

# MANAGEMENT'S DISCUSSION AND ANALYSIS

as at November 29, 2013

The Management's Discussion and Analysis (MD&A) section provides a review of the significant developments and issues that influenced Tembec Inc.'s financial performance during the fiscal year ended September 28, 2013, as compared to the fiscal year ended September 29, 2012. The MD&A should be read in conjunction with the audited consolidated financial statements for the fiscal year ended September 28, 2013. Financial data has been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). All financial references are stated in Canadian dollars, unless otherwise noted. All references to quarterly information relate to Tembec's fiscal quarters. Adjusted EBITDA, net debt to total capitalization, free cash flow and certain other financial measures utilized in the MD&A are non-IFRS financial measures. As they have no standardized meaning prescribed by IFRS, they may not be comparable to similar measures presented by other companies. Non-IFRS financial measures are described in the section "Use of non-IFRS financial measures".

The MD&A includes "forward-looking statements" within the meaning of securities laws. Such statements relate, without limitation, to the Company's or management's objectives, projections, estimates, expectations or predictions of the future and can be identified by words such as "may", "will", "could", "anticipate", "estimate", "expect", and "project", the negative or variations thereof, and expressions of similar nature. Forward-looking statements are based on certain assumptions and analyses made by the Company in light of its experience, information available to it and its perception of future developments. Such statements are subject to a number of risks and uncertainties, including, but not limited to, changes in foreign exchange rates, product selling prices, raw material and operating costs and other factors identified in the Company's periodic filings with securities regulatory authorities. Many of these risks are beyond the control of the Company and, therefore, may cause actual actions or results to materially differ from those expressed or implied herein. The forward-looking statements contained herein reflect the Company's expectations as of the date hereof and are subject to change after such date. The Company disclaims any intention to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise,

unless required by applicable securities legislation. The information in this MD&A is as at November 29, 2013. Disclosure contained in this document is current to that date, unless otherwise stated.

Throughout the MD&A, "Tembec" or "Company" means Tembec Inc. and its consolidated subsidiaries. Tembec's operations consist of five reportable business segments: Forest Products, Specialty Cellulose Pulp, Paper Pulp, Paper and Corporate. On September 28, 2013, the Company had approximately 3,500 employees, as compared to 3,700 at the end of the prior fiscal year. The Company operates manufacturing facilities in Quebec, Ontario, British Columbia, the state of Ohio as well as in Southern France. Principal facilities are described in the subsequent sections of the MD&A.

## 2013 VS. 2012

### FINANCIAL SUMMARY

(in millions of dollars, unless otherwise noted)

|   | 2012   | 2013          |
|---|--------|---------------|
| Sales   | 1,666  | <b>1,534</b>  |
| Freight and other deductions                            | 232    | <b>201</b>    |
| Lumber export taxes                                     | 7      | <b>3</b>      |
| Cost of sales (excluding depreciation and amortization) | 1,290  | <b>1,159</b>  |
| SG&A  | 74     | <b>72</b>     |
| Share-based compensation                                | (1)    | <b>1</b>      |
| Adjusted EBITDA   | 64     | <b>98</b>     |
| Depreciation and amortization                           | 46     | <b>40</b>     |
| Other items   | 50     | <b>29</b>     |
| Operating earnings (loss)                               | (32)   | <b>29</b>     |
| Interest, foreign exchange and other                    | 41     | <b>28</b>     |
| Exchange loss (gain) on long-term debt                  | (13)   | <b>14</b>     |
| Loss before income taxes                                | (60)   | <b>(13)</b>   |
| Income tax expense                                      | 22     | <b>21</b>     |
| Net loss  | (82)   | <b>(34)</b>   |
| Basic and diluted net loss in dollars per share         | (0.82) | <b>(0.34)</b> |
| Total comprehensive earnings (loss)                     | (131)  | <b>115</b>    |
| <br>  |        |               |
| Total assets (at year-end)                              | 1,059  | <b>1,021</b>  |
| Total long-term debt (at year-end) <sup>(1)</sup>       | 339    | <b>385</b>    |
| Total long-term liabilities (at year-end)               | 627    | <b>509</b>    |

<sup>(1)</sup> Includes current portion

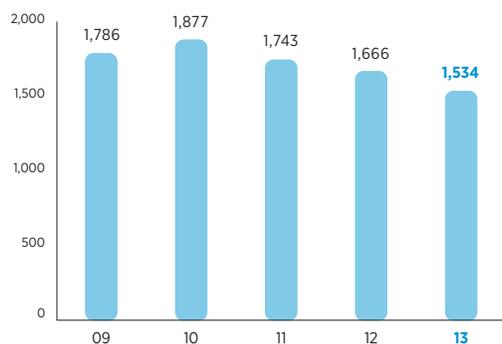
### BUSINESS SEGMENTS

During the December 2012 quarter, the Company reorganized its internal reporting structure, which impacted segment disclosure included in the financial statements and MD&A. Prior to the change, the Company had reported the results of the Skookumchuck, British Columbia (BC), Northern Bleached Softwood Kraft (NBSK) pulp mill as part of the Specialty Cellulose

and Chemical Pulp segment. Subsequent to the organizational change, the mill was regrouped with the high-yield pulp mills in a new segment called Paper Pulp. The Specialty Cellulose and Chemical Pulp segment was renamed Specialty Cellulose Pulp. Comparative prior year segment information has been restated in the financial statements to conform to the new presentation.

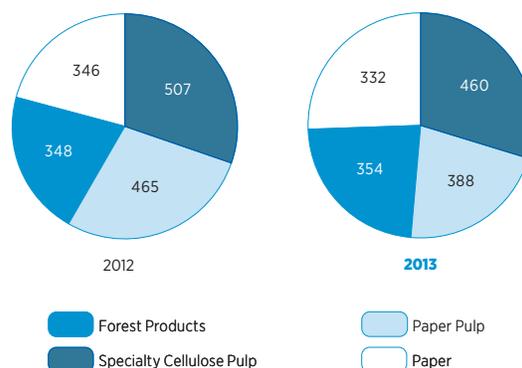
### Consolidated Sales

(in millions of dollars)



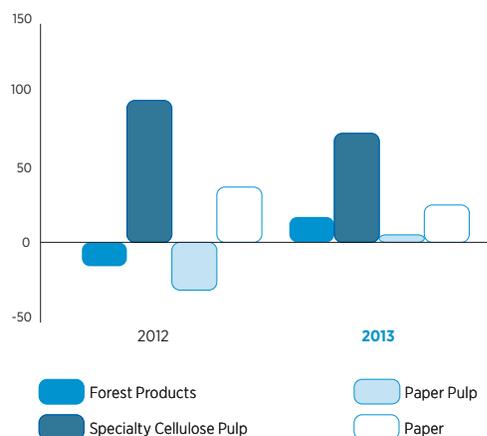
### Consolidated Sales by Segment

(in millions of dollars)

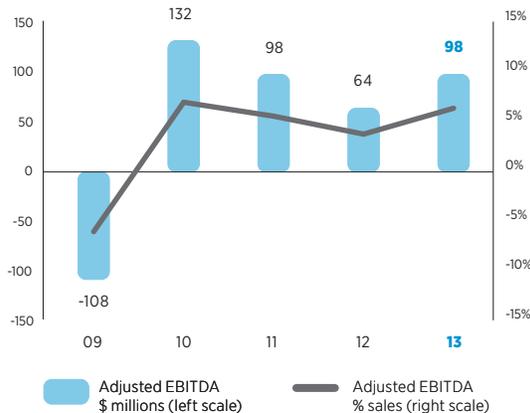


### Adjusted EBITDA by Segment

(in millions of dollars)



### Financial Performance



Fiscal 2009 and 2010 results not restated for IFRS

## SALES

(in millions of dollars)

|                          | 2012  | 2013  | Total variance | Price variance | Volume and mix variance |
|--------------------------|-------|-------|----------------|----------------|-------------------------|
| Forest Products          | 432   | 420   | (12)           | 43             | (55)                    |
| Specialty Cellulose Pulp | 507   | 460   | (47)           | 3              | (50)                    |
| Paper Pulp               | 507   | 418   | (89)           | 9              | (98)                    |
| Paper                    | 346   | 332   | (14)           | (9)            | (5)                     |
| Corporate                | 13    | 12    | (1)            | -              | (1)                     |
|                          | 1,805 | 1,642 | (163)          | 46             | (209)                   |
| Less: intersegment sales | (139) | (108) | 31             |                |                         |
| Sales                    | 1,666 | 1,534 | (132)          |                |                         |

Sales decreased by \$132 million as compared to fiscal 2012. Currency was not a significant factor as the Canadian dollar averaged US \$0.985, a 0.7% decrease from US \$0.992 in the prior year. Forest Products segment sales decreased by \$12 million as a result of lower shipments, partially offset by higher prices. Specialty Cellulose Pulp segment sales decreased by \$47 million due to lower shipments. Paper Pulp segment sales decreased by \$89 million due to lower shipments. Paper segment sales decreased by \$14 million due to lower prices and shipments.

In terms of geographical distribution, the U.S. remained the Company's principal market with 39% of consolidated sales in fiscal 2013, as compared to 37% in the prior year. Canadian sales represented 19% of sales, as compared to 18% in the prior year. Sales outside of the U.S. and Canada represented the remaining 42% in fiscal 2013, as compared to 45% a year ago.

### ADJUSTED EBITDA

(in millions of dollars)

|                          | 2012 | 2013 | Total<br>variance | Price<br>variance | Cost and<br>volume<br>variance |
|--------------------------|------|------|-------------------|-------------------|--------------------------------|
| Forest Products          | (16) | 17   | 33                | 43                | (10)                           |
| Specialty Cellulose Pulp | 95   | 73   | (22)              | 3                 | (25)                           |
| Paper Pulp               | (32) | 5    | 37                | 9                 | 28                             |
| Paper                    | 37   | 25   | (12)              | (9)               | (3)                            |
| Corporate                | (20) | (22) | (2)               | -                 | (2)                            |
|                          | 64   | 98   | 34                | 46                | (12)                           |

Adjusted EBITDA of \$98 million was \$34 million higher than the prior year. Forest Products segment adjusted EBITDA was up \$33 million from the prior year as a result of higher prices, partially offset by higher costs. Specialty Cellulose Pulp segment adjusted EBITDA declined by \$22 million due to higher costs

and lower volumes. Paper Pulp segment adjusted EBITDA improved by \$37 million due to lower costs and higher prices. Paper segment adjusted EBITDA declined by \$12 million due to lower prices and higher costs.

### OPERATING EARNINGS (LOSS)

(in millions of dollars)

|                          | 2012  | 2013 | Total<br>variance | Adjusted<br>EBITDA<br>variance | Depreciation<br>variance | Other<br>items<br>variance |
|--------------------------|-------|------|-------------------|--------------------------------|--------------------------|----------------------------|
| Forest Products          | (4)   | 8    | 12                | 33                             | 1                        | (22)                       |
| Specialty Cellulose Pulp | 84    | 59   | (25)              | (22)                           | (3)                      | -                          |
| Paper Pulp               | (105) | (33) | 72                | 37                             | 9                        | 26                         |
| Paper                    | 35    | 22   | (13)              | (12)                           | (1)                      | -                          |
| Corporate                | (42)  | (27) | 15                | (2)                            | -                        | 17                         |
|                          | (32)  | 29   | 61                | 34                             | 6                        | 21                         |

The Company generated operating earnings of \$29 million compared to an operating loss of \$32 million in fiscal 2012.

The Forest Products segment generated operating earnings of \$8 million, as compared to an operating loss of \$4 million in fiscal 2012. In addition to the previously noted improvement in adjusted EBITDA, the sale of the BC sawmills and the hardwood flooring operations in fiscal 2012 led to lower depreciation expense. During the prior fiscal year, the Company recorded a gain of \$24 million related to the sale of the BC sawmills. The Company also sold its Toronto, Ontario, hardwood flooring plant and concurrently closed its Huntsville, Ontario, hardwood flooring plant. The combined effect was a charge of \$2 million.

The Specialty Cellulose Pulp segment generated operating earnings of \$59 million compared to operating earnings of \$84 million in the prior year. The previously noted decline in adjusted EBITDA led to the lower operating earnings.

The Paper Pulp segment generated an operating loss of \$33 million compared to an operating loss of \$105 million in the prior year. In addition to the previously noted improvement in adjusted EBITDA, the segment saw depreciation expense decline by \$9 million due to the sale of the Skookumchuck, BC, NBSK pulp mill. The prior year operating results included a \$50 million asset impairment charge relating to the Chetwynd, BC, high-yield pulp mill. The current year included a \$22 million asset impairment charge and a subsequent \$2 million loss on sale related to the Skookumchuck pulp mill.

The Paper segment generated operating earnings of \$22 million compared to operating earnings of \$35 million in the prior year. The previously noted decline in adjusted EBITDA led to the lower operating earnings.

Corporate segment results improved by \$15 million, primarily due to "Other items". In fiscal 2013, the Company generated a \$2 million gain related to the sale of the Cranbrook, BC, office. The prior year included a \$16 million loss relating to the impairment of a loan receivable from Temlam Inc. The latter is currently under creditor protection and owns an idled laminated veneer lumber (LVL) facility located in Amos, Quebec. The Company has a 50% secured interest in the facility. The prior year also included a gain of \$4 million relating to the sale of a minority equity interest in two dissolving pulp mills.

## SEGMENT REVIEW – 2013 VS. 2012

### FOREST PRODUCTS

(in millions of dollars)

|   | 2012   | 2013 |
|---|--------|------|
| Sales <sup>(1)</sup>                        | 432    | 420  |
| Freight and other deductions                | 41     | 39   |
| Lumber export taxes                         | 7      | 3    |
| Cost of sales <sup>(1)</sup>                | 385    | 350  |
| SG&A  | 15     | 11   |
| Adjusted EBITDA                             | (16)   | 17   |
| Adjusted EBITDA margin on sales             | (3.7)% | 4.0% |
| Depreciation and amortization               | 10     | 9    |
| Other items:                                |        |      |
| Gain on sale of BC sawmills                 | (24)   | -    |
| Loss on sale/closure of flooring operations | 2      | -    |
| Operating earnings (loss)                   | (4)    | 8    |
| Identifiable assets (excluding cash)        | 216    | 155  |

<sup>(1)</sup> Includes intersegment sales eliminated on consolidation

The Forest Products segment is divided into two main areas of activity: forest resource management and manufacturing operations.

The Forest Resource Management group is responsible for managing all of the Company's Canadian forestry operations. This includes the harvesting of timber, either directly or by contractual agreements, and all silviculture and regeneration work required to ensure a sustainable supply for the manufacturing units. The group is also responsible for third party timber purchases, which are needed to supplement total requirements. The group's main objective is the optimization of the flow of timber into various manufacturing units. As the Company's forest activity in Canada is conducted primarily on Crown lands, the Forest Resource Management group works closely with provincial governments to ensure harvesting plans and operations comply with established regulations and that stumpage charged by the provinces is reasonable and reflects the fair value of the timber being harvested. During fiscal 2013, the Company's operations harvested and delivered 3.2 million cubic metres of timber, compared to 3.9 million cubic metres in the prior year.

Additional supply of approximately 0.6 million cubic metres was secured mainly through purchases and exchanges with third parties, compared to 0.8 million cubic metres in the prior year.

The Forest Products segment includes operations located in Quebec and Ontario. At the end of the March 2012 quarter, the Company sold its two BC sawmills. The sawmills had a capacity of 450 million board feet of lumber, which represented approximately 29% of the Company's total SPF lumber capacity at that time. The SPF lumber operations can produce approximately 880 million board feet of lumber. The specialty wood operations can annually produce 30 million board feet of hardwood lumber. During the December 2011 quarter, the Company sold its Toronto, Ontario, hardwood flooring plant and announced the closure of its Huntsville, Ontario, hardwood flooring plant. The two operations had a combined capacity of 20 million square feet of hardwood flooring. The Company's engineered wood operations consist of two finger joint lumber operations, which were idle for all of fiscal 2012 and fiscal 2013.

The following summarizes the current annual capacity of each facility by product group:

| <b>SPF LUMBER</b>                                  | <b>mbf</b> |
|--|------------|
| Stud lumber - La Sarre, QC                         | 135,000    |
| Stud lumber - Senneterre, QC                       | 100,000    |
| Stud lumber - Cochrane, ON                         | 110,000    |
| Stud lumber - Kapuskasing, ON                      | 105,000    |
| Random lumber - Béarn, QC                          | 110,000    |
| Random lumber - Chapleau, ON                       | 135,000    |
| Random lumber - Hearst, ON                         | 160,000    |
| Finger joint lumber - Cranbrook, BC                | 25,000     |
|  | 880,000    |
| <b>SPECIALTY WOOD</b>                              | <b>mbf</b> |
| Hardwood lumber - Huntsville, ON                   | 30,000     |
| <b>ENGINEERED WOOD</b>                             | <b>mbf</b> |
| Engineered finger joint lumber - La Sarre, QC      | 60,000     |
| Engineered finger joint lumber - Kirkland Lake, ON | 30,000     |
|  | 90,000     |

The segment is dominated by SPF lumber, which represented 97% of building material sales in fiscal 2013, compared to 94% in the prior year. The volume of SPF lumber sold in fiscal 2013 decreased by 92 million board feet or 11%. The sale of the Company's two BC sawmills at the end of the March 2012 quarter had a significant impact on shipments and volumes. Shipments of lumber from the two sawmills during the first two quarters of the prior year totalled 172 million board feet. Lumber shipments from the Company's Eastern sawmills increased by 80 million board feet, partially offsetting the previously noted

decrease. Shipments were equal to 82% of capacity, up from 73% in fiscal 2012. Market conditions for lumber improved and this translated into increased demand and prices. US \$ reference prices for random lumber were up by US \$71 per mbf on average while stud lumber increased by US \$51 per mbf. Currency was not a significant factor as the Canadian dollar averaged US \$0.985, a 0.7% decrease from US \$0.992 in the prior year. The combined result was a \$59 per mbf price increase from a year ago.

Specialty wood represented 3% of building material sales in fiscal 2013, down from 6% in the prior year. The decline was due to the sale of the Toronto, Ontario, hardwood flooring plant and the closure of the Huntsville, Ontario, hardwood flooring plant.

There were no engineered wood sales in fiscal 2012 and 2013. The two finger joint facilities were idle for all of fiscal 2012 and fiscal 2013.

The Forest Products segment produced and shipped approximately 870,000 tonnes of wood chips in fiscal 2013, 67% of which were directed to the Company's pulp and paper operations. In 2012, the segment produced 977,000 tonnes

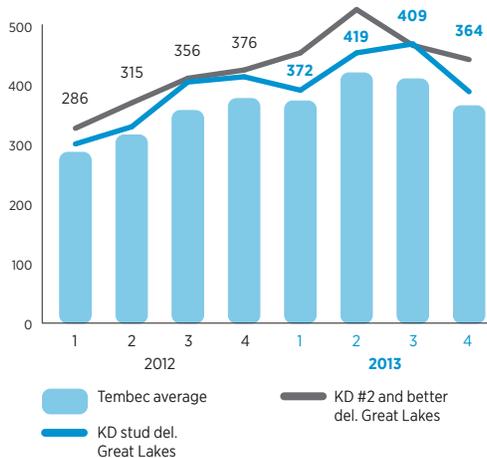
and shipped 80% of this volume to the pulp and paper mills. The internal transfer price of wood chips is based on current and expected market transaction prices.

Total sales for this segment reached \$420 million, a decrease of \$12 million over the prior year. After eliminating internal sales, the Forest Products segment generated 23% of Company consolidated sales, up from 21% in the prior year. The segment's main market is North America, which represented 100% of consolidated sales in fiscal 2013, compared to 97% in the prior year.

|                                      | Sales<br>(\$ millions) |      | Shipments<br>(000 units) |       | Selling prices<br>(\$ / unit) |      |
|--------------------------------------|------------------------|------|--------------------------|-------|-------------------------------|------|
|                                      | 2012                   | 2013 | 2012                     | 2013  | 2012                          | 2013 |
| <b>SPF lumber (mbf)</b>              | 282                    | 295  | 835.7                    | 743.8 | 337                           | 396  |
| <b>Specialty wood</b>                |                        |      |                          |       |                               |      |
| Hardwood (mbf)                       | 8                      | 9    | 12.7                     | 13.6  | 629                           | 662  |
| Hardwood flooring (000 square ft)    | 10                     | -    | 2.2                      | -     | 4,545                         | -    |
|                                      | 18                     | 9    |                          |       |                               |      |
| <b>Engineered wood</b>               |                        |      |                          |       |                               |      |
| Engineered finger joint lumber (mbf) | -                      | -    | -                        | -     | -                             | -    |
| <b>Total building materials</b>      | 300                    | 304  |                          |       |                               |      |
| Wood chips, logs and by-products     | 132                    | 116  |                          |       |                               |      |
| <b>Total sales</b>                   | 432                    | 420  |                          |       |                               |      |
| Internal wood chips and other sales  | (84)                   | (66) |                          |       |                               |      |
| <b>Consolidated sales</b>            | 348                    | 354  |                          |       |                               |      |

**Quarterly Prices – Eastern SPF Delivered**

(US \$ per mbf)



**MARKETS**

The Company markets its lumber with its own internal sales force.

The benchmark random length Eastern SPF average lumber price (#2 and better delivered Great Lakes) increased from US \$370 per mbf to US \$441 per mbf in 2013. The reference price for stud lumber also increased with the Eastern average lumber price (delivered Great Lakes) up from US \$353 per mbf to US \$404 per mbf. The prices were driven by an improving U.S. housing market. Housing starts in the U.S. on a seasonally adjusted basis averaged 906,000 units in fiscal 2013, an increase over the 729,000 units in fiscal 2012. However, these remain below the 2 million unit mark experienced in the 2004-2006 period and the +1.2 million average that would be indicative of normal market conditions. While the Company recognized several years ago that U.S. housing starts could not maintain the 2 million unit per year run rate, and that a degree of market correction would likely occur at some point, the duration of the correction has been significantly longer than those of prior cycles. The negative effects of the sub-prime mortgage difficulties, the latter having fuelled the strong demand in 2004-2006, have been much greater in terms of impact than originally anticipated. During fiscal 2013, the Company shipped 388,800 mbf into the U.S. market from its Eastern sawmills. In the prior year, shipments to the U.S. from

the Eastern sawmills were 295,000 mbf and shipments from the two Western sawmills were 77,200 mbf in the first six months of fiscal 2012. The improved U.S. market conditions drove the 32% increase in Eastern lumber shipments to the U.S.

While the U.S. housing market improved, this was not the case for the Canadian housing market. Housing starts in Canada on a seasonally adjusted basis averaged 190,000 units, an 11% decline from 214,000 units in the prior year. The weaker Canadian demand for lumber did not affect prices, which are determined primarily by the much larger U.S. market. During fiscal 2013, the Company shipped 355,000 mbf into the Canadian market from its Eastern sawmills. In the prior year, Canadian shipments from the Eastern sawmills totalled 369,200 mbf and shipments from the two Western sawmills were 94,300 mbf in the first six months of fiscal 2012.

The Company's financial performance continued to be impacted by export taxes on lumber shipped to the U.S. Effective October 12, 2006, the governments of Canada and the United States implemented an agreement for the settlement of the softwood lumber dispute. The Softwood Lumber Agreement (SLA) requires that an export tax be collected by the Government of Canada, which is based on the price and volume of lumber shipped. Since that date, the Company's Eastern Canadian sawmills have been subject to export quota limitations and a 5% export tax on lumber shipped to the U.S. The SLA provides that during periods of relatively high prices, as was the case during the spring and summer months of 2013, the export tax rate declines. In fiscal 2013, the average tax rate on Eastern lumber shipped to the U.S. was 1.9% and the total cost was \$3 million. In fiscal 2012, the average tax rate on Eastern lumber shipments to the U.S. was 4.8% and the total cost was \$4 million. The rate decline was due to the higher prices. The impact of the lower rate was partially offset by the increased shipments to the U.S. market.

The Company sold its two BC sawmills in March 2012. As such, the MD&A data includes the mills financial results for the first six months in fiscal 2012. The BC sawmills were subject to a 15% export tax, but shipments were not quota limited. In fiscal 2012, the average rate on shipments was 15% and the total cost was \$3 million.

## OPERATING RESULTS

The following summarizes adjusted EBITDA variances by major element:

|                          | Variance - favourable (unfavourable) |              |            |                           |         |       |       |
|--------------------------|--------------------------------------|--------------|------------|---------------------------|---------|-------|-------|
| (in millions of dollars) | Price                                | Export taxes | Mill costs | Inventory NRV adjustments | Freight | Other | TOTAL |
| SPF lumber               | 43                                   | 1            | (12)       | (3)                       | (3)     | 6     | 32    |
| Other segment items      | -                                    | -            | -          | -                         | -       | 1     | 1     |
|                          | 43                                   | 1            | (12)       | (3)                       | (3)     | 7     | 33    |

In fiscal 2013, adjusted EBITDA was \$17 million compared to negative adjusted EBITDA of \$16 million in the prior year. SPF Lumber adjusted EBITDA improved by \$32 million. The previously noted higher selling prices for lumber increased adjusted EBITDA by \$43 million. The higher prices were assisted by currency as the Canadian dollar averaged US \$0.985, a 0.7% decrease from US \$0.992 in the prior year. The previously noted decline in export taxes on Eastern lumber shipped to the U.S. increased adjusted EBITDA by a further \$1 million. Sawmill manufacturing costs increased by \$12 million, primarily due to increased fibre costs. In the prior year, the segment had benefited from a \$3 million favourable adjustment to the carrying values of logs and lumber inventories. There was no net realizable value adjustment in fiscal 2013. The \$6 million positive variance in "Other" related primarily to the two BC sawmills. In the first six months of the prior year, the sawmills had generated negative adjusted EBITDA of \$5 million. The adjusted EBITDA margin to total sales was 4.0% compared to negative 3.7% in the prior year.

The following summarizes operating results variances by major element:

| (in millions of dollars)      | 2012 | 2013 | Variance favourable (unfavourable) |
|-------------------------------|------|------|------------------------------------|
| Adjusted EBITDA               | (16) | 17   | 33                                 |
| Depreciation and amortization | 10   | 9    | 1                                  |
| Other items (gain)            | (22) | -    | (22)                               |
| Operating earnings (loss)     | (4)  | 8    | 12                                 |

The Forest Products segment generated operating earnings of \$8 million, as compared to an operating loss of \$4 million in fiscal 2012. In addition to the previously noted improvement in adjusted EBITDA, the sale of the BC sawmills and the hardwood flooring operations led to lower depreciation expense. During the prior fiscal year, the Company recorded a gain of \$24 million related to the sale of the BC sawmills. The Company sold its Toronto, Ontario, hardwood flooring plant and concurrently closed its Huntsville, Ontario, hardwood flooring plant. The combined effect was a charge of \$2 million.

**SPECIALTY CELLULOSE PULP**

(in millions of dollars)

|                                      | 2012  | 2013  |
|--------------------------------------|-------|-------|
| Sales - Pulp                         | 407   | 360   |
| Sales - Chemicals                    | 100   | 100   |
|                                      | 507   | 460   |
| Freight and other deductions         | 40    | 36    |
| Cost of sales                        | 352   | 331   |
| SG&A                                 | 20    | 20    |
| Adjusted EBITDA                      | 95    | 73    |
| Adjusted EBITDA margin on sales      | 18.7% | 15.9% |
| Depreciation and amortization        | 11    | 14    |
| Operating earnings                   | 84    | 59    |
| Identifiable assets (excluding cash) | 398   | 538   |

The Specialty Cellulose Pulp segment consists of two manufacturing facilities, which produce specialty cellulose pulps.

The specialty cellulose pulp mills have an annual capacity of 310,000 tonnes per year. The pulp produced at the two pulp mills is a high purity cellulose utilized in a wide variety of specialized products such as pharmaceuticals, food additives, and industrial chemicals. The Temiscaming mill also produces "viscose" grade pulp, which is utilized in the production of viscose staple fibre, which in turn is used to produce rayon for the textile industry.

The specialty cellulose mills generate lignin as a by-product of the sulphite process, which is sold to third parties. The Temiscaming mill also includes a facility that produces ethanol as a by-product that is also sold to third parties.

The segment also includes a stand-alone resin business, which produces powder and liquid phenolic resins at two operating sites in Quebec: Temiscaming and Longueuil. The Company also operates a third facility located in Toledo, Ohio, which manufactures powder and liquid amino-resins. The chemical business periodically purchases and re-sells third party pulp mill by-product chemicals.

The following summarizes the annual operating capacity of each facility:

| <b>SPECIALTY CELLULOSE</b>                    | <b>tonnes</b> |
|---|---------------|
| Specialty cellulose - Temiscaming, QC         | 160,000       |
| Specialty cellulose - Tartas, France          | 150,000       |
|   | 310,000       |
| <b>CHEMICALS</b>                              | <b>tonnes</b> |
| Resin and related products                    |               |
| - Temiscaming and Longueuil, QC; Toledo, Ohio | 170,000       |
| Lignin - Temiscaming, QC; Tartas, France      | 190,000       |
| Ethanol - Temiscaming, QC (million litres)    | 12.1          |

Total sales for the Specialty Cellulose Pulp segment were \$460 million, a decrease of \$47 million from the prior year. The decrease was due to lower shipments of specialty grades. The Specialty Cellulose Pulp segment generated 30% of Company consolidated sales, unchanged from the prior year. The Specialty Cellulose Pulp segment is a global business. In fiscal 2013 and 2012, 62% of consolidated sales were generated outside of Canada and the U.S.

|                                     | Sales<br>(\$ millions) |      | Shipments<br>(000 units) |       | Selling prices<br>(\$ / unit) |       |
|-------------------------------------|------------------------|------|--------------------------|-------|-------------------------------|-------|
|                                     | 2012                   | 2013 | 2012                     | 2013  | 2012                          | 2013  |
| <b>Specialty pulp</b>               |                        |      |                          |       |                               |       |
| Specialty cellulose (tonnes)        | 353                    | 318  | 215.1                    | 186.3 | 1,641                         | 1,705 |
| Viscose grade (tonnes)              | 54                     | 43   | 42.3                     | 44.9  | 1,264                         | 951   |
|                                     | 407                    | 361  | 257.4                    | 231.2 |                               |       |
| <b>Chemicals</b>                    |                        |      |                          |       |                               |       |
| Resin and related products (tonnes) | 55                     | 56   | 55.7                     | 50.6  | 987                           | 1,107 |
| Lignin (tonnes)                     | 29                     | 26   | 132.4                    | 94.8  | 219                           | 274   |
| Ethanol (000 litres)                | 9                      | 9    | 10.0                     | 10.3  | 900                           | 874   |
|                                     | 93                     | 91   |                          |       |                               |       |
| <b>Other sales</b>                  | 7                      | 8    |                          |       |                               |       |
| <b>Consolidated sales</b>           | 507                    | 460  |                          |       |                               |       |

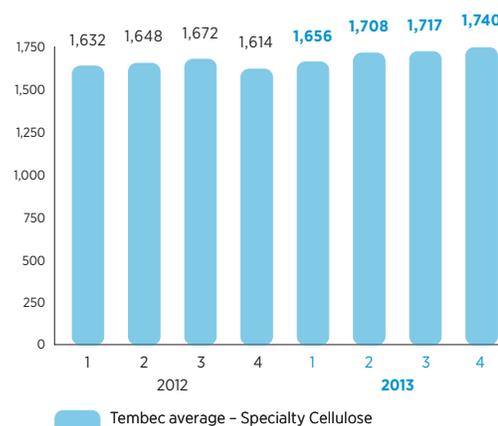
## MARKETS

The Company markets its pulp on a world-wide basis, primarily through its own sales force. Permanent sales offices are maintained in Toronto, Canada and Dax, France. Contractual arrangements with third party representatives are also utilized.

The shipments to capacity ratio for specialty pulp was 75% in fiscal 2013 versus 83% in the prior year. The decrease in shipment ratio was due primarily to a decrease of 28,800 tonnes in specialty grade pulp shipments. During fiscal 2012 and 2013, both mills operated as planned and no production curtailments were taken for market conditions. However, demand for specialty grades was weaker in fiscal 2013 and as a result the mills operated at a reduced rate, producing 16,700 fewer tonnes than in the prior year. Despite the lower demand, realized prices increased by \$64 per tonne, assisted by a Canadian dollar that was weaker versus the euro and the US dollar. Market conditions in the viscose grade continued to weaken from the record levels reached in 2011 and prices declined by \$313 per tonne. The viscose grade market continues to suffer from excess production capacity brought on by the very high prices reached in 2011. The Company has a strategy of gradually reducing its exposure to the viscose market by producing additional specialty grade volume. Unfortunately, the weaker specialty market conditions experienced in fiscal 2013 did not permit the Company to make any progress with this strategy. In fiscal 2013, viscose grade shipments totalled 44,900 tonnes, compared to 42,300 tonnes in the prior year.

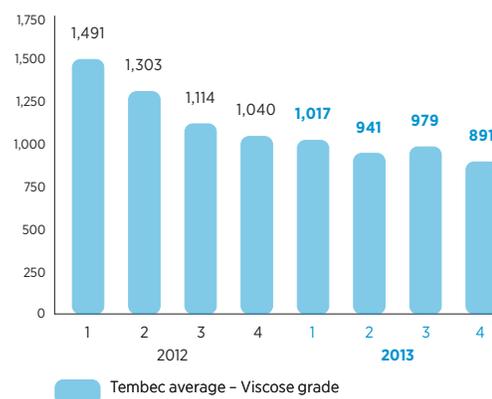
### Quarterly Prices – Specialty Cellulose

(CDN \$ per tonne)



### Quarterly Prices – Viscose Grade

(CDN \$ per tonne)



## OPERATING RESULTS

The following summarizes adjusted EBITDA variances by major element:

| (in millions of dollars) | Variance - favourable (unfavourable) |            |                           |                |       |       |
|--------------------------|--------------------------------------|------------|---------------------------|----------------|-------|-------|
|                          | Price                                | Mill costs | Inventory NRV adjustments | Mix and volume | Other | TOTAL |
| Specialty cellulose      | (2)                                  | (10)       | (1)                       | (12)           | 1     | (24)  |
| Chemicals                | 5                                    | (3)        | -                         | -              | -     | 2     |
|                          | 3                                    | (13)       | (1)                       | (12)           | 1     | (22)  |

Fiscal 2013 adjusted EBITDA was \$73 million compared to \$95 million in the prior year, a decrease of \$22 million. Higher realized prices for specialty grades increased adjusted EBITDA by \$12 million. But this was more than offset by the significant decline in viscose grade prices, which reduced adjusted EBITDA by \$14 million. Manufacturing costs at the two specialty pulp mills increased by \$10 million, primarily for chemicals and under-absorption of fixed costs as the two mills produced 16,700 fewer tonnes in fiscal 2013. During the current year, the segment also absorbed a net realizable value charge of \$1 million on the carrying value of its viscose grade pulp inventories as pricing ended the year at levels that were less than total estimated delivered cost. Adjusted EBITDA was also negatively impacted by a volume variance of \$12 million caused by lower shipments of specialty grade pulp.

The \$5 million favourable chemicals price variance was due to higher lignin and resin prices. However, resin raw material costs increased by \$4 million and resin profitability declined by \$2 million. The increase of \$2 million in chemicals adjusted EBITDA was due to the Canadian lignin business, which experienced higher prices and lower costs.

The Temiscaming specialty cellulose mill purchased approximately 305,700 bone dry tonnes of wood chips in fiscal 2013, down from 370,200 in the prior year. Of this amount, approximately 73% was supplied by the Forest Products segment, compared to 66% in the prior year. The remaining requirements were purchased from third parties under contracts and agreements of various durations. The pulp mill located in Southern France purchased 284,000 bone dry tonnes of wood in fiscal 2013 as compared to 287,000 bone dry tonnes in the prior year. The fibre is sourced from many private landowners.

Overall, lower viscose grade prices and higher manufacturing costs reduced adjusted EBITDA margins from 18.7% in 2012 to 15.9% in 2013.

The following summarizes operating results variances by major element:

| (in millions of dollars)      | Variance favourable (unfavourable) |      |      |
|-------------------------------|------------------------------------|------|------|
|                               | 2012                               | 2013 |      |
| Adjusted EBITDA               | 95                                 | 73   | (22) |
| Depreciation and amortization | 11                                 | 14   | (3)  |
| Operating earnings            | 84                                 | 59   | (25) |

The Specialty Cellulose Pulp segment generated operating earnings of \$59 million during the most recently completed fiscal year, compared to operating earnings of \$84 million in the prior year. The previously noted decline in adjusted EBITDA led to the lower operating earnings.

**PAPER PULP**

(in millions of dollars)

|                                      | 2012   | 2013 |
|--------------------------------------|--------|------|
| Sales <sup>(1)</sup>                 | 507    | 418  |
| Freight and other deductions         | 105    | 80   |
| Cost of sales <sup>(1)</sup>         | 427    | 325  |
| SG&A                                 | 7      | 8    |
| Adjusted EBITDA                      | (32)   | 5    |
| Adjusted EBITDA margin on sales      | (6.3)% | 1.2% |
| Depreciation and amortization        | 23     | 14   |
| Other item:                          |        |      |
| Chetwynd impairment loss             | 50     | -    |
| Skookumchuck asset impairment loss   | -      | 22   |
| Loss on sale of Skookumchuck         | -      | 2    |
| Operating loss                       | (105)  | (33) |
| Identifiable assets (excluding cash) | 302    | 142  |

<sup>(1)</sup> Includes intersegment sales eliminated on consolidation

The Paper Pulp segment consisted of four market pulp manufacturing facilities. Prior to May 2013, the Company owned and operated a chemical softwood kraft (NBSK) paper pulp mill located in Skookumchuck, BC. The mill had a capacity to produce 270,000 tonnes per year. Its financial results are included in the segment's results for all of fiscal 2012 and for approximately eight months in fiscal 2013. The remaining three facilities are hardwood high-yield pulp mills. They produce pulp with a combination of mechanical and chemical processes. The Company produces hardwood grades made from maple, aspen and birch. High-yield pulps have a lower tensile and tear strength than kraft pulps, but they offer advantages on bulk and opacity. They compete against other hardwood or "short fibre" grades, with Bleached Eucalyptus Kraft (BEK) being the most prominent. The Chetwynd, BC, mill has been idle since September 2012 due to relatively low prices resulting from significant new capacity start-ups of BEK pulp mills in the Southern hemisphere.

The following summarizes the annual capacity of each facility:

| HIGH-YIELD PULP                       | tonnes  |
|---------------------------------------|---------|
| Hardwood high-yield - Temiscaming, QC | 315,000 |
| Hardwood high-yield - Matane, QC      | 250,000 |
| Hardwood high-yield - Chetwynd, BC    | 240,000 |
|                                       | 805,000 |

This segment shipped 542,700 tonnes of high-yield pulp in fiscal 2013 compared to 640,700 tonnes in the prior year. The Chetwynd, BC, pulp mill did not operate in fiscal 2013, reducing shipments by 175,800 tonnes. This reduction was partially offset by higher shipments from the Company's two other high-yield pulp mills. NBSK pulp shipments declined by 58,400 tonnes as a result of the sale of the Skookumchuck pulp mill in mid-May 2013.

High-yield pulp shipments include 61,600 tonnes consumed by the Company's paperboard operations, as compared to 60,100 tonnes in the prior year. The paperboard operations did not utilize any internally produced NBSK in fiscal 2013, as compared to 17,300 tonnes consumed in the prior year.

Total sales for the Paper Pulp segment were \$418 million, a decrease of \$89 million from the prior year. After eliminating internal sales, the Paper Pulp segment generated 25% of Company consolidated sales, as compared to 28% in the prior year. The Paper Pulp segment is more export oriented than the other business segments within the Company. In 2013, 86% of consolidated pulp sales were generated outside of Canada and the U.S., as compared to 87% in the prior year. China alone accounted for 44% of sales compared to 38% in the prior year.

|                           | Sales<br>(\$ millions) |      | Shipments<br>(000 tonnes) |        | Selling prices<br>(\$/tonne) |      |
|---------------------------|------------------------|------|---------------------------|--------|------------------------------|------|
|                           | 2012                   | 2013 | 2012                      | 2013   | 2012                         | 2013 |
| Hardwood high-yield pulp  | 352                    | 308  | 640.7                     | 542.7  | 549                          | 568  |
| NBSK pulp                 | 155                    | 110  | 222.5                     | 164.1  | 697                          | 670  |
| Total sales               | 507                    | 418  | 863.2                     | 706.8  |                              |      |
| Internal sales            | (42)                   | (30) | (77.4)                    | (61.6) |                              |      |
| <b>Consolidated sales</b> | 465                    | 388  | 785.8                     | 645.2  |                              |      |

## MARKETS

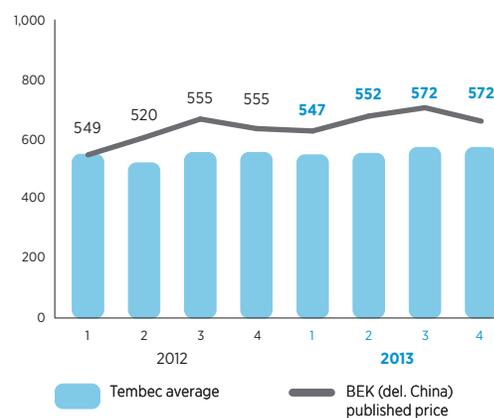
The Company markets its pulp on a world-wide basis, primarily through its own sales force. Sales offices are maintained in Toronto, Canada and Dax, France. Contractual arrangements with third party representatives are also utilized.

The shipments to capacity ratio for high-yield pulp was at 96% versus 80% in the prior year. The fiscal 2013 ratio does not include the capacity of the Chetwynd pulp mill, which has been indefinitely idled since September 2012 due to relatively weak demand and pricing for high-yield pulp. While the reference price for BEK increased by US \$53 per tonne, the increase in high-yield pricing was a more modest US \$14 per tonne. Currency was relatively unchanged as the Canadian dollar averaged US \$0.985, a 0.7% decline from US \$0.992 in the prior year. Overall, Canadian dollar prices for high-yield pulp increased by \$19 per tonne. Inventory levels ended the year at 22 days of supply as compared to 35 days at the end of fiscal 2012.

The shipments to capacity ratio for NBSK pulp was 96% in fiscal 2013, up from 82% in the prior year. In fiscal 2012, the Skookumchuck mill productivity had been adversely affected by 17 days of unplanned downtime to effect repairs on its recovery boiler. The benchmark price (delivered China) increased by US \$1 per tonne. However, discounts to reference prices increased year-over-year and NBSK price realizations declined by \$27 per tonne.

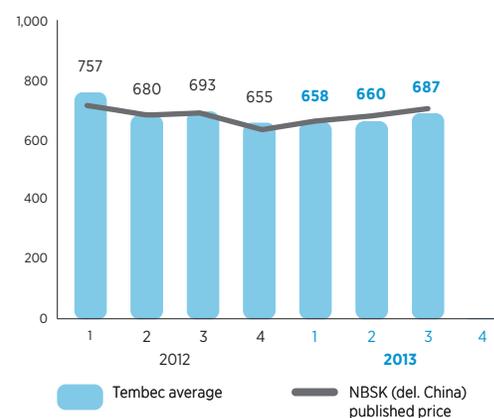
### Quarterly Prices – High-Yield

(US \$ per tonne)



### Quarterly Prices – NBSK

(US \$ per tonne)



## OPERATING RESULTS

The following summarizes adjusted EBITDA variances by major element:

| (in millions of dollars) | Variance - favourable (unfavourable) |            |                           |       |       |
|--------------------------|--------------------------------------|------------|---------------------------|-------|-------|
|                          | Price                                | Mill costs | Inventory NRV adjustments | Other | TOTAL |
| High-yield pulps         | 13                                   | (8)        | 5                         | 11    | 21    |
| NBSK pulp                | (4)                                  | 19         | 2                         | 1     | 18    |
| Other segment items      | -                                    | -          | -                         | (2)   | (2)   |
|                          | 9                                    | 11         | 7                         | 10    | 37    |

Fiscal 2013 adjusted EBITDA was \$5 million compared to negative \$32 million in the prior year. The previously noted increase in high-yield pulp selling prices increased adjusted EBITDA by \$13 million. This was partially offset by a \$4 million reduction due to weaker NBSK prices. Mill level costs at the two high-yield pulp mills increased by \$8 million, primarily due to higher chemical costs. Manufacturing costs at the NBSK mill improved significantly. In the prior year, the mill had absorbed costs related to 17 days of unplanned downtime to repair its recovery boiler. The segment also benefited from a favourable variance of \$7 million on the net realizable value (NRV) of finished goods inventories. In the prior year, low pulp selling prices in the September 2012 quarter had generated a charge of \$3 million on the estimated NRV of finished goods inventories. During the fiscal 2013, pricing gradually improved and the Company recorded a gain of \$4 million relating to NRV adjustments on the carrying value of finished goods inventories. The \$11 million favourable variance in "Other" category relates primarily to the Chetwynd high-yield pulp mill, which generated negative adjusted EBITDA of \$12 million in the prior year.

The pulp mills purchased approximately 834,500 bone dry tonnes of wood chips in fiscal 2013, down from 1,189,000 in the prior year. The decline was due to the idling of the Chetwynd high-yield pulp mill and the sale of the Skookumchuck NBSK pulp mill. Of this amount, approximately 20% was supplied by the Forest Products segment, compared to 29% in the prior year. The remaining requirements were purchased from third parties under contracts and agreements of various durations.

Overall, higher high-yield pulp prices and lower NBSK costs increased profitability with an adjusted EBITDA margin of 1.2% compared to negative 6.3% in the prior year.

The following summarizes operating results variances by major element:

| (in millions of dollars)      |       |      | Variance favourable (unfavourable) |
|-------------------------------|-------|------|------------------------------------|
|                               | 2012  | 2013 |                                    |
| Adjusted EBITDA               | (32)  | 5    | 37                                 |
| Depreciation and amortization | 23    | 14   | 9                                  |
| Other items                   | 50    | 24   | 26                                 |
| Operating loss                | (105) | (33) | 72                                 |

The Paper Pulp segment generated an operating loss of \$33 million during the most recently completed fiscal year, compared to an operating loss of \$105 million in the prior year. In addition to the previously noted improvement in adjusted EBITDA, the segment saw depreciation expense decline by \$9 million due primarily to the sale of the Skookumchuck pulp mill. The prior year operating results included a \$50 million asset impairment charge relating to the Chetwynd high-yield pulp mill. The current year included a \$22 million asset impairment charge and a subsequent \$2 million loss on sale related to the Skookumchuck pulp mill.

**PAPER**

(in millions of dollars)

|                                      | 2012  | 2013 |
|--------------------------------------|-------|------|
| Sales                                | 346   | 332  |
| Freight and other deductions         | 46    | 46   |
| Cost of sales                        | 252   | 250  |
| SG&A                                 | 11    | 11   |
| Adjusted EBITDA                      | 37    | 25   |
| Adjusted EBITDA margin on sales      | 10.7% | 7.5% |
| Depreciation and amortization        | 2     | 3    |
| Operating earnings                   | 35    | 22   |
| Identifiable assets (excluding cash) | 120   | 137  |

The Paper segment currently includes two paper manufacturing facilities with a total of three paper machines. The mill located in Kapuskasing, Ontario, produces newsprint on two machines. The facility located in Temiscaming, Quebec, produces multi-ply coated bleached board on one machine. The board mill is partially integrated with a high-yield pulp mill. The total capacity of the Paper segment is 420,000 tonnes.

The following summarizes the products and capacity of each facility:

| <b>COATED BLEACHED BOARD</b> | <b>tonnes</b> |
|------------------------------|---------------|
| Temiscaming, QC              | 180,000       |
| <b>NEWSPRINT</b>             | <b>tonnes</b> |
| Kapuskasing, ON              | 240,000       |

Coated bleached board shipments represented 44% of Paper segment shipments in fiscal 2013, unchanged from the prior year. As a percentage of total segment sales, coated bleached board represented 61% of sales compared to 59% in the prior year.

Newsprint shipments represented 56% of Paper segment shipments in fiscal 2013, unchanged from the prior year. In terms of total segment sales, newsprint represented 39% of sales compared to 41% in the prior year.

Sales for the Paper segment totalled \$332 million, as compared to \$346 million in the prior year. The segment generated 22% of Company consolidated sales, as compared to 21% in fiscal 2012. The focus of the paper business is North America, which accounted for 94% of consolidated sales in 2013, unchanged from the prior year. The U.S. alone accounted for 74% of sales in fiscal 2013, as compared to 77% in the prior year.

|  | Sales<br>(\$ millions) |      | Shipments<br>(000 tonnes) |       | Selling prices<br>(\$/tonne) |       |
|--|------------------------|------|---------------------------|-------|------------------------------|-------|
|  | 2012                   | 2013 | 2012                      | 2013  | 2012                         | 2013  |
| Coated bleached board (rolls and sheets) | 204                    | 201  | 171.2                     | 169.9 | 1,192                        | 1,183 |
| Newsprint                                | 142                    | 131  | 221.8                     | 215.9 | 640                          | 608   |
| <b>Consolidated sales</b>                | 346                    | 332  | 393.0                     | 385.8 |                              |       |

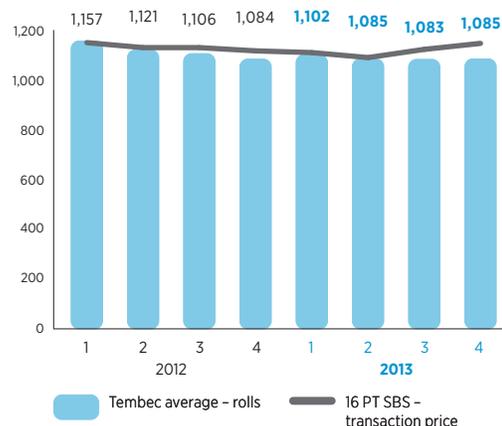
## MARKETS

The benchmark reference price for coated bleached board rolls (16 point) averaged US \$1,118 per short ton in fiscal 2013, a US \$14 per short ton decrease over the prior year. Relatively stable pricing was supported by good market demand. The shipments to capacity ratio for coated bleached board was 94% in fiscal 2013 compared to 95% in the prior year. These percentages reflect the good market fundamentals of the North American coated bleached board market over the last two years. The board mill operated at "full" capacity in both fiscal 2012 and fiscal 2013, with no market downtime taken in either year. The small decline in US \$ prices was partially offset by currency as the Canadian dollar averaged \$0.985, a 0.7% decrease from US \$0.992 in the prior year. Overall, average price realizations for rolls and sheets declined by \$9 per short ton. The inventory level at year-end was at 36 days, compared to 50 days at the end of the prior year.

The benchmark newsprint price (48.8 gram – East Coast) averaged US \$617 per tonne in fiscal 2013, a decrease of US \$23 per tonne from the prior year. The shipments to capacity ratio for newsprint was 90% as compared to 92% in the prior year. While these ratios would normally be indicative of a stable market, that was not the case for North American newsprint, as demand continued to decline. Inventory levels at year-end were at 11 days, as compared to 14 days at the end of the prior year, which is a normal level for the newsprint mill.

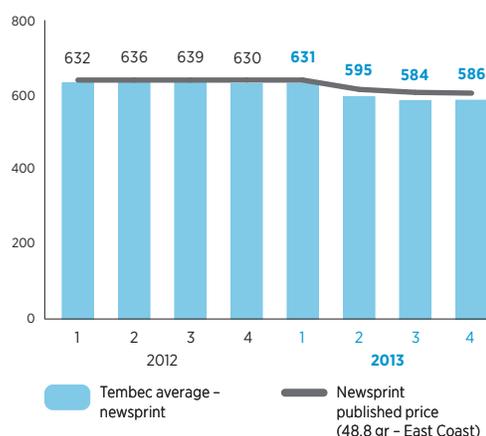
### Quarterly Prices – Coated Bleached Board

(US \$ per short ton)



### Quarterly Prices – Newsprint

(US \$ per tonne)



## OPERATING RESULTS

The following summarizes adjusted EBITDA variances by major element:

| (in millions of dollars) | Variance - favourable (unfavourable) |            |             |       |       |
|--------------------------|--------------------------------------|------------|-------------|-------|-------|
|                          | Price                                | Mill costs | Freight SGA | Other | TOTAL |
| Coated bleached board    | (2)                                  | (6)        | 1           | 1     | (6)   |
| Newsprint                | (7)                                  | 4          | (2)         | -     | (5)   |
| Other segment items      | -                                    | -          | -           | (1)   | (1)   |
|                          | (9)                                  | (2)        | (1)         | -     | (12)  |

Fiscal 2013 adjusted EBITDA was \$25 million compared to \$37 million in the prior year. Lower coated bleached board and newsprint prices reduced adjusted EBITDA by \$9 million. Manufacturing costs at the coated bleached board mill increased by \$6 million, primarily for purchased pulp, chemicals and under-absorption of fixed costs, as the mill produced 7,400 fewer tonnes. Manufacturing costs at the newsprint mill declined by \$4 million, primarily as a result of lower energy costs.

The coated bleached board mill utilizes a combination of chemical kraft and high-yield pulp to produce a three-ply sheet. During fiscal 2013, the mill utilized 61,600 tonnes of high-yield pulp supplied by the Temiscaming high-yield pulp mill versus 60,000 tonnes in fiscal 2012. In the prior year, the mill consumed 17,300 tonnes of NBSK supplied by the Company's Skookumchuck pulp mill. There were no internal NBSK shipments in fiscal 2013. The balance of pulp requirements is purchased from third parties.

The newsprint mill utilizes virgin fibre, primarily in the form of wood chips. During fiscal 2013, the operations purchased 234,400 bone dry tonnes of virgin fibre, of which approximately 81% was internally sourced. In the prior year, 238,500 bone dry tonnes of virgin fibre were purchased, with 80% being sourced internally.

Overall, the lower prices and the higher costs reduced adjusted EBITDA margins from 10.7% to 7.5%.

The following summarizes operating results variances by major element:

| (in millions of dollars)      | Variance favourable (unfavourable) |      |      |
|-------------------------------|------------------------------------|------|------|
|                               | 2012                               | 2013 |      |
| Adjusted EBITDA               | 37                                 | 25   | (12) |
| Depreciation and amortization | 2                                  | 3    | (1)  |
| Operating earnings            | 35                                 | 22   | (13) |

The Paper segment generated operating earnings of \$22 million compared to operating earnings of \$35 million in the prior year. The previously noted decline in adjusted EBITDA led to the lower operating earnings.

**CORPORATE**

(in millions of dollars)

|  | 2012 | 2013 |
|--|------|------|
| General and administrative expenses        | 21   | 21   |
| Share-based compensation                   | (1)  | 1    |
| Other items:                               |      |      |
| Custodial - idled facilities               | 10   | 7    |
| Gain on sale of BC office                  | -    | (2)  |
| Impairment of Temlam loan receivable       | 16   | -    |
| Gain on sale of minority equity investment | (4)  | -    |
| Operating expenses                         | 42   | 27   |

The Company recorded a \$1 million expense for share-based compensation in the current year as compared to a \$1 million credit in the prior year. Senior executives currently participate in a long-term incentive plan, which entitles participants to potentially receive units that are equal in value to one common share. The units have a defined vesting period and are subject to performance conditions that ultimately determine the amount of units that vest and are earned by plan participants. Non-executive members of the Board of Directors receive a portion of their fees in the form of "Deferred Share Units" (DSU). The DSUs vest at specified dates. The period credit/expense for the share-based compensation plans consists of normal periodic variation in the number of units based on anticipated or normal vesting and the changes in the value of the Company's share price.

The Corporate segment's "other items" include expenses relating to several permanently idled facilities. The costs relate to custodial, site security, legal and remediation activities. These "legacy" costs totalled \$7 million in the most recent year, as compared to \$10 million in the prior year.

In fiscal 2013, the Company generated a gain of \$2 million related to the sale of the Cranbrook, BC, office.

The prior year includes a \$16 million loss relating to the impairment of a loan receivable from Temlam Inc. The latter is currently under creditor protection and owns an idled laminated veneer lumber (LVL) facility located in Amos, Quebec. The Company has a 50% secured interest in the facility. The cutting rights that were previously attached to the LVL facility were granted to another company. In the absence of a guaranteed fibre supply, the Company concluded that the re-start of the facility was unlikely and adjusted its carrying value to the amount anticipated to be realized upon liquidation or sale. The prior year also included a gain of \$4 million relating to the sale of a minority equity interest in two dissolving pulp mills.

## NON-OPERATING ITEMS

### INTEREST, FOREIGN EXCHANGE AND OTHER

(in millions of dollars)

|                          | 2012 | 2013 |
|--------------------------|------|------|
| Interest on debt         | 38   | 42   |
| Interest income          | (1)  | -    |
| Capitalized interest     | (2)  | (9)  |
| Foreign exchange items   | 4    | (1)  |
| Employee future benefits | -    | (7)  |
| Bank charges and other   | 2    | 3    |
|                          | 41   | 28   |

The interest expense relates primarily to interest on the US \$305 million 11.25% senior secured notes maturing in December 2018. In the prior year, the amount of outstanding notes was US \$255 million for the first five months of the year. The increase in capitalized interest was caused by the Temiscaming specialty cellulose project. Foreign exchange items relate primarily to gains or losses on the translation of US \$ net monetary assets. When the Canadian dollar weakens versus the US dollar, as was the case in the most recent fiscal year, gains are generated. In the prior year, the Canadian dollar strengthened versus the US dollar and a loss was generated. The credit for employee future benefits results from the anticipated return on plan assets exceeding the amount of obligation accretion.

### TRANSLATION OF FOREIGN DEBT

During fiscal 2013, the Company recorded a loss of \$14 million on the translation of its US \$ denominated debt as the relative value of the Canadian dollar decreased from US \$1.017 to US \$0.971.

During fiscal 2012, the Company recorded a gain of \$13 million on the translation of its US \$ denominated debt as the relative value of the Canadian dollar increased from US \$0.971 to US \$1.017.

### INCOME TAXES

The following table reconciles the anticipated income tax expense/recovery based on the statutory rate to the actual income tax expense/recovery:

| (in millions of dollars)        | 2012 | 2013 |
|---------------------------------|------|------|
| Loss before income taxes        | (60) | (13) |
| Anticipated income tax recovery | (16) | (3)  |
| Increase (decrease):            |      |      |
| Difference in statutory rates   | 6    | 1    |
| Unrecognized tax asset          | 32   | 21   |
| Permanent differences           | -    | 2    |
| Income tax expense              | 22   | 21   |

During fiscal 2013, the Company recorded an income tax expense of \$21 million on a loss before income taxes of \$13 million. The income tax expense reflected a \$24 million unfavourable variance versus an anticipated income tax recovery of \$3 million based on the Company's effective tax rate of 26.3%. The difference in statutory income tax rate increased the expense by \$1 million. This included an increase of \$6 million due to the higher corporate tax rate applicable to the Company's French operations, partially offset by a decrease of \$5 million due to reduced operations in the Province of BC. The most significant item was a \$21 million increase related to non-recognition of tax assets. This included a \$24 million increase related to the losses of the Canadian operations for which no deferred tax asset was recognized. Based on past financial performance, it has not been determined that future realization of these assets is probable. This was partially offset by the recognition of \$3 million of tax assets related to the

Company's U.S. operations. Based on past financial performance, it has been determined that the future realization of this amount is probable. Permanent differences increased the expense by \$2 million.

During fiscal 2012, the Company recorded an income tax expense of \$22 million on a loss before income taxes of \$60 million. The income tax expense reflected a \$38 million unfavourable variance versus an anticipated income tax recovery of \$16 million based on the Company's effective tax rate of 26.3%. The difference in statutory income tax rates increased the expense by \$6 million. This was due primarily to the higher corporate tax rate applicable to the Company's French operations. The most significant item was a \$32 million increase related to non-recognition of tax assets of the Canadian operations.

## NET LOSS

The Company generated a net loss of \$34 million or \$0.34 per share for the year ended September 28, 2013, compared to a net loss of \$82 million or \$0.82 per share for the year ended September 29, 2012. As noted previously, the Company's financial results were impacted by certain specific items. The following table summarizes the impact of these items on the reported financial results. The Company believes it is useful supplemental information as it provides an indication of results excluding the specific items. This supplemental information

is not intended as an alternative measure for net earnings as determined by IFRS. The table below contains the gain or loss on translation of foreign debt, which is a recurring item. Because the Company has a substantial amount of US \$ denominated debt, relatively minor changes in the value of the Canadian dollar versus the US dollar can lead to large unrealized periodic gains or losses. As well, this item receives capital gain/loss tax treatment and is not tax-affected at regular business income rates.

|   | 2012        |              | 2013        |              |
|---|-------------|--------------|-------------|--------------|
|   | \$ millions | \$ per share | \$ millions | \$ per share |
| Net loss as reported - in accordance with IFRS              | (82)        | (0.82)       | (34)        | (0.34)       |
| Specific items (after-tax):                                 |             |              |             |              |
| Loss (gain) on translation of foreign debt                  | (11)        | (0.11)       | 12          | 0.12         |
| Impairment of Temlam loan receivable                        | 14          | 0.14         | -           | -            |
| Gain on sale of minority equity investment                  | (4)         | (0.04)       | -           | -            |
| Loss on sale/closure of hardwood flooring plants            | 2           | 0.02         | -           | -            |
| Gain on sale of BC sawmills                                 | (18)        | (0.18)       | -           | -            |
| Asset impairment - Chetwynd pulp mill                       | 37          | 0.37         | -           | -            |
| Asset impairment and loss on sale of Skookumchuck pulp mill | -           | -            | 17          | 0.17         |
| Gain on sale of BC office                                   | -           | -            | (1)         | (0.01)       |
| Costs for permanently idled facilities                      | 8           | 0.08         | 6           | 0.06         |
| Unrecognized deferred tax assets on above items             | 10          | 0.10         | 10          | 0.10         |
| Net earnings (loss) excluding specific items                |             |              |             |              |
| - not in accordance with IFRS                               | (44)        | (0.44)       | 10          | 0.10         |

## COMPREHENSIVE EARNINGS (LOSS)

The following table summarizes the impact of items affecting the reported total comprehensive earnings (loss) during the last two fiscal years:

| (in millions of dollars)                                       | 2012  | 2013 |
|--|-------|------|
| Net loss   | (82)  | (34) |
| Foreign currency translation gain (loss) on foreign operations | (11)  | 15   |
| Employee future benefit gain (loss)                            | (38)  | 132  |
| Recognition of tax asset                                       | -     | 2    |
| Total comprehensive earnings (loss)                            | (131) | 115  |

Comprehensive items include gains or losses related to the currency translation of the assets and liabilities of the Company's French and U.S. operations. The gains or losses are generated by the changes in the end of period exchange rates. During fiscal 2013, the currency translation of the French operations generated a gain of \$16 million, partially offset by a loss of \$1 million relating to U.S. operations. In the prior year, the currency translation of the French operations generated a loss of \$12 million, partially offset by a gain of \$1 million relating to U.S. operations.

During fiscal 2013, the Company recognized a gain of \$132 million relating to the reduction of the estimated net obligation for employee future benefits. The average discount rate applied to estimate the present value of future obligations increased from 3.7% to 4.6%, thereby reducing estimated future obligations

by \$102 million. As well, the actual return on plan assets exceeded the expected return by \$31 million. The Company also recognized a loss of \$1 million based on plan experience in fiscal 2013. Comprehensive earnings were increased by \$2 million due to recognition of a deferred tax asset generated by previously unrecognized losses of the U.S. operations. It has been determined that the realization of this amount of tax assets is probable. In the prior year, the Company recognized a loss of \$38 million relating to the increase of the estimated net obligation for employee future benefits. The average discount rate applied to estimate the present value of future obligations decreased from 4.5% to 3.7%, thereby increasing estimated future obligations by \$79 million. This was partially offset by the actual return on plan assets being \$31 million higher than the expected return. The Company also recognized a gain of \$10 million based on plan experience of fiscal 2012.

## SUBSEQUENT EVENTS

On September 30, 2013, the Company announced the BC Land Sale Initiative with the objective of realizing up to \$75 million in gross proceeds by December 2014. At the date of this report, the Company completed the sale of various parcels of land for total gross proceeds of \$23 million.

On November 6, 2013, China issued its preliminary determination to antidumping duties to be applied to viscose grade pulp imported from Canada, the United States and Brazil. The Company was assigned a duty rate of 13% on viscose shipments to China. The antidumping duties do not apply to the specialty cellulose

pulp mill located in Tartas, France. The specialty cellulose mill located in Temiscaming, Quebec, currently produces and sells approximately 40,000 tonnes per year of viscose grade pulp into the Chinese market. The balance of the mill's production is specialty grades, which are not subject to the antidumping duties. Based on the aforementioned volume and current prices for viscose grade pulp in China, the impact of the duties on the Company's financial results would be approximately \$4 million per year. In anticipation of the potential antidumping duties, the Company has been developing a plan to reduce their impact.

## QUARTERLY FINANCIAL INFORMATION

(in millions of dollars, except per share amounts)

|  | 2012    |          |         |          | 2013    |          |         |          |
|--|---------|----------|---------|----------|---------|----------|---------|----------|
|  | Dec. 11 | March 12 | June 12 | Sept. 12 | Dec. 12 | March 13 | June 13 | Sept. 13 |
| Sales  | 401     | 407      | 415     | 443      | 376     | 407      | 399     | 352      |
| Adjusted EBITDA  | 12      | 2        | 27      | 23       | 19      | 24       | 30      | 25       |
| Depreciation and amortization                                    | 12      | 10       | 11      | 13       | 11      | 9        | 9       | 11       |
| Other items  | 2       | (5)      | 2       | 51       | 1       | 23       | 4       | 1        |
| Operating earnings (loss)  | (2)     | (3)      | 14      | (41)     | 7       | (8)      | 17      | 13       |
| Net earnings (loss)  | (16)    | (14)     | (5)     | (47)     | (10)    | (26)     | (4)     | 6        |
| Basic and fully diluted net earnings (loss) in dollars per share | (0.16)  | (0.14)   | (0.05)  | (0.47)   | (0.10)  | (0.26)   | (0.04)  | 0.06     |
| Comprehensive earnings (loss)                                    | (21)    | (14)     | (10)    | (86)     | (4)     | 35       | 34      | 50       |

### FOURTH QUARTER ANALYSIS

The Company reported net earnings of \$6 million or \$0.06 per share in the fourth quarter ended September 28, 2013, compared to a net loss of \$47 million or \$0.47 per share in the same quarter of fiscal 2012. The weighted average number of common shares outstanding was 100 million, unchanged from the prior year.

Sales decreased by \$91 million from the same quarter a year ago. Currency was a positive factor as the Canadian dollar averaged US \$0.963, a 4.0% decrease from US \$1.003 in the year ago quarter. Forest Products segment sales decreased by \$3 million as a result of lower shipments. Specialty Cellulose Pulp segment sales decreased by \$10 million due to lower shipments, partially offset by higher prices. Paper Pulp segment sales declined by \$67 million due to lower shipments. Paper segment sales declined by \$15 million due to lower shipments.

Adjusted EBITDA increased by \$2 million from the prior year quarter. Forest Products segment adjusted EBITDA declined by \$7 million from the prior year quarter due to higher costs. Specialty Cellulose Pulp segment adjusted EBITDA decreased by \$3 million due to higher costs, partially offset by higher prices. Paper Pulp segment adjusted EBITDA increased by \$16 million due to lower costs and higher prices. Paper segment adjusted EBITDA decreased by \$6 million due to higher costs.

The Company generated operating earnings of \$13 million compared to an operating loss of \$41 million in the same quarter a year ago. The improvement in operating results is due primarily to a favourable variance in other items. In the prior year quarter, the Company had absorbed a charge of \$50 million relating to the impairment of the Chetwynd, BC, high-yield pulp mill.

There were no significant interest expense variances quarter-over-quarter. The interest expense relates primarily to interest on the US \$305 million 11.25% senior secured notes maturing in December 2018. The increase in capitalized interest is related to the Temiscaming, QC, specialty cellulose project. Foreign exchange items relate primarily to gains or losses on the translation of US \$ net monetary assets. When the Canadian dollar strengthens versus the US dollar, as was the case in both September quarters, losses are generated. The credit for employee future benefits results from the anticipated return on plan assets exceeding the amount of obligation accretion.

During the September 2013 quarter, the Company recorded a gain of \$7 million on the translation of its US \$ denominated debt as the relative value of the Canadian dollar increased from US \$0.951 to US \$0.971.

During the September 2012 quarter, the Company recorded a gain of \$13 million on the translation of its US \$ denominated debt as the relative value of the Canadian dollar increased from US \$0.976 to US \$1.017.

During the September 2013 quarter, the Company recorded an income tax expense of \$5 million on earnings before income taxes of \$11 million. The income tax expense reflected a \$2 million unfavourable variance versus an anticipated income tax expense of \$3 million based on the Company's effective tax rate of 26.3%. The difference in statutory income tax rates reduced the income tax expense by \$4 million. This included a decrease of \$5 million due to the reduced operations in the province of BC, partially offset by an increase of \$1 million due to the higher corporate tax rate applicable to the Company's French operations. This item was offset by a \$9 million increase related to the non-recognition of tax assets. The September 2013 quarter absorbed an \$11 million increase related to period losses of the Canadian operations for which no deferred tax asset was recognized. Based on past financial performances, it has not been determined that the future realization of these assets is probable. This was partially offset by a \$2 million decrease relating to a deferred tax asset generated by previously unrecognized losses of the U.S. operations. Based on past financial performances, it has been determined that the future realization of this amount of tax assets is probable. Permanent differences increased the expense by \$3 million.

During the September 2012 quarter, the Company recorded an income tax expense of \$5 million on a loss before income taxes of \$42 million. The income tax expense reflected a \$16 million unfavourable variance versus an anticipated income tax recovery of \$11 million based on the Company's effective tax rate of 26.3%. The higher corporate tax rate applicable to the Company's French operations increased the expense by \$2 million. The prior year quarter absorbed a \$16 million increase related to period losses of the Canadian operations for which no deferred tax asset was recognized. Permanent differences decreased the expense by \$2 million.

Comprehensive items include gains or losses related to the currency translation of the assets and liabilities of the Company's French and U.S. operations. The gains or losses are generated by the changes in the end of period exchange rates. During the September 2013 quarter, the currency translation of the French operations generated a gain of \$3 million. In the September 2012 quarter, the currency translation of the French operations generated a loss of \$2 million. The currency translation of the U.S. operations generated a gain of \$1 million.

During the September 2013 quarter, the Company recognized a gain of \$39 million relating to the reduction of the estimated net obligation for employee future benefits. The average discount rate applied to estimate the present value of future obligations increased from 4.5% to 4.6%, thereby reducing estimated future obligation by \$19 million. As well, the actual return on plan assets exceeded the expected return by \$21 million. The Company also recognized a loss of \$1 million based on plan experience of the most recent fiscal year. Comprehensive earnings were increased by \$2 million due to the recognition of a deferred tax asset generated by previously unrecognized losses of the U.S. operations. Based on past financial performance, it has been determined that the future realization of this amount of tax assets is probable. During the September 2012 quarter, the Company recognized a loss of \$38 million relating to the increase of the estimated net obligation for employee future benefits. The average discount rate applied to estimate the present value of future obligations decreased from 4.5% to 3.7%, thereby increasing estimated future obligations by \$79 million. This was partially offset by the actual return on plan assets being \$31 million higher than the expected return. The Company also recognized a gain of \$10 million based on plan experience of fiscal 2012.

The fourth quarter 2013 interim MD&A issued on November 21, 2013, provides a more extensive analysis of items having impacted the Company's fourth quarter financial results.

## SUMMARY OF QUARTERLY RESULTS

On a quarterly basis, sales and margins were negatively impacted by relatively low lumber and paper pulp prices. Currency continued to negatively impact Canadian operations as the Canadian dollar remained close to parity over the last eight quarters, averaging US \$0.987 with a quarterly average high of US \$1.009 and a low of US \$0.963.

The Forest Products segment generated adjusted EBITDA of \$1 million during the last eight quarters. This represents an average margin of 0.1% on sales of \$852 million. The U.S. lumber and housing market was relatively weak during the last two years and the Company's lumber shipments to capacity ratio averaged 78%. The U.S. market has recently improved and lumber prices have followed this trend. The Forest Products segment posted four quarters of positive adjusted EBITDA in fiscal 2013, with a margin of 4.0%. The financial performance was negatively impacted by export taxes on lumber shipped to the United States. The total amount incurred over the last two years was \$10 million. However, the impact of lumber export taxes is declining as the lumber market improves and prices increase. The \$3 million incurred in fiscal 2013 represents the lowest level since export taxes were imposed in 2006.

The Specialty Cellulose Pulp segment generated adjusted EBITDA of \$168 million during the last eight quarters. This represents an average margin of 17.4% on sales of \$967 million. The margins averaged 18.7% in fiscal 2012 when specialty cellulose pulp prices were higher. A weakening of pulp prices in fiscal 2013 resulted in weaker results and average margins declined to 15.9%.

The Paper Pulp segment generated negative adjusted EBITDA of \$27 million during the last eight quarters. This represents a negative margin of 2.9% on sales of \$925 million. The market for paper pulp has been weak over the last two years, but improved slightly in fiscal 2013. This allowed the segment to generate positive adjusted EBITDA of \$5 million in fiscal 2013.

The Paper segment generated adjusted EBITDA of \$62 million over the last eight quarters. This represents an average margin of 9.1% on sales of \$678 million. Prices for coated bleached board and newsprint have not fluctuated significantly over the last two years and segment financial results have been relatively stable.

Corporate general and administrative expenses of the Company have averaged approximately \$5 million per quarter over the last two years and there has been no significant changes in the composition of those expenses.

Overall, the Company generated adjusted EBITDA of \$162 million in the last eight quarters. This represents an average margin of approximately 5.1% on sales of \$3.2 billion.

Other items reduced the Company's operating earnings by \$79 million during the last eight quarters. While there were several offsetting favourable and unfavourable items, the most significant unfavourable items were a \$50 million asset impairment charge taken in the September 2012 quarter and an asset impairment charge of \$22 million taken in the March 2013 quarter.

The Company recorded a loss of \$1 million on the translation of its foreign-denominated debt over the last two years. However, the impact of the quarterly US debt translation gains and losses added considerable volatility to the financial results, with the impact ranging from a gain of \$13 million in the September 2012 quarter to a loss of \$11 million in the June 2013 quarter.

During the last two years, the Company has recorded an income tax expense of \$43 million. The expense relates primarily to its French operations as the Canadian operations have significant amounts of unrecognized tax assets.

## FINANCIAL POSITION AND LIQUIDITY

### FREE CASH FLOW

(in millions of dollars)

|  | 2012  | 2013  |
|--|-------|-------|
| Cash flow from operations before working capital changes | 13    | 36    |
| Less:  |       |       |
| Additions to property, plant and equipment               | 120   | 137   |
| Interest on debt   | 38    | 42    |
| Free cash flow (negative)                                | (145) | (143) |

Cash flow from operations before working capital changes in fiscal 2013 was \$36 million, compared to \$13 million in the prior year. The increase in cash flow was caused by the higher adjusted EBITDA. After allowing for capital expenditures of \$137 million and interest on debt of \$42 million, free cash flow in fiscal 2013 was negative \$143 million compared to negative \$145 million in the prior year. In fiscal 2013, non-cash working capital items

used \$13 million. The increase in working capital was caused by a \$33 million decline in trade payables and accruals. The prior year-end balance included significant payables and accruals for construction and annual maintenance shutdowns. As a result, cash flow from operations improved from negative \$72 million in fiscal 2012 to \$23 million in fiscal 2013.

### CAPITAL SPENDING

(in millions of dollars)

|  | 2012 | 2013 |
|--|------|------|
| Forest Products                          | 12   | 7    |
| Specialty Cellulose Pulp - Cogen project | 56   | 78   |
| Specialty Cellulose Pulp - other         | 30   | 32   |
| Paper Pulp                               | 13   | 10   |
| Paper                                    | 7    | 9    |
| Corporate                                | 2    | 1    |
| Net capital expenditures                 | 120  | 137  |
| As a % of consolidated sales             | 7.2% | 8.9% |
| As a % of depreciation                   | 261% | 343% |

During fiscal 2013, capital expenditures totalled \$137 million compared to \$120 million in the prior year. The Company estimates that annual capital expenditures of \$35 million to \$40 million are required to adequately maintain its facilities. The higher level of capital expenditures relates to one relatively large capital project. In March 2012, the Company announced a major capital investment to upgrade its specialty cellulose mill in Temiscaming, Quebec. The project involves the replacement of three low-pressure boilers with a single new high-pressure boiler designed to burn waste sulphite liquor generated by the specialty cellulose manufacturing process. The project also includes the installation of a new 50-megawatt electrical turbine. The total estimated cost of the project is currently \$235 million. During fiscal 2013, \$78 million was spent on the project, bringing total cumulative project expenditures to \$137 million.

The completion of the boiler portion of the project is scheduled for May 2014 and the start-up of the turbine should occur in October 2014. The Company anticipates that the Temiscaming specialty cellulose project will improve annual adjusted EBITDA by approximately \$48 million. The improvement will include approximately \$28 million of incremental electricity revenues, \$7 million of operating and maintenance cost reduction and \$13 million of productivity and margin enhancements associated with the production increase of 15,000 tonnes of specialty pulp per year.

## ACQUISITIONS, INVESTMENTS AND DIVESTITURES

On November 25, 2011, the Company sold its Toronto, Ontario, hardwood flooring plant for proceeds of \$13 million. Concurrently, the Company also announced the closure of its Huntsville, Ontario, hardwood flooring plant. The sale of the Toronto plant and the closure of the Huntsville plant resulted in a charge of \$2 million that was recorded in the Company's fiscal 2012 financial results.

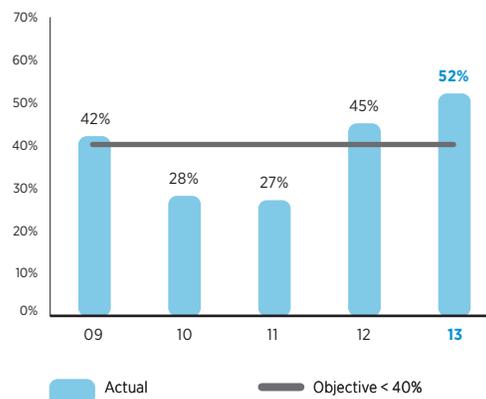
On March 23, 2012, the Company sold its British Columbia Southern Interior wood products assets for proceeds of \$66 million. The sale included the Elko and Canal Flats sawmills and approximately 1.1 million cubic meters of combined Crown tenures, private land and contract annual allowable cut. As a result of the sale, the Company recorded a gain of \$24 million in the fiscal 2012 financial results.

On May 17, 2013, the Company sold its NBSK pulp mill located in Skookumchuck, BC, for proceeds of \$97 million. As a result of the sale, the Company recorded an asset impairment charge of \$22 million and a loss on sale of \$2 million in the fiscal 2013 financial results.

## FINANCING ACTIVITIES

The Company's objective is to maintain the net debt to total capitalization ratio at 40% or less. The goal is to keep a relatively strong balance sheet and maintain the ability of the Company to access capital markets at favourable rates. The net debt to total capitalization ratio of the Company was 52% as at September 28, 2013, as compared to 45% at the end of the prior fiscal year. The increase was due to new debt to fund the previously noted Temiscaming specialty cellulose Cogen project. The Company anticipates that the net debt to total capitalization ratio will remain in excess of its target until the Temiscaming Cogen project is completed and begins to generate the projected incremental adjusted EBITDA.

### Net Debt to Total Capitalization



**LONG-TERM DEBT**

(in millions of dollars)

|  | 2012 | 2013 |
|--|------|------|
| Tembec Industries - US \$305 million 11.25% senior secured notes due December 2018 | 300  | 314  |
| Temiscaming project financing - 6.35% secured term loan                            | 20   | 20   |
| Temiscaming project financing - 5.5% secured term loan                             | -    | 40   |
| French operations  | 22   | 17   |
| Kirkland Lake Engineered Wood Products Inc.  | 8    | 9    |
| Other debt   | 2    | 2    |
| Total long-term debt   | 352  | 402  |
| Less net unamortized financing costs   | 13   | 17   |
|  | 339  | 385  |
| Current portion included in above  | 16   | 16   |

In August 2010, the Company completed a private offering of US \$255 million of 11.25% senior secured notes maturing in December 2018. In February 2012, the Company issued a further US \$50 million of senior secured notes with the same terms and conditions as the original US \$255 million notes. The notes are senior secured obligations of the Company, secured by a first priority lien on the majority of the property and assets of the Company. They are also secured by a second priority lien on accounts receivable, inventories and certain intangibles.

In March 2012, the Company entered into a \$75 million term loan facility to assist with the financing of the previously mentioned Temiscaming, Quebec, specialty cellulose project. The interest rate on the facility is 5.5%. The loan has a 15½-year term consisting of a 42-month construction or drawdown period followed by a 12-year amortization period. The term of the loan will be shortened by three years if the Company does not complete certain future capital expenditures at the Temiscaming specialty cellulose mill. The loan is secured by a second ranking charge on the project assets. The Company has also granted the lender a five-year option starting on the first loan disbursement date to acquire 3 million common shares at a price of \$7 per share. This option expires on August 30, 2017. As at the end of September 2013, the Company had drawn \$40 million of the \$75 million available. During the September 2013 quarter, the Company negotiated an additional tranche of project financing, effectively increasing the total funding from the lender to \$93 million. This new \$18 million tranche is also secured by a second charge on project assets and the interest rate

remains at 5.5%. This second tranche is repayable in 48 equal monthly instalments beginning in April 2016. In connection with the additional funding, the Company granted the lender a five-year option to acquire 712,000 common shares at a premium of 30% over the average trading price of the shares over the five business days prior to the issuance of the option. This option will be granted on the date of the first advance under the second \$18 million tranche, which cannot occur until the Company has drawn the entire \$75 million of the first tranche.

In June 2012, the Company entered into a \$30 million term loan facility to assist with the financing of the previously noted specialty cellulose project in Temiscaming, Quebec. The interest rate on this loan is the greater of 6.35% and the yield on equivalent terms Government of Canada bonds plus 4.25% at the date the funds are advanced. The loan is secured by a first ranking charge on the project assets. In July 2012, the Company received \$20 million representing the first advance under the facility. The interest rate on this advance was set at 6.35%. During the September 2013 quarter, the Company increased the size of the facility to \$40 million. As part of the loan amendment, the terms of the remaining \$10 million to be drawn on the original facility were amended to correspond to those of the new \$10 million in funding. The initial \$20 million drawn in July 2012 is repayable in blended monthly instalments over an eight-year period beginning in July 2014, with a "balloon" payment of \$12 million to be repaid in July 2022. In mid-October 2013, the Company received the remaining \$20 million on the facility.

This second tranche bears interest at a rate of 6.86% and is repayable in blended monthly instalments over a period of eight years beginning in November 2014, with a "balloon" payment of \$12 million to be repaid in October 2022.

The two previously noted facilities will be utilized to fund \$73 million of the \$98 million required to complete the Temiscaming, Quebec, specialty cellulose project. The Company intends to fund the remaining amount from available cash resources and cash flows from operations.

The debt of the French operations relates to the Company's specialty cellulose pulp mill. The decrease in debt was due to scheduled amortization payments.

Moody's Investors Service (Moody's) has assigned a B3 rating to the senior secured notes and the same level for the Company's corporate credit rating. Standard and Poor's (S&P) has assigned a CCC+ rating to the senior secured notes as well as the Company's corporate credit rating. Moody's has a "negative" outlook with respect to its rating. S&P has a "developing" outlook with respect to its rating.

The current portion of long-term debt includes \$9 million related to the Kirkland Lake Engineered Wood Products facility. This operation has been idle for several years and the loan has been subject to a "standstill" agreement between the Company and the lender. This is a non-recourse facility and while it is classified as a current item, the Company considers it highly unlikely that it will repay this facility in the next 12 months.

At the end of September 2013, the Company had total cash of \$74 million (including restricted cash) plus unused operating lines of \$35 million for total liquidity of \$109 million. At the end of September 2012, the Company had total cash of \$92 million and unused operating lines of \$48 million for total liquidity of \$140 million. The Company has set an objective of maintaining a minimum liquidity of \$135 million to \$150 million. The Company defines "operating lines" to include loans of various durations, which are secured by charges on accounts receivable and/or inventories. Operating lines are used primarily to fund short-term requirements associated with both seasonal and cyclical inventory increases which can occur in the Company's business segments. The Company would not normally draw on the operating lines to fund capital expenditures or normal average working capital requirements. The operating lines are established across several entities and jurisdictions to ensure they meet the needs of the various operating units.

The following table summarizes the unused operating lines at the end of the last two fiscal years:

| <b>OPERATING LINES</b>        |      |      |
|-------------------------------|------|------|
| (in millions of dollars)      | 2012 | 2013 |
| Borrowing base                | 187  | 168  |
| Less: availability reserve    | (23) | (20) |
| Net availability              | 164  | 148  |
| Outstanding letters of credit | (48) | (56) |
| Amount drawn                  | (68) | (57) |
| Unused amount                 | 48   | 35   |

In March 2011, the Company entered into a five-year \$200 million ABL (asset-based loan) facility expiring in March 2016. In March 2013, the Company disclosed that it had reached an agreement with existing ABL lenders to amend and extend the facility. The maturity date was extended by one year and is now set to expire in March 2017. The Company also negotiated a reduction of the aggregate revolving loan commitment from \$200 million to \$175 million and related adjustments to certain thresholds due to a reduction in the number of mills it operates. The ABL has a first priority charge over the receivables and inventories of the Company's Canadian operations. The facility is subject to a permanent availability reserve of \$15 million. This amount is increased to \$25 million if the Company's trailing 12-month adjusted EBITDA falls below \$60 million. There is also a variable reserve, which totalled \$5 million at the end of the September 2013 quarter.

The outstanding letters of credit constitute security for various operating items, principally the unfunded portion of supplementary retirement plans, future landfill closure liabilities and performance guarantees related to electricity generation agreements. The Company does not have any other significant off-balance sheet arrangements.

The French operations are supported by "receivable factoring" agreements. As such, the borrowing base fluctuates periodically, depending on shipments and cash receipts.

### COMMON SHARES

(in millions)

|                              | 2012 | 2013 |
|------------------------------|------|------|
| Shares outstanding - opening | 100  | 100  |
| Shares outstanding - ending  | 100  | 100  |

There were no shares issued in fiscal 2012 and fiscal 2013.

Prior to February 29, 2012, there were 11,093,943 outstanding warrants. The warrants were convertible into an equal amount of common shares. They would have been deemed to be exercised and automatically converted into common shares if the 20-day volume-weighted average trading price of a single common share reached or exceeded \$12.00 or immediately prior to any

transaction that would have constituted a change of control at a purchase price per common share equal to at least \$12.00. The warrants expired unexercised on February 29, 2012.

Pursuant to options granted under the prior Long-Term Incentive Plan (LTIP), an additional 95,852 shares may be issued. The weighted average exercise price of the options was \$60.09 per share with expiry dates up to 2016. As at September 28, 2013, all of the options were exercisable.

On August 30, 2012, the Company granted a lender a five-year option to acquire 3 million common shares at a price of \$7 per share. The option expires August 30, 2017. As well, the Company agreed to grant the same lender a five-year option to acquire 712,000 common shares at a premium of 30% on the average trading price of the share over five business days prior to the issuance of the option. The option will be granted on the date of a future advance.

## FINANCIAL INSTRUMENTS AND CONTRACTUAL OBLIGATIONS

### FINANCIAL ASSETS AND LIABILITIES

(in millions of dollars)

|  | September 28, 2013 |            |
|--|--------------------|------------|
|  | Carrying value     | Fair value |
| Financial assets                           |                    |            |
| Cash and cash equivalents                  | 73                 | 73         |
| Restricted cash                            | 1                  | 1          |
| Trade and other receivables                | 157                | 157        |
| Loans receivable                           | 10                 | 10         |
| Financial liabilities                      |                    |            |
| Operating bank loans                       | 57                 | 57         |
| Trade, other payables and accrued charges  | 195                | 195        |
| Interest payable                           | 10                 | 10         |
| Long-term debt (including current portion) | 385                | 428        |

The carrying values for cash and cash equivalents, restricted cash, trade and other receivables, loans receivable, operating bank loans, trade, other payables and accrued charges, and interest payable approximate their fair values due to the near-term maturity of these instruments.

The fair value of the long-term debt is \$43 million higher than its carrying value. Unamortized financing costs increased the fair value by \$17 million. The fair value was increased by a further \$26 million as the Company's US \$305 million senior secured notes were trading above par at year-end.

### FINANCIAL RISKS

#### Credit risk

Credit risk arises from the possibility that entities to which the Company sells products may experience financial difficulty and be unable to fulfill their contractual obligations. The Company does not have a significant exposure to any individual customer or counterparty. The Company reviews a new customer's credit history before extending credit and conducts regular reviews of its existing customers' credit performance. All credit limits are subject to evaluation and revision at any time based on changes in levels of creditworthiness and must be reviewed at least once per year. Sales orders cannot be processed unless a credit limit has been properly approved. The Company may require payment

guarantees, such as letters of credit, or obtain credit insurance coverage. Bad debt expense has not been significant in the past. The allowance for doubtful accounts at September 2013 was negligible, unchanged from the prior year.

#### Liquidity risk

Liquidity risk arises from the possibility that the Company will not be able to meet its financial obligations as they fall due. The Company has an objective of maintaining liquidity equal to 12 months of maintenance capital expenditures, interest and principal repayments and seasonal working capital requirements, which would require approximately \$135 million to \$150 million of liquidity. As noted previously, the Company had total cash of \$74 million plus unused operating lines of \$35 million, for total liquidity of \$109 million as at September 28, 2013.

The Company currently has sufficient available cash resources and access to additional funding to meet its commitments for at least the next 12-month period. This is based on certain assumptions regarding general economic conditions, the availability of borrowings on existing credit facilities to fund operating and capital requirements and the projected operating results of the various business segments. Access to future borrowings is dependent on meeting the terms and conditions contained in the Company's various credit facilities. An adverse perception in the capital markets of the Company's financial condition or prospects could limit future access to debt and equity markets.

The Company is currently proceeding with an ambitious capital expenditure program, including a \$235 million project at the Temiscaming specialty cellulose mill, which is increasing liquidity risk. The Company has negotiated two credit agreements that will provide up to \$133 million of project financing for the Temiscaming specialty cellulose project. These project credit facilities contain terms and conditions specific to the project, including project completion commitments. If general economic conditions were to deteriorate significantly, or if the Company was unable to meet the terms of the new project credit facilities, or if future operating performance is significantly below expectations, the Company may have to reduce or defer its capital expenditure plans.

**Foreign currency risk**

This item is discussed in detail in a subsequent section of the MD&A, "Significant Risks and Uncertainties".

**Interest rate risk**

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. This will have little impact on the Company's financial results since the majority of the Company's debts are at fixed interest rates.

**Commodity price and operational risk**

These items are discussed in detail in a subsequent section of the MD&A, "Significant Risks and Uncertainties".

**CONTRACTUAL OBLIGATIONS**

(in millions of dollars)

|                            | Total | Within 1 year | 2 - 3 years | 4 - 5 years | After 5 years |
|----------------------------|-------|---------------|-------------|-------------|---------------|
| Long-term debt             | 402   | 16            | 13          | 11          | 362           |
| Interest on long-term debt | 214   | 40            | 78          | 77          | 19            |
| Operating leases           | 9     | 4             | 4           | 1           | -             |
| Purchase obligations       | 170   | 106           | 54          | 10          | -             |
| Pension obligations:       |       |               |             |             |               |
| Current service costs      | 119   | 8             | 15          | 15          | 81            |
| Past service costs         | 172   | 37            | 65          | 33          | 37            |
|                            | 1,086 | 211           | 229         | 147         | 499           |

The table above shows the Company's contractual obligations as at September 28, 2013. The Company has long-term debt with contractual maturities and applicable interest. The operating lease obligations relate primarily to property and equipment rentals entered into in the normal course of business. Purchase obligations relate to ongoing normal commercial commitments to purchase timber, wood chips, energy, chemicals and other

operating inputs. They also include outstanding obligations relating to capital expenditures. Pension obligations have two components. The current service costs are limited to a 15-year period and are based on estimated future employee service for existing registered defined benefit plans. Past service costs include estimated solvency and going concern amortization payments.

## 2012 VS. 2011

### FINANCIAL SUMMARY

(in millions of dollars, unless otherwise noted)

|   | 2011   | 2012   |
|---|--------|--------|
| Sales   | 1,743  | 1,666  |
| Adjusted EBITDA                                   | 98     | 64     |
| Depreciation and amortization                     | 48     | 46     |
| Other items                                       | 3      | 50     |
| Operating earnings (loss)                         | 47     | (32)   |
| Net loss  | (5)    | (82)   |
| Basic and diluted net loss in dollars per share   | (0.05) | (0.82) |
| Total assets (at year-end)                        | 1,093  | 1,059  |
| Total long-term debt (at year-end) <sup>(1)</sup> | 289    | 339    |
| Total long-term liabilities (at year-end)         | 574    | 627    |

<sup>(1)</sup> Includes current portion

Sales decreased by \$77 million as compared to fiscal 2011. Currency was favourable as the Canadian dollar averaged US \$0.992, a 2.1% decrease from US \$1.013 in the prior year. Forest Products segment sales decreased by \$39 million as a result of lower shipments, partially offset by higher prices. Specialty Cellulose and Chemical Pulp segment sales decreased by \$31 million due to significantly lower shipments and prices. High-Yield Pulp segment sales decreased by \$26 million due to lower shipments and prices. Paper segment sales increased by \$7 million due to primarily to higher prices.

In fiscal 2012, adjusted EBITDA declined by \$34 million over the prior year. Forest Products segment adjusted EBITDA was up \$31 million from the prior year primarily as a result of higher prices. Specialty Cellulose and Chemical Pulp segment adjusted EBITDA declined by \$48 million due to higher costs and lower prices. High-Yield Pulp segment adjusted EBITDA declined by \$26 million due to higher costs and lower prices. Paper segment adjusted EBITDA improved by \$8 million due to higher prices and lower costs.

### OPERATING EARNINGS (LOSS)

(in millions of dollars)

|  | 2011 | 2012 | Total<br>variance | Adjusted<br>EBITDA<br>variance | Depreciation<br>variance | Other<br>items<br>variance |
|--|------|------|-------------------|--------------------------------|--------------------------|----------------------------|
| Forest Products                          | (64) | (4)  | 60                | 31                             | 4                        | 25                         |
| Specialty Cellulose<br>and Chemical Pulp | 121  | 71   | (50)              | (48)                           | (2)                      | -                          |
| High-Yield Pulp                          | (14) | (92) | (78)              | (26)                           | (2)                      | (50)                       |
| Paper                                    | 26   | 35   | 9                 | 8                              | 1                        | -                          |
| Corporate                                | (22) | (42) | (20)              | 1                              | 1                        | (22)                       |
|  | 47   | (32) | (79)              | (34)                           | 2                        | (47)                       |

The Company generated an operating loss of \$32 million in fiscal 2012 compared to operating earnings of \$47 million in the prior year.

The Forest Products segment generated an operating loss of \$4 million, as compared to an operating loss of \$64 million in fiscal 2011. In addition to the previously noted improvement in adjusted EBITDA, the sale of the BC sawmills and the hardwood flooring operations led to lower depreciation expense. During fiscal 2012, the Company recorded a gain of \$24 million related to the sale of the BC sawmills. The Company sold its Toronto, Ontario, hardwood flooring plant and concurrently closed its Huntsville, Ontario, hardwood flooring plant. The combined effect was a charge of \$2 million. In the prior year, the segment recorded a charge of \$2 million relating to the permanent closure of the Taschereau, Quebec, sawmill. The charge was for severance and other closure costs. The Company also absorbed a charge of \$1 million related to severance payments at an idled planer mill in Cranbrook, BC.

The Specialty Cellulose and Chemical Pulp segment generated operating earnings of \$71 million compared to operating earnings of \$121 million in the prior year. The previously noted decline in adjusted EBITDA led to the lower operating earnings.

The High-Yield Pulp segment generated an operating loss of \$92 million compared to an operating loss of \$14 million in the prior year. In addition to the previously noted decline in adjusted EBITDA, the segment absorbed an impairment charge of \$50 million relating to the property, plant and equipment, including supplies and materials, of the Chetwynd, BC, pulp mill.

The Paper segment generated operating earnings of \$35 million compared to operating earnings of \$26 million in the prior year. The previously noted improvement in adjusted EBITDA led to the higher operating earnings.

The Corporate segment's "other items" include expenses relating to several permanently idled facilities. The costs relate to custodial, site security, legal and remediation activities. These "legacy" costs totalled \$10 million in fiscal 2012, as compared to \$7 million in the prior year. Fiscal 2012 includes a \$16 million loss relating to the impairment of a loan receivable from Temlam Inc. The latter is currently under creditor protection and owns an idled laminated veneer lumber (LVL) facility located in Amos, Quebec. The Company has a 50% secured interest in the facility. The cutting rights that were previously attached to the LVL facility were granted to another company. In the absence of a guaranteed fibre supply, the Company concluded that the re-start of the facility is unlikely and has adjusted its carrying value to the amount anticipated to be realized upon liquidation or sale. Fiscal 2012 also includes a gain of \$4 million relating to the sale of a minority equity interest in two dissolving pulp mills. The prior year includes a gain of \$4 million related to the filing of Tembec USA LLC under Chapter 7 of the Bankruptcy Code of the United States. The gain was generated by a reduction in the Company's accrued benefit obligation. The period also included a gain of \$3 million related to the sale of hydro-electric generating assets located in Smooth Rock Falls, Ontario.

## INTEREST, FOREIGN EXCHANGE AND OTHER

(in millions of dollars)

|   | 2011 | 2012 |
|---|------|------|
| Interest on debt                        | 32   | 38   |
| Interest income                         | (1)  | (1)  |
| Capitalized interest                    | -    | (2)  |
| Fees - new working capital facility     | 2    | -    |
| Foreign exchange items                  | -    | 4    |
| Change in fair value of warrants (gain) | (5)  | -    |
| Bank charges and other                  | 3    | 2    |
|   | 31   | 41   |

The increase in the interest expense relates primarily to the issue of a US \$50 million additional tranche of 11.25% senior secured notes in February 2012. This brought the total amount outstanding of 11.25% senior secured notes to US \$305 million, which constitutes the bulk of the Company's annual interest expense. Foreign exchange items relate primarily to gains or losses on the translation of US \$ net monetary assets. When the Canadian dollar strengthens versus the US dollar, losses are generated. This was the case in fiscal 2012.

During fiscal 2012, the Company recorded a gain of \$13 million on the translation of its US \$ denominated debt as the relative value of the Canadian dollar increased from US \$0.971 to US \$1.017.

During fiscal 2011, the Company recorded a loss of \$1 million on the translation of its US \$ denominated debt as the relative value of the Canadian dollar decreased from US \$0.975 to US \$0.971.

During fiscal 2012, the Company recorded an income tax expense of \$22 million on a loss before income taxes of \$60 million. The income tax expense reflected a \$38 million unfavourable variance versus an anticipated tax recovery of \$16 million based on the Company's effective tax rate of 26.3%. Fiscal 2012

absorbed a \$32 million unfavourable variance related to period losses for which no deferred tax asset was recognized. Based on past financial performance, deferred income tax assets of the Company's Canadian operations have not been recognized as it has not been determined that future realization of these assets is probable. The expense was also increased by \$6 million due to higher statutory income tax rates in France.

During fiscal 2011, the Company recorded an income tax expense of \$20 million on earnings before income taxes of \$15 million. The income tax expense reflected a \$16 million unfavourable variance versus an anticipated tax expense of \$4 million based on the Company's effective tax rate of 27.8%. Fiscal 2011 absorbed a \$10 million unfavourable variance related to period losses for which no deferred tax asset was recognized. The expense was also increased by \$6 million due to higher statutory income tax rates in France.

The Company generated a net loss of \$82 million or \$0.82 per share for the year ended September 29, 2012, compared to a net loss of \$5 million or \$0.05 per share for the year ended September 24, 2011.

## CRITICAL ACCOUNTING ESTIMATES

### Property, plant and equipment depreciation

The Company records its property, plant and equipment, primarily production buildings and equipment, at cost. Interest costs are capitalized for projects in excess of \$1 million that have a duration in excess of one year. Investment tax credits or capital assistance received reduce the cost of the related assets. Property, plant and equipment acquired as a result of a business acquisition are recorded at their estimated fair value. Depreciation of property, plant and equipment is provided over their estimated useful lives, generally on a straight-line basis. The estimated useful lives of property, plant and equipment are based on judgement and the best currently available information. Changes in circumstances can result in the actual useful lives differing from our estimates. Revisions to the estimated useful lives of property, plant and equipment constitute a change in accounting estimate and are dealt with prospectively

by amending the amount of future depreciation expense. There were no significant revisions to the estimated useful lives of property, plant and equipment in fiscal 2013 and fiscal 2012.

### Impairment of non-financial assets

The Company must review the carrying value of non-financial assets when events or changes in circumstances indicate that the value may have been impaired and is not recoverable through future operations and cash flows. If any such indication exists, then the asset's recoverable amount is estimated. The recoverable amount of a non-financial asset is the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

For the purpose of impairment testing, assets that cannot be tested individually are grouped together into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets. An impairment loss is recognized if the carrying amount of an asset exceeds its estimated recoverable amount. Impairment losses are recognized in profit or loss. An impairment loss recognized in prior periods is assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized. To estimate future cash flows, the Company uses operating and financial assumptions, primarily those contained in its most recent multi-year operating plan. In fiscal 2012, the Company recorded \$50 million related to the impairment of the Chetwynd, BC, high-yield pulp mill. In fiscal 2013, the Company recorded \$22 million related to the impairment of the Skookumchuck, BC, NBSK pulp mill prior to its sale.

#### **Employee future benefits**

The Company contributes to several defined benefit pension plans, primarily related to employees covered by collective bargaining agreements. The Company also provides post-retirement benefits to retirees, primarily healthcare related. For post-retirement benefits, funding of disbursements is done on a "pay as you go" basis. The Company uses independent actuarial firms to quantify the amount of pension and post-retirement obligations. The Company, based on its own experience and recommendations from its actuarial firms, evaluates the underlying assumptions on an annual basis. Discount rates utilized to calculate the present value of future obligations is prescribed by IFRS accounting standards. Changes in estimates or assumptions can have a substantial impact on the amount of pension and post-retirement benefit expense, the carrying values on the balance sheet, and, in the case of defined benefit plans, the amount of plan surplus or deficit. At September 28, 2013, the fair value of defined benefit pension plan assets was \$746 million, an amount equal to 91% of the estimated accrued benefit pension obligations of \$817 million, generating a shortfall of \$71 million. The plan deficit was \$243 million at the end of the prior year. The deficit decrease of \$172 million that occurred over the 12-month period was due to several items. The deficit was decreased by \$31 million as the return on plan assets exceeded the assumed

rate of return. The deficit was further reduced by \$34 million as employer contributions of \$44 million exceeded the current service cost of \$10 million. Finally, an actuarial gain of \$98 million decreased the obligations at the end of the fiscal year. This item was caused by an increase in the applicable discount rate from 3.69% to 4.60%. The discount rate is tied to rates applicable to high-quality corporate bonds (AA or higher) in effect at the end of the fiscal year. Pension expense included in cost of sales in fiscal 2013 was \$10 million, as compared to \$9 million in the prior year. Based on current assumptions, employer contributions and pension expense in cost of sales in fiscal 2014 are expected to be approximately \$34 million and \$9 million respectively. There is no assurance that current assumptions will materialize in future periods. The defined benefit pension plans may be unable to earn the assumed rate of return. Market driven changes to discount rates and other variables may result in changes to anticipated Company contribution amounts.

With regard to other employee future benefit plans, the accrued benefit obligation at year-end was \$29 million, a decrease from \$41 million in the prior year. The obligation declined by \$9 million due to the sale of the Skookumchuck pulp mill. The previously noted increase in discount rates generated an actuarial gain, decreasing the obligation by \$4 million. Employer contributions were \$1 million in fiscal 2013 and fiscal 2012. The Company recognized an expense of \$2 million in fiscal 2013 as compared to \$3 million in the prior year. Based on current assumptions, the amount of employer contributions and the amount of expense to be recognized in fiscal 2014 are expected to be approximately \$2 million for each item.

#### **Deferred income taxes**

Deferred income tax is provided for using the asset and liability method and recognizes temporary differences between the tax values and the financial statement carrying amounts of balance sheet items as well as certain carry forward items. The Company only recognizes a deferred income tax asset to the extent that the future realization of the tax asset is probable. This is based on estimates and assumptions as to the future financial performance of the various taxable legal entities in the various tax jurisdictions. At September 28, 2013, the Company had unrecognized deferred tax assets of \$544 million, a decrease from \$561 million at the end of the prior year.

## USE OF NON-IFRS FINANCIAL MEASURES

The following summarizes non-IFRS financial measures utilized in the MD&A. As there is no generally accepted method of calculating these financial measures, they may not be comparable to similar measures reported by other companies.

**Adjusted EBITDA** refers to earnings before interest, income taxes, depreciation, amortization and other items. Since the Company excludes "other items" such as gains and losses on significant asset disposals, restructuring charges and custodial costs for permanently idled facilities, it differs from EBITDA. Adjusted EBITDA does not have any standardized meaning according to IFRS. The Company defines adjusted EBITDA as sales less cost of sales and selling, general and administrative expenses, meaning it represents operating earnings before depreciation, amortization and other items. The Company considers adjusted EBITDA to be a useful indicator of the financial performance of the Company, the business segments and the individual business units. The most comparable financial measure is operating earnings or loss. The following table is a reconciliation of operating earnings to the Company's definition of adjusted EBITDA:

| (in millions of dollars)      | 2012 | 2013 |
|-------------------------------|------|------|
| Operating earnings (loss)     | (32) | 29   |
| Depreciation and amortization | 46   | 40   |
| Other items                   | 50   | 29   |
| <b>Adjusted EBITDA</b>        | 64   | 98   |

**Free cash flow** refers to cash provided by operating activities before changes in non-cash working capital balances less interest expense and capital expenditures. Working capital changes are excluded as they are often seasonal and temporary in nature. The Company considers free cash flow to be a useful indicator of its ability to generate discretionary cash flow, thereby improving its overall liquidity position.

**Net debt** refers to debt less cash, restricted cash and cash equivalents.

**Total capitalization** refers to net debt plus deferred tax liabilities, employee future benefit liabilities, provisions, other long-term liabilities, and shareholders' equity.

**Net debt to total capitalization** is used by the Company to measure its financial leverage.

| (in millions of dollars)                          | 2012 | 2013 |
|---|------|------|
| Long-term debt                                    | 323  | 369  |
| Net unamortized financing costs                   | 13   | 17   |
| Current portion of long-term debt                 | 16   | 16   |
| Operating bank loans/<br>Bank indebtedness        | 68   | 57   |
| Less: total cash                                  | (92) | (74) |
| <b>Net debt</b>                                   | 328  | 385  |
| Long-term liabilities                             | 304  | 140  |
| Shareholders' equity                              | 102  | 220  |
| <b>Total capitalization</b>                       | 734  | 745  |
| <b>Net debt to total<br/>capitalization ratio</b> | 45%  | 52%  |

## CHANGES IN ACCOUNTING POLICIES AND ESTIMATES

During the years ended September 29, 2012 and September 28, 2013, there were no new standards that impacted the Company's consolidated financial statements.

## IMPACT OF ACCOUNTING PRONOUNCEMENTS ON FUTURE REPORTING PERIODS

### **IFRS 7 FINANCIAL INSTRUMENTS – DISCLOSURES**

---

In December 2011, the IASB amended the standard IFRS 7, *Financial Instruments – Disclosures*, to provide additional information about offsetting of financial assets and financial liabilities. IFRS 7 has been amended to require disclosures that will enable users of financial statements to evaluate the effect or potential effect of netting arrangements, including rights of set-off associated with an entity's recognized financial assets and recognized financial liabilities, on the entity's balance sheet. An entity provides information including the gross amounts subject to rights of set-off, amounts set off in accordance with the offsetting criteria, amounts of financial instruments subject to master netting arrangements or similar agreements, and the related net amounts to meet the disclosure objective.

These amendments are effective for annual periods beginning on or after January 1, 2013. The Company will adopt the new standard, which will not have an impact on the amounts recorded, in its fiscal 2014 financial statements.

### **IFRS 9 FINANCIAL INSTRUMENTS**

---

In November 2009, the IASB issued IFRS 9, *Financial Instruments* (IFRS 9), and in October 2010, the IASB published amendments to IFRS 9 (IFRS 9 R).

IFRS 9 R supersedes IFRS 9 and is effective for annual periods beginning on or after January 1, 2015, with early adoption permitted. For annual periods beginning before January 1, 2015, either IFRS 9 or IFRS 9 R may be applied. This standard provides guidance on the classification and measurement of financial liabilities and the presentation of gains and losses

on financial liabilities designated at fair value through profit and loss. When an entity elects to measure a financial liability at fair value, gains or losses due to changes in the credit risk of the instrument must be recognized in other comprehensive income. The Company has not yet begun the process of assessing the impact that the new standard will have on its financial statements and does not plan to early adopt the new requirement.

### **IFRS 13 FAIR VALUE MEASUREMENT**

---

In May 2011, the IASB issued the standard, IFRS 13, *Fair Value Measurement*. IFRS 13 is a comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. It also establishes disclosures about fair value measurement. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and in many cases does not reflect a clear measurement basis or consistent disclosures.

The new standard is effective for annual periods beginning on or after January 1, 2013, with early adoption permitted. The Company will adopt the new standard, which will not have an impact on the amounts recorded, in its fiscal 2014 financial statements.

## AMENDMENTS TO IAS 19 EMPLOYEE BENEFITS

In June 2011, the IASB published an amended version of IAS 19, *Employee Benefits*. Adoption of the amendment is required for annual periods beginning on or after January 1, 2013, with early adoption permitted. This standard was amended to:

- a) require the interest cost and expected return on plan assets, which currently reflect different rates, be replaced with a net interest amount that is calculated by applying the discount rate to the net defined benefit liability (asset). The impact of this portion of the amended standard is an increase in net finance cost as the Company's return on plan assets will effectively be at a lower rate;
- b) eliminate the option to defer the recognition of gains and losses arising in defined benefit plans;
- c) require gains and losses relating to those plans to be presented in other comprehensive income; and

d) improve the disclosure requirements concerning the characteristics of defined benefit plans and the risks arising from those plans.

The amended standard also incorporates changes to the accounting for termination benefits. The amendment will be applied retrospectively. The Company estimates that the effect on the consolidated balance sheet as at September 28, 2013, would be an increase of the net defined benefit liability of \$2 million and an increase of the deficit of \$2 million. The effect on the consolidated statement of net earnings (loss) for the year ended September 28, 2013, would be an increase of the net finance costs by approximately \$18 million and an increase of the other comprehensive earnings by the same amount. The Company is still in a process of assessing the impact that the new standard will have on the income tax expense in the statement of net earnings (loss) and in the statement of comprehensive earnings (loss). The Company will adopt the new requirements in its fiscal 2014 financial statements.

## SIGNIFICANT RISKS AND UNCERTAINTIES

### PRODUCT PRICES

The Company's financial performance is dependent on the selling prices of its products. The markets for lumber, paper pulp and paper products are cyclical and are influenced by a variety of factors. These factors include periods of excess product supply due to industry capacity additions, periods of decreased demand due to weak general economic activity, inventory de-stocking by customers, and fluctuations in currency exchange rates. During periods of low prices, the Company is subject to reduced revenues and margins, resulting in substantial declines in profitability and possibly net losses.

Based on 2014 planned sales volumes, the following table illustrates the approximate annual impact of changes to average Canadian dollar selling prices on adjusted EBITDA:

### SELLING PRICE SENSITIVITY

|   | Impact on<br>adjusted EBITDA<br>(\$ millions) | Average selling<br>prices (\$/unit)<br>Sept. 2013<br>quarter |
|---|---|--|
| Specialty cellulose pulp<br>- \$25/tonne            | 7   | 1,598  |
| Paper pulp - \$25/tonne                             | 12  | 606  |
| Coated bleached board<br>and newsprint - \$25/tonne | 10  | 887  |
| SPF lumber - \$10/mbf                               | 7   | 378  |

The Company's strategy is to develop niche products where possible; maintain low cost, high-quality flexible production facilities; establish and develop long-term relationships with its customers. In addition, the Company may periodically purchase lumber, pulp and newsprint derivative commodity contracts to mitigate the impact of price volatility. At September 28, 2013 and at September 29, 2012, the Company did not hold any significant product derivative commodity contracts.

## FOREIGN EXCHANGE

The Company's revenues for most of its products are affected by fluctuations in the relative exchange rates of the US dollar and the euro as compared to the Canadian dollar. The Company generates approximately \$900 million of US \$ denominated sales annually from its Canadian operations. As a result, any decrease in the value of the US dollar and the euro relative to the Canadian dollar reduces the amount of revenues realized on sales in local currency. In addition, since business units purchase the majority of their production inputs in local currency, fluctuations in foreign exchange can significantly affect the unit's relative cost position when compared to competing manufacturing sites in other currency jurisdictions.

Based on 2014 planned sales volumes and prices, the following table illustrates the impact of a 1% change in the value of the US dollar versus the Canadian dollar and the euro. For illustrative purposes, an increase of 1% in the value of the US dollar is assumed. A decrease would have the opposite effects of those shown below:

### FOREIGN EXCHANGE SENSITIVITY

(in millions of dollars)

|  |    |
|--|----|
| Sales increase                                   | 10 |
| Cost of sales increase                           | 3  |
| Adjusted EBITDA increase                         | 7  |
| Interest expense increase                        | -  |
| Cash flow increase                               | 7  |
| Loss on translation<br>of US \$ denominated debt | 3  |
| Pre-tax earnings increase                        | 4  |

Direct US \$ purchases of raw materials, supplies and services provide a partial offset to the impact on sales. The above does not include the potential indirect impact of currency on the cost of items purchased in Canadian dollars.

To potentially further reduce the impact of fluctuations in the value of the US dollar, the Company has a policy, which permits hedging up to 50% of its anticipated US \$ receipts for up to 36 months in duration. At September 28, 2013 and September 29, 2012, the Company did not hold any foreign exchange contracts.

## OPERATIONAL RISKS

The manufacturing activities conducted by the Company's operations are subject to a number of risks including availability and price of fibre, competitive prices for purchased energy, a productive and reliable workforce, compliance with environmental regulations, maintenance and replacement/upgrade of process equipment to manufacture competitive quality products and the requirement to operate the manufacturing facilities at high rates of utilization and efficiency to maintain a competitive cost structure.

Fibre represents the Company's major raw material in the production of wood products, pulp and paper. In Canada, virgin fibre or timber is sourced primarily by agreements with provincial governments. The agreements are granted for various terms from five to 25 years and are generally subject to regular renewals every five years. The agreements incorporate commitments with respect to sustainable forest management, silvicultural work, forest and soil renewal, as well as cooperation with other forest users. In addition, the Company has undertaken, on a voluntary basis, to have its timber harvesting certified by the Forest Stewardship Council® (FSC®). The Company expects the agreements to be extended as they come up for renewal. Aboriginal groups have claimed substantial portions of land in various provinces over which they claim aboriginal title or in which they have a traditional interest and for which they are seeking compensation from various levels of government. The Company has taken a proactive approach to enhance the economic participation of First Nations in its operations wherever feasible. The Company's operation in France sources its fibre requirements from various private sources, primarily through long-term supply arrangements.

Energy is an important component of mill costs, especially for high-yield pulp mills and newsprint mills. In 2013, purchased energy costs totalled approximately \$94 million, 50% of which was electricity. Electrical purchases are made primarily from large public utilities, at rates set by regulating bodies. In certain jurisdictions, electricity is deregulated, which can lead to greater price volatility. To mitigate the effect of price fluctuations on its financial performance, the Company employs several tactics, including the securing of longer term supply agreements, the purchase of derivative commodity contracts and operational curtailments in periods of high prices (load shedding).

At September 2013 and September 2012, the Company did not hold any derivative commodity contracts relating to purchased electricity. Fossil fuels, primarily natural gas, are purchased at market rates. The Company periodically purchases derivative commodity contracts to reduce its exposure. At September 28, 2013 and September 29, 2012, the Company did not hold any natural gas derivative commodity contracts.

Nearly all the Company's manufacturing units have a unionized workforce. Over the past 30 years, the Company has successfully negotiated new collective agreements in nearly all instances, with relatively few work stoppages. At many of the Company's facilities, as well as those of the North American industry as a whole, we have seen reductions in employment levels resulting from technological and process improvements resulting in a workforce with more years of service. This increases the relative costs of pensions and benefits. At September 2013, the Company had approximately 2,700 employees covered by collective bargaining agreements. At September 28, 2013, there were seven agreements covering 26 employees that had expired. During fiscal 2014, six collective agreements covering 875 employees will expire. The remaining contracts expire at various dates up to January 2019. The Company anticipates it will reach satisfactory agreements on contracts currently under active negotiations and those expiring in the future.

The Company's operations are subject to industry-specific environmental regulations relating to air emissions, wastewater (effluent) discharges, solid waste, landfill operations, forestry practices, and site remediation. The Company has made significant progress in reducing the environmental impact of its operations over the last 15 years. This has occurred as a result of changes in manufacturing processes, the installation of specialized equipment to treat/eliminate the materials being discharged and the implementation of standardized practices such as ISO 14001.

The production of lumber, pulp and paper is capital intensive. The Company estimates that it must invest approximately \$35 million to \$40 million per year on capital expenditures to avoid degradation of its current operations. As the majority of the funding is provided by cash flow from operations, there can be no assurance that the funds will be available to meet all of the Company's capital expenditure needs. Failure to reinvest can lead to older equipment that is less productive, less reliable and more costly to maintain and operate. The risk of technological obsolescence also increases. Capital expenditure projects can be large in scale, requiring the Company to maintain and/or acquire expertise in the design, planning and execution of major capital projects. There are inherent risks in the capital expenditure process, including the potential for project cost overruns, new equipment that does not perform to anticipated or projected levels, a lengthy start-up period and disruptions to normal operations. Due to relatively low operating cash flow generation over the last several years, the Company has limited capital expenditures. This has led to a "backlog" of capital expenditure projects in many operating facilities. The Company is currently proceeding with a \$235 million Cogen project at the Temiscaming specialty cellulose mill. As a portion of the funding for the Cogen project is to be provided by operating cash flows, there is a risk that the Company may experience delays or cost overruns in executing this project or other required capital expenditures.

Because of the relatively high fixed cost component of certain manufacturing processes, especially in pulp and paper, the operations are 24/7 with target efficiency in the 80-85% range. Failure to operate at these levels jeopardizes the continued existence of a mill. Producers are forced to operate the facilities at "full" rate even when demand is not sufficient to absorb all of the output. This can lead to oversupply and lower prices, further increasing the inherent cyclicality of the industry.

## **TRADE RESTRICTIONS / LUMBER EXPORT TAXES**

---

The Company's manufacturing operations are located primarily in Canada. However, sales into the Canadian market represented only 19% of consolidated sales in fiscal 2013. As such, the Company's financial results are highly dependent on its ability to sell its products into the "export" markets. Tariffs and trade barriers that reduce or prohibit the movement of our products across international borders constitute an ongoing risk. The agreement between Canada and the United States over softwood lumber is a case in point. On October 12, 2006, Canada and the United States entered into an agreement to govern the shipment of Canadian softwood lumber into the United States. The outcome was less than satisfactory. Through a combination of quotas and export taxes, the agreement will ensure that Canadian producers of softwood lumber will remain at a competitive disadvantage versus U.S. producers when it comes to accessing the U.S. market. China has recently imposed antidumping duties on viscose grade pulp imports. The impact of these duties on the Company's ability to access the Chinese market is still being assessed as of the date of this report.

## **FINANCIAL RISKS / DEBT SERVICE**

---

Of the total long-term debt of \$402 million, 78% relates to the US \$305 million senior secured notes maturing December 2018. The notes do not require periodic payments for principal amortization. Since the entire principal amount will become due on the maturity date, it is possible the Company will not have the required funds/liquidity to repay the principal due. The Company may require access to the public or private debt markets to issue new debt instruments to replace or partially replace the notes. There is no assurance that the Company will be able to refinance the notes on commercially acceptable terms.

In addition to the above significant risks, the Company's Annual Information Form (AIF) provides a comprehensive list of risk factors related to the Company's operations. The AIF can be found on SEDAR.

## EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

The Company's President and Chief Executive Officer and the Company's Executive Vice President, Finance and Chief Financial Officer have designed, or have caused to be designed under their supervision, disclosure controls and procedures to provide reasonable assurance that material information relating to the Company has been made known to them and that information required to be disclosed in the Company's annual filings, interim filings or other reports filed by it or submitted by it under securities legislation is recorded, processed, summarized and

reported within the time periods specified by applicable securities legislation. The Company's President and Chief Executive Officer and the Company's Executive Vice President, Finance and Chief Financial Officer have evaluated, or caused to be evaluated under their supervision, the effectiveness of the Company's disclosure controls and procedures and have determined, based on that evaluation, that such disclosure controls and procedures are effective at the financial year-end.

## INTERNAL CONTROL OVER FINANCIAL REPORTING

The Company's President and Chief Executive Officer and the Company's Executive Vice President, Finance and Chief Financial Officer have designed, or have caused to be designed under their supervision, internal control over financial reporting as defined under National Instrument 52-109 – *Certification of Disclosure in Issuer's Annual and Interim Filings*, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS. The Company's President and Chief

Executive Officer and the Company's Executive Vice President, Finance and Chief Financial Officer have evaluated, or caused to be evaluated under their supervision, the effectiveness of the Company's internal control over financial reporting and have determined, based on the criteria established in Enterprise Risk Management – Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission and on this evaluation, that such internal controls over financial reporting are effective at the financial year-end.

## CHANGES IN INTERNAL CONTROLS

During the period covered by this report, there have been no changes that have materially affected, or are reasonably likely to materially affect Tembec's internal control over financial reporting.

## OVERSIGHT ROLE OF AUDIT COMMITTEE AND BOARD OF DIRECTORS

The Audit Committee reviews the Company's annual MD&A and related financial statements with management and the external auditors, and recommends their approval to the Board. Management and the internal auditor of the Company also

present periodically to the committee a report of their assessment of the Company's internal controls and procedures for financial reporting.

## ADDITIONAL INFORMATION

Additional information relating to Tembec, including the Annual Information Form, can be found on SEDAR at [sedar.com](http://sedar.com) and on the Company's website at [tembec.com](http://tembec.com).

# MANAGEMENT RESPONSIBILITY

The consolidated financial statements and all information in the Financial Report are the responsibility of the Company's management. The consolidated financial statements have been prepared by management in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) and, where necessary, include amounts, which are based on best estimates and judgement. Financial information presented throughout the Financial Report is consistent with the data presented in the consolidated financial statements.

A system of internal accounting and administrative controls is maintained by management in order to provide reasonable assurance that transactions are appropriately authorized, assets are safeguarded and financial records are properly maintained to provide accurate and reliable financial statements.

The Company's external auditors are responsible for auditing the consolidated financial statements and giving an opinion thereon. In addition, the Company employs internal auditors to evaluate the effectiveness of its systems, policies and procedures.

The Board of Directors has appointed an Audit Committee, consisting solely of independent directors, which reviews the consolidated financial statements and recommends their approval to the Board of Directors. The Committee meets periodically with the external auditors, the internal auditors and management to review their respective activities and the discharge of each of their responsibilities. Both the external and internal auditors have direct access to the Committee to discuss the scope of their audit work and the adequacy of internal control systems and financial reporting procedures.

The accompanying consolidated financial statements have been audited by the external auditors, KPMG LLP, whose report follows.



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



**MICHEL J. DUMAS**  
Executive Vice President, Finance and Chief Financial Officer

November 29, 2013