



FORTRESS PAPER LTD.

Q1 2008

FOR THE THREE MONTHS ENDED

MARCH 31, 2008

**FORTRESS PAPER LTD.
FIRST QUARTER 2008
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 month period ended March 31, 2008 and with the audited consolidated financial statements for the year ended December 31, 2007 (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 March 31, 2008 relative to the previous quarter and prior year comparative quarter.

This interim 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.

Throughout this discussion, reference is made to EBITDA (defined as earnings 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 May 12, 2008.

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.

The Company completed its initial public offering ("IPO") on June 28, 2007 by the issuance of 5,000,000 common shares at an offering price of \$8.00 per share for total proceeds of \$40 million. The shares commenced trading on the Toronto Stock Exchange on June 28, 2007 under the symbol "FTP". At the same time IPO proceeds were used to repay a CHF 6.4 million note (CAD 5.6 million). In July 2007, pursuant to an underwriting agreement between the Company and the underwriters, in connection with the initial public offering of the Company, the underwriters exercised their option to purchase an additional 750,000 common shares of the Company at a price of \$8.00 per share, bringing the total gross proceeds from the IPO to \$46 million. Net of issuance costs the Company received proceeds of \$40.6 million.

First Quarter 2008 Earnings Review

Selected Financial Information and Statistics

| (thousands of dollars, except per unit amounts and shipments, unaudited) | Q1 2008 | Q4 2007 | Q1 2007 |
|--|---------|---------|---------|
| Sales | 49,789 | 37,537 | 38,251 |
| EBITDA ¹ | 6,643 | 4,255 | 2,841 |
| Operating income | 5,527 | 3,380 | 2,448 |
| Net income | 4,189 | 2,279 | 1,094 |
| Shipments (tonnes) | 15,004 | 13,247 | 13,470 |

¹See net earnings to EBITDA reconciliation.

Overview

Sales. Sales for the three months ended March 31, 2008 were significantly higher relative to the fourth and first quarters of 2007 primarily due to capacity increases at both our mills and the continued shift at the Dresden mill towards more non-woven wallpaper base.

Landqart produces various specialty and security papers. Security paper production includes banknotes which result in varying degrees of EBITDA margin depending on the complexity of the features included. Landqart's production and sales during the first half of 2008 will have a greater percentage of lower security banknotes compared to the second half of 2008.

Cost of Products Sold. Cost of products sold was \$38.2 million or 76.7% of sales for the three months ended March 31, 2008. In the fourth and first quarters of 2007 cost of products sold were \$28.1 million or 74.9% and \$30.0 million or 78.4%, respectively. The mills operated at full capacity during the respective periods.

Selling, General and Administrative. Selling, general and administrative expenses were \$4.9 million (fourth quarter 2007, \$5.2 million and first quarter 2007, \$5.4 million) and were comprised primarily of sales commissions, marketing, corporate and administrative expenses.

Stock-based Compensation. Stock-based compensation expense was \$0.4 million during the period (fourth quarter 2007, \$0.3 million and first quarter 2007, \$nil) reflecting the grant of 982,675 options issued to directors and officers of the Company in fiscal 2007 and 30,000 issued to an employee in January 2008.

EBITDA. As a result of the foregoing factors, EBITDA was \$6.6 million for the first quarter of 2008 compared to \$4.3 million and \$2.8 million for the fourth and first quarters of 2007, respectively.

Net earnings to EBITDA reconciliation:

| (thousands of dollars, unaudited) | Q1 2008 | Q4 2007 | Q1 2007 |
|-----------------------------------|---------|---------|---------|
| Net earnings | 4,189 | 2,279 | 1,094 |
| Income tax | 2,130 | 906 | 845 |
| Other expense | (943) | 58 | 32 |
| Interest expense | 151 | 137 | 477 |
| Amortization | 740 | 588 | 393 |
| Stock based compensation | 376 | 287 | - |
| EBITDA | \$6,643 | \$4,255 | \$2,841 |

Foreign exchange. During the first quarter of 2008, the Company's results were positively affected by the depreciating Canadian dollar relative to the Euro and Swiss Franc. Relative to the Canadian dollar, the average Euro and Swiss Franc rates have strengthened during the quarter by approximately 3.5 cents and 4.5 cents respectively when compared to the fourth quarter average for 2007. Based on the production and sales for the quarter ended March 31, 2008, every 1 percent decrease in the Canadian dollar relative to the Euro and Swiss Franc impacts EBITDA positively by approximately \$72,000 for the quarter.

Operating Results by Business Segment

Landqart Mill

| (thousands of dollars, except per unit amounts and shipments, unaudited) | Q1 2008 | Q4 2007 | Q1 2007 |
|--|---------|---------|---------|
| Sales | 20,725 | 17,072 | 17,189 |
| Operating income | 750 | 1,715 | 522 |
| Shipments (tonnes) | 4,603 | 4,138 | 4,425 |

Dresden Mill

| (thousands of dollars, except per unit amounts and shipments, unaudited) | Q1 2008 | Q4 2007 | Q1 2007 |
|--|---------|---------|---------|
| Sales | 29,064 | 20,465 | 21,062 |
| Operating income | 5,732 | 2,556 | 2,125 |
| Shipments (tonnes) | 10,401 | 9,109 | 9,045 |

Liquidity and Capital Resources

The Company has no exposure to asset backed commercial paper or off balance sheet instruments.

The Company has a net positive cash position of \$8.3 million (cash and cash equivalents less debt). EBITDA amounted to \$6.6 million in the three months ended March 31, 2008.

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 the IPO 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 outstanding convertible note 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.

Operating Activities

Fortress operates in a cyclical industry and its operating cash flows vary accordingly. Fortress' principal operating cash expenditures are for compensation, fibre, chemicals and debt service. Operating activities generated cash of \$3.8 million in the first quarter of 2008 compared to \$3.1 million in the fourth quarter of 2007 and \$1.1 million in the first quarter of 2007.

Working capital is subject to cyclical operating needs, the timing of collection of receivables and the payment of payables and expenses.

Investing Activities

Investing activities in the first quarter of 2008 used cash of \$2.0 million related to the purchase of plant and equipment at the mills. During the same period, the Company received 6,500,000 shares of iDcentrix for licensing of LQard exclusive rights for the United States and Mexico and non exclusive rights for other countries. Concurrent with this transaction, iDcentrix became a public company. The fair value of the shares initially recorded as an increase in other income was determined to be \$560. The Company recognized \$257 as other expenses for previously unrecorded equity losses relating to 2007. The Company recognized \$303 as other expenses for equity losses relating to the three months ended March 31, 2008.

Financing Activities

Financing activities in the first quarter of 2008 used cash of \$4.8 million primarily related to the repayment of operating loans and long term debt amounting to \$6.6 million partially offset by 1.8 million in additional loans.

Related Party Transactions

In the three month period ended March 31, 2008, the Company, in the normal course of business, has paid office and administration expenses of \$23,000 (2007 - \$23,000) to a company with a common director.

These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

Outstanding Shares

The number of common shares outstanding at March 31, 2008 and the date of this report was 10,203,300. The number of options outstanding at March 31, 2008 and the date of this report was 1,012,675.

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, allocation of purchase price of acquisitions, stock based compensation, pensions and post-retirement obligations, income taxes and contingencies. Actual results could differ from these estimates.

Changes in Accounting Policies

Effective January 1, 2008, the Company adopted the Canadian Institute of Chartered Accountants' new Handbook Sections; 1535 "Capital Disclosures", 3862 "Financial Instruments – Disclosures" and 3863 "Financial Instruments – Presentation". Handbook Sections 3862 and 3863 replace Section 3861 "Financial Instruments – Disclosure and

Presentation". These recommendations have been incorporated into the unaudited interim consolidated financial statements.

Section 1535 – Capital Disclosures

This Section establishes standards for disclosing information about an entity's capital and how it is managed. Under this standard the Company is required to disclose qualitative and quantitative information that enables users of the financial statements to evaluate the Company's objectives, policies and processes for managing capital (see note 7 to the interim consolidated financial statements).

Section 3031 – Inventories

This Section replaces Section 3030 and prescribes the accounting treatment for inventories and provides guidance on the determination of costs and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on assigning costs to inventories and in conjunction with Section 3061 "Property Plant and Equipment", provides guidance on classification of major spare parts. The adoption of this Section did not have a significant impact on the Company.

Section 3862 – Financial Instruments – Disclosures

This Section requires entities to provide disclosure of quantitative and qualitative information in their financial statements that enable users to evaluate (a) the significance of financial instruments for the entity's financial position and performance; and (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and management's objectives, policies and procedures for managing such risks (see note 11 to the interim consolidated financial statements).

Section 3863 – Financial Instruments – Presentation

This Section establishes standards for presentation of financial instruments and non-financial derivatives.

Internal Controls Over Financial Reporting

During the quarter ended March 31, 2008, there were no changes in the Company's internal controls over financial reporting that materially affected, or would be reasonably likely to materially affect, such controls.

Management's Outlook

The market for security papers remains strong with the driving forces continuing to be innovation to stay ahead of counterfeiters, quality of the end products, and the confidence in and reputation of suppliers. The wallpaper base market's trend of displacing traditional paper-based products with the improved non-woven wallpaper bases continues to be a major factor in the industry with positive implications for the Company. The Company has a very strong balance sheet and continues to selectively evaluate both organic opportunities to further increase capacity and external acquisitions to take advantage of strong industry fundamentals for our portfolio of products.

Earnings Sensitivity

Based on production and sales for the quarter ended March 31, 2008, changes in pulp prices and exchange rates could affect annualised EBITDA as follows:

| | |
|---|---------------------------|
| Pulp price sensitivity – 1% price increase | \$324,000 negative impact |
| Canadian dollar sensitivity – 1% strengthening against the Euro and Swiss Franc | \$288,000 negative impact |

Risks and Uncertainties

A comprehensive discussion of Risk Factors is included in the Company's 2007 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)

| | Q1 2008 | Q4 2007 | Q3 2007 | Q2 2007 | Q1 2007 |
|---|---------|---------|---------|---------|---------|
| Sales | 49,789 | 37,537 | 34,065 | 35,441 | 38,251 |
| Operating income | 5,527 | 3,380 | 1,406 | 3,364 | 2,448 |
| EBITDA | 6,643 | 4,255 | 2,196 | 4,319 | 2,841 |
| Net income | 4,189 | 2,279 | 211 | 1,700 | 1,094 |
| Basic EPS | \$0.41 | \$0.22 | \$0.02 | \$0.40 | \$0.35 |
| Diluted EPS | \$0.38 | \$0.22 | \$0.02 | \$0.38 | \$0.20 |
| Weighted average shares outstanding | | | | | |
| Basic (thousands) | 10,203 | 10,204 | 10,049 | 4,275 | 3,102 |
| Weighted average shares outstanding | | | | | |
| Diluted (thousands) | 11,141 | 11,141 | 10,986 | 5,212 | 6,227 |
| Average Swiss/Canadian exchange rate ⁽¹⁾ | 0.8946 | 0.8563 | 0.8720 | 0.8982 | 0.9501 |
| Average Euro/Canadian exchange rate ⁽¹⁾ | 1.4691 | 1.4213 | 1.4370 | 1.4801 | 1.5355 |

(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 March 31, 2008 | As at December 31, 2007 |
|---|-------------------------|----------------------------|
| ASSETS | | |
| Current | | |
| Cash and cash equivalents | \$ 42,284 | \$ 45,307 |
| Trade accounts receivable | 17,321 | 11,778 |
| Other accounts receivable | 3,221 | 2,899 |
| Inventories | 24,939 | 23,808 |
| Prepaid expenses | 370 | 420 |
| | 88,135 | 84,212 |
| Restricted cash | 47 | 44 |
| Property, plant and equipment | 32,267 | 30,626 |
| Employee future benefits | 9,996 | 8,303 |
| | 88,135 | 84,212 |
| Total assets | \$ 130,445 | \$ 123,185 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current | | |
| Operating loans (<i>note 4</i>) | \$ - | \$ 5,854 |
| Accounts payable and accrued liabilities | 21,081 | 20,319 |
| Income taxes payable | 5,333 | 3,241 |
| Other current liabilities | 2,870 | 3,037 |
| Current portion of long-term debt (<i>note 4</i>) | 5,325 | 4,813 |
| | 34,609 | 37,264 |
| Long-term debt (<i>note 4</i>) | 28,659 | 23,799 |
| Future income taxes | 2,899 | 2,408 |
| Total liabilities | \$ 66,167 | \$ 63,471 |
| Shareholders' equity (<i>note 5</i>) | | |
| Share capital | 58,427 | 58,428 |
| Contributed surplus | 1,884 | 1,508 |
| Retained earnings (deficit) | 3,967 | (222) |
| Total shareholders' equity | 64,278 | 59,714 |
| Total liabilities and shareholders' equity | \$ 130,445 | \$ 123,185 |

(See accompanying notes)

(Signed) *Chadwick Wasilenkoff*

(Signed) *Richard Whittall*

Chadwick Wasilenkoff
Director

Richard Whittall
Director

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

| | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 |
|--|--|--|
| Sales | \$ 49,789 | \$ 38,251 |
| Costs and expenses | | |
| Cost of products sold | (38,200) | (29,988) |
| Amortization | (740) | (393) |
| Selling, general and administration | (4,946) | (5,422) |
| Stock-based compensation (<i>note 6</i>) | (376) | - |
| Operating income | 5,527 | 2,448 |
| Other | | |
| Interest, net | 151 | (477) |
| Other expense, net (<i>note 3</i>) | - | 20 |
| Foreign exchange gain | (943) | (52) |
| Net income before income taxes | 6,319 | 1,939 |
| Income tax expense | (2,130) | (845) |
| Net income and comprehensive income | \$ 4,189 | \$ 1,094 |
| Earnings per share | | |
| Basic | \$ 0.41 | \$ 0.35 |
| Diluted | \$ 0.38 | \$ 0.20 |
| Weighted average number of shares outstanding | | |
| Basic | 10,203,491 | 3,102,061 |
| Diluted | 11,140,991 | 6,227,061 |
| | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 |
| Retained earnings (deficit) | | |
| Balance — beginning of period | \$ (222) | \$ (5,506) |
| Earnings | 4,189 | 1,094 |
| Balance — end of period | \$ 3,967 | \$ (4,412) |

(See accompanying notes)

FORTRESS PAPER LTD.
CONSOLIDATED STATEMENTS OF CASHFLOWS
(figures are in thousands of Canadian dollars except where indicated - unaudited)

| | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 |
|---|--|--|
| Cash flows from (used by) operating activities | | |
| Net income | \$ 4,189 | \$ 1,094 |
| Items not affecting cash: | | |
| Amortization | 740 | 393 |
| Future income taxes | 491 | (4) |
| Foreign exchange loss (gain) on long term debt | 4,013 | (71) |
| Foreign exchange loss (gain) on operating loan | 256 | (10) |
| Stock based compensation | 376 | - |
| | 10,065 | 1,402 |
| Change in non-cash working capital items | | |
| Accounts receivable | (5,865) | 3 |
| Inventories | (1,131) | (99) |
| Prepaid expenses | 50 | (285) |
| Other assets | 2,363 | (809) |
| Accounts payable and other | (1,693) | 909 |
| | 3,789 | 1,121 |
| Cash flows from (used by) financing activities | | |
| Issuance of common shares, net of issue costs (<i>note 5</i>) | - | 814 |
| Shares repurchased | (1) | - |
| Repayment of long-term debt | (424) | (245) |
| Proceeds from long-term debt | 1,759 | 256 |
| Repayment of operating loans | (6,110) | - |
| Proceeds from operating loans | - | 125 |
| Repayment of note payable | - | (2,999) |
| | (4,776) | (2,049) |
| Cash flows from (used by) investing activities | | |
| Additions to property, plant and equipment | (2,033) | (1,064) |
| Restricted cash | (3) | 2,926 |
| | (2,036) | 1,862 |
| Increase in cash position | (3,023) | 934 |
| Cash and cash equivalents, beginning of period | 45,307 | 7,320 |
| Cash and cash equivalents, end of period | 42,284 | 8,254 |
| Supplementary cash flow information (<i>note 10</i>) | | |

(See accompanying notes)

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

1. THE COMPANY AND BASIS OF PRESENTATION

Fortress Paper Ltd. (the "Company") 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.

The Company completed its initial public offering on June 28, 2007 by the issuance of 5,000,000 common shares at an offering price of \$8.00 per share for total proceeds of \$40,000. The shares commenced trading on the Toronto Stock Exchange under the symbol "FTP". On July 19, 2007, pursuant to an underwriting agreement between the Company and the Underwriters dated June 20, 2007, in connection with the initial public offering of the Company, the Underwriters exercised their option to purchase an additional 750,000 Common shares of the Company issued at a price of \$8.00 per shares, bringing the total gross proceeds from the initial public offering of Fortress Paper Ltd. to \$46,000.

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, 2007 (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, 2007 consolidated financial statements except as disclosed in note 2.

2. CHANGES IN ACCOUNTING POLICIES

Effective January 1, 2008, the Company adopted the Canadian Institute of Chartered Accountants' new Handbook Sections; 1535 "Capital Disclosures", 3862 "Financial Instruments – Disclosures" and 3863 "Financial Instruments – Presentation". Handbook Sections 3862 and 3863 replace Section 3861 "Financial Instruments – Disclosure and Presentation". These recommendations have been incorporated into these unaudited interim consolidated financial statements.

Section 1535 – Capital Disclosures

This Section establishes standards for disclosing information about an entity's capital and how it is managed. Under this standard the Company is required to disclose qualitative and quantitative information that enables users of the financial statements to evaluate the Company's objectives, policies and processes for managing capital (note 7).

Section 3031 – Inventories

This Section replaces Section 3030 and prescribes the accounting treatment for inventories and provides guidance on the determination of costs and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on assigning costs to inventories and in conjunction with Section 3061 "Property Plant and Equipment", provides guidance on classification of major spare parts. The adoption of this Section did not have a significant impact on the Company.

Section 3862 – Financial Instruments – Disclosures

This Section requires entities to provide disclosure of quantitative and qualitative information in their financial statements that enable users to evaluate (a) the significance of financial instruments for the entity's financial position and performance; and (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and management's objectives, policies and procedures for managing such risks (note 11).

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

Section 3863 – Financial Instruments – Presentation

This Section establishes standards for presentation of financial instruments and non-financial derivatives.

3. INVESTMENTS

During the year ended December 31, 2007, the Company received 3,500,000 shares of a private company, namely iDcentrix Inc. (“iDcentrix”), for licensing of LQard Canadian rights. The initial fair value of the shares was determined to be \$Nil. The Company is deemed to exert significant influence over iDcentrix through its share ownership and accounts for its investment in iDcentrix using the equity method.

During the three months ended March 31, 2008, the Company received 6,500,000 shares of iDcentrix for licensing of LQard exclusive rights for the United States and Mexico and non exclusive rights for other countries. Concurrent with this transaction, iDcentrix became a public company. The fair value of the shares initially recorded as an increase in other income was determined to be \$560. The Company recognized \$257 as other expenses for previously unrecorded equity losses relating to 2007. The Company recognized \$303 as other expenses for equity losses relating to the three months ended March 31, 2008. There are currently \$14 in unrecognized equity losses relating to the three months ended March 31, 2008.

The shares of iDcentrix closed at \$1.04 per share at March 31, 2008. The shares held by the Company are subject to certain trading restrictions.

4. LONG-TERM DEBT AND OPERATING LOANS

Long-term debt

| | <u>March 31,</u> <u>2008</u> | <u>December 31,</u> <u>2007</u> |
|---|---------------------------------|------------------------------------|
| Convertible debt due 2011; interest at prime +2% (a) | \$ 7,500 | \$ 7,500 |
| Credit agreement with bank maturing 2009 and 2013; interest at 2.65% secured by current assets (EUR 1,346 and 1,346) | 2,187 | 1,943 |
| Credit agreement with bank maturing 2008, 2009, and 2011; interest at 5.0%, 3.8% and 4.0% secured by mortgage (CHF 4,250 and 4,350) | 4,403 | 3,793 |
| Credit agreement with bank maturing 2009 and 2012; interest at 4.8% and Libor + 2.0% unsecured (CHF 7,850 and 7,850) | 8,133 | 6,845 |
| Credit agreement with bank maturing 2011, 2017 and 2018; interest up to Libor + 2%, 5.8%, and 4.8% secured by fixed assets (CHF 10,435 and 8,566) | 10,812 | 7,470 |
| Capital leases; interest at 4.7% (CHF 349 and 629) | 361 | 548 |
| Capital leases; interest at 4.2% (EUR 634 and 678) | 1,029 | 978 |
| | <hr/> | <hr/> |
| | 34,425 | 29,077 |
| Less: Convertible debt allocated to contributed surplus, net of accretion (a) | (441) | (465) |
| Less: Current portion | (5,325) | (4,813) |
| | <hr/> | <hr/> |
| | \$ 28,659 | \$ 23,799 |

FORTRESS PAPER LTD.

**NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(unaudited, Canadian dollars, amounts in thousands except share and per share data)**

- (a) The convertible debt ("Convertible Note") is a senior secured convertible note of the Company in the principal amount of \$7,500 that matures in August, 2011. The Convertible Note bears interest at an annual rate equal to the prime rate of a national Canadian bank, plus 2%. The Convertible Note is secured by a first security lien upon all or substantially all of the Company's assets.

Commencing August 1, 2007, any holder of the Convertible Note (a "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 at the IPO offering price of \$8.00 per share. Notwithstanding the foregoing, the maximum number of Shares issuable to Mercer upon a conversion shall be the number that results in Mercer holding, as close as possible without exceeding, 49.9% of the issued and outstanding shares as of the date of the applicable conversion.

The Company has initially recorded a liability portion of \$6,900 and an equity portion of \$600 in contributed surplus. The liability portion has been calculated using present value of future cash outflows using a 10% discount rate.

The Company may redeem the Convertible Note on or after August 1, 2009, in whole or in part, at 100% of the principal amount to be redeemed together with interest accrued thereon up to but not including the redemption date.

The Convertible Note also contains positive and negative covenants of the Company customary for secured financings of this nature, including limitations in respect of the granting of security, dispositions of material assets, ceasing to carry on business, consolidation, amalgamation or mergers and the incurrence of indebtedness. In addition, the Company has covenanted to permit Mercer to appoint up to one third of the directors of the Company so long as there remains any outstanding obligation under the Convertible Note.

Operating loans

At March 31, 2008, the Company has \$Nil in operating lines of credit available.

At December 31, 2007, the Company had approximately \$6,659 in operating lines of credit available secured by inventory and accounts receivable, of which \$5,854 was drawn down. Interest was payable at rates from 5.25% to 6.0%.

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

5. 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, 2006 | 3,000,000 | \$ 12,000 | \$ 5,600 |
| Private placements | 203,500 | 814 | — |
| Performance based compensation | 1,250,000 | 5,000 | (5,000) |
| Initial public offering | 5,750,000 | 46,000 | — |
| Share issue costs | — | (5,386) | — |
| Stock compensation | — | — | 908 |
| Balance, December 31, 2007 | 10,203,500 | \$ 58,428 | \$ 1,508 |
| Stock compensation | — | — | 376 |
| Share repurchase | (200) | (1) | — |
| Balance, March 31, 2008 | 10,203,300 | \$ 58,427 | \$ 1,884 |

Share capital reorganization

Effective June 20, 2007, the Company consolidated its outstanding common shares on the basis of one new common share for every two existing common shares. The impact of the share capital consolidation has been reflected in these consolidated financial statements and the accompanying notes.

Private Placements

On July 19, 2007, pursuant to an underwriting agreement between the Company and the Underwriters dated June 20, 2007, entered into in connections with the initial public offering of the Company, the Underwriters exercised their option to purchase an additional 750,000 Common shares of the Company issued at a price of \$8.00 per shares, bringing the total gross proceeds from the initial public offering of Fortress Paper Ltd. to \$46,000.

On June 28, 2007, the Company completed its initial public offering of 5,000,000 Common shares at an offering price of \$8.00 per share for total proceeds of \$40,000.

On February 22, 2007 the Company raised \$400 by the issuance of 100,000 shares through a private placement.

On February 6, 2007 the Company raised \$414 by the issuance of 103,500 shares through a private placement.

6. STOCK OPTIONS

During 2006 the Company adopted a stock incentive plan. The exercise price of options granted under the stock incentive 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. The maximum number of options that may be granted must not exceed 10% of the common shares outstanding at the time of the grant.

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On April 5, 2007 and May 2, 2007 two tranches of options were granted for 320,350 and 122,325 shares, respectively to directors and officers of the Company with an exercise price equivalent to the IPO price with expiry 10 years from the IPO date (June 20, 2007). On November 1, 2007 a further two tranches of options were granted for 240,000 and 300,000 shares to directors of the Company with expiry 10 years from the grant date. On January 1, 2008 a further tranche of options was granted for 30,000 shares to an employee of the company with expiry 10 years from the grant date.

The stock options vest from one year to three years from the IPO or grant dates.

The estimated fair value for the 30,000 options granted during the three months ended March 31, 2008 was \$77. Prorating the total amount based on the vesting schedule \$376 has been expensed during the three months ended March 31, 2008 as stock-based compensation in the statement of operations with a corresponding amount recorded as contributed surplus in shareholders' equity.

The weighted average fair value of the options, being \$3.09 per option, has been estimated at the grant dates 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 are as follows:

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

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

| | Number of options | Exercise Price |
|-----------------------------------|--------------------------|-----------------------|
| Granted April 5, 2007 | 320,350 | \$ 8.00 |
| Granted May 2, 2007 | 122,325 | 8.00 |
| Granted November 1, 2007 | 540,000 | 8.00 |
| Balance, December 31, 2007 | 982,675 | \$ 8.00 |
| Granted January 1, 2008 | 30,000 | \$ 8.00 |
| Balance, March 31, 2008 | 1,012,675 | \$ 8.00 |

At March 31, 2007, 147,558 stock options were exercisable (December 31, 2007 – 147,558). No stock options were exercised during the three month period ended March 31, 2008 or the year ended December 31, 2007.

7. CAPITAL DISCLOSURES

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 business cycle. The company continuously monitors the public and private debt markets and the public equity markets in order to assure that its capital

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structure is appropriately balanced. The Company is currently in a net cash position and can be materially influenced by changes in the relative value of the Canadian dollar, Swiss Franc, and Euro.

The Company's capital is comprised of net cash and shareholders' equity:

| | <u>March 31, 2008</u> | <u>December 31, 2007</u> |
|---------------------------|-----------------------|--------------------------|
| Cash and cash equivalents | \$ 42,284 | \$ 45,307 |
| Less total debt | (33,984) | (34,466) |
| Net cash | <u>8,300</u> | <u>10,841</u> |
| Shareholders' equity | <u>64,278</u> | <u>59,714</u> |

During the three months ended March 31, 2008 the Company was in compliance with all external capital requirements and covenants related to its debt facilities.

8. RELATED PARTY TRANSACTIONS

In the three month period ended March 31, 2008, the Company, in the normal course of business, has paid office and administration expenses of \$23 (2007 - \$23) to a company with a common director.

These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

9. EMPLOYEE FUTURE BENEFITS

Pension expenses of \$124 were recorded for the three months ended March 31, 2008. No pension expense was recorded for the three months ended March 31, 2007 due to the overfunded pension.

10. SUPPLEMENTARY CASH FLOW INFORMATION

| | <u>Three Months Ended March 31, 2008</u> | <u>Three Months Ended March 31, 2007</u> |
|-------------------|--|--|
| Interest paid | \$ 381 | \$ 583 |
| Income taxes paid | 49 | - |
| Net cash | <u>8,300</u> | <u>10,841</u> |

Non cash items

Change in non cash property, plant and equipment purchases included in accounts payable were \$231 (2007 - \$Nil).

During the three months ended March 31, 2008 the Company received 6,500,000 shares of iDcentrix for licensing of LQard North American rights.

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11. FINANCIAL INSTRUMENTS

Classification of Financial Instruments

The Company has classified its cash and cash equivalents as held-for-trading. Accounts receivable are classified as loans and receivables and are measured at amortized cost. Accounts payable and accrued liabilities, other liabilities, and long-term debt, including interest payable, are classified as other liabilities, all of which are measured at amortized cost. The Company has no derivatives embedded in its financial or non-financial contracts that are not closely related to the host contract.

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.

I. 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 financial institutions. The cash and cash equivalents balance at March 31, 2008 was \$42.3 million (December 31, 2007 - \$45.3 million).

The Company utilizes a combination of credit insurance and self-insurance to manage the risk associated with trade receivables. Approximately 80% of the outstanding 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 1.3 million CHF and is considered collectable. The Company's trade receivable balance at March 31, 2008 was \$17.3 million (December 31, 2007 - \$11.8 million).

II. 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 March 31, 2008, the Company's accounts payable and accrued liabilities totalled \$21.1 million (December 31, 2007 - \$20.3), all of which fall due for payment within one year of the balance sheet date.

At March 31, 2008, and December 31, 2007, the Company was in a positive net cash position (cash and cash equivalents less total debt).

III. 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.

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a. Interest rate risk:

The Company is exposed to interest rate risk through its financial assets and financial obligations bearing variable interest rate. The Company's cash and cash equivalents include term deposits with an original maturity date of 90 days or less.

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.

Reasonable fluctuations of 50 bps in the applicable market interest rates are not expected to have a material impact on the Company's results of operations.

The Company currently does not use derivative instruments to reduce its exposure to interest rate risk.

b. Currency risk:

The Company is exposed to foreign exchange risk primarily in Euros, Swiss Francs, and Canadian dollars. The Company's products are sold globally with prices denominated primarily in Euros and Swiss Francs. The majority of the Company's expenditures are denominated in Euros and Swiss Francs. In addition the Company holds financial assets and liabilities in the local operating currencies. At March 31, 2008 the Company held \$27.1 million in Canadian dollar cash and cash equivalents (December 31, 2007 - \$32.8 million).

For the periods ending March 31, 2007 and 2008, the Company has not used derivative instruments to reduce its exposure to currency risk.

Fluctuations of 1% in the exchange rates for Euros and Swiss Francs, when compared to the Canadian dollar, are not expected to have a material impact on the Company's results of operations due to both the sales and expenditures being primarily denominated in local currencies.

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12. 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. No single customer accounted for 10% or more of the Company's total sales.

Three Months Ended March 31, 2008

| | Dresden Papier (Germany) | Landqart (Switzerland) | Corporate (Canada) | Fortress Paper Consolidated |
|---------------------------------|---|-----------------------------------|-------------------------------|--|
| Sales | \$ 29,064 | 20,725 | - | \$ 49,789 |
| Operating earnings (loss) | \$ 5,732 | 750 | (955) | \$ 5,527 |
| Amortization | \$ 383 | 357 | - | \$ 740 |
| Stock-based compensation | \$ - | - | (376) | \$ (376) |
| Property, plant and equipment | \$ 10,480 | 21,786 | - | \$ 32,266 |
| Capital expenditures | \$ 358 | 2,022 | - | \$ 2,380 |
| Sales by geographic area | % | % | | % |
| Germany | 52.8 | 7.4 | | 33.8 |
| Switzerland | - | 20.9 | | 8.8 |
| Other Western Europe | 23.3 | 44.7 | | 32.3 |
| Eastern Europe | 20.4 | 13.6 | | 17.5 |
| Other | 3.5 | 13.4 | | 7.6 |
| Total | 100.0 | 100.0 | | 100.0 |

Three Months Ended March 31, 2007

| | Dresden Papier (Germany) | Landqart (Switzerland) | Corporate (Canada) | Fortress Paper Consolidated |
|---------------------------------|---|-----------------------------------|-------------------------------|--|
| Sales | \$ 21,062 | 17,189 | - | \$ 38,251 |
| Operating earnings (loss) | \$ 2,125 | 522 | (199) | \$ 2,448 |
| Amortization | \$ 267 | 126 | - | \$ 393 |
| Stock-based compensation | \$ - | - | - | \$ - |
| Property, plant and equipment | \$ 8,961 | 9,794 | - | \$ 18,755 |
| Capital expenditures | \$ 308 | 2,414 | - | \$ 2,722 |
| Sales by geographic area | % | % | | % |
| Germany | 51.9 | 9.1 | | 32.7 |
| Switzerland | - | 24.9 | | 11.2 |
| Other Western Europe | 24.9 | 40.2 | | 31.8 |
| Eastern Europe | 22.4 | 11.5 | | 17.5 |
| Other | 0.8 | 14.3 | | 6.8 |
| Total | 100.0 | 100.0 | - | 100.0 |