MESSAGE TO SHAREHOLDERS

Fiscal 2013 was an important year for the Company as it made significant strides in the implementation of the Transformation Plan. This included the divestment of certain non-core businesses and reaching the 50% completion mark on the Temiscaming Energy Project investment. The completion of the Transformation Plan will drive further margin improvements and reduce the volatility of the Company's earnings.

Tembec continued its journey towards becoming a world-class Company in health and safety performance by reducing recordable incidents by 16% in 2013. This follows reductions of 32% in 2012 and 25% in 2011 and now marks eight consecutive years of improvement in the Company's health and safety performance. The commitment and contribution of the Company's employees have been critical elements in the sustained improvement.

The financial results were below expectations, but improved materially over the previous year. Adjusted EBITDA for 2013 was $98 million versus $64 million in the previous year. The Company's Specialty Cellulose business continued to be the main driver of earnings, although market conditions weakened somewhat throughout the year. The Paper business generated steady earnings with stable market conditions. The Forest Products business continued a positive trend that started in late 2012 with prices in a range to allow for positive adjusted EBITDA. The Paper Pulp business contributed modest earnings in a fairly stable market.

The Company continued to manage its cash flow judiciously while continuing with its investment in the $235 million energy project at the Temiscaming specialty cellulose facility. Additional projects identified in the Business Improvement Plan have been deferred until cash flow permits, which will likely occur after the start-up of the Temiscaming Project.

INVESTMENTS

The construction of the new liquor recovery boiler and 50-megawatt (MW) steam turbine that began in 2012 is now more than 50% complete. The project will replace three obsolete, low-pressure boilers with a new high-pressure boiler. In addition to the electricity revenue, the project will provide efficiency benefits to the specialty cellulose mill and reduce maintenance and capital costs.

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

The construction budget for the Temiscaming Project was revised from $190 million to $235 million in 2013. The higher cost was due to the decision to increase the capacity of the boiler by 20% over the initial design. This was done to accommodate a future capacity expansion of the specialty cellulose mill. The projected benefit was also increased from $42 million to $48 million per year.

While capital expenditures were limited throughout the year, the Company did complete a low consistency refiner project at the Kapuskasing newsprint mill to reduce electricity consumption. The project was partially funded by Ontario's "Industrial Accelerator Program". The Company also began installing the first of four new autograders at sawmill sites.

Defined Benefit Pension Plans

The Company administers several defined benefit pension plans on behalf of current and past employees. As highlighted in last year's report, the rapid and significant declines in interest rates over the last several years created significant deficits in the plans, requiring large increases in the Company's contributions. Throughout this period, investments in the plans continued to generate very good returns.

Fortunately, the negative trend for the pension plan deficits and ensuing contributions has ended, and positive conditions are now converging to rectify the situation. Long-term interest rates have increased, which has reduced the deficits. This, combined with another year of good investment performance and the high level of contributions made by the Company, has significantly reduced the deficits of the various registered plans. The deficit decreased from $200 million in September 2012 to $34 million at the end of fiscal 2013.

The declining deficit will allow the Company to significantly reduce contributions in 2014 and the trend should continue in subsequent years.

Forest Products

The lumber business showed signs of recovery in 2012 with increased demand and improved prices. Economic conditions and housing affordability in the United States have created an improved environment for new home construction. Strong demand for lumber in China continued throughout the year, drawing a large volume of product from the North American markets. These items helped to keep the lumber markets in relative balance, which led to improved product prices.

U.S. housing starts did improve materially from 2012 to 2013. However, the housing starts remain substantially below normalized levels. In 2013, the housing starts trended towards 1 million per year, but this is below a trend line number of approximately 1.5 million per year. This indicates that there is a strong probability for further increases in lumber demand as the economic recovery continues. The Company anticipates that a full housing recovery will not occur until 2016.

Chinese lumber demand from North America has been a significant boost for producers and has partially mitigated the low demand for new home construction. However, the Chinese demand has been mainly for random lengths and has not had much effect on stud lumber. For this reason, the selling price of stud lumber dropped significantly below random length prices in the second half of 2013. This has had an impact on the financial results for Eastern Canadian producers, such as ourselves, who produce large volumes of stud lumber. It is believed that part of this price gap is seasonal and will decline during the peak home construction season.

Specialty Cellulose

The Company has made the Specialty Cellulose business the center piece of its Transformation Plan. This business has the potential to generate superior margins with considerably lower volatility than other segments of the forest products industry. Favorable long-term trends exist for the products and there are large barriers of entry for new entrants. For these reasons, the Company has decided to focus its capital investments in the two specialty cellulose mills.

The initial focus of investment in the specialty mills was on the Tartas, France, operation. Over the last decade, the mill was converted from fluff pulp grades to 100% specialty cellulose grades. This required substantial investments in process changes, environmental improvements and most recently, green energy. The investments and transformation have made the Tartas mill a world-class facility in both product quality and cost structure among mills in this sector.

The Company has now turned its focus to the Temiscaming specialty cellulose facility with the objective of duplicating the results at Tartas. This mill has been a producer of specialty cellulose for decades and provided the product technology to convert the French facility. However, certain sections of the mill are in need of upgrades. The first in a two-step investment plan is the aforementioned energy investment, which will not only significantly reduce manufacturing costs, but will improve process reliability and product quality. The second investment will involve new digesters and related equipment.

After several good years of demand growth and price increases, certain specialty cellulose markets experienced softness in demand in 2013. This was most prevalent in the “ether” grades for construction related materials. Other specialty grades remained relatively stable. Markets have been impacted by poor economic conditions in Europe and generally lackluster global economic growth. These conditions are likely to continue for the next 12-24 months. The Specialty Cellulose business is expected to drive the Company’s profitability through this period.

Paper Pulp

The Company sold its Skookumchuck NBSK mill in 2013, further reducing its exposure to the paper pulp sector. It now operates two high-yield pulp mills in Quebec. This is part of the ongoing refocusing of the Company driven by the Transformation Plan. The lower margins and higher volatility of this sector do not meet the objective of generating higher margins with reduced volatility.

The markets for hardwood paper pulp could be challenging in the short and medium-term due to the anticipated start-up of over 4 million tonnes of new capacity in Brazil. There is a risk of excess supply of pulp and downward pressure on price. The Company has been preparing for this eventuality by focusing on a product differentiation strategy with its maple pulp and on cost reduction efforts in the pulp mill operations.

Paper

The coated bleached board and newsprint operations have been consistent generators of profitability for the Company. The coated bleached board business has been stable with relatively firm pricing. The newsprint business continues to experience demand decline in North America and prices have declined over the last year. Future capacity reduction will be required in order to maintain adequate prices.

TRANSFORMATION PLAN

The Company’s Management and Board of Directors continue with its ambitious multi-year Transformation Plan, with the objective of improving margins, reducing earnings volatility and ultimately driving shareholder value. This has taken place during a period of challenging business conditions that presented some unexpected issues as highlighted in this report.

The Transformation Plan targets the Specialty Cellulose business as the key core business of the Company, and focuses investment on green energy projects within these operations. The Plan also contemplates strategic options for the other businesses to maximize the value to shareholders. The divestment of certain assets has occurred as a result of this Plan.

LIGHT AT THE END OF THE TUNNEL

Managing cash flow and generating profitability has been challenging during the implementation of the Transformation Plan. However, the Company believes that significant improvements will occur throughout 2014 to enhance financial performance and cash flow. The Temiscaming Energy Project will be concluded within the year, drastically reducing capital expenditures, and the operating cash flow will improve with the start-up of the boiler and turbine by the Fall of 2014. The sale of approximately $75 million of land in British Columbia is anticipated in 2014. The Company’s contributions to the defined benefit pension plans will drop in 2014 and continue to rapidly taper down thereafter. All these events are expected to converge and favorably impact the cash flow, profitability, and balance sheet of the Company. Other parts of the Transformation Plan will also be executed as conditions allow. It is expected that shareholders will be rewarded for their patience as the Company works toward completion of the Transformation Plan.

JAMES M. LOPEZ
President and Chief Executive Officer

JAMES V. CONTINENZA
Executive Chairman of the Board