# FORTRESS PAPER LTD.

# Q2 2010

## FOR THE THREE AND SIX MONTHS ENDED

## JUNE 30, 2010

**FORTRESS PAPER LTD.**
**MANAGEMENT'S DISCUSSION AND ANALYSIS**

This Management's Discussion and Analysis ("MD&A") of the financial condition and results of operations of Fortress Paper Ltd ("Fortress" or the "Company") has been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and should be read in conjunction with the unaudited consolidated financial statements and the notes thereto for the three and six month periods ended June 30, 2010 and with the audited consolidated financial statements for the year ended December 31, 2009 (available on SEDAR at www.sedar.com). The MD&A provides a review of the significant developments that have impacted the Company's performance during the quarter ended June 30, 2010 relative to the previous quarter and prior year comparative quarter.

This MD&A contains certain forward-looking statements that reflect the current views and/or expectations of the Company with respect to its performance, business and future events. The reader is cautioned that forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements including, without limitation, those relating to damage to our reputation, competition, maintaining our market position, marketability and price of our products, technology and protection of our intellectual property, dependence on our major customers, fluctuations in the price and supply of raw materials, fluctuations in foreign exchange and other risk factors detailed in our filings with Canadian securities regulatory authorities. These risks, as well as others, could cause actual results and events to vary significantly. The Company does not undertake any obligation to release publicly any revisions for updating any voluntary forward-looking statements, except as required by law.

Throughout this discussion, reference is made to EBITDA (defined as net income before interest, income taxes, depreciation, amortization, non-operating income and expenses and stock based compensation), which the Company considers to be an indicative measure of operating performance and a good metric to evaluate profitability. EBITDA is not a generally accepted earnings measure and should not be considered as an alternative to net income or cash flows as determined in accordance with GAAP. As there is no standardized method of calculating EBITDA, the Company's use of the term may not be directly comparable with similarly titled measures used by other companies. A reconciliation of EBITDA to net income reported in accordance with GAAP is included in this MD&A.

The information in this report is as at August 6, 2010.

All financial references are in Canadian dollars unless otherwise noted.

## Description of Business

The Company was incorporated on May 30, 2006 under the laws of the Province of British Columbia. Fortress Paper Ltd. is an international producer of security and other specialty papers and products. The Company owns and operates three mills, the Landqart mill located in Switzerland, the Dresden mill located in Germany and the Fortress Specialty Cellulose mill located in Quebec, Canada. Fortress' security papers include banknote, passport and visa papers. The security papers produced at the Landqart mill incorporate internationally recognized overt and covert security features which are embedded into the paper and supplemented with customer-specific features. The Landqart mill has leveraged its extensive security papers competence to develop additional commercial applications using its in-house know-how and technology of security features to create innovative paper-based security products. Fortress' specialty papers business includes non-woven wallpaper base products, as well as graphic and technical papers. The Dresden mill produces coated and uncoated wallpaper base for wallpaper manufacturers. Fortress Paper's pulp business includes northern bleached hardwood kraft ("NBHK") produced at the Fortress Specialty Cellulose mill with plans to convert this capacity into dissolving pulp production along with the construction of a biomass based cogeneration plant.

## Highlights

Reported EBITDA for the Company was $8.1 million for the second quarter of 2010, an improvement compared to $5.8 million in the first quarter of 2010 and $5.7 million in the second quarter of 2009. The strength in the pulp prices during the period resulted in higher costs at our Dresden and Landqart mills which were offset by impressive sales development at the Fortress Specialty Cellulose mill.

Fortress reported adjusted net income of $4.3 million for the second quarter of 2010 on sales of $60.5 million. In the second quarter of 2009 the Company reported adjusted net income of $2.7 million on sales of $49.6 million. For the first quarter of 2010, the Company reported adjusted net income of $3.0 million on sales of $50.3 million. The improved earnings were the result of significant contribution from the Fortress Specialty Cellulose mill. Pulp production and sales at the Fortress Specialty Cellulose mill began in late May and capitalized on the strong pulp prices. These higher pulp prices increased cost of sales and slightly decreased the margins at both our Dresden mill and Landqart mill. The higher input prices along with a significant depreciation of the EUR and CHF to the CAD in both the prior quarter and prior year comparative period contributed to the lower earnings results from these respective mills.

On April 30, 2010 the Company completed the purchase of a NBHK pulp mill located in Thurso, Quebec from Fraser Papers Inc. through a wholly-owned subsidiary, Fortress Specialty Cellulose Inc. ("Fortress Specialty Cellulose"), for the net proceeds of approximately $1.2 million. The Company intends to convert this mill into a specialty cellulose (dissolving pulp) operation and to build a biomass-based cogeneration plant. The valuation of this acquisition for accounting purposes and the effect on the financial statements of the Company have been disclosed in the unaudited consolidated financial statements and the notes thereto for the three and six month periods ended June 30, 2010 and within this Management Discussion and Analysis.

Concurrent with this acquisition the Company finalized $102.4 million in project financing with a term of 10 years secured by the assets of Fortress Specialty Cellulose. Interest will be calculated at a fixed rate of 5.0% per annum for the first five years, followed by a rate of up to 5.5% for the remaining 5 years.

Also concurrent with this acquisition Fortress Paper issued a $15 million convertible debenture to a financial institution. The convertible debt matures in five years with an interest rate of 7% per annum. The debenture is convertible, in whole or in part, at the option of the holder into common shares of Fortress Paper at any time at a conversion price equal to $20.00 per share. Fortress Paper can redeem the debenture, in whole or in part, at any point after two years if the volume weighted average trading price of common shares on the TSX during 20 consecutive days, is not less than $25.00 per share.

Subsequent to the quarter end, Fortress Paper completed a public offering of 1,739,000 common shares of the Company and the underwriters exercised their over-allotment option and purchased an additional 161,050 common shares at a price of $23.50 per share, resulting in aggregate gross proceeds under the offering of $44.7 million. Proceeds of the offering will be used to finance certain capital expenditures relating to its Fortress Specialty Cellulose mill and its rebuild of papermachine number 1 ("PM1") at the Landqart mill, and for working capital.

**Management's Outlook**

The start-up of the Fortress Specialty Cellulose mill in Thurso, Quebec has gone better than planned. Although recently NBHK pulp prices have softened management remains confident that reasonable profit margins will be maintained until the conversion to dissolving pulp is complete. The conversion has begun with the acquisition of digesters, specialized process equipment and other ancillary equipment purchased from Stora Enso Oyi Cellulose Inc. In addition our Dresden operation has recently implemented price increases for our non-woven wallpaper base. This has been required due to increasing pulp prices globally. Management anticipates margins at our Dresden mill will return to their historical levels. The Landqart mill will continue to produce a product mix of high and low security bank note papers with a temporary focus on non-woven wallpaper base production on PM1. Non-woven wallpaper production will cease at Landqart once PM1 is converted to banknote production. The ongoing rebuild of PM1 is currently on time and on budget.

**Second Quarter 2010 Earnings Review**

***Three Months Ended June 30, 2010***

***Analysis of Specific Items Affecting Comparability of Net Income***

| (thousands of dollars, except per share figures, unaudited) | Q2 2010 | Q1 2010 | Q2 2009 |
|---|---|---|---|
| Net income as reported | 40,378 | 179 | 1,926 |
| Foreign exchange loss | 1,638 | 2,380 | 766 |
| Deferred expenses written off | - | 476 | - |
| Fair value gain on acquisition | (41,804) | - | - |
| Acquisition costs expensed | 681 | - | - |
| Start-up costs associated with Fortress Specialty Cellulose mill | 3,368 | - | - |
| Adjusted net income | 4,261 | 3,035 | 2,692 |
| Net income per share (EPS), as reported | 3.94 | 0.02 | 0.19 |
| Net income per share (EPS) diluted, as reported | 3.53 | 0.02 | 0.19 |
| Adjusted net income per share | 0.42 | 0.30 | 0.26 |
| Adjusted net income per share diluted | 0.37 | 0.28 | 0.26 |

***Selected Financial Information and Statistics***

| (thousands of dollars, except shipments, unaudited) | Q2 2010 | Q1 2010 | Q2 2009 |
|---|---|---|---|
| Sales | 60,544 | 50,304 | 49,638 |
| EBITDA[1] | 8,102 | 5,808 | 5,699 |
| Operating income | 1,440 | 4,202 | 4,460 |
| Net income | 40,378 | 179 | 1,926 |
| Adjusted net income | 4,261 | 3,035 | 2,692 |
| Paper shipments (tonnes) | 16,324 | 16,386 | 14,181 |
| Pulp shipments (tonnes) | 18,848 | - | - |

[1]See net income to EBITDA reconciliation.

***Net income to EBITDA reconciliation:***

| (thousands of dollars, unaudited) | Q2 2010 | Q1 2010 | Q2 2009 |
|---|---|---|---|
| Net income | $40,378 | $179 | $1,926 |
| Income tax | 1,067 | 1,462 | 1,511 |
| Foreign exchange loss | 1,638 | 2,380 | 766 |
| Fair value gain on acquisition | (41,804) | - | - |
| Start-up costs | 3,368 | - | - |
| Acquisition costs expensed | 681 | - | - |
| Interest expense | 160 | 181 | 257 |
| Amortization | 2,029 | 1,388 | 1,029 |
| Stock based compensation | 585 | 218 | 210 |
| EBITDA | $8,102 | $5,808 | $5,699 |

*Overview*

Reported EBITDA for the Company was $8.1 million for the second quarter of 2010, an improvement compared to $5.8 million in the first quarter of 2010 and $5.7 million in the second quarter of 2009. The strength in the pulp prices during the period resulted in higher costs at our Dresden and Landqart mills which were offset by impressive sales and margin development at the Fortress Specialty Cellulose mill.

Total paper product shipments were in line with the previous quarter and significantly higher to the prior year comparative quarter primarily due to a capacity increase at the Dresden mill.

Total NBHK pulp shipments reflect approximately one month of sales as the Fortress Specialty Cellulose mill ramped up production in late May after having been idle for some time. The mill in Thurso was purchased April 30, 2010.

Cost of products sold were $50.0 million or 82.6% of sales for the three months ended June 30, 2010 compared to $38.6 million or 77.8% of sales for the prior year comparative period. In the previous quarter cost of products sold were $38.6 million or 76.7% of sales. Included in cost of sales for the second quarter of 2010 are $3.4 million in start-up costs associated with the Fortress Specialty Cellulose mill. Excluding these amounts cost of products sold were 77.0% of sales which is in line with prior periods.

Selling, general and administrative expenses for the second quarter of 2010 were $6.5 million (second quarter 2009, $5.3 million and first quarter 2010, $5.9 million) and were comprised primarily of sales commissions, marketing, corporate and administrative expenses. Included in selling, general and administrative expenses were $1.2 million related to the Fortress Specialty Cellulose mill of which acquisition costs represented $0.7 million. Stock compensation for the quarter was $0.6 million compared to $0.2 million for each of the prior quarter and prior year comparative quarter. The increase reflects restricted share units awarded in connection with the acquisition of the mill in Thurso.

***Acquisition of Thurso Pulp Mill***

On April 30, 2010 the Company completed the purchase of a northern bleached hardwood kraft pulp mill located in Thurso, Quebec from Fraser Papers Inc. through a wholly-owned subsidiary, Fortress Specialty Cellulose Inc., for $3 million. The Company intends to convert the Thurso operations into a dissolving pulp mill.

The allocation of the purchase price to assets acquired and liabilities assumed is based upon estimated fair values at the date of acquisition. Fair values are estimated using market information where applicable; however, directly comparable information is not always readily available so significant estimates and judgment are used. The Company believes it has made reasonable assumptions with respect to determining the fair values recognized. Management has substantially completed the process of determining fair values for the assets and liabilities acquired. However, the purchase price allocation is subject to change if new information becomes available as the valuation is completed in 2010.

A gain of $41,804 has been recognized as the estimated fair values of the net assets acquired exceed consideration paid. The gain has been included as other income in the statement of operations.

The acquisition has been accounted for as follows:

| | |
|---|---|
| Assets acquired at fair values: | |
| Inventory | $ 6,019 |
| Property, plant and equipment | 58,915 |
| | 64,934 |
| | |
| Liabilities assumed at fair values: | |
| Accounts payable | $ 3,652 |
| Asset retirement obligations | 562 |
| Future income tax liabilities | 15,916 |
| | 20,130 |
| Net assets acquired at fair values | 44,804 |
| Consideration paid | 3,000 |
| Fair value adjustment gain on acquisition | $ 41,804 |

Operating Results by Business Segment

*ThursoMill*

| (thousands of dollars, except for shipments, unaudited) | Q2 2010 | |
|---|---|---|
| Sales | 13,543 | |
| Operating loss | (1,124) | |
| Operating income adjusted for start-up and acquisition costs | 2,925 | |
| Shipments (tonnes) | 18,848 | |

The Fortress Specialty Cellulose mill began pulp production in late May. Included in operating income are start-up costs of $3.4 million and acquisition costs of $0.7 million. Operating income adjusted for these amounts is $2.9 million which is a result of the strong pulp market.

*Landqart Mill*

| (thousands of dollars, except for shipments, unaudited) | Q2 2010 | Q1 2010 | Q2 2009 |
|---|---|---|---|
| Sales | 18,070 | 19,111 | 20,861 |
| Operating income | 285 | 646 | 28 |
| Shipments (tonnes) | 4,172 | 4,287 | 4,127 |

The CHF experienced depreciation in the quarter on average compared to the prior quarter and prior year comparative quarter. Shipments have remained strong; however, the combined impact of a depreciating CHF against the CAD, increased pulp prices on our specialty papers and the lower margin security paper sales has resulted in lower operating income and sales relative to the prior period comparative.

*Dresden Mill*

| (thousands of dollars, except for shipments, unaudited) | Q2 2010 | Q1 2010 | Q2 2009 |
|---|---|---|---|
| Sales | 28,931 | 31,193 | 28,777 |

| | | | |
|---|---|---|---|
| Operating income | 3,681 | 5,326 | 5,477 |
| Shipments (tonnes) | 12,152 | 12,099 | 10,054 |

The EUR experienced significant depreciation in the quarter on average compared to the prior quarter and prior year comparative quarter. Shipments have remained strong and in line with the previous quarter. Shipments are approximately 21% higher than the previous year comparative period due to increased production capacity at the mill. Price increases have been implemented towards the end of the quarter to balance the higher pulp prices. The order book at the Dresden mill remains strong. Revenues and expenses continue to be denominated in EUR and therefore a depreciating currency relative to the CAD does not impact our operations or local currency profitability.

***Six Months Ended June 30, 2010***

***Analysis of Specific Items Affecting Comparability of Net Income***

| (thousands of dollars, except per share figures, unaudited) | **June 30, 2010** | **June 30, 2009** |
|---|---|---|
| Net income as reported | 40,557 | 5,510 |
| Foreign exchange loss (gain) | 4,018 | (289) |
| Deferred expenses written off | 476 | - |
| Fair value gain on acquisition | (41,804) | - |
| Acquisition costs expensed | 681 | - |
| Start-up costs associated with Fortress Specialty Cellulose mill | 3,368 | - |
| Adjusted net income | 7,296 | 5,221 |
| Net income per share (EPS), as reported | 3.96 | 0.54 |
| Net income per share (EPS) diluted, as reported | 3.65 | 0.54 |
| Adjusted net income per share | 0.71 | 0.51 |
| Adjusted net income per share diluted | 0.66 | 0.51 |

***Selected Financial Information and Statistics for the Six Months Ended:***

| (thousands of dollars, except for shipments, unaudited) | **June 30, 2010** | **June 30, 2009** |
|---|---|---|
| Sales | 110,848 | 96,261 |
| EBITDA[1] | 13,911 | 10,731 |
| Operating income | 5,642 | 8,225 |
| Net income | 40,557 | 5,510 |
| Adjusted net income | 7,296 | 5,221 |
| Paper Shipments (tonnes) | 32,710 | 26,904 |
| Pulp Shipments (tonnes) | 18,848 | - |

[1]See net income to EBITDA reconciliation.

***Net income to EBITDA reconciliation:***

| (thousands of dollars, unaudited) | **June 30, 2010** | **June 30, 2009** |
|---|---|---|
| Net income | $40,557 | $5,510 |
| Income tax | 2,529 | 2,555 |
| Foreign exchange (gain) loss | 4,018 | (289) |
| Fair value gain on purchase | (41,804) | - |
| Start-up costs | 3,368 | - |
| Acquisition costs expensed | 681 | - |
| Interest expense | 341 | 449 |
| Amortization | 3,417 | 2,096 |
| Stock based compensation | 804 | 410 |
| EBITDA | $13,911 | $10,731 |

*Overview*

Reported EBITDA for the Company was $13.9 million for the six months ended June 30, 2010, an improvement compared to $10.7 million in the six months ended June 30, 2009. Excluding EBITDA contribution from the Fortress Specialty Cellulose mill of $3.5 million, EBITDA would be $10.4 million which is in line with the prior year comparative period.

Total paper product shipments were higher to the prior comparative period due to capacity increases at the Dresden mill and the impact of the global financial crisis which resulted in lower shipments in early 2009.

Total NBHK pulp shipments reflect approximately one month of sales as the Fortress Specialty Cellulose mill ramped up production in late May after having been idle for some time. The mill in Thurso was purchased April 30, 2010.

Included in operating income are start-up costs of $3.4 million and acquisition costs of $0.7 million related to Fortress Specialty Cellulose. Operating income for the Company for the six month period ended June 30, 2010 adjusted for these amounts is $9.7 million. The operating income for the six month period ended June 30, 2009 was $8.2 million.

Operating Results by Business Segment

*Fortress Specialty Cellulose Mill*

| (thousands of dollars, except for shipments, unaudited) | **June 30, 2010** | |
|---|---|---|
| Sales | 13,543 | |
| Operating income | (1,124) | |
| Operating income adjusted for start-up and acquisition costs | 2,925 | |
| Shipments (tonnes) | 18,848 | |

Results at Fortress Specialty Cellulose reflect sales and shipments beginning in late May. Operating income includes start-up costs of $3.4 million and acquisition costs of $0.7 million. Operating income adjusted for these amounts was $2.9 million which was a result of the strong pulp market and efficient production.

*Landqart Mill*

| (thousands of dollars, except for shipments, unaudited) | **June 30, 2010** | **June 30, 2009** |
|---|---|---|
| Sales | 37,181 | 41,222 |
| Operating income | 931 | 868 |
| Shipments (tonnes) | 8,459 | 7,848 |

The depreciation of the CHF to the CAD has negatively impacted sales and operating income in the current period relative to the prior period. In the first half of 2010 the security paper sales have been dominated by lower margin products. Operating income has also been negatively impacted by higher cotton and linter prices. The specialty papers sales have been largely influenced by non-woven simplex wallpaper base production which has also been impacted by the significant increase in pulp prices over the first half of the year relative to the prior period.

*Dresden Mill*

| (thousands of dollars, except for shipments, unaudited) | **June 30, 2010** | **June 30, 2009** |
|---|---|---|
| Sales | 60,124 | 55,039 |
| Operating income | 9,007 | 9,511 |
| Shipments (tonnes) | 24,251 | 19,056 |

The significant depreciation of the EUR to the CAD has negatively impacted operating income and sales in the current period relative to prior period; however the impact of the increased tonnes sold at the Dresden more than offset the negative impact of exchange on sales. Pulp price increases have also negatively impacted operating earnings. Despite these influences Dresden continues to perform well and towards the end of the quarter has implemented price increases. The order book at the Dresden mill remains strong. Revenues and expenses continue to be denominated in EUR and therefore a depreciating currency relative to the CAD does not impact our operations or local currency profitability.

Tonnes shipped were 27% higher relative to the prior year due to a combination of the capital programs increasing capacity and the prior year global financial challenges experienced early in 2009. Relative to the first half of 2009 the tonnes shipped were 21% higher as a result of capacity increases at the mill.

**Liquidity and Capital Resources**

The Company's objectives when managing capital are to safeguard its assets and maintain a globally competitive cost structure while looking for growth opportunities to provide returns to its shareholders. In addition, the Company works with all relevant stakeholders to ensure the safety of its operations and employees, and remain in compliance with all environmental regulations and enhance the communities in which it operates.

The Company constantly monitors and assesses its financial performance in order to ensure that its net debt levels are prudent, taking into account the anticipated direction of the Company and business cycle. The company continuously monitors the public and private debt markets and the public equity markets in order to assure that its capital structure is appropriately balanced. The Company's results can be materially influenced by changes in the relative value of the Swiss Franc, Euro and US dollar to the Canadian dollar.

Although there can be no assurances, Fortress believes that cash generated from operations, together with amounts available under its credit facilities and net proceeds from equity financing will be sufficient to meet its debt service requirements, capital expenditure needs and working capital needs for the foreseeable future. Fortress' future operating performance and its ability to service its debt and pay other indebtedness of Fortress will be subject to future economic conditions and the financial success of Fortress' business and other factors, many of which are not within Fortress' control, including changes in market prices for its security and specialty papers and raw material costs.

*Financial Risk Management*

The Company is exposed to a number of risks as a result of holding financial instruments. These risks include credit risk, liquidity risk and market risk.

**Credit Risk**

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. Financial instruments that potentially subject the Company to credit risk include cash and cash equivalents and accounts receivable.

Cash and cash equivalents includes cash on deposit with an original maturity date of 90 days or less. In order to mitigate the risk of financial loss, cash on deposit is held with major Canadian and international financial institutions. The cash and cash equivalents balance at June 30, 2010 was $25.7 million (December 31, 2009 - $33.2 million). The Company does not have holdings in asset backed commercial paper.

The Company utilizes a combination of credit insurance and factoring to manage the risk associated with trade receivables. Approximately 91% of the outstanding Dresden and Landqart mill's trade receivables are covered under credit insurance. The majority of the balance is with large and financially sound customers. Accounts receivable aged greater than 90 days is $0.5 million and is considered collectable. The Company's trade receivable balance at June 30, 2010 was $15.1 million (December 31, 2009 - $18.0 million). In addition, the Fortress Specialty Cellulose mill has a pulp purchase and sale agreement with an exclusive distributor who had placed 100% of the mills sales for the three months ended June 30, 2010. The distributor assumes collection risk.

**Liquidity Risk**

Liquidity risk is the risk that the Company will be unable to meet its financial obligations as they fall due. The Company manages liquidity risk through management of its capital structure in conjunction with cash flow forecasting including anticipated investing and financing activities.

At June 30, 2010, the Company's accounts payable and accrued liabilities totaled $30.0 million (December 31, 2009 - $22.4 million), all of which fall due for payment within one year of the balance sheet date.

The Company manages liquidity risk through ongoing review of accounts receivable balances and the management of its cash and debt positions and equity financing.

**Market Risk**

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in interest rates and foreign currency.

Interest rate risk:

The Company is exposed to interest rate risk through its financial assets and financial obligations bearing variable interest rate. The Company believes that interest rate fluctuations would not have a significant impact on net income.

The Company manages interest rate risk by maximizing the interest earned on excess funds while maintaining the liquidity necessary to meet day-to-day operating cash flow requirements. The Company currently does not use derivative instruments to reduce its exposure to interest rate risk.

**Selected Cash Flow Items**

| | Three Months Ended June 30, 2010 | Three Months Ended June 30, 2009 | Six Months Ended June 30, 2010 | Six Months Ended June 30, 2009 |
|---|---|---|---|---|
| Cash provided before working capital changes | 1,418 | 2,569 | 3,098 | 6,496 |
| Non-cash working capital change | (5,431) | 1,256 | (9,575) | (7,156) |
| **Cash provided from (used by) operating activities** | (4,013) | 3,825 | (6,477) | (660) |
| **Cash provided from financing activities** | 18,729 | 4,121 | 25,206 | 3,936 |
| Additions to property, plant and equipment | (11,628) | (1,834) | (21,926) | (3,483) |
| Deferred expenses and other | 1,054 | (165) | 480 | (476) |
| Acquisition of Thurso Pulp Mill | (3,000) | - | (3,000) | - |
| **Cash provided from (used by) investing activities** | (13,574) | (1,999) | (24,446) | (3,959) |
| **Change in cash position** | 1,142 | 5,947 | (5,717) | (683) |
| Foreign exchange (loss) gain on cash and cash equivalents | (245) | (369) | (1,778) | (605) |

On April 30, 2010 the Company received $15 million in proceeds for an unsecured convertible note of the Company in the principal amount of $15 million that matures in April, 2015. The convertible note bears interest at an annual rate equal to 7%, calculated semi-annually with the first installment due on October 31, 2010.

By the end of the second quarter of 2010, the Company has utilized 8.5 million EUR of the 18.5 million EUR facility arranged by the Dresden mill with GE Capital Bank AG in connection with the rebuild of the Landqart mill's papermachine 1 to produce banknote papers.

Capital expenditures in the second quarter of 2010 and year to date have primarily been incurred for the paper machine 1 rebuild at Landqart.

Acquisition related expenses (deferred expenses) in prior periods were capitalized. Effective April 1, 2010, the Company adopted Section 1582 of the Canadian Institute of Chartered Accountants Handbook which requires the Company to expense such costs.

**Foreign Currency**

The financial statements of the Company are susceptible to unrealized translation gains and losses when translating to Canadian dollars. Each mill has revenues and expenses in their own local currency, therefore these gains and losses are not realized for local cash flow purposes.

**Outstanding Shares**

The number of common shares outstanding at June 30, 2010 was 10,246,000. At the date of this report common shares outstanding were 12,146,050. The number of options outstanding at June 30, 2010 and the date of this report was 740,175. At June 30, 2010 and the date of this report there were 231,295 restricted share units. At June 30, 2010 and the date of this report there were 31,567 and 32,856 deferred share units outstanding, respectively.

**Critical Accounting Estimates**

The preparation of financial statements and related disclosures in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Significant estimates are used for, but not limited to, the accounting for doubtful accounts, depreciation and amortization, asset impairments, valuation of equity investment, derivative financial instruments, fair value of assets acquired in a business combination, stock based compensation, pensions and post-retirement obligations, income taxes and contingencies. Actual results could differ from these estimates.

**Changes in Accounting Policies**

*Current Year*

i) Capitalization of interest expense

Effective January 1, 2010, the Company retroactively changed their accounting policy to allow for the capitalization of interest for borrowings related to the construction of property, plant and equipment. This change in policy did not significantly impact the consolidated financial statements for prior years.

ii) Business combinations

Effective April 1, 2010, the Company early adopted the Canadian Institute of Chartered Accountants' Handbook Section 1582, "Business Combinations". The section, which replaces the former Section 1581, "Business Combinations", established standards for the measurement of a business combination and the recognition and measurement of assets acquired and liabilities assumed. The section applies prospectively to business combinations for which the acquisition date is on or after the date of adoption. The effects of the applying this section can be shown in note 3 of our unaudited interim financial statements for the acquisition of the Thurso mill.

Under Section 1581, companies had the option to capitalize costs acquisition related costs directly attributable to the acquisition. Under Section 1582, the company is required to account for acquisition related costs as expenses in the period in which the costs are incurred. As a result of this change the company expensed $390 during the three months ended June 30, 2010 related to the purchase of the Thurso mill which had previously been capitalized under Section 1581.

iii) Consolidated financial statements

Effective April 1, 2010, the Company early adopted the Canadian Institute of Chartered Accountants' Handbook Section 1601, "Consolidated Financial Statements". This section, which, together with the new section 1602, replaces the former Section 1600, "Consolidated Financial Statements" carries forward existing guidance on aspects of the preparation of consolidated financial statements subsequent to acquisitions other than non-controlling interests. The adoption of this Section did not significantly impact the consolidated financial statements of the Company.

iv) Non-controlling interest

Effective April1, 2010, the Company early adopted the Canadian Institute of Chartered Accountants' Handbook Section 1602, "Non controlling interests". This section carries forward existing guidance on aspects of accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. The adoption of this Section did not significantly impact the consolidated financial statements of the Company.

*Prior Year*

Effective January 1, 2009, the Company adopted the Canadian Institute of Chartered Accountants' new Handbook Section 3064, "Goodwill and Intangible Assets". This section replaces CICA Handbook Section 3062, "Goodwill and Intangible Assets", and establishes revised standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. The new standard also provides guidance for the treatment of various preproduction and start-up costs and requires that these costs be expensed as incurred. The adoption of this new policy did not significantly impact the consolidated financial statements.

**Disclosure Controls and Internal Controls Over Financial Reporting**

Fortress Paper's management, including the Chairman, President, Chief Executive Officer, and Chief Financial Officer acknowledge responsibility for the design of disclosure controls and procedures (DC&P) and internal controls over financial reporting (ICFP) as those terms are defined in NI52-109.

There were no changes in internal controls over financial reporting that occurred during the quarter ended June 30, 2010 that have materially affected, or are reasonably likely to materially affect, Fortress Paper's internal control over financial reporting.

**Conversion to International financial reporting standards (IFRS)**

On February 13, 2008, the Accounting Standards Board announced that publicly accountable entities will be required to prepare financial statements in accordance with International Financial Reporting Standards (IFRS) for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. The Company will rely mainly on internal resources to ensure compliance with IFRS. The Company intends to convert to these new standards according to the timetable set for these new rules.

The Company has formally established a transition plan and project implementation team. The project team consists initially of members from Finance. Reporting is done to senior management and to the Audit Committee on a quarterly basis.

The Company has substantively completed the detailed diagnostic plan which included identifying significant accounting policy differences and their related areas of impact in terms of systems, procedures and financial statements. Differences between IFRS and Canadian generally accepted accounting principles (GAAP), in addition to those referenced below, may continue to be identified based on further detailed analysis by the Company and other changes to IFRS prior to the Company's conversion to IFRS in 2011. The Company will continue to review all proposed and continuing projects of the International Accounting Standards Board to determine their impact and will continue to invest in training and resources throughout the transition period to facilitate a timely conversion.

Set out below are some of the key areas where changes in accounting policies are expected that may materially impact the Company's consolidated financial statements. The list and comments should not be regarded as a complete list of changes that will result from a transition to IFRS. It is intended to highlight the more significant areas we have identified to date. Analysis of changes is still in process and not all decisions have been finalized where choices of accounting policies are available.

*Accounting Policy Impact and Decisions*

<u>Employee Benefits</u>

IAS 19, "Employee Benefits", permits a Company to recognize actuarial gains and losses immediately in other comprehensive income rather than amortized through earnings. IFRS 1 also provides an option to recognize immediately in equity all cumulative actuarial gains and losses existing as at the date of transition to IFRS. The Company currently plans on taking the exemption under IFRS 1.

Property, Plant and Equipment

IFRS 1 permits a Company to revalue individual items of property, plant and equipment at their fair value as at the date of transition to IFRS. The Company is currently evaluating this option.

Business Combinations

IFRS 1 provides an exemption that allows Companies transitioning to IFRS to not restate business combinations entered into prior to the date of transition. The Company currently plans to take this exemption.

Provisions

IAS 37, “Provisions, Contingent Liabilities and Contingent Assets”, requires a provision to be recognized when there is a present obligation as a result of a past transaction or event; it is probable that an outflow of resources will be required to settle the obligation; and a reliable estimate can be made of the obligation. The threshold of “probable” is a lower threshold than “likely”, which is used in Canadian GAAP. Therefore, it is possible that there may be some contingent liabilities which would meet the recognition criteria under IFRS that were not recognized under Canadian GAAP. Other differences between IFRS and Canadian GAAP exist in relation to the measurement of provisions, such as the methodology for determining the best estimate where there is a range of equally possible outcomes (IFRS uses the mid-point of the range, whereas Canadian GAAP uses the low-end of the range), and the requirement under IFRS for provisions to be discounted where material.

**Subsequent Events**

In July 2010, Fortress Paper completed a public offering of 1,739,000 common shares of the Company and the underwriters exercised their over-allotment option and purchased an additional 161,050 common shares at a price of $23.50 per share, resulting in aggregate gross proceeds under the offering of $44.7 million. Proceeds of the offering will be used to finance certain capital expenditures relating to its Fortress Specialty Cellulose mill and its rebuild of PM1 at the Landqart mill, and for working capital.

**Risks and Uncertainties**

A comprehensive discussion of Risk Factors is included in the Company’s 2009 annual information form available on SEDAR at www.sedar.com.

## Selected Quarterly Information

| (thousands of dollars, except per unit amounts, earnings per share ("EPS"), exchange rates and shares outstanding, unaudited) | Q2 2010 | Q1 2010 | Q4 2009 | Q3 2009 |
|---|---|---|---|---|
| Sales | 60,544 | 50,304 | 51,049 | 51,000 |
| Operating income | 1,440 | 4,202 | 6,292 | 5,198 |
| EBITDA | 8,102 | 5,809 | 7,885 | 6,967 |
| Net income | 40,378 | 179 | 3,720 | 3,467 |
| Basic EPS | $3.94 | $0.02 | $0.36 | $0.34 |
| Diluted EPS | $3.53 | $0.02 | $0.35 | $0.34 |
| Weighted average shares outstanding Basic (thousands) | 10,237 | 10,234 | 10,234 | 10,234 |
| Weighted average shares outstanding Diluted (thousands) | 11,450 | 10,713 | 10,487 | 10,296 |
| Average Swiss/Canadian exchange rate(1) | 0.9278 | 0.9832 | 1.0341 | 1.0335 |
| Average Euro/Canadian exchange rate (1) | 1.3057 | 1.4381 | 1.5600 | 1.5699 |

| (thousands of dollars, except per unit amounts, earnings per share ("EPS"), exchange rates and shares outstanding, unaudited) | Q2 2009 | Q1 2009 | Q4 2008 | Q3 2008 |
|---|---|---|---|---|
| Sales | 49,638 | 46,623 | 46,331 | 43,744 |
| Operating income | 4,460 | 3,765 | 4,399 | 4,993 |
| EBITDA | 5,699 | 5,032 | 5,966 | 6,234 |
| Net income | 1,926 | 3,584 | 2,778 | 2,312 |
| Basic EPS | $0.19 | $0.35 | $0.27 | $0.22 |
| Diluted EPS | $0.19 | $0.35 | $0.27 | $0.22 |
| Weighted average shares outstanding Basic (thousands) | 10,234 | 10,234 | 10,235 | 10,302 |
| Weighted average shares outstanding Diluted (thousands) | 10,234 | 10,234 | 10,235 | 10,471 |
| Average Swiss/Canadian exchange rate(1) | 1.0498 | 1.0845 | 1.0470 | 0.9699 |
| Average Euro/Canadian exchange rate (1) | 1.5891 | 1.6226 | 1.5960 | 1.5623 |

(1) Source – Bank of Canada (average noon rate for the period)

**FORTRESS PAPER LTD.**
**CONSOLIDATED BALANCE SHEETS**
**(Canadian dollars, amounts in thousands, unaudited)**

| | As at June 30, 2010 | As at December 31, 2009 |
|---|---|---|
| **ASSETS** | | |
| **Current** | | |
| Cash and cash equivalents | $ 25,710 | $ 33,205 |
| Trade accounts receivable | 15,095 | 18,034 |
| Other accounts receivable | 7,747 | 2,614 |
| Inventories | 36,787 | 26,880 |
| Prepaid expenses | 2,364 | 873 |
| | 87,703 | 81,606 |
| Restricted cash | 41 | 45 |
| Deferred expenses (*note 2*) | - | 476 |
| Property, plant and equipment | 126,959 | 47,852 |
| Employee future benefits *(note 4)* | 9,970 | 9,888 |
| **Total assets** | $ 224,673 | $ 139,867 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **Current** | | |
| Accounts payable and accrued liabilities *(note 5)* | $ 29,964 | $ 22,447 |
| Income taxes payable | 808 | 4,446 |
| Current portion of future income taxes | 1,658 | - |
| Current portion of long-term debt *(note 6)* | 5,858 | 5,378 |
| | 38,288 | 32,271 |
| Long-term debt *(note 6)* | 40,013 | 18,984 |
| Future income taxes | 16,396 | 2,028 |
| **Total liabilities** | $ 94,697 | $ 53,283 |
| **Shareholders' equity** *(note 7)* | | |
| Share capital | 59,083 | 59,083 |
| Contributed surplus | 5,923 | 3,088 |
| Retained earnings | 64,970 | 24,413 |
| **Total shareholders' equity** | 129,976 | 86,584 |
| **Total liabilities and shareholders' equity** | $ 224,673 | $ 139,867 |

**Commitments** *(note 11)*

**Subsequent events** *(note 12)*

*(See accompanying notes)*

Approved by the Board of Directors:

"Chadwick Wasilenkoff" — Director

"Richard Whittall" — Director

**FORTRESS PAPER LTD.**
**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME AND RETAINED EARNINGS**
**(Canadian dollars, amounts in thousands, unaudited)**

| | Three Months Ended June 30, 2010 | Three Months Ended June 30, 2009 | Six Months Ended June 30, 2010 | Six Months Ended June 30, 2009 |
|---|---|---|---|---|
| **Sales** | $ 60,544 | $ 49,638 | $ 110,848 | $ 96,261 |
| **Costs and expenses** | | | | |
| Cost of products sold | (50,011) | (38,618) | (88,583) | (74,681) |
| Amortization | (2,029) | (1,029) | (3,417) | (2,096) |
| Selling, general and administration | (6,480) | (5,321) | (12,403) | (10,849) |
| Stock-based compensation *(note 7)* | (585) | (210) | (804) | (410) |
| **Operating income** | 1,439 | 4,460 | 5,641 | 8,225 |
| **Other** | | | | |
| Interest, net | (160) | (257) | (341) | (449) |
| Fair value gain on acquisition *(note 3)* | 41,804 | - | 41,804 | - |
| Foreign exchange (loss) gain | (1,638) | (766) | (4,018) | 289 |
| **Net Income before income taxes** | 41,445 | 3,437 | 43,086 | 8,065 |
| Income tax expense | (1,067) | (1,511) | (2,529) | (2,555) |
| **Net income and comprehensive income** | $ 40,378 | $ 1,926 | $ 40,557 | $ 5,510 |
| **Earnings per share** | | | | |
| **Basic** | $3.94 | $0.19 | $3.96 | $0.54 |
| **Diluted** | $3.53 | $0.19 | $3.65 | $0.54 |
| **Weighted average number of shares outstanding** | | | | |
| **Basic** | 10,237,209 | 10,233,500 | 10,235,365 | 10,233,500 |
| **Diluted** | 11,449,753 | 10,233,500 | 11,108,181 | 10,233,500 |

| | Three Months Ended June 30, 2010 | Three Months Ended June 30, 2009 | Six Months Ended June 30, 2010 | Six Months Ended June 30, 2009 |
|---|---|---|---|---|
| **Retained earnings** | | | | |
| Balance — beginning of period | $ 24,592 | $ 15,300 | $ 24,413 | $ 11,716 |
| Earnings | 40,378 | 1,926 | 40,557 | 5,510 |
| **Balance — end of period** | $ 64,970 | $ 17,226 | $ 64,970 | $ 17,226 |

*(See accompanying notes)*

**FORTRESS PAPER LTD.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(Canadian dollars, amounts in thousands, unaudited)**

| | Three Months Ended June 30, 2010 | Three Months Ended June 30, 2009 | Six Months Ended June 30, 2010 | Six Months Ended June 30, 2009 |
|---|---|---|---|---|
| **Cash flows from operating activities** | | | | |
| Net income | $ 40,378 | $ 1,926 | $ 40,557 | $ 5,510 |
| Items not affecting cash: | | | | |
| Amortization | 2,029 | 1,029 | 3,417 | 2,096 |
| Future income taxes | 107 | (83) | 110 | (177) |
| Foreign exchange loss (gain) on long term debt | (122) | (881) | (1,764) | (1,947) |
| Foreign exchange loss (gain) on cash and cash equivalents | 245 | 369 | 1,778 | 605 |
| Fair value gain on acquisition | (41,804) | - | (41,804) | - |
| Stock based compensation | 585 | 209 | 804 | 409 |
| | 1,418 | 2,569 | 3,098 | 6,496 |
| Change in non-cash working capital items | | | | |
| Accounts receivable | (935) | (2,113) | (2,194) | (8,795) |
| Inventory | (3,025) | 1,423 | (3,888) | 1,513 |
| Prepaid expenses | (1,863) | 62 | (1,491) | 26 |
| Other assets | (366) | 441 | (82) | 941 |
| Accounts payable and other | 758 | 1,443 | (1,920) | (841) |
| | (4,013) | 3,825 | (6,477) | (660) |
| **Cash flows from financing activities** | | | | |
| Repayment of long-term debt | (1,194) | (1,762) | (1,393) | (1,949) |
| Proceeds from long-term debt | 19,988 | 5,960 | 26,743 | 6,041 |
| Payment on capital leases | (65) | (77) | (144) | (156) |
| | 18,729 | 4,121 | 25,206 | 3,936 |
| **Cash flows from investing activities** | | | | |
| Additions to property, plant and equipment | (11,628) | (1,834) | (21,926) | (3,483) |
| Acquisition of Thurso pulp mill (*note 3*) | (3,000) | | (3,000) | |
| Deferred expenses | 1,053 | (165) | 476 | (476) |
| Restricted cash | 1 | - | 4 | - |
| | (13,574) | (1,999) | (24,446) | (3,959) |
| **Increase (decrease) in cash position** | 1,142 | 5,947 | (5,717) | (683) |
| Foreign exchange (loss) gain on cash and cash equivalents | (245) | (369) | (1,778) | (605) |
| Cash and cash equivalents, beginning of period | 24,813 | 19,321 | 33,205 | 26,187 |
| **Cash and cash equivalents, end of period** | $ 25,710 | $ 24,899 | $ 25,710 | $ 24,899 |

**Supplementary cash flow information** *(note 10)*

*(See accompanying notes)*

## 1. NATURE OF OPERATIONS

Fortress Paper Ltd. (the "Company" or "Fortress") was incorporated on May 30, 2006 under the laws of the Province of British Columbia. From the date of incorporation to July 31, 2006 the Company was inactive. The Company's fiscal year end is December 31. Fortress owns and operates two paper mills, the Landqart mill located in Switzerland and the Dresden mill located in Germany, and a pulp mill in Canada. Fortress' security papers include banknote, passport and visa papers. The security papers produced at the Landqart mill incorporate internationally recognized overt and covert security features which are embedded into the paper and supplemented with customer-specific features. The Landqart mill has leveraged its extensive security papers competence to develop additional commercial applications using its in-house know-how and technology of security features to create innovative paper-based security products. Fortress' specialty papers business includes non-woven wallpaper base products, as well as graphic and technical papers. The Dresden mill produces coated and uncoated wallpaper base for wallpaper manufacturers. The pulp mill, Fortress Specialty Cellulose, produces northern bleached hardwood kraft and is in the process of being converted into a dissolving pulp mill.

These unaudited interim financial statements do not include all of the disclosures required by Canadian generally accepted accounting principles for annual financial statements and, accordingly, should be read in conjunction with the consolidated financial statements and notes as at and for the year ended December 31, 2009 (available on SEDAR at www.sedar.com). These unaudited interim financial statements follow the same accounting policies and methods of their application as December 31, 2009 consolidated financial statements except as disclosed in Note 2 and 5.

## 2. CHANGE IN ACCOUNTING POLICY

Current Year

i) Capitalization of interest expense

Effective January 1, 2010, the Company retroactively changed their accounting policy to allow for the capitalization of interest for borrowings related to the construction of property, plant and equipment. This change in policy did not significantly impact the consolidated financial statements for prior years.

ii) Business combinations

Effective April 1, 2010, the Company early adopted the Canadian Institute of Chartered Accountants' Handbook Section 1582, "Business Combinations". The section, which replaces the former Section 1581, "Business Combinations", established standards for the measurement of a business combination and the recognition and measurement of assets acquired and liabilities assumed. The section applies prospectively to business combinations for which the acquisition date is on or after the date of adoption. The effects of applying this section can be shown in note 3 for the acquisition of the Thurso mill.

Under Section 1581, companies had the option to capitalize acquisition related costs directly attributable to the business combination. Under Section 1582, the company is required to account for acquisition related costs as expenses in the period in which the costs are incurred. As a result of this change the company expensed $390 during the three months ended June 30, 2010 related to the purchase of the Thurso mill which had previously been capitalized under Section 1581.

iii) Consolidated financial statements

Effective April 1, 2010, the Company early adopted the Canadian Institute of Chartered Accountants' Handbook Section 1601, "Consolidated Financial Statements". This section, which, together with the new section 1602, replaces the former Section 1600, "Consolidated Financial Statements" carries forward existing guidance on aspects of the preparation of consolidated financial statements subsequent to acquisitions other than non-controlling interests. The adoption of this Section did not significantly impact the consolidated financial statements of the Company.

iv) Non-controlling interests

Effective April1, 2010, the Company early adopted the Canadian Institute of Chartered Accountants' Handbook Section 1602, "Non controlling interests". This section carries forward existing guidance on aspects of accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. The adoption of this Section did not significantly impact the consolidated financial statements of the Company.

Prior Year

Effective January 1, 2009, the Company adopted the Canadian Institute of Chartered Accountants' new Handbook Section 3064, "Goodwill and Intangible Assets". This section replaces CICA Handbook Section 3062, "Goodwill and Intangible Assets", and establishes revised standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. The new standard also provides guidance for the treatment of various preproduction and start-up costs and requires that these costs be expensed as incurred. The adoption of this new policy did not significantly impact the consolidated financial statements.

## 3. ACQUISITION OF THURSO PULP MILL

On April 30, 2010 the Company completed the purchase of a northern bleached hardwood kraft pulp mill located in Thurso, Quebec from Fraser Papers Inc. through a wholly-owned subsidiary, Fortress Specialty Cellulose Inc. ("Fortress Specialty Cellulose" or "FSC"), for $3 million. The Company intends to convert the Thurso operations into a dissolving pulp mill.

The allocation of the purchase price to assets acquired and liabilities assumed is based upon estimated fair values at the date of acquisition. Fair values are estimated using market information where applicable; however, directly comparable information is not always readily available so significant estimates and judgment are used. The Company believes it has made reasonable assumptions with respect to determining the fair values recognized. Management has substantially completed the process of determining fair values for the assets and liabilities acquired. However, the purchase price allocation is subject to change if new information becomes available as the valuation is completed in 2010.

A gain of $41,804 has been recognized as the estimated fair values of the net assets acquired exceed consideration paid. The gain has been included as other income in the statement of operations.

The acquisition has been accounted for as follows:

**(Unaudited, Canadian dollars, amounts in thousands except share and per share data)**

| | |
|---|---|
| Assets acquired at fair values: | |
| Inventory | $ 6,019 |
| Property, plant and equipment | 58,915 |
| | 64,934 |
| | |
| Liabilities assumed at fair values: | |
| Accounts payable | $ 3,652 |
| Asset retirement obligations | 562 |
| Future income tax liabilities | 15,916 |
| | 20,130 |
| Net assets acquired at fair values | 44,804 |
| Consideration paid | 3,000 |
| Fair value gain on acquisition | $ 41,804 |

## 4. EMPLOYEE FUTURE BENEFITS

Defined benefit pension expenses of $160 and $330 were recorded for the three and six month periods ended June 30, 2010. Defined benefit pension expenses of $386 and $785 were recorded for the three and six month periods ended June 30, 2009.

## 5. ASSET RETIREMENT OBLIGATION

| | |
|---|---|
| Asset retirement obligation, current | $ 562 |

The Company has costs associated with containment and on-going maintenance relating to landfill sites. These costs are measured at fair value which approximates the cost a third party would incur in performing the tasks associated with the landfill sites. These obligations represent estimated undiscounted future payments of $562 to remediate the landfills at the end of their useful lives. These payments are expected to occur within the next 12 months and as such, have been recorded in accounts payable and have not been discounted.

**(Unaudited, Canadian dollars, amounts in thousands except share and per share data)**

## 6. LONG-TERM DEBT AND OPERATING LOANS

*Long-term debt*

| | June 30, 2010 | December 31, 2009 |
|---|---|---|
| Credit agreement with bank maturing 2014; interest at 2.65% secured by current assets (EUR 2,827; 2009 - EUR 3,233) | $ 3,685 | $ 4,835 |
| Credit agreement with lender maturing 2018; interest at 6.2% and 7.1% secured by fixed assets (EUR 8,186 and 2009 - nil) (a) | 10,671 | – |
| Credit agreement with bank maturing 2012; interest at 4.8% unsecured (CHF 3,925; 2009 - CHF 4,710) | 3,863 | 4,760 |
| Credit agreement with bank maturing 2011, 2013 and 2018; interest up to 3.1% and 4.9% secured by fixed assets (CHF 13,950; 2009 - CHF 14,130) | 13,731 | 14,281 |
| Capital leases; interest at 4.0% (EUR 235; 2009 - EUR 324) | 307 | 486 |
| Credit agreement with lender maturing 2015; interest at 7% unsecured (b) | 14,788 | – |
| Credit agreement with lender maturing 2014; interest up to 5.5% secured by assets (c) | 857 | – |
| | 47,901 | 24,362 |
| Less: Convertible debt allocated to contributed surplus (b) | (2,031) | – |
| Less: Current portion | (5,858) | (5,378) |
| | $ 40,013 | $ 18,984 |

Borrowings under the above agreements require maintenance of certain financial and non-financial covenants. The company has been in compliance with all covenants for the three and six months ended June 30, 2010.

(a) The credit agreement is a facility for up to EUR 18.5 million of which EUR 8.5 million has been drawn as at June 30, 2010. The facility bears interest at a rate of 6.2% up until the commercial production of the rebuilt paper machine at the Landqart facility. At the time of commercial production the loan is repayable in equal installments over 7 years and bears interest at a rate of 7.1%.

Transaction costs of $537 have been netted against the proceeds of the loan. Interest has been calculated at 7.6% using the effective interest rate method. The accretion recorded as an increase in the long term debt for the three and six month periods ended June 30, 2010 was $30 and $33 respectively.

(b) The convertible debt ("Convertible Note") is an unsecured convertible note of the Company in the principal amount of $15,000 that matures in April, 2015. The Convertible Note bears interest at an annual rate equal to 7%, calculated semi-annually with the first installment due on October 31, 2010.

Commencing April 30, 2010, the holder of the Convertible Note (the "Holder") may, at its option, convert the Convertible Note into common shares at any time until the close of business on the last business day prior to maturity. The conversion price shall be equal to $20.00 per share.

(Unaudited, Canadian dollars, amounts in thousands except share and per share data)

The Company may redeem the Convertible Note on or after April 30, 2012, at its option and repay in advance this option in whole or in part at par plus accrued and unpaid interest if the volume weighted average trading price of common shares on the TSX during 20 consecutive trading days, is not less than $25.00 per share.

The Company has initially recorded a liability portion of $12,969 and an equity portion of $2,031 in contributed surplus. The liability portion was valued using a 10.8% initial interest rate. Transaction costs of $270 have been netted against the liability portion of the loan and will be amortized at an effective interest rate of 16.3% assuming a 2 year expected life of the loan. Accretion of $58 has been recorded as an increase in the long term debt for the three and six month periods ended June 30, 2010.

(c) The credit agreement is a facility for up to $102.4 million of which $1.7 million has been drawn as at June 30, 2010. The facility bears interest at a rate of 5% for the first five years of the loan and at a rate of up to 5.5% for the second five years of the loan. Commencing after two years the facility is repayable in equal installments up to June 30, 2020.

Transaction costs of $891 have been netted against the proceeds of the loan. Interest has been calculated at 5.6% using the effective interest rate method. The accretion recorded as an increase in the long term debt for the three and six month periods ended June 30, 2010 was $6.

## 7. SHAREHOLDERS' EQUITY

(a) **Authorized:**

Unlimited number of common shares without par value
Unlimited number of preferred shares with par value $1,000

(b) **Issued and fully paid — common shares**:

| | Number of Shares | Share Capital | Contributed Surplus |
|---|---|---|---|
| **Balance, December 31, 2008** | 10,233,500 | $ 59,083 | $ 2,107 |
| Stock compensation | — | — | 981 |
| **Balance, December 31, 2009** | 10,233,500 | $ 59,083 | $ 3,088 |
| Stock compensation | 12,500 | — | 804 |
| Convertible debt | — | — | 2,031 |
| **Balance, June 30, 2010** | 10,246,000 | $ 59,083 | $ 5,923 |

## 8. STOCK OPTIONS

During 2006 the Company adopted a stock incentive plan. The exercise price of options granted under the stock option plan shall be as determined by the Board of Directors when such options are granted, subject to any limitations imposed by any relevant stock exchange or regulatory authority.

At the Company's annual general meeting held April 30, 2009 shareholders approved a long term incentive plan which provides for the grant of restricted share units, performance share units and deferred share units to key employees and directors of the Company. The aggregate number of shares issuable under the long-term incentive plan in respect of awards, together with shares reserved for issuance under all of the Company's other security-based compensation arrangements, shall not exceed ten percent of the Company's issued and outstanding shares.

(Unaudited, Canadian dollars, amounts in thousands except share and per share data)

*Stock Options*

In June 2009, options were granted for 35,000 shares which vest over two years to an employee and officer of the Company. The weighted average fair value of the options granted during 2009 was estimated at $2.98 per option (2008 - $2.57) at the grant date using the Black Scholes option pricing model. Option pricing models require the input of highly subjective assumptions including the expected volatility. Changes in the assumptions can materially affect the fair value estimate, and, therefore, the existing models do not necessarily provide a reliable measure of the fair value of the Company’s stock options. Assumptions used in the pricing model were as follows:

| | 2009 | 2008 |
|---|---|---|
| Risk free interest rate | 1.78% | 4% |
| Expected life of options | 5 years | 5 years |
| Annualized volatility | 53% | 40% |
| Dividend rate | Nil | Nil |

Stock option transactions and the number of stock options outstanding are summarised as follows:

| | Number of options | Exercise Price |
|---|---|---|
| **Balance, December 31, 2008** | 1,012,675 | $ 8.00 |
| Forfeiture May 25, 2009 | (25,000) | 8.00 |
| Cancelled June 10, 2009 | (282,500) | 8.00 |
| Granted June 23, 2009 | 35,000 | 8.00 |
| **Balance, December 2009 and June 30, 2010** | 740,175 | $ 8.00 |

As at June 30, 2010, 498,275 stock options were exercisable (December 31, 2009 – 486,842). No stock options were exercised during the quarter ended June 30, 2010, or during the year ended December 31, 2009. The stock options issued have various vesting dates which range from one to three years from the IPO or grant dates. The weighted average remaining expected life of the stock options issued as at June 30, 2010 is 2.3 years. The Company recorded $64 and $127 stock compensation expense and contributed surplus for the three and six months ended June 30, 2010 and $208 and $410 for the three and six months ended June 30, 2009.

*Deferred Share Unit Awards*

A Deferred Share Unit (“DSU”) is a right granted to a non-employee director to receive one common share of the Company, from treasury, on a deferred basis. The value of the DSUs, when redeemed, is equal to the market value of the shares on the redemption date, including the value of dividends paid on the Company's common shares, if any, as if they had been reinvested in additional DSUs on each payment date. The DSUs may only be redeemed upon a director's retirement from the Company. The Company recognizes the expense at the time of grant. On April 16, 2010, non-employee directors were awarded 1,312 units in aggregate. The Company recorded $32 and $92 stock compensation expense and contributed surplus for the three and six months ended June 30, 2010 (2009 - $nil). At June 30, 2010 there were 31,567 units outstanding.

*Restricted Share Unit Awards*

A Restricted Share Unit ("RSU") is a right granted to a key employee to receive one common share of the Company, from treasury, on a time vested basis. The fair value of restricted share awards is determined based upon the number of shares granted and the quoted price of the Company's stock on the date of grant. Restricted shares generally vest over three years. The Company recognizes the expense on a straight-line basis over the vesting period. On June 3, 2010 restricted shares of 75,000 units were awarded to key employees. For the three and six months ended June 30, 2010, $489 and $585 was recorded as stock compensation expense and contributed surplus (2009 - $nil). As at June 30, 2010, the total remaining unrecognized compensation cost related to RSUs amounted to $2,417, which will be amortized over their remaining vesting period. At June 30, 2010 there were 231,295 units outstanding.

## 9. SEGMENTED INFORMATION

The segmentation of the Company's manufacturing operations by mill is based on a number of factors, including production, production processes, and economic characteristics. The Landqart mill produces specialty and security papers while the Dresden mill produces non-woven wallpaper base products. During the three month period ended June 30, 2009, the Company earned revenue from one customer representing approximately 11% of sales. Fortress Specialty Cellulose had a pulp purchase and sale agreement with an exclusive distributor who had placed 100% of the mills sales for the three months ended June 30, 2010. During the six month period ended June 30, 2009, the Company earned revenue from two customers each representing approximately 10% of sales. No single customer accounted for 10% or more of the Company's total sales for the six months ended June 30, 2010.

**FORTRESS PAPER LTD.**
**NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS**
**(Unaudited, Canadian dollars, amounts in thousands except share and per share data)**

| | Three months ended June 30, 2010 | | | | |
|---|---|---|---|---|---|
| | **Dresden Mill** (Germany) | **Landqart Mill** (Switzerland) | **FSC Mill** (Canada) | **Corporate** (Canada) | **Fortress Paper Consolidated** |
| Sales | $ 28,931 | 18,070 | 13,543 | — | $ 60,544 |
| Operating earnings (loss) | $ 3,681 | 285 | (1,124) | (1,402) | $ 1,440 |
| Amortization | $ (605) | (815) | (609) | — | $ (2,029) |
| Stock-based compensation[1] | $ — | — | — | (585) | $ (585) |
| Capital expenditures | $ 1,331 | 9,612 | 1,323 | — | $ 12,266 |
| Property, plant and equipment | $ 22,661 | 44,668 | 59,630 | — | $ 126,959 |
| **Sales by geographic area** | **%** | **%** | **%** | | **%** |
| Germany | 37.5 | 27.2 | — | | 26.1 |
| Switzerland | — | 17.9 | — | | 5.3 |
| Other Western Europe | 27.5 | 36.3 | 69.6 | | 39.5 |
| Eastern Europe | 31.3 | 14.1 | — | | 19.3 |
| North America | — | — | 24.5 | | 5.4 |
| Other | 3.7 | 4.5 | 5.9 | | 4.4 |
| Total | 100.0 | 100.0 | 100.0 | — | 100.0 |

[1]Stock-based compensation is included in operating earnings (loss)

| | Three months ended June 30, 2009 | | | |
|---|---|---|---|---|
| | **Dresden Mill** (Germany) | **Landqart Mill** (Switzerland) | **Corporate** (Canada) | **Fortress Paper Consolidated** |
| Sales | $ 28,777 | 20,861 | — | $ 49,638 |
| Operating earnings (loss) | $ 5,477 | 28 | (1,045) | $ 4,460 |
| Amortization | $ (514) | (515) | — | $ (1,029) |
| Stock-based compensation[2] | $ — | — | (210) | $ (210) |
| Capital expenditures | $ 162 | 1,521 | — | $ 1,683 |
| Property, plant and equipment | $ 16,723 | 27,775 | — | $ 44,498 |
| **Sales by geographic area** | **%** | **%** | | **%** |
| Germany | 54.6 | 19.0 | | 39.7 |
| Switzerland | — | 28.1 | | 11.8 |
| Other Western Europe | 21.1 | 36.1 | | 27.4 |
| Eastern Europe | 23.3 | 7.7 | | 16.7 |
| Other | 1.0 | 9.1 | | 4.4 |
| Total | 100.0 | 100.0 | — | 100.0 |

[2]Stock-based compensation is included in operating earnings (loss)

**FORTRESS PAPER LTD.**
**NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS**
**(Unaudited, Canadian dollars, amounts in thousands except share and per share data)**

| | Six months ended June 30, 2010 | | | | |
|---|---|---|---|---|---|
| | **Dresden Mill** (Germany) | **Landqart Mill** (Switzerland) | **Thurso Mill** (Canada) | **Corporate** (Canada) | **Fortress Paper Consolidated** |
| Sales | $ 60,124 | 37,181 | 13,543 | — | $ 110,848 |
| Operating earnings (loss) | $ 9,007 | 931 | (1,124) | (3,172) | $ 5,642 |
| Amortization | $ (1,184) | (1,624) | (609) | — | $ (3,417) |
| Stock-based compensation[1] | $ — | — | — | (804) | $ (804) |
| Capital expenditures | $ 3,640 | 18,390 | 1,323 | — | $ 23,353 |
| Property, plant and equipment | $ 22,661 | 44,668 | 59,630 | — | $ 126,959 |
| **Sales by geographic area** | % | % | % | | % |
| Germany | 39.4 | 27.6 | — | | 30.7 |
| Switzerland | — | 14.3 | — | | 4.8 |
| Other Western Europe | 27.7 | 39.8 | 69.6 | | 36.8 |
| Eastern Europe | 30.0 | 10.6 | — | | 19.9 |
| North America | | — | 24.5 | | 3.0 |
| Other | 2.9 | 7.7 | 5.9 | | 4.8 |
| Total | 100.0 | 100.0 | 100.0 | — | 100.0 |

[1]Stock-based compensation is included in operating earnings (loss)

| | Six months ended June 30, 2009 | | | |
|---|---|---|---|---|
| | **Dresden Mill** (Germany) | **Landqart Mill** (Switzerland) | **Corporate** (Canada) | **Fortress Paper Consolidated** |
| Sales | $ 55,039 | 41,222 | — | $ 96,261 |
| Operating earnings (loss) | $ 9,511 | 868 | (2,154) | $ 8,225 |
| Amortization | $ (1,103) | (993) | — | $ (2,096) |
| Stock-based compensation[2] | $ — | — | (410) | $ (410) |
| Capital expenditures | $ 1,128 | 1,930 | — | $ 3,058 |
| Property, plant and equipment | $ 16,723 | 27,775 | — | $ 44,498 |
| **Sales by geographic area** | % | % | | % |
| Germany | 43.3 | 18.3 | | 32.6 |
| Switzerland | 0.2 | 27.8 | | 12.0 |
| Other Western Europe | 23.3 | 37.4 | | 29.3 |
| Eastern Europe | 31.6 | 5.8 | | 20.6 |
| Other | 1.6 | 10.7 | | 5.5 |
| Total | 100.0 | 100.0 | — | 100.0 |

[2]Stock-based compensation is included in operating earnings (loss)

(Unaudited, Canadian dollars, amounts in thousands except share and per share data)

## 10. SUPPLEMENTARY CASH FLOW INFORMATION

| | Three Months Ended June 30, 2010 | Three Months Ended June 30, 2009 | Six Months Ended June 30, 2010 | Six Months Ended June 30, 2009 |
|---|---|---|---|---|
| Interest paid | $ 315 | $ 245 | $ 634 | $ 464 |
| Income taxes paid | 1,573 | 937 | 5,730 | 3,561 |

**Non cash items**

Non cash property, plant and equipment purchases included in accounts payable increased by $801 for the three months ended June 30, 2010 and decreased by $228 for the three months ended June 30, 2009.

Non cash property, plant and equipment purchases included in accounts payable increased by $1,584 for the six months ended June 30, 2009 and decreased by $581 for the six months ended June 30, 2009.

## 11. COMMITMENTS

As at June 30, 2010 the company has committed to purchase $21.7 million in property, plant and equipment over the next twelve months.

## 12. SUBSEQUENT EVENTS

In July 2010, Fortress Paper completed a public offering of 1,739,000 common shares of the Company and the underwriters exercised their over-allotment option and purchased an additional 161,050 common shares at a price of $23.50 per share, resulting in aggregate gross proceeds under the offering of $44,651. Proceeds of the offering will be used to finance certain capital expenditures relating to its Fortress Specialty Cellulose mill and its rebuild of papermachine number 1at the Landqart mill, and for working capital.