

# Message to **Shareholders**

Fiscal 2016 was a very good year with significant improvements in a number of areas resulting in the doubling of the Company's adjusted EBITDA from fiscal 2015. This large increase came almost entirely from improved operating performance as changes in product pricing and currency had very little impact. Free cash flow from improved results and lower capital spending allowed the Company to focus on reducing debt.

Excellent progress continues toward becoming a world-class health and safety organization. The Occupational Safety and Health Administration (OSHA) Incident Rate (OIR) dropped by 12% year-over-year to an all-time low of 2.2 in 2016. The focus remains on training, employee ownership, accountability and eliminating risks of all types. The Company will not be satisfied until incidents, no matter how minor, are eliminated.

The increase in adjusted EBITDA can be attributed to improvement in all the business units except Paper Pulp, which experienced a slight decline. The Specialty Cellulose and Paper segments contributed an additional \$48 million and \$34 million of adjusted EBITDA respectively. Overall, the \$148 million of adjusted EBITDA generated in fiscal 2016 exceeded the Company's expectations and positions the Company well going into fiscal 2017.

The Temiscaming energy project became fully optimized in fiscal 2016 and is now generating the anticipated benefits. This \$273 million investment, which includes a new recovery boiler and turbine with a capacity of 60 megawatts, was a large contributor to the major improvement in the earnings of the Temiscaming speciality cellulose operation. The Company targeted energy cost reduction, mill productivity improvements and operating cost reductions with this project. These objectives have been achieved and the operating team is now developing opportunities to further increase electricity production and capitalize on the flexibility built into the 25-year purchase power agreement. This has been a very successful project and the Temiscaming mill is now a world-class speciality cellulose operation.

The low interest rate environment over the last half decade created significant funding shortfalls in defined benefit pension plans, including Tembec's. This required the Company to make significant excess pension plan contributions to comply with Provincial regulations. The Company's Canadian defined benefit plans are now nearly fully funded according to these regulations and are overfunded on a going-concern basis. Future excess funding requirements of these plans are not expected to materially impact the Company's cash flow.

The Company has invested heavily in capital expenditures over the past several years, mainly in the Temiscaming energy project. Expenditures are now down to normalized levels and are expected to remain there for the next several years. Future investments will be in smaller discrete projects to upgrade the Company's manufacturing facilities and reduce costs. Due to the focus on the Temiscaming energy project, the Company has a backlog of very high return and low risk projects.

The large energy investment in Temiscaming and significant pension funding requirements led to increased leverage on the balance sheet. The Company is now generating free cash flow and will focus on debt reduction as a priority. Good progress was made in fiscal 2016.

## Forest Products

The Company's expectation for the lumber markets in fiscal 2016 included a slow but steady improvement in U.S. housing starts. This trend began several years ago and continued as expected. Lumber markets have been relatively balanced with normal seasonal demand volatility impacting prices. Barring any extraordinary events, such as a potential trade dispute with the United States, good product prices and improved profitability are expected for this segment.

The Company has focused its capital investments in other areas in recent years, and it is now turning its attention to a Business Improvement Plan for the lumber business. A three-year capital investment plan that will be implemented will improve the competitiveness of the sawmills. The plan includes high return / low risk projects.

## Specialty Cellulose

The Specialty Cellulose segment has been the focus of most of the Company's capital expenditures including the Temiscaming energy project, and the Company's two manufacturing sites are now highly competitive operations on a global scale due to these investments. Electrical energy production on both sites, along with upgraded manufacturing capabilities, will ensure the Company maintains its leadership position in the production of specialty cellulose.

The Company has been focused on increasing the volumes of specialty grades from its two manufacturing facilities. The Company has developed higher purity and higher viscosity products to meet evolving opportunities in the market place and to grow market share.

Changes in the competitive landscape over the last several years and stagnant demand for specialty cellulose products created a negative pricing environment. The situation began to reverse in fiscal 2016 and product pricing hit bottom for most of the Company's products. Rebalanced markets and improved demand for specialty cellulose has allowed producers to increase prices for most specialty cellulose grades going into calendar 2017. This change and the Company's improved cost structure should lead to strong financial results in the new year and beyond.

## Paper Pulp

The Company operates two high-yield pulp mills in the province of Quebec, which produce hardwood pulps that compete directly with kraft hardwood pulp. Excellent progress was made in fiscal 2016 in improving the productivity of these two facilities and lowering costs. Challenging market conditions at the beginning of the fiscal year caused the Company to take downtime at the Temiscaming facility. However, conditions improved in the second quarter and that allowed the Company to operate both mills fully for the balance of the year and implement small price increases.

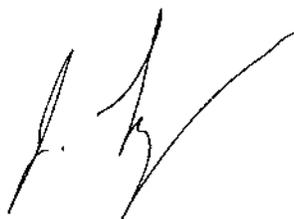
Despite growth in demand for high-yield pulp and more broadly, hardwood pulp, the markets remain challenging due to ongoing capacity additions, primarily in the southern hemisphere. This new capacity is likely to suppress prices for paper pulp and lead to relatively low levels of profitability in fiscal 2017.

## Paper

The Paper segment had an outstanding fiscal 2016, led by the coated bleached board business. The group benefited from stable and profitable prices for coated bleached board, as well as several price increases in the newsprint business.

The coated bleached board mill operated very well in the fiscal year due to some equipment upgrades and improved steam supply from the new Temiscaming energy plant. This business successfully developed new products to allow a shift of part of the sales mix into more profitable sectors and avoided competing directly against overseas imports. Continued strong operating performance and the improved grade mix should generate similar levels of profitability in fiscal 2017.

The newsprint business remained profitable in fiscal 2016 despite the ongoing challenges in this sector. Capacity closures and mill conversions removed enough newsprint supply to tighten market conditions and allow for several price increases. These increases and the mill's relatively low cost position should allow this business to be profitable for the foreseeable future.



**JAMES M. LOPEZ**

President and Chief Executive Officer

## General

The Company is very pleased with the earnings turnaround in fiscal 2016. The significant improvement in cost and productivity at the Company's facilities has left it well positioned to generate superior results in fiscal 2017 and beyond. Cash flow from operations will continue to be utilized to pay down debt and improve manufacturing facilities. Additional operating improvements and strong market tailwinds in the specialty cellulose business should provide the opportunity to drive shareholder value.



**JAMES V. CONTINENZA**

Executive Chairman of the Board