POTLATCH CORP
Form 10-Q
October 23, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)
x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2012
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)

Delaware	82-0156045
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
601 West First Avenue, Suite 1600 Spokane, Washington	99201
(Address of principal executive offices)	(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 x 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 x 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	x	Accelerated filer	o
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x
The number of shares of common stock of the registrant outstanding as of October 12, 2012 was 40,373,461.

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES
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Part I

ITEM 1.
Financial Statements

Potlatch Corporation and Consolidated Subsidiaries
Consolidated Statements of Income
Unaudited (Dollars in thousands, except per-share amounts)

	Quarter Ended September 30, 2012	2011	Nine Months Ended September 30, 2012	2011
Revenues	$151,911	$152,891	$381,835	$387,494
Costs and expenses:				
Cost of goods sold	109,806	108,420	287,469	287,473
Selling, general and administrative expenses	13,342	7,837	35,994	28,469
Asset impairment charge	—	1,180	—	1,180
	123,148	117,437	323,463	317,122
Operating income	28,763	35,454	58,372	70,372
Interest expense, net	(6,280)	(6,632)	(19,043)	(21,123)
Income before income taxes	22,483	28,822	39,329	49,249
Income tax provision	(3,884)	(3,223)	(10,599)	(7,505)
Net income	$18,599	$25,599	$28,730	$41,744
Net income per share:				
Basic	$0.46	$0.64	$0.71	$1.04
Diluted	0.46	0.63	0.71	1.03
Distributions per share	$0.31	$0.51	$0.93	$1.53
Weighted-average shares outstanding (in thousands):				
Basic	40,357	40,187	40,317	40,147
Diluted	40,571	40,380	40,503	40,360

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

Potlatch Corporation and Consolidated Subsidiaries
Consolidated Statements of Comprehensive Income
Unaudited (Dollars in thousands)

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	$18,599	$25,599	$28,730	$41,744
Other comprehensive income, net of tax:				
Defined benefit pension plans and other postretirement employee benefits:				
Amortization of prior service credit included in net periodic cost, net of tax of $(836), $(765), $(2,548) and $(2,297)	(1,308)	(1,198)	(3,986)	(3,592)
Amortization of actuarial loss included in net periodic cost, net of tax of $1,801, $1,354, $5,405 and $4,061	2,819	2,117	8,457	6,351
Other comprehensive income, net of tax	1,511	919	4,471	2,759
Comprehensive income	$20,110	$26,518	$33,201	$44,503

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

Potlatch Corporation and Consolidated Subsidiaries
Consolidated Condensed Balance Sheets
Unaudited (Dollars in thousands, except per-share amounts)

	September 30, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash	$9,033	$7,819
Short-term investments	53,429	62,989
Receivables, net	24,532	13,533
Inventories	29,431	28,603
Deferred tax assets	11,909	11,909
Other assets	10,435	9,998
Total current assets	138,769	134,851
Property, plant and equipment, net	58,093	61,453
Timber and timberlands, net	455,415	459,687
Deferred tax assets	44,541	57,924
Other assets	11,898	32,305
	$708,716	$746,220
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current installments on long-term debt	$8,413	$21,661
Accounts payable and accrued liabilities	67,046	55,948
Total current liabilities	75,459	77,609
Long-term debt	337,308	344,742
Liability for pensions and other postretirement employee benefits	135,854	163,116
Other long-term obligations	20,210	18,615
Stockholders' equity	139,885	142,138
	$708,716	$746,220
Shares outstanding (in thousands)	40,369	40,202
Stockholders' equity per share	$3.47	$3.54
Working capital	$63,310	$57,242
Current ratio	1.8	1.7

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

Potlatch Corporation and Consolidated Subsidiaries
Consolidated Condensed Statements of Cash Flows
Unaudited (Dollars in thousands)

	Nine Months Ended September 30,	
	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$28,730	$41,744
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and amortization	19,271	22,916
Basis of real estate sold	1,623	10,053
Change in deferred taxes	10,539	7,506
Gain on disposition of property, plant and equipment	(1)	(106)
Employee benefit plans	3,001	(1,589)
Equity-based compensation expense	3,057	3,144
Asset impairment	—	1,180
Proceeds from sales deposited with a like-kind exchange intermediary	(526)	—
Funding of qualified pension plans	(21,630)	(9,400)
Working capital changes	(1,031)	(3,342)
Net cash provided by operating activities	43,033	72,106
CASH FLOWS FROM INVESTING ACTIVITIES		
Decrease in short-term investments	9,560	10,559
Proceeds from company owned life insurance (COLI) loan	21,751	—
Additions to property, plant and equipment	(3,502)	(4,163)
Additions to timber and timberlands	(8,367)	(7,915)
Proceeds from disposition of property, plant and equipment	35	185
Other, net	(1,252)	(1,564)
Net cash provided by (used for) investing activities	18,225	(2,898)
CASH FLOWS FROM FINANCING ACTIVITIES		
Distributions to common stockholders	(37,520)	(61,458)
Payments on long-term debt	(21,662)	(5,011)
Issuance of common stock	709	1,230
Change in book overdrafts	(29)	(1,377)
Deferred financing costs	(30)	(343)
Employee tax withholdings on equity-based compensation	(1,714)	(1,610)
Other, net	202	(15)
Net cash used for financing activities	(60,044)	(68,584)
Increase in cash	1,214	624
Cash at beginning of period	7,819	5,593
Cash at end of period	$9,033	$6,217
SUPPLEMENTAL CASH FLOW INFORMATION		
Cash paid (received) during the period for:		
Interest, net of amount capitalized	$13,171	$13,974
Income taxes, net	(38)	(5,977)
Non-cash investing activity:		
Additions to timber and timberlands	60	341

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

Potlatch Corporation and Consolidated Subsidiaries
Notes to Consolidated Financial Statements
Unaudited (Dollars in thousands)

NOTE 1.
Basis of Presentation
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.
The accompanying Consolidated Statements of Income for the quarters and nine months ended September 30, 2012 and 2011, the Consolidated Statements of Comprehensive Income for the quarters and nine months ended September 30, 2012 and 2011, the Consolidated Condensed Balance Sheets at September 30, 2012 and December 31, 2011 and the Consolidated Condensed Statements of Cash Flows for the nine months ended September 30, 2012 and 2011 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.
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, 2011, as filed with the Securities and Exchange Commission on February 17, 2012.

NOTE 2.
Recent Accounting Pronouncements
In June 2011, the Financial Accounting Standards Board, or FASB, issued Accounting Standard Update, or ASU, 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income, to increase the prominence of other comprehensive income in the financial statements. An entity has the option to present the components of net income and comprehensive income in either one or two consecutive financial statements. The new guidance is effective for fiscal years and interim periods beginning after December 15, 2011. We adopted this guidance and presented the components of net income and comprehensive income in two consecutive statements. The adoption of ASU 2011-05 did not have a material effect on our consolidated financial condition or results of operations.

NOTE 3.
Income Taxes
As a real estate investment trust, or REIT, if we meet certain requirements we generally are not subject to federal and state corporate income taxes on our income from investments in real estate that we distribute to our shareholders. We are, however, subject to corporate taxes on income earned by our taxable REIT subsidiaries, or Potlatch TRS, and 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, except for sales that occurred in 2011. The Small Business Jobs Act of 2010 modified the built-in gains provisions to exempt sales of real properties by a REIT in 2011, if five years of the recognition period had elapsed before January 1, 2011. 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.
For the quarters ended September 30, 2012 and 2011, we recorded income tax provisions related to Potlatch TRS of $3.9 million and $3.2 million, respectively, due to pre-tax income. For the nine months ended September 30, 2012 and 2011, we recorded income tax provisions related to Potlatch TRS of $10.5 million and $7.5 million, respectively, due to pre-tax income. For the nine months ended September 30, 2012, we recorded income tax expense of $0.1 million related to the sale of REIT properties.

We reviewed our tax positions at September 30, 2012 and determined that no uncertain tax positions were taken during the first nine months of 2012, and that no new information was available that would require derecognition of previously taken positions.

We reflect accrued interest related to tax obligations, as well as penalties, in our provision for income taxes. During the nine months ended September 30, 2012 and 2011, amounts for interest and penalties included in our tax provision were insignificant. At September 30, 2012 and December 31, 2011, we had no accrued interest or penalties related to income taxes.

NOTE 4.
Earnings per Share
The following table reconciles the number of shares used in calculating the basic and diluted earnings per share for the quarters and nine months ended September 30:

	Quarter Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands, except per-share amounts)	2012	2011	2012	2011
Net income	$18,599	$25,599	$28,730	$41,744
Basic weighted-average shares outstanding	40,356,512	40,187,334	40,316,957	40,147,133
Incremental shares due to:				
Stock options	27,558	44,147	20,263	54,048
Performance shares	119,400	120,182	102,000	129,691
Restricted stock units	67,598	28,639	63,938	29,005
Diluted weighted-average shares outstanding	40,571,068	40,380,302	40,503,158	40,359,877
Basic net income per share	$0.46	$0.64	$0.71	$1.04
Diluted net income per share	$0.46	$0.63	$0.71	$1.03
Anti-dilutive shares excluded from the calculation:				
Performance shares	—	77,767	—	77,767
Restricted stock units	—	—	1,000	2,700
Total anti-dilutive shares excluded from the calculation	—	77,767	1,000	80,467

NOTE 5.
Equity-Based Compensation
As of September 30, 2012, we had three stock incentive plans under which stock option, performance share or restricted stock unit, or RSU, grants were outstanding, with approximately 367,000 shares authorized for future use under the 2005 Stock Incentive Plan.
The following table details our compensation expense for the quarters and nine months ended September 30:

	Quarter Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2012	2011	2012	2011
Employee equity-based compensation expense:				
Performance shares	$891	$942	$2,598	$2,707
Restricted stock units	168	155	459	437
Total employee equity-based compensation expense	$1,059	$1,097	$3,057	$3,144
Related net income tax benefit	$—	$—	$—	$—
Director deferred compensation expense (income)	$1,126	$(373)	$1,553	$484

There were no realized tax benefits related to the excess of the deductible amount over the compensation cost recognized in the Consolidated Condensed Statements of Cash Flows during any of the periods presented above.

STOCK OPTIONS

The following table summarizes outstanding stock options as of September 30, 2012 and changes during the nine months ended September 30, 2012:

(Dollars in thousands, except exercise prices)	Shares	Weighted Avg. Exercise Price	Aggregate Intrinsic Value
Outstanding at January 1	144,684	$23.34	
Shares exercised	(40,830)	16.63	$679
Shares canceled or expired	—	—	
Outstanding and exercisable at September 30	103,854	25.68	1,214

There were no unvested stock options outstanding during the nine months ended September 30, 2012. The aggregate intrinsic value of stock options exercised during the nine months ended September 30, 2011 was $1.3 million.

The following table summarizes outstanding stock options as of September 30, 2012:

	Options Outstanding and Exercisable		
Range of Exercise Prices	Outstanding	Weighted Avg. Remaining Contractual Life	Weighted Avg. Exercise Price
$14.4398	11,545	0.17 years	$14.44
$19.2569	30,340	1.17 years	19.26
$30.9204	61,969	2.17 years	30.92
$14.4398 to $30.9204	103,854	1.66 years	25.68

Cash received from stock option exercises for the nine months ended September 30, 2012 and 2011 was $0.7 million and $1.2 million, respectively. No actual tax benefits were realized for tax deductions from options exercised during either period.

PERFORMANCE SHARES

The following table presents the key inputs used in the Monte Carlo simulation method to calculate the fair value of the performance share awards in 2012 and 2011, and the resulting fair values:

	2012	2011
Shares granted	85,028	77,767
Stock price as of valuation date	$31.11	$39.10
Risk-free rate	0.40%	1.26%
Fair value of a performance share	$34.24	$55.84

The following table summarizes outstanding performance share awards as of September 30, 2012, and changes during the nine months ended September 30, 2012:

(Dollars in thousands, except grant date fair value)	Shares	Weighted Avg. Grant Date Fair Value	Aggregate Intrinsic Value
Unvested shares outstanding at January 1	154,594	$50.54	
Granted	85,028	34.24	
Forfeited	(2,596)	44.99	
Unvested shares outstanding at September 30	237,026	44.76	$8,657

As of September 30, 2012, there was $4.2 million of unrecognized compensation cost related to non-vested performance share awards, which is expected to be recognized over a weighted average period of 1.25 years.

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RESTRICTED STOCK UNITS

The following table summarizes outstanding RSU awards as of September 30, 2012, and changes during the nine months ended September 30, 2012:

(Dollars in thousands, except grant date fair value)	Shares	Weighted Avg. Grant Date Fair Value	Aggregate Intrinsic Value
Unvested shares outstanding at January 1	36,359	$35.60	
Granted	19,725	31.38	
Vested	(1,290)	33.27	
Forfeited	(1,504)	33.36	
Unvested shares outstanding at September 30	53,290	34.16	$1,991

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 nine months ended September 30, 2012 was less than $0.1 million. As of September 30, 2012, there was $0.8 million of unrecognized compensation cost related to non-vested RSU awards, which is expected to be recognized over a weighted average period of 1.3 years.

NOTE 6.

Detail of Certain Balance Sheet Accounts

The following tables detail certain accounts as of the balance sheet dates:

(Dollars in thousands)	September 30, 2012	December 31, 2011
Inventories:		
Lumber and other manufactured wood products	$13,168	$12,002
Logs	11,703	12,400
Materials and supplies	4,560	4,201
	$29,431	$28,603
Current Other Assets:		
Basis of real estate held for sale	$7,433	$7,433
Prepaid expenses	1,567	1,128
Deferred charges	1,435	1,437
	$10,435	$9,998
Noncurrent Other Assets:		
Developed land costs	$3,626	$3,635
Derivative asset associated with interest rate swap	3,170	2,409
Deferred charges	2,973	4,129
Noncurrent investments	1,496	22,043
Restricted cash	526	—
Other	107	89
	$11,898	$32,305

The decrease in Noncurrent Other Assets - Noncurrent investments as of September 30, 2012 from December 31, 2011 was due to borrowing against our company owned life insurance, or COLI, plan, based on the cash surrender value that had accumulated over the years, to make a pension contribution.

NOTE 7.

Pension Plans and Other Postretirement Employee Benefits

The following tables detail the components of net periodic cost (benefit) of our pension plans and other postretirement employee benefits, or OPEB, for the quarters and nine months ended September 30:

Quarters ended September 30:

	Pension Plans		Other Postretirement Employee Benefits	
(Dollars in thousands)	2012	2011	2012	2011
Service cost	$1,309	$1,114	$71	$112
Interest cost	4,997	5,331	620	871
Expected return on plan assets	(7,188)	(7,951)	—	—
Amortization of prior service cost (credit)	192	171	(2,336)	(2,134)
Amortization of actuarial loss	3,839	2,479	781	992
Net periodic cost (benefit)	$3,149	$1,144	$(864)	$(159)

Nine months ended September 30:

	Pension Plans		Other Postretirement Employee Benefits	
(Dollars in thousands)	2012	2011	2012	2011
Service cost	$3,928	$3,342	$213	$335
Interest cost	14,990	15,994	1,859	2,614
Expected return on plan assets	(21,566)	(23,853)	—	—
Amortization of prior service cost (credit)	577	513	(7,111)	(6,402)
Amortization of actuarial loss	11,517	7,437	2,345	2,975
Net periodic cost (benefit)	$9,446	$3,433	$(2,694)	$(478)

Our minimum funding requirement for 2012 was $9.7 million. During the first quarter of 2012, we borrowed against our COLI plan, based on the cash surrender value that had accumulated over the years, to make a $21.6 million pension contribution. We contributed $9.3 million to our qualified salaried pension plan, $6.8 million to our qualified hourly pension plan and $5.5 million to our qualified non-represented pension plan, with $11.9 million being discretionary funding. We do not anticipate additional contributions to any of our qualified pension plans in 2012. During the nine months ended September 30, 2012, we made contributions of $1.3 million to our non-qualified supplemental pension plan.

The following table details the components of "Other comprehensive income, net of tax" on our Consolidated Statements of Comprehensive Income of our pension plans and OPEB for the quarters and nine months ended September 30:

	Quarter Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2012	2011	2012	2011
Other comprehensive income, net of tax, related to:				
Defined benefit pension plans	$2,459	$1,616	$7,377	$4,849
OPEB obligations	(948)	(697)	(2,906)	(2,090)
Other comprehensive income, net of tax	$1,511	$919	$4,471	$2,759

NOTE 8.
Financial Instruments
The following table presents the estimated fair values of our financial instruments as of the balance sheet dates:

(Dollars in thousands)	September 30, 2012 Carrying Amount	Fair Value	December 31, 2011 Carrying Amount	Fair Value
Cash, restricted cash and short-term investments (Level 1)	$62,988	$62,988	$70,808	$70,808
Net derivative asset related to interest rate swaps (Level 2)	3,170	3,170	2,409	2,409
Derivative asset related to lumber swap (Level 2)	—	—	480	480
Long-term debt, including current installments on long-term debt (including fair value adjustments related to fair value hedges) (Level 2)	345,721	361,111	366,403	373,791

FAIR VALUE HEDGES OF INTEREST RATE RISK
As of September 30, 2012, we had six separate interest rate swap agreements with notional amounts totaling $46.75 million, associated with our $22.5 million debentures and $24.25 million of our medium-term notes. The swaps convert interest payments with fixed rates between 6.95% and 8.89% to variable rates of three-month LIBOR plus spreads between 4.738% and 6.518%. The interest rate swaps terminate at various dates between December 2015 and February 2018.
No net unrealized gain or loss was recognized in income for all periods presented because we recognized no hedge ineffectiveness.
NON-DESIGNATED LUMBER SWAP
In February 2012, we entered into two commodity swap contracts for a total of 22,500 mbf (thousand board feet) of southern yellow pine, which settled during the second quarter of 2012. In September 2011, we entered into a commodity swap contract for 31,200 mbf of southern yellow pine with an effective date of November 1, 2011 and a termination date of February 29, 2012. In October 2010, we entered into a commodity swap contract for 14,300 mbf of southern yellow pine, which settled in the first quarter of 2011. Changes in the fair value of derivatives not designated in hedging relationships are recorded directly in net income. As of September 30, 2012 there were no outstanding lumber swap contracts.
The following table presents the fair values of derivative instruments as of the balance sheet dates:

(Dollars in thousands)	Balance Sheet Location	September 30, 2012	December 31, 2011
Fair Value of Derivative Assets:			
Derivatives designated as hedging instruments:			
Interest rate contracts	Other assets (non-current)	$3,170	$2,409
Total derivatives designated as hedging instruments		$3,170	$2,409
Derivatives not designated as hedging instruments:			
Lumber contracts	Receivables, net	$—	$480
Total derivatives not designated as hedging instruments		$—	$480

There were no derivatives recorded as liabilities as of September 30, 2012 or December 31, 2011.

The following table details the effect of derivatives on the Consolidated Statements of Income for the quarters and nine months ended September 30:

	Location of Gain (Loss) Recognized in Income	Gain (Loss) Recognized in Income			
		Quarter Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)		2012	2011	2012	2011