

# Message to Shareholders

As anticipated, 2014 was a transitional year for the Company. The most important strategic activity was the Temiscaming Energy Project, which was completed in the quarter following the fiscal year-end and began commissioning and start-up. This will contribute to improvements in profitability and cash flow in fiscal 2015.

The transformation of the Company's health and safety culture continued in 2014. The Company completed its ninth consecutive year of continuous improvement in health and safety performance. The objective remains unchanged: Tembec strives to become a world-class company in providing its employees with the safest work environment possible.

The financial results for the year were essentially unchanged from fiscal 2013. Adjusted EBITDA for 2014 was \$90 million versus \$97 million in the prior year. The Company finished the year with two relatively strong quarters. Unfortunately, this was not enough to offset the challenges experienced in the first half of the year. In the first quarter, the Company completed a significant upgrade of the bleaching process of the Tartas facility, which is the most profitable of all the Company's mills. The start-up of the mill after the upgrade was much more difficult than anticipated as several technical problems were encountered. The issues were fully resolved in the first quarter; however, there was a very negative impact on the results. Additionally, extreme weather conditions in North America had a very negative impact on energy costs and productivity at several operations in the second quarter, severely impacting the results in the period.

## Tembec Energy Project

The investment in the Temiscaming Energy Project will significantly improve the competitiveness of the Temiscaming Specialty Cellulose facility. Key to the investment is a 25-year power purchase agreement with Hydro-Québec. The agreement provides the Company the right to sell all output to the utility for a guaranteed rate. It also provides the Company with the opportunity to produce and sell additional electricity in the future.

The estimated final construction cost of \$265 million is higher than anticipated due mainly to construction labour productivity. Low productivity increased direct labour costs and caused delays in project completion, which increased indirect project costs. Commissioning of the boiler and related equipment began in October and continues at the time of writing this report.

## Forest Products

In 2014, U.S. housing starts, a key driver for North American lumber demand, continued the slow recovery from the low point in 2009. Housing construction has lagged the broader economic recovery in the United States and is still well below normalized levels. While economists point toward several reasons, the primary driver appears to be tighter lending standards, which is supported by the poor first-time home buyer data. Housing fundamentals are expected to improve gradually, providing conditions for a continued slow and steady increase in U.S. housing starts.

Poor weather at the start of calendar 2014 severely affected housing starts in much of North America. While this affected the demand for most lumber products, it had a particularly negative effect on stud lumber, which is more sensitive to new home construction than random lengths lumber. This led to an unusually large price gap between these products. The financial results of the Company's lumber business were poor early in the year due to the relatively heavy weighting of stud lumber in the Company's sales mix.

## Specialty Cellulose

The Specialty Cellulose business remains the cornerstone of the Company's long-term strategy. This highly technical business provides good long-term growth prospects in highly diversified end-use applications that are sensitive to global GDP growth. In the short term, significant capacity additions of specialty cellulose have created a more competitive environment, which led to lower prices in 2014.

The current oversupply situation is likely to continue for the next 12 to 24 months. While most of the excess production is in the acetate grades, it has also impacted the other specialty grades, as some producers with the capability have attempted to redirect volume into these other markets.

The Company is the largest producer of ethers grade specialty cellulose, which is the second largest segment after acetate. Despite fierce competition, the Company has successfully defended its market share. The commercial and technical success with the Company's ethers customers has provided a solid foundation to develop and maintain long-term relationships.

The Company has also successfully defended its market share with a number of its strategic customers in the acetate, MCC and nitrocellulose markets due to strong, long-term relationships. However, these markets have become much more price competitive than in past years, which has forced the Company to be aggressive in defending its market share.

The Company has made significant investments in its two specialty cellulose facilities. The objective is to generate superior margins in the long term and to establish an extremely competitive cost structure. The aforementioned energy project in Temiscaming is a critical element of this strategy, and the business is in a good position to deal with the current competitive situation.

## Paper Pulp

The global paper pulp business continues to experience increases in demand for fiber. The long-term projection for demand for paper pulp products continues to be good with the main growth coming from the developing economies. In the short term, significant additional hardwood pulp capacity has been built in South America, which has led to an imbalanced market, driving down the price of hardwood paper pulps. Toward the end of fiscal 2014, markets became relatively balanced, which stabilized prices. It is expected that hardwood paper pulp producers will increase prices in early 2015.

The Company's paper pulp capacity consists of two high-yield hardwood pulp mills. Prices for hardwood high-yield pulp products normally follow the price for bleached eucalyptus kraft pulp. The current market situation has the Company's Paper Pulp business operating at marginal profitability. It is anticipated that this will continue into 2015.

## Paper

The Company's Paper business consists of a coated bleached board mill and a newsprint mill. The bleached board mill is one of the most modern in North America, producing high-quality packaging and board for a variety of applications. The newsprint mill produces standard newsprint and bulky paper for certain paperback book applications.

The North American coated bleached board business is well balanced, allowing for a stable and profitable pricing environment. The business continued to be an important contributor to profitability in fiscal 2014, and this is expected to continue in 2015.

The North American newsprint demand continued to decline, forcing producers to be more dependent on offshore sales to maintain a full order book. While the prices in North America remained stable, export markets have been much more competitive, causing prices to decline. The Company anticipates the current market trends to continue.

## Conclusion

The fiscal 2013 message to shareholders was entitled “Light at the end of the Tunnel”, anticipating significant changes to the Company’s cash flow by the end of fiscal 2014. It anticipated a significant reduction in excess contributions to fund pension plans. It also anticipated the completion of the capital spending on the Temiscaming Energy Project and new revenues from the start-up of the turbine. These elements are all coming together as anticipated, even though the energy project will be completed two to three months later than previously projected. The Company does anticipate a significant improvement in cash flow in 2015.

November 24, 2014



**JAMES M. LOPEZ**

President and Chief Executive Officer



**JAMES V. CONTINENZA**

Executive Chairman of the Board