

# Message to Shareholders

The financial results for 2011 were below expectations due to low prices for some of the Company's key products and further strengthening of the Canadian dollar. Nevertheless, this was an important year as the Company made important strides toward its ongoing repositioning. The objective of this process is to raise the overall margins and reduce the volatility of earnings through a combination of focused capital investments and targeted transactions. Ultimately, the Company will reduce its dependency on high commodity prices to generate acceptable rates of return.

Health and safety performance continued to improve, with the Company's Occupational Safety and Health Administration (OSHA) incident rate improving by 25% between 2010 and 2011. This reflects an ongoing multi-year plan designed to raise levels of awareness, communications and accountability. Health and safety is the top priority throughout Tembec, from frontline employees to the President and Chief Executive Officer. The objective is to be an industry leader in this critical area.

EBITDA was \$95 million for the year versus \$132 million for the previous year. Market conditions were very favorable for the Company's Specialty and Commodity Dissolving Pulp and NBSK businesses. However, conditions weakened for the High-Yield Pulp business and remained weak for the Forest Products business. The Paper results strengthened in the year with the newsprint business accounting for most of the improvement.

In the previous year, the Company placed significant focus on the balance sheet achieving both an extension of term debt maturities until 2018 and debt reduction. In 2011, the asset-based loan was replaced with maturity in 2016. With the debt portion of the balance sheet in good shape, and with strong liquidity, the Company can now focus on the repositioning of its asset base.

Last year, the Company indicated that a Business Improvement Plan (BIP) had been developed with the objective of achieving first or second quartile cost position for all of its assets. Within the BIP, priorities have been established to drive capital investment strategy and a dominant theme has emerged. A large portion of the investment will be in the Company's specialty dissolving pulp assets where margins are higher and more predictable. Also, a large portion of the overall BIP will focus on green energy investments, which will involve high return projects with low cash flow volatility. Again, the objective is to improve the overall margins and returns for shareholders and reduce the vulnerability to swings in product prices.

## INVESTMENTS

Consistent with the above-mentioned strategy, the Company has launched several energy capital projects in 2011. In addition to these projects, some basic reinvestment in the existing asset base has taken place with the objective of improving equipment reliability and productivity. These investments will continue for the next two years and will lead to improved operating results beginning in mid-2012.

The Company commenced a new turbine project at the specialty dissolving pulp mill in Tartas, France, to produce approximately 8 megawatts of green electricity generated by biomass. This \$21 million project will increase EBITDA at this facility by \$8 million per year and position the mill to be one of the lowest cost facilities in this sector. The project is forecasted to start up in July 2012.

A \$25 million methane biogas reactor project was started at the Matane, Quebec, high-yield pulp mill. This project received grants from the province of Quebec and the Federal Government totalling \$24 million, making the net capital cost to the Company \$1 million. The project will eliminate the need to burn oil at this facility to dry pulp, improving EBITDA by \$6 million per year. This is also forecasted to start up in July 2012.

The Company's Board of Directors has approved a major energy investment at its specialty dissolving pulp mill in Temiscaming, Quebec, to produce green electricity from waste liquor. This \$190 million project will involve the installation of a high pressure liquor recovery boiler and an electrical turbine, which will result in the production of 40 megawatts of electricity and 5,000 tonnes of additional specialty dissolving pulp. The project should generate \$42 million of incremental EBITDA and position this facility to also be among the lowest cost producers. This project is conditional upon signing a purchase power agreement with Hydro Quebec, which is expected to be finalized in the March 2012 quarter.

Also under evaluation is the expansion of specialty dissolving pulp production in Temiscaming, Quebec. A study is underway to determine the feasibility of adding 30,000 tonnes of additional pulp capacity and 10 megawatts of additional electricity generation. This study is expected to be completed in 2012.

### **Forest Products**

The lumber business remained extremely challenging in 2011. The primary reason was the continued slump in housing starts in the U.S., which averaged just over a half million for the year, approximately a third of the normalized levels. Declining housing values and highly accommodating monetary policy created very affordable housing conditions. However, this did very little to stimulate the demand for new homes. Tight credit conditions, high unemployment and extremely high foreclosure rates persisted throughout the year, stifling demand for new home construction.

There were some bright spots in the lumber market. Shipments of Canadian lumber to China continued at a record pace during the year pulling significant volume out of the North American market and providing partial relief to the excess supply. Canadian housing starts were robust in 2011, providing solid demand conditions in Canada, particularly for Eastern Canadian producers. While these two markets provided some mitigation for the poor U.S. market, prices remained below profitable levels.

It is anticipated that the U.S. housing market will take several more years to recover to normalized levels. Banks will have to process and resell the high volume of homes still in the foreclosure pipeline. A meaningful reduction in unemployment will likely take several more years to achieve. As conditions improve, it is expected that new home construction will follow and demand for lumber will improve.

Canada and the United States entered into a Softwood Lumber Agreement (SLA) in 2006, which imposed an export tax on shipments to the U.S., and for some provinces, limitations (quotas) on volumes shipped. The majority of both Canadian and U.S. lumber producers believe it is in their best interest for the SLA to be extended until October 2015 pursuant to the extension clause in the agreement, and as a result, the Canadian and U.S. Governments are expected to take steps to ratify this extension.

### **Dissolving Pulp**

Fiscal 2011 was a very good year for both the specialty and commodity dissolving pulp markets. Specialty dissolving pulp

demand was very strong in the previous year and carried over into 2011, creating conditions that allowed for significant price increases.

Specialty dissolving pulp is a highly technical product designed for individual customers in very technical applications. There are significant barriers to enter into this business that include capital costs of equipment and technical expertise. Most of the business in this sector is done under long-term contracts with periodic price negotiations. In 2011, as prices were negotiated, substantial increases were obtained by specialty pulp producers as the prevalent conditions were significantly in favor of producers.

The long-term outlook for specialty dissolving pulp appears very positive with various segments of the customer base forecasting growth in the range of 2-6% per year. The three largest producers are contemplating capacity expansion to meet this growth in demand, with some projects officially announced and others under study. Normally, growth in supply in a sector of this size can create imbalances if too much product is brought into the market too quickly. However, this business is in a unique situation where specialty pulp capacity can be swung to produce the commodity grade keeping the specialty markets in balance. Commodity dissolving pulp mills cannot easily swing into the specialty grades.

Demand for the commodity dissolving pulp also dramatically increased during the year due to the convergence of unusual global conditions and steady growth in demand. This caused a spike in spot prices to record levels.

Over the last several years, Viscose Staple Fibre (VSF) capacity has expanded to satisfy the growing demand for rayon, particularly in the emerging markets. The demand for commodity dissolving pulp, which is the main raw material for VSF, has grown proportionately. Shortages in cotton supply, caused by floods and drought in various producing regions around the globe, began in 2010 and carried over into mid-2011, causing cotton prices to spike. These high cotton prices, coupled with strong demand fundamentals in the VSF market, caused global VSF prices to spike, which in turn pushed commodity dissolving prices to record highs. In the second half of 2011, the markets for cotton, VSF and commodity dissolving pulp have rebalanced and prices have fallen although they remain at profitable levels. The medium to long-term demand outlook for VSF and commodity dissolving pulp is projected to be positive. Significant pulp capacity expansion projects have been announced to supply this growing market.

The near-term and long-term fundamentals for the specialty dissolving pulp market are very positive, and prices will likely increase in 2012. The commodity grade is expected to experience a well supplied market over the next year, with prices falling from 2011 levels. The Company will further reduce its sales into the commodity market in 2012 in order to satisfy the growing needs of customers in the specialty markets.

**Paper Pulp**

The medium and long-term demand for paper pulps is forecasted to be very positive, driven by growing demand in the emerging markets. Over the past two decades, non-integrated paper, paperboard and tissue capacity has been built in these markets where there is a significant deficit of wood fiber supply. In the case of China, this has caused very large increases in imports of pulp, recovered paper and wood chips. Non-integrated paper capacity now makes up 32% of the total global production as compared to approximately 20% two decades ago. The growth in global pulp demand and the increase in non-integrated capacity is expected to continue.

As a result of the growing demand and wood fiber deficit in the emerging markets, cost structures are changing around the world. The price of recovered paper in the developed market has increased significantly as the emerging markets target these supply regions for procurement at the same time while the volumes of recovered paper have been declining. Coinciding with this trend, the demand for imported hardwood chips into China, as well as growing demand in other parts of the world, has driven hardwood chip prices to record highs. This is shifting the cost structure of much of the global pulp and paper industry, exacerbated by the weakening of the US dollar. In the long term, this trend will favor companies with stable fiber costs.

Slow economic growth in the developed economies and global credit issues had an effect on paper pulp demand in 2011.



**JAMES M. LOPEZ**  
President and Chief Executive Officer

This caused a decline in all paper pulp prices in the second half of 2011. It is expected that, due to limitations to growth in supply of softwood paper pulp and the cost structure of this sector, prices will recover early in 2012.

Most of the Company's paper pulp capacity is in the hardwood high-yield pulp sector. This product experienced a decline earlier in 2011 due to the start-up of new capacity in China. This product is influenced by the fundamentals of the hardwood markets, which will take longer to recover as compared to the softwood pulp market.

**Paper**

The Company's focus in the paper sector has been in the coated bleached board and newsprint businesses. The North American paperboard business has been stable allowing for relatively high operating rates and reasonable pricing levels. The weak U.S. economy will likely have some effect on demand, but no significant changes are anticipated in operating rates or price.

The newsprint business continues to be a sector in steady decline in North America. The decline in demand has been mitigated by a combination of temporary and permanent capacity closures and increased offshore exports. However, these measures have not been enough to raise prices to a profitable level for a large number of North American operations. This has been evident by the severe financial challenges faced by large producers in this sector. Further capacity reductions will be required to restore the profitability of this business to sustainable levels.

**SUMMARY**

The Company's Management and Board of Directors are focused on the implementation of the Strategic Plan. While a number of initiatives have been completed, significant steps remain in the repositioning of Tembec to reach our goal of higher margins and more stable earnings. While this is occurring, the Company will remain focused on cost reductions, operational excellence and becoming a world class health and safety organization.



**JAMES V. CONTINENZA**  
Chairman of the Board