

POTLATCH CORP  
Form 10-Q  
July 30, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended June 30, 2010

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 1-32729

**POTLATCH CORPORATION**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**82-0156045**  
(I.R.S. Employer  
Identification No.)

**601 West 1st Ave., Suite 1600**

**Spokane, Washington**  
(Address of principal executive offices)

**99201**  
(Zip Code)

**(509) 835-1500**

(Registrant's telephone number, including area code)

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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares of common stock of the registrant outstanding as of June 30, 2010 was 39,986,773.

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**POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES**

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ITEM 1.

**Financial Statements**

Potlatch Corporation and Consolidated Subsidiaries

Consolidated Condensed Statements of Operations and Comprehensive Income

Unaudited (Dollars in thousands, except per-share amounts)

|   | Quarter Ended<br>June 30, |           | Six Months Ended<br>June 30, |            |
|---|---------------------------|-----------|------------------------------|------------|
|   | 2010                      | 2009      | 2010                         | 2009       |
| Revenues  | \$ 128,978                | \$ 78,782 | \$ 234,396                   | \$ 208,375 |
| Costs and expenses:   |                           |           |                              |            |
| Cost of goods sold  | 97,295                    | 67,569    | 182,789                      | 151,640    |
| Selling, general and administrative expenses                  | 9,401                     | 10,589    | 17,846                       | 20,200     |
|   | 106,696                   | 78,158    | 200,635                      | 171,840    |
| Earnings from continuing operations before interest and taxes | 22,282                    | 624       | 33,761                       | 36,535     |
| Interest expense, net   | (7,089)                   | (4,872)   | (14,177)                     | (9,676)    |
| Earnings (loss) from continuing operations before taxes       | 15,193                    | (4,248)   | 19,584                       | 26,859     |
| Income tax (provision) benefit                                | (3,365)                   | 7,940     | (6,372)                      | 5,604      |
| Earnings from continuing operations                           | 11,828                    | 3,692     | 13,212                       | 32,463     |
| Discontinued operations:                                      |                           |           |                              |            |
| Gain (loss) from discontinued operations                      | (136)                     | 130       | (440)                        | (6,424)    |
| Income tax (provision) benefit                                | 51                        | (56)      | 166                          | 2,547      |
|   | (85)                      | 74        | (274)                        | (3,877)    |
| Net earnings  | \$ 11,743                 | \$ 3,766  | \$ 12,938                    | \$ 28,586  |
| Other comprehensive income, net of tax                        | 450                       | 1,077     | 7,075                        | 2,032      |
| Comprehensive income  | \$ 12,193                 | \$ 4,843  | \$ 20,013                    | \$ 30,618  |

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Earnings per common share from continuing operations:

|         |         |         |         |         |
|---------|---------|---------|---------|---------|
| Basic   | \$ 0.29 | \$ 0.09 | \$ 0.33 | \$ 0.82 |
| Diluted | 0.29    | 0.09    | 0.33    | 0.81    |

Gain (loss) per common share from discontinued operations:

|         |    |    |           |           |
|---------|----|----|-----------|-----------|
| Basic   | \$ | \$ | \$ (0.01) | \$ (0.10) |
| Diluted |    |    | (0.01)    | (0.09)    |

Net earnings per common share:

|         |         |         |         |         |
|---------|---------|---------|---------|---------|
| Basic   | \$ 0.29 | \$ 0.09 | \$ 0.32 | \$ 0.72 |
| Diluted | 0.29    | 0.09    | 0.32    | 0.72    |

|                                |         |         |         |         |
|--------------------------------|---------|---------|---------|---------|
| Distributions per common share | \$ 0.51 | \$ 0.51 | \$ 1.02 | \$ 1.02 |
|--------------------------------|---------|---------|---------|---------|

Average shares outstanding (in thousands):

|         |        |        |        |        |
|---------|--------|--------|--------|--------|
| Basic   | 39,972 | 39,745 | 39,930 | 39,743 |
| Diluted | 40,211 | 39,869 | 40,164 | 39,876 |

Certain 2009 amounts have been reclassified to conform to the 2010 presentation.

The accompanying notes are an integral part of these consolidated financial statements.

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Potlatch Corporation and Consolidated Subsidiaries

Consolidated Condensed Balance Sheets

Unaudited (Dollars in thousands, except per-share amounts)

|   | June 30,<br>2010 | December 31,<br>2009 |
|---|------------------|----------------------|
| <b>ASSETS</b>   |                  |                      |
| Current assets:   |                  |                      |
| Cash  | \$ 5,658         | \$ 1,532             |
| Short-term investments  | 34,606           | 53,506               |
| Receivables, net  | 28,044           | 18,161               |
| Inventories   | 20,887           | 24,493               |
| Other assets  | 66,605           | 24,006               |
| Total current assets  | 155,800          | 121,698              |
| Property, plant and equipment, net                                | 69,139           | 75,839               |
| Timber and timberlands, net                                       | 482,519          | 533,173              |
| Deferred tax assets   | 60,930           | 64,873               |
| Other assets  | 27,733           | 27,982               |
|   | \$ 796,121       | \$ 823,565           |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                       |                  |                      |
| Current liabilities:  |                  |                      |
| Current installments on long-term debt                            | \$ 5,011         | \$ 11                |
| Accounts payable and accrued liabilities                          | 57,009           | 58,462               |
| Total current liabilities   | 62,020           | 58,473               |
| Long-term debt  | 363,378          | 368,420              |
| Liability for pensions and other postretirement employee benefits | 143,122          | 149,398              |
| Other long-term obligations                                       | 18,877           | 17,484               |
| Stockholders' equity  | 208,724          | 229,790              |
|   | \$ 796,121       | \$ 823,565           |
| Stockholders' equity per common share                             | \$ 5.22          | \$ 5.77              |
| Working capital   | \$ 93,780        | \$ 63,225            |
| Current ratio   | 2.5:1            | 2.1:1                |

Certain 2009 amounts have been reclassified to conform to the 2010 presentation.

The accompanying notes are an integral part of these consolidated financial statements.



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Potlatch Corporation and Consolidated Subsidiaries

Consolidated Condensed Statements of Cash Flows

Unaudited (Dollars in thousands)

|   | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--------------------------------------|-------------|
|   | <b>2010</b>                          | <b>2009</b> |
| <b>CASH FLOWS FROM CONTINUING OPERATIONS</b>  |                                      |             |
| Net earnings  | \$ 12,938                            | \$ 28,586   |
| Adjustments to reconcile net earnings to net operating cash flows from continuing operations: |                                      |             |
| Loss from discontinued operations   | 274                                  | 3,877       |
| Depreciation, depletion and amortization  | 14,212                               | 11,518      |
| Proceeds from sales deposited with a like-kind exchange intermediary                          |                                      | (2,030)     |
| Basis of real estate sold   | 4,713                                | 6,864       |
| Change in deferred taxes  | 7,268                                | (12,304)    |
| Net loss on disposition of property, plant and equipment                                      | 1,105                                |             |
| Other   | (995)                                | 26          |
| Working capital changes   | (7,268)                              | 718         |
| Net cash provided by operating activities from continuing operations                          | 32,247                               | 37,255      |
| <b>CASH FLOWS FROM INVESTING</b>  |                                      |             |
| Change in short-term investments  | 18,901                               | 19,199      |
| Additions to property, plant and equipment  | (5,881)                              | (6,079)     |
| Proceeds from disposition of property, plant and equipment                                    | 3,100                                |             |
| Other, net  | (1,088)                              | (201)       |
| Net cash provided by investing activities from continuing operations                          | 15,032                               | 12,919      |
| <b>CASH FLOWS FROM FINANCING</b>  |                                      |             |
| Change in book overdrafts   | (1,287)                              | 380         |
| Decrease in notes payable   |                                      | (7,800)     |
| Issuance of common stock  | 1,432                                | 91          |
| Change in long-term debt  | 136                                  | (392)       |
| Distributions to common stockholders  | (40,759)                             | (40,540)    |
| Employee tax withholdings on vested performance share awards                                  | (1,967)                              |             |
| Other, net  | (114)                                | (40)        |
| Net cash used for financing activities from continuing operations                             | (42,559)                             | (48,301)    |
| Cash flows provided by continuing operations  | 4,720                                | 1,873       |
| Cash flows from discontinued operations:  |                                      |             |
| Operating cash flows  | (649)                                | (580)       |
| Investing cash flows  | 55                                   |             |



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|                             |          |          |
|-----------------------------|----------|----------|
| Increase in cash            | 4,126    | 1,293    |
| Cash at beginning of period | 1,532    | 885      |
| Cash at end of period       | \$ 5,658 | \$ 2,178 |

**SUPPLEMENTAL CASH FLOW INFORMATION**

Cash paid (received) during the year for:

|                                     |           |           |
|-------------------------------------|-----------|-----------|
| Interest, net of amount capitalized | \$ 13,246 | \$ 16,059 |
| Income taxes                        | 1,582     | (558)     |

Non-cash investing activity:

|                                     |     |
|-------------------------------------|-----|
| Additions to timber and timberlands | 202 |
|-------------------------------------|-----|

Non-cash financing activity:

|  |         |
|--|---------|
| Restricted cash payment from Clearwater Paper Corporation for the maturity of credit sensitive debentures (See Note 8 to 2009 Form 10-K) | 106,250 |
|--|---------|

The accompanying notes are an integral part of these consolidated financial statements.

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Potlatch Corporation and Consolidated Subsidiaries

Notes to Consolidated Condensed Financial Statements

Unaudited (Dollars in thousands)

NOTE 1.

**General**

For purposes of this report, any reference to Potlatch, the company, we, us, and our means Potlatch Corporation and all of its wholly owned subsidiaries, except where the context indicates otherwise.

Potlatch is a real estate investment trust, or REIT, for federal income tax purposes. The REIT tax rules require that we derive most of our income, other than income generated by a taxable REIT subsidiary, from investments in real estate, which for us primarily consists of income from the sale of standing timber. Through our wholly owned taxable REIT subsidiary, which we refer to in this report as Potlatch TRS, we operate a real estate sales and development business and five manufacturing facilities that produce lumber and plywood.

The accompanying Consolidated Condensed Balance Sheets at June 30, 2010 and December 31, 2009, the Consolidated Condensed Statements of Operations and Comprehensive Income for the quarters and six months ended June 30, 2010 and 2009, and the Consolidated Condensed Statements of Cash Flows for the six months ended June 30, 2010 and 2009 have been prepared in conformity with accounting principles generally accepted in the United States of America. We believe that all adjustments necessary for a fair statement of the results of such interim periods have been included.

In December 2008, we completed the spin-off of Clearwater Paper Corporation, or Clearwater Paper, which owns and operates our former pulp-based manufacturing businesses, consisting of our former pulp and paperboard and consumer products segments, as well as our former wood products operations located in Lewiston, Idaho. In May 2008, our Prescott, Arkansas lumber mill permanently ceased operations due to poor market conditions. As a result, any expenses associated with Clearwater Paper and Prescott are classified within discontinued operations in the financial statements for the quarters and six months ended June 30, 2010 and 2009. Financial information for the quarter and six months ended June 30, 2009 includes a legal settlement and related legal expenses associated with the sale of our oriented strand board, or OSB, operations in 2004, as described in Note 4.

The Patient Protection and Affordable Care Act, as amended by the Health Care and Reconciliation Act of 2010, was enacted in March 2010 and included a change in the deductibility of drug expenses reimbursed under the Medicare Part D retiree drug subsidy program beginning after 2012. As a result of this legislation, deferred taxes associated with our retiree health care liabilities based on prior law were required to be adjusted, resulting in a net charge to earnings in the first quarter of 2010 of approximately \$3.0 million. In March 2010, we sold our Idaho particleboard manufacturing facility's buildings and equipment. As a result of the sale, we recorded charges totaling \$0.4 million, primarily related to severance benefits. During the quarter ended June 30, 2010, we sold the railroad we operated in Idaho resulting in a pre-tax loss of \$1.8 million, which is recorded within cost of goods sold attributable to the Wood Products segment. During the quarter ended June 30, 2009, we recognized an income tax benefit resulting from the Federal tax credit allowed with respect to electricity produced from qualified energy resources and sold to an unrelated party. See Note 3 for additional information about this tax credit. All other adjustments were of a normal recurring nature.

This Quarterly Report on Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2009, as filed with the Securities and Exchange Commission on February 18, 2010.

NOTE 2.

**Recent Accounting Pronouncements**

In January 2010, the Financial Accounting Standards Board, or FASB, issued authoritative guidance for fair value measurements, which requires additional disclosures and clarifications to existing disclosures. This authoritative guidance requires a reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and also to describe the reasons for these transfers. This authoritative guidance also requires enhanced disclosure of activity in Level 3 fair value measurements. The new disclosures and clarifications of existing disclosures for Level 1 and Level 2 fair value measurements became effective for the first interim reporting period after December 15, 2009, and are therefore included in our 2010 quarterly Form 10-Q filings. Disclosures regarding activity within Level 3 fair value measurements become effective for the first interim reporting period after December 15, 2010. Refer to Note 12 for information and related disclosures regarding our fair value measurements.

In February 2010, the FASB issued Accounting Standards Update, or ASU, 2010-09. The update provides amendments to Accounting Standards Codification Subtopic 855-10 and states that an SEC filer is not required to disclose the date through which subsequent events have been evaluated. However, consistent with current GAAP, entities are required to evaluate subsequent events through the date that the financial statements are issued. This ASU was effective immediately and applied during preparation of the consolidated condensed financial statements.

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NOTE 3.

**Income Taxes**

As a REIT, if we meet certain requirements, we generally will not be subject to federal and state corporate income taxes on our ordinary and capital gains income from our real estate investments that we distribute to our shareholders. We will, however, be subject to corporate taxes on built-in gains (the excess of fair market value at January 1, 2006 over tax basis on that date) with respect to the REIT's sale of any real property owned at such date within the first ten years following our conversion to a REIT. The built-in gains tax is eliminated or deferred if sale proceeds are reinvested in like-kind property in accordance with the like-kind exchange provisions of the Internal Revenue Code. The built-in gains tax is not applicable to the sale of timber pursuant to a stumpage sale agreement or timber deed.

We also sell REIT properties that result in gains that are not deferred in accordance with the like-kind exchange provisions of the Internal Revenue Code. For the quarters ended June 30, 2010 and 2009, we recorded income tax expense of \$0 and \$0.8 million, respectively, related to these sales. For the six months ended June 30, 2010 and 2009, we recorded income tax expense of \$0.3 million and \$12.1 million, respectively, related to these sales.

We incur federal and state corporate income taxes on earnings from our real estate sales and development activities and the wood products manufacturing operations conducted by Potlatch TRS. For the quarter ended June 30, 2010, we recorded an income tax provision related to the continuing operations of Potlatch TRS of \$3.7 million, which was due to pre-tax income in that entity. For the quarter ended June 30, 2009, we recorded an income tax benefit related to the continuing operations of Potlatch TRS of \$3.0 million, which was due to pre-tax losses in that entity. For the six months ended June 30, 2010, we recorded an income tax provision related to the continuing operations of Potlatch TRS of \$3.5 million, which was due to pre-tax income in that entity. For the six months ended June 30, 2009, we recorded an income tax benefit related to the continuing operations of Potlatch TRS of \$11.9 million, which was due to pre-tax losses in that entity.

The Patient Protection and Affordable Care Act, as amended by the Health Care and Reconciliation Act of 2010, was enacted in March 2010 and included a change in the deductibility of drug expenses reimbursed under the Medicare Part D retiree drug subsidy program beginning after 2012. As a result of this legislation, deferred taxes associated with our retiree health care liabilities based on prior law were required to be adjusted, resulting in a net charge to earnings in the first quarter of 2010 of approximately \$3.0 million. During the quarter ended June 30, 2010, we recorded an income tax benefit related to continuing operations of Potlatch TRS of \$0.3 million attributable to the Part D reimbursements received during the quarter that were non-taxable.

During the quarter ended June 30, 2009, we recognized an income tax benefit of \$5.8 million, classified within continuing operations, attributable to the years 2005 through 2008, resulting from the Federal tax credit allowed with respect to electricity produced from qualified energy resources and sold to an unrelated party. This tax credit expired at the end of 2009. The \$0.2 million income tax benefit associated with the six months ended June 30, 2009 is reflected in the income tax benefit for continuing operations for both the quarter and six month period.

We reviewed our tax positions at June 30, 2010, and determined that no uncertain tax positions were taken during the first six months of 2010, and that no new information was available that would require derecognition of previously taken positions.

We reflect interest related to tax obligations, as well as penalties, in our provision for income taxes. During the quarters and six months ended June 30, 2010 and 2009, we reflected less than \$0.1 million and \$0, respectively, in interest and penalties. At June 30, 2010 and December 31, 2009, we had \$1.0 million accrued as a receivable for interest with respect to open refunds.

NOTE 4.

**Discontinued Operations**

In December 2008, we completed the spin-off of Clearwater Paper, which owns and operates our former pulp-based manufacturing businesses, consisting of our former pulp and paperboard and consumer products segments, as well as our former wood products operations located in Lewiston, Idaho. In May 2008, our Prescott, Arkansas lumber mill permanently ceased operations due to poor market conditions. We are actively pursuing a sale of the assets associated with this facility. As a result, any expenses associated with Clearwater Paper and Prescott are classified within discontinued operations in the financial statements for the quarters and six months ended June 30, 2010 and 2009.

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The results of discontinued operations for the quarter ended June 30, 2009, included OSB-related legal expenses of \$0.1 million. The results of discontinued operations for the six months ended June 30, 2009, included a pre-tax charge of \$5.75 million for the legal settlement related to the sale of our OSB manufacturing facilities in 2004, as well as \$0.8 million of OSB-related legal expenses.

NOTE 5.

**Like-Kind Exchanges**

In order to acquire and sell assets, primarily timberlands, in a tax efficient manner, we enter into like-kind exchange, or LKE, tax-deferred transactions. There are two main types of LKE transactions: forward transactions, in which property is sold and the proceeds are reinvested by acquiring similar property; and reverse transactions, in which property is acquired and similar property is subsequently sold by us. Both forward and reverse transactions must be completed within prescribed time periods under Internal Revenue Code section 1031.

We use a qualified intermediary to facilitate LKE transactions. Proceeds from forward transactions are held by the intermediary and are classified as restricted cash, within non-current assets, because the funds must be reinvested in similar properties. If the acquisition of suitable LKE properties is not completed within 180 days of the sale of the company-owned property, the proceeds are distributed to us by the intermediary and are reclassified as available cash and applicable income taxes are determined. Proceeds from reverse transactions are not restricted because the funds are available upon demand; therefore, these proceeds are included in short-term investments. In the case of reverse transactions in which we have not yet completed LKE sales of company-owned land to match with property purchased on our behalf by the intermediary, the amount associated with the property purchased on our behalf but not yet matched with LKE sales is classified as a long-term asset and included in Timber and timberlands, net in our Consolidated Condensed Balance Sheets and as Deposits on timberlands in the investing activities section of our Consolidated Condensed Statements of Cash Flows. Amounts deposited with a third party towards the potential future purchase of property that are not matched with LKE sales are also included in Timber and timberlands, net in our Consolidated Condensed Balance Sheets and as Deposits on timberlands in our Consolidated Condensed Statements of Cash Flows.

At June 30, 2010, and December 31, 2009, we had no proceeds from land sales deposited with a qualified LKE intermediary.

NOTE 6.

**Earnings per Common Share**

The following table reconciles the number of common shares used in calculating the basic and diluted earnings per share from continuing operations:

| (Dollars in thousands, except per-share amounts)             | Quarter Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|--|---------------------------|------------|------------------------------|------------|
|  | 2010                      | 2009       | 2010                         | 2009       |
| Earnings from continuing operations                          | \$ 11,828                 | \$ 3,692   | \$ 13,212                    | \$ 32,463  |
| Basic average common shares outstanding                      | 39,972,087                | 39,744,604 | 39,930,065                   | 39,743,463 |
| Incremental shares due to:                                   |                           |            |                              |            |
| Common stock options   | 110,450                   | 19,366     | 102,361                      | 14,159     |
| Performance shares   | 95,597                    | 78,877     | 99,859                       | 90,208     |
| Restricted stock units                                       | 32,835                    | 26,611     | 31,450                       | 27,787     |
| Diluted average common shares outstanding                    | 40,210,969                | 39,869,458 | 40,163,735                   | 39,875,617 |
| Basic earnings per common share from continuing operations   | \$ 0.29                   | \$ 0.09    | \$ 0.33                      | \$ 0.82    |
| Diluted earnings per common share from continuing operations | \$ 0.29                   | \$ 0.09    | \$ 0.33                      | \$ 0.81    |

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For the quarter ended June 30, 2010, 81,162 performance share awards and 750 restricted stock units were excluded from the computation of diluted earnings per share because their effect was anti-dilutive. For the quarter ended June 30, 2009, 112,269 performance share awards, 2,500 restricted stock units and options to purchase 126,178 shares of common stock were excluded from the computation of diluted earnings per share because their effect was anti-dilutive. Options to purchase 86,426 shares of common stock were also excluded from the computation of diluted earnings per share for the quarter ended June 30, 2009, because the per-share exercise prices of the stock options were greater than the average market price of our common stock during the period.

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For the six months ended June 30, 2010, 81,162 performance share awards and 750 restricted stock units were excluded from the computation of diluted earnings per share because their effect was anti-dilutive. For the six months ended June 30, 2009, 112,269 performance share awards, 21,720 restricted stock units and options to purchase 126,178 shares of common stock were excluded from the computation of diluted earnings per share because their effect was anti-dilutive. Options to purchase 86,426 shares of common stock were also excluded from the computation of diluted earnings per share for the six months ended June 30, 2009, because the per-share exercise prices of the stock options were greater than the average market price of our common stock during the period.

NOTE 7.

### **Equity-Based Compensation**

At June 30, 2010, we had three stock incentive plans, the 1995, 2000 and 2005 plans, under which stock option, performance share or restricted stock unit, or RSU, grants were outstanding. All of these plans have received shareholder approval. We were originally authorized to issue up to 1.7 million shares, 1.4 million shares and 1.6 million shares under our 1995 Stock Incentive Plan, 2000 Stock Incentive Plan and 2005 Stock Incentive Plan, respectively. At June 30, 2010, no shares were available for future use under the 1995 Stock Incentive Plan, while approximately 101,000 and 522,000 shares were authorized for future use under the 2000 and 2005 Stock Incentive Plans, respectively. We issue new shares of common stock to pay stock option exercises and to settle performance share awards and RSU awards.

During the quarter ended June 30, 2010, we recorded equity-based compensation expense of \$1.0 million, of which \$0.9 million related to performance shares and \$0.1 million related to RSUs. During the quarter ended June 30, 2009, we recorded equity-based compensation expense of \$0.9 million, of which \$0.8 million related to performance shares and \$0.1 million related to RSUs. During the six months ended June 30, 2010, we recorded equity-based compensation expense of \$1.9 million, of which \$1.6 million related to performance shares and \$0.3 million related to RSUs. During the six months ended June 30, 2009, we recorded equity-based compensation expense of \$1.8 million, of which \$1.5 million related to performance shares and \$0.3 million related to RSUs. All outstanding stock options were fully vested prior to January 2006. The net income tax benefit associated with our equity-based compensation expense totaled \$0 and less than \$0.1 for the three months ended June 30, 2010 and 2009, respectively, and \$0 and \$0.4 million for the six months ended June 30, 2010 and 2009, respectively.

Our outside directors are granted an annual award of common stock units that is credited to an account established on behalf of each director. These accounts are then credited with additional common stock units equal in value to the distributions that are paid on the same amount of common stock. Upon separation from service as a director, the common stock units held by the director in his or her stock unit account will be converted to cash based upon the then market price of the common stock and paid to the director.

Our outside directors also can each elect to defer compensation in the form of common stock units. We record compensation expense or income during each reporting period based on the amount of compensation deferred during the period and the increase or decrease in the value of our common stock. We recorded director deferred compensation expense totaling \$0.3 million and \$0.2 million for the quarters ended June 30, 2010 and 2009, respectively. We recorded director deferred compensation expense totaling \$0.9 million for the six months ended June 30, 2010, and income totaling less than \$0.1 million for the six months ended June 30, 2009.

For the six months ended June 30, 2010 and 2009, there were no cash flows representing the realized tax benefit related to the excess of the deductible amount over the compensation cost recognized as a financing cash inflow in the Consolidated Condensed Statements of Cash Flows.

### **STOCK OPTIONS**

All outstanding stock options were granted with an exercise price equal to the market price on the date of grant, were fully exercisable after two years and expire not later than 10 years from the date of grant. No new stock options were granted in 2010 or 2009.

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A summary of outstanding stock options and changes during the six months ended June 30, 2010, is presented below:

| (Dollars in thousands, except exercise prices) | Shares   | Weighted Avg.<br>Exercise<br>Price | Aggregate<br>Intrinsic Value |
|--|----------|------------------------------------|------------------------------|
| Outstanding at January 1                       | 329,426  | \$ 21.14                           |                              |
| Shares exercised                               | (68,001) | 21.06                              | \$ 597                       |
| Shares canceled or expired                     |          |                                    |                              |
| Outstanding and exercisable at June 30         | 261,425  | 21.16                              | 3,809                        |

There were no unvested stock options outstanding during the six months ended June 30, 2010. The aggregate intrinsic value of stock options exercised during the six months ended June 30, 2009 was less than \$0.1 million.

The following table summarizes information about stock options outstanding at June 30, 2010:

| Range of Exercise Prices | Options Outstanding and Exercisable |  |                                    |
|--------------------------|-------------------------------------|--|------------------------------------|
|                          | Outstanding                         | Weighted Avg.<br>Remaining<br>Contractual Life | Weighted Avg.<br>Exercise<br>Price |
| \$13.8594 to \$16.6452   | 70,271                              | 2.05 years                                     | \$ 15.21                           |
| \$18.6083 to \$19.2569   | 122,352                             | 2.65 years                                     | 19.09                              |
| \$30.9204                | 68,802                              | 4.42 years                                     | 30.92                              |
| \$13.8594 to \$30.9204   | 261,425                             | 2.95 years                                     | 21.16                              |

Cash received from stock option exercises for the six months ended June 30, 2010 and 2009 was \$1.4 million and less than \$0.1 million, respectively. The actual tax benefits realized for tax deductions from option exercises totaled \$0 for the quarters and six months ended June 30, 2010 and 2009.

**PERFORMANCE SHARES**

Performance share awards granted under the stock incentive plans have a three-year performance period and shares are issued at the end of the period if the performance measure is met. The performance measure is based on the percentile ranking of our total shareholder return relative to the total shareholder return performance of both a selected peer group of companies and a larger group of indexed companies over the three-year performance period. The number of shares actually issued, as a percentage of the amount subject to the performance share award, could range from 0% to 200%. Performance share awards granted under our stock incentive plans do not have voting rights unless and until shares are issued upon settlement. If shares are issued at the end of the three-year performance measurement period, the recipients will receive distribution equivalents in the form of additional shares at the time of payment equal to the distributions that would have been paid on the shares earned had the recipients owned the shares during the three-year period.

A Monte Carlo simulation method is used to estimate the stock prices of Potlatch and the selected peer group and index companies at the end of the three-year performance period. The expected volatility of each company's stock price and covariance of returns among the peer group and index companies are key assumptions within the Monte Carlo simulation. Historical volatility over a term similar to the performance period is considered a reasonable proxy for forecasted volatility. Likewise, because the returns of Potlatch and the peer group and index companies are correlated, the covariance, a measure of how two variables tend to move together, is calculated over a historical term similar to the performance period and applied in the simulations. The simulations use the stock prices of Potlatch and the peer group and index companies as of the award date as a starting point. Multiple simulations are generated, resulting in share prices and total shareholder return values for Potlatch and the peer group and index companies. For each simulation, the total shareholder return of Potlatch is ranked against that of the peer group and index companies. The future value of the performance share unit is calculated based on a multiplier for the percentile ranking and then discounted to present value. The discount rate is the risk-free rate as of the award date for a term consistent with the performance period. Awards are also credited with dividend equivalents at the end of the performance period, and as a result, award values are not adjusted for dividends.





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The following table presents the key inputs used in calculating the fair value of the performance share awards in 2010 and 2009, and the resulting fair values:

|                                   | 2010     | 2009     |
|-----------------------------------|----------|----------|
| Shares granted                    | 81,162   | 112,269  |
| Stock price as of valuation date  | \$ 31.88 | \$ 24.30 |
| Risk-free rate                    | 1.29%    | 1.18%    |
| Fair value of a performance share | \$ 45.30 | \$ 33.32 |

A summary of outstanding performance share awards as of June 30, 2010, and changes during the six months ended June 30, 2010 is presented below:

| (Dollars in thousands, except grant date fair value) | Shares  | Weighted Avg.<br>Grant Date<br>Fair Value | Aggregate<br>Intrinsic Value |
|--|---------|---|------------------------------|
| Unvested shares outstanding at January 1             | 171,595 | \$ 40.04                                  |                              |
| Granted  | 81,162  | 45.30                                     |                              |
| Forfeited  | (7,664) | 39.23                                     |                              |
| Unvested shares outstanding at June 30               | 245,093 | 41.81                                     | \$ 8,264                     |

As of June 30, 2010, there was \$5.2 million of unrecognized compensation cost related to non-vested performance share awards. The cost is expected to be recognized over a weighted average period of 1.65 years.

**RESTRICTED STOCK UNITS**

Our 2005 Stock Incentive Plan also allows for awards to be issued in the form of RSUs. During 2010 and 2009, certain officers and other select employees of the company were granted RSU awards that will accrue dividend equivalents based on distributions paid during the RSU vesting period. The dividend equivalents will be converted into additional RSUs that will vest in the same manner as the underlying RSUs to which they relate. The terms of certain of the awards state that 20% of the RSUs vest on each of the first and second anniversaries of the grant date of the awards, with the remaining 60% vesting on the third anniversary. The terms of certain other RSUs provide for vesting upon the expiration of a set period of approximately three years.

A summary of the status of outstanding RSU awards as of June 30, 2010, and changes during the six months ended June 30, 2010, is presented below:

| (Dollars in thousands, except grant date fair value) | Shares  | Weighted Avg.<br>Grant Date<br>Fair Value | Aggregate<br>Intrinsic Value |
|--|---------|---|------------------------------|
| Unvested shares outstanding at January 1             | 41,559  | \$ 32.57                                  |                              |
| Granted  | 16,559  | 32.55                                     |                              |
| Vested   | (5,292) | 44.47                                     |                              |
| Forfeited  | (3,698) | 29.90                                     |                              |
| Unvested shares outstanding at June 30               | 49,128  | 31.48                                     | \$ 1,755                     |

For RSU awards granted during the period, the fair value of each share was determined on the date of grant using the grant date market price. The total fair value of RSU awards vested during the six months ended June 30, 2010 was \$0.2 million.

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As of June 30, 2010, there was \$0.8 million of total unrecognized compensation cost related to non-vested RSU awards. The cost is expected to be recognized over a weighted average period of 1.35 years.

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NOTE 8.

**Inventories**

Inventories at the balance sheet dates consist of:

| (Dollars in thousands)                      | June 30, 2010 | December 31, 2009 |
|---|---------------|-------------------|
| Lumber and other manufactured wood products | \$ 13,592     | \$ 14,057         |
| Logs, pulpwood, chips and sawdust           | 3,973         | 5,973             |
| Materials and supplies                      | 3,322         | 4,463             |
|   | \$ 20,887     | \$ 24,493         |

NOTE 9.

**Other Assets**

Other assets at the balance sheet dates consist of:

| (Dollars in thousands)             | June 30, 2010 | December 31, 2009 |
|------------------------------------|---------------|-------------------|
| <b>Current Other Assets:</b>       |               |                   |
| Basis of real estate held for sale | \$ 51,011     | \$ 8,905          |
| Deferred tax assets                | 8,872         | 8,872             |
| Prepaid expenses                   | 3,642         | 3,094             |
| Assets held for sale               | 3,080         | 3,135             |
|                                    | \$ 66,605     | \$ 24,006         |
| <b>Noncurrent Other Assets:</b>    |               |                   |
| Noncurrent investments             | \$ 20,721     | \$ 20,255         |
| Deferred charges                   | 6,842         | 7,341             |
| Other                              | 170           | 386               |
|                                    | \$ 27,733     | \$ 27,982         |

The basis of real estate held for sale is primarily comprised of timberland in Wisconsin and Arkansas that we anticipate will be sold before year-end.

Noncurrent investments primarily consist of company-owned life insurance stated at cash surrender value. Deferred charges primarily consist of deferred financing costs, which are being amortized over the life of the associated debt.

NOTE 10.

**Pension Plans and Other Postretirement Employee Benefits**

The following table details the components of net periodic cost (benefit) of our pension plans and other postretirement employee benefits, or OPEB, for the quarters and six months ended June 30, 2010 and 2009:

Quarters ended June 30:

| (Dollars in thousands)                      | Pension Plans |          | Other Postretirement<br>Employee Benefits |          |
|---|---------------|----------|---|----------|
|   | 2010          | 2009     | 2010                                      | 2009     |
| Service cost                                | \$ 1,104      | \$ 1,424 | \$ 75                                     | \$ 406   |
| Interest cost                               | 5,405         | 5,781    | 911                                       | 1,930    |
| Expected return on plan assets              | (8,268)       | (8,929)  |   |          |
| Amortization of prior service cost (credit) | 200           | 205      | (2,135)                                   | (246)    |
| Amortization of actuarial loss              | 2,029         | 1,065    | 829                                       | 543      |
| Curtailment loss                            |               | 198      |   |          |
| Net periodic cost (benefit)                 | \$ 470        | \$ (256) | \$ (320)                                  | \$ 2,633 |

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Six months ended June 30:

| (Dollars in thousands)                      | Pension Plans   |                 | Other Postretirement<br>Employee Benefits |                 |
|---|-----------------|-----------------|---|-----------------|
|   | 2010            | 2009            | 2010                                      | 2009            |
| Service cost                                | \$ 2,316        | \$ 2,848        | \$ 208                                    | \$ 812          |
| Interest cost                               | 10,825          | 11,562          | 1,986                                     | 3,860           |
| Expected return on plan assets              | (16,567)        | (17,857)        |   |                 |
| Amortization of prior service cost (credit) | 406             | 410             | (4,286)                                   | (492)           |
| Amortization of actuarial loss              | 4,087           | 2,130           | 2,316                                     | 1,085           |
| Curtailement loss (gain)                    | 64              | 198             | (320)                                     |                 |
| <b>Net periodic cost (benefit)</b>          | <b>\$ 1,131</b> | <b>\$ (709)</b> | <b>\$ (96)</b>                            | <b>\$ 5,265</b> |

As reported in our 2009 Annual Report on Form 10-K, our company-sponsored pension plans were underfunded at December 31, 2009. We are not required to make contributions during 2010 as a result of carry-forward credits that we earned from discretionary contributions made in prior periods. We estimate cash payments will total approximately \$1.7 million in 2010 to our non-qualified supplemental pension plan. As of June 30, 2010, \$0.9 million of contributions had been made. Payments to be made in 2010 for OPEB obligations represent benefit costs incurred during the year by eligible participants.

NOTE 11.

**Comprehensive Income**

The components of comprehensive income for the quarters and six months ended June 30, 2010 and 2009 were as follows:

| (Dollars in thousands)  | Quarter Ended<br>June 30, |                 | Six Months Ended<br>June 30, |                  |
|---|---------------------------|-----------------|------------------------------|------------------|
|   | 2010                      | 2009            | 2010                         | 2009             |
| Net earnings  | \$ 11,743                 | \$ 3,766        | \$ 12,938                    | \$ 28,586        |
| Other comprehensive income (loss), net of tax   |                           |                 |                              |                  |
| Defined benefit pension plans and OPEB obligations:   |                           |                 |                              |                  |
| Amortization of prior service credit included in net periodic cost, net of tax of \$(755), \$(16), \$(1,513) and \$(32) | (1,180)                   | (25)            | (2,367)                      | (50)             |
| Amortization of actuarial loss included in net periodic cost, net of tax of \$1,115, \$627, \$2,498 and \$1,254         | 1,743                     | 981             | 3,905                        | 1,961            |
| Curtailement loss (gain), net of tax of \$0, \$77, \$(100) and \$ 77  |                           | 121             | (156)                        | 121              |
| Recognition of deferred taxes related to actuarial gain on OPEB obligations   | (113)                     |                 | 5,693                        |                  |
| Other comprehensive income, net of tax  | 450                       | 1,077           | 7,075                        | 2,032            |
| <b>Comprehensive income</b>   | <b>\$ 12,193</b>          | <b>\$ 4,843</b> | <b>\$ 20,013</b>             | <b>\$ 30,618</b> |

Of the \$0.5 million reported as other comprehensive income, net of tax, for the quarter ended June 30, 2010, \$1.4 million and \$(0.9) million related to our defined benefit pension plans and OPEB obligations, respectively. Of the \$1.1 million reported as other comprehensive income, net of tax, for the quarter ended June 30, 2009, \$0.9 million and \$0.2 million related to our defined benefit pension plans and OPEB obligations, respectively.

Of the \$7.1 million reported as other comprehensive income, net of tax, for the six months ended June 30, 2010, \$2.8 million and \$4.3 million related to our defined benefit pension plans and OPEB obligations, respectively. Of the \$2.0 million reported as other comprehensive income,

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net of tax, for the six months ended June 30, 2009, \$1.7 million and \$0.3 million related to our defined benefit pension plans and OPEB obligations, respectively.

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NOTE 12.

**Financial Instruments****DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

We record all derivatives on our balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether we have elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge.

We formally document all relationships between hedging instruments and hedged items, as well as the risk-management objective and strategy for undertaking various hedge transactions.

On June 30, 2010, we entered into nine separate interest rate swap agreements with notional amounts totaling \$68.25 million, each effective July 1, 2010, associated with our \$22.5 million debentures and \$45.75 million of our medium-term notes. The swaps converted interest payments with fixed rates ranging between 6.95% and 8.89% to a three-month LIBOR plus a spread between 4.738% and 7.8375%. The interest rate swaps terminate at various dates ranging from January 2011 to February 2018. Our risk management objective and strategy is to protect against the risk of adverse changes in fair value attributable to changes in the 3-month LIBOR swap rate, the designated benchmark interest rate being hedged, on \$68.25 million of fixed-rate debt. All of the interest rate swaps qualify for and have been designated as fair value hedges under the short-cut method of FASB Accounting Standard Codification, or ASC, 815, *Derivatives and Hedging*. As such, the net changes in fair value of the derivatives and the net changes in fair value of the hedged items are each recorded within interest expense. As of June 30, 2010, we recognized a derivative liability within other long-term obligations of \$0.2 million and a reduction to the carrying amount of our debt, representing the changes in fair value of the hedged items, of \$0.2 million, with offsetting amounts reflected within interest expense.

**FAIR VALUE OF FINANCIAL INSTRUMENTS**

Estimated fair values of our financial instruments are as follows:

| (Dollars in thousands)   | June 30, 2010   |            | December 31, 2009 |            |
|--|-----------------|------------|-------------------|------------|
|  | Carrying Amount | Fair Value | Carrying Amount   | Fair Value |
| Cash and short-term investments (Level 1)  | \$ 40,264       | \$ 40,264  | \$ 55,038         | \$ 55,038  |
| Derivative liability related to interest rate swaps (Level 2)                            | 177             | 177        |                   |            |
| Long-term debt (including fair value adjustments related to fair value hedges) (Level 2) | 368,389         | 369,278    | 368,431           | 364,978    |

A framework has been established for measuring fair value, which provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described below.

Level 1 Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets.

Level 2 Inputs to the valuation methodology include:

Quoted prices for similar assets or liabilities in active markets;



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Quoted prices for identical or similar assets or liabilities in inactive markets;

Inputs other than quoted prices that are observable for the asset or liability; and

Inputs that are derived principally from or corroborated by observable market data by correlation or other means. If the asset or liability has a specified (contractual) term, the Level 2 input must be observed for substantially the full term of the asset or liability.

Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

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The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

For short-term investments, the carrying amount approximates fair value due to the short-term nature of the investments. The fair value of our long-term debt is estimated based upon the quoted market prices for the same or similar debt issues. For long-term debt for which there is no quoted market price, fair value is estimated based on average market prices for comparable liquid bonds. For both our derivative liability and associated adjustment to the hedged debt, the fair value is estimated based on the theoretical cost to cash settle the transactions on June 30, 2010, partially offset by the consideration of credit risk, or credit standing, of the counterparties to the transactions and the effect of any credit enhancements related to the transactions.

Significant transfers into and out of Level 1 occur on a routine basis based on our liquidity resources and requirements. Normal fluctuations occur due to items such as cash inflows from accounts receivable collections and cash outflows for items such as payrolls, accounts payable payments and quarterly dividend distributions. Level 2 financial instruments consist of long-term debt, derivative liability and associated adjustment to the hedged debt. As compared to December, 31, 2009, no significant transfers have occurred.

NOTE 13.

## **Commitments and Contingencies**

In January 2007, the U.S. Environmental Protection Agency, or EPA, notified us that we are a potentially responsible party under the federal Comprehensive Environmental Response, Compensation and Liability Act of 1980 and the Clean Water Act for clean-up of a site known as Avery Landing in northern Idaho. We own a portion of the land at the Avery Landing site, which we acquired in 1980 from the Milwaukee Railroad. The land we own at the site and adjacent properties were contaminated with petroleum as a result of the Milwaukee Railroad's operations at the site and adjacent properties prior to 1980. We entered into a consent order with the EPA in August 2008 to conduct an Engineering Evaluation/Cost Analysis, or EE/CA, study to determine the best means of addressing the contamination at the site. In January 2010, we submitted our draft EE/CA report to the EPA outlining various alternatives for addressing the contamination at the entire site (including adjacent properties). The range of cost estimates for the various alternatives to address the contamination at the entire site is from \$0.7 million to \$8.2 million. In April 2010, we were notified by the EPA that they determined the EE/CA report submitted by us contained deficiencies. Accordingly, the EPA will now be completing the EE/CA report for the Avery Landing site and also producing the Biological Assessment and Cultural Resources Evaluation reports. We anticipate the EPA will issue the reports in the fall of 2010. Currently we are under no legal obligation to implement any remedy selected by the EPA. We believe we have valid defenses available to limit our potential liability at the site. There is also the possibility of pursuing recovery from third parties as a means of further limiting our liability. As of June 30, 2010, we have accrued \$0.7 million for this matter.

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NOTE 14.

**Segment Information**

| (Dollars in thousands)   | Quarter Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                   |
|--|---------------------------|-------------------|------------------------------|-------------------|
|  | 2010                      | 2009              | 2010                         | 2009              |
| <b>Segment Revenues</b>  |                           |                   |                              |                   |
| Resource   | \$ 50,455                 | \$ 27,288         | \$ 95,268                    | \$ 74,494         |
| Real Estate  | 10,456                    | 4,697             | 13,903                       | 52,733            |
| Wood Products  | 77,166                    | 54,701            | 144,935                      | 99,530            |
|  | 138,077                   | 86,686            | 254,106                      | 226,757           |
| Elimination of intersegment revenues                           | (9,099)                   | (7,904)           | (19,710)                     | (18,382)          |
| <b>Total consolidated revenues</b>                             | <b>\$ 128,978</b>         | <b>\$ 78,782</b>  | <b>\$ 234,396</b>            | <b>\$ 208,375</b> |
| <b>Intersegment revenues or transfers</b>                      |                           |                   |                              |                   |
| Resource   | \$ 9,099                  | \$ 7,904          | \$ 19,710                    | \$ 18,382         |
| <b>Total intersegment revenues or transfers</b>                | <b>\$ 9,099</b>           | <b>\$ 7,904</b>   | <b>\$ 19,710</b>             | <b>\$ 18,382</b>  |
| <b>Operating Income (Loss)</b>                                 |                           |                   |                              |                   |
| Resource   | \$ 15,026                 | \$ 4,525          | \$ 24,947                    | \$ 15,371         |
| Real Estate  | 5,117                     | 1,507             | 7,015                        | 43,019            |
| Wood Products  | 5,956                     | (2,993)           | 11,184                       | (14,176)          |
| Eliminations and adjustments                                   | 2,136                     | 4,336             | 2,573                        | 5,087             |
|  | 28,235                    | 7,375             | 45,719                       | 49,301            |
| Corporate  | (13,042)                  | (11,623)          | (26,135)                     | (22,442)          |
| <b>Earnings (loss) from continuing operations before taxes</b> | <b>\$ 15,193</b>          | <b>\$ (4,248)</b> | <b>\$ 19,584</b>             | <b>\$ 26,859</b>  |

NOTE 15.

**Guarantor Subsidiaries**

On November 3, 2009, Potlatch sold \$150 million aggregate principal amount of 7.5% senior notes due on November 1, 2019. The notes are unconditionally guaranteed by certain of Potlatch's subsidiaries. We filed a registration statement with the SEC, which was effective May 7, 2010, pursuant to which we offered to exchange the senior notes and related subsidiary guarantees for notes and subsidiary guarantees with substantially similar terms that are registered under the Securities Act. All of the original notes were tendered for the registered notes in June 2010.

In accordance with SEC rules, the registration of the notes does not result in a requirement to file periodically separate financial information with respect to an issuer, its guarantor subsidiaries and its non-guarantor subsidiaries where the parent entity has no independent assets or operations, the guarantees are full and unconditional and joint and several, and the non-guarantor subsidiaries are minor, all as defined by applicable SEC rules.

Separate financial information about Potlatch, Potlatch's guarantor subsidiaries and its non-guarantor subsidiaries is not presented because Potlatch holds all of its assets and conducts all of its operations through its subsidiaries and has no independent assets or operations. Potlatch's subsidiaries, other than the subsidiary guarantors, are minor in significance. The guarantees of our subsidiary guarantors are full and unconditional and joint and several. Except with respect to REIT tax rules, there are no significant restrictions on the ability of Potlatch or any of the subsidiary guarantors to obtain funds from any of our subsidiaries by dividend or loan. The tax rules with which we must comply to maintain

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our status as a REIT limit our ability to use dividends from Potlatch TRS to service our indebtedness. In particular, at least 75% of our gross income for each taxable year as a REIT must be derived from sales of our standing timber and other types of real estate income. No more than 25% of our gross income may consist of dividends from Potlatch TRS and other non-qualifying types of income. This requirement may limit our ability to receive dividends from Potlatch TRS and may impact our ability to service our indebtedness using cash flows from Potlatch TRS.

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ITEM 2.

**Management's Discussion and Analysis of Financial Condition and Results of Operations**

**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION**

This report contains, in addition to historical information, certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including without limitation, statements regarding future revenues, cash flows, the funding of our operations and debt service, the nature of our REIT income, dividend distributions, compliance with REIT tax rules, timber harvest levels, costs, manufacturing output, capital expenditures, the funding of our pension plans, tax refunds, FSC certification of our timberlands, future land sales and acquisitions, and like-kind exchanges and tax consequences. Words such as anticipate, expect, will, intend, plan, target, project, believe, schedule, estimate, could, can, may, and similar expressions are intended to identify such forward-looking statements. These forward-looking statements reflect our current views regarding future events based on estimates and assumptions, and are therefore subject to known and unknown risks and uncertainties and are not guarantees of future performance. Our actual results of operations could differ materially from those expressed or implied by forward-looking statements contained in this report. Important factors that could cause or contribute to such differences include those factors discussed in Item 1A of our Annual Report on Form 10-K, as well as the following:

changes in timber harvest levels on our lands;

changes in timber prices;

changes in timberland values;

changes in policy regarding governmental timber sales;

changes in the United States and international economies;

changes in the level of residential and commercial construction and remodeling activity;

changes in tariffs, quotas and trade agreements involving wood products;

changes in demand for our products;

changes in production and production capacity in the forest products industry;

competitive pricing pressures for our products;

unanticipated manufacturing disruptions;

changes in general and industry-specific environmental laws and regulations;

unforeseen environmental liabilities or expenditures;

weather conditions;

changes in raw material and other costs;

collectability of amounts owed by customers;

the ability to satisfy complex rules in order to remain qualified as a REIT; and

changes in tax laws that could reduce the benefits associated with REIT status.

Forward-looking statements contained in this report present our views only as of the date of this report. Except as required under applicable law, we do not intend to issue updates concerning any future revisions of our views to reflect events or circumstances occurring after the date of this report.

## **OVERVIEW**

We are a real estate investment trust, or REIT, with approximately 1.6 million acres of timberlands in Arkansas, Idaho, Minnesota and Wisconsin. Through wholly owned taxable subsidiaries, which we refer to in this report as Potlatch TRS, we operate a real estate sales and development business and five manufacturing facilities that produce lumber and plywood.

As of June 30, 2010, our business was organized into three segments:

The business of our Resource segment consists of the management of our timberlands to optimize revenue producing opportunities while at the same time adhering to our strict stewardship standards. Management activities include planting and harvesting trees and building and maintaining roads, as well as deriving ancillary revenues from hunting and recreation leases, biomass production, mineral rights and various leasing opportunities. For the first six months of 2010, Resource segment revenues were \$95.3 million, representing approximately 38% of our revenues from continuing operations, before elimination of intersegment revenues. Intersegment revenues were \$19.7 million for the six-month period.

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The business of our Real Estate segment consists primarily of the sale of selected non-core timberland real estate. From time to time, we also take advantage of opportunities to sell timberland where we believe pricing to be particularly attractive, to match a sale with a purchase of more desirable property in order to utilize LKE tax-deferred transactions or to meet various financial and strategic objectives. The segment also plays an active role in negotiations for all timberland acquisitions, and engages in real estate subdivision and development activities through Potlatch TRS. Results for the segment depend on the demand for our non-core timberlands, the timing of closing of sales of properties and our ability to match sales of property with acquisitions in LKE transactions. Consequently, revenues for the segment are seldom comparable or predictable between periods. Real Estate segment revenues for the first six months of 2010 were \$13.9 million, representing approximately 5% of our revenues from continuing operations, before elimination of intersegment revenues. The segment did not have intersegment revenues during the period.

In July 2010, we entered into an agreement to sell approximately 29,600 acres of timberland in Wisconsin and 11,900 acres in Arkansas to RMK Timberland Group, or RMK, a timber investment management organization, for approximately \$29 million. The sale is expected to close by the end of August 2010. In addition, we granted RMK an option to purchase 29,100 additional acres in Wisconsin and another 17,400 acres in Arkansas during the fourth quarter of 2010 for approximately \$35 million. The total Wisconsin sale includes all but approximately 1,200 acres of our land in Wisconsin, and those remaining Wisconsin properties are currently under contract to sell, or are expected to be sold within the next two to three years. All of the sale properties are held within Potlatch TRS. These properties are reported under Current other assets in our Consolidated Condensed Balance Sheets.

Our Wood Products segment manufactures lumber and plywood at five mills located in Arkansas, Idaho, Michigan and Minnesota. The segment's products are largely commodity products, which are sold to wholesalers for nationwide distribution primarily for use in home building and other construction activity. Wood Products segment revenues were \$144.9 million for the first six months of 2010, representing approximately 57% of our revenues from continuing operations, before elimination of intersegment revenues. The segment did not have intersegment revenues during the period.

## **FACTORS INFLUENCING OUR RESULTS OF OPERATIONS AND CASH FLOWS**

The operating results of our Resource, Real Estate and Wood Products business segments have been and will continue to be influenced by a variety of factors, including the cyclical nature of the forest products industry, changes in timber prices and in harvest levels from our timberlands, competition, timberland valuations, demand for our non-core timberland for higher and better use purposes, the efficiency and level of capacity utilization of our wood products manufacturing operations, changes in our principal expenses, such as log costs, asset dispositions or acquisitions, and other factors.

**Fluctuating Timber Prices.** Our results of operations and cash flows are materially affected by the fluctuating nature of timber prices. A variety of factors affect prices for timber, including factors affecting demand, such as changes in economic conditions, construction activity levels, interest rates, credit availability, population growth and weather conditions, as well as changes in timber supply and other factors. All of these factors can vary by region and by timber type, such as sawlogs or pulpwood logs. In the first six months of 2010, average sawlog prices were approximately 12% and 4% higher in our Northern and Southern regions, respectively, compared to the same period in 2009. In the first six months of 2010, average pulpwood prices were approximately 4% lower in our Northern region and 10% higher in our Southern region compared to the same period in 2009.

Timber prices are also affected by changes in timber availability at the local and national level. Our timberland ownership is currently concentrated in Arkansas, Idaho, Minnesota and Wisconsin. In Arkansas and Minnesota, most timberlands are privately owned. Historically, increases in timber prices have often resulted in substantial increases in harvesting on private timberlands, including lands not previously made available for commercial timber operations, causing a short-term increase in supply that has tended to moderate price increases. Decreases in timber prices have often resulted in less harvesting activity, causing short-term decreases in supply that have tended to moderate price decreases. In Idaho, where a greater proportion of timberland is government owned, any substantial increase in timber harvesting from government-owned lands could significantly reduce timber prices, which would harm our results of operations. For more than twenty-five years, environmental concerns and other factors have limited timber sales by federal agencies, which historically had been major suppliers of timber to the United States forest products industry, particularly in the West. Any reversal of policy that substantially increases timber sales from government lands could have a material adverse effect on our results of operations and cash flows. On a local level, timber supplies can fluctuate depending upon factors such as changes in weather conditions and in the harvest strategies of local forest products industry participants, as well as occasionally high timber salvage efforts due to events such as storm damage, unusual pest infestations or fires.

**Harvest Levels.** Changes in harvest levels on our timberlands also may have a significant impact on our results of operations. Over the long term, we manage our timberlands on a sustainable yield basis to achieve a balance between timber growth and timber harvests. From time to time, however, we may choose, consistent with our environmental commitments, to harvest timber at levels above or below our estimate of sustainability for various reasons. In 2009, the





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overall harvest from our timberlands was 3.8 million tons. Based on our current projections that take into consideration such factors as market conditions, the ages of our timber stands and recent timberland acquisitions and sales, we expect the overall timber harvest from our lands in 2010 to be approximately 4.0 to 4.4 million tons, increasing to approximately 4.8 million tons annually over the next five to ten years, subject to adjustment depending upon market conditions. The pending sale of our Wisconsin acreage and the two tracts of timberlands in Arkansas reduced our annual expected harvest level from 5.1 million tons over the next five to ten years to approximately 4.8 million tons. Our future timber harvest levels will continue to be affected by acquisitions of additional timberlands and sales of existing timberlands.

On a short-term basis, we may adjust our timber harvest levels in response to market conditions. For example, due to strengthening sawlog prices, during the first six months of 2010 our sawlog harvest volumes increased 41% in our Northern region and 14% in our Southern region over the same period in 2009. A less robust pulpwood pricing environment resulted in a 10% and 16% decrease in pulpwood harvested in the Northern and Southern regions, respectively, compared to the 2009 period. We also experience seasonally lower harvest activity during the winter and spring due to weather conditions. In addition, future timber harvest levels may be affected by changes in estimates of long-term sustainable yield because of genetic improvements and other silvicultural advances, natural disasters, fires and other hazards, regulatory constraints and other factors beyond our control.

**Demand for and Timing of Real Estate Sales.** A number of factors, including availability of credit, a slowing of real estate development, changes in population growth patterns and changes in demographics could reduce the demand for our timberland as a real estate asset. In addition, changes in the interpretation or enforcement of current laws, or the enactment of new laws, regarding the use and development of real estate or changes in the political composition of governmental bodies could lead to new or greater costs, delays and liabilities that could materially adversely affect our real estate business. The timing of real estate sales is a function of many factors, including the general state of the economy, demand in local real estate markets, the number of properties listed for sale, the seasonal nature of sales, the plans of adjacent landowners, and our expectations of future price appreciation. For example, our Real Estate segment revenues were \$38.8 million higher in the first six months of 2009 compared to the same period in 2010, primarily due to a large non-strategic land sale of approximately 24,500 acres in Arkansas for approximately \$43.3 million in January 2009. There was no comparable large real estate sale in the first six months of 2010. Delays in the completion of transactions or the termination of potential transactions may be beyond our control. These events could adversely affect our operating results.

**Cyclical Wood Products Markets.** The operating results of our wood products manufacturing operations are cyclical. Historical prices for our wood products have been volatile, and we, like other manufacturers in the forest products industry, have limited direct influence over the timing and extent of price changes for our products. The demand for our wood products is affected by the level of new residential construction activity and, to a lesser extent, home repair and remodeling activity, which are subject to fluctuations due to changes in economic conditions, interest rates, population growth, weather conditions and other factors.

The profitability of our Wood Products segment depends largely on our ability to operate our facilities efficiently and at or near full capacity. Our operating results can be adversely affected if market demand does not justify operating at these levels or if our operations are inefficient or suffer significant interruption for any reason.

The forest products industry in general and the wood products business in particular have been adversely affected since 2008 by the national decline in home building and the resulting weak demand and lower prices for wood products. In December 2009, we recorded a pre-tax asset impairment charge of \$3.0 million related to our Idaho particleboard manufacturing assets. The fair value of the impaired assets was estimated based on expected future cash flows. In March 2010, we sold the particleboard manufacturing facility's buildings and equipment, but not the underlying land. We entered into a lease agreement with the purchaser pursuant to which we will receive nominal lease revenues on the property for the next ten years. As a result of the sale, we recorded additional charges totaling \$0.4 million, primarily related to severance benefits. These costs are reflected in the operating results of the Wood Products segment. Improving prices and demand for manufactured wood products in the first half of 2010 have caused other mills in our operating regions to restart their operations, and as a result, supply has increased and demand and prices have begun to drop. Consequently, we expect lower manufactured wood products prices for the second half of 2010, but not down to the low levels experienced in the first half of 2009.

One of the most significant expenses of our Wood Products segment is the cost of sawlogs and wood fiber needed to supply our manufacturing facilities. The cost of logs that supply our lumber mills has at times fluctuated greatly as a result of the factors discussed above affecting the price of our timber. Selling prices of our wood products have not always increased in response to log price increases, nor have log prices always decreased in conjunction with declining wood products prices. On occasion, the results of operations of our wood products business have been, and may in the future be, adversely affected if we are unable to pass cost increases through to our customers.

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**Competition.** The markets for our timber and wood products are highly competitive, and companies that have substantially greater financial resources than we do compete with us in each of our lines of business. Logs and other fiber from our timberlands, as well as our wood products, are subject to competition primarily from timberland owners and wood products manufacturers in North America.

**Acquisitions.** As a result of our REIT conversion, we are better able to compete for acquisitions of timberlands against other entities that use tax-efficient structures. It is uncertain whether any timberland acquisitions we make will perform in accordance with our expectations. We anticipate financing acquisitions through cash from operations, borrowings under our credit facility or proceeds from equity or debt offerings. Our inability to finance future acquisitions on favorable terms or the failure of any acquisition to perform as we expect could harm our results of operations.

### **CRITICAL ACCOUNTING POLICIES**

Our principal accounting policies are discussed on pages 58-64 of our Annual Report on Form 10-K for the year ended December 31, 2009. Our accompanying consolidated condensed financial statements have been prepared in conformity with accounting principles generally accepted in the United States, which require management to make estimates that affect the amounts of revenues, expenses, assets and liabilities reported. The following are critical accounting matters which are both very important to the portrayal of our financial condition and results of operations and which require some of management's most difficult, subjective and complex judgments. The accounting for these matters involves forming estimates based on current facts, circumstances and assumptions which, in management's judgment, could change in a manner that could materially affect management's future estimates with respect to such matters and, accordingly, could cause our future reported financial condition and results of operations to differ materially from financial results reported based on management's current estimates. Changes in these estimates are recorded periodically based on updated information. Our critical accounting policies are discussed below.

**Timber and timberlands.** Timber and timberlands are recorded at cost, net of depletion. Expenditures for reforestation, including all costs related to stand establishment, such as site preparation, costs of seeds or seedlings and tree planting, are capitalized. Expenditures for forest management, consisting of regularly recurring items necessary to the ownership and administration of our timber and timberlands, are accounted for as current operating expense. Our depletion is determined based on costs capitalized and the related current estimated recoverable timber volume. Recoverable volume does not include anticipated future growth, nor are anticipated future costs considered.

There are currently no authoritative accounting rules relating to costs to be capitalized in the timber and timberlands category. We have used relevant portions of current accounting rules, industry practices and our judgment in determining costs to be capitalized or expensed. Alternate interpretations and judgments could significantly affect the amounts capitalized. Additionally, models and observations used to estimate the current recoverable timber volume on our lands are subject to judgments that could significantly affect volume estimates.

Following are examples of factors that add to the complexity of the assumptions we make regarding capitalized or expensed costs:

harvest cycles can vary by geographic region and by species of timber;

weather patterns can affect annual harvest levels;

environmental regulations and restrictions may limit our ability to harvest certain timberlands;

changes in harvest plans may occur;

scientific advancement in seedlings and timber growing technology may affect future harvests;

land sales and acquisitions may affect volumes available for harvest; and

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major forest fire events or pest infestations can significantly affect future harvest levels. Different assumptions for either the cost or volume estimates, or both, could have a significant effect upon amounts reported in our statements of operations and financial condition. Because of the number of variables involved and the interrelationship between the variables, sensitivity analysis of individual variables is not practical.

**Long-lived assets.** A significant portion of our total assets are invested in our timber and timberlands and our wood products manufacturing facilities. The cyclical patterns of our businesses cause cash flows to fluctuate by varying degrees from period to period. As a result, long-lived assets are a material component of our financial position with the potential for material change in valuation if assets are determined to be impaired.

Our long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable, as measured by its undiscounted estimated future cash flows. We use our operational budgets to estimate future cash flows. Budgets are inherently uncertain estimates of future performance due to the fact that all inputs, including revenues, costs and capital spending, are subject to frequent change for many different reasons, including the reasons previously described above under Factors Influencing our Results of Operations and Cash Flows. Because of the number of variables involved, the interrelationship between the variables

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and the long-term nature of the impairment measurement, sensitivity analysis of individual variables is not practical. Budget estimates are adjusted periodically to reflect changing business conditions, and operations are reviewed, as appropriate, for impairment using the most current data available. For the six months ended June 30, 2010 and 2009, there were no impairment charges for any of our assets associated with our continuing operations.

**Income taxes.** We believe it is more likely than not that we will have sufficient future taxable income to realize our deferred tax assets. The ultimate realization of deferred tax assets depends on the generation of future taxable income during the periods in which temporary differences are deductible. In making this assessment, we consider the scheduled reversal of deferred tax liabilities (including the impact of available carryforward periods), projected taxable income and tax planning strategies. In order to fully realize the deferred tax assets, we will need to generate future taxable income before the expiration of the deferred tax assets as specified in the Internal Revenue Code. Based on projected taxable income for Potlatch TRS, over the periods for which the deferred tax assets are deductible, as well as certain tax planning strategies that management has undertaken, we believe that it is more likely than not that we will realize the benefits of these deductible differences and carryforwards, net of the existing valuation allowances at June 30, 2010. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced and management is unable to implement one or more of the tax planning strategies that it has identified. Such tax planning strategies include the transfer of income-producing timberlands from the REIT to Potlatch TRS to generate taxable income sufficient to fund our pension and other postretirement employee benefit obligations.

**Derivative instruments and hedging activities.** We record all derivatives on our balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether we have elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge.

We formally document all relationships between hedging instruments and hedged items, as well as the risk-management objective and strategy for undertaking various hedge transactions.

On June 30, 2010, we entered into nine separate interest rate swap agreements with notional amounts totaling \$68.25 million, each effective July 1, 2010, associated with our \$22.5 million debentures and \$45.75 million of our medium-term notes. The swaps converted interest payments with fixed rates ranging between 6.95% and 8.89% to a three-month LIBOR plus a spread between 4.738% and 7.8375%. The interest rate swaps terminate at various dates ranging from January 2011 to February 2018. Our risk management objective and strategy is to protect against the risk of adverse changes in fair value attributable to changes in the 3-month LIBOR swap rate, the designated benchmark interest rate being hedged, on \$68.25 million of fixed-rate debt. All of the interest rate swaps qualify for and have been designated as fair value hedges under the short-cut method of FASB Accounting Standard Codification, or ASC, 815, *Derivatives and Hedging*. As such, the net changes in fair value of the derivatives and the net changes in fair value of the hedged items are each recorded within interest expense.

**Discontinued operations.** In December 2008, we completed the spin-off of Clearwater Paper Corporation, or Clearwater Paper, which owns and operates our former pulp-based manufacturing businesses, consisting of our former pulp and paperboard and consumer products segments, as well as our former wood products operations located in Lewiston, Idaho. In May 2008, our Prescott, Arkansas lumber mill permanently ceased operations due to poor market conditions. We are actively pursuing a sale of this facility. As a result, any expenses associated with Clearwater Paper and Prescott are classified within discontinued operations in the periods covered by this report.

These events required us to record estimates of liabilities at the time of the events. In making these judgments, we considered contractual obligations, legal liabilities and possible incremental costs incurred as a result of these restructuring transactions. Our estimated liabilities could differ materially from actual costs incurred, with resulting adjustments to future period earnings for any differences.

We sold our oriented strand board, or OSB, manufacturing facilities to Ainsworth Lumber Co. Ltd., or Ainsworth, in 2004. In 2006, Ainsworth filed a complaint against us, which we settled in April 2009 for \$5.75 million. See Note 13 to our consolidated financial statements included in our 2009 Annual Report on Form 10-K for additional information regarding this settlement. The settlement amount and all related legal expenses have been accounted for as discontinued operations during the quarter and six months ended June 30, 2009.

**Environmental liabilities.** We record accruals for estimated environmental liabilities when such contingencies are probable and reasonably estimable. These estimates reflect assumptions and judgments as to the probable nature, magnitude and timing of required investigation, remediation and monitoring activities. In making these estimates, we consider, among other things, the activities we have conducted at any particular site, information obtained through



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consultation with applicable regulatory authorities and third parties, and our historical experience at other sites that are judged to be comparable. We must also consider the likelihood of changes in governmental regulations, advancements in environmental technologies and changing legal standards regarding liability. Due to the numerous uncertainties and variables associated with these assumptions and judgments, and changes in governmental regulations and environmental technologies, our accruals are subject to substantial uncertainties, and our actual costs could be materially more or less than the estimated amounts.

**Pension and other postretirement employee benefits.** The determination of pension plan expense and the requirements for funding our pension plans are based on a number of actuarial assumptions. Two critical assumptions are the discount rate applied to pension plan obligations and the rate of return on plan assets. For OPEB obligations related to certain health care and life insurance benefits provided to qualified retired employees, critical assumptions in determining OPEB expense are the discount rate applied to benefit obligations and the assumed health care cost trend rates used in the calculation of benefit obligations.

Note 12 to our 2009 Annual Report on Form 10-K consolidated financial statements includes information on the components of pension and OPEB expense and the underlying actuarial assumptions used to calculate periodic expense for the three years ended December 31, 2009, as well as the funded status for our pension plans and OPEB obligations as of December 31, 2009 and 2008. Note 10, Pension Plans and Other Postretirement Employee Benefits, of this Form 10-Q includes information on the components of pension and OPEB expense for the quarters and six months ended June 30, 2010 and 2009.

The discount rate used in the determination of pension benefit obligations and pension expense is a weighted average benchmark rate based on high-quality fixed income investment interest rates. At December 31, 2009 and 2008, we calculated obligations using discount rates of 5.65% and 6.15%, respectively. To determine the expected long-term rate of return on pension assets, we employ a process that analyzes historical long-term returns for various investment categories, as measured by appropriate indices. These indices are weighted based upon the extent to which plan assets are invested in the particular categories in arriving at our determination of a composite expected return. The assumed long-term rates of return on pension plan assets used for the years ended December 31, 2009 and 2008 were 8.5% and 9.0%, respectively.

The total periodic pension plan benefit in 2009 was \$3.5 million. An increase in the discount rate or the rate of expected return on plan assets, all other assumptions remaining the same, would increase the pension plan benefit, and conversely, a decrease in either of these measures would decrease the plan benefit. As an indication of the sensitivity that the pension benefit has to the discount rate assumption, a 25 basis point change in the discount rate would affect the annual plan benefit by approximately \$0.7 million. A 25 basis point change in the assumption for the expected return on plan assets would affect the annual plan benefit by approximately \$1.0 million. The actual rates of return on plan assets may vary significantly from the assumption used because of unanticipated changes in financial markets.

As a result of the steep downturn in the stock market in late 2008 and early 2009, our company-sponsored pension plans were underfunded at December 31, 2009 and 2008. In April 2009, an Internal Revenue Service pronouncement provided significant funding relief to single-employer defined benefit plan sponsors. Consequently, we were not required to make contributions during 2009 to our defined benefit plans. We are also not required to make contributions during 2010 as a result of carry-forward credits that we earned from discretionary contributions made in prior periods. We estimate cash payments will total approximately \$1.7 million in 2010 to our non-qualified supplemental pension plan. As of June 30, 2010, \$0.9 million of contributions had been made. Payments made for OPEB obligations represent benefit costs incurred during the year by eligible participants.

For our OPEB obligations, the expense for 2009 was \$13.5 million. The discount rate used to calculate OPEB obligations, which was determined using the same methodology we used for our pension plans, was 5.65% and 6.15% at December 31, 2009 and 2008, respectively. The assumed health care cost trend rate used to calculate OPEB obligations and expense for 2009 was a 7.5% increase over the previous year, with the rate of increase scheduled to decline ratably to an assumption of 5% in 2069.

As an indication of the sensitivity that OPEB expense has to the discount rate assumption, a 25 basis point change in the discount rate would affect OPEB expense by less than \$0.1 million. A 1% change in the health care cost trend rate assumption would have affected 2009 OPEB expense by approximately \$0.9 million to \$1.0 million and our OPEB obligation (liability) by approximately \$1.5 million to \$1.8 million. The actual rates of health care cost increases may vary significantly from the assumption used because of unanticipated changes in health care costs.

Due to our restructuring of retiree health care benefits and the freezing of our subsidy of health care plan costs to eligible retirees announced in the fourth quarter of 2009, beginning January 1, 2010, most eligible retirees will bear all future health care cost increments, and the remainder of the eligible retirees will bear a larger portion of future cost increments, culminating in a fixed company subsidy as they attain age 65, upon which date all future health care cost increments will be borne by the retirees. As a result, our OPEB obligations and future costs have been reduced.



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The Patient Protection and Affordable Care Act, as amended by the Health Care and Reconciliation Act of 2010, was enacted in March 2010 and included a change in the deductibility of drug expenses reimbursed under the Medicare Part D retiree drug subsidy program beginning after 2012. As a result of this legislation, deferred taxes associated with our retiree health care liabilities based on prior law were required to be adjusted, resulting in a net charge to earnings in the first quarter of 2010 of approximately \$3.0 million.

Periodic pension and OPEB expense are included in Cost of goods sold and Selling, general and administrative expenses in the Consolidated Condensed Statements of Operations and Comprehensive Income. The expense is allocated to all business segments. At June 30, 2010 and December 31, 2009, liabilities are recorded for underfunded plans. The funded status of a benefit plan is measured as the difference between plan assets at fair value and the benefit obligation. For underfunded plans, the estimated liability to be payable in the next twelve months is recorded as a current liability, with the remaining portion recorded as long-term. See Note 12 to our 2009 Form 10-K consolidated financial statements for further discussion.

## **COMPONENTS OF REVENUES AND EXPENSES**

**Revenues.** Revenues consist of sales of logs, standing timber, real estate and wood products, net of discounts, returns and allowances and any sales taxes collected. Sales taxes, when collected, are recorded as a current liability until remitted to the appropriate governmental entities and presented net within revenues.

**Cost of goods sold.** Cost of goods sold consists of depreciation of manufacturing assets, depletion, cost basis of real estate sold and amortization, plus materials, labor and other operating expenses. Materials, labor and other operating expenses consist primarily of the cost of raw materials, including wood fiber, energy and chemicals, personnel costs, repair and maintenance expenses, and freight associated with customer shipments.

**Selling, general and administrative expense.** Selling, general and administrative expense primarily consists of compensation and associated costs for sales and administrative personnel, as well as depreciation and amortization on assets used in administrative functions.

**Interest expense, net.** Net interest expense is the interest paid on our outstanding debt, offset by interest income from any short-term investments. This category also includes amortization of debt issuance costs.

## **RESULTS OF OPERATIONS**

As noted above, our business is organized into three reporting segments: Resource; Real Estate; and Wood Products. Sales or transfers between segments are recorded as intersegment revenues based on prevailing market prices. Because of the role of our Resource segment in supplying our Wood Products segment with a portion of its wood fiber needs, intersegment revenues can represent a significant portion of the Resource segment's total revenues. Our other segments generally do not generate intersegment revenues.

In the period-to-period discussion of our results of operations below, when we discuss our consolidated revenues, contributions by each of the segments to our revenues are reported after elimination of intersegment revenues. In the Discussion of Business Segments section below, segment revenues are presented before elimination of intersegment revenues.



**Table of Contents****Quarter Ended June 30, 2010 Compared to Quarter Ended June 30, 2009**

The following table sets forth period-to-period changes in items included in our Consolidated Condensed Statements of Operations and Comprehensive Income for the quarters ended June 30, 2010 and 2009.

| (Dollars in thousands)  | Quarters Ended<br>June 30, |           | Increase<br>(Decrease) |
|---|----------------------------|-----------|------------------------|
|   | 2010                       | 2009      |                        |
| Revenues  | \$ 128,978                 | \$ 78,782 | \$ 50,196              |
| Costs and expenses:   |                            |           |                        |
| Cost of goods sold  | 97,295                     | 67,569    | 29,726                 |
| Selling, general and administrative expenses                  | 9,401                      | 10,589    | (1,188)                |
|   | 106,696                    | 78,158    | 28,538                 |
| Earnings from continuing operations before interest and taxes | 22,282                     | 624       | 21,658                 |
| Interest expense, net   | (7,089)                    | (4,872)   | (2,217)                |
| Earnings (loss) from continuing operations before taxes       | 15,193                     | (4,248)   | 19,441                 |
| Income tax (provision) benefit                                | (3,365)                    | 7,940     | (11,305)               |
| Earnings from continuing operations                           | 11,828                     | 3,692     | 8,136                  |
| Discontinued operations, net of tax                           | (85)                       | 74        | (159)                  |
| Net earnings  | \$ 11,743                  | \$ 3,766  | \$ 7,977               |

Certain 2009 amounts have been reclassified to conform to the 2010 presentation.

**Revenues** Revenues increased \$50.2 million, or 64%, in the quarter ended June 30, 2010, compared to the same period in 2009, due to increased revenues from all three business segments. A more detailed discussion of revenues follows in Discussion of Business Segments.

**Cost of goods sold** Cost of goods sold increased \$29.7 million, or 44%, in the second quarter of 2010 compared to the same period in 2009. The higher expenses were primarily due to increased log costs and other expenses associated with increased production at our wood products manufacturing facilities, higher logging and hauling expense and depletion from the Resource segment due to increased harvest levels and a higher cost basis of real estate sold.

**Selling, general and administrative expenses** Selling, general and administrative expenses decreased \$1.2 million, or 11%, in the quarter ended June 30, 2010 compared to the same period in 2009, primarily due to decreased employee benefits-related expenses.

**Interest expense, net** Net interest expense increased \$2.2 million, or 46%, in the second quarter of 2010 over the same period in 2009. Interest expense increased \$1.8 million over the same period in 2009, primarily due to interest associated with our \$150 million senior notes issuance in November 2009, partially offset by the fact that we did not incur any interest expense related to our bank credit facility, as we had no outstanding borrowings during the second quarter of 2010. Amortization of deferred issuance costs increased \$0.4 million in the second quarter of 2010 over 2009, primarily related to our November senior notes issuance.

**Income tax (provision) benefit** We recorded an income tax provision of \$3.4 million and an income tax benefit of \$7.9 million related to our continuing operations for the quarters ended June 30, 2010 and 2009, respectively. The income tax provision in the second quarter of 2010 resulted from pre-tax income of Potlatch TRS. The income tax benefit in the second quarter of 2009 resulted from pre-tax losses from Potlatch TRS and a federal tax credit associated with electricity produced from qualified energy resources and sold to an unrelated party, partially offset by built-in gains taxes on land sales in the period that we were not able to match for Section 1031 purposes. (See Note 3 to the financial statements for additional information related to the federal tax credit associated with the sale of electricity produced from qualified energy resources.)

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**Discontinued operations** The results of discontinued operations for the second quarters of both 2010 and 2009 included expenses associated with the Clearwater Paper businesses spun off in December 2008 and the Prescott mill closed in May 2008. The results for the second quarter of 2009 also included OSB-related legal expenses of \$0.1 million.

**Table of Contents****DISCUSSION OF BUSINESS SEGMENTS**

| (Dollars in thousands)  | Quarters Ended    |                  | Increase<br>(Decrease) |
|---|-------------------|------------------|------------------------|
|   | 2010              | June 30,<br>2009 |                        |
| <b>Segment Revenues:</b>  |                   |                  |                        |
| Resource  | \$ 50,455         | \$ 27,288        | \$ 23,167              |
| Real Estate   | 10,456            | 4,697            | 5,759                  |
| Wood Products   | 77,166            | 54,701           | 22,465                 |
| <b>Total segment revenues, before intersegment eliminations</b>                                 | <b>\$ 138,077</b> | <b>\$ 86,686</b> | <b>\$ 51,391</b>       |
| <b>Operating Income (Loss):</b>   |                   |                  |                        |
| Resource  | \$ 15,026         | \$ 4,525         | \$ 10,501              |
| Real Estate   | 5,117             | 1,507            | 3,610                  |
| Wood Products   | 5,956             | (2,993)          | 8,949                  |
| <b>Total segment operating income, before eliminations and adjustments, and corporate items</b> | <b>\$ 26,099</b>  | <b>\$ 3,039</b>  | <b>\$ 23,060</b>       |

**Resource Segment** Revenues for the segment increased \$23.2 million, or 85%, during the second quarter of 2010 over the same period in 2009, primarily as a result of a 46% increase in total sales volumes and a 29% increase in the weighted average price per ton. Our planned reduction in 2009 harvest levels, primarily in Idaho, took effect during the second quarter of 2009. In our Northern region, sawlog sales volumes and prices increased 148% and 22%, respectively. Northern pulpwood sales volumes increased 33% while prices decreased 4%. In our Southern region, sawlog sales volumes and prices increased 16% and 13%, respectively. Southern pulpwood sales volumes remained unchanged while prices for pulpwood increased 20%.

Expenses for the segment increased \$12.7 million, or 56%, during the second quarter of 2010 over the second quarter of 2009, primarily due to higher logging and hauling expense and depletion due to the increased harvest levels.

Operating income for our Resource segment increased \$10.5 million in the second quarter of 2010 over the same period in 2009.

**Real Estate Segment** Revenues increased \$5.8 million, expenses increased \$2.2 million and operating income increased \$3.6 million in the second quarter of 2010 compared to the same period in 2009. The increases are due to the number of acres sold, the types of properties sold and the sales prices per acre. Results for this segment depend to a large extent on the timing of closings of transactions for properties we sell and the types of properties sold.

The following table summarizes our real estate sales for the second quarters of 2010 and 2009:

|                           | Quarters Ended June 30, |                    |              |                    |
|---------------------------|-------------------------|--------------------|--------------|--------------------|
|                           | 2010                    |                    | 2009         |                    |
|                           | Acres Sold              | Average Price/Acre | Acres Sold   | Average Price/Acre |
| HBU development           | 1,872                   | \$ 2,014           | 628          | \$ 2,278           |
| Rural real estate         | 3,294                   | 1,097              | 2,927        | 1,116              |
| Non-strategic timberlands | 3,500                   | 877                |              |                    |
| <b>Total</b>              | <b>8,666</b>            |                    | <b>3,555</b> |                    |

**Wood Products Segment** Revenues for the segment increased \$22.5 million, or 41%, in the second quarter of 2010 over the same period in 2009, primarily due to average lumber selling prices per board foot being 34% higher than the previous year combined with a 9% increase in sales volumes.

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Expenses for the segment increased \$13.5 million, or 23%, in the second quarter of 2010 over the same quarter in 2009. The increased expenses were primarily the result of higher costs of sales associated with increased sales volumes. In addition, during the second quarter of 2010 we sold the railroad we operated in Idaho, which resulted in a pre-tax loss of \$1.8 million.

The Wood Products segment reported operating income of \$6.0 million for the second quarter of 2010, compared to an operating loss of \$3.0 million in the same quarter of 2009.

**Table of Contents****Six Months Ended June 30, 2010 Compared to Six Months Ended June 30, 2009**

The following table sets forth period-to-period changes in items included in our Consolidated Condensed Statements of Operations and Comprehensive Income for the six months ended June 30, 2010 and 2009.

| (Dollars in thousands)  | Six Months Ended<br>June 30, |            | Increase<br>(Decrease) |
|---|------------------------------|------------|------------------------|
|   | 2010                         | 2009       |                        |
| Revenues  | \$ 234,396                   | \$ 208,375 | \$ 26,021              |
| Costs and expenses:   |                              |            |                        |
| Cost of goods sold  | 182,789                      | 151,640    | 31,149                 |
| Selling, general and administrative expenses                  | 17,846                       | 20,200     | (2,354)                |
|   | 200,635                      | 171,840    | 28,795                 |
| Earnings from continuing operations before interest and taxes | 33,761                       | 36,535     | (2,774)                |
| Interest expense, net   | (14,177)                     | (9,676)    | (4,501)                |
| Earnings from continuing operations before taxes              | 19,584                       | 26,859     | (7,275)                |
| Income tax (provision) benefit                                | (6,372)                      | 5,604      | (11,976)               |
| Earnings from continuing operations                           | 13,212                       | 32,463     | (19,251)               |
| Discontinued operations, net of tax                           | (274)                        | (3,877)    | 3,603                  |
| Net earnings  | \$ 12,938                    | \$ 28,586  | \$ (15,648)            |

Certain 2009 amounts have been reclassified to conform to the 2010 presentation.

**Revenues** Revenues increased \$26.0 million, or 12%, in the six months ended June 30, 2010, compared to the same period in 2009, primarily due to increased revenues from the Wood Products and Resource segments, partially offset by decreased revenues from our Real Estate segment. A more detailed discussion of revenues follows in Discussion of Business Segments.

**Cost of goods sold** Cost of goods sold increased \$31.1 million, or 21%, in the first six months of 2010 compared to the same period in 2009. The higher expenses were primarily due to increased log costs and other expenses associated with increased production at our wood products manufacturing facilities, higher logging and hauling expense and depletion from the Resource segment due to increased harvest levels.

**Selling, general and administrative expenses** Selling, general and administrative expenses decreased \$2.4 million, or 12%, in the first six months of 2010 compared to the same period in 2009, primarily due to decreased compensation and benefits-related expenses in the first half of 2010.

**Interest expense, net** Net interest expense increased \$4.5 million, or 47%, in the first half of 2010 compared to the first half of 2009. Interest expense increased \$3.7 million over the same period in 2009, primarily due to interest associated with our \$150 million senior notes issuance in November 2009, partially offset by the fact that we did not incur any interest expense related to our bank credit facility, as we had no outstanding borrowings during the first six months of 2010. Amortization of deferred issuance costs increased \$0.8 million in the first half of 2010 over 2009, primarily related to our November 2009 senior notes issuance.

**Income tax (provision) benefit** We recorded an income tax provision of \$6.4 million and an income tax benefit of \$5.6 million related to our continuing operations for the six month periods ended June 30, 2010 and 2009, respectively. The income tax provision in the 2010 period was due to pre-tax income of Potlatch TRS. The income tax benefit in the 2009 period resulted from pre-tax losses from Potlatch TRS and a federal tax credit associated with electricity produced from qualified energy resources and sold to an unrelated party, partially offset by built-in gains taxes on land sales in the period that we were not able to match for Section 1031 purposes. (See Note 3 to the financial statements for additional information related to the federal tax credit associated with the sale of electricity produced from qualified energy resources.)

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**Discontinued operations** The results of discontinued operations for the six months ended June 30, 2010 and 2009 included expenses associated with the Clearwater Paper businesses spun off in December 2008 and the Prescott mill closed in May 2008. The 2009 results also included a pre-tax charge of \$5.75 million for the legal settlement related to the sale of our OSB manufacturing facilities in 2004, as well as \$0.8 million of OSB-related legal expenses.

**Table of Contents****DISCUSSION OF BUSINESS SEGMENTS**

| (Dollars in thousands)  | Six Months Ended<br>June 30, |                   | Increase<br>(Decrease) |
|---|------------------------------|-------------------|------------------------|
|   | 2010                         | 2009              |                        |
| <b>Segment Revenues:</b>  |                              |                   |                        |
| Resource  | \$ 95,268                    | \$ 74,494         | \$ 20,774              |
| Real Estate   | 13,903                       | 52,733            | (38,830)               |
| Wood Products   | 144,935                      | 99,530            | 45,405                 |
| <b>Total segment revenues, before intersegment eliminations</b>                                 | <b>\$ 254,106</b>            | <b>\$ 226,757</b> | <b>\$ 27,349</b>       |
| <b>Operating Income (Loss):</b>   |                              |                   |                        |
| Resource  | \$ 24,947                    | \$ 15,371         | \$ 9,576               |
| Real Estate   | 7,015                        | 43,019            | (36,004)               |
| Wood Products   | 11,184                       | (14,176)          | 25,360                 |
| <b>Total segment operating income, before eliminations and adjustments, and corporate items</b> | <b>\$ 43,146</b>             | <b>\$ 44,214</b>  | <b>\$ (1,068)</b>      |

**Resource Segment** Revenues for the segment increased \$20.8 million, or 28%, during the first six months of 2010 over the same period in 2009, primarily as a result of a 14% increase in total sales volumes and a 13% increase in the weighted average price per ton. Our 2009 planned harvest deferral began in the second quarter of 2009. In our Northern region, sawlog sales volumes and prices increased 41% and 12%, respectively. Northern pulpwood sales volumes and prices decreased 10% and 4%, respectively. The pulpwood market in Idaho declined during the first half of 2010 due to a region-wide reduction in demand as a result of other companies' closures of two large pulp manufacturing facilities in the Pacific Northwest. In our Southern region, sawlog sales volumes and prices increased 14% and 4%, respectively, in the first six months of 2010 over the same period in 2009. Southern pulpwood sales volumes decreased 16%, while prices for pulpwood increased 10%.

Expenses for the segment increased \$11.2 million, or 19%, during the first six months of 2010 over the same period in 2009, primarily due to higher logging and hauling expense and depletion due to the increased harvest levels.

Operating income for our Resource segment increased \$9.6 million, or 62%, for the first six months of 2010 over the same period in 2009.

**Real Estate Segment** Revenues decreased \$38.8 million, expenses decreased \$2.8 million and operating income decreased \$36.0 million in the first six months of 2010 compared to the same period in 2009, all primarily due to the sale of approximately 24,500 acres of non-strategic timberlands in Arkansas for approximately \$43.3 million in January 2009. Results for this segment depend to a large extent on the timing of closings of transactions for properties we sell and the types of properties sold.

The following table summarizes our real estate sales for the six months ended June 30, 2010 and 2009:

|                           | Six Months Ended June 30, |                       |               |                       |
|---------------------------|---------------------------|-----------------------|---------------|-----------------------|
|                           | 2010                      |                       | 2009          |                       |
|                           | Acres<br>Sold             | Average<br>Price/Acre | Acres<br>Sold | Average<br>Price/Acre |
| HBU development           | 2,064                     | \$ 2,004              | 1,060         | \$ 2,128              |
| Rural real estate         | 5,729                     | 1,169                 | 4,953         | 1,156                 |
| Non-strategic timberlands | 3,500                     | 877                   | 27,551        | 1,624                 |
| <b>Total</b>              | <b>11,293</b>             |                       | <b>33,564</b> |                       |

**Wood Products Segment** Revenues for the segment increased \$45.4 million, or 46%, in the first six months of 2010 over the same period in 2009, primarily due to average lumber selling prices per board foot 30% higher than the previous year combined with an 18% increase in sales volumes. Several of our mills ran at reduced production levels in the first half of 2009 due to market conditions and lack of demand for

manufactured wood products.

Expenses for the segment increased \$20.0 million, or 18%, for the first six months of 2010 over the same period in 2009. The increased expenses were the result of higher costs of sales associated with increased sales volumes. In addition, during the second quarter of 2010 we sold the railroad we operated in Idaho, which resulted in a pre-tax loss of \$1.8 million.



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The Wood Products segment reported operating income of \$11.2 million for the first six months of 2010, compared to an operating loss of \$14.2 million in the same period in 2009.

**LIQUIDITY AND CAPITAL RESOURCES**

At June 30, 2010, our financial position included long-term debt of \$368.4 million, including current installments on long-term debt of \$5.0 million. Stockholders' equity for the first six months of 2010 decreased \$21.1 million primarily due to our regular quarterly cash distributions to common stockholders of \$40.8 million, partially offset by net earnings of \$12.9 million. The ratio of long-term debt to stockholders' equity was 1.76 to 1 at June 30, 2010, compared to 1.60 to 1 at December 31, 2009.

Working capital totaled \$93.8 million at June 30, 2010, an increase of \$30.6 million from the December 31, 2009 balance of \$63.2 million. The significant changes in the components of working capital are as follows:

Other current assets increased \$42.6 million primarily due to the reclassification of timberland in Wisconsin and Arkansas that we anticipate will be sold before year-end from a noncurrent asset status to current.

Short-term investments decreased \$18.9 million primarily due to the payment of the regular quarterly cash distribution to common stockholders, partially offset by improved business results that have generated additional available cash for operations.

Receivables increased \$9.9 million primarily due to an increase in trade receivables as a result of increased sales volumes and prices.

The current portion of long-term debt increased \$5.0 million due to the scheduled maturity of \$5.0 million of medium-term notes in January 2011.

Scheduled payments due on long-term debt during each of the five years subsequent to December 31, 2010, are as follows:

| <b>(Dollars in thousands)</b> |          |
|-------------------------------|----------|
| 2011                          | \$ 5,011 |
| 2012                          | 21,662   |
| 2013                          | 8,413    |
| 2014                          | 21,000   |
| 2015                          | 22,500   |

**Cash Flows Summary**

The following table presents information regarding our cash flows for the six months ended June 30, 2010 and 2009.

| <b>(Dollars in thousands)</b>                 | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--------------------------------------|-------------|
|   | <b>2010</b>                          | <b>2009</b> |
| <b>Cash flows from continuing operations:</b> |                                      |             |
| Net cash provided by operations               | \$ 32,247                            | \$ 37,255   |
| Net cash provided by investing                | 15,032                               | 12,919      |
| Net cash used for financing                   | (42,559)                             | (48,301)    |
| Cash flows provided by continuing operations  | 4,720                                | 1,873       |
| Cash flows used for discontinued operations   | (594)                                | (580)       |

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|                             |          |          |
|-----------------------------|----------|----------|
| Increase in cash            | 4,126    | 1,293    |
| Cash at beginning of period | 1,532    | 885      |
| Cash at end of period       | \$ 5,658 | \$ 2,178 |

Net cash provided by operating activities from continuing operations for the first six months of 2010 totaled \$32.2 million, compared to \$37.3 million for the same period in 2009. The decrease was primarily due to lower operating earnings, no proceeds deposited with the LKE intermediary, changes in deferred taxes and decreased cash from working capital changes in the first six months of 2010 compared to the same period in 2009.

Net cash provided by investing activities from continuing operations totaled \$15.0 million and \$12.9 million for the six months ended June 30, 2010 and 2009, respectively. In the first six months of 2010, an \$18.9 million change in short-term investments and \$3.1 million of proceeds from the disposition of property, plant and equipment was partially offset by \$5.9 million of capital expenditures. In the first six months of 2009, a \$19.2 million change in short-term investments was partially offset by \$6.1 million of capital expenditures. Capital expenditures in both periods were primarily for reforestation activities and routine general replacement projects for our wood products manufacturing facilities.

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Net cash used for financing activities from continuing operations totaled \$42.6 million and \$48.3 million for the six months ended June 30, 2010 and 2009, respectively. Net cash used for financing activities in the first six months of 2010 was primarily for payment of our regular quarterly cash distributions to common stockholders of \$40.8 million. Net cash used for financing activities in the first six months of 2009 was primarily for payment of our regular quarterly cash distributions to stockholders of \$40.5 million and a \$7.8 million paydown on the outstanding balance of our bank credit facility.

Our regular quarterly cash distributions totaled \$40.8 million in the first six months of 2010. Based on our outlook for 2010 and taking into account planned harvest and real estate sales activities, we expect to fund a majority of our 2010 annual cash distributions using the cash flows from our timberland operations and proceeds from real estate sales. Any shortfall between cash available for distribution from operations and our 2010 distributions to stockholders is expected to be funded through cash on hand, bank borrowings, or a combination thereof. Our ability to fund distributions through bank borrowings is subject to our continued compliance with debt covenants, as well as the availability of borrowing capacity under our lending arrangements. If our operations do not generate sufficient cash flows and we are unable to borrow, we may be required to reduce our quarterly distributions. In addition, even if cash available for distribution from our operations is sufficient on an annual basis to fund the entire distribution to stockholders, we anticipate that it may be necessary to utilize some short-term borrowing to fully fund distributions in the first half of each year as a result of lower harvest activity during winter and early spring. Significant decreases in timber or real estate prices, reduced harvests or real estate sales activities, or other factors that have a material adverse effect on the cash flows from our operations could result in our inability to maintain our current distribution rate.

In addition, the rules with which we must comply to maintain our status as a REIT limit our ability to use dividends from our wood products manufacturing business for the payment of stockholder distributions. In particular, at least 75% of our gross income for each taxable year as a REIT must be derived from sales of our standing timber and other types of real estate income. No more than 25% of our gross income may consist of dividends from Potlatch TRS and other non-qualifying types of income. This requirement may limit our ability to receive dividends from Potlatch TRS and may impact our ability to fund distributions to stockholders using cash flows from Potlatch TRS.

Our board of directors, in its sole discretion, will determine the actual amount of distributions to be made to stockholders based on consideration of a number of factors, including, but not limited to, our results of operations, cash flow and capital requirements, economic conditions in our industry and the markets for our products, tax considerations, borrowing capacity, debt covenant restrictions, timber prices, harvest levels on our timberlands, market demand for timberlands, including timberland properties we have identified as potentially having a higher and better use, and future acquisitions and dispositions.

On November 3, 2009, we sold \$150 million aggregate principal amount of senior notes. The notes are due on November 1, 2019, have an interest rate of 7.5% and were issued at a price equal to 98.284% of their face value. The notes are general unsecured obligations and are therefore not secured by our assets. They are equal in right of payment with all existing and future unsecured senior debt and are senior in right of payment to all existing and future senior subordinated and subordinated debt. The notes are effectively subordinated to all of our existing and future secured debt to the extent of the value of the assets securing such debt, including borrowings under our secured bank credit facility and approximately \$71.3 million of other debt, which is secured by a pledge of the capital stock of our subsidiaries and by 640,900 acres of our timberlands in Idaho. The notes are unconditionally guaranteed by certain of our subsidiaries.

We have the option to redeem all or a portion of the notes at any time before maturity at a redemption price equal to 100% of the principal amount thereof plus a premium and accrued and unpaid interest. In addition, at any time prior to November 1, 2012, we have the option to redeem up to 35% of the principal amount of the notes with the net cash proceeds of certain equity offerings at a redemption price equal to 107.5% of the principal amount thereof plus accrued interest.

The terms of the notes limit our ability and the ability of any subsidiary guarantors to borrow money, pay dividends, redeem or repurchase capital stock, enter into sale and leaseback transactions, and create liens. With respect to the limitation on dividends and the repurchase of our capital stock, these restricted payments are permitted as follows:

We may use 100% of our Funds Available for Distribution, or FAD, for the period January 1, 2010 through the end of the quarter preceding the payment date, less cumulative restricted payments previously made from FAD during that period, to make restricted payments.

If our cumulative FAD, less cumulative restricted payments previously made from FAD, is insufficient to cover a restricted payment, then we are permitted to make payments from a basket amount, which was approximately \$90.1 million at June 30, 2010.



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If our cumulative FAD less our aggregate restricted payments made from FAD is insufficient to cover a restricted payment and we have depleted the basket, we may still make a restricted payment, so long as, after giving effect to the payment, our ratio of indebtedness to earnings before interest, taxes, depreciation, depletion, amortization and basis of real estate sold, or EBITDDA, from continuing operations for the preceding four full fiscal quarters does not exceed 4.25 to 1.00.

FAD, as defined in the indenture governing the senior notes, is earnings from continuing operations, plus depreciation, depletion and amortization, plus basis of real estate sold, and minus capital expenditures. For purposes of this definition, capital expenditures exclude all expenditures relating to direct or indirect timberland purchases in excess of \$5 million. Under this definition, our FAD for the twelve months ended June 30, 2010 was \$92.6 million and our distributions paid in this same twelve-month period were \$81.4 million.

Our current secured bank credit facility, which expires on December 8, 2013, provides for a revolving line of credit of up to \$250 million, including a \$35 million subfacility for letters of credit and a \$20 million subfacility for swing line loans. Usage under either or both subfacilities reduces availability under the revolving line of credit. Subject to certain conditions and agreement of the lenders, the facility may be increased by up to an additional \$100 million. As of June 30, 2010, there were no borrowings outstanding under the revolving line of credit, and approximately \$6.8 million of the letter of credit subfacility was being used to support several outstanding letters of credit. Available borrowing capacity at June 30, 2010 was \$243.2 million. Loans made under our bank credit facility can be either (1) Eurodollar loans, which bear interest at the one-month LIBOR or (2) Base Rate loans, which bear interest equal to the highest of (a) the current Federal Funds Rate plus 1/2 of 1%, (b) the one-month LIBOR, or (c) the rate effectively equal to the bank's prime rate. The interest rate we pay for borrowings under either type of loan includes an additional applicable rate of between 3.0% and 4.0%, based upon our Funded Indebtedness to Capitalization Ratio from the prior quarter. As of June 30, 2010, we were able to borrow under the bank credit facility with the additional applicable rate of 3.75%. We pay commitment fees of 0.5% on the unused balance of the bank credit facility.

The bank credit facility is secured by a pledge of the capital stock of our subsidiaries and by 640,900 acres of our timberlands in Idaho to satisfy the minimum collateral coverage ratio, as described below. This pledge is on an equal rights of payment and level of seniority basis with the \$22.5 million principal amount of 6.95% debentures due 2015 and the \$48.8 million principal amount of medium-term notes due 2011 through 2022.

The agreement governing our bank credit facility contains certain covenants that limit our ability and that of our subsidiaries to create liens, merge or consolidate, dispose of assets, incur indebtedness and guarantees, repurchase or redeem capital stock and indebtedness, make certain investments or acquisitions, enter into certain transactions with affiliates or change the nature of our business. The bank credit facility also contains financial maintenance covenants establishing a minimum interest coverage ratio, a minimum collateral coverage ratio and a maximum funded indebtedness to capitalization ratio. We will be permitted to pay distributions to our stockholders under the terms of the credit facility so long as we remain in pro forma compliance with the financial maintenance covenants.

The table below sets forth the most restrictive covenants in the bank credit facility and our status with respect to these covenants as of June 30, 2010.

|   | Covenant Requirement | Actual Ratio at June 30, 2010 |
|---|----------------------|-------------------------------|
| Minimum Interest Coverage Ratio                     | 2.50 to 1.00 *       | 4.81 to 1.00                  |
| Minimum Collateral Coverage Ratio                   | 2.25 to 1.00         | 3.56 to 1.00                  |
| Maximum Funded Indebtedness to Capitalization Ratio | 60.0%                | 53.3%                         |

\* Commencing October 1, 2010, the Minimum Interest Coverage Ratio will increase to 2.75 to 1.00 and commencing October 1, 2011, the Minimum Interest Coverage Ratio will increase to 3.00 to 1.00.

Events of default under the bank credit facility include, but are not limited to, payment defaults, covenant defaults, breaches of representations and warranties, cross defaults to certain other material agreements and indebtedness, bankruptcy and other insolvency events, material adverse judgments, actual or asserted invalidity of security interests or loan documentation, and certain change of control events.

We and several of our subsidiaries are parties to the bank credit agreement and eligible to borrow thereunder, subject to the \$250 million aggregate credit limit and continued compliance with debt covenants. Any borrowings by one of these entities under the bank credit facility reduces the credit available for all the entities. As a result, borrowings by Potlatch TRS under the bank credit facility will, until repaid, reduce the amount of borrowings otherwise available to us for purposes such as the funding of quarterly distributions.

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We believe that our cash, cash flows from continuing operations and available borrowings under our bank credit facility will be sufficient to fund our operations, regular stockholder distributions, capital expenditures and debt service obligations for the next twelve months. We cannot assure, however, that our business will generate sufficient cash flows from operations or that we will be in compliance with the financial covenants in our bank credit facility so that future borrowings thereunder will be available to us. Thus, our ability to fund our operations and stockholder distributions will be dependent

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upon our future financial performance, which will be affected by general economic, competitive and other factors, including those discussed above under the heading Factors Influencing our Results of Operations and Cash Flows, many of which are beyond our control.

### **OFF-BALANCE SHEET ARRANGEMENTS**

We currently are not a party to off-balance sheet arrangements that would require disclosure under this section.

### **ENVIRONMENTAL**

We are subject to extensive federal and state environmental regulation of our operating facilities and timberlands, particularly with respect to air emissions, wastewater discharges, solid and hazardous waste management, site remediation, forestry operations, and threatened and endangered species. Compliance with environmental regulations is a significant factor in our business and requires capital expenditures as well as additional operating costs. Capital expenditures specifically designated for environmental compliance totaled less than \$0.1 million during 2009 and are expected to be approximately \$0.1 million in 2010.

Our timberlands have been audited by independent third parties for compliance with the Forest Stewardship Council, or FSC, program and the International Standardization Organization, or ISO, 14001 standard for environmental management systems. Our timberlands in Idaho and Arkansas were audited in 2009 by an independent third party for compliance with the ISO 14001 standard for environmental management systems. A field audit for Minnesota and Wisconsin was not required during 2009. We were certified to be in compliance with the ISO 14001 standard on our timberlands. Our timberlands in Arkansas, Minnesota and Wisconsin were audited in late 2009 by an independent third party for compliance with the FSC forest management standard. A field audit for Idaho was not required during 2009. We have not yet received our audit reports from the FSC, but anticipate continued certification under the FSC program for our timberlands, although the certification of our Arkansas timberlands is subject to satisfactory resolution of a corrective action request with respect to certain harvesting and stand re-establishment issues. Participation in the FSC and ISO programs is voluntary, and can require operating processes which are more stringent than existing federal or state requirements.

In January 2007, the U.S. Environmental Protection Agency, or EPA, notified us that we are a potentially responsible party under the federal Comprehensive Environmental Response, Compensation and Liability Act of 1980 and the Clean Water Act for clean-up of a site known as Avery Landing in northern Idaho. We own a portion of the land at the Avery Landing site, which we acquired in 1980 from the Milwaukee Railroad. The land we own at the site and adjacent properties were contaminated with petroleum as a result of the Milwaukee Railroad's operations at the site and adjacent properties prior to 1980. We entered into a consent order with the EPA in August 2008 to conduct an Engineering Evaluation/Cost Analysis, or EE/CA, study to determine the best means of addressing the contamination at the site. In January 2010, we submitted our draft EE/CA report to the EPA outlining various alternatives for addressing the contamination at the entire site (including adjacent properties). The range of cost estimates for the various alternatives to address the contamination at the entire site is from \$0.7 million to \$8.2 million. In April 2010, we were notified by the EPA that they determined the EE/CA report submitted by us contained deficiencies. Accordingly, the EPA will now be completing the EE/CA report for the Avery Landing site and also producing the Biological Assessment and Cultural Resources Evaluation reports. We anticipate the EPA will issue the reports in the fall of 2010. Currently we are under no legal obligation to implement any remedy selected by the EPA. We believe we have valid defenses available to limit our potential liability at the site. There is also the possibility of pursuing recovery from third parties as a means of further limiting our liability. As of June 30, 2010, we have accrued \$0.7 million for this matter.

The EPA has developed Maximum Achievable Control Technology, or MACT, standards under the Federal Clean Air Act for air emissions from plywood and composite wood facilities. We believe that we have complied with the applicable MACT standards. We also believe that our manufacturing facilities and timberland operations are currently in substantial compliance with applicable environmental laws and regulations. We cannot be certain, however, that situations that may give rise to material environmental liabilities will not be discovered or that the enactment of new environmental laws or regulations, or changes in existing laws or regulations, or their enforcement, will not require significant expenditures by us.

ITEM 3.

### **Quantitative and Qualitative Disclosures About Market Risk**

Our exposure to market risks on financial instruments includes interest rate risk on our short-term investments, bank credit facility and interest rate swap agreements.

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Our short-term investments are invested in time or demand deposits, certificates of deposit and U.S. Treasury and U.S. government agency obligations, all of which have very short maturity periods, and they therefore earn an interest rate commensurate with low-risk instruments. We do not attempt to hedge our exposure to interest rate risk for our short-term investments. All short-term investments are made in compliance with the requirements of the Internal Revenue Code with respect to qualifying REIT investments.



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The interest rates applied to borrowings under our bank credit facility adjust often and therefore react quickly to any movement in the general trend of market interest rates. We do not attempt to mitigate the effects of short-term interest rate fluctuations on our bank credit facility borrowings through the use of derivative financial instruments. There were no outstanding borrowings at June 30, 2010.

The majority of our long-term debt is fixed rate and therefore changes in market interest rates do not expose us to interest rate risk for these financial instruments. However, on June 30, 2010, we entered into interest rate swap agreements, effective July 1, 2010, on \$68.25 million of fixed rate debt securities, or approximately 19% of our long-term debt. The swaps converted interest payments with fixed rates ranging between 6.95% and 8.89% to a three-month LIBOR plus a spread between 4.738% and 7.8375%.

The major debt rating agencies routinely evaluate our debt and our access to capital, and our costs of borrowing can increase or decrease depending on our credit rating. Since October 2005, S&P has rated our senior unsecured debt at BB. In December 2008, S&P raised its issue-level rating on our existing notes and debentures to BB+. In February 2010, S&P affirmed our BB rating, with a stable outlook. Since October 2004, Moody's has rated our senior unsecured debt at Ba1. Moody's affirmed this rating, with a stable outlook, in January 2010.

**QUANTITATIVE INFORMATION ABOUT MARKET RISKS**

(Dollars in thousands)

|                       | Expected Maturity Date (as of June 30, 2010) |          |           |          |           | Thereafter | Total      |
|-----------------------|--|----------|-----------|----------|-----------|------------|------------|
|                       | 2010   | 2011     | 2012      | 2013     | 2014      |            |            |
| Long-term debt:       |  |          |           |          |           |            |            |
| Fixed rate            | \$ 0   | \$ 5,011 | \$ 21,662 | \$ 8,413 | \$ 21,000 | \$ 315,335 | \$ 371,421 |
| Average interest rate | 0%   | 8.6%     | 8.3%      | 7.5%     | 7.1%      | 7.1%       | 7.2%       |
| Fair value at 6/30/10 |  |          |           |          |           |            | \$ 369,278 |

ITEM 4.

**Controls and Procedures**

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities and Exchange Act of 1934, or the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of disclosure controls and procedures is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Subject to the limitations noted above, our management, with the participation of our CEO and CFO, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the fiscal quarter covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the CEO and CFO concluded that, as of June 30, 2010, our disclosure controls and procedures were effective to meet the objective for which they were designed and operated at the reasonable assurance level.

There were no changes in our internal control over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**Part II**

ITEM 1.

**Legal Proceedings**

We are a party to various legal proceedings arising in the ordinary course of business, which we do not believe to be material to our business, financial condition or liquidity.

ITEM 6.

**Exhibits**

The exhibit index is located on page 34 of this Form 10-Q.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

July 30, 2010  
Date

**POTLATCH CORPORATION**

/s/ Eric J. Cremers  
Eric J. Cremers  
Vice President, Finance &

Chief Financial Officer  
(Duly Authorized Officer & Principal Financial Officer)

July 30, 2010  
Date

/s/ Terry L. Carter  
Terry L. Carter  
Controller and Treasurer

(Duly Authorized Officer & Principal Accounting Officer)

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POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

**EXHIBIT INDEX**

| <b>EXHIBIT<br/>NUMBER</b> | <b>DESCRIPTION</b>   |
|---------------------------|--|
| (4)                       | Registrant undertakes to furnish to the Commission, upon request, any instrument defining the rights of holders of long-term debt.   |
| (31)                      | Rule 13a-14(a)/15d-14(a) Certifications.   |
| (32)                      | Furnished statements of the Chief Executive Officer and Chief Financial Officer under 18 U.S.C. Section 1350.  |
| 101                       | The following financial information from Potlatch Corporation's Quarterly Report on Form 10-Q for the quarter ended June 30, 2010, filed on July 30, 2010, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Condensed Statements of Operations and Comprehensive Income for the quarters and six months ended June 30, 2010 and 2009, (ii) the Consolidated Condensed Balance Sheets at June 30, 2010 and December 31, 2009, (iii) the Consolidated Condensed Statements of Cash Flows for the six months ended June 30, 2010 and 2009, and (iv) the Notes to Consolidated Condensed Financial Statements, tagged as blocks of text. |