third fiscal quarters of fiscal 2005. Input cost pressures and significant temporary capacity closures from the labour action impacting competitors in Finland during fiscal 2005 prevented further price deterioration. Average price realised in US dollar terms was \$923 per metric tonne in fiscal 2005, 3.6% up from \$891 per metric tonne in fiscal 2004. In euro terms average prices per metric tonne were 0.5% lower.

For Sappi Fine Paper South Africa, sales increased by \$12 million (3.9%) to \$323 million in fiscal 2005. Based on average sales, the additional accounting week in fiscal 2005 accounted for \$6 million of the increase. This increase is primarily attributable to the result of the currency translation effect (\$21 million), reduced by lower average selling prices realised in Rand terms (\$8 million). Despite the additional volume sold due to the additional accounting week, lower volumes contributed to a decrease of \$1 million in sales. The average price realised for fine paper products in South Africa in US dollar terms increased by 4.2% to \$1,019 per metric tonne in fiscal 2005 as a result of the currency translation effect, while in Rand terms, the average price realised in fiscal 2005 decreased by 2.7% as a result of the pressure of continued imports into South Africa caused by the Rand's strength against the US dollar. The pressure of the currency strength also resulted in lower margin export sales increasing by 5,800 metric tonnes in fiscal 2005.

*Sappi Forest Products.* Total sales volume for Sappi Forest Products increased by 8.5% to 3.3 million metric tonnes in fiscal 2005. The volume of timber sold increased by 210,000 metric tonnes (13.8%), due to strong local demand for timber, and the volume of paper pulp sold increased by 23%, due to higher production in fiscal 2005, while chemical cellulose (dissolving pulp) volumes were 2% lower, mainly due to the replenishment of inventories. The additional accounting week accounted for 62,000 metric tonnes (\$19 million), based on average sales. Sappi Forest Product's sales increased by \$81 million (8.8%) to \$998 million in fiscal 2005, from \$917 million in fiscal 2004. This increase is attributable mainly to the currency translation effect (\$66 million) and increased volumes (\$78 million), partly reduced by lower selling prices in Rand terms (\$63 million). The average price for chemical cellulose (dissolving pulp) increased by 5.8% in fiscal 2005, mainly due to strong demand in fiscal 2005, especially in the viscose market, despite a general decline in demand in China. The average price for NBSK pulp decreased by 1.1% in fiscal 2005.

#### *Operating Expenses*

Group operating expenses (comprising cost of goods sold, SG&A expenses and other expenses) increased by \$615 million (13.5%) to \$5,155 million in fiscal 2005. This increase consisted of increases in cost of goods sold (\$381 million, with \$136 million representing higher raw materials and energy costs and \$151 million representing the currency translation effect), other expenses (\$223 million) and selling, general and administrative expenses (\$11 million), including additional costs due to the additional accounting week (cost of goods sold \$85 million and SG&A \$7 million, based on average expenses). The total increase in Group operating expenses of \$615 million included \$233 million relating to the Muskegon and Usutu impairment charges and \$170 million due to the currency translation effect (of which Europe represented \$87 million and southern Africa \$83 million). We have been vigilant in trying to control costs and offset cost increases where possible. The ongoing initiatives that we put in place over the last few years to offset the impact of cost increases delivered significant savings in fiscal 2005. On a constant currency basis, Group fixed costs increased by only 1% in fiscal 2005.

Operating expenses for Sappi Fine Paper North America increased by \$263 million, primarily as a result of the \$183 million Muskegon impairment charges, and partly as a result of increased cost of sales of \$91 million, (of which price increases for raw material and energy input costs were \$71 million), partly reduced by decreased volumes (\$11 million). The additional accounting week accounted for \$33 million based on average expenses.

Operating expenses for our European operations increased by euro 27 million (1.6%), or by \$119 million in US dollar terms. The \$119 million increase was due primarily to the currency translation effect of \$87 million and volume increases of \$34 million. The additional accounting week accounted for euro 33 million (\$41 million) based on average expenses. Price increases for raw material and energy input costs accounted for an increase of \$47 million.

Operating expenses at Sappi Fine Paper South Africa increased by R113 million, (5.7%) or by \$39 million in US dollar terms, \$22 million of which was the currency translation effect. The R113 million increase included the impact of the additional accounting week (R39 million \$6 million), based on average expenses, the costs relating to the temporary closure in fiscal 2005 of the Stanger bleached plant (R36 million \$6 million), an increase in the provision for spares obsolescence (R22 million \$4 million), the effect of increases in prices of raw materials and energy (R31 million \$5 million) and an increase in finished goods obsolescence provision (R8 million \$1 million).

Operating expenses for Forest Products increased by R923 million (19.0%) in Rand terms, or \$199 million in US dollar terms, of which \$61 million was the currency translation effect, \$62 million was volume increases (including the additional costs due to the additional accounting week), \$50 million (R312 million) was the Usutu impairment charge and \$26 million was price increases. The \$26 million price increases included the result of increases in prices of raw materials and energy costs of \$20 million (R125 million). Operating expenses was reduced by the benefit of \$52 million relating to the plantation adjustment (\$18 million less than fiscal 2004 primarily due to fewer timber price increases). The 19.0% increase in operating expenses in Rand terms is mainly due to the 8.5% increase in volumes sold and the \$50 million impairment charges for the Usutu mill.

SG&A expenses, which are included in the group operating expenses discussed above, were \$382 million in fiscal 2005, \$11 million higher than \$371 million in fiscal 2004. \$11 million was as a result of the currency translation effect, \$8 million was due to the extra accounting week based on average expenses, reduced primarily by a lower charge for bad debt provisions of \$7 million for our European operations, compared to the charge for bad debt provisions in fiscal 2004.

Other expenses, which are included in the group operating expenses described above, represent all profit and expenditure relating to activities other than that which is regarded as normal trading. Other expenses of \$259 million in fiscal 2005 (\$36 million in fiscal 2004) relate mainly to asset impairment charges (\$232 million) and restructuring charges (\$22 million), reduced by the release of a \$6 million provision at Sappi Fine Paper Europe. The \$232 million asset impairment charges relate mainly to our North American Muskegon mill (\$183 million) and our southern African Usutu mill (\$50 million). The \$22 million restructuring charges relate mainly to our initiatives in North America to address the regional overhead structure. In fiscal 2004, other expenses of \$36 million included \$32 million of restructuring charges, mainly at our North American Westbrook mill (\$16 million), the closure of our London office (\$5 million) and staff compliment reductions at our North American and Forest Products operations (\$11 million) and also included charges relating to the write-off of assets at all of our divisions.

Group operating expenses per metric tonne increased by \$58 (9.2%) to \$689 in fiscal 2005 from \$631 per metric tonne in fiscal 2004. The increase of 9.2% was largely the result of the Muskegon and Usutu impairment charges (\$31 per metric tonne or 4.9%), the currency translation effect (\$23 per metric tonne or 3.6%) as well as higher raw materials and energy costs (\$18 per metric tonne or 2.9%). The ongoing initiatives that we put in place over the last few years to offset the impact of cost increases delivered significant savings in fiscal 2005. The 4.0% increase in volume sold in fiscal 2005 resulted in the fixed cost component of operating expenses being spread over more tonnes, thereby decreasing fixed costs on a per metric tonne basis. Excluding the Muskegon and Usutu impairment charges, the overall increase of operating expenses per metric tonne was contained to 4.3% per metric tonne from fiscal 2004, compared to the 8.4% increase in total operating expenses, excluding the Muskegon and Usutu impairment charges.

At our North American operations, operating expenses per metric tonne increased by 18.8%, mainly due to the Muskegon impairment charge (\$183 million) and higher raw materials and energy costs (\$71 million). Operating expenses per metric tonne at our European operations increased by 4.1% due to the strengthening of the euro against the dollar (in euro terms operating expenses per metric tonne were flat compared to fiscal 2004 levels). For our South African fine paper operations, operating expense per metric tonne in US dollars increased by 13.5% (in Rand terms operating expense per metric tonne increased by 6.0%), mainly as a result of higher raw material and energy costs and other costs relating to increased provisions and mill closures described above. For Forest Products, operating expense per metric tonne, in dollar terms, increased by 17.2%, mainly due to the effect of the Usutu impairment charge (\$50 million) and also as a result of the strengthening of the Rand against the dollar. In Rand terms, and excluding the effect of the Usutu impairment charge, operating expenses per metric tonne increased mainly due to higher raw materials and energy costs.

### ***Operating Loss/Profit***

Group operating loss amounted to \$137 million in fiscal 2005, and represented a decrease of \$325 million (172.9%) from an operating profit of \$188 million in fiscal 2004, primarily attributable to decreases in operating profit for our Fine Paper division (\$212 million), (mainly due to a decrease of \$178 million at our North American Fine Paper division) and Forest Products division (\$118 million). Operating loss included charges of \$233 million relating to the Muskegon and Usutu impairment, the restructuring charge of \$22 million and \$136 million relating to higher raw materials and energy costs. The ongoing initiatives that we put in place over the last few years to offset the impact of cost increases delivered significant savings in fiscal 2005. Operating loss was enhanced by the release of a \$6 million provision at Sappi Fine Paper Europe, and lower charges for European bad debt provisions of \$7 million. It was also enhanced by the benefit of \$52 million relating to the plantation adjustment (\$18 million less than fiscal 2004).

Our Group operating margin, or the ratio of operating profit (loss) to sales, decreased to negative 2.7% in fiscal 2005 compared to a profit of 4.0% in fiscal 2004 and 6.3% in fiscal 2003. The lower operating profit and operating margin reflect the effect of the Muskegon and Usutu impairment charges (\$233 million) and the continuing difficult trading conditions in our major fine paper markets, resulting in lower average prices realised in local currency in our European and southern African operations. This was reduced by higher average prices realised at our North American operations, and higher raw materials and energy costs at all our divisions (\$136 million).

*Sappi Fine Paper.* Operating profit for Sappi Fine Paper decreased to an operating loss of \$206 million in fiscal 2005 from an operating profit of \$6 million in fiscal 2004, mainly due to an increased operating loss in fiscal 2005 for Sappi Fine Paper North America (\$178 million) as well as decreases in operating profit at our South African (\$27 million) and European Fine paper divisions (\$7 million). This decrease in operating profit reflects the effect of the Muskegon impairment charge (\$183 million), higher raw materials and energy costs (\$118 million) and the impact of the \$21 million restructuring charge for our North American operations. Operating margin was negative 5.1% in fiscal 2005 compared to an operating margin of 0.2% in fiscal 2004 and to 4.6% in fiscal 2003.

Sappi Fine Paper North America incurred operating losses of \$270 million in fiscal 2005 and \$92 million in fiscal 2004. Operating margin was negative 18.5% in fiscal 2005 compared to negative 6.7% in fiscal 2004. These decreases in operating profit and operating margin in fiscal 2005 reflects the effect of the Muskegon impairment charge (\$183 million), higher raw materials and energy costs (\$71 million) and the impact of the restructuring charge (\$21 million). Delivery costs had decreased significantly and we will continue to be vigilant in controlling costs and offsetting cost increases where possible. Profitability will also be impacted positively by the expected full year savings of \$50 million resulting from the Muskegon impairment and the restructuring of the corporate overhead structure.

Operating profit for Sappi Fine Paper Europe decreased by \$7 million (8.4%) to \$76 million in fiscal 2005 from \$83 million in fiscal 2004. Operating margin decreased to 3.4% in fiscal 2005 from 3.9% in fiscal 2004. These decreases in operating profit and operating margin reflect the continuing difficult trading conditions in Europe, and were primarily due to the impact of higher raw materials and energy costs coupled with lower average selling prices realised in euro terms. Operating profit was enhanced in fiscal 2005 by the release of a \$6 million provision and lower charges for bad debt provisions of \$7 million, both at Sappi Fine Paper Europe. Improved productivity and cost reductions contained operating expense per metric tonne in euro terms in fiscal 2005, which contained to some extent the reduction in operating profit and operating margin.

The operating loss of \$12 million for Sappi Fine Paper South Africa decreased from an operating profit of \$15 million in fiscal 2005. Operating margin decreased to negative 3.7% in fiscal 2005 from 4.8% in fiscal 2004. These decreases in operating profit and operating margin reflect lower selling prices per metric tonne realised in Rand terms (2.7%) and higher raw materials and energy costs, while the operating expenses per metric tonne in Rand terms increased by 6.0%, 3.3% of which was due to higher provisions for obsolescence and the Stanger pulp mill temporary closure costs.

*Sappi Forest Products.* Sappi Forest Products operating profit decreased by \$118 million (61.8%) to \$73 million in fiscal 2005. Operating margin was 7.3% in fiscal 2005, compared to 20.8% in fiscal 2004. These decreases in operating profit and operating margin reflect the Usutu impairment charges (\$50 million) and higher raw materials and energy costs (\$20 million), whilst average selling price per metric tonne decreased in Rand terms (6.3%). The fair value adjustment for plantations enhanced operating profit by \$52 million in fiscal 2005, \$18 million less when compared to fiscal 2004. In Rand terms, operating expenses per metric tonne increased by 9.7% in fiscal 2005, mainly due to the impact of the Usutu impairment charges and higher raw materials and energy costs.

*Corporate.* Operating losses decreased by \$5 million in fiscal 2005 from a loss of \$9 million in fiscal 2004 mainly as a result of higher operating profits for our captive insurance company Lignin (\$3 million).

#### **Year Ended September 2004 Compared to Year Ended September 2003**

Fiscal 2004 was characterised by strong demand growth in the North American market, driven by renewed economic growth and a buoyant advertising market. Demand for coated woodfree grades grew at an annualised rate of 3.5%. As a result, we have been able to implement price increases during the course of fiscal 2004. In Western Europe, demand for coated woodfree paper grew by 6.8% in fiscal 2004, a significant increase on growth of 1% in fiscal 2003 and 1.5% in fiscal 2002. With supply exceeding demand in the earlier part of the fiscal year, however, price increases in the European market did not materialise during this fiscal year. During that period, there was a significant overcapacity of coated fine paper relative to demand which, on average for fiscal 2004, led to weakening prices for our Fine Paper operations. The pulp market was affected by increased demand during the first half of fiscal 2004, mainly due to demand from China's growing paper industry. The increased demand translated into higher prices. Towards the end of fiscal 2004 when Chinese demand decreased, prices fell as customer inventories were reduced. Due to the conditions of weak markets in fiscal 2003 and to contain rising costs, the company, early in fiscal 2004, completed a number of restructuring initiatives announced during fiscal 2003, as described in the Company and Business Overview section.

The US dollar weakened during fiscal 2004 by 12.5% against the euro and by 19.8% against the Rand.

The translation of our results from local currencies to US dollar for reporting purposes tends to distort comparisons between periods when currencies are volatile. For example, as a result of the weakening of the average US dollar rate against the euro and the Rand during fiscal 2004, a 7.1% reduction in average selling price realised in euro translates to a 4.6% increase in US dollar, and a 12.6% decrease in average selling price realised in Rand translates to an 8.7% increase in US dollar.

We refer to this as the currency translation effect in the following discussion of our financial condition and results of operations.

A more detailed discussion and explanation of the material factors that affect our results of operations described below, is contained in the sections *Principal Factors Impacting our Results*, *Inflation and Interest Rates* and *Mill Closures, Acquisitions and Dispositions*, elsewhere in this *Operating and Financial Review and Prospects*. These factors include market fluctuations, exchange rates, taxation, net finance costs and significant cost factors, including cost reduction initiatives.

### *Sales*

Sales represent the net sales value of all products sold to outside parties. For a full description see our revenue recognition policy in note 2 of our Group annual financial statements included elsewhere in this Annual Report.

In fiscal 2004, the volume of products sold increased by 518,000 metric tonnes (7.8%) to 7,193,000 metric tonnes, from 6,675,000 metric tonnes in fiscal 2003. The volume of products sold during fiscal 2004 increased for all our divisions as follows, for Sappi Fine Paper North America (61,000 metric tonnes), Sappi Fine Paper Europe (155,000 metric tonnes), Sappi Fine Paper South Africa (18,000 metric tonnes) and Sappi Forest Products (284,000 metric tonnes).

Group sales increased by \$429 million to \$4,728 million in fiscal 2004 from \$4,299 million in fiscal 2003 (10.0%). The sales of our Fine Paper division increased by \$254 million and Forest Products by \$175 million. The increase in Group sales is primarily due to the translation of our results from local currencies to US dollar for reporting purposes (\$479 million) which tends to distort comparisons between periods when currencies are volatile. During fiscal 2004 the US dollar weakened by 12.5% on average against the euro, and by 19.8% on average against the Rand. Group sales also increased due to higher volumes sold (\$285 million) across all regions, reduced by lower selling prices realised in local currencies (\$335 million).

*Sappi Fine Paper.* The total volume sold by Sappi Fine Paper (including pulp) in fiscal 2004 increased by 234,000 metric tonnes (6.0%) to 4.1 million metric tonnes. Sappi Fine Paper Europe's volumes increased by 155,000 metric tonnes to 2.4 million metric tonnes (6.9%), slightly below industry-wide coated fine paper growth of 8.2%. For Sappi Fine Paper North America, volumes sold increased by 61,000 metric tonnes (4.4%), to 1.4 million metric tonnes. Industry demand for coated fine paper in North America grew by 3.5% in fiscal 2004. In fiscal 2004, Sappi Fine Paper South Africa claimed back market share lost in fiscal 2003, and increased volumes sold by 18,000 metric tonnes to 318,000 metric tonnes.

Total sales for Sappi Fine Paper increased by \$254 million (7.1%) to \$3,811 million in fiscal 2004. This increase is due to the currency translation effect (\$297 million) and increased volume (\$209 million), reduced by lower average selling prices realised in local currencies (\$252 million). Average prices realised in US dollar terms in fiscal 2004 increased as a result of the currency translation effect by \$10 per metric tonne (1.1%) to \$918 per metric tonne, up from \$908 per metric tonne in fiscal 2003.

Sales for Sappi Fine Paper North America decreased by \$11 million (0.8%) to \$1,373 million in fiscal 2004. Selling prices were lower (\$73 million) offset by increased volumes (\$62 million). The average price realised decreased by 5.0% to \$951 per metric tonne in fiscal 2004, mainly due to weak markets for coated paper in North America in the earlier part of fiscal 2004, as well as the pressure from continued imports into the US.

Sappi Fine Paper Europe sales increased by \$224 million (11.8%) to \$2,127 million in fiscal 2004. This increase is due to the currency translation effect (\$236 million) and increased volumes (\$131 million), reduced by lower selling prices in euro terms (\$143 million). Average price realised in US dollar terms was \$891 per metric tonne in fiscal 2004, up 4.6% from \$852 per metric tonne in fiscal 2003. In euro terms

average prices per metric tonne were 7.1% lower due to the continued surplus of supply compared to demand for coated fine paper in Europe, particularly in the early part of the year. Operating rates improved through the year.

For Sappi Fine Paper South Africa, sales increased by \$41 million (15.2%) to \$311 million in fiscal 2004. This increase is primarily attributable to the result of the currency translation effect (\$62 million) and partly due to an increase in volume sold (\$16 million), reduced by lower average selling prices realised in Rand terms (\$36 million). The average price realised for fine paper products in South Africa in US dollar terms increased by 8.7% to \$978 per metric tonne in fiscal 2004, as a result of the currency translation effect, while in Rand terms, the average price realised in fiscal 2004 decreased by 12.4% as a result of the pressure of continued imports into South Africa caused by the Rand's strength against the US dollar.

*Sappi Forest Products.* Total sales volumes for Sappi Forest Products increased by 10.3% to 3.0 million metric tonnes in fiscal 2004. There were increases in volumes of chemical cellulose (dissolving pulp) (10.3%) and commodity paper products (1.4%) while paper pulp volumes were 5.5% lower. The increased chemical cellulose (dissolving pulp) volume was mainly as a result of the closure of competitor capacity as well as the increased demand in the viscose staple industry, fuelled by higher prices for cotton, which is a competing product. Sappi Forest Product's sales increased by \$175 million (23.6%) to \$917 million in fiscal 2004. This increase is attributable mainly to the currency translation effect (\$181 million), and increased volumes (\$76 million), partly offset by lower selling prices in Rand terms (\$82 million). The average price for chemical cellulose (dissolving pulp) increased by 21.9% in fiscal 2004, in line with NBSK prices, to which it is linked. For paper pulp, the average price realised in US dollar terms increased by 12.8% per metric tonne reflecting the improved market conditions for that product.

#### *Operating Expenses*

Group operating expenses (comprising cost of goods sold, selling, general and administrative expenses and other expenses) increased by \$513 million (12.7%) to \$4,540 million in fiscal 2004. This increase was mainly due to the currency translation effect of \$429 million of which Europe represented \$227 million and southern Africa \$202 million. Operating expenses for Sappi Fine Paper North America increased by \$92 million, primarily as a result of increased volumes (\$61 million) and partly as a result of increased wood and energy costs (\$25 million). Operating expenses in North America were further increased by restructuring charges of \$20 million. Operating expenses in our European operations increased by 1.8% in euro terms, despite the 6.9% increase in volume sold, mainly due to lower fixed costs as a result of improved productivity and cost reduction initiatives. Operating expenses at Sappi Fine Paper South Africa increased by 1.4% in Rand terms. Forest Products operating expenses decreased by 7.3% in Rand terms. Excluding the effects of AC 137, the accounting standard for plantations, they increased by 1.6% in Rand terms, similar to the magnitude of the volume increase.

Selling, general and administrative expenses (SG&A), which are included in the group operating expenses discussed above, increased by \$55 million (17%) to \$371 million in fiscal 2004. \$30 million was as a result of the currency translation effect, and \$8 million was due to additional bad debt provisions in Europe. SG&A expenses in fiscal 2003 were favourably affected by a \$10 million once-off relief from the SFPNA pension plan amendment.

Other expenses, which are included in the group operating expenses described above, represent all profit and expenditure relating to activities other than that which is regarded as normal trading. Other expenses of \$36 million in fiscal 2004 (\$27 million in fiscal 2003) included \$32 million of restructuring charges and also included charges relating to the write-off of assets at all of our divisions. In fiscal 2003 other expenses consisted of a pre-tax charge of \$32 million for asset impairment and related write-off of inventory at our Westbrook mill (Sappi Fine Paper North America), reduced by net other profit of \$5 million relating

to various other items, including a net profit of \$3.0 million relating to the sale of a scrapped paper machine at our Gratkorn mill in Austria (Sappi Fine Paper Europe).

Operating expenses per metric tonne increased by \$28 (4.6%) to \$631 in fiscal 2004 from \$603 per metric tonne in fiscal 2003. The 7.8% increase in volume sold in fiscal 2004 resulted in the fixed cost component of operating expenses, being spread over more tonnes, thereby decreasing on a per metric tonne basis. This contained the overall increase of operating expenses per metric tonne to 4.6% from fiscal 2003, compared to the 12.7% increase in total operating expenses. This increase of 4.6% was largely the result of the currency translation effects described in the next paragraph.

At our North American operations, operating expense per metric tonne increased by 2.2% due to higher raw materials and energy costs. Operating expense per metric tonne increased by 7.1% at our European operations due to the strengthening of the euro against the dollar (in euro terms operating expense per metric tonne decreased by 4.8% as a result of cost reductions). For our South African fine paper operations, operating expense per metric tonne in US dollars increased by 18.9% (in Rand terms operating expense per metric tonne decreased by 4.7%) as a result of cost reductions. For Forest Products operating expense per metric tonne, in dollar terms, increased 4.8% particularly as a result of the strengthening of the Rand against the dollar. In Rand terms and excluding the effect of the accounting standard on plantations AC137 ( AC137 ), operating expenses per metric tonne were contained at fiscal 2003 levels.

### ***Operating Profit***

Group operating profit decreased by \$84 million (30.9%) to \$188 million in fiscal 2004, from \$272 million in fiscal 2003, primarily attributable to decreases in operating profit for our Fine Paper division (\$158 million), (mainly due to a decrease of \$103 million at our North American Fine Paper division), offset mainly by an increased operating profit of \$78 million for our Forest Products division.

Our Group operating margin, or the ratio of operating profit to sales, decreased to 4.0% in fiscal 2004 compared to 6.3% in fiscal 2003. The lower operating profit and operating margin reflect the continuing difficult trading conditions in our major fine paper markets, resulting in lower average prices realised in local currency in all our fine paper operations, and are also partly attributable to the currency translation effect on the costs of our European and southern African operations.

*Sappi Fine Paper.* Operating profit for Sappi Fine Paper decreased by \$158 million (96.3%) to \$6 million in fiscal 2004 mainly due to lower operating profit in fiscal 2004 for Sappi Fine Paper North America (\$103 million), as well as decreases in operating profit at our European (\$35 million) and South African Fine Paper divisions (\$20 million). Operating margin was 0.2% in fiscal 2004 as compared to 4.6% in fiscal 2003.

Operating profit for Sappi Fine Paper Europe decreased by \$35 million (29.7%) to \$83 million in fiscal 2004 from \$118 million in fiscal 2003. Operating margin decreased to 3.9% in fiscal 2004 from 6.2% in fiscal 2003. These decreases in operating profit and operating margin reflects the difficult trading conditions in Europe in the earlier part of the fiscal year, and were primarily due to lower average prices realised in euro terms. Improved productivity and cost reductions decreased operating expense per metric tonne in euro terms by 4.8% in fiscal 2004, which offset to some extent the reduction in operating profit and operating margin.

Sappi Fine Paper North America incurred an operating loss of \$92 million in fiscal 2004 compared to an operating profit of \$11 million in fiscal 2003. This decrease in operating profit reflecting the continuing difficult trading conditions in the US in the earlier parts of fiscal 2004, which resulted in lower average selling prices realised. Operating profit was also negatively impacted in fiscal 2004 by higher raw materials and energy costs and by a \$20 million restructuring charge.



The operating profit of \$15 million for Sappi Fine Paper South Africa decreased from \$35 million in fiscal 2003. Selling prices realised in Rand terms decreased by 12.8%, while the operating expenses per metric tonne in Rand terms decreased by 4.7%. Operating margin decreased to 4.8% in fiscal 2004 from 13.0% in fiscal 2003, mainly due to the decrease in average selling prices realised in Rand terms.

*Sappi Forest Products.* Sappi Forest Products operating profit increased by \$78 million (69.0%) to \$191 million in fiscal 2004. This is mainly attributable to higher average selling prices realized, which increased on average by 11.9%, and also to the 10.3% increase in volumes sold. The fair value adjustment for plantations under AC137, had the effect of increasing operating profit by \$70 million in fiscal 2004. In Rand terms and excluding the fair value adjustment for plantations, operating expenses by metric tonne were contained at fiscal 2003 levels. Operating margin increased to 20.8% in fiscal 2004, from 15.2% in fiscal 2003.

*Corporate.* Operating losses increased by \$4 million as a result of the inclusion of the UK pension costs, which in the prior year and up to the closure of the London office were included in the Fine Paper results.

#### *Net Finance Costs*

Net finance costs consist of gross interest and other finance costs, interest received, interest capitalised, foreign exchange gains and losses and change in fair value of financial instruments. Net finance costs were \$87 million in fiscal 2005 compared to \$110 million in fiscal 2004. Gross interest cost increased by \$13 million to \$146 million in fiscal 2005, mainly as a result of increased interest rates in fiscal 2005. The benefit of the swaps in prior years was reduced by an increase in interest rates as benchmark swap rates increased by 200 basis points from fiscal 2004. Average gross interest-bearing borrowings of \$2,049 million in fiscal 2005 decreased by \$23 million compared to \$2,072 million in fiscal 2004.

Net finance costs also included a \$17 million gain relating to the change in fair value of financial instruments (fiscal 2004 \$11 million loss) driven by movements in interest rates and exchange rates. It includes a gain of \$13 million recorded in the third quarter of fiscal 2005 as a result of an accounting mismatch, which arose from our inability to apply hedge accounting in respect of our interest rate swaps for a period during that quarter.

Net finance costs were \$110 million in fiscal 2004 compared to \$111 million in fiscal 2003. Gross interest cost decreased by \$17 million over fiscal 2003 to \$133 million as a result of a full year's benefit of having swapped fixed rate debt to floating rates during fiscal 2003. During fiscal 2004, we concluded an additional \$107 million of fixed to variable interest rate swaps. The benefit of the swaps was reduced by an increase in interest rates as benchmark swap rates increased by 96 basis points from fiscal 2003. Increased average borrowing levels in fiscal 2004 also adversely affected interest costs.

Net finance costs in fiscal 2004 also included an \$11 million loss relating to mark-to-market adjustments on financial instruments (fiscal 2003 \$6 million gain) driven by movements in interest rates and exchange rates.

Net finance cost before finance costs capitalised (\$88 million) was covered 6.3 times by cash generated by operations (\$554 million) in fiscal 2005, compared to 5.5 times in fiscal 2004 and 5.8 times in fiscal 2003. The reduction in fiscal 2004 was mainly due to lower levels of profits and cash flow.

Finance costs capitalised in fiscal 2005 amounted to \$1 million, compared to \$2 million in each of fiscal 2004 and fiscal 2003. Finance costs capitalised relate mainly to the capitalised interest on major projects under construction. Following the adoption in fiscal 2004 of AC137, we no longer capitalised interest to the holding costs of plantations.

## *Taxation*

Total taxation amounted to a tax credit of \$11 million in fiscal 2005, compared to a tax credit of \$17 million in fiscal 2004 and a tax charge of \$18 million in fiscal 2003. Total taxation in fiscal 2005 increased by \$6 million from fiscal 2004. The effective tax rate was 4.9% for fiscal 2005 compared with negative 22.5% for fiscal 2004 and positive 11.0% for fiscal 2003. Despite the loss in fiscal 2005, the decrease in the tax benefit and the increase in the effective rate in fiscal 2005 were primarily as a result of the tax relief on the net loss before tax of \$320 million for Sappi Fine Paper North America not being fully recognised under applicable accounting rules. Further reduction in the benefit is due to non-relief of the impairment charges relating to the Usutu mill. The impact of these two adjustments increased the group's tax charge by \$121 million. This was, however, partially offset by tax rate reductions in the Netherlands and South Africa.

Total taxation in fiscal 2004 decreased by \$35 million from fiscal 2003 due to profits before tax reducing to \$78 million from \$161 million in fiscal 2003, and as a result of the geographical split of profits and losses. Further reductions in tax were due to the reversal of tax provisions previously raised for exposures that have been resolved as well as the reduction in fiscal 2004 of the Austrian tax rate from 34% to 25%. The impact of all these adjustments was \$26 million. This was however offset by the reversal of net deferred tax assets of \$20 million in Europe and southern Africa.

The decrease in the effective tax rate in fiscal 2004 was primarily the result of the geographical split of profits and losses and the utilisation of previously unrecognised tax losses. Our North American operations, where the nominal tax rate is 39.5%, reported a Net Loss before Tax of \$140 million. The tax rate benefited further from the reversal of tax provisions previously raised for exposures that have been resolved in fiscal 2004 and the reduction in fiscal 2004 of the Austrian tax rate from 34% to 25%. The impact of all these adjustments was \$26 million. This was however offset by the reversal of net deferred tax assets of \$20 million in Europe and southern Africa.

Tax 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 tax liabilities of legal entities trading in such jurisdictions are calculated in accordance with group taxation principles. In certain cases entities are subject to tax in more than one jurisdiction. Where the entity is entitled to a corresponding tax credit in the country of fiscal residence, this entitlement is reflected in the tax charge. Should there not be any entitlement to a tax credit, the foreign tax paid is included as part of the tax 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 33 to our Group annual financial statements included elsewhere in this Annual Report.

Sappi International S.A. ( SISA ) is a corporation incorporated in Belgium. SISA is our group treasury and operates in Belgium under a co-ordination centre license granted by the Belgian government that includes an alternative method of calculating the taxation liability of a co-ordination centre. This license was originally granted in 1993 and is valid until December 31, 2005. The Belgian government has 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. As it is a general tax measure it does not only benefit a specific group of taxpayers in Belgium, and as such was approved by the European Commission as being compatible with European requirements. There is no time limit to this tax measure and we do not anticipate that the tax charge for SISA will be materially affected by the new legislation.

Sappi accounts for taxation using the undistributed tax rate for SA GAAP and using the distributed rate for US GAAP. This is reflected as a reconciling item in the annual financial statements (refer note 42 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 \$31 million (fiscal 2004 and fiscal

2003: \$38 million). During fiscal 2005 we changed our policy on STC. We adopted AC501 accounting for STC. This standard now requires the recognition of a deferred tax asset for unused STC credits to the extent that they will be utilised in the future. This has resulted in the recognition of a deferred tax asset for unused STC credits. 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%, which was decreased from 30% in fiscal 2005. 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 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 SA GAAP 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 25% of the total equity shares; however, according to recent draft legislation which has not yet been enacted, this minimum interest will soon be reduced to 20% of the equity shares and voting rights) in the foreign company declaring the dividend, but certain dividends are excluded from this exemption by 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 R15,000 of such income (the exemption is firstly to be applied to foreign dividends and only if they do not exceed R2,000, the excess is to be applied to foreign interest).

*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 which are specifically excluded from the definition of an asset. 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)/Profit*

We incurred a net loss of \$213 million in fiscal 2005 compared to a net profit of \$95 million in fiscal 2004, primarily due to the Muskegon and Usutu impairment charges of \$233 million pre-tax (\$223 million after tax). The decrease is also due to low selling prices realized in local operating currencies, the effect of the strong Rand on our South African margins and higher raw materials and energy costs, especially in our North American and European operations. Net profit was also negatively impacted by restructuring charges of \$22 million pre-tax (\$21 million after tax). Net profit was positively impacted by the ongoing initiatives that we put in place over the last few years to offset the impact of cost increases, by the release of a \$6 million provision and lower charges for bad debt provisions of \$7 million, both at Sappi Fine Paper Europe. It was also enhanced by the benefit of \$52 million before tax relating to the plantation adjustment (\$18 million less than fiscal 2004 primarily due to fewer timber price increases).

Earnings per share decreased to a loss of 94 US cents per share in fiscal 2005, from earnings per share of 42 US cents per share in fiscal 2004 and 62 US cents in fiscal 2003.

Net profit decreased by \$48 million (33.6%) to \$95 million in fiscal 2004 from \$143 million in fiscal 2003, mainly due to low prices in local operating currencies, the effect of the strong Rand on our South African margins and higher raw materials and energy costs, especially in our North American operations. Net profit was also negatively impacted by restructuring charges of \$32 million pre-tax (\$22 million after tax), but positively impacted by \$47 million after tax, following the implementation of AC 137 in fiscal 2004. Net profit was also favourably impacted by net tax credits of \$6 million, described under taxation above.

## **Liquidity and Capital Resources**

### *Operations*

#### **Fiscal 2005**

Cash retained from operating activities amounted to \$271 million in fiscal 2005 compared to \$345 million in fiscal 2004. During fiscal 2005 we generated cash from operations of \$554 million compared to \$601 million in fiscal 2004. The reduction of \$47 million in cash generated compared to fiscal 2004 is mainly the result of lower profit before tax in fiscal 2005. Cash generated was reduced by finance costs paid (net of interest income) of \$112 million (\$3 million more than fiscal 2004), by taxation paid of \$43 million (\$12 million more than fiscal 2004) and also by \$60 million cash being utilised in working capital (\$10 million more than fiscal 2004).

Total non-cash items in fiscal 2005 amounted to \$691 million, which was \$278 million higher than the \$413 million in fiscal 2004, and included:

- The asset impairment and machine and mill closure costs of \$232 million, mainly relating to the Muskegon and Usutu mills.
- Depreciation and fellings charges of \$488 million, which were \$25 million higher than fiscal 2004 due to the currency translation effect (\$14 million) and the additional accounting week, based on average weekly charges (\$9 million).
- Increased other long term liabilities (Pension liability) of \$48 million, mainly at our European operations.
- The \$21 million North American restructuring provision.
- Increased provision for obsolete inventory of \$10 million.
- Loss on sale and write-off of fixed assets of \$10 million, (\$7 million higher than fiscal 2004), reduced by
- Fair value gains on plantations of \$118 million (\$7 million lower than fiscal 2004), due to lower timber price increases when compared to fiscal 2004, and
- The release of a \$6 million provision at Sappi Fine Paper Europe in fiscal 2005.

The increase in fiscal 2005 in working capital of \$60 million compared to a \$50 million increase in fiscal 2004, and consisted of:

- \$98 million decrease in payables consisting largely of a decrease in other payables (\$72 million), mainly at our North American operations of \$39 million, due to lower pension accruals (\$30 million) and decreased provision for rebates (\$12 million) and at our European operations of \$13 million, mainly relating to decreased employee accruals (\$9 million). Trade payables decreased at our European operations by \$21 million compared to fiscal 2004 and decreased at our North American operations by \$15 million compared to fiscal 2004. This decrease in trade payables was



mainly due to the fiscal 2005 year end occurring after the calendar month end payment run, compared to the fiscal 2004 year end which occurred before the calendar month end payment run.

- \$35 million decrease in receivables related mainly to a decrease in trade receivables at our South African Fine Papers division of \$9 million and a net decrease in trade and other receivables of \$8 million at Forest Products, resulting from higher levels of securitisation compared to fiscal 2004. During the year our South African operations entered into an increased securitization structure with Rand Merchant Bank.
- \$3 million decrease in inventories related mainly to a decrease at our European operations of \$10 million and at our North American operations of \$5 million, mainly as a result of production downtime, offset by an increase in inventory at our South African Fine Papers division of \$13 million, primarily due to higher finished goods and work in progress inventory compared to fiscal 2004.

The increase of \$11 million in finance costs paid in fiscal 2005 was mainly due to increased levels of average borrowings and higher interest rates paid on borrowings.

Taxation paid of \$43 million in fiscal 2005 was \$12 million higher than fiscal 2004. This was mainly the result of the finalization of certain long outstanding issues with the South African Revenue Authorities.

#### **Fiscal 2004**

Cash retained from operating activities amounted to \$345 million in fiscal 2004 and \$421 million in fiscal 2003. During fiscal 2004 we generated cash from operations of \$601 million compared to \$645 million in fiscal 2003. The reduction in cash compared to fiscal 2003 is the result of a decrease in profits before tax which was \$78 million in fiscal 2004, \$83 million lower than fiscal 2003. Cash was further reduced by tax paid of \$31 million, a \$64 million increase compared to fiscal 2003. Working capital utilised was \$50 million, \$29 million less than the utilisation in fiscal 2003. Cash was also reduced by finance costs paid of \$136 million, \$7 million less than fiscal 2003 and was enhanced by adjustments for non-cash items of \$413 million.

Total adjustments for non-cash items in fiscal 2004 were \$413 million, \$40 million higher than the \$373 million in fiscal 2003, and included:

- Depreciation and felling charges of \$463 million, \$69 million higher than fiscal 2003, due to increased additions to fixed assets as well as the currency translation effect.
- Provisions of \$86 million, mainly relating to increased pension and post retirement benefit provisions.
- Lower asset impairment and machine and mill closure costs, \$32 million less than fiscal 2003 (\$32 million in fiscal 2003 Sappi Fine Paper North America (principally related to the Westbrook machine closure)) reduced by
- Fair value gains on plantations of \$125 million, \$83 million higher than fiscal 2003, due to timber price increases and reduced delivery costs.

During fiscal 2004, working capital increased by \$50 million compared to a \$79 million increase in fiscal 2003. The \$50 million increase in working capital consists of:

- \$27 million increase in inventories relating to our European operations primarily due to the replenishing of stock levels at year end.
- \$38 million increase in receivables related mainly to an increase in trade receivables of \$54 million at our North American operations primarily due to an early cut-off date used for securitisation





purposes. Trade receivables at our European operations decreased by \$17 million due to lower net sales compared to fiscal 2003.

- \$15 million increase in payables consisted largely of an increase in other payables, mainly at our North American operations of \$54 million due to collections of securitised receivables on behalf of State Street Bank. Trade and other payables at our Forest Products division decreased by \$40 million due to lower capital and interest accruals compared to fiscal 2003.

The decrease of \$7 million in finance costs paid in fiscal 2004 was mainly due to the benefit of the fixed to variable interest rate swaps.

Taxation paid in fiscal 2004 was \$64 million higher than fiscal 2003. This is impacted by a tax refund of \$58 million received by our North American operations in fiscal 2003. No similar refund was received in fiscal 2004.

### *Investing*

Cash utilised in investing activities was \$379 million in fiscal 2005 and \$356 million in fiscal 2004. Cash utilised in investing activities in fiscal 2005 related mainly to capital expenditure on non-current assets of \$294 million, our investment in China (\$61 million), as well as an increase of \$29 million in investments and loans, mainly due to increased pension and other post retirement payments at Sappi Fine Paper Europe (\$24 million).

Cash capital expenditure decreased to \$294 million in fiscal 2005 from \$331 million in fiscal 2004. The decrease in cash capital expenditure of \$37 million in fiscal 2005 was impacted by the currency translation effect of \$11 million. The \$294 million spent in fiscal 2005 consisted of \$183 million (\$219 million in fiscal 2004) relating to expenditure to maintain operations and \$111 million of expenditure to expand operations. Included in fiscal 2004 were the group software upgrades and certain head office expenditure.

The capital expenditure of \$111 million in fiscal 2005 to expand operations mainly consisted of:

- Projects at our European operations amounting to \$58 million, including the replacement of operating equipment and finishing house automation of \$14 million at our Gratkorn mill and \$11 million on the rebuild of our Ehingen mill.
- \$27 million at our Forest Products division, including \$18 million on de-bottlenecking at Saiccor mill.
- Expenditure of \$26 million at our North American operations, including \$17 million at the Cloquet mill on product improvements and cost reductions.

Cash utilised in investing activities was \$356 million in fiscal 2004 and \$310 million in fiscal 2003. Cash utilised in investing activities in fiscal 2004 related mainly to capital expenditure on non-current assets of \$331 million, as well as an increase of \$27 million in investments and loans, mainly due to top up payments made to a European pension fund.

Cash capital expenditure excluding acquisitions, increased to \$331 million in fiscal 2004 from \$297 million in fiscal 2003. The increase in fiscal 2004 is mainly due to the currency translation effect (\$42 million). The \$331 million spent in fiscal 2004 consisted of \$219 million relating to expenditure to maintain operations and \$112 million of expenditure to expand operations. Capital expenditure to maintain operations of \$219 million is higher than \$165 million spent in fiscal 2003 and includes the group software upgrade and certain head office expenditure.

The capital expenditure of \$112 million in fiscal 2004 to expand operations mainly consisted of:

- Projects at our European operations amounting to \$39 million, in particular a new sheeter and woodyard upgrade at our Gratkorn mill.
- \$68 million at our Forest Product division, including \$17 million at Ngodwana mill for a de-bottlenecking project, as well as \$22 million at the Tugela mill to reduce production costs.

Our capital expenditure programme varies from year to year, and high expenditure in one year is not necessarily indicative of future capital expenditure as explained in detail in our discussion on Capital expenditure included elsewhere in this Operating and Financial Review and Prospects.

### *Financing*

Net cash of \$7 million was utilised in fiscal 2005, compared to \$121 million utilised in fiscal 2004 and \$147 million raised in fiscal 2003. Cash utilised in fiscal 2005 related mainly to the repayment of short-term interest-bearing borrowings (\$249 million), partly reduced by an increase in overdraft (\$156 million mainly at Sappi Trading Pulp (\$134 million)), and by the proceeds from long-term interest bearing borrowings (\$114 million).

Cash utilised in fiscal 2004 related mainly to the repayment of bank overdrafts of \$162 million, partially offset by the net proceeds from interest-bearing borrowings raised of \$57 million.

In June 2002, SPH 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 SISA. 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 SPH, Sappi Limited or SISA s option. We used the proceeds of this issuance to refinance existing indebtedness, 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. The benefit of the reduced finance cost resulting from the swaps has increased by approximately \$11 million to \$19 million in fiscal 2004, when compared to fiscal 2003. Due to the increasing US dollar interest rates in fiscal 2005 the benefit of the reduced finance cost from the swaps has decreased to \$5 million in fiscal 2005 from \$19 million in fiscal 2004. In the event that short-term rates increase further, the benefit will reduce accordingly and could result in additional interest costs if rates increase significantly.

In May 2003, SPH raised a facility in the amount of \$575 million, repayable in 2 tranches from OeKB. Tranche A ( OeKB A tranche ) of \$115 million was repaid in a single payment on December 31, 2004 and Tranche B ( OeKB B tranche ) of \$460 million is repayable in a single payment on December 31, 2010. The OeKB A tranche bore interest at the OeKB floating rate plus an applicable margin of 0.5% and the OeKB B tranche bears interest at an agreed fixed rate of 4.10%. Interest is payable quarterly in arrears on both tranches. The \$575 million proceeds were partly used to refinance \$374 million of other 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 was R500 million (approximately \$70 million). During fiscal 2004 Sappi Manufacturing increased the Commercial Paper facility to R1 billion (approximately \$157 million) of which approximately R290 million (\$46 million) was utilised at the end of September 2005. The average interest rate that the Commercial Paper facility currently attracts is the JIBAR rate plus 5 basis points.

In June 2005 SPH raised a new credit facility of euro 600 million, with a maturity date of June 2010. The new facility replaced and refinanced a facility raised in fiscal 2001 maturing in July 2006. The refinancing was undertaken to improve the terms and conditions of the replacement facility, specifically the pricing of the margin and the commitment fee, and also to ensure the long-term nature of the new facility. The funding margin is determined by a rating grid and based on the current credit rating attracts a margin between 40.0 and 47.5 basis points over EURIBOR, depending on the level of utilisation. This syndicated credit facility is to be used for general corporate purposes and was unutilised at the end of fiscal 2005.

As is the norm for bank loan debts, a portion of our financial indebtedness is subject to cross default provisions. Breaches in bank covenants in certain subsidiaries, if not corrected in time, might result in a default in group debt, and, in this case, a portion of our consolidated liabilities might eventually become payable on demand. At the end of fiscal 2005 and fiscal 2004, the group was in compliance with the bank covenants restrictions. Sappi and Sappi Manufacturing must abide by certain financial covenants.

In previous years the banking covenants were calculated at the combined level of SPH and SISA. During fiscal 2005 this has been changed to measure the covenants at the consolidated Sappi Limited level, following the issuance in fiscal 2005 of a Sappi Limited guarantee of the long-term borrowings of the SPH/SISA group. Accordingly, it is more appropriate to measure the covenants at the consolidated group level. Covenants that exist for Sappi Manufacturing (Pty) Ltd have not been affected and remain at that level.

We presently meet all the financial ratios that apply to our major credit agreements. The covenants on the facility are based on our Net Debt to Total Capitalisation ratio and EBITDA to Net Interest ratio, and are measured based on our quarterly results.

The Group has adequate working capital, cash on hand and short and long-term banking facilities to meet its short-term commitments. As at the end of fiscal 2005, Sappi had aggregate unused borrowing facilities (committed and uncommitted) of \$1,229 million (\$350 million in South Africa and \$879 million in Europe) compared to \$1,275 million (\$283 million in South Africa and \$987 million in Europe) at the end of fiscal 2004. The \$46 million decrease over fiscal 2004 is largely due to the currency translation effect, as the euro/USD rate weakened from 1.23 to 1.20 and the R/USD strengthened from 6.42 to 6.37 in fiscal 2005. At the end of fiscal 2003, Sappi had aggregate unused borrowing facilities (committed and uncommitted) of \$1,118 million (\$179 million in South Africa and \$939 million in Europe).

The maturity profile of long-term interest bearing borrowings of the Group has been extended substantially in the past 4 years. Average time to maturity for long-term interest bearing borrowings at the end of fiscal 2001 was 4.7 years, and has been extended to 8.4 years at the end of fiscal 2005. This is largely due to the issue of 10 and 30-year bonds in fiscal 2002 (\$750 million) and an 8-year syndicated loan facility (euro 500 million or \$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 fiscal 2005 Sappi had \$367 million of cash resources and unutilised available banking facilities of \$1,229 million (of which \$753 million is committed). At the end of fiscal 2004 we had \$484 million of cash resources and unutilised available banking facilities of \$1,275 million (of which \$723 million was committed). The \$47 million decrease in unutilised available banking facilities in fiscal 2005 is due to the currency translation effect.

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.

Sappi has 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; and
- Availability of tax efficient structures to moderate financing costs.

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 21 to our Group annual financial statements included elsewhere in this Annual Report. For a profile of our borrowings repayment schedule, see note 21 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 37 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 2005, approximately 45% of our gross borrowings were at fixed rates, compared with approximately 42% at the end of fiscal 2004 and 45% at the end of fiscal 2003. The increase in fixed interest rate borrowings in fiscal 2005 was largely due to the new OeKB \$54 million loan described above at a fixed rate. The decrease in fixed interest rates in fiscal 2004 was achieved by swapping the fixed interest rates of the public bonds and other fixed rate debt to floating interest rates linked to US LIBOR. See note 37 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 fiscal 2005, our total interest bearing borrowings and overdraft, were \$2.0 billion, in line with the level of \$2.1 billion at the end of fiscal 2004 and fiscal 2003. At the end of fiscal 2005 cash and cash equivalents decreased by \$117 million from \$484 million at the end of fiscal 2004, mainly due to the dividend payment (\$68 million) and the repayment of loans in fiscal 2005.

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 control regulations. 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 may 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 32, securitisation facilities described in note 18 and an equity accounted investment described in note 16, 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. This qualifies as an operating lease under the applicable accounting principles. The lease term expires after 15 years, and we have an option to either return the paper machine; renew the lease for at least 2 years, but for no longer than 80% of its remaining useful life; or repurchase it at its fair market value at the end of the lease term. An option exists to repurchase the paper machine at an earlier date of 29 January 2008 for the original purchase price multiplied by a factor of 50.10%. To exercise the option, we must provide notice of between 180 and 360 days prior to the early buyout date. There is no right of refusal associated with the early buyout option. The future minimum obligations under this lease are included in the amounts presented above.

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. An unrelated investor owns the facility. The agreement expires in 2008 and we have an option to purchase the facility 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 arrangement are included in the amounts presented above.

Although those lease arrangements are a method of financing, a leasing arrangement that qualifies for accounting treatment as an 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 between 86% and 99% 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 SPEs are funded in the Commercial Paper market. For the purpose of liquidity requirements under the State Street Bank securitisation facility, banks with a short term (Standard & Poor's) S&P rating of at least A1 and a short-term Moody's rating of at least P-1 (and equivalent rating from any other rating agency, if any) provide a standby liquidity facility. 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. On some programmes, the downgraded bank can be required to deposit the unused portion of its commitment to avoid replacement. 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.

With Rand Merchant Bank, virtually all receivables are securitised, however we retain 15% of the credit risk on the receivables on a proportionate basis, after all recoveries, including insurance recoveries. With State Street Bank 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. At the end of fiscal 2005 this amounted to \$59 million (fiscal 2004: \$53 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 fiscal 2005 amounted to \$465 million (fiscal 2004: \$470 million).

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 (not applicable to all programs). The impact on liquidity varies according to the terms of the agreement; generally however, future trade receivables would be recorded on balance sheet until a replacement agreement was entered into.

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

Resulting from the implementation of International Financial Reporting Standards (IAS32 and IAS39) in fiscal 2006, see International Financial Reporting Standards ( IFRS ), \$268 million of the \$465 million of our securitised receivables at the end of fiscal 2005 will be brought on to the balance sheet, (fiscal 2004:\$409 million of the \$470 million securitised), which will also increase short-term debt by \$346 million (fiscal 2004: \$490 million) and decrease trade and other payables by \$78 million at the end of fiscal 2005 (fiscal 2004: \$81 million). The related expense will no longer be reflected in SG&A, but will be included in finance costs. The increase in finance cost and decrease in SG&A for fiscal 2005 will be approximately \$14 million.

*Equity Accounted Investment.* In 1998, 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 special purpose entity ( SPE ), 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 SPE repaid us the note of \$156 million, which it funded through the issue of notes payable to a consortium of institutional investors, pledging the Plum Creek notes as collateral. The qualifying SPE 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 raise funding using the promissory notes as collateral in a manner that would not result in either debt or the Plum Creek notes being reflected on our balance sheet. This would not be the case if we monetised the promissory notes through an issuance of secured notes directly or by an entity that was required to be consolidated in our financial statements under the applicable accounting principles.

Interest is collected quarterly on the Plum Creek Notes and paid semi-annually to the SPE s noteholders. The SPE 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 SPE and the holders of the notes payable issued by the SPE have no recourse to us.

The SPE is not consolidated in our financial statements because we have taken the position that it is controlled by an unrelated investor which has sufficient equity capital at risk to support such a position. The SPE has a put option available through May 4, 2006, that may require us to purchase all, but not less

than all, of the SPE's interests at fair market value to be calculated in accordance with the agreement. Our investment of \$19 million at the end of fiscal 2005 (fiscal 2004: \$20 million) in the SPE 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 SPE.

### **Capital Expenditures**

Capital expenditures in fiscal 2005, fiscal 2004 and fiscal 2003 were as follows:

	<b>Year Ended September</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(\$ millions)</b>		
<b>Sappi Fine Paper</b>			
Sappi Fine Paper North America	90	75	78
Sappi Fine Paper Europe	124	102	104
Sappi Fine Paper South Africa	27	10	13
<b>Total</b>	<b>241</b>	<b>187</b>	<b>195</b>
Sappi Forest Products	101	146	101
Corporate	3	1	
<b>Group Total</b>	<b>345</b>	<b>334</b>	<b>296</b>

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 2005, fiscal 2004 and fiscal 2003 amounted to approximately \$183 million, \$219 million and \$165 million, respectively. 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 former corporate parent invested approximately \$1 billion on capital and investment expenditures from 1988 to 1994. In addition, there was 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 2004, 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 are expected to 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.

The capital expenditure to expand operations during fiscal 2005 included major projects at our European Gratkorn and Ehingen mills, South African Saiccor mill and Cloquet mill in North America. Total capital spending for the Sappi Group during fiscal 2005 amounted to 82% of depreciation. Capital spending for the Sappi Group during fiscal 2006 is expected to amount to approximately 90% of depreciation including expenditure relating to the proposed Saiccor expansion project. Capital spending is expected to be funded primarily through internally generated funds. For further details about our capital commitments, see note 32 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 2005 that can be quantified.

	Payments Due by Period				
	Total (\$ millions)	Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years
Long-Term Debt Obligations <sup>(1)</sup>	1,795	241	187	75	1,292
Capital Lease Obligations <sup>(1)</sup>	75	29	19	3	24
Operating Lease Obligations <sup>(2)</sup>	225	50	73	47	55
Purchase Obligations <sup>(3)</sup>	412	235	149	28	
Other Long-Term Liabilities Reflected on Balance Sheet <sup>(4)</sup>	26	2	4	2	18
Group Total	2,533	557	432	155	1,389

(1) Refer to note 21.

(2) Operating leases are future minimum obligations under operating leases. Refer to note 32.

(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 \$331 million on Balance sheet, the company has an additional amount of \$305 million 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 22.

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 7, 2005, 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 2005, is approximately 19.4 million shares (or approximately 8.1% of our issued shares) at an average price of \$9.61 (R74.55) per share, of which 7.0 million shares had been utilised by the Sappi Limited Share Incentive Trust to meet its obligations. During fiscal 2005 we acquired approximately 1.3 million shares for a total consideration of approximately \$15.9 million. We held approximately 13.2 million treasury shares (or approximately 5.5% of our issued shares) at the end of fiscal 2005. As at December 7, 2005, the Sappi share price was \$11.33 (R73.99).

The JSE Limited 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 \$0.30 per share in fiscal 2005, \$0.30 per share in fiscal 2004 and \$0.29 per share in fiscal 2003. 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. In fiscal 2005 we declared a \$0.30 per share dividend. Our dividends were covered 1.2 times based on average earnings during the 5 year period which ended in fiscal 2005 (fiscal 2004: 3.0 times).

### *Mill Closures, Acquisitions, Dispositions and Impairment; and Joint Venture*

*Usutu impairment.* During the first quarter of fiscal 2005 we announced the impairment of our Usutu mill. The Usutu mill is an unbleached kraft pulp mill and forms part of the Sappi Forest Products reporting segment. Due to continued losses an impairment review was conducted which led to the recognition of impairment charges of \$50 million. Plans are in place to improve the mill's productivity in the face of the relative strength of the Rand against the dollar. The mill has a valuable plantation resource and at a weaker exchange rate of the Rand against the dollar, the mill will have good prospects of returning to profitability.

*Muskegon impairment.* During the third quarter of fiscal 2005 we announced the impairment of our North American Muskegon mill, and recorded impairment charges of \$183 million in fiscal 2005. A detailed discussion of this impairment is contained in the section "Restructuring", elsewhere in this Operating and Financial Review and Prospects.

*Joint Venture with Shandong Chenming Paper Holdings Limited.* During fiscal 2005 we acquired 34% of Jiangxi Chenming Paper Company Limited ( Jiangxi Chenming ) in a joint venture with Shandong Chenming Paper Holdings Limited ( Shandong Chenming ) (47.2%), together with Jiangxi Paper Industry Company Limited (3.8%), Shinmoorim Paper Manufacturing Company Limited of South Korea (7.5%), and the International Finance Corporation ( IFC ) (7.5%). Our equity contribution was approximately \$60 million.

The mill has a 350,000 metric tonnes per annum light-weight coated paper machine together with a bleached thermo mechanical pulp (BTMP) mill, de-inked pulp plant, and power plant. The mill is located in Nanchang, the capital of Jiangxi Province which is in southeast China. The mill was commissioned in August 2005.

**The total cost of the project is approximately \$440 million. The IFC had arranged the debt financing for the project, which is without recourse to Sappi. The IFC holds 7.5% of the equity and has also approved \$50 million in long-term debt for its own account.**

*Westbrook machine closure.* We announced the closure of the number 14 paper line at our Westbrook mill in Maine, North America in November 2003. This followed our decision to take out capacity to improve the supply demand balance in the United States. The machine that was closed was our highest cost paper machine. In the last quarter of fiscal 2003 we wrote off the assets and related inventory and took a charge of \$19 million after tax (\$32 million pre-tax). We also incurred a further charge of approximately \$16 million pre-tax in the first quarter of fiscal 2004 in respect of severance, retrenchment and related costs. The total number of employees affected by this closure was 145 people.

*Clan Sawmill.* We ceased operations at Clan sawmill (South Africa) in the last quarter of fiscal 2003 and closed the mill in December 2003. The mill, with an annual log intake of 80,000 m<sup>3</sup>, used old technology and did not have a competitive log supply. The closure did not have a material impact on our results, but resulted 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. We employed approximately 200 fewer people when we acquired the Cloquet mill than were previously employed there. We 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, which 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.

#### **Pensions and Post-retirement Benefits Other than Pensions**

The Group provides various post-retirement benefits to its active and retired employees worldwide including: pension, post-retirement health and other life benefits.

The unfunded status of the company's pension plans increased by \$28 million to a deficit of \$367 million at the end of fiscal 2005, from the deficit of \$339 million at the end of fiscal 2004. Post-retirement benefit liabilities (other than pension) increased by \$6m to \$178 million from the end of fiscal 2004.

Benefit obligations and fair value of plan assets across the regions are as follows at the end of fiscal 2005 and fiscal 2004:

	2005	Fair value of plan assets	2004	Fair value of plan assets
	Benefit Obligation (\$ millions)		Benefit Obligation	
Pensions	1,589	1,222	1,420	1,081
Post-retirement Benefits other than pensions	178		172	

Actual returns for the various regional pension funds during fiscal 2005 were significantly better than actuarial projections, which improved asset levels as at the end of fiscal 2005. However, discount rates in all funds have been adjusted downwards, reflecting lower prevailing interest rates. The lower discount rates across the regions increased liabilities by approximately \$134 million, thereby having a negative effect on the funded status of the Group's plans from the end of fiscal 2004 to the end of fiscal 2005.

The key assumptions used to compile plan assets and liabilities at the end of fiscal 2005 and fiscal 2004 were as follows:

	Europe		North America		United Kingdom		South Africa	
	2005 %	2004 %	2005 %	2004 %	2005 %	2004 %	2005 %	2004 %
Discount rate	3.68	4.63	5.50	5.65	5.00	5.50	8.10	9.00
Return on assets	5.19	5.20	8.25	8.50	5.75	5.50	9.71	10.18
Salary increase	2.99	3.14	3.50	3.75	4.00	4.00	5.49	6.00

The Group's net periodic pension expense in fiscal 2006 is expected to decrease to \$38 million from \$62 million in fiscal 2005 due to the recognition of prior actuarial losses through IFRS adoption. Employer contributions for pensions are expected to rise by approximately \$16 million to \$79 million primarily due to increases in North American funding requirements.

A 1% increase in discount rates would decrease the pension liability by approximately \$193 million and the related pension expense by approximately \$14 million per annum.

A 1% increase in the healthcare cost trend rates would increase the accumulated other post-retirement benefit obligation by \$12 million and the aggregate of the service and interest cost components of net periodic other post-retirement benefit expense by \$1 million per annum.

The South African pension fund is, from fiscal 2005, closed to new employees.

For further information see note 34 and 35 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 its 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 on-going and aims to lower the risk of incurring losses from uncontrolled incidents.

Sappi follows a practice of insuring its 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 years 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.

Sappi has a global insurance structure and the majority of insurance is placed with its own captive insurance company Lignin which in turn reinsures the vast majority of the risk with third-party insurance companies.

We have successfully placed the renewal of our 2006 insurance cover at rates lower than 2005. Self-insured deductibles for any one property damage occurrence have remained at \$25 million, with an unchanged aggregate limit of \$40 million. For property damage and business interruption, there generally does not seem to be cost effective cover available to full value, however the directors believe that the loss limit cover of \$1 billion should be adequate for what they have determined as the reasonably foreseeable loss for any single claim.

Insurance cover for credit risks currently applies to Sappi's North American, 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.

*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, including judgements and estimates as to future product pricing, raw material costs, volumes of product sold, appropriate discount rates (weighted average cost of capital), changes in the planned use of machinery or equipment or closing of facilities. Where independent information is available this is used. Actual circumstances or outcomes could vary significantly from such estimates, including as a result of changes in the economic and business environment. These variances could result in changes in 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.

Goodwill impairment tests are performed annually to compare the fair value of each of our reporting units (cash generating) to its carrying amount. Goodwill impairment testing is conducted at reporting unit levels of our business and is based on a cash flow based valuation model to determine the fair value of the reporting unit. The assumptions used in estimating future cash flows were based upon our business forecasts and incorporated external information from industry sources, where applicable. Actual outcomes could vary significantly from our business forecasts. Changes in certain of these estimates could have a material effect on the estimated fair value of the reporting unit. In addition to the judgements described in the preceding paragraph that are necessary in estimating future cash flows, significant judgements in estimating discounted cash flows also include the selection of the discount rate (weighted average cost of capital) and the terminal value (net present value at end of period where there is a willing buyer and seller)

multiple used in our valuation model. The discount rate used in our valuation model considered a targeted debt and equity mix, a market risk premium, and other factors consistent with valuation methodologies. The terminal value multiple used in our valuation model considered the valuations for comparable companies.

Based on the results of the impairment evaluation described above, the recorded goodwill was not impaired as the fair value of each reporting unit exceeded the carrying value. Small changes to the valuation model would not significantly impact the results of our valuation; however, if future cash flows were materially different than our forecasts, then the assessment of the potential impairment of the carrying value may be impacted.

*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. In recognising deferred tax assets the company considers profit forecasts including the effect of exchange rate fluctuations on sales and external market conditions. Where it is probable that a position may be successfully challenged, based on reported challenges by revenue authorities of similar positions taken by other taxpayers, as well as items already raised by revenue authorities during audits, but for which resolution has not yet been reached, a valuation allowance or tax provision is raised for the tax on the probable adjustment. 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 recognised are considered realisable, actual amounts could be reduced if future taxable income is not achieved. This can materially affect our reported net income 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 are either attributable to a particular risk associated with a recognised asset or liability or a forecasted transaction. The financial instruments that are used in hedging transactions are assessed both at inception and quarterly thereafter to ensure they are effective in offsetting changes in either the fair value or cash flows of the related underlying exposures. Hedge accounting is mainly used for debt instruments to hedge interest rate and foreign currency risk exposures. We do not use hedge accounting for trading transactions.

In relation to fair value hedges, which meet the conditions for hedge accounting, any gain or loss from re-measuring 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. External market data is applied in re-measuring the hedging financial instrument.

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. External market data is applied in measuring

the hedge effectiveness of the financial instrument. Hedge ineffectiveness is recognised immediately against income. The net gain, after taxation, on revaluation of hedging instruments deferred in equity was \$16 million in fiscal 2005 (fiscal 2004 \$1 million net gain and fiscal 2003: \$14 million net loss).

*Plantations.* We state our plantations at their fair value. Fair value is determined using the present value method for immature timber and the standing value method for mature timber. All changes in fair value are recognised in income in the period in which they arise.

Land, logging roads and related facilities are accounted for under property, plant and equipment. The trees are accounted for as plantations. Land is not depreciated. Logging roads and related facilities are depreciated at various rates over a period of 3 to 10 years depending on expected life of each road or related facility. Trees are generally felled at the optimum age when ready for intended use. At the time the tree is felled it is taken out of plantations (non-current assets) and accounted for under inventory (current assets).

Assumptions and estimates are used in the recording of plantation volumes, cost per metric tonne, and depletion. Changes in the assumptions or estimates used in these calculations may affect the Group's results, in particular, plantation and depletion costs.

A major assumption and estimation is the growth estimation. The inputs to our growth model are complex and involve estimations, all of which are regularly updated. Growth models derived from measured data from permanent sample plots are used for growth estimation. The long term sample plot network is representative of the species and sites on which we grow trees. Periodic adjustments are made to existing models for new genetic material.

Depletions include the fair value of timber felled, which is determined on the average method, plus amounts written off standing timber to cover loss or damage caused by, for example, fire, disease and stunted growth. Depletions are accounted for on a cost per metric tonne allocation method. Tonnes are calculated using the projected growth to rotation age and extrapolated to current age on a straight line basis.

The fair value of immature timber (softwood less than eight years and hardwood less than five years) is the discounted value of the expected delivered market price for estimated timber volumes less cost of delivery and estimated maintenance costs up to when the timber becomes usable by our own mills. The discount rate used is the pre-tax Rand cost of capital of the South African companies. The fair value of mature timber is based on the market price for estimated timber volumes less cost of delivery.

Cost of delivery includes all costs associated with getting the harvested agricultural produce to the market, being harvesting, loading, transport and allocated fixed overheads.

The group is exposed to financial risks arising from climatic changes, disease and other natural risks such as fire, flooding and storms and human-induced losses arising from strikes, civil commotion and malicious damage. These risks are covered by an appropriate level of insurance as determined by management. In addition, management focuses close attention to good husbandry techniques and fire-fighting methods. The plantations have an integrated management system that is certified to ISO 9001, ISO 14001, OHSAS 18001 and FSC standards.

For further information see note 13 of our Group annual financial statements included elsewhere in this Annual Report.

*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 and set the expense for the next fiscal year. 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.

*Pension plans*

The key assumptions used to compile pension plan assets and liabilities at the end of fiscal 2005 and fiscal 2004 were as follows:

	Europe		North America		United Kingdom		South Africa	
	2005	2004	2005	2004	2005	2004	2005	2004
	%	%	%	%	%	%	%	%
Discount rate	3.68	4.63	5.50	5.65	5.00	5.50	8.10	9.00
Return on assets	5.19	5.20	8.25	8.50	5.75	5.50	9.71	10.18
Salary increase	2.99	3.14	3.50	3.75	4.00	4.00	5.49	6.00

The benefit obligations and fair value of plan assets at the end of fiscal 2005 were as follows:

	Benefit obligation (\$ millions)	Fair value of Plan assets	Net Funded/ (Unfunded) status
<b>Pension funds</b>			
Europe	624	457	(167 )
North America	442	289	(153 )
United Kingdom	222	170	(52 )
South Africa	301	306	5
	1,589	1,222	367

Actual returns for the various regional pension funds during fiscal 2005 were significantly better than actuarial projections, which improved asset levels as at the end of fiscal 2005. However, discount rates in all funds have been adjusted downwards, reflecting lower prevailing interest rates. The lower discount rates across the regions increased liabilities by \$134 million, thereby having a negative effect on the funded status of the Group's plans at the end of fiscal 2005 compared to the end of fiscal 2004.

The unfunded status of the company's pension plans increased by \$28 million to a deficit of \$367 million at the end of fiscal 2005 from a deficit of \$339 million at the end of fiscal 2004.

Edgar Filing: SAPPI LTD - Form 20-F

Net periodic pension costs using the assumptions above were as follows at the end of fiscal 2005, fiscal 2004 and fiscal 2003:

	2005	2004	2003
	(\$ millions)		
<b>Pension costs</b>			
Europe	16	13	15
North America	25	25	19
United Kingdom	6	8	4
South Africa	15	7	3
	62	53	41

The Group's net periodic pension expense in fiscal 2006 is expected to decrease to \$38 million from \$62 million in fiscal 2005 due to the recognition of prior actuarial losses through IFRS adoption. Employer contributions for pensions are expected to rise by approximately \$16 million to \$79 million primarily due to increases in North American funding requirements.

A 1% increase in discount rates would decrease the pension liability by approximately \$193 million and the related pension expense by approximately \$14 million per annum.

*Post retirement benefits other than pensions*

The key assumptions used to compile post retirement benefit obligations other than pensions were as follows at the end of fiscal 2005 and fiscal 2004:

	North America		South Africa	
	2005	2004	2005	2004
	%	%	%	%
Discount rate to estimate accumulated benefit	5.50	5.65	8.10	9.00
Health care cost trends to value APBO	10.00	10.00	5.60	6.50
Which gradually reduce to an ultimate rate of	5.00	5.00	5.60	6.50
Over a period of (years)	5	5		

The benefit obligations and fair value of plan assets at the end of fiscal 2005 were as follows:

	Benefit obligation	Fair value of
	(\$ millions)	Plan assets
<b>Other post-retirement benefits</b>		
North America	109	
South Africa	69	
	178	

Discount rates are drawn from high quality corporate bond yield indices with terms similar to those of fund liability profiles. Discount rate assumptions have been adjusted downwards in all funds, reflecting, respectively, prevailing lower interest rates. This has increased the net unfunded status of other post-retirement benefits plans by \$6m to \$178 million at the end of fiscal 2005 from the end of fiscal 2004.



Post retirement benefit costs other than pensions using the assumptions above were as follows at the end of fiscal 2005, fiscal 2004 and fiscal 2003:

	2005	2004	2003
	(\$ millions)		
<b>Other post-retirement benefits cost</b>			
North America	11	16	
South Africa	7	6	6
	18	22	6

A 1% increase in the health care cost trend rates would increase the accumulated other post-retirement benefit obligation by approximately \$12 million and the aggregate of the service and interest cost components of net periodic other post-retirement benefit cost by \$1 million per annum.

A 1% decrease in the health care cost trend rates would decrease the accumulated other post-retirement benefit obligation by approximately \$11 million and the aggregate of the service and interest cost components of net periodic other post-retirement benefit cost by \$1 million per annum.

*Provisions.* Provisions are required to be recorded when the group has a present legal or constructive obligation as a result of past events, for which it is probable that an outflow of economic benefits will occur, and where a reliable estimate can be made of the amount of the obligation. Best estimates, being the amount that the Group would rationally pay to settle the obligation, are recognised as provisions at balance sheet date. Risks, uncertainties and future events, such as changes in law and technology, are taken into account by management in determining the best estimates.

Where the effect of discounting is material, provisions are discounted. The discount rate used is the pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability, all of which requires management judgement.

The establishment and review of the provisions requires significant judgement by management as to whether or not there is a probable obligation and as to whether or not a reliable estimate can be made of the amount of the obligation, which requires judgements as to the likelihood of future payment. All provisions are reviewed at each balance sheet date. Various uncertainties can result in obligations not being considered probable or estimable for significant periods of time. As a consequence, potentially material obligations may have no provisions and a change in facts or circumstances that results in an obligation becoming probable or estimable can lead to a need for the establishment of material provisions. In addition, where estimated amounts vary from initial estimates the provisions may be revised materially, up or down, based on the facts.

The Group periodically restructures its business units for productivity and business improvement initiatives and records charges for reductions in its workforce, the closure of manufacturing facilities, and other actions related thereto. These events require estimates of liabilities for employee separation payments and related benefits, equipment removal, environmental cleanup and other costs. The actual costs incurred could differ materially from those estimated at balance sheet date.

The Group is required to record provisions for estimated environmental liabilities, based on current interpretations of environmental laws and regulations, when expenditures are considered probable and can be reasonably estimated. These estimates reflect management assumptions and judgements as to the probable nature, magnitude and timing of required investigations, remediation and monitoring activities, changes in governmental regulations, insurance recoveries and the contributions by other potentially responsible parties. These assumptions and judgements are subject to various uncertainties which could result in estimated costs that could materially differ from the actual costs incurred.

The Group is required to record provisions for legal contingencies when the contingency is probable of occurring and the amount of the loss can be reasonably estimated. Liabilities provided for legal matters require judgements regarding projected outcomes and ranges of losses based on historical experience and recommendations of legal counsel. Litigation is however unpredictable and actual costs incurred could differ materially from those estimated at the balance sheet date.

Provisions for dismantling of property, plant and equipment are only recognised when a legal or constructive obligation arises.

For further information, see Item 8-Financial Information-Legal Proceedings .

### **Changes in Accounting Policies and Practices**

There was one accounting policy change in each of fiscal 2005, fiscal 2004 and fiscal 2003. During fiscal 2005 we changed our policy on STC. We adopted AC501 accounting for STC. This standard now requires the recognition of a deferred tax asset for unused STC credits to the extent that they will be utilised in the future. This has resulted in the recognition of a deferred tax asset for unused STC credits. 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. The implementation of this policy decreased net profit after tax by \$8 million (fiscal 2004: \$3 million). It had the effect of increasing shareholders' equity by \$38 million at the beginning of fiscal 2005. For further detail on the deferred tax asset and deferred tax expense recognised for STC, refer note 9 and 14 of our Group annual financial statements included elsewhere in this Annual Report.

During fiscal 2004 we changed our accounting policy with regard to plantations. We previously stated our plantations at the lower of cost less depletions and realisable value. Cost included all expenditure incurred on acquisition, forestry development, establishment and maintenance of plantations, and finance charges. Following the adoption of AC137, we no longer capitalise silvicultural expenses and finance costs to plantations nor do we amortise plantations to the income statement. Movements in the fair value of plantations now impact operating profit. The implementation of this policy had the effect of enhancing net profit before tax by \$66 million and enhancing net profit after tax by \$47 million for fiscal 2004. The new policy will lead to increased volatility from one reporting period to the next.

The group's policy is to show separately, as other income or expenses, certain items that are of such size, nature or incidence that their separate disclosure is relevant to explain the group's performance. Previously these items, entitled non-trading income or loss, were excluded from operating profit. Circular 3/2004 issued by the South African Institute of Chartered Accountants requires the inclusion of these items. Consequently, operating profit had been restated to take these requirements into account. This had resulted in a decrease in operating profit of \$27 million for fiscal 2003 (fiscal 2002: decrease of \$17 million).

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.

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

Our accounting policy changes are reflected in note 3 of our Group annual financial statements included elsewhere in this Annual Report.

## New Accounting Standards

### International Financial Reporting Standards ( IFRS )

We are required by the JSE Limited to report under IFRS from fiscal 2006. Our preparation for the adoption of IFRS is advanced. The adoption of IFRS will lead to some changes in the Group's accounting policies, results, and the presentation of its financial statements, and other disclosures within the Annual Report, which are currently in accordance with South African GAAP.

Based on our current assessment of published IFRS requirements, the principal effects on our financial statements are the treatment of employee benefit liabilities and expenses, share based payments and securitised receivables. No significant reporting adjustments for property, plant and equipment are currently foreseen.

Previously unrecognised actuarial employee benefit gains and losses will be recognised, resulting in an increase in pension and other post retirement benefit liabilities and a corresponding reduction in equity. This adjustment will lead to a reduction in employee benefit expenses in fiscal 2006 and future fiscal years because the amortization of past losses is no longer required. The cost of share options and grants, as calculated using the binomial method will be reflected in the income statement over the vesting period. A significant portion of our securitised receivables will be brought on to the balance sheet, increasing both trade receivables and short-term debt. The related expense will no longer be reflected in SG&A, but will be included in finance costs. There will be other changes which are not expected to have a significant impact on earnings or balance sheet ratios.

The net impact of these changes is currently not expected to have a material impact on earnings per share in fiscal 2006.

The consideration of our adoption of IFRS is subject to ongoing review and possible amendment through interpretive guidance from the International Accounting Standards Board. Further, the presentation of the transition to IFRS at year-end as well as income statement and balance sheet captions may be different to the initial expectation of the impact noted above.

For a discussion of new South African and US accounting standards, and the implementation of IFRS, see note 43 of our Group annual financial statements included elsewhere in this Annual Report.

### United States GAAP Reconciliation

Our Group annual financial statements are prepared in accordance with South African GAAP, which differ from United States GAAP in certain significant respects. A comparison of our results and shareholders' equity for fiscal 2005, fiscal 2004 and fiscal 2003 shown under South African GAAP and after reflecting certain adjustments which would arise if United States GAAP were to be applied instead of South African GAAP, is as follows for fiscal 2005, fiscal 2004 and fiscal 2003:

	2005 (audited) (\$ millions)	2004 (audited)	2003 (audited)
Net profit:			
South African GAAP	(213 )	95	143
United States GAAP	(332 )	46	148
Shareholders' equity:			
South African GAAP	1,881	2,157	1,983
United States GAAP	1,579	1,979	1,908

As more fully described and quantified in note 42 to our Group annual financial statements included elsewhere in this Annual Report, the major differences between South African GAAP and United States

GAAP relate to STC on undistributed reserves, fair value hedges, accounting for plantations, accounting for business combinations, pre-commissioning expenses and pension programmes and post-retirement medical benefits. For a discussion of a material weakness in fiscal 2005 in our internal control over financial reporting relating to our US GAAP reconciliation, see Item 15 Controls and Procedures. Our results and shareholders' equity in accordance with United States GAAP for prior years have been restated. See note 42 to our Group annual financial statements included elsewhere in this Annual Report for further detail.

## Other Items

### South African Exchange Controls

South Africa's exchange control regulations provide for restrictions on the exporting of capital and for various other exchange control matters. Transactions between residents of the Common Monetary Area (comprising South Africa, the Republic of Namibia and the Kingdoms of Lesotho and Swaziland), on the one hand (including corporations), and non-residents of the Common Monetary Area, on the other hand, are subject to these exchange control regulations which are enforced by the Exchange Control Department of the South African Reserve Bank (hereinafter referred to as Excon).

The present exchange control system in South Africa is used principally to control capital movements. South African companies are generally not permitted to export capital from South Africa or to hold foreign currency or foreign assets without the approval of the South African exchange control authorities. Foreign investment by South African companies is also restricted. As a result, a South African company's ability to raise and deploy capital outside the Common Monetary Area is restricted. The granting of loans from outside South Africa to Sappi Limited or its South African subsidiaries and their ability to borrow from non-resident sources is regulated. Further, where 75% or more of a South African company's capital, assets, earnings, voting securities, voting power, power of control or earnings are directly or indirectly controlled by or vested in non-residents of the Republic of South Africa, the company is designated an affected person and certain restrictions are placed on its ability to obtain local financial assistance.

The South African authorities have expressed a commitment to a phased liberalisation of exchange controls and have relaxed certain exchange controls over recent years.

Some of the more salient recent changes to the South African exchange control regulations regarding South African corporations are as follows:

- South African corporations wishing to establish new approved foreign ventures are now permitted to transfer funds abroad for this purpose. There is no limit to the amount of funds which may be transferred save that, the foreign investment may only be acquired and such funds may only be transferred abroad once Excon has approved the type of foreign investment, which it will only do if the foreign investment accords with Excon's foreign investment criteria (applicable at the relevant time), and with regard to larger foreign investments Excon may require capital outflows to be staggered in order to manage the potential impact on the foreign exchange market.
- South African corporations which have been granted approval to transfer funds abroad for purposes of acquiring an approved foreign investment, will now be entitled to retain abroad foreign dividends which relate to the operation of the approved foreign investment and any foreign dividend which may have been repatriated to South Africa after 26 October 2004, may thereafter be transferred abroad again, at any time and for any purpose other than for purposes of a non-resident (which is directly or indirectly controlled by a South African resident) using such funds to reinvest into the South African market.
- South African corporations wishing to invest abroad may apply for permission to use corporate assets or share swaps and share placement transactions to finance approved foreign investments.

The latter mechanism entails the placement of the locally quoted company's shares with long term overseas holders who, in payment for the shares, provide the foreign currency abroad which the company then uses to acquire the target investment. Since February 2001, institutional investors are no longer entitled to make use of the asset swap mechanism but are, however, entitled to acquire foreign portfolio investments of either 15% or 20% of total assets, depending on the type of institutional investor.

Controls on current account transactions, with the exception of certain discretionary expenses, have been abolished and are now dealt with by authorised dealers in terms of the Exchange Control Rulings.

Authorised dealers in foreign exchange may, against the production of suitable documentary evidence, provide forward cover to South African residents in respect of fixed and ascertained foreign exchange commitments covering the movement of goods.

It is not possible to predict whether existing exchange controls will be abolished, continued or modified by the South African Government in the future.

For further information, see Item 10 Additional Information Exchange Controls .

### **Environmental Matters**

We operate in an industry subject to extensive environmental regulations. Typically, we do not separately account for environmental operating expenses but do not anticipate any material expenditures related to such matters. We do separately account for environmental capital expenditures. See note 41 to our Group annual financial statements included elsewhere in this Annual Report for a discussion of these matters.

### **Research and Development, Patents and Licenses, etc.**

Our research and development efforts focus on the improvement of product quality and production processes as well as the development of new products. Research and development is managed at a number of regional technology centres. These centres of excellence provide the basis to leverage unique sets of skills and provide customer focused product development. We spent approximately \$27 million, \$21 million and \$19 million on research and development activities during fiscal 2005, fiscal 2004 and fiscal 2003, respectively.

#### ***North America***

Sappi Fine Paper North America's research and development activities are centred at Westbrook. This centre has a proud history of product innovation; for example, it developed both one- and two-sided coated paper.

In addition, Sappi Fine Paper North America has a number of proprietary technologies, including the on-line finishing technology and its Ultracast® electron-beam technology. Sappi Fine Paper North America on-line finishing technology is used in its production of coated paper at Somerset and Muskegon. Sappi Fine Paper North America's Ultracast® technology is utilised in speciality papers such as release papers used in the production of high fidelity imitation leather and other surfaces.

#### ***Europe***

Sappi Fine Paper Europe maintains research and development centres at its Maastricht and Gratkorn sites. These facilities work closely with the research facility at Sappi Fine Paper North America in order to achieve efficiencies and ensure rapid implementation of improvements.

Sappi Fine Paper Europe's research and development centres have concentrated on developing new paper qualities. The research and development effort has developed coated fine paper of outstanding quality. The paper which was developed satisfies the demands of modern high performance printing machines, while maintaining a consistent quality between the paper produced at the various Sappi mills. The Maastricht research and development centre also has overseen the introduction of triple coating through the use of its triple blade coating concept. More recently, the research and development centres have concentrated on optimising product characteristics in relation to various types of paper machines at each mill, in order to improve efficiencies and quality of production. In 1990, the Alfeld mill became the first mill to produce coated fine paper using 100% totally chlorine-free (TCF) pulp.

#### *Southern Africa*

Sappi Forest Products focuses upon developing technology related to plantation forestry, pulping, bleaching and related environmental technology and chemical cellulose (dissolving pulp) technology. In the 1970s, we patented the Sapoxal oxygen bleaching process and licensed the technology in major pulp and paper manufacturing countries. This process facilitates the reduction or elimination of elemental chlorine in pulp bleaching. Oxygen bleaching has subsequently become an industry standard. At our recently opened Technology Centre in Pretoria, we continue our research and development related to bleaching, and are currently involved in biotechnology research, which is being conducted in order to develop a more environmentally friendly pulping and bleaching process. We are also a leader in technology aimed at reducing water consumption in pulp and paper mills. At our forest research centre in Tweedie, we focus upon the genetic improvement of plantation forests so as to maximise the yield of high quality pulp. Research on the modification of fibres to enhance characteristics for end products is also currently being conducted.

We are also active in chemical cellulose (dissolving pulp) research for Saiccor. The focus is largely on product development to provide more product options and this has allowed us to expand the value added product range from Saiccor. Most significantly our chemical cellulose (dissolving pulp) is used to produce high quality viscose, acetate, feminine healthcare products and food additives.

**ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES**

**Directors and Senior Management**

The Articles of Association of Sappi Limited provide that the Board of Directors (the Board) must consist of not less than four nor more than twenty Directors at any time. The Board currently consists of fourteen Directors.

The business address for all of the Directors is 48 Ameshoff Street, Braamfontein, Johannesburg 2001, Republic of South Africa. All of the Directors are South African citizens except for Jonathan Leslie (a British citizen), Meyer Feldberg and James Healey (United States citizens), Wolfgang Pfarl (an Austrian citizen), Klaas de Kluis (a Dutch citizen) and Helmut Mamsch (a German citizen).

***Executive Directors***

*Jonathan Charles Alexander Leslie (55) BA (Juris), MA.*

Chief Executive Officer, joined Sappi in April 2003. Mr Leslie was educated at Trinity College, Oxford, receiving a Master of Arts degree in Jurisprudence. He was called to the Bar in 1974. Prior to joining Sappi he spent 26 years with Rio Tinto and was appointed director of Rio Tinto plc in 1994. He had wide experience of the company's interests in Africa, Australia, Latin America and the United States, including as Managing Director of Rössing Uranium in Namibia. Mr Leslie was Chief Executive of the Copper Group from 1997 to 1999 and Chief Executive of the Diamonds and Gold Group from 1999 until joining Sappi.

*John Leonard Job (60) BSc (Hons), PhD.*

Executive Director responsible for Technology and Risk Management. Dr Job joined Sappi in July 1999 and was appointed to the board in August 1999. He served as Chairman of Sappi's South African businesses until the end of December 2004 when he relinquished his responsibility for the South African businesses. He continued with his responsibility for Technology and Risk Management and from April to October 2004 also assumed the responsibility as President and Chief Executive Officer of Sappi Fine Paper North America. He has 25 years experience in the chemical industry and was formerly the Chief Executive Officer of Sentrachem.

*Wolfgang Pfarl (61) MS (Economics and Business Administration).*

Chief Executive Officer of Sappi Fine Paper Europe. Mr Pfarl was appointed to his present position in December 1997 following Sappi's acquisition of KNP Leykam. In 1989, he was appointed Chairman of the Executive board of Leykam-Mürztaler and became Executive Chairman of KNP Leykam after the merger in 1993 of the fine paper production activities of NV Koninklijke KNP BT (now Buhrmann NV) and the Austrian paper producer Leykam-Mürztaler. Mr Pfarl was appointed to the board of Sappi Limited in December 1997.

*Donald Gert Wilson (48) BCom CTA, CA (SA).*

Executive Director Finance of Sappi Limited. He joined Sappi in April 1999 and was appointed to the board in May 1999. Mr Wilson has held various executive financial positions in the Barloworld Group, a South African-based international industrial corporation, mainly within their Caterpillar earthmoving division.

The Executive Directors are the Executive Officers of Sappi.

***Non-Executive Directors***

*Eugene van As (66).*

Chairman. Mr van As joined Sappi in December 1976 as the Managing Director of Sappi Kraft (Pty) Limited and was appointed to the board in January 1977. In 1978, Mr van As was appointed Group Managing Director and Chief Executive Officer, Sappi Limited, becoming Executive Chairman in 1991 and Non-executive Chairman on his retirement as an Executive Director in 2003. He is also a Director of Sanlam Limited and a trustee of a number of education and research bodies.

*David Charles Brink (66) (independent). MSc Eng (Mining), DCom (hc), Graduate Diploma (Company Direction).*

Mr Brink was appointed a Non-executive Director of Sappi Limited in March 1994 and is currently a member of the Audit Committee, of the Compensation Committee and the Nomination and Governance Committee. Mr Brink is Chairman of Unitrans Limited and Deputy Chairman of ABSA Bank Limited and ABSA Group Limited. He is a director of Sanlam Limited, and BHP Billiton Limited and Plc. Mr Brink is also a board member of the National Business Initiative, he is co-chairman of the Business Trust and is also a founder member of the Independent Directors Initiative. Mr Brink retired as Chairman of Murray & Roberts at the end of 2003.

*Klaas de Kluis (69) (independent). Master of Law.*

From January 1998 until July 1998, Mr de Kluis acted as Chairman of the Executive board of NV Koninklijke KNP BT (now Buhrmann NV). He held the position of Vice Chairman of the Executive board of NV Koninklijke KNP BT from March 1993 to April 1996. Presently he is a member of the supervisory boards of a number of private companies in the Netherlands and is Chairman of the Audit Committee of the board of directors of Sappi Limited. Mr de Kluis was appointed to the board of directors of Sappi Limited in January 1998.

*Meyer Feldberg (64) (independent). BA, MBA, PhD.*

Professor Feldberg's career has included a number of teaching and leadership positions in the business schools of the universities of Cape Town, Northwestern and Tulane. He is currently Dean Emeritus and the Sanford C Bernstein Professor of Leadership and Ethics at Columbia Business School. Professor Feldberg serves on the Advisory board of the British American Business Council and has served on the Council of Competitiveness in Washington DC. In 2001, the International Centre in New York honoured Professor Feldberg as a distinguished foreign-born American who has made a significant contribution to American life. He is a director of many major public companies including Federated Department Stores Inc, Revlon Inc, PRIMEDIA Inc, UBS Funds and Select Medical Corporation. Professor Feldberg was appointed to the board of directors of Sappi Limited in March 2002 and is currently Chairman of the Nomination and Governance Committee and a member of the Compensation Committee.

*James Edward Healey (64) (independent). BSc (Public Accounting), Honorary Doctor (Commercial Science), CPA (USA).*

Mr Healey joined the Sappi Limited board with effect from July 2004. He is a member of the Audit Committee of Sappi Limited and Chairman of the Audit Committee of Sappi Fine Paper North America. He has held various senior financial positions in a career spanning 37 years. In 1995, Mr Healey became Vice President and Treasurer of Bestfoods, formerly CPC International Inc. In 1997 he became Executive Vice President and Chief Financial Officer of Nabisco Holdings Inc, one of the world's largest snack food manufacturers, a position from which he retired at the end of 2000. He is a member of the board of directors of Interchange Financial Services Corporation.

*Deenadayalen (Len) Konar (51) (independent) BCom, MAS, DCom, CA (SA).*



Previously Professor and Head of the Department of Accountancy at the University of Durban-Westville. He is a member of the King Committee on Corporate Governance, the Securities Regulation Panel and the Institute of Directors. Companies of which he is a non-executive Director and serves on the audit committee include Old Mutual South Africa, the South African Reserve Bank, Kumba Resources Limited, Illovo Sugar, JD Group and Steinhoff International Holdings. Dr Konar serves as chairman of the audit committees of Old Mutual South Africa, the South African Reserve Bank, Kumba Resources Limited, Illovo Sugar and Steinhoff International Holdings. Dr Konar joined the board of Sappi Limited in March 2002 and is a member of the Audit Committee, the Human Resources Committee and is also the Chairman of the Audit Committee of Sappi southern Africa region. He was appointed as an External Audit Committee member of the International Monetary Fund in Washington in December 2004.

*Helmut Claus-Jurgen Mamsch (60) (independent).*

Mr Mamsch studied economics at Deutsche Aussenhandels-und Verkehrs-Akademie, Bremen and also received training in business administration and shipping in Germany, the UK and Belgium. He worked for 20 years in international trade and shipping. In 1989 he joined VEBA AG (now E.ON AG), one of Germany's largest utility-based conglomerates. From 1993 to 2000 he was a VEBA AG management board member and as from 1998 responsible for their US electronic businesses, Corporate Strategy and Development. In 1997 he joined Logica as Non-executive Director and in 2002 was appointed Deputy Chairman. He is also a Non-executive Director of GKN plc. Mr Mamsch joined the board of Sappi Limited in January 2004 and is currently a member of the Audit Committee and also a member of the Compensation Committee of Sappi Limited and Chairman of the Audit Committee of Sappi Fine Paper Europe.

*Bridgette Radebe (45) (independent). BA (Pol Sc & Socio).*

In the last 16 years, Ms Radebe has worked in a broad range of sectors across industry and commerce with a particular focus in mining. Ms Radebe is the Executive Chairperson of Mmakau Mining and she also chairs the South African Mining Development Association. She was closely involved in developing the South African Mineral & Petroleum Resources Development Act and the Mining Charter. She is also a Director of the Leadership Foundation IWF, Washington, and serves on the boards of the National Research Foundation and the New Africa Mining Fund. Ms Radebe joined the Sappi Limited board in May 2004 and is a member of the Human Resources Committee of Sappi Limited and also the Non-executive representative on the Sustainability Committee, a management committee of Sappi Limited.

*Franklin Abraham Sonn (66) (independent). BA Hons, HDipEd.*

Dr Sonn was appointed to the board of directors of Sappi Limited in July 1999 and is currently a member of the Nomination and Governance Committee of Sappi Limited. He was the former Rector of Peninsula Technikon for 17 years and appointed democratic South Africa's first ambassador to the United States from 1995 to 1998. Dr Sonn is the recipient of eleven honorary doctorates in law, education, humanities and philosophy from various institutions in South Africa, Europe and North America. His current board positions include amongst others, African Star Ventures (Pty) Ltd as Executive Chairman, Steinhoff Group Holdings Ltd, Macsteel Holdings (Pty) Ltd, Capespan Group Holdings Ltd, ABSA Group Ltd, ABSA Bank Ltd and ABSA Personal Bank, New Africa Capital Ltd and Pioneer Food Group Ltd. He was appointed Chancellor of the University of the Free State in 2002 and serves as Deputy President of the Chamber of Commerce and Industry in South Africa (CHAMSA) and as Chairman, Trustee and Patron to numerous organisations of civil society.

#### ***Compensation***

The non-executive directors fees are proposed by the Executive Committee and agreed by the Human Resources Committee and approved by the Board. In addition to these non-executive directors fees Mr E van As received a retainer in fiscal 2005 of US\$ 166,886 (2004: US\$ 124,705).

See notes 44 to 46 to our Group annual financial statements contained elsewhere in this Annual Report for details, by director, on Directors remuneration, Directors interests and Directors participation in the Sappi Limited Share Incentive Trust and Sappi Limited Performance Share Incentive Plan.

### ***Board Practices***

At every annual general meeting of Sappi Limited, as near as possible to, but not less than, one third of the Directors are required to retire from office but are eligible for re-election. The Directors to retire are those who have been longest in office since their last election, or as between Directors who have been in office for an equal length of time since their last election, in the absence of agreement, determined by lot. In addition, the appointment of any Director appointed since the last annual general meeting will require to be confirmed, failing which the appointment will cease.

Following the Board's decision to split the roles of Chairman and Chief Executive Officer, Jonathan Leslie was appointed as Director and Chief Executive of Sappi Limited effective from April 2003 and Eugene van As was appointed as Non-Executive Chairman.

The length of the term of office of Jonathan Leslie as a Director is determined by the Board; the Board has not specified the length of his term. In the case of Eugene van As, while he was Executive Chairman of Sappi Limited, the Board determined the length of his term as a Director. Following his becoming Non-Executive Chairman of Sappi Limited, in terms of the Articles of Association of Sappi Limited, his term of office in line with all other Directors will be a maximum of three years per term. His current term will end at the annual general meeting on March 6, 2006, and he will be standing for re-election for a further three year term.

The following table sets forth the terms of office of the other Directors.

<b>Name</b>	<b>Start of term</b>	<b>Latest date of end of term</b>
David Charles Brink	2005	2008
Meyer Feldberg	2005	2008
James Edward Healey	2005	2008
John Leonard Job	2003	2006
Klaas de Kluis	2003	2006
Deenadayalen Konar	2003	2006
Helmut Claus-Jürgen Mamsch	2004	2007
Wolfgang Pfarl	2005	2008
Bridgette Radebe	2005	2008
Franklin Abraham Sonn	2005	2008
Eugene van As	2004	2006
Donald Gert Wilson	2004	2006

No retirement or other benefits arise from the retirement of Directors by rotation or on termination for any other reason.

### ***Audit Committee***

An Audit Committee of the Board was established in 1984 and assists the Board in discharging its responsibilities to safeguard the Group's assets, maintain adequate accounting records and develop and maintain effective systems of internal financial control. It also oversees the financial reporting process and is concerned with compliance with accounting policies, Group policies, legal requirements and internal controls within the Group. It interacts with and evaluates the effectiveness of the external and internal audit process and reviews compliance with the Group's code of ethics.

The Audit Committee consists of five independent Non-Executive Directors of the Board (Klaas de Kluis (Chairman), David Charles Brink, James Edward Healey, Deenadayalen Konar and Helmut Claus-Jürgen Mamsch) and is directed by a specific mandate from the Board. The adequacy of the mandate is reviewed and reassessed annually. The Audit Committee meets with senior management, which includes the Chief Executive Officer and the Executive Director Finance, at least four times a year. The external and internal auditors attend these meetings and have unrestricted access to the Committee and its Chairman. The Audit Committee also meets at least once per year with the management Disclosure Committee. The external and internal auditors meet privately with the Audit Committee Chairman on a regular basis. The Audit Committee Chairman attends the annual general meeting.

Regional audit committees exist in the three major regions and are chaired by independent Non-Executive Directors. These committees have a mandate from the group's audit committee, to whom they report on a regular basis and they meet at least four times per year.

#### ***Nomination and Governance Committee***

The Nomination and Governance Committee of the Board consists of three independent Non-Executive Directors (David Charles Brink, Meyer Feldberg (Chairman) and Franklin Abraham Sonn) and Eugene van As, the Chairman of the Group. The Committee considers the composition of the Board, retirements and appointments of additional and replacement Non-Executive Directors and makes appropriate recommendations to the Board. The Chief Executive Officer attends meetings by invitation.

#### ***Human Resources Committee***

The Human Resources Committee of the Board consists of two independent Non-Executive Directors (Deenadaylen Konar and Bridgette Radebe) and Eugene van As, the Chairman of the Group and of the Committee. The responsibilities of the Committee are, among other things, to determine human resource policy and strategy. Human Resources Committees exist for all the company's major operating subsidiaries outside of southern Africa.

#### ***Compensation Committee***

The Compensation Committee of the Board consists of three independent Non-Executive Directors (David Charles Brink (Chairman), Meyer Feldberg and Helmut Claus-Jürgen Mamsch. The responsibilities of the Committee are mainly to determine the remuneration and incentives in respect of the Chief Executive Officer and those executives reporting directly to the Chief Executive Officer.

#### **Corporate Governance**

On November 4, 2003 the New York Stock Exchange (NYSE) established new corporate governance rules. The application of the NYSE rules is restricted for foreign companies, recognizing that such companies have to comply with domestic requirements. As a foreign private issuer, Sappi must comply with three NYSE rules:

- Satisfy the audit committee requirements of the Securities and Exchange Commission;
- Chief Executive Officer must promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of Section 303(A) of the Sarbanes-Oxley Act of 2002, and
- Provide a brief description of any significant difference between its corporate governance practices and those followed by US companies under the NYSE listing standards.

As Sappi is listed on the JSE in Johannesburg, Sappi is required to comply with the King Report on Corporate Governance for South Africa 2002. Although there are differences between the King Report and the NYSE corporate governance rules, Sappi believes it is in compliance with the King Report and has otherwise voluntarily adopted corporate governance practices comparable in all significant respects to the requirements of the NYSE corporate governance rules except as described below.

<b>New York Stock Exchange (NYSE) Corporate Governance Rules</b>	<b>Sappi's Governance Practice</b>
<b>1. Nominations / Corporate Governance Committee</b>	
Listed companies must have a nomination/corporate governance committee composed entirely of independent directors	Sappi has a nominations committee composed of four non-executive directors, of whom three are independent.

## Employees

The following table sets forth the number of employees as at the close of each fiscal year ended September.

	2005	2004	2003
<b>Sappi Fine Paper</b>			
North America	2,781	3,054	3,268
Europe	5,437	5,532	5,686
Southern Africa	1,879	1,962	2,016
<b>Sappi Forest Products</b>	5,254	5,178	5,695
<b>Sappi Trading</b>	162	164	164
<b>Corporate Office</b>	105	120	110
<b>Total</b>	15,618	16,010	16,939

### *North America*

At the end of September 2005, Sappi Fine Paper North America had 2,781 employees, down from 3,054 in September 2004. The headcount reductions during fiscal 2005 are the result of restructuring initiatives that occurred at Muskegon Mill and throughout the corporate staff with the closure of the PM 4 machine and the mothballing of the pulp mill.

Approximately 65% of employees are represented by twelve international unions under nine different contracts. The labour contracts for Cloquet, Allentown and the Westbrook mill mechanical unions (four) were successfully negotiated in 2003. The Westbrook, Somerset, and Muskegon Mills United Steelworkers union contracts that expired in May 2002, June 2003 and August 2005 respectively are under negotiation and the Cloquet USW contract expires in April 2006.

Sappi Fine Paper North America has experienced no work stoppage in the past fourteen years and believes that its relationship with its employees is satisfactory. While we hope to reach agreements on new contracts at all affected sites in North America, in the event that agreements cannot be reached and a prolonged work stoppage that results in a curtailment of output ensues at any or all such sites, our business could be adversely affected.

### *Europe*

Sappi Fine Paper Europe employed 5,437 people at the end of September 2005.

Restructuring took place at Nijmegen to reduce costs, and headcount was reduced by 24 people in total and impacted all functions. In order to further improve cost efficiencies, a synergy project between Maastricht and Lanaken mills was undertaken. The sharing of some functions across both mills, because of the close proximity of the mills to one another, resulted in 48 headcount reductions (across both mills) in 2005. The works council and unions at each of the mills have been consulted.

A substantial number of Sappi Fine Paper Europe employees are represented by trade unions.

Sappi Fine Paper Europe is subject to industry-wide collective agreements that are in place with trade unions in Germany, Austria and Belgium and which relate to its employees in each of the relevant mills. At our mills in The Netherlands and in the United Kingdom, Sappi Fine Paper Europe has entered into shop-floor agreements with the respective trade unions. Overall labour relations have been very stable in each of these countries despite some minor strike actions in the course of our recent collective labour agreement negotiations at our Lanaken mill in Belgium.

In addition to trade unions, Sappi Fine Paper Europe also consults with various local, national and European works councils. These work councils serve primarily in an advisory role. Sappi Fine Paper Europe is required, under certain circumstances, to keep the works councils informed of activities that affect the work force and to consult with one or more of the works councils before proceeding with a course of action. This is especially relevant for any major reorganisation.

### ***Southern Africa***

Sappi employed 7,288 people in Southern Africa at the end of September 2005. Of this total, Sappi Fine Paper South Africa and Sappi Forest Products employed 1,879 and 5,254 people respectively, with the balance being employed Sappi Trading (50) and Corporate (105). Unionised employees belong to one of four unions that enjoy recognition by Sappi, namely United Association of South Africa (UASA), Solidarity, the Swaziland Agricultural and Plantations Workers Union and the Chemical (SAPPWU), Energy, Paper, Printing, Wood and Allied Workers Union (CEPPAWU), of which the latter is the largest. Restructuring took place at Usutu Mill (Swaziland) after extensive engagement with the relevant trade union.

We believe that we generally have had satisfactory relations with the trade unions operating at our southern African mills. Pulp and paper industry wage negotiations occur annually and in 2005 were conducted without any industrial action, despite several industry wide wage related strikes.

A Bargaining Council was established for the wood and paper sector. The objective of the Bargaining Council is to give effect to the promotion and regulation of labour related issues.

HIV/AIDS has a high profile within Sappi and extensive work has been undertaken to manage the risks posed to employees and the organisation. Following an initial anonymous voluntary study in 2003, a second comprehensive study was conducted in 2005. Based on a participation rate of greater than 80% at the operating units tested, we estimate that the overall infection rate in our southern African operations is approximately 13.7%.

Our HIV/AIDS response strategy places special emphasis on testing and counselling. Since August 2002, our medical care for employees has included treatment to prevent mother to child transmission. Anti-retroviral treatment has been offered to HIV-infected permanent employees from the beginning of 2003. Thirty-four percent of the estimated population of HIV positive employees are actively engaged in an HIV/AIDS managed care programme, which is a significant improvement on the prior year's participation rate. Of these employees actively engaged in a care programme, 40% are receiving anti-retroviral treatment.

The continued provision of treatment is subject to annual approval by Sappi. Funding has been received from the Forestry Industry Educational and Training Authority for an industry-wide HIV/AIDS project which will focus on pulp and paper students. The HIV/AIDS co-ordinator for Sappi Southern Africa will co-ordinate this project for the industry body. In July 2005, Sappi joined the Global Business Coalition on HIV/AIDS.

Labour and employment law has changed substantially in South Africa in the past several years. Recent legislation such as the Labour Relations Act adopted in 1996 and the Basic Conditions of Employment Act adopted in 1998 have substantially enhanced the rights of employees, including the right to engage in protected industrial action.

In addition, in October 1998, the South Africa Parliament adopted the Employment Equity Act (No. 55 of 1998). The Employment Equity Act requires employers who employ 50 or more employees to implement affirmative action measures designed to ensure that suitably qualified persons from previously disadvantaged groups have equal employment opportunities and are equitably represented in the workforce of such employers. The provisions of the Employment Equity Act which pertain to the prohibition of unfair discrimination, the monitoring by employees and trade union representatives of compliance with the Act, the institution of legal proceedings concerning contraventions of the Act, the protection of employee rights and the formulation of codes of good practice and regulations pertaining to the Act were implemented on August 9, 1999. The implementation of the balance of the Act, dealing primarily with affirmative action measures, commenced on December 1, 1999. As required by the Act, Sappi drafted employment equity plans after consultation with representative employee forums and has submitted the prescribed reports to the Department of Labour as from May 2000. In October 2005, Sappi submitted an updated employment equity plan for the next five years.

Diversity management and awareness has been addressed across the region in order to facilitate further progress of the equity programme. Current diversity management and awareness programmes have been reviewed so as to ensure appropriate interventions to address the equity objectives for the next five-year period.

The Skills Development Act (No. 97 of 1998), which came into force on September 10, 1999, provided an institutional framework to devise and implement workplace strategies in order to develop and improve the skills of the South African workforce. The financing of skills development is provided for under the Skills Development Levies Act by means of a levy/grant system.

The Skills Development Act, Skills Development Levies Act and the South African Qualifications Authorities Act (No. 58 of 1995), including proposed amendments to the latter, have continued to receive significant attention during the past year. Equity forums established under the Employment Equity Act were mandated to serve as Learning Forums, and their constitutions, roles and responsibilities continue to be entrenched. The forums played a major role in preparing the Skills Plans submitted to the Forests Industries Education & Training Authority. A skills levy of 1%, specified in accordance with the Skills Development Levies Act, was paid via Internal Revenue to the Forest Industries Education and Training Authority. With the amendments to the National Skills strategy for 2005 to 2010, the grant amounts and claim processes have significantly changed to ensure agreement between management and employee representatives is attained and that a project driven approach to initiatives is encouraged.

## **Share Ownership**

### ***The Sappi Limited Share Incentive Scheme***

We have offered a share purchase scheme to eligible Officers and employees since 1979. During March 1997, The Sappi Limited Share Incentive Scheme, as amended from time to time (the *Share Incentive Scheme*), was adopted at the Annual General Meeting of Sappi Limited. Under the Share

Incentive Scheme, Officers or other employees of Sappi, its subsidiaries and other entities controlled or jointly controlled by Sappi selected by the Sappi Board of Directors are offered the opportunity to acquire shares ( *Scheme Shares* ), options to acquire shares ( *Share Options* ) or rights and options to enter into agreements with Sappi Limited or the Sappi Limited Share Incentive Trust to acquire shares ( *Allocation Shares* ). Participants may also be given the opportunity to acquire a combination of Scheme Shares, Share Options and Allocation Shares.

From the 2005 fiscal year we have also offered a performance share scheme to eligible officers and employees. Under the Sappi Limited Performance Share Incentive Plan (the *Performance Share Incentive Plan* ), officers or other employees of Sappi, its subsidiaries and other entities controlled or jointly controlled by Sappi selected by the Sappi Board of Directors are offered Conditional Contracts to acquire Shares for no cash consideration. If the performance criteria from time to time determined by the Human Resources Committee or Compensation Committee of the Board ( *Performance Criteria* ) applicable to each Conditional Contract are met or exceeded, then Participants shall be entitled to receive such number of shares as specified in the Conditional Contract for no cash consideration after the fourth anniversary of the date on which the board resolves to award a Conditional Contract to that Participant. The Performance Criteria shall entail a benchmarking of the company's performance against an appropriate peer group of companies.

For a detailed description of the Share Incentive Scheme, the Performance Shares Incentive Plan and recent amendments thereto, see note 36 to our Group annual financial statements included elsewhere in this Annual Report.

As of November 25, 2005, certain Directors of Sappi had been granted an aggregate of 849,000 Share Options, 408,000 Allocation Shares and 64,000 Performance Shares. None of the Directors of Sappi holds more than 1% of our issued share capital.

**ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS****Major Shareholders**

The following table sets forth certain information with respect to the ownership of the ordinary shares, R1.00 par value, of Sappi Limited by the shareholders of record of Sappi Limited as of September 30, 2005, holding 5% or more of the outstanding ordinary shares.

<b>Name of Registered Holder</b>	<b>Number of Shares</b>	<b>Percentage</b>
Standard Bank Nominees (Transvaal) (Proprietary) Limited <sup>(1)</sup>	114,019,883	50.5
Nedcor Bank Nominees Limited <sup>(1)</sup>	40,599,193	18.0
First National Nominees (Proprietary) Limited <sup>(1)</sup>	23,092,117	10.2
ABSA Nominees (Proprietary) Limited	21,422,380	9.5
Industrial Development Corporation of South Africa Limited	15,420,620	6.8
All Directors and Executive Officers as a Group <sup>(2)</sup>	1,925,785	0.9

(1) The registered holders have advised us that it holds shares for numerous clients and there has not been any significant percentage change in the holdings for the last three years.

(2) Includes shares issuable upon exercise of options granted under Sappi's Share Incentive Scheme. See Item 6 Directors, Senior Management and Employees Compensation .

The authorised share capital of Sappi Limited consists of 325,000,000 shares. As of September 30, 2005, the issued share capital consisted of 239,071,892 shares. Due to shares bought back and being held in a subsidiary company, the issued share capital, less treasury shares, was 225,870,878 as of September 30, 2005. It is common in South Africa for shares to be held through nominees. As of September 30, 2005, the five largest shareholders of record (four of which are nominees) owned approximately 95% of the shares. We believe that, as of September 30, 2005, based on registered addresses and disclosure by nominee companies, 46% of our shares were held beneficially in North America, 42% of our shares were held beneficially in South Africa and 12% of our shares were held beneficially in Europe and elsewhere, excluding the shares owned by subsidiaries of Sappi.

On September 30, 2005, there were approximately 44 record holders (including nominees) of ADSs and 48 record holders of shares in the United States. At that date, there were 45,194,295 ADSs and 62,827,405 shares (totalling 108,021,170 shares) held beneficially by holders with registered addresses in the United States. We believe, however, that more than 40% of our shares are owned beneficially by US holders.



Pursuant to the Companies Amendment Act Number 37 of 1999, where securities of an issuer are registered in the name of a person and that person is not the holder of the beneficial interest in all of the securities held by the registered shareholder, the registered shareholder is obliged, at the end of every three-month period to disclose to the issuer the identity of each person on whose behalf the registered holder holds securities and the number and price of securities issued by that issuer held on behalf of each such person. We authorised Thomson Financial to conduct a monthly investigation into the beneficial ownership of Sappi Limited shares. All beneficial holdings were investigated to determine whether there are any shareholders which hold 5% or more of our shares. As a result of these investigations, we have ascertained that some of the shares registered in the names of the nominee holders are managed by various fund managers and that, as of September 30, 2005, the following fund managers were responsible for 5% or more of the issued share capital of Sappi Limited.

<b>Name of Fund Manager</b>	<b>Number of Shares Managed</b>	<b>Percentage</b>
Templeton Investment Council LLC	30,778,924	13.6
RMB Asset Management (South Africa)	25,958,766	11.5

Under South African law, there is no obligation on the part of shareholders of Sappi Limited to disclose to Sappi Limited arrangements or understandings that may exist between or among them with respect to the holding or voting of shares unless such arrangement or understanding constitutes an affected transaction under the Securities Regulation Code on Takeovers and Mergers. An affected transaction means, among other things, any transaction which has or will have the effect of vesting control of any company in any person or two or more persons acting in concert in whom control did not vest prior to such transaction or scheme. Control is defined with reference to a specified percentage, which is currently 35% of the entire issued share capital of a company. The major shareholders have no different voting rights.

#### **Related Party Transactions**

For information on related party transactions, see note 39 to our Group annual financial statements contained elsewhere in this Annual Report.

**ITEM 8. FINANCIAL INFORMATION**

**Consolidated Statements and Other Financial Information**

See Item 18 Financial Statements and the F-pages for the Report of the Independent Auditors.

***Legal Proceedings***

We become involved from time to time in various claims and lawsuits incidental to the ordinary course of our business. We are not currently involved in legal proceedings which, either individually or in the aggregate, are expected to have a material adverse effect on our business, assets or properties.

**North America**

Since May 2004, a number of class actions have been filed in federal and state courts alleging that Sappi Limited and Sappi Fine Paper North America participated in a price fixing conspiracy with other manufacturers of publication paper. The cases filed in federal courts assert a violation of the federal antitrust laws, while the cases filed in state courts allege violations of state antitrust and unfair competition statutes. These lawsuits seek treble damages and injunctive relief, as well as other costs associated with the litigation. Class determination and merits discovery are expected to occur during 2006. While no trial date has been set, a trial is not expected before 2007.

In late July 2003, Sappi Fine Paper North America was served with a lawsuit in the Muskegon County Circuit Court brought by a number of Muskegon residents. The plaintiffs claim that pollutants, air contaminants, noise, dust, debris and bad odours have materially injured their persons and property, for which they are now seeking monetary damages, injunctive relief and attorney fees. The attorneys for the plaintiffs attempted to have the case certified as a class action, but this certification was defeated in June 2004. This matter was settled during 2005.

**Europe**

On May 25 and 26, 2004 the EU Commission carried out an unannounced inspection visit at Sappi Fine Paper Europe's headquarters in Brussels in the context of what appears to be an industry wide antitrust examination. The EU Commission has copied and taken away a substantial quantity of business documents. In its decision to authorise the inspection visit, the EU Commission alleges that Sappi Fine Paper Europe was involved in antitrust infringing collusive action with competitors. The EU Commission's investigation could last for several years.

In June 2003, an anti-dumping case was initiated by the Indian authorities against coated paper imports in the calendar year 2002 from the European Union and Indonesia. This anti-dumping procedure was terminated on December 17, 2004 due to a no-injury finding without imposing any sanctions against the exporters concerned including Sappi Fine Paper Europe.

**South Africa**

The Restitution of Land Rights Act (Act 22 of 1994), as amended, provides for the restoration of rights in land or other equitable redress to persons or communities dispossessed of their land rights after June 19, 1913 as a result of old laws or practices discriminating on the basis of race. The legislation empowers the Minister of Land Affairs to expropriate land in order to restore it to a successful claimant provided that there is just and equitable compensation to the owner of the land. Claims under the Act were required to be filed on or before December 31, 1998 and are presently being processed by the Commission on Restitution of Land Rights and adjudicated upon by the Land Court. This process is expected to continue for many years. As one of the largest land owners in South Africa, we anticipate that a substantial number of claims may affect land we own. The process of determining the extent of claims filed in respect

of our land and the potential impact of these claims on our South African operations continues. To date, we have been notified of seventeen formal Land Claims made in respect of portions of Sappi plantations in the Mpumalanga area, and twenty others made in respect of portions of Sappi plantations in KwaZulu Natal. These claims have not been finalised and are still under investigation by the Regional Land Claims Commissioner.

***Dividend Policy***

Our current policy is to consider dividends on an annual basis and to declare cash dividends in US dollars. We declared a dividend number 82 of 30 US cents for fiscal 2005. South African shareholders will be paid the Rand equivalent of the US dollar denominated declaration.

The current dividend policy of Sappi Limited is to provide dividend payments which incorporate, over time, real growth for shareholders by providing dividend payments whose cover will vary in line with changes in the business cycle but maintaining a long-term average dividend cover of three times. (Dividend cover is calculated by dividing earnings per share by dividends per share. A dividend cover of three times therefore means a dividend pay out ratio of approximately 33% of net income.).

In accordance with South African common law, dividends may be declared only out of distributable profits. Holders of American Depositary Receipts (ADRs) on the relevant record date will be entitled to receive any dividends payable in respect of the shares underlying the ADSs, subject to the terms of the Deposit Agreement among us, The Bank of New York and the ADR holders (the Deposit Agreement ). There is no restriction under South African exchange control regulations on the free transferability of cash dividends to non-resident shareholders or ADS holders. See Item 10-Additional Information-Exchange Controls .

South African companies pay Secondary Tax on Companies at the flat rate of 12.5% in respect of the amount of dividends declared by the company less all dividends which accrue to the company during its relevant dividend cycle . See Item 10 Additional Information-Taxation .

***Significant Changes***

Except as otherwise disclosed in this Annual Report, no significant change has occurred in our financial position since October 2, 2005.

**ITEM 9. THE OFFER AND LISTING****Offer and Listing Details**

The table below sets forth, for the periods indicated, the high and low prices and the volume of trading activity in the shares on the JSE, as reported by the JSE, and the high and low prices and the volume of trading activity in the ADSs on the New York Stock Exchange ( NYSE ), as reported by the NYSE.

	Shares		Trading Volume (million)	ADSs		Trading Volume (million)
	High (SA cents per share)	Low		High (\$ per ADS)	Low	
<b>Annual highs and lows</b>						
Fiscal 2005	9,550	5,780	264.7	15.50	9.14	83.6
Fiscal 2004	10,450	7,720	302.5	16.13	12.60	51.3
Fiscal 2003	12,950	8,550	245.8	14.52	10.30	48.3
Fiscal 2002	16,200	7,650	181.8	15.00	8.40	48.1
Fiscal 2001	8,700	4,380	240.1	10.37	5.75	51.6
<b>Quarterly highs and lows</b>						
<b>2005</b>						
Fourth quarter	7,990	6,610	48.1	12.17	10.05	16.2
Third quarter	7,750	5,780	63.6	12.40	9.14	24.8
Second quarter	8,600	7,255	67.3	15.50	11.92	18.1
First quarter	9,550	7,450	85.7	14.90	12.20	24.5
<b>2004</b>						
Fourth quarter	9,710	8,695	62.8	16.13	13.21	8.8
Third quarter	9,825	8,360	74.7	15.35	12.70	10.4
Second quarter	10,450	8,460	83.6	14.23	12.79	20.1
First quarter	9,690	7,720	81.4	13.71	12.60	12.0
<b>Monthly highs and lows</b>						
<b>2005</b>						
November	8,050	6,350	17.5	11.42	9.49	5.9
October	7,590	6,105	21.1	11.55	9.46	6.9
September	7,990	6,800	19.2	12.17	10.80	6.4
August	7,150	6,610	15.5	11.04	10.25	4.8
July	7,400	6,800	13.5	10.82	10.05	5.1
June	7,500	6,600	22.0	11.14	9.75	7.4

On December 7, 2005, the closing price for our shares on the JSE was 7,399 SA cents per share and the closing price of the ADSs on the NYSE was \$11.33 per ADS.

**Markets**

The principal market for the ordinary shares of Sappi Limited is the JSE. The ordinary shares of Sappi Limited are also listed on the London Stock Exchange. In February 2000, we announced our decision to delist our shares from the Paris Bourse with effect from March 29, 2000. This decision was based on the low volume of shares traded, the cost of maintaining the listing and the additional reporting standards required by the Bourse. On September 21, 2005, we announced our decision to delist our shares from the Frankfurt Stock Exchange with effect from November 10, 2005. This decision was based on the low volume of shares traded on the Exchange. On November 5, 1998, ADRs evidencing ADSs of Sappi Limited commenced trading on the NYSE under the symbol SPP. The Bank of New York serves as depositary

( the Depository ) with respect to the ADSs. Prior to the commencement of trading of the ADSs on the NYSE, our ordinary shares were traded in the United States in the over-the-counter market pursuant to a sponsored unrestricted American Depositary Receipt facility established in 1994. Price data relating to that trading is not considered meaningful and has not been included in this Annual Report.

On October 26, 1999, Sappi and The Bank of New York amended the Deposit Agreement to change, with effect from October 27, 1999, the number of ordinary shares represented by each ADS from 10 ordinary shares per ADS to 1 ordinary share per ADS. The prices for ADSs set forth in the following paragraphs and the table above reflect this change.

Prior to our global equity offering, which was completed on November 22, 1999, trading of the ADSs on the NYSE had been sporadic with the volumes traded varying between zero and 231,000 ADSs per day. Since that offering, trading of the ADSs has increased substantially. The ADS price has reached a high of \$16.13 and a low of \$3.22 since trading commenced. On some days, trading volume in ADSs on the NYSE has exceeded the volume traded on the JSE.

### *The JSE*

The JSE was formed in 1887 and provides facilities for the buying and selling of a wide range of securities, including equity, corporate debt securities, warrants in respect of securities, as well as Krugerrands. The JSE is a self-regulatory organisation operating under the supervision of the Ministry of Finance, through the Financial Services Board and its representative, the Registrar of Stock Exchanges.

The market capitalisation of South African equity securities was approximately \$344 billion as at October 31, 2005. The actual float available for public trading is significantly smaller than the aggregate market capitalisation because of the large number of long-term holdings by listed holding companies in listed subsidiaries and associates, the existence of listed pyramid companies and cross holdings between listed companies. Liquidity on the JSE (measured by reference to the total market value of securities traded as a percentage of the total market capitalisation at the end of the period) was 50% for the 12 months ended October 31, 2005. Trading is concentrated in a growing, but small, number of companies. As of the end of October 2005, there were 266 listed companies on the JSE.

Following the introduction of the FTSE/JSE free float indices, the FTSE/JSE All Share Index only includes those companies that constitute the top 99% of the market capitalisation of the JSE. The three main sectors in the market are Resources, Financials and Industrials. As of October 31, 2005, the All Share Index included 157 companies. The Financial and Industrial Index and the Resources Index included 31 and 20 companies, respectively, and accounted for approximately 48% and 39%, respectively, of the total market capitalisation of the JSE.

The JSE settles securities trades electronically through STRATE (Share Transactions Totally Electronic) the central securities depository for the equities market. All trades are downloaded from the JSE SETS automated trading system to the JSE's Broker Deal Accounting (BDA) system, which manages the settlement status of every trade. The BDA system interfaces with STRATE's system which in turn interfaces with those of the custodian banks. The JSE's Settlement Authority monitors all trades from time of execution to settlement to ensure performance.

Shares may not be traded on the JSE unless they have been dematerialized through STRATE. Contractual, rolling settlement has been introduced by the JSE in order to increase the speed, certainty and efficiency of the settlement mechanism and to fall into line with international practices. While settlement on the JSE is currently made five days after each trade (T + 5), the JSE in conjunction with STRATE is exploring with the industry how best to reduce the settlement period further to (T+3) without introducing undue risk.

**ITEM 10. ADDITIONAL INFORMATION**

**Memorandum and Articles of Association**

The following description is a summary of various provisions of the Memorandum ( Memorandum ) and Articles of Association ( Articles ) of Sappi Limited, the South African Companies Act (the Companies Act ) and the listings requirements of the JSE, which does not purport to be complete and is qualified in its entirety by reference to all of the provisions of those sources.

Sappi Limited is a public company incorporated in South Africa with registration number 1936/008963/06.

***Purpose of the Company***

Paragraph 3 of the Memorandum states that Sappi Limited is established, among other things, to manufacture, produce, buy, sell and deal in pulp, timber, paper, cardboard and other stated products.

***Directors***

In terms of the articles:

At every annual general meeting of Sappi Limited, as near as possible to, but not less than one third of the Directors (excluding any Director appointed after the conclusion of the preceding annual general meeting, the Executive Chairman, the Chief Executive Officer and the Managing Director) are required to retire from office but are eligible for re-election. The Directors to retire are those who have been longest in office since their last election or, as between Directors who have been in office for an equal length of time since their last election, in the absence of agreement, determined by lot. Any Director who has held office for three years since his last election is also required to retire at such annual general meeting. In addition, the appointment of any Director appointed after the conclusion of the preceding annual general meeting will require to be confirmed at the next annual general meeting, failing which the appointment will cease.

Except as set out in the following paragraph, a Director may not vote in respect of any contract or arrangement or any other proposal in which he has any material interest other than by virtue of his interest in ordinary shares or debentures or other securities of or otherwise in or through Sappi Limited. A Director will not be counted in the quorum at a meeting in relation to any resolution on which he is barred from voting.

A Director shall be entitled to vote and be counted in the quorum in respect of any resolution concerning any of the following matters:

- the giving of any security or indemnity to him in respect of money lent or obligations incurred by him at the request of or for the benefit of Sappi Limited or any of its subsidiaries;
- the giving of any security or indemnity to a third party in respect of a debt or obligation of Sappi Limited or any of its subsidiaries for which he himself has assumed responsibility in whole or in part under a guarantee or indemnity or by the giving of security;
- any proposal concerning an offer of shares or debentures or other securities of or by Sappi Limited or any of its subsidiaries for subscription or purchase in which offer he is or is to be interested as a participant in the underwriting or sub-underwriting of these securities;
- any proposal concerning any other company in which he is interested directly or indirectly and whether as an officer, shareholder or otherwise; provided that he is not the holder of or beneficially interested in 1% or more of any class of the equity share capital of that company or of the voting rights available to shareholders of that company; and

- any proposal concerning the adoption, modification or operation of a superannuation fund or retirement benefits scheme under which he may benefit and which has been approved by or is subject to and conditional upon approval of the Commissioner of Inland Revenue for taxation purposes.

The remuneration of the Directors for their services as such shall be determined from time to time by a general meeting, save that in the discretion of the Board, there may in each year be paid out of the funds of Sappi Limited to, and divided among, the Directors who have held office during the year in respect of which the remuneration is to be paid, a sum, by way of remuneration for their services as Directors, not exceeding US\$ 500 000 (five hundred thousand dollars), which remuneration shall be paid in such proportions as shall be determined by the Directors or a majority of them. If any Director is required to perform extra services or reside abroad or is otherwise specially occupied about Sappi Limited's business, he is entitled to receive remuneration to be fixed by the Directors (either in addition to, or in substitution for, the aforementioned remuneration). The Directors shall be paid all their travelling and other expenses properly and necessarily expended by them in and about the business of Sappi Limited.

The Directors may exercise all the powers of Sappi Limited to borrow money and to mortgage or charge its undertaking and property or any part thereof and to issue debentures, which may be issued at par, at a discount or at a premium, and other securities. The borrowings will be restricted so that, except with the previous sanction of an ordinary resolution of Sappi Limited in general meeting, the aggregate principal amount outstanding of all moneys borrowed by Sappi Limited and/or any of its subsidiaries will not at any time exceed an amount equal to 2.5 times the aggregate of the nominal amount of the issued share capital of Sappi Limited and the total of the amounts standing to the credit of the combined capital and revenue reserve accounts of Sappi Limited and its subsidiaries (including any share premium account, capital redemption reserve fund and retained surplus after deducting the amounts of any debit balance in the income statement but excluding sums set aside for taxation and amounts attributable to outside shareholders in subsidiaries), as shown in the latest consolidated balance sheet, adjusted as may be necessary in respect of any variation in the share premium account of Sappi Limited since the date of the latest audited balance sheet.

#### ***Secretary***

The Companies Act requires the directors of each public company to appoint a secretary who is permanently resident in South Africa, and who, in the opinion of the directors, has the requisite knowledge and experience to carry out the duties of and secretary of a public company.

#### ***Disclosure of Interest in Shares***

The Companies Act requires the disclosure of beneficial interests in the outstanding shares of a company. Where securities of an issuer are registered in the name of a person and that person is not the holder of the beneficial interest in all of the securities held by the registered shareholder, the registered shareholder is obliged, at the end of every three-month period after June 30, 1999, that is, commencing on September 30, 1999, to disclose to the issuer the identity of each person on whose behalf the registered holder holds securities and the number and class of securities issued by that issuer held on behalf of each such person. Moreover, an issuer of securities may, by notice in writing, require a person who is a registered shareholder of, or whom the issuer knows or has reasonable cause to believe to have a beneficial interest in, a security issued by the issuer, to confirm or deny whether or not such person holds that beneficial interest and, if the security is held for another person, the person to whom the request is made is obliged to disclose to the issuer the identity of the person on whose behalf a security is held. The addressee of the notice may also be required to give particulars of the extent of the beneficial interest held during the three years preceding the date of the notice. All issuers of securities are obliged to establish and maintain a register of the disclosures described above and to publish in their annual financial statements a list of the

persons who hold beneficial interests equal to or in excess of 5% of the total number of securities of that class issued by the issuer together with the extent of those beneficial interests.

#### ***Register of Members***

Sappi Limited keeps a register of Shareholders in South Africa and London, England. Sappi Limited may keep a branch share register in any foreign country, subject to the approval of the Reserve Bank.

#### ***Share Capital***

The authorised share capital of Sappi Limited consists of 325,000,000 ordinary shares with a par value R1.00 per share. All the ordinary shares in issue rank *pari passu* with each other and are fully paid and not subject to calls for additional payments of any kind. Trading in the ordinary shares in Sappi Limited has been dematerialised under the terms of the STRATE initiative of the JSE and the provisions of section 91A of the Companies Act relating to uncertified securities apply in respect of those shares which have been dematerialised.

The ADSs trade on the NYSE. The rights of holders of ADSs are governed by the Deposit Agreement pursuant to which the ADSs are issued and such rights differ in certain respects from the rights of holders of ordinary shares.

#### ***Dividends***

Sappi Limited in general meeting or the Board may, from time to time, declare a dividend to be paid to the registered holders of shares (the Shareholders ) in proportion to the number of ordinary shares held by them. No dividend on ordinary shares will bear interest. Dividends are declared payable to Shareholders registered as such on a date subsequent to the date of the declaration of the dividend as determined by the Board. This date may not be less than 14 days after the date of the publication of the announcement of the declaration of the dividend.

Sappi Limited in general meeting may not declare a dividend in excess of the amount recommended by the Board. All unclaimed dividends may be retained by Sappi Limited, invested or otherwise utilised by the Board for the benefit of Sappi Limited until claimed; provided that dividends unclaimed after a period of twelve years may be declared forfeited by the Board. Forfeited dividends revert to Sappi Limited and may be dealt with by the Directors as they deem fit.

Any dividend or other sum payable in cash to a Shareholder may be transmitted by electronic bank transfer or ordinary post to the address of the Shareholder recorded in the register or any other address the Shareholder may previously have given to Sappi Limited in writing. Sappi Limited will not be responsible for any loss in transmission.

Any dividend may be paid and satisfied, either wholly or in part, by the distribution of specific assets as the Board may at the time of declaring the dividend determine and direct.

It is Sappi Limited's policy to declare dividends in US dollars and the Board may at the time of declaring a dividend make such regulations as it may think fit in regard to the payment in any currency and rate of exchange. For further information on our dividend policy, see Item 8-Financial Information-Dividend Policy .

Holders of ADSs on the relevant record date will be entitled to receive any dividends payable in respect of the ordinary shares underlying the ADSs, subject to the terms of the Deposit Agreement. Cash dividends will be paid by the Depositary to holders of ADSs in accordance with the Deposit Agreement.



*Voting Rights*

Subject to any rights or restrictions attached to any class of shares, every Shareholder present in person, by authorised representative or by proxy, will have, on a show of hands, one vote only and, in the case of a poll, every Shareholder present in person, by authorised representative or by proxy, will have that proportion of the total votes in Sappi Limited which the aggregate amount of the nominal value of the shares held by that Shareholder bears to the aggregate of the nominal value of all the shares issued by Sappi Limited and, accordingly, since there is currently only one class of issued shares, one vote for every share held by him.

*Issue of Additional Shares and Pre-emption Rights*

Subject to the provisions of the Companies Act and the listings requirements of the JSE, Sappi Limited in a general meeting may issue, or may authorise the Board to issue, unissued shares.

Holders of shares have no pre-emptive rights under the Articles. Under the listings requirements of the JSE, however, any unissued shares of Sappi Limited must first be offered to existing Shareholders pro rata to their holdings of shares unless these shares are issued for the acquisition of assets or a specific or general approval is granted to the Directors at any general meeting authorising the issue of shares for cash. Whenever Sappi Limited wishes to sell for cash shares held as treasury stock by a subsidiary of Sappi Limited, such use must comply with the listings requirements as if such use was a new issue of shares for cash.

Sappi Limited in general meeting may upon the recommendation of the Board resolve to capitalise all or any part of the amount of the undivided profits, reserves resulting from a sale or revaluation of assets of Sappi Limited or premium created on the issue of any shares or debentures and may apply such sums in paying up unissued shares of Sappi Limited to be issued as fully paid capitalisation shares to Shareholders.

*Variation of Rights*

Whenever the capital of Sappi Limited is divided into different classes of shares, the rights or restrictions attached to any class of shares in issue may be amended, varied, modified or cancelled by general meeting of Sappi Limited; provided that the consent in writing of the holders of at least three fourths of the issued shares of that class or of a special resolution passed at a separate general meeting of the holders of such shares is required if the amendment, variation, modification or cancellation will directly or indirectly adversely affect those rights or restrictions.

The rights or restrictions attached to any class of shares will not, unless otherwise expressly provided by the conditions of issue of such shares, be deemed to be directly or indirectly adversely affected by the creation or issue of other shares ranking equally with them.

*Distribution of Assets on Liquidation*

If Sappi Limited is liquidated, whether voluntarily or compulsorily, the assets remaining after the payment of all the liabilities of Sappi Limited and the costs of winding-up shall be distributed among the Shareholders in proportion to the numbers of shares respectively held by them, subject to the rights of any Shareholders to whom shares have been issued on special conditions and subject to Sappi Limited's right to apply set-off against the liability, if any, of Shareholders for unpaid capital or premium. Furthermore, the liquidator, with the authority of a special resolution, may divide among the Shareholders, in specie or kind, the whole or any part of the assets, whether or not those assets consist of property of one kind or different kinds.

*Share Repurchases and Capital Reductions*

Subject to the provisions of the Companies Act and the listings requirements of the JSE, Sappi Limited may with the prior approval of a special resolution of its shareholders in general meeting

- acquire any shares issued by Sappi Limited on the basis that all or a portion of the price payable on such acquisition may be paid out of any funds of or available to Sappi Limited whether or not such payment results in a reduction of the issued share capital, share premium, reserves (including statutory non-distributable reserves), stated capital or any capital or redemption reserve fund of Sappi Limited;
- authorise any subsidiary of Sappi Limited to acquire shares in Sappi Limited.

Subject to the provisions of the Companies Act and the listings requirements of the JSE, Sappi Limited may reduce its issued share capital, share premium, stated capital, reserves (including statutory non-distributable reserves) and/or capital redemption reserve fund by way of an ordinary resolution of shareholders in general meeting and a resolution of directors. Similarly, subject to the provisions of the Companies Act and the requirements of the JSE, Sappi Limited may by way of an ordinary resolution of shareholders in general meeting and a resolution of directors make payments to its shareholders, whether or not such payments result in a reduction of the issued share capital, share premium, stated capital, reserves (including statutory non-distributable reserves) and/or any capital redemption reserve fund. An ordinary resolution of shareholders is not, however, required for the payment of dividends.

*Changes in Capital or Objects and Powers of Sappi Limited*

Subject to the provisions of the Companies Act, Sappi Limited may from time to time by special resolution:

- increase, consolidate, sub-divide or cancel all or any part of its capital;
- convert any of its shares, whether issued or not, into shares of another class;
- convert all or any of its paid-up shares into stock and re-convert such stock into paid-up shares; or
- convert any shares having a par value into shares having no par value and vice versa.

*Rights of Minority Shareholders and Fiduciary Duties*

Majority shareholders of South African companies have no fiduciary obligations under South African common law to minority shareholders. However, under the Companies Act, a shareholder may, under certain circumstances, seek relief from the court if he has been unfairly prejudiced by the company. The provisions in the Companies Act are designed to provide relief for oppressed shareholders without necessarily overruling the majority's decision. There may also be common law personal actions available to a shareholder of a company. The fiduciary obligations of Directors may differ from those in the United States and certain other countries. In South Africa, the common law imposes on Directors a duty to act with care and skill and a fiduciary duty to conduct the company's affairs in the best interests of the company.

*General Meetings of Shareholders*

Sappi Limited is obliged to hold an annual general meeting not more than nine months after the end of every financial year of Sappi Limited and within fifteen months after the date of the last preceding annual general meeting of Sappi Limited. The Board may, whenever it thinks fit, convene a general meeting and must do so on the request of 100 Shareholders or of Shareholders holding at the date of

request not less than one-twentieth of the total voting rights of all Shareholders having a right to vote at general meetings of Sappi Limited.

Sappi Limited is required by law to provide at least 21 clear days' notice for any annual general meeting and for meetings at which special resolutions are proposed, and at least 14 clear days' notice for all other meetings.

Notice under the Articles must be given or served on any Shareholder or Director, as the case may be, either by delivery, electronic mail, telefacsimile or by sending it through the post. Any notice to Shareholders must simultaneously be given to the secretary or other suitable official of any recognised stock exchange on which the shares of Sappi Limited are listed in accordance with the requirements of that stock exchange. Every such notice shall be deemed, unless the contrary is proved, to have been received, if it is delivered, on the date on which it is so delivered, if it is sent by post, on the day on which it is posted, if it is sent by electronic mail, on the day it was sent or, if it is sent by telefacsimile, on the day on which it was successfully transmitted.

No business may be transacted at any general meeting unless the requisite quorum is present when the meeting proceeds to business. The quorum for the passing of special resolutions is Shareholders holding in the aggregate not less than 25% of the total votes of all Shareholders entitled to vote at the meeting, present in person or by proxy. In all other cases, the quorum is three Shareholders present in person or by proxy and entitled to vote or, if a Shareholder is a body corporate, represented. If within ten minutes from the time appointed for the meeting a quorum is not present, the meeting, if convened upon the requisition of Shareholders, will be dissolved and, in all other cases, will stand adjourned to the same day in the next week, or if that be a public holiday, the next business day, at the same time and place. At the adjourned meeting, those Shareholders who are present or represented thereat shall constitute a quorum.

At a general meeting, a resolution put to the vote will be decided by a show of hands unless a poll is demanded by (1) the chairman, (2) not less than five Shareholders having the right to vote at such meeting, (3) a Shareholder or Shareholders representing not less than one tenth of the total voting rights of all Shareholders having the right to vote at the meeting or (4) in accordance with the Companies Act.

Resolutions will be carried by a majority of the votes recorded at the meeting except in the case of a special resolution which must be passed either, on a show of hands, by not less than 75% of the number of Shareholders entitled to vote who are present in person or by proxy or, where a poll has been demanded, by not less than 75% of the total votes to which the Shareholders present in person or by proxy are entitled. In the event of a tie, the chairman has the deciding vote if he is a Shareholder.

#### ***Annual Report and Accounts***

The Board is required to keep such accounting records and books of account as are prescribed by the Companies Act. Generally, no Shareholder (other than a Director) has any right to inspect any accounting record book, account or document of Sappi Limited.

The Board is required, in respect of every financial year of Sappi Limited, to prepare annual consolidated financial statements of Sappi Limited and present them before the annual general meeting required to be held in that year.

The annual consolidated financial statements of Sappi Limited must, in conformity with generally accepted accounting practice in South Africa, fairly present the state of affairs and business of Sappi Limited and all its consolidated subsidiaries at the end of the financial year concerned and the profit or loss of Sappi Limited and all its consolidated subsidiaries for that financial year.

### ***Transfer of Shares***

All ordinary shares are free from any restriction under the Articles on the right to transfer. A Shareholder who holds his shares in dematerialised form will have an account with a Central Securities Depository Participant. Transfer of ownership of such shares will be effected by debiting the account from which transfer is effected and crediting the account to which transfer is effected. The transferor will be deemed to remain the holder of the shares until the name of the transferee is entered in the share register or relevant subregister of Sappi Limited in respect of these shares. Only Shareholders that have handed in their paper share certificates have an account with a Central Securities Depository Participant. Under the rules of the JSE Shareholders cannot sell their shares on the JSE until the shares have been dematerialised.

### ***Rights of Shareholders***

There are no limitations in the Memorandum or Articles and general limitations under South African law on the right of Shareholders to hold or exercise voting rights attaching to any ordinary shares in Sappi Limited.

### ***Changes in Control***

Any person acquiring shares of Sappi will (in addition to any regulatory and legal requirements outside South Africa) need to comply with the following to the extent applicable. Various transactions including, without limitation, those which result in a person or a group of persons acting in concert holding shares entitling the holder or holders to exercise or cause to be exercised 35% or more of the voting rights at meetings of Sappi Shareholders and those transactions entailing a disposal of the whole or substantially the whole of the undertaking of Sappi Limited or the whole or the greater part of its assets will be subject to the Securities Regulation Code on Takeovers and Mergers (the Code) which is regulated by the Securities Regulation Panel. The Code imposes various obligations in such circumstances including the requirement of an offer to minority shareholders. A transaction will be subject to the approval of the competition authorities under the Competition Act No. 89 of 1998, as amended (the Competition Act) if it results in the acquisition of control, as defined in the Competition Act, and otherwise falls within the scope of the Competition Act. The Competition Act prevents a transaction falling within its scope from being implemented without the required approvals. To the extent applicable, the transaction will be subject to the listings requirements of the JSE. Depending on the circumstances, approvals of the Exchange Control Department of the South African Reserve Bank and other applicable regulatory authorities may also be required.

### ***Amendment of Memorandum or Articles***

The Memorandum or Articles may only be amended by way of a special resolution, proposed at a general meeting of Shareholders at which Shareholders holding at least 25% of the total votes of all Shareholders entitled to vote thereat are present in person or by proxy, which is passed, on a show of hands, by not less than 75% of those present in person or by proxy or, on a poll, by not less than 75% of the total votes to which Shareholders present in person or by proxy are entitled.

### ***Material Contracts***

On May 7, 2003, a syndicated loan of EURO 500,106,406 was provided to Sappi Papier Holding GmbH (SPH). This loan was arranged by Bank Austria Creditanstalt and was supported by a syndicate of 18 European banks. Funding of the facility was provided by the Oesterreichische Kontrollbank Aktiengesellschaft (OeKB), a banking corporation incorporated in Austria, and the syndicate of banks assumed the credit risk by providing a guarantee to the OeKB. The loan to SPH is fully and

unconditionally guaranteed by Sappi International SA (SISA), a corporation incorporated in Belgium. The loan consists of two tranches, repayable in two bullet payments. Tranche A (amounting to EURO 100,021,281) was repaid on December 31, 2004. Tranche B (amounting to EURO 400,085,124) bears interest at the OeKB EURO fixed financing rate plus an applicable facility fee. The interest on the loan is payable semi-annually on June 30 and December 31 of each year, commencing on June 30, 2003. SPH may prepay the whole or any part of the loan by giving 30-days notice. SPH has agreed to pay certain additional amounts should they arise in respect of withholdings or deductions for taxes in certain jurisdictions on payments to the syndicate banks. SPH and SISA have also agreed to observe certain covenants with respect to the loan and the guarantee, including limitations on liens, sale and leaseback transactions and on mergers and consolidations. It is an event of default if Sappi Limited ceases to own, directly or indirectly, a majority of SPH's share capital, without the prior written consent of a majority of the lenders. On November 18, 2005, an amendment to this loan agreement was signed to harmonise the terms and conditions of all SPH's long-term debt in line with the terms and conditions of the recently completed EURO 600,000,000 multi-currency revolving credit facility (see below). The loan to SPH is now fully and unconditionally guaranteed by Sappi Limited in addition to SISA and partially guaranteed by Sappi Trading Pulp AG, a corporation incorporated in Switzerland.

On June 29, 2005, a five-year multi-currency revolving credit facility (maturing in June 2010) in a maximum aggregate amount of EURO 600,000,000 was provided to Sappi Papier Holding GmbH ( SPH ), Sappi International S.A. ( SISA ) and Sappi Trading Pulp AG as borrowers. This facility was arranged by BNP Paribas, J P Morgan PLC and SG Corporate and Investment Banking and was supported by a syndicate of 16 additional financial institutions. The facility is currently fully and unconditionally guaranteed by Sappi Limited, SPH and Sappi Trading Pulp AG (although the banks have consented to a limitation of the Sappi Trading Pulp AG guarantee). Sappi International S.A has also provided a limited guarantee of the facility. The facility replaces the outstanding amount of the A Tranche (amounting to EUR 562.5 million) of the syndicated credit facility raised in July 2001. The early replacement of this A Tranche was undertaken to improve the terms and conditions thereof, including the pricing of the margin and commitment fee, and also to ensure the long-term nature of the new facility. The funding margin is determined by a rating grid and, based on the current credit rating, attracts a margin between 40 and 47.5 basis points over Euribor or Libor, depending on the currency of the loan and the level of utilisation. This facility is to be used for general corporate purposes and was unutilised at the end of September 2005. It is subject to interest coverage and debt covenants measured at the Sappi Limited consolidated level. SPH, Sappi Limited, SISA and Sappi Trading Pulp have agreed to observe certain covenants which include limitations on liens, sale and leaseback transactions and on mergers and consolidations. In addition, if any of SPH, SISA or Sappi Trading Pulp cease to be wholly owned, directly or indirectly, by Sappi Limited, or if a third party becomes the beneficial owner of more than 35% of the shares of Sappi Limited, then each financial institution has the option of demanding repayment of its participation in any outstanding loans and terminating its obligations under the facility.

At the Annual General Meeting of Shareholders held on March 7, 2005, shareholders adopted the Sappi Limited Performance Share Incentive Plan ( Plan ) in addition to the Sappi Limited Share Incentive Trust ( Trust ) which had been adopted on March 5, 1997, and fixed the aggregate number of shares which may be acquired by all participants under the Plan together with the Trust at 19,000,000 shares, which constitute 7.9% of the issued share capital of Sappi Limited. In terms of the Plan, Participants (who must be officers and other employees of the company) may be awarded conditional contracts to acquire shares for no cash consideration. If the performance criteria determined from time to time by the Human Resources Committee or Compensation Committee of the Board ( Performance Criteria ) applicable to each Conditional Contract, are met or exceeded, then Participants would be entitled to receive the number of shares specified in the Conditional Contract for no cash consideration after the fourth anniversary of the date on which the Conditional Contract was awarded to the Participant. The Performance Criteria entail benchmarking the company's performance against an appropriate peer group of companies. If the board

determines that the Performance Criteria embodied in a Conditional Contract have not been satisfied or exceeded, the number of shares allotted and issued and/or transferred to a Participant under the Conditional Contract will be adjusted downwards.

## Exchange Controls

### *Introduction*

South Africa's exchange control regulations provide for restrictions on the exporting of capital and for various other exchange control matters. Transactions between residents of the Common Monetary Area (comprising South Africa, the Republic of Namibia and the Kingdoms of Lesotho and Swaziland), on the one hand (including corporations), and non-residents of the Common Monetary Area, on the other hand, are subject to these exchange control regulations which are enforced by the Exchange Control Department of the South African Reserve Bank (Excon).

The present exchange control system in South Africa is used principally to control capital movements. South African companies are generally not permitted to export capital from South Africa or to hold foreign currency or foreign assets without the approval of the South African exchange control authorities. Foreign investment by South African companies is also restricted. As a result, a South African company's ability to raise and deploy capital outside the Common Monetary Area is restricted. The granting of loans from outside South Africa to Sappi Limited or its South African subsidiaries and their ability to borrow from non-resident sources is regulated. Further, where 75% or more of a South African company's capital, assets, earnings, voting securities, voting power, power of control or earnings are directly or indirectly controlled by or vested in non-residents of the Republic of South Africa, the company is designated an "affected person" and certain restrictions are placed on its ability to obtain local financial assistance.

The South African authorities have expressed a commitment to a phased liberalisation of exchange controls and have relaxed certain exchange controls over recent years.

Some of the more salient recent changes to the South African exchange control regulations regarding South African corporations are as follows:

- South African corporations wishing to establish new approved foreign ventures are now permitted to transfer funds abroad for this purpose. There is no limit to the amount of funds which may be transferred except that, the foreign investment may only be acquired and such funds may only be transferred abroad once Excon has approved the type of foreign investment, which it will only do if the foreign investment accords with its foreign investment criteria (applicable at the relevant time), and with regard to larger foreign investments Excon may require capital outflows to be staggered in order to manage the potential impact on the foreign exchange market.
- South African corporations which have been granted approval to transfer funds abroad for purposes of acquiring an approved foreign investment, will now be entitled to retain abroad foreign dividends which relate to the operation of the approved foreign investment and any foreign dividend which may have been repatriated to South Africa after 26 October 2004, may thereafter be transferred abroad again, at any time and for any purpose other than for purposes of a non-resident (which is directly or indirectly controlled by a South African resident) using such funds to reinvest into the South African market.
- South African corporations wishing to invest abroad may apply for permission to use corporate assets or share swaps and share placement transactions to finance approved foreign investments. The latter mechanism entails the placement of the locally quoted company's shares with long term overseas holders who, in payment for the shares, provide the foreign currency abroad which the company then uses to acquire the target investment. Since February 2001, institutional investors are no longer entitled to make use of the asset swap mechanism but are, however, entitled to acquire

foreign portfolio investments of either 20% or 25% of total assets, depending on the type of institutional investor.

Controls on current account transactions, with the exception of certain discretionary expenses, have been abolished and are now dealt with by authorised dealers in terms of the Exchange Control Rulings.

Authorised dealers in foreign exchange may, against the production of suitable documentary evidence, provide forward cover to South African residents in respect of fixed and ascertained foreign exchange commitments covering the movement of goods.

It is not possible to predict whether existing exchange controls will be abolished, continued or modified by the South African Government in the future.

For further information, see [Item 5 Operating and Financial Review and Prospects Other Items-South African Exchange Controls](#) .

### *Sales of Shares*

Under present South African exchange control regulations, the ordinary shares and ADSs of Sappi Limited are freely transferable outside the Common Monetary Area between non-residents of the Common Monetary Area. In addition, the proceeds from the sale of shares on the JSE on behalf of shareholders who are not residents of the Common Monetary Area are freely remittable to such shareholders (other than former residents of South Africa). Share certificates held by non-residents must however be endorsed with the words *non-resident* .

### *Dividends*

There is no restriction under South African exchange control regulations on the free transferability of cash dividends to shareholders or ADR holders who have never been resident in South Africa. Dividends declared to a former resident of South Africa out of capital gains, or out of income earned from normal trading activities prior to the date of emigration, must be placed to the credit of a blocked account with a South African authorised dealer in foreign exchange. Dividends declared out of income earned from normal trading activities subsequent to the date of emigration are, however, remittable. See [Taxation](#) and [Item 8 Financial Information Dividend Policy](#) . The Minister of Finance stated on February 26, 2003 that emigrants' blocked assets are to be unwound and such emigrants are entitled, on application to the South African Reserve Bank, and subject to an exiting schedule and an exit charge of 10% to exit such blocked assets from South Africa.

Prior to fiscal 2000, it was our policy to declare cash dividends in Rand. It is now our policy to declare cash dividends in US dollars. We declared a dividend (number 82) of 30 US cents for fiscal 2005. South African shareholders will be paid the Rand equivalent of the US dollar denominated declaration. Shareholders on the UK registry will be paid the UK pounds sterling equivalent of the US dollar denominated declaration and ADS holders will be paid in US dollars. Holders of ADSs on the relevant record date will be entitled to receive any dividends payable in respect of the shares underlying the ADSs, subject to the terms of the Deposit Agreement. Subject to exceptions provided in the Deposit Agreement, cash dividends will be paid by the Depositary to holders of ADSs in accordance with the Deposit Agreement. The Depositary will charge holders of ADSs, to the extent applicable, taxes and other governmental charges and specified fees and other expenses, including a fee not in excess of \$0.02 per ADS (or portion thereof) for any cash distributions made pursuant to the Deposit Agreement, other than distributions of cash dividends. See [Item 8 Financial Information Dividend Policy](#) .

Subject to exceptions relating to former residents of South Africa, shareholders who are not residents of the Common Monetary Area who are in receipt of script dividends and who elect to dispose of the relevant shares may remit the proceeds arising from the sale of the relevant shares.

## **Taxation**

Prospective investors should consult their professional advisers on the possible tax consequences of buying, holding or selling any Securities under the laws of their country of citizenship, residence or domicile. The discussions that follow for each jurisdiction are based upon the applicable laws and interpretations thereof as in effect as of the date hereof, all of which laws and interpretations are subject to change or differing interpretations, which changes or differing interpretations could apply retroactively.

### **South Africa**

The following discussion represents the views of Werksmans, our South African counsel.

#### *General*

The discussion below is based on current legislation. A new Revenue Laws Amendment Bill ( the draft Bill ) was recently released in draft form. The promulgation of the draft Bill as legislation may impact on what is stated below.

#### *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.

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 25% of the total equity shares; however, according to the draft Bill, this minimum interest will be reduced to 20% of the equity shares and voting rights) in the foreign company declaring the dividend, but certain dividends are excluded from this exemption by 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 R15,000 of such income (the exemption is firstly to be applied to foreign dividends and only if they do not exceed R2,000, the excess is to be applied to foreign interest).





*Withholding Tax on Dividends*

Sappi Limited will not be obliged to withhold any form of non-resident shareholders' tax on dividends paid to non-residents of South Africa. However, any future decision to re-impose a withholding tax on dividends declared by South African residents to non-resident shareholders is generally permissible under the terms of a reciprocal tax treaty entered into between South Africa and the United States (the Treaty); provided that the Treaty generally limits the withholding tax to 5% of the gross amount of the dividends if the beneficial owner of the shares is a company holding directly at least 10% of the voting stock of the company paying the dividends and to 15% of the gross amount of the dividends in all other cases.

*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%.

*Duty on the Shares*

South African duty is payable by the company upon the issue of shares at the rate of 0.25% of the issue price. Such duty will be paid by Sappi Limited.

On a subsequent change of beneficial ownership of the shares, South African uncertificated securities tax (UST) is generally payable in respect of transactions involving listed shares purchased from or through a member of a stock exchange or a depository institution and stamp duty is generally payable for the registration of transfer of all other shares, both duties generally being payable at 0.25% of the higher of the consideration or the market value of the share concerned. South African stamp duty is payable regardless of whether the transfer is executed within or outside South Africa. There are certain exceptions to the payment of stamp duty where, for example, the instrument of transfer is executed outside South

Africa and registration of transfer is effected in any branch register kept by the relevant company, subject to certain provisions set forth in the South African Stamp Duties Act of 1968.

Transfers of ADSs between non-residents of South Africa will not attract South African duties. However, if shares are withdrawn from the deposit facility, or are acquired from the Depository in exchange for ADSs representing the shares or the relevant Depository Receipt is cancelled so that the underlying shares are sold, duties will become payable on the same basis and at the same rates set out above.

*Secondary Tax on Companies ( STC )*

This tax is paid by South African companies at the flat rate of 12.5% in respect of the amount of dividends declared less all dividends which accrued to them (but subject to certain exclusions) during its relevant dividend cycle . Dividend cycle means the period commencing on the day following the date of accrual to a company s shareholders of the last dividend declared by that company and ending on the date on which the dividend in question accrues to the shareholder concerned. An excess of dividends accruing to a company over dividends paid may be carried forward to subsequent dividend cycles as an STC credit.

The imposition of STC effectively means that a dual corporate tax system exists in South Africa comprising a normal income tax and STC. Liability for STC is determined independently from normal income tax. Accordingly, a company without a normal tax liability may have a liability for STC, and vice versa, and may be liable for both normal tax and STC. The nominal value of capitalisation shares awarded to shareholders as part of the equity share capital of a company by transferring reserves or undistributed profits to the company s equity share capital do not incur STC and it has become common practice for listed South African companies to offer capitalisation shares forming part of the equity share capital of a company in lieu of cash dividends. The capitalisation shares must carry the right to participate to an unlimited extent in the dividends or capital of the company in order to constitute equity share capital. However, any amount transferred from reserves (excluding any share premium account not consisting of capitalised profits) or undistributed profits to the equity share capital of a company is, in principle, deemed to be profits available for distribution to shareholders and may constitute a dividend (i.e., be subject to STC) on a subsequent partial reduction or redemption of capital, or upon reconstruction or liquidation of the company. Capitalisation shares which do not qualify as equity shares and are awarded by a transfer of reserves or undistributed profits (other than that portion of the share premium account not consisting of capitalised profits) are regarded as dividends and, as such, attract STC. Foreign dividends do not serve to reduce a company s STC liability.

A double taxation treaty between South Africa and the United States came into effect during 1997 and was promulgated under Government Notice R. 1721 (Government Gazette 18553) on December 15, 1997.

*United States*

*Introduction*

This section, which represents the views of Cravath, Swaine & Moore LLP, our US counsel, summarises the material US Federal income tax consequences to holders of our ordinary shares and ADSs as of the date of this Annual Report. The summary applies to you only if you hold our ordinary shares or ADSs, as applicable, as a capital asset for tax purposes (that is, for investment purposes). The summary does not cover US state or local or non-US law. This summary is based in part upon representations of the Depositary made to Sappi and the assumption that each obligation in the Deposit Agreement and any related agreements will be performed in accordance with its terms. In addition, this summary does not apply to you if you are a member of a class of holders subject to special rules, such as:

- a dealer in securities or currencies;
- a trader in securities that elects to use a mark-to-market method of accounting for your securities holdings;
- a bank;
- a life insurance company;
- a tax-exempt organisation;
- a person that holds our ordinary shares or ADSs as part of a straddle or a hedging, integrated, constructive sale or conversion transaction for tax purposes;
- US holder (as defined below) whose functional currency for tax purposes is not the US dollar;
- a person liable for alternative minimum tax; or
- a person that owns, or is treated as owning, 10% or more of any class of our ordinary shares.

For purposes of the discussion below, you are a US holder if you are a beneficial owner of our ordinary shares or ADSs who or which is:

- an individual US citizen or resident alien;
- a corporation, or entity taxable as a corporation, that was created under US law (federal or state); or
- an estate or trust whose worldwide income is subject to US Federal income tax.

If you are not a US holder, you are a non-US holder and the discussion below titled -US Federal Income Tax Consequences to non-US Holders will apply to you.

If a partnership holds our ordinary shares or ADSs, the tax treatment of a partner will generally depend upon the status of the partner and upon the activities of the partnership. If you are a partner of a partnership holding our ordinary shares or ADSs, you should consult your tax advisor.

*US Federal Income Tax Consequences to US Holders*

*ADSs.* In general, for US Federal income tax purposes, US Holders of ADSs will be treated as the beneficial owners of the ordinary shares underlying those ADSs.

*Distributions.* The gross amount of any distribution (other than in liquidation), including the fair market value of all distributions of ordinary shares whenever a holder may elect to receive cash distributions in lieu of ordinary share

distributions, that you receive with respect to our ordinary shares or ADSs (before reduction for South African income tax, if any, withheld from such distributions) generally

122

---

will be included in your gross income on the day on which you, in the case where you own ordinary shares, or the Depositary, in the case where you own ADSs, receive the distribution. This distribution will be taxed to you as a dividend (that is, ordinary income) to the extent such distribution does not exceed our current or accumulated earnings and profits, as calculated for US Federal income tax purposes ( E&P ). Dividends received by an individual US holder during taxable years before 2009 will generally be taxed at a maximum rate of 15%, provided certain holding period requirements and other conditions are satisfied. Dividends received by an individual US holder for taxable years after 2008 will be subject to tax at ordinary income rates. To the extent any distribution exceeds our E&P, the distribution will first be treated as a tax-free return of capital to the extent of your adjusted tax basis in our ordinary shares or ADSs, as applicable, and will be applied against and reduce such basis on a dollar-for-dollar basis (thereby increasing the amount of gain and decreasing the amount of loss recognised on a subsequent disposition of such ordinary shares or ADSs). To the extent that such distribution exceeds your adjusted tax basis, the distribution will be taxed as gain recognised on a sale or exchange of our ordinary shares or ADSs, as applicable. See -Sale or Other Disposition of Company Ordinary Shares and ADSs , below. Because we are not a US corporation, no dividends-received deduction will be allowed to a corporate US holder with respect to dividends paid by us.

Distributions on the ordinary shares and ADSs are expected to be made by us in US dollars, to the extent necessary. In the event that distributions on the ordinary shares and ADSs are made by us in Rand, any dividends paid in Rand generally will be included in your gross income in a US dollar amount calculated by reference to the exchange rate in effect on the day you, in the case of ordinary shares, or the Depositary, in the case of ADSs, receive the dividend. It is anticipated that the Depositary will, in the ordinary course, convert Rand received by it as distributions on the ADSs into US dollars. To the extent that the Depositary does not convert the Rand into US dollars at the time that you are required to take the distribution into your gross income for US Federal income tax purposes, you may recognise foreign exchange gain or loss, taxable as ordinary income or loss, on the later conversion of the Rand into US dollars. The gain or loss recognised will generally be based upon the difference between the exchange rate in effect when the Rand are actually converted and the spot exchange rate in effect at the time the distribution is taken into account and any such gain or loss will generally be treated as United States source income for US foreign tax credit purposes.

Dividends paid by us will generally be treated as foreign source income for US foreign tax credit limitation purposes. Subject to certain limitations, US holders may elect to claim a foreign tax credit against their US Federal income tax liability for South African tax withheld (if any) from dividends received in respect of our ordinary shares or ADSs, as applicable. The limitation on foreign taxes eligible for credit is calculated separately with respect to specific classes of income. For this purpose, dividends paid by us in respect of our ordinary shares or ADSs, as applicable, generally will be passive income or, in the case of certain types of US holders, financial services income and therefore any US tax imposed on these dividends cannot be offset by excess foreign tax credits that you may have from foreign source income not qualifying as passive income or financial service income, respectively. Recently-enacted legislation will simplify the foreign tax credit limitation rules and reduce the number of classes to two, effective for taxable years ending after December 31, 2006. For such taxable years, any such dividend income generally will be passive income or, in the case of certain types of US holders, general income. Additional limitations on the credit apply to individual US holders receiving dividends if the dividends are eligible for the 15% maximum tax rate on dividends described above. US holders that do not elect to claim a foreign tax credit may instead claim a deduction for South African tax withheld (if any).

*Sale or Other Disposition of Company Ordinary Shares and ADSs.* Subject to the discussion of passive foreign investment companies below, generally speaking, in connection with the sale or other taxable disposition of our ordinary shares or ADSs, as applicable:

- you will recognise gain or loss equal to the difference (if any) between:
- the US dollar value of the amount realised on such sale or other taxable disposition; and
- your adjusted tax basis in such ordinary shares or ADSs;
- any gain or loss will be capital gain or loss and will be long-term capital gain or loss if your holding period for our ordinary shares or ADSs, as applicable, is more than one year at the time of such sale or other taxable disposition;
- long-term capital gains recognised by individual US holders during taxable years before 2009 will generally be taxed at a maximum rate of 15%;
- any gain or loss will generally be treated as having a United States source for United States foreign tax credit purposes; and
- your ability to deduct capital losses (if any) is subject to limitations.

If you are a cash basis US holder who receives foreign currency (e.g., Rand) in connection with a sale or other taxable disposition of our ordinary shares or ADSs, as applicable, the amount realised will be based on the US dollar value of the foreign currency received with respect to such ordinary shares or ADSs, as determined on the settlement date of such sale or other taxable disposition.

If you are an accrual basis US holder, you may elect the same treatment required of cash basis taxpayers with respect to a sale or other taxable disposition of our ordinary shares or ADSs, as applicable, provided that the election is applied consistently from year to year. Such election may not be changed without the consent of the Internal Revenue Service. If you are an accrual basis US holder and do not elect to be treated as a cash basis taxpayer (pursuant to the Treasury Regulations applicable to foreign currency transactions) for this purpose, you may have a foreign currency gain or loss for US Federal income tax purposes because of differences between the US dollar value of the foreign currency received prevailing on the date of the sale or other taxable disposition of our ordinary shares or ADSs, as applicable, and the date of payment. Any such currency gain or loss generally will be treated as ordinary income or loss and would be in addition to gain or loss, if any, that you recognised on the sale or other taxable disposition of our ordinary shares or ADSs, as applicable.

You may incur South African stamp duty or MST in connection with a subsequent registration of transfer of ordinary shares. See *South Africa Duty on the Shares* . In such case, stamp duty or MST, as applicable will not be a creditable tax for US foreign tax credit purposes, but will be deductible. In the case of an individual US holder, such deduction will be subject to specified limits on the deductibility of investment expenses.

*Passive Foreign Investment Company.* US holders (who are not tax-exempt) would be subject to a special, adverse tax regime (that would differ in certain respects from that described above) if we were or were to become a passive foreign investment company for US Federal income tax purposes. Although the determination of whether a corporation is a passive foreign investment company is made annually, and thus may be subject to change, we do not believe that we are, nor do we expect to become, a passive foreign investment company. Notwithstanding the foregoing, we urge you to consult your own US tax advisor regarding the adverse US Federal income tax consequences of owning the stock of a passive foreign investment company and of making certain elections designed to lessen those adverse consequences.

*US Federal Income Tax Consequences to Non-US Holders*

*Distributions.* If you are a non-US holder, you generally will not be subject to US Federal income tax on distributions made on our ordinary shares or ADSs unless:

- you conduct a trade or business in the United States; and
- the dividends are effectively connected with the conduct of that trade or business (and, if an applicable income tax treaty so requires as a condition for you to be subject to US Federal income tax on a net income basis in respect of income from our ordinary shares or ADSs, as applicable, such dividends are attributable to a permanent establishment that you maintain in the United States).

If you fail the above test, you generally will be subject to tax in respect of such dividends in the same manner as a US holder, as described above. In addition, any effectively connected dividends received by a non-US corporation may also, under certain circumstances, be subject to an additional branch profits tax at a 30% rate or such lower rate as may be specified by an applicable income tax treaty.

*Sale or Other Disposition of Company Ordinary Shares and ADSs.* If you are a non-US holder, you will not be subject to US Federal income tax, including withholding tax, in respect of gain recognised on a sale or other taxable disposition of our ordinary shares or ADSs, as applicable, unless:

- your gain is effectively connected with a trade or business that you conduct in the United States (and, if an applicable income tax treaty so requires as a condition for you to be subject to US Federal income tax on a net income basis in respect of gain from the sale or other disposition of our ordinary shares or ADSs, as applicable, such gain is attributable to a permanent establishment maintained by you in the United States) or
- you are an individual and are present in the United States for at least 183 days in the taxable year of the sale or other disposition, and either:
  - your gain is attributable to an office or other fixed place of business that you maintain in the United States; or
  - you have a tax home in the United States.

Effectively connected gains realised by a non-US corporation may also, under certain circumstances, be subject to an additional branch profits tax at a rate of 30% or such lower rate as may be specified by an applicable income tax treaty.

*Backup Withholding and Information Reporting*

Payments and sale proceeds in respect of our ordinary shares or ADSs, as applicable, that are made in the United States or by a US related financial intermediary may be subject to US information reporting rules. You will not be subject to backup withholding of US Federal income tax provided that:

- you are a corporation or other exempt recipient; or
- you provide a taxpayer identification number (which, in the case of an individual, is his or her social security number) and meet other information reporting and certification requirements.

If you are a non-US holder, you generally are not subject to information reporting and backup withholding, but you may be required to provide a certification of your non-US status in order to establish that you are exempt. You may be subject to information reporting and backup withholding if you sell your ordinary shares or ADSs through a US broker and you are not eligible for an exemption. You may be subject to information reporting, but not backup withholding if you sell your shares or ADSs through a broker with certain connections with the US and you are not eligible for an exemption.





Amounts withheld under the backup withholding rules may be credited against your US Federal income tax liability, and you may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the Internal Revenue Service.

#### **Documents on Display**

The documents concerning Sappi Limited referred to in this Annual Report may be inspected at the registered office of Sappi Limited at 48 Ameshoff Street, Braamfontein, Johannesburg, Republic of South Africa.

#### **ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The principal market risks (that is, the risk of loss arising from adverse changes in market rates and prices) to which Sappi is exposed are:

- interest rates on interest bearing debt;
- foreign exchange rates, generating translation and transaction gains and losses;
- fair value fluctuations on financial instruments;
- fair value fluctuations on plantations,
- credit risk;
- commodity prices, affecting the cost of products, and.
- discount rates for post employment benefits.

For a detailed description of these risks, see notes 1, 13, 34, 35 and 37 to our Group annual financial statements included elsewhere in this Annual Report.

#### **Commodity Price Risk**

The selling prices of the majority of products manufactured and purchase prices of many raw materials used generally fluctuate in line with commodity cycles. Prices of chemical cellulose generally follow those of paper pulp, although the cycle is generally less volatile. As a result, the sale of chemical cellulose also tends to act as a natural hedge for paper pulp. Our total pulp production capacity is over 100% of our total pulp requirements. However, there are differences between the types of pulp required in our paper making operations and the grades of pulp we produce, as well as regional differences. We are therefore a buyer as well as a seller of paper pulp. Other than maintaining a high level of pulp integration, no hedging techniques are applied. For a description of our level of pulp integration, see Item 4 Information on the Company The Pulp and Paper Industry Pulp, Item 4 Information on the Company Business Overview Sappi Fine Paper, Item 4 Information on the Company Business Overview Supply Requirements and Item 5 Operating and Financial Review and Prospects Operating Results Markets. Despite our present relatively high level of pulp integration on a Group-wide basis, in the event of significant increases in the prices of pulp integration on a Group-wide basis, our non-integrated and partially integrated operations could be adversely affected if they are unable to raise paper prices by amounts sufficient to maintain margins.

#### **ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

Not applicable.

**PART II**

**ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

Not applicable.

**ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS**

Not applicable.

**ITEM 15. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report (the Evaluation Date ) Sappi's management (with the participation of its Chief Executive Officer and Executive Director-Finance), conducted an evaluation pursuant to Rule 13a-15 promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act ), of the effectiveness of the design and operation of its disclosure controls and procedures. Based on this evaluation, Sappi's chief executive officer and chief financial officer concluded that, solely because of the material weakness in our internal control over financial reporting described below relating to errors in our US GAAP reconciliations, such disclosure controls and procedures were not effective to provide reasonable assurance that information required to be disclosed by Sappi in reports it files or submits under the Exchange Act is recorded, processed, summarised and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of our annual financial statements would not have been detected or prevented. During the course of the 2005 financial closing process our independent auditors noted that certain items accounted for as fair value hedges in terms of South African Generally Accepted Accounting Practice (SA GAAP), do not qualify for hedge accounting in terms of US GAAP; however, we had not identified or adjusted for this difference in the preparation of our US GAAP reconciliation. This led to a further management investigation to evaluate the impact on all the hedging arrangements and regions within the Group. The full impact and nature of the error was subsequently reported to the Group Audit Committee where preliminary discussions on remediation plans were held.

While correctly accounted for in terms of SA GAAP, management determined that this difference in US GAAP was not identified in fiscal 2005 or during previous financial years by our internal control over financial reporting, resulting in a potential error in our fiscal 2005 US GAAP reconciliation and errors in previously reported US GAAP reconciliations. The 2005 impact would have been an overstatement of net income on a US GAAP basis of approximately \$39 million if not detected. Because of the potential magnitude of this impact in fiscal 2005, the non-detection of this item was regarded by management as evidence of a material weakness in its internal control over financial reporting. Based upon management's investigation of this item and the identification, principally by our independent auditors during their year-end audit, of several other previously unidentified differences between SA GAAP and US GAAP, management believes that controls over the reconciliation between SA GAAP and US GAAP are currently inadequate and represent a material weakness in our internal control over financial reporting. The aggregate value of these previously unidentified differences led to the decision to restate our US GAAP reconciliations as described in note 42 to our Group annual financial statements included elsewhere in this Annual Report.

We reported in our Annual Report on Form 20-F for fiscal 2004 that our level of US GAAP expertise was limited and that we were in the process of investigating options to strengthen our capabilities. Subsequently improvements in our internal control over financial reporting were made to address this issue, including the introduction of reporting schedules that facilitate the evaluation of non-routine and

judgmental items for SA GAAP and US GAAP reporting. In order to address the material weakness described above further efforts will include focus on the following areas:

- Accounting training programs with a specific focus on US GAAP
- Circumstances where external accounting opinions will be sought in future
- Oversight and review processes in the corporate office
- Strengthening of internal US GAAP expertise

Changes referred to last year in the business and information technology (IT) systems have continued in the current financial year:

#### ***North America***

A number of IT systems previously developed in Europe are being deployed in North America. The number of peripheral IT technologies used previously has been reduced and more reliance has been placed on our core Enterprise Resource Planning system (ERP), SAP. In particular we are anticipating a significant improvement in the control environment surrounding our sales, logistical and operations planning environments. These systems are at an advanced stage of deployment.

#### ***Southern Africa***

In southern Africa the ERP system was upgraded to a newer version of SAP, with the last business units having gone live in June 2005. As part of the project, business processes were reviewed and improved from both a control and efficiency point of view.

#### **ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

The Board has determined that Dr Deenadayalen Konar qualifies as an audit committee financial expert on the Audit Committee of Sappi Limited. The Board determined that Dr Konar acquired the required attributes by way of education, practical experience, practice as a registered accountant and auditor, and participation as a member of the audit committees of significant entities that have applied International Accounting Standards or Generally Accepted Accounting Practice. See Item 6 for a description of Dr Konar's background and relevant experience. Dr Konar is an independent Non-Executive Director of Sappi.

#### **ITEM 16B. CODE OF ETHICS**

We have adopted the Sappi Code of Ethics (the Code) that applies to all of our employees, including our Chief Executive Officer, Executive Director-Finance and Group Financial Controller (such officers, collectively, the senior officers). The Code, as it applies to our senior officers, is complemented by a Corporate Compliance Policy adopted by our Board of Directors regarding Ethics Guidelines for Senior Officers (the Senior Officer Corporate Compliance Policy). We believe the Code, as supplemented by our Senior Officer Corporate Compliance Policy, constitutes a code of ethics as defined in Item 16B of Form 20-F.

We have filed a copy of the Code and the Senior Officer Corporate Compliance Policy as an exhibit.

**ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Principal independent auditor fees paid for the year ended September 2005 and 2004 were as follows:

	2005	2004
	(US\$ million)	
Audit-fees(1)	5	5
Audit-related fees		1
Sub-total	5	6
Tax services(2)	5	3
All other fees		
	10	9

(1) Audit-fees consist of assurance and related services that are reasonably related to the performance of the audit or review of the group's financial statements.

(2) These are fees for professional services performed by Deloitte & Touche with respect to tax compliance, tax advice and tax planning. This includes advice on tax aspects of group acquisitions, disposals, reorganisations, and financing, as well as analysis of the impact on the group for changes to tax laws in various countries.

**Audit Committee Pre-Approval Policy**

In accordance with our audit committee pre-approval policy, all audit and non-audit services performed for us by our independent accountants were pre-approved by the audit committee of our board of directors, which concluded that the provision of such services by the independent accountants was compatible with the maintenance of that firm's independence in the conduct of its auditing functions.

The pre-approval policy provides for specific audit committee pre-approval, prior to engagement, of any services, other than audit services covered by the annual engagement letter. In addition, services to be provided by the independent accountants that are not within the category of pre-approved services must be approved by the audit committee prior to engagement, regardless of the service being requested and the amount.

Requests or applications for services that require specific separate approval by the audit committee are required to be submitted to the audit committee by both management and the independent accountants, and must include a detailed description of the services to be provided and a joint statement confirming that the provision of the proposed services does not impair the independence of the independent accountants.

Pre-approval may be granted either by the audit committee or its chairman or any member of the audit committee to whom this authority has been delegated by the audit committee. Where pre-approval is granted by an individual member of the audit committee, the matter is tabled for noting at the next meeting of the full Sappi Limited audit committee.

**ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Not applicable.

**ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASER**

The following table sets forth information with respect to Sappi's share repurchases in the 2005 financial year:

	<b>Total number of shares purchased</b>	<b>Average price paid per share</b>	<b>Number of shares purchased as part of publicly announced program</b>	<b>Maximum number of shares that may yet be purchased under the program</b>
Nov 1 to Nov 30, 2004	1,250,000	\$ 12.73	1,250,000	10,706,175

Sappi has stated its intention, on November 9, 2000, to acquire Sappi shares through a wholly owned Sappi subsidiary, subject to applicable stock exchange and legal limitations. Sappi has been given approval at its annual general meetings of shareholders, including the meetings held on March 1, 2004 and March 7, 2005, to purchase its shares up to a maximum of 10% of the issued ordinary share capital in any one financial year. The general authority is subject to the Listings Requirements of the JSE Limited and the Companies Act No. 61 of 1973 of South Africa, as amended, and is granted until the next annual general meeting. Some of the repurchased shares, which have been repurchased, have been, and will continue to be, utilised to meet the requirements of the Sappi Limited Share Incentive Trust from time to time.

130

---

**PART III**

**ITEM 17. FINANCIAL STATEMENTS**

Sappi Limited is furnishing financial statements pursuant to the instructions of Item 18 of Form 20-F.

**ITEM 18. FINANCIAL STATEMENTS**

The Group annual financial statements and schedules together with the Report of the Independent Auditors are included as the F pages to this Annual Report.

131

---

**ITEM 19. EXHIBITS**

- 1.1 Memorandum and Articles of Association of Sappi Limited, as amended and restated on March 4, 1999, incorporated by reference to Exhibit 1.1 to the 1998 Annual Report on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on March 29, 1999.
- 1.2 Special Resolution of Sappi Limited dated March 2, 2000 pursuant to the South African Companies Act effecting certain amendments to the Articles of Association of Sappi Limited, incorporated by reference to Exhibit 1.1 to the 1999 Annual Report on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on March 23, 2000.
- 2.1 Specimen Ordinary Share Certificate, incorporated by reference to Exhibit 2.1 to the Registration Statement on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on October 22, 1998.
- 2.2 Amended and Restated Deposit Agreement among Sappi Limited, The Bank of New York, as depositary, and the Owners from time to time of American Depositary Receipts dated October 26, 1999, incorporated by reference to Exhibit 2.2 to the Annual Report on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on December 27, 2001.
- 2.3 Form of American Depositary Receipt (included in Exhibit 2.2).
- 2.6 Long-term debt instruments not exceeding 10% of our total assets. Sappi Limited undertakes to provide the Securities and Exchange Commission with copies upon request.
- 4.1 Sappi Limited Share Incentive Scheme, incorporated by reference to Exhibit 3.12 to the Registration Statement on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on October 22, 1998.
- 4.2 Form of Deed of Amendment to The Sappi Limited Share Incentive Scheme dated January 19, 1998 between Sappi Limited, David Charles Brink and Thomas Louw de Beer, incorporated by reference to Exhibit 2.1 to the 1999 Annual Report on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on March 23, 2000.
- 4.3 Second Deed of Amendment to The Sappi Limited Share Incentive Scheme dated March 2, 2000 between Sappi Limited, David Charles Brink and Thomas Louw de Beer, incorporated by reference to Exhibit 2.2 to the 1999 Annual Report on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on March 23, 2000.
- 4.4 Agreement among KNP Leykam Zellstoff GmbH, Norske Skog Bruck GmbH, Patria Papier und Zellstoff AG and Zellstoff Pöls AG dated December 17, 1996, incorporated by reference to Exhibit 3.13 to the Registration Statement on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on October 22, 1998.
- 4.7 Contract of Sale between the South African Forestry Company Limited (SAFCOL) and Sappi Manufacturing (Pty) Limited dated May 12, 1995, incorporated by reference to Exhibit 3.16 to the Registration Statement on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on October 22, 1998.
- 4.9 Asset Purchase Agreement between Potlatch Corporation and Northern Holdings LLC (renamed Sappi Cloquet LLC) dated March 18, 2001, incorporated by reference to Exhibit 4.9 to the Annual Report on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on December 30, 2002.
- 4.10 Credit Facility, dated May 7, 2003, among Sappi Papier Holding AG as borrower, Sappi International S.A. as guarantor, Bank Austria Creditanstalt AG as mandated lead arranger and agent and various financial institutions as lenders, incorporated by reference to Exhibit 4.10 to the Annual Report on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on December 19, 2003.

132



- 4.11 Resolution passed by the members of the Human Resources Committee of Sappi Limited on amendments to the Sappi Limited Share Incentive Scheme, incorporated by reference to Exhibit 4.11 to the Annual Report on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on December 17, 2004.
- 4.12 An amendment dated November 18, 2005, to the Credit Facility, dated May 7, 2003 as described in 4.10.
- 4.13 Multi-Currency Revolving Credit Facility, dated June 29, 2005, among Sappi Papier Holding GmbH ( SPH ), Sappi International S.A. ( SISA ) and Sappi Trading Pulp AG as borrowers and BNP Paribas, J P Morgan PLC, SG Corporate and Investment Banking, as mandated lead arrangers and the additional financial institutions named therein.
- 4.14 The Sappi Limited Performance Share Incentive Plan, dated March 7, 2005 between Sappi Limited, David Charles Brink, and Meyer Feldberg (as Trustees), incorporated by reference to Exhibit 4.3 to the Registration Statement on Form S-8 of Sappi Limited filed with the Securities and Exchange Commission on December 15, 2004.
- 6.1 Computation of Earnings per Share, incorporated by reference to note 10 of the notes to the Group annual financial statements included elsewhere in this Annual Report.
- 7.1 An explanation of other ratios used in this Annual Report, incorporated by reference to Exhibit 7.1 to the Annual Report on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on December 30, 2002.
- 8.1 List of significant subsidiaries, incorporated by reference to Item 4 Information on the Company-Organisational Structure included elsewhere in this Annual Report.
- 11.1 Sappi Limited-Corporate Compliance Policies-Ethics Code Guidelines for Senior Officers, incorporated by reference to Exhibit 11.1 to the Annual Report on Form 20-F of Sappi Limited filed with the Securities and Exchange Commission on December 19, 2003.
- 12.1 Certification of Jonathan Leslie, Chief Executive Officer of Sappi Limited pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 12.2 Certification of Donald Wilson, Executive Director-Finance of Sappi Limited pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 13.1 Certification of Jonathan Leslie, Chief Executive Officer of Sappi Limited and Donald Wilson, Executive Director-Finance of Sappi Limited pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorised the undersigned to sign this annual report on its behalf.

Date: December 20, 2005

SAPPI LIMITED  
BY:

/s/ DONALD WILSON  
Name: Donald Wilson  
Title: *Executive Director Finance*

134

---

**SAPPI**

	<b>Page</b>
<b>Group Annual Financial Statements</b>	
Report of the Independent Auditors to the Board of Directors and Shareholders of Sappi Limited	F-2
Group Income Statements for the years ended September 2005, 2004 and 2003	F-3
Group Balance Sheets at September 2005 and 2004	F-4
Group Cash Flow Statements for the years ended September 2005, 2004 and 2003	F-5
Group Statements of Changes in Shareholders' Equity for the years ended September 2005, 2004 and 2003	F-6
Notes to the Group Annual Financial Statements	F-7
<b>Group Annual Financial Statement Schedule</b>	
Schedule I Condensed Company Financial Statements.	S-1
Schedule II Valuation and Qualifying Accounts	S-6

F-1

---

**REPORT OF THE INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the board of directors and shareholders of Sappi Limited:

We have audited the accompanying consolidated balance sheets of Sappi Limited and its subsidiaries as at September 2005 and 2004, and the related consolidated income statements, cash flow statements and statements of changes in shareholders' equity for each of the three years in the period ended September 2005. Our audits also included the financial statement schedules listed in the Index on page F-1. These financial statements and financial statement schedules are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Sappi Limited and its subsidiaries at September 2005 and 2004 and the results of their operations and cash flows for each of the three years in the period ended September 2005 in conformity with South African Statements of Generally Accepted Accounting Practice. Also, in our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note 3 to the consolidated financial statements, in fiscal 2005 the company changed its method of accounting for Secondary Tax on Companies to conform to AC 501: Accounting for Secondary Tax on Companies (STC) and, retroactively, restated the fiscal 2004 and 2003 consolidated financial statements for the change.

South African statements of generally accepted accounting practise vary in certain respects from accounting principles generally accepted in the United States of America. Information relating to the nature and effect of such differences is presented in note 42 to the consolidated financial statements. As discussed in note 42, the accompanying 2004 and 2003 Summary of differences between South African and United States Generally Accepted Accounting Principles has been restated.

Deloitte & Touche

Registered Accountants & Auditors

Chartered Accountants

Johannesburg, South Africa

December 20, 2005

F-2

---

**SAPPI**  
**GROUP INCOME STATEMENT**  
**for the years ended September 2005**

	note	2005 US\$ million	2004	2003
Sales		<b>5,018</b>	4,728	4,299
Cost of sales	4	<b>4,514</b>	4,133	3,684
Gross profit		<b>504</b>	595	615
Selling, general and administrative expenses	5	<b>382</b>	371	318
		<b>122</b>	224	297
Other expenses	6	<b>259</b>	36	25
Operating (loss) profit	7	<b>(137 )</b>	188	272
Net finance costs	8	<b>87</b>	110	111
Gross interest and other finance costs		<b>146</b>	133	150
Interest received		<b>(36 )</b>	(27 )	(30 )
Interest capitalised		<b>(1 )</b>	(2 )	(2 )
Net foreign exchange gains		<b>(5 )</b>	(5 )	(1 )
Net fair value (gain) loss on financial instruments		<b>(17 )</b>	11	(6 )
(Loss) profit before taxation		<b>(224 )</b>	78	161
Taxation (benefit) charge	9	<b>(11 )</b>	(17 )	18
Net (loss) profit for the year		<b>(213 )</b>	95	143
Weighted average number of ordinary shares in issue (millions)		<b>225.8</b>	226.3	229.1
Basic (loss) earnings per share (US cents)	10	<b>(94 )</b>	42	62
Diluted (loss) earnings per share (US cents)	10	<b>(94 )</b>	42	62
Dividends per share (US cents) declared after year-end	11	<b>30</b>	30	29

F-3

**SAPPI**  
**GROUP BALANCE SHEET**  
**at September 2005**

	note	2005 US\$ million	2004
<b>Assets</b>			
<b>Non-current assets</b>			
Property, plant and equipment	12	3,333	3,670
Plantations	13	604	548
Deferred tax assets	14	72	84
Goodwill and intangible assets	15	7	9
Other non-current assets	16	243	166
Other financial assets	37	73	87
<b>Current assets</b>			
Inventories	17	711	765
Trade and other receivables	18	293	323
Other financial assets	37	5	7
Prepaid income taxes			1
Cash and cash equivalents		367	484
<b>Total assets</b>		<b>5,708</b>	<b>6,144</b>
<b>Equity and liabilities</b>			
<b>Shareholders' equity</b>			
Ordinary share capital and share premium	19	867	871
Non-distributable reserves	20	263	367
Hedging reserves		14	(1 )
Retained earnings		737	920
<b>Non-current liabilities</b>			
Interest-bearing borrowings	21	1,600	1,693
Deferred tax liabilities	14	411	453
Other non-current liabilities	22	331	314
Non-current provisions	23		3
<b>Current liabilities</b>			
Interest-bearing borrowings	21	270	364
Overdraft		159	11
Trade and other payables		916	986
Taxation payable		120	137
Provisions	23	20	26
<b>Total equity and liabilities</b>		<b>5,708</b>	<b>6,144</b>

**SAPPI**  
**GROUP CASH FLOW STATEMENT**  
**for the years ended September 2005**

	note	2005 US\$ million	2004	2003
<b>Cash retained from operating activities</b>		<b>271</b>	345	421
Cash generated from operations	24	<b>554</b>	601	645
•Increase in working capital	25	<b>(60 )</b>	(50 )	(79 )
Cash generated from operating activities		<b>494</b>	551	566
•Finance costs paid	26	<b>(147 )</b>	(136 )	(143 )
•Interest income		<b>35</b>	27	30
•Taxation (paid) received	27	<b>(43 )</b>	(31 )	33
Cash available from operating activities		<b>339</b>	411	486
•Dividends paid		<b>(68 )</b>	(66 )	(65 )
<b>Cash utilised in investing activities</b>		<b>(379 )</b>	(356 )	(310 )
Investment to maintain operations		<b>(268 )</b>	(244 )	(178 )
•Replacement of non-current assets	28	<b>(183 )</b>	(219 )	(165 )
•Proceeds on disposal of non-current assets	29	<b>5</b>	2	8
•Increase in investments and loans		<b>(90 )</b>	(27 )	(21 )
Investment to expand operations		<b>(111 )</b>	(112 )	(132 )
•Additions of non-current assets		<b>(111 )</b>	(112 )	(132 )
<b>Cash effects of financing activities</b>		<b>(7 )</b>	(121 )	147
Proceeds from interest-bearing borrowings		<b>1,383</b>	490	1,542
Repayment of interest-bearing borrowings		<b>(1,518 )</b>	(433 )	(1,351 )
(Decrease) increase in other non-current liabilities		<b>(13 )</b>	(3 )	5
Redemption of minority interests				(7 )
Share buybacks		<b>(15 )</b>	(13 )	(55 )
Increase (decrease) in bank overdrafts		<b>156</b>	(162 )	13
<b>Net movement in cash and cash equivalents</b>		<b>(115 )</b>	(132 )	258
Cash and cash equivalents at beginning of year		<b>484</b>	584	253
Translation effects		<b>(2 )</b>	32	73
<b>Cash and cash equivalents at end of year</b>	30	<b>367</b>	484	584

This Cash Flow Statement complies with IAS 7.

**SAPPI**  
**GROUP STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY**  
**for the years ended September 2005**

	Number of ordinary shares	Ordinary share capital	Share premium	Ordinary share capital and share premium	Non- distributable reserves	Hedging reserves	Retained earnings	Total
	US\$ million							
<i>Balance September 2002 As reported</i>	230.2	22	550	572	230	12	783	1,597
Change in accounting policy (Refer to note 3)					(15 )		40	25
<i>Balance September 2002</i>	230.2	22	550	572	215	12	823	1,622
Net movements not recognised through the income statement	(3.3 )	10	211	221	82	(15 )	(5 )	283
Transfer from distributable reserves					4		(4 )	
Foreign currency translation reserve		10	258	268	78	(1 )		345
Gain on revaluation of hedging instruments						5		5
Deferred tax arising on gain on revaluation of hedging instruments						(5 )		(5 )
Loss on revaluation of hedging instruments						(20 )		(20 )
Deferred tax arising on loss on revaluation of hedging instruments						6		6
Share buybacks less transfers to Sappi Limited Share Incentive Trust	(3.3 )		(47 )	(47 )			(1 )	(48 )
Net profit for the year							143	143
Dividends US\$0.26 per share*							(65 )	(65 )
<i>Balance September 2003</i>	226.9	32	761	793	297	(3 )	896	1,983
Net movements not recognised through the income statement		3	75	78	70	2	(5 )	145
Transfer from distributable reserves					5		(5 )	
Foreign currency translation reserve		3	84	87	65	1		153
Loss on revaluation of hedging instruments						(2 )		(2 )
Deferred tax arising on gain on revaluation of hedging instruments						3		3
Share buybacks less transfers to Sappi Limited Share Incentive Trust			(9 )	(9 )				(9 )
Net profit for the year							95	95
Dividends US\$0.28 per share*							(66 )	(66 )
<i>Balance September 2004</i>	226.9	35	836	871	367	(1 )	920	2,157
Net movements not recognised through the income statement	(1.0 )		(4 )	(4 )	(104 )	15	98	5
Transfer to/from distributable reserves					(98 )		98	
Foreign currency translation reserve			10	10	(6 )	(1 )		3
Gain on revaluation of hedging instruments						23		23
Deferred tax arising on gain on revaluation of hedging instruments						(7 )		(7 )
Share buybacks less transfers to Sappi Limited Share Incentive Trust	(1.0 )		(14 )	(14 )				(14 )
Net profit for the year							(213 )	(213 )
Dividends US\$0.29 per share*							(68 )	(68 )