MESSAGE TO SHAREHOLDERS

The financial results for 2012 were below expectations, primarily due to poor market conditions for paper pulp. External economic factors continue to hamper the Company's ability to achieve its full economic potential. The Company did continue with strategic investments in certain energy projects, the most significant being the $190 million energy investment at the Temiscaming specialty cellulose site. The focus remains to increase profit margins and reduce volatility of earnings.

The Company continued to make significant strides in its health and safety performance, achieving a 32% reduction in recordable incidents in 2012 versus the previous year. This follows a 25% reduction in 2011 and marks seven consecutive years of improvement in the Company's health and safety performance. The focus will remain on transforming the health and safety culture to achieve world class levels.

Adjusted EBITDA for 2012 was $64 million versus $98 million in the previous year. Market conditions were generally favorable for the Specialty Cellulose business throughout the year, providing the primary driver for the earnings. The Paper business was stable with very little volatility in price, allowing this business to be a steady contributor of cash flow. The Forest Products business, which has had a negative impact on profitability for the last several years, finally turned profitable in the final quarter of the year. The Company's Paper Pulp business, the largest of all the Company's businesses, suffered from poor product pricing and generated negative adjusted EBITDA.

The Company has embarked on the implementation of a Business Improvement Plan focusing on capital expenditures on key projects to increase overall adjusted EBITDA margins and to reduce the volatility of earnings. Several of these projects were completed last year and a new $190 million project was launched in 2012. These projects have placed demands on the Company's cash flow as expected. The Company's defined benefit pension plans are being greatly impacted by declining interest rates, increasing funding requirements and making extra demands on cash flow. Given the challenging conditions in some of the Company's major markets, and the cash requirements to fund the strategic projects and excess pension funding obligations, the Company will continue with judicious cash flow management to maintain adequate levels of liquidity.

INVESTMENTS

In 2012, the Company began construction of the $190 million energy investment at its Temiscaming specialty cellulose mill. This will replace three old low pressure recovery boilers with a new high pressure boiler. A new 50-megawatt (MW) steam turbine will also be installed to produce electricity from the steam generated by the new boiler. The project will result in an adjusted EBITDA improvement of approximately $42 million per year through a combination of electricity revenue, cost reduction and productivity improvements.

A critical element of the Temiscaming energy investment is a power purchase agreement with Hydro-Quebec that was signed in 2012. The agreement provides for a guaranteed purchase of electricity produced by the new turbine at a fixed price of $106 per MW/hour (based on 2012), which is adjusted for inflation annually, for a 25 year-term.

The Company began construction of the Temiscaming energy project in 2012. Procurement of the major equipment and most of the civil construction work is complete. The Company targeted an aggressive construction schedule with the boiler starting up in December 2013 and the turbine starting April 2014. It has now been determined that the construction will be delayed and the start-up of the boiler will be postponed until the Spring of 2014 due to the high demand for contractors and construction workers in the Province of Quebec. It will be impossible to achieve the December 2013 boiler completion cost effectively in the over-heated construction market in Quebec.

After the completion of the $190 million investment, a second phase is being planned, which will involve a capacity expansion of this operation through the installation of new digesters. The new recovery boiler, turbine and power purchase agreement with Hydro-Quebec have been upsized to accommodate this second phase of investment.

Several other green energy projects were brought to completion in 2012 and will contribute to improved profitability in 2013. The new turbine installed at the Tartas specialty cellulose mill is now in full operation. The biomass boiler installed at the Béarn sawmill has been successfully commissioned and is operating at the expected level. The anaerobic treatment plant at the Matane high-yield pulp mill was commissioned in September and is in ramp-up mode. Once the Matane project is fully optimized, it is expected that these three green energy projects will generate an additional $21 million of adjusted EBITDA per year.

Defined Benefit Pension Plans

The Company administers several defined benefit pension plans in Canada on behalf of current and past employees. The progressive declines in interest rates over the last several years have led to increases in the estimated present value of future pension obligations. This in turn led to the creation of "solvency" or "wind up" deficits, which required that the Company fund amounts well in excess of normal annual costs. In fiscal 2012, the Company made $34 million of excess payments into its defined benefit pension plans. When combined with investment returns that exceeded the plan assumptions, the Company's defined benefit pension plans are now approaching fully funded status on a going-concern basis. The Company is now in a better position to reduce defined benefit pension plan risk should future investment returns permit or discount rates increase.

As well, the Company has taken steps to reduce defined benefit pension risk by making a number of changes to its plans. All salaried employees are now on a defined contribution pension plan. As collective agreements have been renewed with unionized employees at several of the Company's facilities, the pension plans have been changed to require all new employees to participate in defined contribution plans.

Forest Products

The Company's lumber business has experienced several years of very poor results due to the low levels of new home construction in the United States. As expected, this market is taking several years to recover and has yet to hit normalized levels. Despite near record levels in housing affordability in the U.S., tight credit conditions, high unemployment and economic uncertainty have all created headwinds in the new home construction market.

As highlighted in last year's report, the emergence of China as a new and significant market for North American lumber has helped keep the North American market somewhat balanced and has effectively set a floor on prices. While this market did not grow in 2012, shipments at levels comparable to 2011 continued, providing an important outlet for product and helping to maintain a balanced market in North America.

The second half of 2012 began to show signs of improvement in the U.S. housing market. Levels of existing home and new home inventories declined in the U.S. and housing starts in this market increased substantially over the same period of the previous year, but still remained below normalized levels. During this period, demand at the box stores, which typically service the repair and renovation market, also increased. These factors, combined with the steady demand from China, created a favorable environment for lumber sales in North America and pushed up prices materially. This allowed the Company's lumber segment to generate positive adjusted EBITDA in the fiscal fourth quarter, which was the first positive quarter in several years.

The U.S. demographic and household formation projections, combined with continued high levels of affordability and increased consumer confidence, point toward an improving housing market in the U.S. While some lumber capacity will likely be restarted in North America in 2013, it is anticipated that the positive conditions seen in the latter half of 2012 will continue in the coming year.

Specialty Cellulose

Fiscal 2012 was another good year for the Company's specialty cellulose business. Demand throughout most of the year was strong, but did experience a slowdown in some sectors in the latter part of the year. The Company successfully implemented price increases across all of its specialty grades.

The Company continues to sell viscose grade pulp from the Temiscaming operation. This market declined from the very strong conditions the year prior. While the viscose demand is stable and is still expected to grow over the next five years, capacity additions of viscose grade pulp have created excess supply, which has driven down prices in the second half of 2012.

The long-term outlook for specialty cellulose remains strong. A number of the Company's strategic customers have indicated aggressive growth plans and that additional supply will be required from Tembec in order for them to achieve their objectives. These needs will be accommodated in the short-term by phasing out the viscose commodity grade, which began last year. The viscose grade represented 15-20% of the total output of the Company's specialty pulp mills in fiscal 2012. Additional specialty cellulose capacity will be added with phase two of the Temiscaming investment plan, which will accommodate additional customer requirements in the long-term.

In the short-term, growth in specialty cellulose markets will be slowed by the current economic conditions impacting certain sectors, particularly the construction business. The European situation is the biggest concern and the effect that it is having on business prospects in China. It is unclear how long it will take to resolve the situation.

The Company remains focused on the specialty cellulose business due to the higher margins and reduced volatility that this sector offers. The long-term prospects for overall growth in demand will benefit those companies with the assets and technology to compete in this sector. As one of the largest and most specialized companies servicing this business, Tembec feels confident that its future prospects are excellent.

Paper Pulp

Fiscal 2012 was a disappointing year for both softwood and hardwood paper pulps. The dramatic slowdown in the European economy and declining consumer confidence had a significant negative impact on the demand for pulp. Europe is still the largest consumer of market pulp in the world. Demand from China, while still increasing, was unable to pick up the slack in the market. The result was a drop in both hardwood and softwood prices. The price level in the September quarter reached the cash breakeven point for many pulp mills, including the Company's high-yield pulp mills.

In the short-term, it is expected that supply and demand will be in relative balance and prices should begin to recover for both softwood and hardwood pulp. Softwood is likely to benefit from a stable supply and consistent demand, potentially leading to a more favorable price environment. While the situation will likely improve for hardwood producers in the short-term, the new hardwood pulp capacity scheduled to start-up in 2013 and 2014 poses a threat to the overall hardwood market balance.

It is expected that 4 million to 5 million tonnes of new bleached eucalyptus pulp capacity will start up in Brazil in 2013-2014, bringing substantial hardwood pulp capacity onto the market in a short period of time. While mid-term projections indicate that this new supply can be absorbed into the global pulp markets based on growing demand, it is unclear if it can be absorbed as quickly as the new production enters the market. This potential oversupply situation could keep downward pressure on prices. The Company's high-yield pulp competes in a number of applications with eucalyptus pulp and will be affected by low prices in this market. To prepare for a potential weak pulp market, the Company has taken a number of steps to mitigate the downside impact on its high-yield pulp business. This includes the indefinite idling of the Chetwynd, BC, pulp mill.

Paper

The Company sells into both the newsprint and coated paper board markets. The North American newsprint market has been stable for a prolonged period of time. While demand by daily newspapers has continued to decline over the past year, the rate of decline has decelerated. The loss in volume in the U.S. daily newspaper market has been compensated by capacity reductions, increased off-shore shipments and substitution for other grades. The result has been price stability, allowing the Company to generate stable earnings in this business.

The coated bleached board business suffers from declining demand in North America. The Company has been successful in offsetting this through product and customer diversification. This has resulted in stable sales volumes and relatively stable product pricing. This business should continue to be a consistent contributor of adjusted EBITDA for the Company.

SUMMARY

The Company's Management and Board of Directors remain focused on the implementation of the strategic plan. This includes certain strategic initiatives to improve liquidity and maximize shareholder value. Cash flow will be managed prudently in the short-term during this period of economic uncertainty and relatively high capital investment. Significant progress has been made on the journey to becoming a world-class health and safety organization, but there is more to be done.

JAMES M. LOPEZ
President and Chief Executive Officer

James V Continenza

JAMES V. CONTINENZA
Chairman of the Board