Management's Discussion & Analysis

Three-month period ended June 30, 2007 compared with three-month period ended June 30, 2006.

The following Management's Discussion and Analysis ("MD&A") dated August 14, 2007 should be read in conjunction with the MD&A for the year ended December 31, 2006, the audited consolidated financial statements for the year ended December 31, 2006, and the unaudited consolidated interim financial statements of the Company for the three months ended June 30, 2007 with the notes thereto. The interim financial results are prepared in accordance with Canadian Generally Accepted Accounting Principles and results are reported in Canadian dollars. The MD&A contains statements that are forward looking in nature. Such statements involve known and unknown risks and uncertainties that may cause the actual results of the Company to be materially different from those expressed or implied by such forward-looking statements. Such items include, among others: general economic and business conditions, product selling prices, raw material and operating costs, changes in foreign currency rates and other factors referenced herein and in the Company's continuous disclosure filings. Additional information, including the Company's annual information form, quarterly and annual reports, and supplementary information is available on SEDAR at www.sedar.com. Press releases and other information are also available in the Financial Information section of the Company's website at www.stella-jones.com.

Operating results

Sales for the second quarter ended June 30, 2007 reached $84.5 million, an increase of $23.1 million, or 37.6% over last year's second quarter sales of $61.4 million. The Carseland, Alberta facility, acquired on July 1, 2006, was responsible for $17.4 million, or about 75% of the year-over-year gain. The Arlington, Washington facility, which was acquired on February 28, 2007, contributed a further $7.3 million in sales. Excluding acquisitions, sales decreased slightly owing to temporary difficulties in securing the railway cars required for timely product shipment during labour conflicts that affected Canada's railway network.

For the six-month period ended June 30, 2007, sales grew by 37.8% to $146.5 million, up from $106.3 million for the same period last year. The aforementioned acquisitions contributed $37.8 million, or 94.0% of the year-over-year increase.

During the second quarter, sales of utility poles grew by 67.8% to $35.9 million, with the Carseland and Arlington facilities accounting for essentially all of the increase. Organic growth was slightly affected by the lack of railcar availability, as mentioned above. This situation also impacted railway tie sales which marginally declined by $0.4 million to $31.6 million. During the quarter, a new treating cylinder was added at the Bangor, Wisconsin facility, but minor start-up issues, which are now resolved, caused sales to be slightly lower than initially expected. Residential lumber sales rose to $12.5 million, an increase largely attributable to the contribution of the Carseland facility and to solid organic growth owed to a resilient renovation market. Industrial lumber sales declined by 7.3% to $4.5 million during the quarter.

Gross profit improved noticeably in the three-month period ended June 30, 2007 both in dollar terms and as a percentage of sales. Gross profit improved to $20.3 million or 24.0% of sales, from $14.1 million or 22.9% of sales in the same period in 2006, an increase of 44.2%. Second quarter margins as a percentage of sales improved or remained stable in every product category compared with the same period last year. The sole exception was the residential lumber category, where margins at the Carseland facility are lower on a percentage of sales basis owing to a full-service offering as opposed to plants providing treating services only. Despite lower margins from the Arlington facility pending its full integration and optimization, a favourable product mix and improved product pricing positively impacted margins, while economies of scale, operational efficiencies and better throughput were also key drivers during the second quarter.

For the first six months of 2007, gross profit stood at $36.2 million or 24.7% of sales, representing an increase of 54.5% over the $23.4 million or 22.0% of sales achieved for the same period a year earlier.

Selling and administrative expenses for the second quarter of 2007 were $5.2 million, an increase of $1.0 million or 23.2% when compared with the same period of 2006. This variation mainly relates to the business acquisitions completed since the end of the second quarter of 2006. However, as a percentage of sales, selling and administrative expenses decreased to 6.1% from 6.8% last year.

After the first six months of 2007, selling and administrative expenses stood at $8.7 million or 5.9% of sales, compared with $6.7 million or 6.3% of sales for the corresponding period in 2006. Of note, last year's selling and administrative expenses included a one-time gain of approximately $550,000 from the lease of certain cutting rights in the Company's British Columbia forestry operations.

Amortization of capital assets reached $1.3 million in the second quarter of 2007, a 61.8% increase from the $803,000 recorded in the second quarter of 2006. This increase reflects the growth of Stella-Jones' capital assets over the past year as a result of acquisitions and investments in new equipment. After six months, amortization amounted to $2.4 million in 2007, an increase of 49.2% over the same period in 2006.

Financial expenses for the three months ended June 30, 2007 were $1.4 million compared with $786,000 for the same period in 2006. The rise in financial expenses is due to increases in short and long-term borrowings as a result of the acquisition of the Carseland, Alberta facility in July 2006, as well as the Arlington, Washington and Juliaetta, Idaho facilities in February 2007, combined with increases in the Company's working capital requirements. For the six-month period, financial expenses stood at $2.8 million in 2007, compared with $1.5 million in 2006.

Income tax expenses amounted to $3.9 million for the second quarter of 2007, representing an effective tax rate of 32.7% compared with 34.3% for the same period in the prior year. For the first half of this year, income tax expenses reached $7.7 million, for an effective tax rate of 35.1% compared with 34.5% for the first half of last year.

Net earnings were $8.1 million, or $0.64 per share, fully diluted, in the second quarter ended June 30, 2007 compared with $5.4 million, or $0.48 per share, fully diluted, in the corresponding period of 2006. For the six-month period ended June 30, 2007, net earnings reached $14.2 million, or $1.12 per share, fully diluted, versus $0.80 last year on a fully diluted basis.

Business Acquisition

On February 28, 2007, the Company announced that its wholly-owned U.S. subsidiary, Stella-Jones Corporation, ("SJ Corp"), acquired the assets of the wood utility pole business of J.H. Baxter & Co. ("Baxter"). Assets acquired included the Baxter production plant located in Arlington, Washington, its pole peeling facility in Juliaetta, Idaho as well as all inventories and accounts receivable relating to its wood pole business.

The acquisition has been accounted for using the purchase method and accordingly, the purchase price was allocated to the assets acquired and liabilities assumed based on Management's estimate of their fair value as of the acquisition date. The following fair value allocation is preliminary and is based on Management's best estimates and information known at the time of preparing these interim unaudited consolidated financial statements. Subsequent revisions to this preliminary fair value allocation, if any, are expected to be accounted for by December 31, 2007. The results of operations of Baxter have been included in the consolidated financial statements from the acquisition date.

The following is a summary of the net assets acquired at fair values:

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Assets acquired	
Accounts receivable	3,792,494
Inventories	9,849,614
Prepaid expenses	143,523
Capital assets	12,605,534
	26,391,165
Liabilities assumed	
Obligation under capital lease	278,995
	26,112,170
Consideration	
Cash, including transaction costs of $386,528	16,975,602
Receivable from vendor	(168,749)
Long-term subordinated note payable to vendor	9,285,600
Reserve amount for transaction costs, included in accounts payable	19,717
	26,112,170

Financing for the transaction was provided by a subordinated vendor note of US$8.0 million as well as additional debt funding under existing and new bank facilities. The new bank facilities are comprised of an increase of US$5.0 million in the operating line of credit of SJ Corp as well as a new 5-year term loan of US$4.0 million, both arranged with its existing U.S. banker.

Liquidity and capital resources

Cash flows from operating activities totaled $9.9 million for the second quarter of 2007, compared with $6.9 million in the corresponding period last year. For the six-month period, cash flows from operating activities were $17.5 million, a $5.8 million increase over the corresponding period last year.

After working capital requirements, year-to-date operating activities have used $5.8 million compared with $2.1 million in the corresponding period last year. Since the beginning of 2007, the $14.1 million increase in accounts receivable is attributable to the increase in sales volume whereas the $5.1 million increase in inventories is related to the regular seasonal build-up of inventories for summer shipments and anticipated future demand. The acquisition of Baxter is also partially responsible for these variances. Consequently, working capital of $96.5 million as at June 30, 2007 represents an increase of $16.5 million from the $80.0 million in working capital as at December 31, 2006.

Short-term bank indebtedness has increased by $16.2 million since December 31, 2006 and stood at $58.4 million as at June 30, 2007 reflecting the Company's increased working capital requirements and the additional bank borrowings related to the February 28, 2007 acquisition, as outlined above. The Company remains within its bank margining limits and was in compliance with all of its banking covenants throughout the six-month period.

Long-term debt and other long-term liabilities, including the current portion, increased by $17.6 million compared to December 31, 2006 levels, to stand at $49.5 million as at June 30, 2007. This increase was attributable to increased borrowings under the Company's term loans and a subordinated vendor note of US$8.0 million issued to Baxter, in conjunction with the February 2007 acquisition.

Shareholders' equity increased to $119.1 million as at June 30, 2007 and now represents a book value of $9.66 per share, up from $8.60 per share at the end of 2006. The Company's long-term debt to equity ratio was 0.42:1 as at June 30, 2007 compared with 0.30:1 as at December 31, 2006, as a result of the increased borrowings for the Baxter acquisition. As at August 13, 2007, the capital stock issued and outstanding consisted of 12,329,969 common shares (12,298,015 as at December 31, 2006).

Capital expenditures were $1.9 million and $4.2 million, respectively, for the second quarter and first six months of 2007. Of these amounts, $1.4 million in the second quarter and $2.8 million in the first six months was related to the expansion of the Bangor, Wisconsin facility with, among other initiatives, the addition of a new treating cylinder. The remainder of the capital acquisitions were for equipment upgrades, renovations and repairs at the Company's other facilities.

Risks and Uncertainties

The risk and uncertainty factors affecting the Company in the future remain substantially unchanged from those included in the Company's annual MD&A contained in its 2006 Annual Report.

Changes in Accounting Policies

The Canadian Institute of Chartered Accountants ("CICA") has issued the following new Handbook Sections which are effective for the Company's interim periods beginning on January 1, 2007:

- Handbook Section 3855, "Financial Instruments – Recognition and Measurement", describes the standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. All financial assets, except for those classified as held-to-maturity or loans and receivables, and derivative financial instruments must be measured at their fair value. All financial liabilities must be measured at their fair value if they are classified as held for trading purposes. If not, they are measured at their carrying value.

  The Company has implemented the following classification:

  Cash and cash equivalents are classified as assets held for trading and are measured at fair value.

  Accounts receivable and loans to certain suppliers are classified as loans and receivables. After their initial fair value measurement, they are measured at amortized cost using the effective interest rate method. For the Company, the measured amount generally corresponds to cost.

  Bank loans, accounts payable, credit facilities, notes, loans payable, and obligations under capital leases are classified as other financial liabilities. After their initial fair value measurement, they are measured at amortized cost using the effective interest rate method. For the Company, the measured amount generally corresponds to cost.

- Handbook Section 1530, "Comprehensive Income", describes how to report and disclose comprehensive income and its components. Comprehensive income is the change in equity of an enterprise during a period arising from transactions and other events and circumstances from non-owner sources. It includes items that would normally not be included in net income such as changes in the foreign currency translation adjustment relating to self-sustaining foreign operations and unrealized gains or losses on available for sale financial instruments. Upon adoption of this section, the consolidated interim financial statements now include a statement of comprehensive income.

- Section 3251, "Equity", replaces Section 3250, "Surplus", and describes the changes in how to report and disclose equity and changes in equity as a result of the new requirements of Section 1530, "Comprehensive Income".

- Handbook Section 3865, “Hedges”, describes when hedge accounting is appropriate. Hedge accounting ensures that all gains, losses, revenues and expenses from the derivative and the item it hedges are recorded in the statement of earnings in the same period.

  The Company enters into foreign exchange forward contracts to limit its exposure under contracted net cash inflows and outflows of US dollars. The Company also enters into interest rate swaps in order to reduce the impact of fluctuating interest rates on its short-term and long-term debt. The Company has documented its use of derivative financial instruments and has concluded that they qualify for hedge accounting.

The adoption of these new standards translated into the following changes as at January 1, 2007: a $568,785 increase in accumulated other comprehensive income, a $848,933 increase in short-term and long-term derivative financial instruments reported under assets and a $280,148 increase in future tax liabilities.

For the three-month period ended June 30, 2007, the Company recorded an increase of $295,835 in accumulated other comprehensive income, an increase of $466,794 in short-term and long-term derivative financial instruments reported under assets and an increase of $170,958 in future tax liabilities. During the period, a gain on foreign exchange forward contracts of $691,129 was reclassified from other comprehensive income to sales.

For the six-month period ended June 30, 2007, the Company recorded an increase of $444,620 in accumulated other comprehensive income, an increase of $688,860 in short-term and long-term derivative financial instruments reported under assets and an increase of $244,239 in future tax liabilities. During the period, a gain on foreign exchange forward contracts of $691,129 was reclassified from other comprehensive income to sales.

Contractual Obligations

In the normal course of business, the Company enters into certain contractual obligations and commercial commitments, such as operating leases, letters of credit and others. The summary of the Company’s obligations and commitments as at December 31, 2006 can be found in its 2006 Annual Report and have not materially changed since December 31, 2006.

Outlook

Stella-Jones is satisfied with its solid performance in the second quarter despite the temporary external logistical disturbances, which have since been resolved. Management remains optimistic about further growth potential in 2007 and beyond.

However, the on-going forest industry strike in southern British Columbia, which began on July 20, 2007, has forced the suspension to date of our operations at New Westminster and at our pole peeling joint venture in Maple Ridge. Our Prince George treating plant is not affected and is in full operation. Any impact on the Company’s profitability would be directly linked with the duration of the suspended operations. As of this writing, Management is unable to assess the potential timing of any settlement. While the Company has contingency plans aimed at maintaining a high level of customer service, such plans would imply higher costs for the Company.

End markets for the Company’s products are continuing to enjoy strong fundamentals. Demand for utility poles is stable and the February 28, 2007 acquisition in the Pacific Northwest will allow the Company to continue to leverage market opportunities and synergies for all of its facilities. Management is looking forward to optimizing the contribution of these assets in coming quarters. In railway ties, the minor production delays related to the expansion of the Bangor, Wisconsin facility with an additional treating cylinder are now behind us and the new production capacity will start to favourably impact results. In

residential lumber, Management expects a solid performance going forward, while our industrial lumber sales should remain sound, although it may be difficult to match last year’s record performance.

Management remains focused on delivering strong bottom line performance to shareholders by integrating recently acquired assets, as well as leveraging the opportunities for external growth currently available to the Company. In this regard, the American market will likely continue to play a significant role in the Company's future expansion.

August 14, 2007